OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

March 2012

China's capital account revolution

Crucial move for world economy – and Beijing

Songzuo Xiang, Deputy Chairman, Advisory Board

China's landmark report on capital account convertibility, setting a road map to liberalise international capital flows and open up its financial services industry, may turn out to be a major step forward in the process of globalisation. Crucially, China sees great benefits for its own economy and its citizens by allowing freer capital interactions with the rest of the world.

Although there are still doubts about the speed and resolve with which the plan may be implemented, the significance of the 24 February report from the People's Bank of China (PBOC) should not be lost. When the world's No.2 economy, No.1 exporter, No.2 importer, No.2 destination for foreign direct investment, and No.1 reserve asset holder, and thus the world's biggest creditor, decides to move, this is a matter of ground-breaking importance.

The momentum of China's internationalisation efforts has been underscored by preparations by China Development Bank to make renminbi loans available to Brazil, India, Russia and South Africa, under plans to boost transactions in non-dollar currencies among the five nations of the so-called BRICS nations.

China is preparing to take action on the capital account, in a multi-stage process over the next few years, with far-reaching implications for international financial markets, for widening use of non-dollar currencies and for the evolution of the global monetary order. The document was released just days before a seminal report from the World Bank, issued with what seems to be the support of the new leadership expected to take over later this year.

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Basel committee in worldwide accounting shake-up on reporting standards

The Basel Committee on Banking Supervision is close to reversing accounting orthodoxy on reporting standards, in a move likely to stir antagonism and acrimony in worldwide financial reporting circles, *writes Michael Lafferty, Co-chairman*. Bank supervisors appear to have persuaded the International Accounting Standards Board (IASB) to make a total about-turn on bad debt accounting and require banks, indeed all businesses, to make provision for 'expected' rather than 'incurred' losses at the balance sheet date from January 2015.

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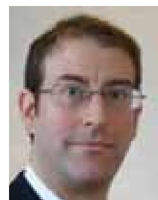

Festering sores

Corollary of collateral

Michael Kaimakliotis, Quantum Global

So far, 2012 is shaping up as a vintage year for investors in Europe. So far. Under the surface are festering sores. Of extreme importance is the increasing subordination of investors in financial sector bonds. The key is the seminal change to the lifeblood of the financial system: collateral.

A prime concern is the greatly-increased amount of bank assets accepted as collateral in the much-extended lending operations in the Eurosystem, both by the European Central Bank itself and under the enlarged Emergency Liquidity Assistance (ELA) of national central banks (NCBs). Added emphasis comes from Bundesbank president Jens Weidmann's concerns about the effective degrading of ECB collateral, in a highly significant letter leaked to the German press on 29 February.

For the time being, there's much to be pleased about. Sovereign bond markets have rallied, in core and peripheral countries. Equity returns are well into double digits.

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Europe diversifies

Companies use time to shift trade

David Marsh, Co-chairman

In the two years of attempts at crisis management in Europe, politicians have frequently spoken, slightly fatuously, about 'saving time'. Enterprises around Europe have been less inclined than governments to waste it, by diversifying their businesses outside Europe. Our coverage this month demonstrates shifting trade ties outside core Europe by Germany and Poland, in contributions from Pawel Kowalewski and Zuzanna Gremiec and the DZ Bank economics team.

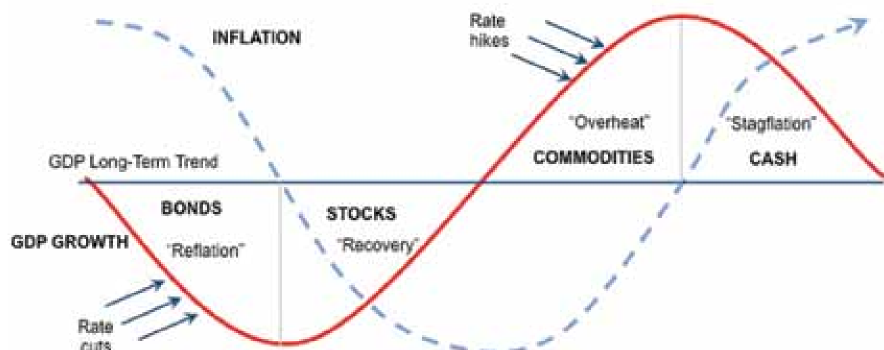
The Bulletin has a strong Germanic flavour, befitting the holding of our second main meeting at the Bundesbank in Frankfurt on 14-15 March. Stewart Fleming hails the upgrading of German growth prospects since the start of the year. Gerhard Schröder, the former German Chancellor, sets down his vision for a more integrated Europe, Paul Betts writes on the alliance between Angela Merkel and Nicolas Sarkozy in the French elections, while John Kornblum compares Merkel with Barack Obama. Stefan Bielmeier and Michael Kaimakliotis focus on clouds on the international growth outlook, and Christopher Tugendhat asks whether Germany can afford to put the European Union's achievements at risk.

Displaying the diversity of opinions in the OMFIF Bulletin, based an analysis of the monetary numbers and other data, Steve Hanke warns that the US faces recession and Europe is heading towards a 'deflationary slump'. Taking an opposing view, Trevor Greetham sees positive news for investors; his chart on how investors should interpret the economic cycle is reproduced below. Again on a more optimistic note, Laurens Jan Brinkhorst spots a new spirit of Europeanism, while Klaas Knot, president of the Nederlandsche Bank, underlines how positive steps are now being taken to putting the 'e' into economic and monetary union.

Further afield, in our main story, Songzuo Xiang and John Adams dissect the latest document from the People's Bank of China on capital account liberalisation. Michael Lafferty reveals how the Basel committee is close to sweeping changes to bank accounting standards. Darrell Delamaide says debate is finely poised on possible Federal Reserve introduction of QE3. Junko Nishioda spells out the burdens on the Bank of Japan, while Hon Cheung reviews progress on Asian bond markets. William Keegan offers his bitter-sweet commentary on goings-on at the ECB. OMFIF seeks to bridge the capital markets of Asia, the US and Europe. In this issue, 14 members of our advisory board combine forces to fulfil that task.

David Marsh

The economic cycle and what it means for investors



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French poll may decide euro fate

Hollande tries to stay cool against terrier Sarkozy

Paul Betts, Advisory Board

France's presidential election campaign, which will have a significant impact on the fate of the new fiscal pact intended to shore up the euro, is rapidly tuning in to a two-horse race. With six weeks to go before the first round of voting, the opinion polls have shown the outsiders losing ground to the two front-runners. Socialist candidate François Hollande is still well in the lead against President Nicolas Sarkozy, whose terrier-like campaigning style has helped him catch up some ground against his rival.

Hollande, who is playing a safety-first game against his mercurial opponent, has said he would renegotiate the treaty signed by 25 member governments of the European Union, although exactly what he would change is unclear. Sarkozy earlier indicated he would stage a referendum on the treaty, part of a promise to bring in more plebiscites on key issues, but withdrew the offer on 27 February on the grounds that the treaty was too complex – perhaps indicating pressure on this sensitive point from Chancellor Angela Merkel.

Sarkozy has secured Merkel's support and the chancellor decided not to meet Hollande during the campaign, rebuffing the German foreign ministry in the process. UK prime minister David Cameron too seems to have found an excuse not to see Hollande, presumably in a bid to maintain the current entente cordiale after the recent chill between the two countries. President Obama also indicated he was not keen to meet Hollande at this stage.

Sarkozy would clearly like nothing better than to force Hollande into a bar room brawl. Hollande has so far resisted and sought to adopt the high moral ground. France, he argues, needs a reassuring presence at the helm and he sees himself filling this avuncular role – a part he played to sleep-inducing perfection when he gave an hour-long speech mainly on education in London on 29 February. These principles have not stopped Sarkozy's own team from engaging in some pretty aggressive tactics, with one of his spokesmen describing the incumbent as a melange of Silvio Berlusconi and Vladimir Putin.

Opinion polls give Hollande a lead of between one to six points in the first round on 22 April and suggest a bigger margin of victory in the second round on 6 May. Marine Le Pen, the National Front candidate, has been steadily losing traction and is now standing at around 16%. Sarkozy has pulled the rug under her nationalist feet by campaigning for French values, law and order and other populist themes, not least suggesting referendums on flexible working rules. The centrist candidate François Bayrou has been gaining ground with 14-15% and is expected to play a far more crucial role in the final outcome than Mme Le Pen.

In the meantime, Sarkozy has not been pulling his punches, even attacking Hollande's current companion Valerie Trierweiler on account of her involvement with financier Vincent Bollore's TV network.

Sarkozy's biggest handicap is his track record of the past five years that makes many promises sound hollow to a world-weary and depressed electorate. So his strategy is to try to reverse the roles by turning the election into a referendum on whether Hollande has the metal, the charisma and the capability of leading the country at a difficult time.

Sarkozy has not helped himself with more examples of the crony capitalism that has coloured his years in the Elysée. The latest was the attempt to place Jean Louis Borloo in the chair of the Veolia environment group to thank him for not running as a centrist candidate. Both EDF and LVMH, two groups whose chairmen are strong Sarkozy supporters, have given him a helping hand by taking over two companies that faced closure or bankruptcy at a time when unemployment and disindustrialisation are at the heart of the campaign.

Sarkozy's biggest handicap is his track record of the past five years that make many promises sound hollow to a depressed electorate. So his strategy is to reverse the roles by turning the election into a referendum on Hollande.

China's capital account revolution *(... continued from page 1)*

The World Bank warns that China faces slower growth and possible social unrest unless it speeds up reforms. [See article on new Chinese leadership on p.5].

The PBOC document conveys four significant messages. First, on balance, opening up the capital account entails more benefits than risks. Second, capital account liberalisation is a prerequisite for China to sustain long-term economic growth and upgrade its industry. Third, China has capacity to control the potential risks involving in opening up its capital account and financial services industry. Fourth, the Chinese financial and monetary authorities will work out an optimum path for capital account convertibility to reduce risks and maximise benefits for China's real economy.

The most important implication of capital account liberalisation is to accelerate international use of the renminbi. China recognises that it cannot achieve internationalisation of its currency with controls on the capital account, interest rate regulation and under-developed domestic financial markets.

Neither can China go down a path that prefigures continuous appreciation of the renminbi. Increased international use of the Chinese currency and deepening domestic financial markets are two sides of the same coin. Liberalising the capital account could become the key catalyst triggering a new Chinese financial revolution and promoting a further economic revolution in the next decade.

China's move has been a long time in the making, accompanied by much discussion and conjecture. Eighteen years ago, in 1994, China realised current account convertibility. Since then, the scheduling and sequence of liberalising the capital account has been a hot issue in Chinese academic and decision-making circles. The Asian financial crisis in 1997 convinced the Chinese authorities that premature opening up of financial markets would result in catastrophic currency and banking upheavals, particularly for an economic system with a pegged exchange rate and with the relatively small foreign reserves of the 1990s.

Since the beginning of the 21st century, with high and now-sustainable GDP growth, and fast accumulation of foreign exchange reserves, an increasing number of commentators and advisers, both within and outside China, have predicted capital account liberalisation and encouraged China to go down that path. Some senior economists and officials even considered the 2008 Olympic Games as the best timing for China to open up its financial industry and capital account. But the US subprime debt crisis and ensuing global financial crisis made the authorities think again.

Self-confidence has risen now that China's biggest state-owned banks have succeeded in global IPOs, the country has emerged as the world's largest creditor and the Chinese financial system has not suffered devastating losses from the global crisis. Of course, even after capital account convertibility is realised, China will retain controls on investment and speculative capital flows. Along with capital account convertibility, China will develop more financial instruments for business people to hedge risks involving flexibility of exchange rates and capital flows for example through foreign exchange derivative products at the Shanghai Foreign Exchange Centre.

China sees three major benefits from capital account liberalisation. First, more foreign investment will flow into the domestic market, generating growth and employment. Second, overseas investment will provide Chinese entrepreneurs with more opportunities to diversify their businesses and Chinese citizens with more financial products to spread their savings. Third, opening up the financial services industry and the capital account is a crucial step to promote much-needed domestic financial competition and innovation.

The dominant positions or even monopoly of state-owned financial institutions and their excessive profits have caused much populist anger, encouraging efforts to open up financial services for foreign as well as domestic private competition. Along with capital account liberalisation, the PBOC has also set an agenda for interest rate liberalisation.

Overseas investment will provide Chinese entrepreneurs with more opportunities to diversify their businesses and Chinese citizens with more financial products to spread their savings.

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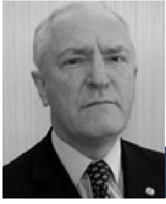

Stability holds the key

Capital account test for new Beijing chief

John Adams, Advisory Board

The export-led growth model is ageing rapidly. Is movement to a rentier society of Chinese overseas investment really possible and politically acceptable?

In less than six months, Xi Jinping, a largely unknown figure, takes over as China's president. A large economic dossier on to his desk will be liberalisation of China's capital account. How he reacts to the challenge is almost wholly unclear. China provides a stark contrast to the US, where Republican hopefuls, with folksy four-letter names, are publicly slogging out their candidatures on issues of sex and religion, decoupled from the harsh economic reality facing their supporters. Xi does not have that luxury.

Already vice president, and son of a former vice prime minister, Xi comes out of China's top drawer, with excellent Communist credentials, a well developed political network, and a record of finessing major problems, whether as governor of a corrupt Fujian Province, or party secretary in recalcitrant, wealthy Shanghai. He knows the ropes; he is a safe pair of hands. Is this enough to take China through the swirling gorges ahead?

He will have in front of him a report, perhaps curiously from the Statistics Department of the People's Bank of China, adducing some interesting, but awkward reasons for liberalisation. Opening the country's capital account, it says, will help Chinese enterprises expand globally at a time when global asset values are at a low level. It will promote internationalisation of the renminbi, prompt economic restructuring, and expand household investment channels. More significantly, it draws on the experience of Indian capital account liberalisation to suggest that foreign investors' participation in the Chinese stock and bond markets might greatly enhance the A-share market, and rid the market of domestic manipulation and the plight of being marginalised.

These are appeals, some populist, to the different interest groups that have arisen in China in the past 25 years. But at the heart of China's decision-making is always a desire for stability, tempered by the knowledge that inflation destroys the mandate to rule. The dreadful opposite example lies in Japan's long period of stagnation and deflation after a property asset bubble uncomfortably similar to China's recent experience.

China's economic problems are growing more difficult to handle. Labour costs are rising. The renminbi has already appreciated 6% in real terms in 2011. China may soon find its goods becoming expensive on world markets. The export-led growth model is ageing rapidly. Can capital account liberalisation really cure all this? Is movement to a rentier society of Chinese overseas investment really possible and politically acceptable?

Perhaps a different genie is already out of the bottle. China's massive quantitative easing has involved not only huge lending, but a rise in non-performing assets to perhaps 40% of banks' loan books, with a heavy concentration in shaky property loans. A recent report from the International Monetary Fund points to some success in cooling the property market – but this may yet rebound negatively on the banks. The scene-shifters in this particular Chinese opera may have already begun to bring on a ruined winter landscape backdrop, even while the doomed protagonists sing of spring.

The report may indeed be a liberalisation manifesto and road map for the incoming administration, but that may be led by someone whose instincts are for steadiness, not reform. The real threats to China, as the IMF asserts, come from banks' over exposure to property, and the still unresolved financial crisis in the West. An external shock could cut China's growth rate in half (to a mere 4%) – below the level at which job creation maintains social cohesion. China has the resources to counteract this threat by domestic initiatives. There is some alleviation in inflationary pressures, which will be welcomed by the new leadership, but food inflation could take off swiftly. China has other non-capital account fish to fry. As one ancient sage put it: 'Govern the country as you would fry whitebait – don't stir them around too much.'

Basel committee in worldwide accounting shake-up on reporting standards *(... continued from page 1)*

Current rules call for provisions to be made for actual or 'incurred losses' at the date of the balance sheet. The new approach will lead to banks reporting vastly different results from those they calculate under current rules. In general, the new rule will require banks to report lower profits in good years, and allow them to claim higher profits or lower losses in bad years.

The matter came to a head recently when the Basel Committee proposed that banks should adopt pro-cyclical provisioning policies to account for bad and doubtful debts. Most central banks in Europe agreed – as did the US Fed, which has a long track record in telling the US accounting regulator to mind its own business when it comes to bank accounting matters. Critics of expected loss accounting say that the same thing is now happening with the IASB, which they say has simply been browbeaten against its better judgement into accepting the new approach. These critics argue that pro-cyclical accounting is nothing more than a return to the bad old days of so-called inner reserves and smoothing of reported results. Perhaps understandably, regulators see pro-cyclical provisioning as nothing more or less than prudence. They like the idea that banks are conserving resources for a rainy day. They do not seem concerned that the new rules will lead to accounts that are misleading to management, shareholders and other users – or, as some predict, that they may even distort the overall economy.

Expected loss provisioning is likely to provoke particular debate in the UK and (mainly Commonwealth) countries that have modelled their company laws on those of Britain. Tax authorities may well object. UK company law defines provisions as 'known losses and liabilities at the balance sheet date' – while reserves are part of shareholders' funds. Accordingly, excessive provisions are in reality hidden or inner reserves and are illegal. The principle was established in 1931 in the London criminal court in the famous Royal Mail Steam Packet Case.

UK banks were exempted from the requirement to publish true and fair accounts until the 1980s – when they voluntarily agreed to give up secret reserves. Sir Malcolm Wilcox, joint chief executive of Midland Bank, told me a few years later that the result was a much more efficient banking system. 'We now have to wait until the end of the year to find out what profits we have made. In the old days we knew at the beginning of the year,' he said.

Festering sores *(... continued from page 1)*

Financial shares are up even more. The euro has risen against the dollar. Bank bonds have posted rarely-seen returns, up 10% since end-November, with more than half of this in 2012.

But let's look deeper at the collateral lying at the heart of both private and official repurchase ('repo') markets which, during normal times, creates much of the liquidity in the financial system. This formed the basis of liquidity-generating securitisation that contributed mightily to the credit crisis. In periods of greater uncertainty, such as now, markets seize up without appropriate supplies of collateral. But the increasing demand for collateralised lending has a corollary: increased subordination of investors with unsecured claims.

Private sector lending to banks is being replaced by ECB lending. ECB operations require collateral. Historically, much of this collateral has been used to meet short-term e.g. overnight, financing needs. Now the collateral is for longer periods, as in the recently-created three-year long-term repurchase operation (LTRO) programme. In early February, the ECB again moved to allow NCBs to define new, looser standards for accepted collateral. Barclays estimated in February that ECB borrowings had encumbered about €1tn of bank assets. Now that €530bn has been allocated in the second-round LTRO on 29 February, this figure will have increased still further.

The banks have not just been providing collateral to the official sector. Banks have covered much of their financing needs through covered bonds or Pfandbriefe. On Barclays estimates, this accounts for another €3.5tn of encumbered assets. While these numbers are relatively small against the European banking system's €50tn-plus aggregate balance sheet, the marginal effect is significant. The phenomenon is likely to increase as investors recognise the problem and rush towards secured lending. RBS estimates that the first LTRO reduced by 1% the attachment point (the point in the capital structure at which funding or capital providers will assume losses). RBS estimates that spreads should rise 15 bp for each 1% decline in the attachment i.e. increase in subordination. So European bank bond investors targeting senior unsecured debt face considerable risks. As more bank assets are encumbered, the difference between senior and subordinated becomes less meaningful.

With ratings agencies making multiple-notch downgrades to major banks' senior debt, this is a cause of great concern. A large part of European banks' total subordinated debt looks likely to end up junk-rated within the next year. As senior debt becomes increasingly subordinated, the banks risk having their core funding instruments downgraded to levels that many investors are mandated to avoid.

ECB lending at some point will crowd out private investment. There are similar concerns regarding its Security Market Programme where each ECB purchase (in view of its preferred creditor status) subordinates holders of peripheral debt. (Perhaps this is one reason why the ECB has stopped the SMP, at least for now.) After massive liquidity injections, a short-term rally may continue. But now that investors' ranking order has changed so much, don't expect spread levels to tighten to historical levels. The good times are perhaps once again behind us.

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Liquidity drives overvaluation

Funds head for industrialised countries' bonds

Stefan Bielmeier, Advisory Board

Industrialised economies slowed sharply at the end of 2011, with aggregate OECD growth falling in the fourth quarter to its lowest level since the crisis of 2008-09. The only positive exception was the robust US economy, since even emerging markets recorded marked slowdowns. However, the latest indicators point to a stabilisation in most countries, and the moderate but robust growth trend is expected to remain intact – especially in the US and China.

Yet the recent slump of China's foreign trade still gives cause for concern, and the Chinese government has taken action in response. The People's Bank of China relaxed its monetary policy stance for the second time in three months in mid-January when it lowered the banks' minimum reserve rate. The PBOC also held out the prospect of renewed tax relief for export industries. Beijing appears very nervous about European economic weakness. The property market is another source of worry. After the authorities' success in cooling overheating, prices are now falling slightly. Although this is a perfectly healthy correction, there are concerns that this could turn into a serious threat to the economy. The first proposals for loosening the present extremely strict controls on property purchases are now being aired.

The recent slump of China's foreign trade still gives cause for concern, and the Chinese government has taken action in response.

China's central bank is not alone in reacting with monetary easing. The European Central Bank's resort to 36-month tenders has paid off. Europe's financial markets show a clear reversal of sentiment. The share prices of European banks and insurers were among the beneficiaries in the first weeks of 2012. Investors have revised upwards their over-pessimistic expectations. Southern European banks are using the ECB's cheap money at 1% to buy relatively high-yielding government bonds. The margins on this business are more than acceptable. It's reminiscent of the Greenspan era of American monetary policy – extremely low official interest rates followed by a build-up of price bubbles – only this time the scene is Europe.

The one big difference is that the consequences are seen mainly in the bond markets and only incidentally in the equity markets. The normal historical pattern is for this process to end in a massive and traumatic correction that paves the way for fundamentally fairer valuations.

So the current state of the euro government bond market gives rise to concern. Determining the fundamental value of European sovereign debt is near-impossible at the moment, and the outcome is laden with uncertainty. The banks that are using central bank money to expand their credit substitution could find themselves facing massive problems in future stress tests, should the reforms falter in countries that have been under pressure.

More than anything else, the European and US financial markets have benefited from a flood of liquidity. Once again, this makes it abundantly clear just how underdeveloped the financial markets of China and other emerging markets still are. The absence of alternatives has caused all this liquidity to flow straight into the established financial markets and distort valuations. This trend is especially evident in the bond markets, and it should not be expected to change in the near future.

The Chinese government cannot yet take the risk of completely opening its financial market and, by extension, its bond market. The exchange rate adjustments would be painfully large and would impose an additional burden on the slowing Chinese economy. The authorities are more likely to stick to a possible longer-term plan that would gradually open up the financial markets over, say, a five-year period and would not expose the Chinese economy to so much pressure. This suggests that industrialised country bond markets will continue to tend towards overvaluation in coming years, since available liquidity just has no other place to go.

Worry after the write-down

Second Greek rescue may not resolve problems

DZ Bank Economic Forecast Table			
GDP growth			
	2011	2012	2013
US	1.7	2.0	2.0
Japan	-0.9	1.5	1.5
China	9.2	8.2	8.8
Euro area	1.5	0.2	0.9
Germany	3.0	1.4	1.5
France	1.7	0.7	1.1
Italy	0.4	-1.2	0.0
Spain	0.7	-0.8	0.0
UK	0.8	0.8	0.5
Addendum			
Asia excl. Japan	7.4	6.7	7.7
World	3.6	3.2	3.7
Consumer prices (% y/y)			
US	3.2	2.4	2.6
Japan	-0.3	0.1	0.1
China	5.4	3.0	3.4
Euro area	2.7	2.1	2.3
Germany	2.5	2.0	2.3
France	2.3	2.2	2.2
Italy	2.3	2.2	2.3
Spain	3.1	1.4	2.1
UK	4.5	2.6	2.3
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.1	2.5	2.8
China	3.6	2.9	3.1
Euro area	-0.6	-0.7	-0.6
Germany	5.1	4.7	4.3
France	-2.2	-2.3	-2.0
Italy	-3.6	-3.1	-3.1
Spain	-4.5	-4.3	-4.3
UK	-2.5	-3.0	-2.0

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

European finance ministers' agreement on a second bail-out package for Greece reduces the immediate risk of a disorderly default and a consequential further dangerous escalation of the debt crisis. Of course, this does not solve Greece's problems in any way.

The private creditors' write-down will reduce the government's debt burden by more than €100bn or 40% of gross domestic product, but whether this leads to a tolerable or sustainable debt level remains to be seen.

Nor has the danger of a debt restructuring been banished in Portugal; however, the country has made much more progress on consolidating its finances than Greece, and is also much more willing to undertake far-reaching reform.

The euro area economy is visibly suffering the effects of several member states' drastic austerity regimes. This consolidation, and the slowdown of the world economy, caused EMU-wide economic output to contract 0.3% (quarter-on-quarter) in at end-2011.

We expect GDP to stagnate in the current quarter even though some of the leading indicators have already improved slightly. Assuming no further escalation of the debt crisis, we expect GDP to return to mildly positive growth from the spring.

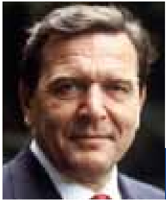
Euro area economic surveys paint a picture of stabilisation and a slightly improving outlook for coming months. According to the EU Commission, Europe's consumers were no longer quite so pessimistic in their responses, while the financial-market analysts polled by the Mannheim-based ZEW Institute have ratcheted their expectations for the economy sharply higher since the New Year.

German business sentiment improved in February for the fourth month in succession despite the debt crisis and the weakness of the global economy.

The Ifo business climate index rose much further than most analysts had predicted. The surveyed companies rate their business conditions better than a month ago. They are also markedly more confident about prospects for the next six months.

This survey shows the German economy is slowly building up steam again after the weak closing quarter of 2011, which makes a recession even more improbable. The present upturn of the German economy is primarily domestically-driven.

We reiterate our existing prediction that Germany's economic output will increase by just under 1.5% this year. The main downside risks to this outlook are the debt crisis and any escalation of the Iran uncertainty that would cause a jump in oil prices.



Why Europe needs growth

More integration to heal mistakes by Kohl and Mitterrand

Gerhard Schröder, former German Chancellor

During efforts to address the European debt crisis, a key mistake the European Union's slow initial response to the problem of Greece's debt. This mistake stems from German policy, which, at the time, gave too much consideration to domestic politics. Aid to Greece was granted too late, infecting other European countries. A swift initial response would have made the crisis more manageable and hence less costly.

The latest EU decisions are steps in the right direction. The fiscal pact, together with the EFSF and ESM rescue packages as well as the European Central Bank's liquidity measures, creates more stability. This must be accompanied by Eurobonds, as soon as there is greater coordination of financial policies. We need both fiscal stability and economic growth. Greece, Ireland, Portugal, Italy and Spain have all made significant progress in cleaning up national budgets. But the situation in these countries shows that the currency crisis cannot be overcome by austerity alone.

There is a risk that the national economies will be more or less strangled by strict austerity measures. In Greece this is already the case. This policy contains significant economic risks. A recession in these countries would have negative repercussions on Germany. The EU would be well advised to soften the harsh austerity measures in these countries by implementing growth programmes.

Growth is also generated through structural reforms. This has been our experience in Germany. In Germany, with the Agenda 2010 programme, we implemented reforms in our social system before other European countries. We made the labour market more flexible; we raised the retirement age to 67; and we adjusted social security to demographic developments. We also invested additional resources in education, research and development. Within just a few years, Germany went from being 'Europe's sick man' to 'Europe's engine'. Germany now is the most competitive economy in Europe. Other countries, like France, Italy, and Spain, will now have to follow suit.

Europe must become more politically integrated. The fundamental mistake of monetary union is that there is no coordination of economic and financial policy. President François Mitterrand and Chancellor Helmut Kohl had two basic ideas in mind. With the common currency Mitterrand wanted to 'enclose' Germany's economic strength and, hence, our political strength. This was doomed to fail because Germany, as an export nation, profits enormously from the euro.

Kohl's mistake was to assume that the monetary union would force a political union. We were unable to do this, even during my term in office. The current crisis makes it abundantly clear that one cannot have a common currency area without having a common financial, economic and social policy. This is why we need a European economic government responsible for improved coordination, and control of individual countries' spending and for common rules of competition.

The European Council must delegate responsibilities and should be transformed into a second chamber with responsibilities similar to those of the Bundesrat, the Federal Assembly in Germany. I am well aware that not everyone in Europe wishes to go down this path. In the future we will have a Europe of two speeds. A core Europe that grows together more quickly politically. And a fringe Europe in favour of greater autonomy. The countries which do not wish to be part of greater European integration will lag behind. Only a united Europe has a chance of survival. When it comes to global competition, a nation-state alone – be it even our strong Germany – is too weak to keep apace economically and politically.

This article is based on a speech to OMFIF in London on 7 February.

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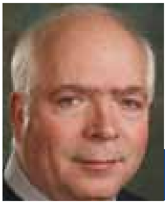
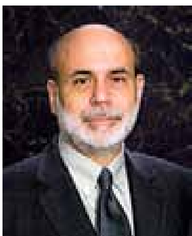


Will they or won't they?

Question marks on new quantitative easing

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. Perhaps part of the new transparency push at the Federal Reserve, FOMC members did not hesitate to show their human side in public appearances this month. The unresolved question whether there'll be a new round of quantitative easing (QE3) continues to hover over the FOMC, with speculation rising that the Fed is contemplating a new form of sterilised long-term bond purchases under which it would mop up part of the proceeds by short-term borrowing.



Ben Bernanke

Bernanke cautious on employment despite good news

Federal Reserve Chairman **Ben Bernanke (voter)** observed during a discussion of student debt during his semiannual appearance before the House Financial Services Committee at the end of February that his own son is on track to accumulate $400,000 in student loan debt as he pursues a degree in medical school in New York. The Fed chairman said the whole question of student debt required 'careful oversight' from regulators. When Bernanke nemesis Ron Paul, the Texas congressman who is running for president, got his turn at questioning, he asked the Fed chairman if he did his own grocery shopping. Not sure where the question was leading, Bernanke hesitantly answered that yes, he did.

Paul pounced on him and said that he would certainly agree, then, that the official inflation rate was much lower than the price increases people were facing in real life. Bernanke responded that the consumer price index was calculated by the Bureau of Labor Statistics, not the Fed, and they seemed pretty serious about it.

In his remarks on monetary policy, Bernanke did not give any assurances that there would be a third round of asset purchases by the Fed, or QE3, though some market participants were looking for that. He did, however, display an abundance of caution about the outlook for employment, despite the recent improvement in the headline rate to 8.3%.

He said the FOMC does 'not anticipate further substantial declines in the unemployment rate over the course of this year.' Looking beyond this year, the policy-makers 'expect the unemployment rate to continue to edge down only slowly toward levels consistent with the Committee's statutory mandate,' he said. He sounded further cautionary notes, including an observation that 'strains in global financial markets posed significant downside risks to the economic outlook.'

Richard Fisher

Fisher sees Mexico as role model for US

Dallas Fed chief **Richard Fisher (non-voter)** also shared some personal details when he went to Mexico City to give a speech at the stock exchange. He talked about growing up there in the 1950s, during a 'golden era' when his only fear was getting rapped across the knuckles with a ruler by 'stern teachers' at school.

Spanish was his first language in school, he confided to his audience, and he still has friends in 'El Norte' who maintain he speaks Spanish better than English. He said he would endeavour to deliver his speech in good 'Mexican Spanish' rather than 'Texan English.'

Fisher praised Mexican efforts to reform its economy and monetary system and said that in some respects Mexico was putting up better macroeconomic numbers than his own country.

Mexico recovered more rapidly from the 2009 recession than the US, getting back to pre-recession levels in just 12 quarters, compared to 15 quarters in the US, Fisher said. American industrial production is still not back to pre-recession levels, he added, but Mexico's industrial production passed its pre-recession peak at the end of 2010.

On the fiscal front, Fisher noted that Mexico at least had a federal budget, whereas the US has not had one for three years running. Mexico's budget deficit was 2.5% in 2011, compared with 8.7% in the US. Mexico's national debt is only 27% of GDP, while the USdebt-to-GDP ratio was 99% in 2012 and was projected at 106% percent in 2012 as the national debt tops $16tn.

One of the reasons for the better fiscal performance, Fisher noted approvingly, is that Mexico has had a balanced budget rule since 2006. While emergencies such as the global financial crisis allow deviations, the Mexican government has shown greater fiscal discipline than the U.S. and has done so in a way that has not hampered economic recovery, he said.

The Fed, the housing market, and economic recovery

Perhaps because the recently released transcripts of FOMC meetings in 2006 show Fed policy-makers blithely optimistic about the evident and growing housing bubble, the US central bank has been greatly preoccupied by the continuing crisis in housing.

Elizabeth Duke

Federal Reserve Board Governor **Elizabeth Duke (voter)** went before a Senate committee to defend the central bank's focus on the sector. When the Fed issued a white paper on the crisis in January, some Republican lawmakers criticised the board for venturing into policy areas beyond its brief.

Duke, whose term expired on 31 January but who will remain in service until a replacement is appointed, told the panel that 'issues related to the housing market and housing finance are important factors in the Federal Reserve's various roles in formulating monetary policy, regulating banks, and protecting consumers of financial services.'

The failure of the housing market to respond to lower interest rates indicates that factors other than financial conditions may be restraining improvement and are thus impeding the economic recovery, she said. The Fed is simply seeking to design policies that would remove obstacles to normal market functioning, she explained.

Perhaps because recently-released FOMC meeting transcripts from 2006 show Fed policy-makers blithely optimistic about the growing housing bubble, the US central bank has been greatly preoccupied by the continuing crisis in housing.

Counter-cyclical monetary policy at the zero bound

John Williams

San Francisco Fed chief **John Williams (voter)** provided some clues as to what policies Fed officials might have in mind when he took part in a discussion in New York on a paper about housing, monetary policy and the recovery.

Williams said that while the collapse in home prices and residential construction have been a big part of the recession story in the US, the broader financial crisis has reduced aggregate demand through non-housing channels as well, affecting regions of the country not particularly hard hit by the housing decline.

This more generalised problem has led to the strong counter-cyclical monetary policy put into effect by the Fed. While the zero bound on interest rates and a partially clogged monetary transmission mechanism have hampered policy efforts, measures taken by the Fed have helped the economy through wealth effects, household intertemporal substitution, the user cost of capital generally, and exchange rates, among other mechanisms.

Given this situation, Williams continued, the Fed might do well not to pursue further across-the-board policies but to concentrate on those that affect particular problem areas. 'For example,' he said, 'purchases of mortgage-related securities appear to have reduced mortgage rates significantly, making them particularly useful given the weakness in the housing sector.'

At a California event earlier in the month, Williams had expressly suggested that a new round of Fed asset purchases might focus on mortgage-backed securities.

At the New York conference, Williams also suggested that fiscal policymakers could directly address the housing-related headwinds in a way to promote a stronger housing recovery and enhance the effects from existing monetary stimulus.

The odd trans-Atlantic couple

Lack of emotion may be positive

John Kornblum, Advisory Board

The fate of the West depends to a large extent on two very dissimilar people on opposite sides of the Atlantic, Barack Obama and Angela Merkel. The son of an itinerant Kenyan scholar and the daughter of a Lutheran pastor who grew up in Communist East Germany have the task of putting capitalism back together.

Each seems equally anxious about economic issues. Yet neither is able to seize the moment. Obama worries that a collapse of the euro could cost him re-election. Merkel is concerned that America's demands that Europe spend more to help weak economies could lead to rampant inflation and weaken European democracy.

Obama worries that a collapse of the euro could cost him re-election. Merkel is concerned that America's demands that Europe spend more could lead to rampant inflation.

The premier role of the US president is self-evident. Germany, by contrast, is inexperienced and uncomfortable in the leadership role it has now assumed, but its industrial and logistical strengths make it one of the winners of globalisation. Where Europe is concerned, Germany is in charge. And Germany increasingly speaks with a single voice: Merkel's.

Their backgrounds could not be more different, but both are outsiders. Neither comes from the traditional leadership elite. Neither is an easy communicator, in the spirit of Bill Clinton or Helmut Kohl. They seem to have a hard time even getting through to each other. Each faces massive economic and political problems not of their making. Neither the US Congress nor the European Union seems able to find the strength or wisdom to make necessary decisions. Obama came into office promising a new beginning, but his dreams have been shattered by economic crisis and a voters' revolt. His politics of consensus — or leading from behind, as some of his supporters call it — have been blocked continuously by the unwillingness of the opposition to find common ground.

Merkel is a physicist who grew up in an atmosphere of fear and distrust. She hates 'visions' and only reluctantly takes initiatives of any kind. Her economic views are influenced as much by Germany's past as by its future. But she is a devout believer in the future of a democratic Europe. She rankles at Obama's repeated calls for action, claiming he simply does not understand the difficulties of creating consensus among 27 nations.

Ironically, neither is really in political trouble. Merkel is a sure bet for re-election in 2013 in a field without real competitors. Obama seemed at times to be weakening, but renewed growth and Republican disarray appear to be playing strongly in his favour. That means they could risk decisive steps if they had the internal motivation. Merkel could rise above the swamp of EU ideology and demand a new framework of European revenue-sharing ensuring stability for Greece and others. Obama could deliver a stirring message of reform which would silence his critics by putting the US government on the road to fiscal responsibility. A commission he appointed for this purpose gave him an excellent bipartisan starting point; its recommendations were ignored.

Political friendships can be important in building resolve in times of crisis. Franklin D. Roosevelt and Winston Churchill are an example, as are George H.W. Bush, Helmut Kohl and Mikhail Gorbachev. This time we seem fated to depend more on cool political calculations rather than friendships. However frustrating their approaches may be, Merkel and Obama represent a new kind of Atlantic community, bound together more by hard economic interests than by the visions of past eras. Europe and America are in the middle of a fundamental 'reset' of their economic and social systems. This can't be pushed ahead in a phone call or two.

Even if they aren't friends, Obama and Merkel work carefully and honestly with each other. We'll continue to wonder how they'll deal with the demons their unique roles have awakened, and hope that each will succeed in rising above them. At times like this, the lack of emotion is probably not so bad.

'Animal spirits' rise in Germany

Test for Bundesbank as growth revised up

Stewart Fleming, Advisory Board

Sentiment is picking up across Europe's largest economy. Centred on Germany, the continent-wide outlook for 2012 is a lot rosier than at the turn of the year. The 'animal spirits' – the swings in consumer and business confidence that John Maynard Keynes identified as vital to an economy's performance – seem to have taken a significant turn for the better.

This is due, at least in part, to the possibility raised in a detailed analysis by the Paris-based Organisation for Economic Cooperation and Development last month that the German economy could once again 'become a growth locomotive for Europe.' Some private sector forecasters have raised their projections for German growth this year to close to 1.5%, double the official Berlin government forecast of 0.7% in January. This would still represent a substantial slowdown from last year's 3%, but the speed of the upgrade has been impressive. Anyone expecting that an improving German or euro area economic outlook will swiftly translate into a trouble-free recovery should think again. Nothing is plain sailing in the single currency area.

A lop-sided euro area upturn led by Germany, which accounts for 27% of the region's output, would present the European Central Bank with quite a dilemma. It would increase pressure for a rise in interest rates from currently abnormal, crisis-level lows, even though the region's sovereign debt crisis is still unresolved, and present a new test for the one-size-fits-all policy.

Indeed, there are signs that the ECB is already responding to this possibility. President Mario Draghi has hinted that markets should not expect a further fall in rates.

Last summer's sudden economic slump was widely put down to the impact of the Japanese tsunami and mounting unease about Europe's sovereign debt crisis and its effect on the world economy if it spread to Italy. In the background, too, were fears about a bank funding crunch in Europe that could spread globally.

As early as October, IMF officials were privately warning that European banks needed to roll over around €500bn of debt in the first half of 2012, but markets for such issues were shutting down. The most important policy change since then has been the ECB's now-repeated long term refinancing operation for banks. At a stroke the ECB disarmed the threat of a continuing credit crunch, which was already underway, according to ECB fourth quarter lending figures. No wonder animal spirits have been on the rise since.

In the case of Germany, however, the story is more complicated, and more interesting. As the OECD points out, uniquely amongst the leading trans-Atlantic economies, Germany has been enjoying a 'jobs miracle' right through the economic crisis which began in the summer of 2007 with the US sub-prime meltdown and which metamorphosed into Europe's sovereign debt crisis. Since it peaked at 10.7 % in 2005, unemployment has fallen steadily in Germany in spite of the financial crisis. It is now under 6%. Unsurprisingly, but belatedly, according to the European Commission, this is beginning to have an impact on domestic consumption. It accounted for two thirds of Germany's growth last year.

The IFO business confidence index for Germany is now in boom territory. With signs of a housing bubble appearing, and the risk of an inflationary jolt from oil prices, this might be time for an interest rate increase. The Bundesbank of old would certainly be getting twitchy. So too, it seems, is the Bundesbank of today. It just does not have its hands on the policy levers any more. Perhaps it's time for Berlin to think of wheeling out macroprudential policy tools to tackle a regional challenge in the single currency area and show Ireland and Spain what they should have been doing as their bubble economies inflated in the early years of the century.

The Bundesbank of old would certainly be getting twitchy. Perhaps it's time for Berlin to think of wheeling out macroprudential policy tools.

The dangers of German dominance

Berlin must cooperate on European growth strategy

Christopher Tugendhat, Advisory Board

The European Union is the most exciting and hopeful political initiative in Europe in modern times. However, popular support in all member states has always been conditional. Once the EU comes to be seen as part of the problem rather than part of the solution, public opinion is likely to turn sharply against it. Now, as a result of the travails of economic and monetary union (EMU), that is becoming the case across wide swathes of the EU.

The Germans should respond to the sage advice of Italian prime minister Mario Monti and indicate that they are willing to co-operate in an EMU growth strategy, without ruling anything out beforehand.

The point at issue is the profound shift in the balance of power among EMU members in favour of Germany. Germany never set out to be a hegemonic power. That is the precise opposite of what EMU was supposed to achieve. However, thanks to the success of German economic policy and the discipline of its people, on the one hand, and the way that the euro has worked out on the other, Germany is now overwhelmingly EMU's dominant power.

For many years in the EU, the power of even the largest member states was tempered, partly by convention and restraint, and partly by presence of three big powers within the EU, each with different attributes, as well of several others that were quite large. The European character was maintained, too, by the roles of European councils as well as the European parliament and Commission in making and implementing decisions.

Now, within EMU, nothing can be achieved without Germany's support or against its will. What Germany wants, Germany gets. Others can make only relatively minor modifications. That is dangerous. Dominant powers are never popular. For reasons of history, German actions and motives are more open to mistrust and misrepresentation than with any other country. Anti-German feeling, already rife in many European countries, is rising all the time. The danger is compounded by Germany's one-size-fits-all diagnosis and treatment of EMU states' economic problems. The proposed new treaty on fiscal discipline is one example. Regardless of the differing causes of national problems, Germany insists on the same austerity measures for all.

Of course, one understands why. German politicians, economists and public opinion believe that that medicine is in the best interests of the other member states and of the EU as a whole. This precept is the price demanded by German electors for helping others. Yet it takes no account of the fact that Germany is the biggest single beneficiary of EMU both in terms of the huge surpluses it has built up trading with other members and through the great success of its exports elsewhere in the world.

I fear that the longer Germany maintains this stance, the worse the possible consequences might become. Several countries, not just Greece, could be condemned to prolonged recessions. And the protests may not stop in the streets. Extremist political forces will gather strength and there could be an explosion against the whole euro edifice and perhaps even against the EU itself. All the Union's great achievements over many years could be put at risk. And in some member states democracy itself may be endangered. I hope Germany will modify its position before it is too late. The Germans should respond to the sage advice of Italian prime minister Mario Monti, among others, and indicate that they are willing to co-operate in an EMU growth strategy, without ruling anything out beforehand. They must be willing to negotiate multilaterally on this, not simply to lay down preconditions.

No country has done more than Germany to build the EU. It has contributed generously in financial terms; it has been a constant source of ideas and constructive proposals; and it has produced many very high-quality officials and politicians who have contributed greatly to policies in many areas. It would be tragic if Germany were now to become the instrument of the dismantlement of so much that has helped to achieve.

A new reality in the making

Euro doomsayers are being proved wrong

Laurens Jan Brinkhorst , Advisory Board

Throughout the European sovereign debt crisis a large chorus of doomsayers (mainly economists) has predicted the fall of the euro, its division in a neuro and a zeuro, and other dramatic consequences, all leading to the end of the European Union in its present form. None of this has happened, because the political nature of the euro project for the future destiny of Europe has not been properly understood.

It has become a commonplace to emphasise the mismatch between a common currency at the European level and the preservation of national independence over economic policies. However, we are seeing a steep decline in financial market tensions. A new political climate is beginning to emerge. The crisis has not yet been fully overcome, but the markets have become considerably more cautious in betting against the euro.

Why has this occurred? The EU has always grown as a result of crises – and the present one has been exceptional in its depth and impact. We are therefore going through a crucial phase. It has taken some time before this new reality (beyond economics) has sunk in with national political leaders. Hence the prevarications and endless hesitations of the past two years. At the same time, the debt crisis has made clear that the European Union is not an abstract idea, but affects our daily life.

After the eruption of the Greek crisis two years ago, many in Europe believed this was a matter for Greece to resolve and that no one else was involved. Now there is recognition that European countries have become much more interdependent. The completion of the internal market, also in finance, and the creation of the euro have considerably accelerated this process. Benjamin Franklin's words – 'If we do not hang together, we will all hang separately' – are apt here.

This sense of co-responsibility has only been grudgingly accepted. The reality of interdependence hit most leaders almost by surprise. But it is this common experience that has pushed the EU, and in particular the euro countries, towards more integration, as seen in the signing of the fiscal pact on budgetary discipline in Brussels on 1 March. There is a strong accent on growth and jobs, but the leaders recognise that the best platform for growth is to restore stability.

Changing bad habits cannot happen overnight. But a quiet revolution has taken place, despite deep-seated resistance to change in most European countries. This beings stronger surveillance of national budgets and deficits, more common rules on banks, and the boosting of rescue mechanisms through the provisional EFSF and the permanent ESM. The European Central Bank, in its courageous, independent role channelling liquidity to banks, has taken the lead in overcoming national reflexes. Two years ago, this was unthinkable.

But there is more. Europeanisation is becoming the answer to globalization. German chancellor Angela Merkel, in a speech at Davos in January, made the point that Germany, as the strongest economy and largest country of the EU, represents no more than 1% of the world population and the EU as a whole not more than 7%. The message is clear. European countries individually are unable to cope with the growing challenges of the new powers of the 21st century, let alone to shape the structures of a more sustainable and safer world.

Most countries on the European continent, through common hardships, but also murderous confrontations in the past century, are beginning to see the inevitability of more, not less Europe, as a way of maintaining, not weakening, their national identity. The larger countries say that only through more European commonalty will their voices continue to be heard in the world of tomorrow. Chancellor Merkel's Davos speech was a clear signal of a new reality in the making.

Changing bad habits cannot happen overnight. But a quiet revolution has taken place, despite deep-seated resistance to change in most European countries.

Restoring confidence in Europe

How to put the 'E' in EMU to work

Klaas Knot, President, De Nederlandsche Bank

EMU stands for economic and monetary union. Many European governments are only now starting to realise that they haven't paid enough attention to the 'E' in EMU. At the root of Europe's sovereign debt crisis we find some individual euro area countries pursuing flawed policies and a failing system of mutual surveillance in the euro area.

These deficiencies pose challenges for EMU's future. While the euro has increased macroeconomic stability and furthered trade and financial integration, the sovereign debt crisis demonstrates that the job is not done yet.

The Netherlands is particularly focused on EMU in view of the openness of its economy. Dutch exports plus imports amount to nearly 150% of GDP. This is slightly less than Belgium and Ireland but compares with between 53% and 63% in France, Italy, Spain and the UK, and less than 30% in the US. As a consequence of this openness, the realisation of the single market and the introduction of the euro brought substantial benefits for the Dutch economy. One of the most significant gains was the boost to trade. Driven by lower transaction costs, lower exchange rate risks and more market transparency, the Netherlands' trade within the euro area developed more strongly than outside. This is one of the reasons why the Dutch economy outperformed the euro area in terms of GDP growth in 14 out of the last 20 years.

Over 60% of our exports go to euro area countries, more than any other EMU member's exports within the euro area. So for the Dutch economy a solution of the European sovereign debt crisis is of vital importance. If EMU were to fall apart, there would be severe consequences for the open Dutch trading nation.

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However, over the last couple of months, European policy makers have done a lot to restore confidence. Most of the sovereign debt markets under strain have calmed down substantially. The most important development has been the finalisation of the fiscal compact, in which political leaders from EMU members and most other EU countries are strengthening the rules governing budgetary discipline in Europe. Another important step is likely to come in March with an evaluation of the capacity of the EFSF and ESM rescue funds. The EFSF in its current form (based on guarantees) and size unfortunately has failed to convince markets that all countries will get through this crisis unharmed.

This is why we as central bankers call upon the European governments to increase the emergency facility as soon as possible.

The ECB has also taken further measures to avoid the sovereign debt crisis from severely dragging down the real economy, introducing a refinancing operation with a maturity of three years which dispensed €490bn in the first tender before Christmas and €530bn in the second one on 29 February. (This is not all 'new' liquidity, since banks also rolled over operations with shorter maturities into this new facility.)

As part of efforts to find a durable solution to the crisis, we need to be clear about the causes. At the start of EMU, there were wide differences in per capita incomes among member countries. It was assumed that catching-up countries would experience faster growth. This is what did happen, but not quite to the extent expected.

Prior to the crisis, such convergence was shown above all by Ireland and to a lesser extent by Greece and Spain. These countries' cumulative growth differentials compared to Germany reached 20% to 45% by 2007. By contrast, Italy and Portugal hardly experienced any real convergence towards the German level, even before to the crisis.

This article is based on a speech to OMFIF in London on 17 February.

Even the Netherlands 'converged' more than these countries. Unfortunately, where the catching-up process did take place, this largely happened through debt, either public or private.

In some countries credit to the private sector grew by more than 10% a year for over a decade. As a result, their debt with the rest of the world grew tremendously.
This was most dramatically the case in Ireland, which moved from a net creditor position of 52% of GDP in 1999 to a net debtor position of 71% of GDP in 2008. Note that the Netherlands is not doing particularly well with regard to this measure either. This is mainly the result of the growth in mortgage loans. In my view the high stock of mortgage debt is among today's biggest vulnerabilities of the Dutch economy.

Besides being largely based on credit, growth convergence was accompanied by relatively high inflation. Whereas Germany experienced lower inflation compared to the euro area average, the inflation rates in Greece, Ireland, Spain and Portugal were much higher. As is now well appreciated, the impact on unit labour costs brought about a substantial deterioration in these countries' competitiveness.

If we look at the biggest economy, Germany, developments in the last decade have been phenomenal. Only a relatively short time ago, Germany was called the sick man of Europe. Now that has changed completely. In particular, the German labour market has been made much more flexible, which has tempered unit labour costs and inflation. This has had a big impact on other EMU countries which can no longer devalue their currencies. Before EMU, between 1970 and 1999, unit labour costs in Germany, the Netherlands and Austria grew by a factor of 2.5 to 3. Over these 28 years, unit labour costs grew by a factor of 12 in Italy, 14 in Spain, 35 in Portugal and 55 in Greece.

By regularly devaluing their currencies, these countries were able to restore competitiveness, but after the launch of EMU this policy option was no longer available. The expectation was that these countries would adapt to this new reality and unit labour costs growth would slow down. Regrettably, this was not the case. When EMU started, countries like Germany, Austria and Finland continued their modest wage policies, while unit labour costs in southern European countries went up at a much higher pace, undermining their competitiveness – a development that was clearly unsustainable. The countries that found themselves at the top of the chart for unit labour costs in 2009 – Greece, Spain, Ireland, Portugal and Italy – one by one ran into trouble. That was no coincidence. Now, adjustments are being enforced by the direct and somewhat brutal action of financial markets.

In these countries, with the exception of Ireland, product and labour markets didn't function properly and they still don't. Markets are overregulated and labour markets are highly inflexible. By addressing these problems, labour productivity can increase, thereby lowering unit labour costs. This will not be easy, but I'm convinced that such steps are absolutely necessary for EMU to function properly.

The divergences in unit labour costs and competitiveness in the euro area of course had repercussions on current account balances. Most southern European countries and, to a lesser extent, Ireland experienced high and steadily increasing current account deficits, the opposite to what happened in Germany and the Netherlands. For many years it was thought that in a monetary union, individual countries' current account balances were no longer relevant. It was believed that what mattered was solely the balance of payments of the euro area as a whole. We know better now.

Of course, besides competitiveness problems, the crisis also had fiscal causes. The Stability and Growth pact didn't prevent some governments from re-embarking on old habits, once they had fulfilled the convergence criteria that enabled them to join EMU. We shouldn't forget, however, that this was facilitated by some of the core countries of EMU. When it became clear that these countries' fiscal policies were not in line with the pact's rules, it was not the policies that were changed, but the pact. This was clearly a mistake.

It is important to note that the gradual worsening of the budget balance in countries like Italy and Portugal was partly due to their competitiveness problems. Since devaluing out

The Stability and Growth pact didn't prevent some governments from re-embarking on old habits, once they had fulfilled the convergence criteria. This was facilitated by some of the core countries of EMU.

of these problems was no longer an option, the declined competitiveness slowed down economic and employment growth. This dampened tax revenues while stimulating social security expenditures. Looking at it this way, the lack of fiscal discipline partly reflected the lack of macroeconomic discipline.

Although Eurobonds are not suitable as a crisis instrument, they could be the light at the end of the tunnel for the citizens of vulnerable euro area countries.

Budgetary discipline in EMU was supposed to be exacted not only by the Stability and Growth Pact. Markets, too, were expected to restrain profligate governments by charging them higher interest rates and, thus, forcing them to change their ways. However, market discipline was largely absent during the first 10 years of EMU, allowing governments to pursue unsustainable policies. And when markets finally started to differentiate between governments, they did so with a vengeance. Although market discipline is now imposing necessary corrections, a stable monetary union cannot be based on such an abrupt mechanism.

So what would a stable monetary union look like? Clearly, some euro area countries have not fully adapted to the fact that they lost the option of currency devaluation to restore competitiveness. If they had, they would have increased their flexibility and growth potential by reforming labour and product markets. Given the spillover effects of postponed structural reforms on the functioning of EMU, these reforms cannot be the sole responsibility of the governments concerned, but should also have a 'European' dimension. This can take different forms.

One way could be to strengthen the macroeconomic imbalances procedure by increasing its focus and enforceability. This could be done, for instance, by introducing more reversed Qualitative Majority Voting. Another way would be to introduce minimum standards or best practices in policy areas where spillovers have turned out to be especially high, such as labour market policies. Importantly, what should be avoided is harmonisation towards some kind of EMU average, as this would incite strong countries to reduce their competitiveness.

A second way forward is for debt ratios to be gradually brought well below the ceiling of 60% of GDP. This lower debt ratio can only be realised and maintained through independent enforcement of the European fiscal rules and by anchoring these rules in national legislation. We need an independent European authority that can intervene in the fiscal policy of countries breaking the agreements.

If – and only if – these conditions have been met, mutualised borrowing arrangements for EMU governments through Eurobonds could be a serious option. Eurobonds could enhance the stability of EMU in several ways. They would prevent a liquidity problem in one euro area country from needlessly transforming into a solvency problem. Moreover, they could provide a firewall against the danger of contagion.

Although Eurobonds are not suitable as a crisis instrument, they could be the light at the end of the tunnel for the citizens of vulnerable euro area countries. The citizens in those countries need to feel that their sacrifices will contribute to a permanent solution – and this must be one that safeguards them against the short-sightedness of both markets and politicians.

Looking ahead – 2012 diary dates

3rd OMFIF Meeting in Europe
Deutsche Bundesbank
The World Economy at a Turning Point
14-15 March, Frankfurt

The ECB and its Balance Sheet
Panel discussion
28 March, Reform Club, London

1st OMFIF Reserve Managers' Seminar
Roundtable and Lunch
30 March, Painter's Hall, London

EMU's Future – 20 years after Maastricht
Golden Series, Lecture and Lunch
26 April, Armourers' Hall, London

Lecture with Patrick Honohan,
Governor, Central Bank of Ireland
8 May, Armourers' Hall, London

2nd Deutsche Bundesbank – OMFIF
Economists Club
Roundtable and dinner
30 May, King's College London

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

Out-of-EMU diversification

Germany, Poland integrate with non-Europe

Paweł Kowalewski and Zuzanna Gromiec, National Bank of Poland

Analysis of German and Polish trade trends yields some intriguing signals about the relative importance of economic ties with European countries. Germany and Poland are diversifying trade away from the EU core towards higher-growth countries elsewhere, both in Asia and in Europe, with countries like Turkey and Russia leading the way.

One striking fact is that France may soon, possibly as early as next year, no longer be Germany's prime export market. Its place may be taken by China.

Prior to the start of economic and monetary union (EMU) and during its first few years, there was a widespread belief that the single currency would spur trade within the euro area. Germany was seen as the main beneficiary, as the euro was supposed to free domestic exporters from the upwards trend of the D-Mark and give them a higher European market share. In fact, with much of the euro area in the doldrums, German companies are successfully re-orientating exports towards non-European countries. If this tendency persists, this could have far-reaching repercussions for the EU as a whole. One striking fact is that France may soon, possibly by next year, no longer be Germany's prime export market. Its place may be taken by China.

A watershed year was 2009, when economies across Europe (with the exception of Poland) were in sometimes massive decline, driven by large-scale contraction of foreign trade. In a list of Germany's top 50 export markets, sales declined to all countries with the exception of China, where economic robustness succeeded in generating an increase of almost 10% in demand for German products. Exports to France, in contrast, fell 13%. The runner-up was India, where German exports fell by 0.7%.

The list of other reasonably resilient economies (where the contraction in 2009 was below 10%) provides a further indication of where German exporters are making most efforts. Sales to Egypt, Iran, Australia, Saudi Arabia, Singapore, Hong Kong, Korea and Israel held up relatively well, while the only European country where German exports fell less than 10% was Switzerland. China's rise in the export market stakes has been unstoppable. In 2009 it increased from 11th to 8th place for German exports. It then became No. 5 and, if the momentum is preserved, by 2013 China will have displaced France as the key recipient of German exports. Moving up the league table fast have been the other BRIC countries – Russia, where German exports have risen by more than 66% in the last two years, Brazil (up 53%) and India (up 34%).

Data for the last two years – as well as telling the familiar story about increasing exports to the so-called BRIC states, the Middle East and Asia – show another region is gaining importance: Spanish-speaking Latin America, with Chile, Mexico and Argentina key performers. In 2010 and 2011, Chile and Argentina bought (on average) over 95% more from Germany than in 2009. The low starting base has an effect here, but a more established country, Mexico (the 27th most important recipient of German exports) registered a solid gain of almost 50% in the same period. Closer to home, a hefty exports increase of 73% to Turkey deserves attention, too.

Needless to say, Germany's increased sales to non-European countries took place at the expense of the EU. Germany's intra-EU-27 exports decreased from 65% of the total in 1999 to 60% in 2010. (And according to latest data the share fell further in 2011 to less than 60%) [See table on p. 21]. Taking the EU confined to the so-called old member states (EU-15), the relative fall is even more pronounced. At the time of launching EMU, the share of Germany's exports within the EU amounted to 57%. In 2010, this share fell below 50%.

One intriguing question is whether other countries in the region are following the German example. The Polish case offers some similarities. Central and eastern European economies underwent a massive shift in trade dependence from the East to the West following the Comecon trading bloc's demise after the Soviet Union broke down. Now, this trend is being partly reversed. Just after EMU was formed, in 2000, the EU-15 share in Polish

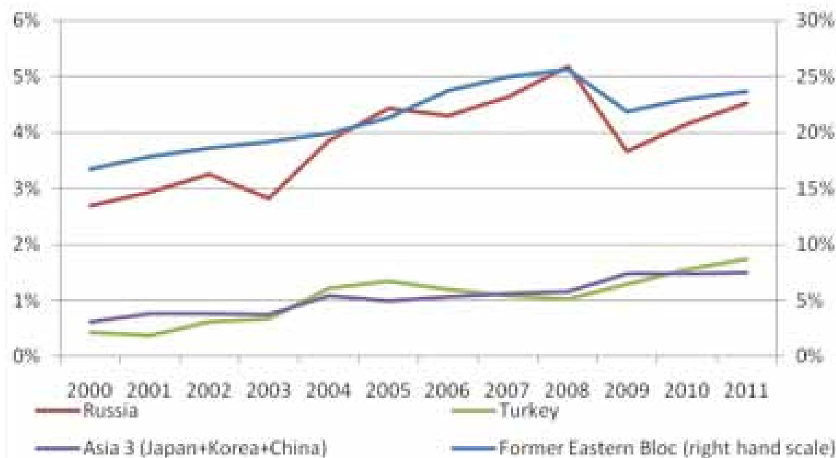
exports amounted to 70%, but this fell to less than 62% in 2011, while former Comecon states' share increased from 17% to 24% over the same period. In line with his trend, Polish exports to the Far East increased as well. The combined share of China, Korea and Japan more than doubled between 2000 and 2011, from 0.6% to 1.5%. Compared with Germany, there has been a still more spectacular relative increase in sales of Polish products to Turkey, with the share rising fourfold, from 0.4% in 2000 to 1.8% in 2011.

A reorientation in trade towards more dynamic regions outside the euro area and outside the EU core is inescapable.

Poland illustrates a wider trend. For the Czech republic, the share of exports to the euro area fell from 74% in 1999 to 66% in 2010. In the case of the whole EU, the decline was smaller: from 88% in 1999 to 84% in 2010. For Hungary, the decreases between 1999 and 2010 were even bigger. The euro area share declined 17 percentage points, to 56% in 2010, and the EU share went down 7 percentage points, to 77%.

A reorientation in trade towards more dynamic regions outside the euro area and outside the EU core is inescapable. Two contradictory trends are noticeable. On the one hand, with the German economy drifting away from a Euro-centric stance, voices may emerge questioning Germany's political commitment to maintaining European integration. On the other hand, this may, in a sense, represent a blessing in disguise, since the tapping of more propitious markets outside the euro area represents a chance of salvation for all members of the euro – not just Germany. Inevitably, though, such opportunities cannot be maximised unless Germany's neighbours follow its example by enacting appropriate reforms to restructure their economies and optimise their trading positions.

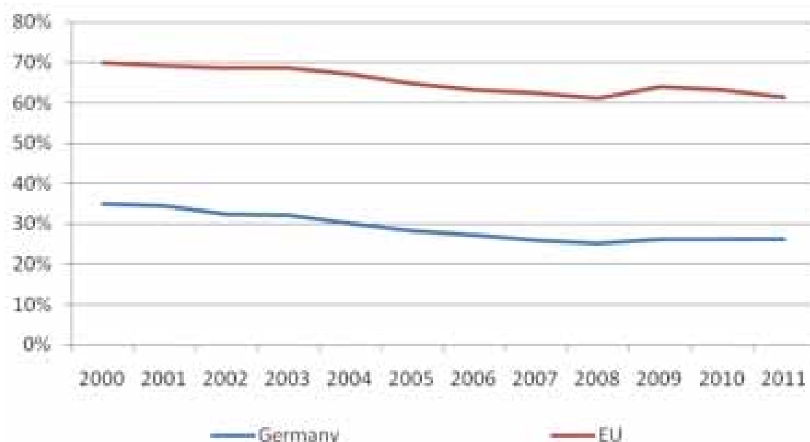
Polish exports to selected countries (shares in total exports)



Source: Eurostat.

Notes: Former Eastern Bloc comprises Russia, Romania, Czech republic, Hungary, Slovakia, Bulgaria, Lithuania, Estonia, Latvia, Belarus and Ukraine.

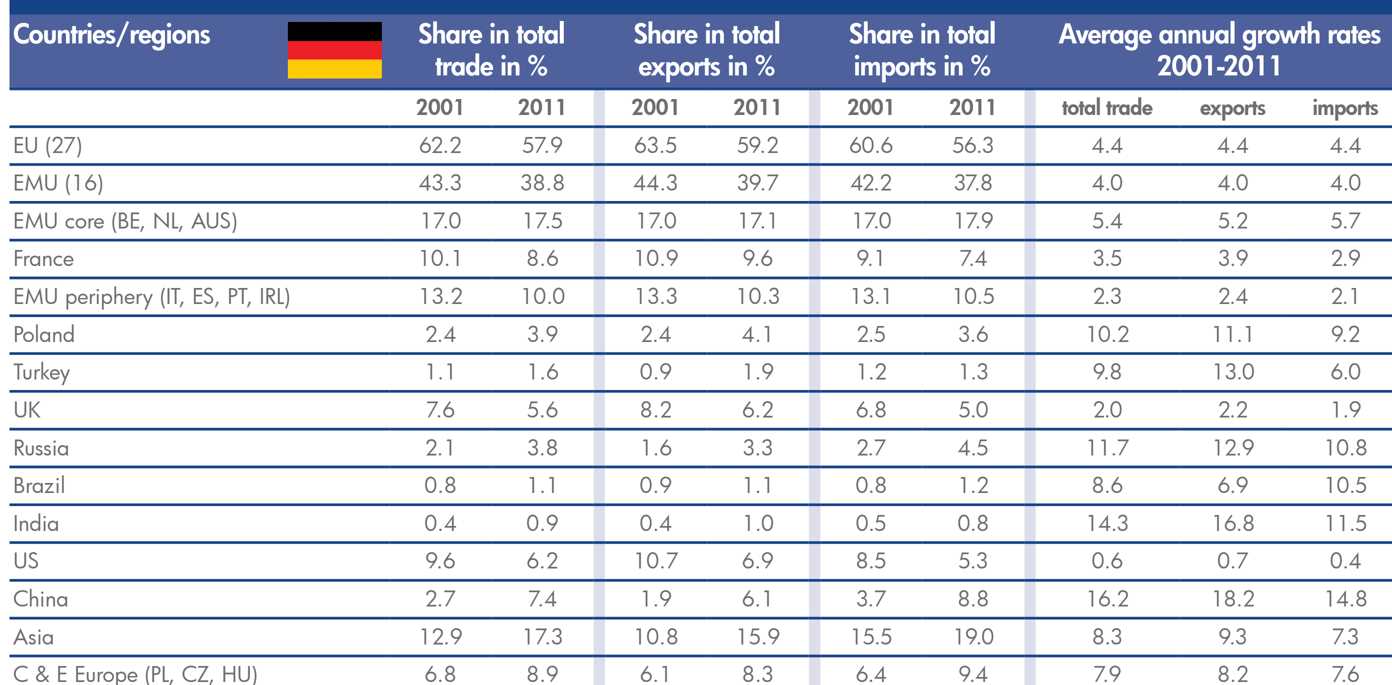
Share of Germany and EU-15 in Polish exports



Source: Eurostat.

Notes: EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

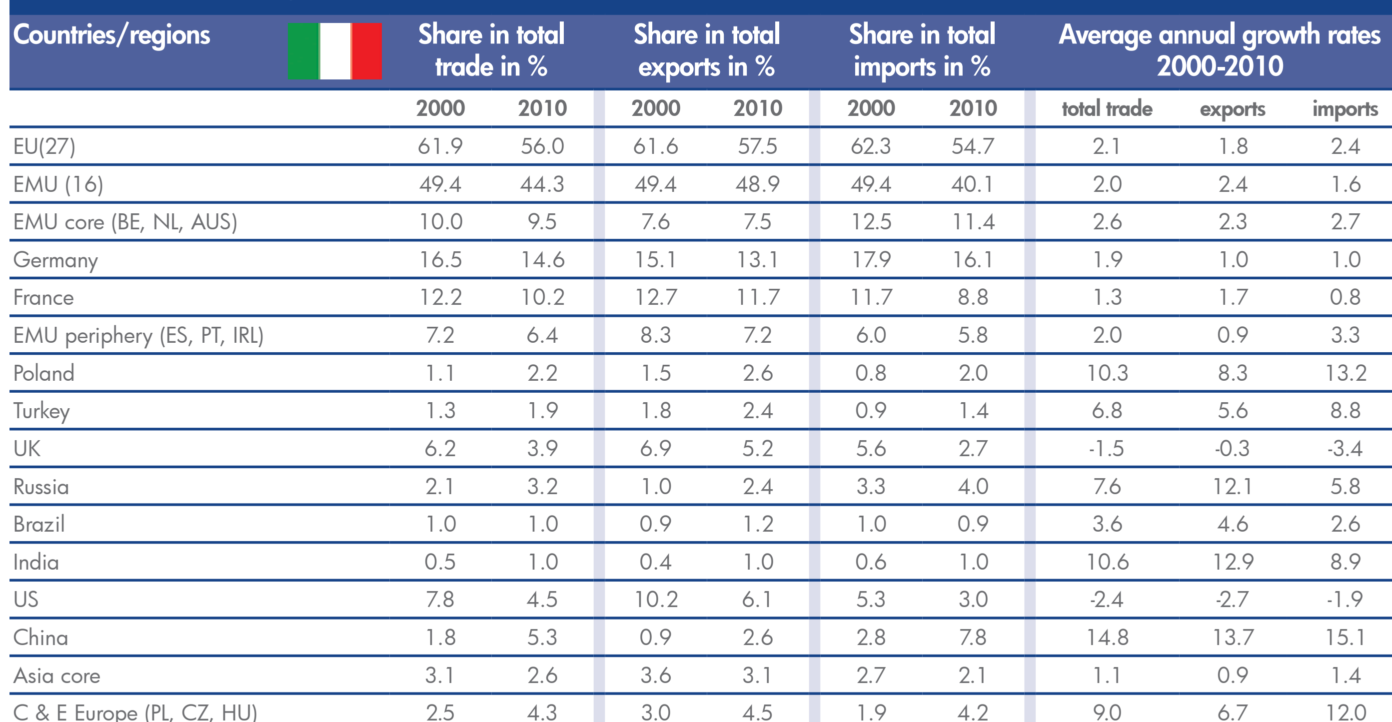
European trade trends



Structure of foreign trade: Germany

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2001-2011		
	2001	2011	2001	2011	2001	2011	total trade	exports	imports
EU (27)	62.2	57.9	63.5	59.2	60.6	56.3	4.4	4.4	4.4
EMU (16)	43.3	38.8	44.3	39.7	42.2	37.8	4.0	4.0	4.0
EMU core (BE, NL, AUS)	17.0	17.5	17.0	17.1	17.0	17.9	5.4	5.2	5.7
France	10.1	8.6	10.9	9.6	9.1	7.4	3.5	3.9	2.9
EMU periphery (IT, ES, PT, IRL)	13.2	10.0	13.3	10.3	13.1	10.5	2.3	2.4	2.1
Poland	2.4	3.9	2.4	4.1	2.5	3.6	10.2	11.1	9.2
Turkey	1.1	1.6	0.9	1.9	1.2	1.3	9.8	13.0	6.0
UK	7.6	5.6	8.2	6.2	6.8	5.0	2.0	2.2	1.9
Russia	2.1	3.8	1.6	3.3	2.7	4.5	11.7	12.9	10.8
Brazil	0.8	1.1	0.9	1.1	0.8	1.2	8.6	6.9	10.5
India	0.4	0.9	0.4	1.0	0.5	0.8	14.3	16.8	11.5
US	9.6	6.2	10.7	6.9	8.5	5.3	0.6	0.7	0.4
China	2.7	7.4	1.9	6.1	3.7	8.8	16.2	18.2	14.8
Asia	12.9	17.3	10.8	15.9	15.5	19.0	8.3	9.3	7.3
C & E Europe (PL, CZ, HU)	6.8	8.9	6.1	8.3	6.4	9.4	7.9	8.2	7.6

Germany increased its trade with the rest of the EU by an annual average 4.4% during the period 2001 - 2011, and with the EMU states by 4.0% – compared with 16.2% in the case of China

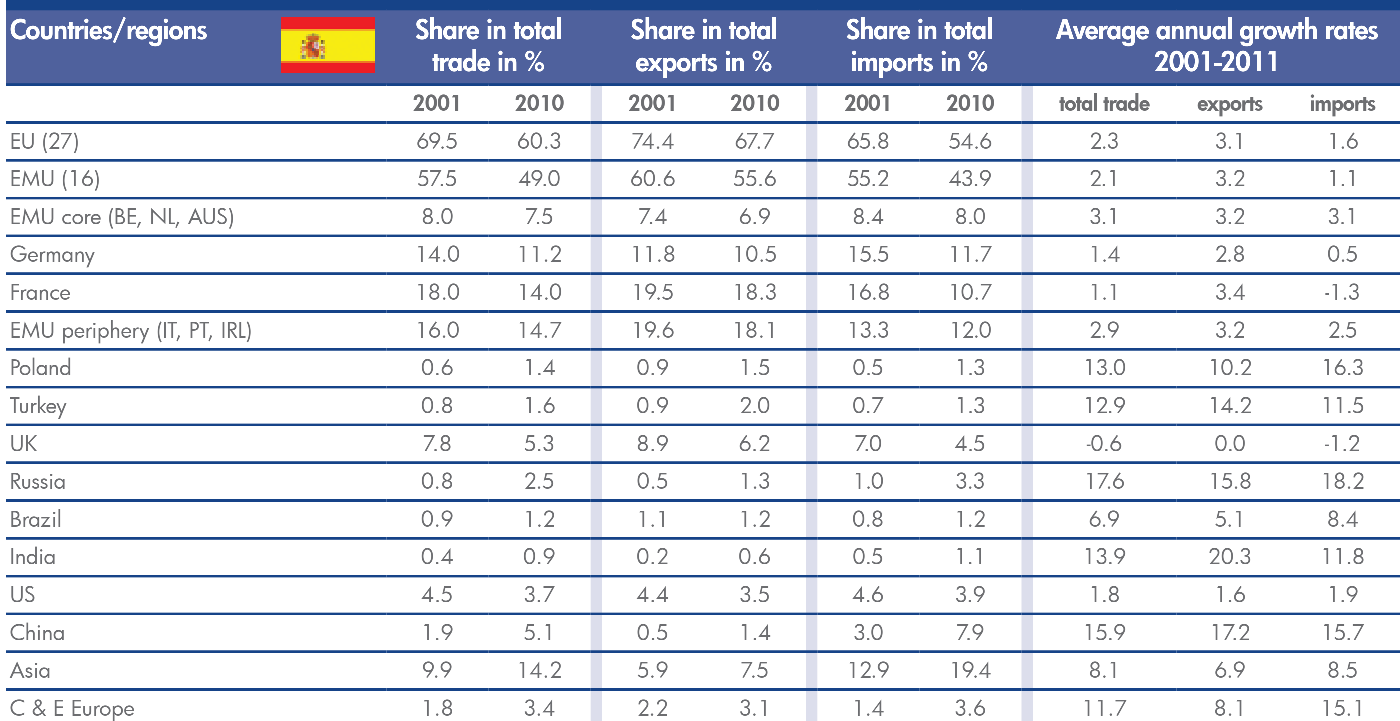


Structure of foreign trade: Italy

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2000-2010		
	2000	2010	2000	2010	2000	2010	total trade	exports	imports
EU(27)	61.9	56.0	61.6	57.5	62.3	54.7	2.1	1.8	2.4
EMU (16)	49.4	44.3	49.4	48.9	49.4	40.1	2.0	2.4	1.6
EMU core (BE, NL, AUS)	10.0	9.5	7.6	7.5	12.5	11.4	2.6	2.3	2.7
Germany	16.5	14.6	15.1	13.1	17.9	16.1	1.9	1.0	1.0
France	12.2	10.2	12.7	11.7	11.7	8.8	1.3	1.7	0.8
EMU periphery (ES, PT, IRL)	7.2	6.4	8.3	7.2	6.0	5.8	2.0	0.9	3.3
Poland	1.1	2.2	1.5	2.6	0.8	2.0	10.3	8.3	13.2
Turkey	1.3	1.9	1.8	2.4	0.9	1.4	6.8	5.6	8.8
UK	6.2	3.9	6.9	5.2	5.6	2.7	-1.5	-0.3	-3.4
Russia	2.1	3.2	1.0	2.4	3.3	4.0	7.6	12.1	5.8
Brazil	1.0	1.0	0.9	1.2	1.0	0.9	3.6	4.6	2.6
India	0.5	1.0	0.4	1.0	0.6	1.0	10.6	12.9	8.9
US	7.8	4.5	10.2	6.1	5.3	3.0	-2.4	-2.7	-1.9
China	1.8	5.3	0.9	2.6	2.8	7.8	14.8	13.7	15.1
Asia core	3.1	2.6	3.6	3.1	2.7	2.1	1.1	0.9	1.4
C & E Europe (PL, CZ, HU)	2.5	4.3	3.0	4.5	1.9	4.2	9.0	6.7	12.0

Italy increased its trade with the rest of the EU by an annual average 2.1% during the period 2000 - 2010, and with the EMU states by 2.0% – compared with 14.8% in the case of China

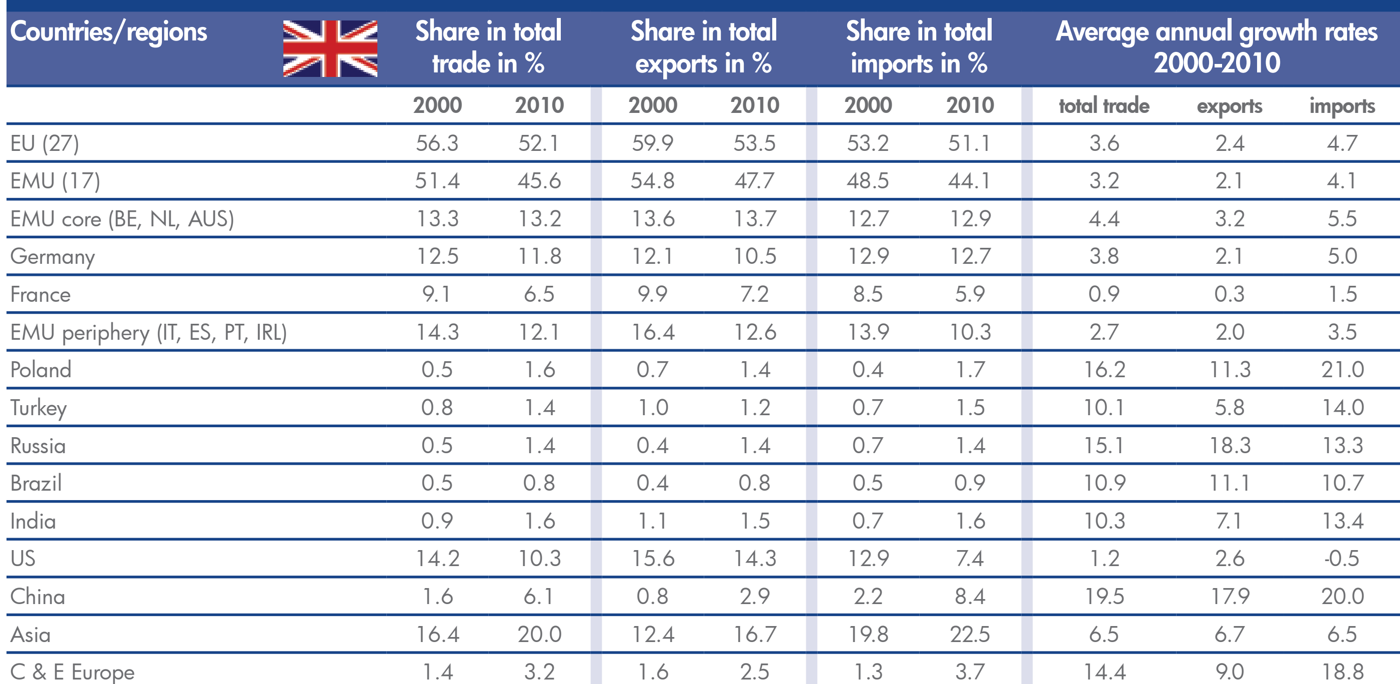
European trade trends



Structure of foreign trade: Spain

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2001-2011		
	2001	2010	2001	2010	2001	2010	total trade	exports	imports
EU (27)	69.5	60.3	74.4	67.7	65.8	54.6	2.3	3.1	1.6
EMU (16)	57.5	49.0	60.6	55.6	55.2	43.9	2.1	3.2	1.1
EMU core (BE, NL, AUS)	8.0	7.5	7.4	6.9	8.4	8.0	3.1	3.2	3.1
Germany	14.0	11.2	11.8	10.5	15.5	11.7	1.4	2.8	0.5
France	18.0	14.0	19.5	18.3	16.8	10.7	1.1	3.4	-1.3
EMU periphery (IT, PT, IRL)	16.0	14.7	19.6	18.1	13.3	12.0	2.9	3.2	2.5
Poland	0.6	1.4	0.9	1.5	0.5	1.3	13.0	10.2	16.3
Turkey	0.8	1.6	0.9	2.0	0.7	1.3	12.9	14.2	11.5
UK	7.8	5.3	8.9	6.2	7.0	4.5	-0.6	0.0	-1.2
Russia	0.8	2.5	0.5	1.3	1.0	3.3	17.6	15.8	18.2
Brazil	0.9	1.2	1.1	1.2	0.8	1.2	6.9	5.1	8.4
India	0.4	0.9	0.2	0.6	0.5	1.1	13.9	20.3	11.8
US	4.5	3.7	4.4	3.5	4.6	3.9	1.8	1.6	1.9
China	1.9	5.1	0.5	1.4	3.0	7.9	15.9	17.2	15.7
Asia	9.9	14.2	5.9	7.5	12.9	19.4	8.1	6.9	8.5
C & E Europe	1.8	3.4	2.2	3.1	1.4	3.6	11.7	8.1	15.1

Spain increased its trade with the rest of the EU by an annual average 2.3% during the period 2001 - 2010, and with the EMU states by 2.1% – compared with 15.9% in the case of China (and 17.6% in the case of Russia)

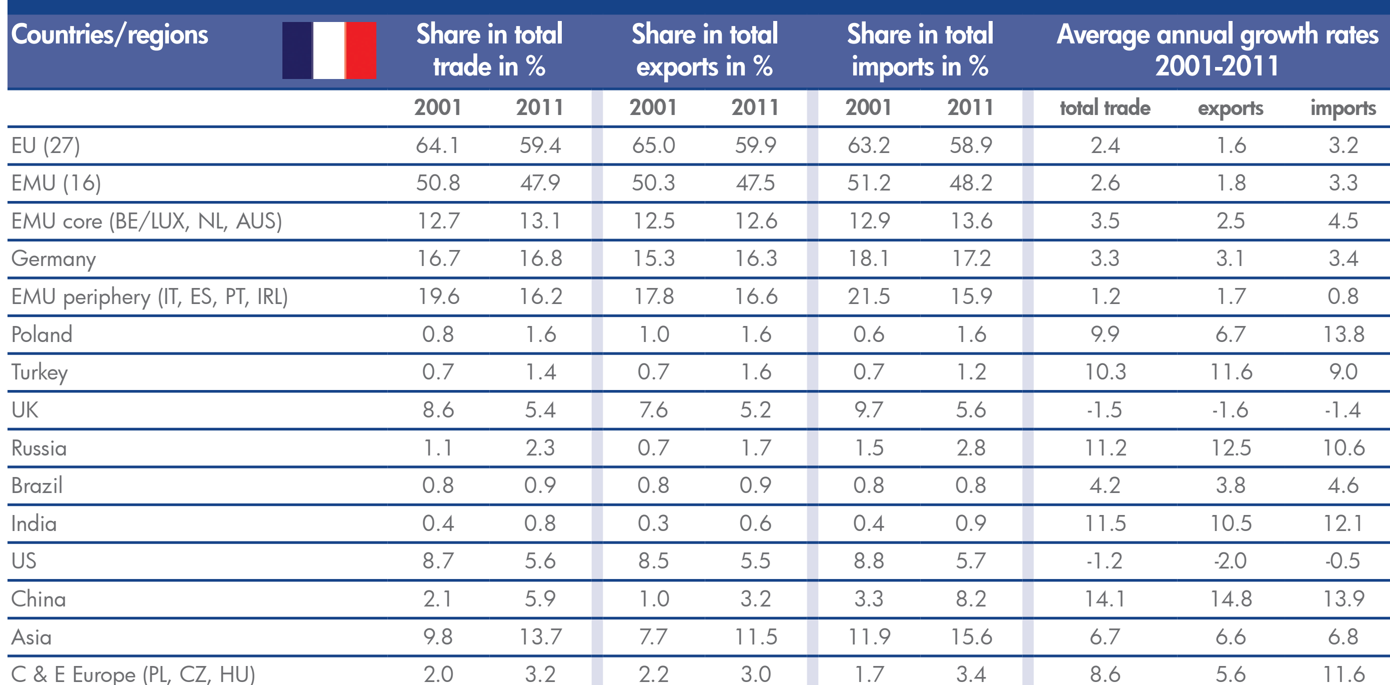


Structure of foreign trade: UK

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2000-2010		
	2000	2010	2000	2010	2000	2010	total trade	exports	imports
EU (27)	56.3	52.1	59.9	53.5	53.2	51.1	3.6	2.4	4.7
EMU (17)	51.4	45.6	54.8	47.7	48.5	44.1	3.2	2.1	4.1
EMU core (BE, NL, AUS)	13.3	13.2	13.6	13.7	12.7	12.9	4.4	3.2	5.5
Germany	12.5	11.8	12.1	10.5	12.9	12.7	3.8	2.1	5.0
France	9.1	6.5	9.9	7.2	8.5	5.9	0.9	0.3	1.5
EMU periphery (IT, ES, PT, IRL)	14.3	12.1	16.4	12.6	13.9	10.3	2.7	2.0	3.5
Poland	0.5	1.6	0.7	1.4	0.4	1.7	16.2	11.3	21.0
Turkey	0.8	1.4	1.0	1.2	0.7	1.5	10.1	5.8	14.0
Russia	0.5	1.4	0.4	1.4	0.7	1.4	15.1	18.3	13.3
Brazil	0.5	0.8	0.4	0.8	0.5	0.9	10.9	11.1	10.7
India	0.9	1.6	1.1	1.5	0.7	1.6	10.3	7.1	13.4
US	14.2	10.3	15.6	14.3	12.9	7.4	1.2	2.6	-0.5
China	1.6	6.1	0.8	2.9	2.2	8.4	19.5	17.9	20.0
Asia	16.4	20.0	12.4	16.7	19.8	22.5	6.5	6.7	6.5
C & E Europe	1.4	3.2	1.6	2.5	1.3	3.7	14.4	9.0	18.8

The UK increased its trade with the rest of the EU by an annual average 3.6% during the period 2000 - 2010, and with the EMU states by 3.2% – compared with 19.5% in the case of China

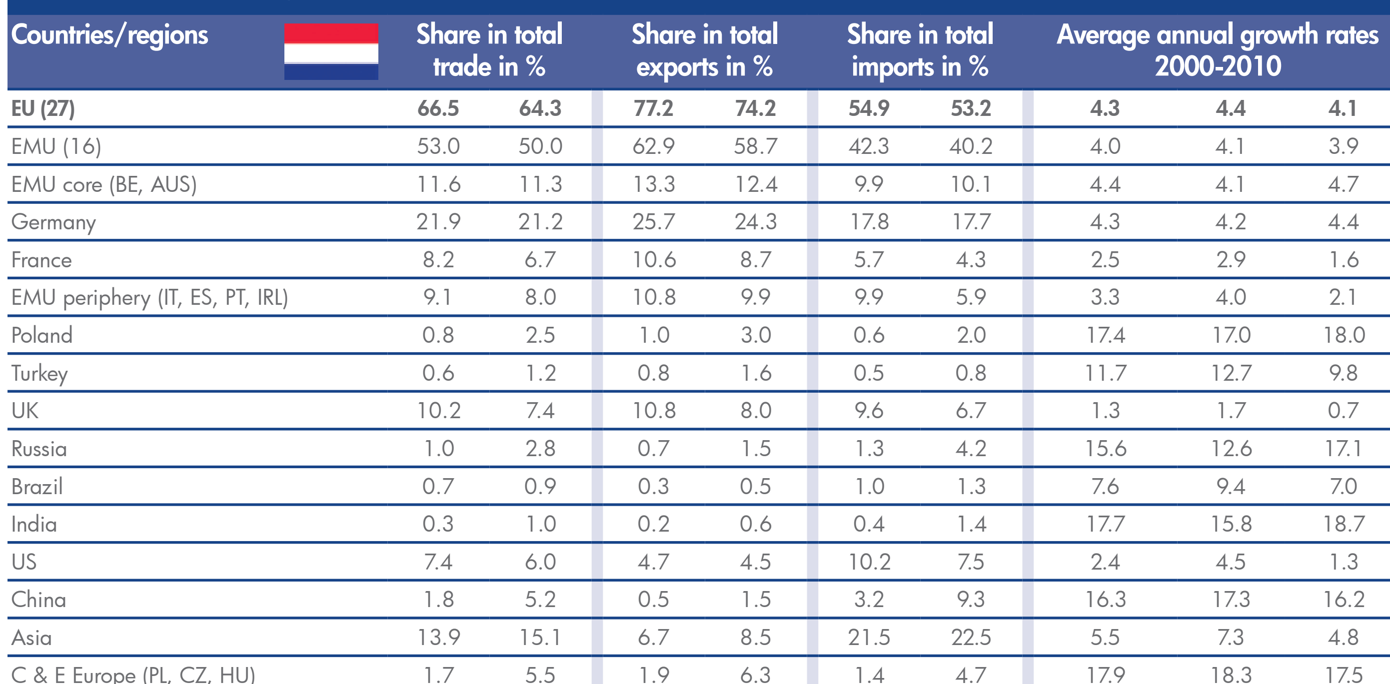
Please note that apparent discrepancies in average annual growth rates of trade in the past decade compared with the data in similar charts in the OMFIF Bulletin of March 2011 reflect base year effects as well as changes in methodology and data revisions.



Structure of foreign trade: France

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2001-2011		
	2001	2011	2001	2011	2001	2011	total trade	exports	imports
EU (27)	64.1	59.4	65.0	59.9	63.2	58.9	2.4	1.6	3.2
EMU (16)	50.8	47.9	50.3	47.5	51.2	48.2	2.6	1.8	3.3
EMU core (BE/LUX, NL, AUS)	12.7	13.1	12.5	12.6	12.9	13.6	3.5	2.5	4.5
Germany	16.7	16.8	15.3	16.3	18.1	17.2	3.3	3.1	3.4
EMU periphery (IT, ES, PT, IRL)	19.6	16.2	17.8	16.6	21.5	15.9	1.2	1.7	0.8
Poland	0.8	1.6	1.0	1.6	0.6	1.6	9.9	6.7	13.8
Turkey	0.7	1.4	0.7	1.6	0.7	1.2	10.3	11.6	9.0
UK	8.6	5.4	7.6	5.2	9.7	5.6	-1.5	-1.6	-1.4
Russia	1.1	2.3	0.7	1.7	1.5	2.8	11.2	12.5	10.6
Brazil	0.8	0.9	0.8	0.9	0.8	0.8	4.2	3.8	4.6
India	0.4	0.8	0.3	0.6	0.4	0.9	11.5	10.5	12.1
US	8.7	5.6	8.5	5.5	8.8	5.7	-1.2	-2.0	-0.5
China	2.1	5.9	1.0	3.2	3.3	8.2	14.1	14.8	13.9
Asia	9.8	13.7	7.7	11.5	11.9	15.6	6.7	6.6	6.8
C & E Europe (PL, CZ, HU)	2.0	3.2	2.2	3.0	1.7	3.4	8.6	5.6	11.6

France increased its trade with the rest of the EU by an annual average 2.4% during the period 2001 - 2011, and with the EMU states by 2.6% – compared with 14.1% in the case of China



Structure of foreign trade: Netherlands

Countries/regions	Share in total trade in %		Share in total exports in %		Share in total imports in %		Average annual growth rates 2000-2010		
EU (27)	**66.5**	**64.3**	**77.2**	**74.2**	**54.9**	**53.2**	**4.3**	**4.4**	**4.1**
EMU (16)	53.0	50.0	62.9	58.7	42.3	40.2	4.0	4.1	3.9
EMU core (BE, AUS)	11.6	11.3	13.3	12.4	9.9	10.1	4.4	4.1	4.7
Germany	21.9	21.2	25.7	24.3	17.8	17.7	4.3	4.2	4.4
France	8.2	6.7	10.6	8.7	5.7	4.3	2.5	2.9	1.6
EMU periphery (IT, ES, PT, IRL)	9.1	8.0	10.8	9.9	9.9	5.9	3.3	4.0	2.1
Poland	0.8	2.5	1.0	3.0	0.6	2.0	17.4	17.0	18.0
Turkey	0.6	1.2	0.8	1.6	0.5	0.8	11.7	12.7	9.8
UK	10.2	7.4	10.8	8.0	9.6	6.7	1.3	1.7	0.7
Russia	1.0	2.8	0.7	1.5	1.3	4.2	15.6	12.6	17.1
Brazil	0.7	0.9	0.3	0.5	1.0	1.3	7.6	9.4	7.0
India	0.3	1.0	0.2	0.6	0.4	1.4	17.7	15.8	18.7
US	7.4	6.0	4.7	4.5	10.2	7.5	2.4	4.5	1.3
China	1.8	5.2	0.5	1.5	3.2	9.3	16.3	17.3	16.2
Asia	13.9	15.1	6.7	8.5	21.5	22.5	5.5	7.3	4.8
C & E Europe (PL, CZ, HU)	1.7	5.5	1.9	6.3	1.4	4.7	17.9	18.3	17.5

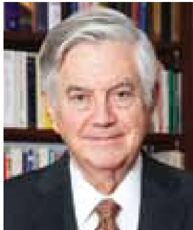
The Netherlands increased its trade with the rest of the EU by an annual average 4.3% during the period 2000 - 2010, and with the EMU states by 4.0% – compared with 16.3% in the case of China (and 17.7% in the case of India)

Source DZ Bank Economics Department

Laurens Jan Brinkhorst, Willem van Hasselt and David White join Advisory Board

Three new members have joined the OMFIF Advisory Board. They are Laurens Jan Brinkhorst, former Dutch Minister of Economic Affairs and Minister of Agriculture, now Professor in International and European Law and Governance at Leiden University; Willem van Hasselt, EU strategy advisor at the Netherlands Ministry of Foreign Affairs, former head of EC Development Cooperation and liaison to the Dutch EU Permanent Representation in Brussels; and David White, former senior journalist at the Financial Times of London, who in more than 30 years at the FT was foreign correspondent in Brazil, France and Spain before becoming Africa Editor. They take membership of the board to 87. (Further members are listed on p.26)

PUBLIC POLICY

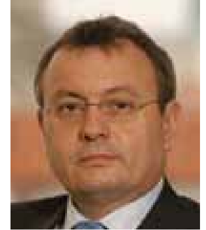

Frits Bolkestein

Laurens Jan Brinkhorst

Neil Courtis

Natalie Dempster

Willem van Hasselt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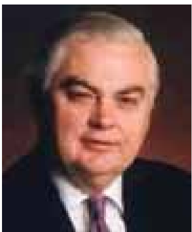
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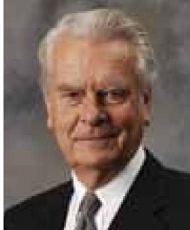
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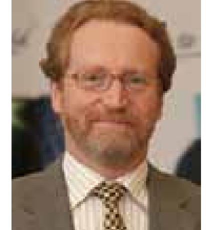
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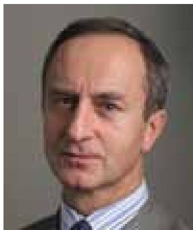
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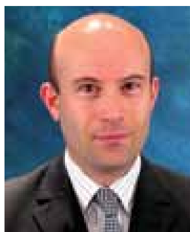
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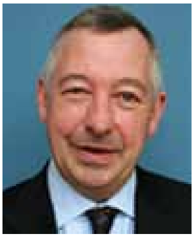
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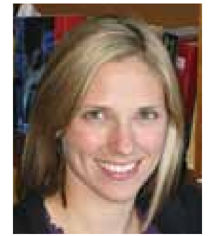
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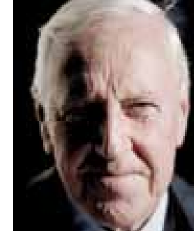
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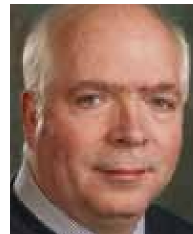
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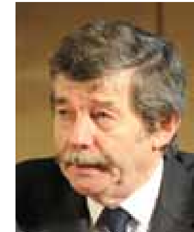
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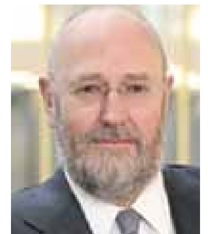
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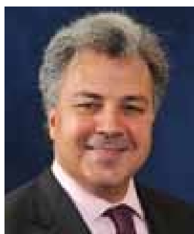
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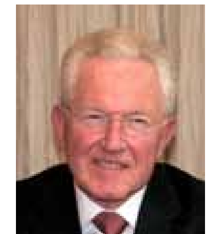
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Data summary of US activity

Chart 1: Final sales to domestic purchasers (annual % change)

Chart 2: Chicago Fed national activity index

Chart 3: Divisia M4 (annual growth rate)

Chart 4: US weekly leading index

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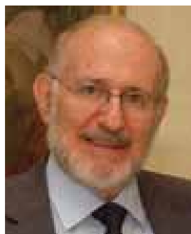
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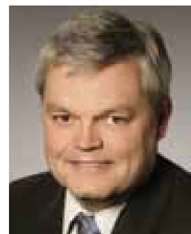
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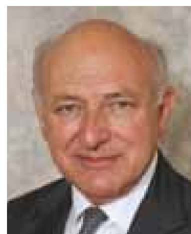
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Little sign of rosy future

Data charts signal bad news in US and Europe

Steve H. Hanke, Advisory Board

Aggregate demand in the US, as measured by nominal final sales to domestic purchasers (FSDP), has trended at an annual rate of 5.1% since 1987 (see the accompanying chart). There have been ups and downs, with three demand bubbles occurring when Alan Greenspan was Federal Reserve chairman. The most dramatic collapse in aggregate demand occurred after the panic of 2008. Although FSDP has rebounded sharply from its low in the second quarter of 2009 [see Chart 1 on p.26], it is growing at a below trend rate, suggesting that the US is in a growth recession.

This picture is confirmed by the Federal Reserve Bank of Chicago's National Activity Index. The index is a weighted average of 85 monthly indicators. A value of zero signals that the economy is growing in line with long-term trends. Positive and negative readings signal above and below trend growth rates, respectively. As Chart 2 shows, the US economy is struggling.

Broad money growth (or lack thereof) explains why the US economy is flat. The best metric for US broad money is the Divisia M4 measure. [See Chart 3.] Unlike conventional money supply measures that represent the simple sum of the components of the money supply (with each component carrying an equal weight), the Divisia metric assigns a weight to each component. The weights are a function of the usefulness that each component of the money supply possesses as a medium of exchange. So currency, travellers' checks and demand deposits receive a relatively high weight, whereas institutional money market funds receive a relatively low weight.

The money supply growth rate, while no longer contracting as it did after the panic of 2008, is barely growing. It's no surprise that the economy is treading water.

And the future doesn't look very rosy. If we look at the weekly leading index for the US, it's not signaling 'boom', but weakness and another recession. [See Chart 4.] And this just isn't any leading index. It is the one produced by the Economic Cycle Research Institute, an organisation founded by one of the fathers of leading indicators, Dr. Geoffrey H. Moore. The institute correctly predicted the beginning and end of the last recession, and that, over the past 15 years, it has spotted the onset of each recession, with no false alarms.

What happens in the US and elsewhere will be conditioned by what occurs in Europe. Using the simple sum M3 broad money measures for selected European countries and the euro area (Divisia measures aren't publicly available), the picture is grim. Indeed, the money supply is contracting in Spain, Portugal and Italy; it's collapsing in Greece; and it's barely growing for the entire euro area. This suggests that a deflationary slump is in the cards for Europe. Accordingly, we shouldn't be surprised that the premier business cycle research institute in America is signaling more trouble ahead for the US economy.

Broad money growth (or lack thereof) explains why the US economy is flat. The money supply growth rate, while no longer contracting as it did after the panic of 2008, is barely growing.

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Monetary backtracking in Tokyo

Structural changes bring burdens for Bank of Japan

Junko Nishioka, RBS Tokyo

The earthquake and tsunami that struck Japan in March 2011 have brought large-scale structural changes for the Japanese economy. These long-term effects include increased energy costs, the possibility of a permanent decline in the current account surplus, and increased issuance of Japanese government bonds (JGBs) that pose a threat to interest rates. All this poses heavy burdens for the Bank of Japan (BoJ), which has recently had to backtrack on its tough credit policy and usher in easier money, part of a world-wide trend that links Frankfurt, Washington, London and Beijing.

In view of the lack of political consensus on fiscal consolidation, further increases in the BoJ balance sheet seem inevitable, at least in the shorter-term.

For the time being, JGB yields remain very low, around 0.98% for 10-year paper, almost half the US treasury yield, greatly helped by the BoJ's expansion of easy monetary policy. Economic prospects for the next few quarters are relatively bright. Fourth quarter 2011 GDP was down 2.7%, owing to the negative contribution of net exports, but domestic demand is quite strong.

Delayed implementation of disaster reconstruction worth Y6.7tn, already funded by 2011 supplementary budgets, will boost the economy, justifying upward pressure on JGB yields. Furthermore, credit rating agencies may downgrade Japan's sovereign rating if the government fails to fulfil planned consumption tax hikes in 2014 (from 5% to 8%) and 2015 (from 8% to 10%).

Against this, the BoJ's decision to accelerate JGB purchases by Y10tn under the asset purchase programme seems to have lowered market fears of a rise in the risk premium. Already before the decision on 14 February, the BoJ had room for JGB buying as it had not breached the existing programme's upper limit. The BoJ's proactive stance has intensified market hopes that the BoJ will sustainably support the JGB market through what amounts to monetary financing. Fiscal consolidation will be required eventually to maintain stability. However, in view of the lack of political consensus on this issue, such a goal still seems a long way off, so further increases in the BoJ balance sheet seem inevitable, at least in the shorter-term.

Among the various difficulties besetting the BoJ, the change in the energy environment is one of the most intractable. The switch in generation towards thermal power rather than atomic sources has increased energy costs for industry. The efforts to secure supplies of liquefied natural gas add further to cost pressures. Although important parts of industry have called for reactivation of Japan's nuclear plants, the government doesn't seem able to influence public opinion in this regard ahead of the planned suspension of operations of the country's 54 nuclear power plants by the end of April.

Another highly important issue is the worsening current account balance. Driven by improved international competitiveness and the expansion of Asian economies, Japan has enjoyed ample trade surpluses over the last 40 years. Also, building external investments through energetic foreign investments and M&A activities have contributed to strong receipts from overseas earnings. These incomes, rolled into the Japanese banking sector, along with growing precautionary domestic savings have enabled smooth take-up of ballooning JGB issuance.

Signs of strain in the current account make the supply-demand balance for JGBs somewhat vulnerable. The Japanese trade deficit is likely to accelerate further, as exports are becoming less competitive, especially in Asian markets, and imports are rising. The surplus on Japanese companies' overseas earnings is shrinking compared with the trade deficit. Eventually, the effect of these changes should be a lower yen and/or a rise in government bond yields. The yen did in fact decline against major currencies in February, a big factor behind the change in course of the Nikkei index, which has gained 16% since January.

Benefits of diversification

Liquidity key for Asian bond markets

Hon Cheung, Advisory Board

The last 18 months have witnessed an upheaval in global fixed income markets. Partly because of circumstances in developed markets and the desire for yield, the appetite for Asian local currency debt has increased along with emerging market debt more broadly, but not to the extent one would expect for a market yielding 3.1% with an average credit rating of around AA-/A+. Asian bond markets provide a favourable contrast to the current concerns over the developed bond markets. Further progress can be expected in the future particularly in the areas of increasing liquidity, growth in local currency corporate bonds and the introduction of derivative contracts supporting the underlying bond markets.

While we face sovereign downgrades in developed markets, in Asia the trend has been towards an upgrading of sovereign credit ratings.

On the whole, international investors have mainly focused on developed markets, a tendency that is normally described as due to risk aversion. Given the view that risks across all kinds of advanced countries have in fact risen, a more accurate reason for investors' behaviour might be that they are showing liquidity preference. Liquidity of Asian bonds is indeed not as high as in developed markets, but, as a recent paper from the Bank for International Settlements showed, liquidity in the Asian local currency bond markets has improved significantly in the last few years.*

Liquidity can be a powerful motivator, but what of investors who do not need to express such a strong liquidity preference? What is the strategic case for Asian local currency debt? Some of the reasons are reasonably well known [see OMFIF Bulletin, November 2010, p. 13-15], for example, strong economic growth, moderate debt to GDP ratios, exposure to currencies that may revalue etc. But there are other attractive features.

First, Asian local currency bonds are, implicitly, asset-backed securities. Much government local currency debt in Asia is issued for sterilisation purposes, in an effort to reduce the growth of money supply that can result from capital inflows. In Asia (not including Japan), we estimate that $2.7tn of foreign reserves are implicitly linked to sterilisation bond claims. Since total Asian bonds outstanding (not including Japan) are around $5.5tn, this represents a 50% asset coverage from foreign reserves. This implicit asset backing crystallises when a foreign bondholder sells and repatriates its proceeds, or when a domestic bondholder sells and turns the proceeds into inflation-matched consumption.

Second, compared with sovereign downgrades in developed markets, in Asia, the trend has been towards an upgrading of sovereign credit ratings. For example, the credit rating for Indonesia was recently upgraded to investment grade earlier this year. There is an expectation that this credit convergence theme will continue.

Third, Asian local currency bonds continue to provide a significant diversifying force to reduce portfolio risk. For developed markets, economic and policy convergence has reduced the benefits associated with diversification into global bond markets. For an investor with a portfolio of German government bonds, adding US government bonds brings limited diversification, since the correlation between German and US bonds is around 0.77. In contrast, inclusion of Asian bonds into the portfolio of German bond is a significant diversifier, with a correlation between German and Asian bonds of 0.16. For all these reasons, international acceptance of Asian bond markets can be expected to show steady progress in the years ahead.

*Local currency bond markets and the Asian Bond Fund 2 Initiative - Eric Chan, Michael Chui, Frank Packer and Eli Remolona, BIS Papers No 63, January 2012

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US and Europe decouple

Liquidity injections improve worldwide investor outlook

Trevor Greetham, Advisory Board

Investors can stop panicking as soon as policy-makers start to, according to an old adage. The fourth quarter of 2011 provided a good illustration. A slowdown in global growth coupled with an existential crisis in the euro area threatened great harm to banks. Counterparty risk surged, stock markets plunged and investor sentiment indicators registered readings reminiscent of the Lehman failure. Central banks including the European Central Bank responded by flooding the world economy with liquidity. Fear turned into fear of missing out. Stock markets started 2012 on a very strong note.

After such a strong run-up, a correction in stock prices is inevitable but there is a good case for using any dip as an opportunity to buy equities. Political risks remain high in the euro area but the crisis could go into remission with a US-led recovery in global growth. We continue to favour US equities despite the European stock market's historical gearing to an improvement in global growth. The US and euro economies show their most pronounced divergence since the German reunification boom in the early 1990s. This time it's in America's favour.

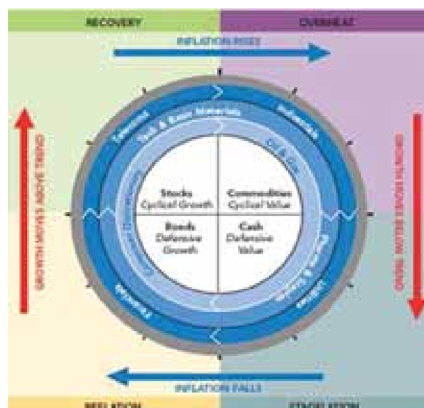
There is a good case for using any dip in stock prices as an opportunity to buy equities. Political risks remain high in the euro area but the crisis could go into remission with a US-led recovery in global growth under way.

For policy-makers, timely information allows them to counter incipient weakness promptly or to tighten pre-emptively. For institutional investors looking to protect capital or exploit opportunities on behalf of their clients, an early understanding of a new economic trend can make the difference between success and failure. Recognising turns in the business cycle as they happen is difficult but the rewards are high. The relative performance of the main asset classes is strongly linked to turns in global growth or inflation cycles that are often not obvious until much later given the time lags and revisions of economic data. This observation forms the basis of the Investment Clock approach that provides a fundamental framework for tactical decision-making.

Historical analysis underlines that different asset classes post their best returns at different stages of the cycle. Government bonds are best when growth is weak, inflation is falling and central banks are easing. Stocks do best when growth first recovers but spare capacity keeps inflation under control and policy loose. Commodities tend to take the lead once spare capacity is exhausted and central banks are raising rates. Cash is often the least bad option during stagflation, though oil and gold offer outsized returns during geopolitical supply shocks.

The Investment Clock diagram shows the same economic cycle drawn as a circle, highlighting the asset classes and equity sectors that have historically done best at each stage. At any point, the assets in the opposite corner have generally performed poorly, offering a natural funding source for tactical positions.

The Investment Clock



Source: Fidelity

This way of thinking about the economic cycle lines up with the sort of output gap analysis carried out by central banks. In both cases, identifying the current state of the economic cycle is the starting point for more detailed research. Like policy-makers, institutional investors are not interested in forecasts but in reality. We track indicators for growth and inflation over time in order to monitor the cycle as it evolves, a process that can be called 'Nowcasting'.

The second half of 2011 was a reflation phase, with global growth weak and inflation lead indicators pointing downwards. Central banks all over the world eased policy. The ECB was forced to implement its own version of quantitative easing, indirectly helping cash-strapped governments by way of massive three-year liquidity injections into euro area banks.

Liquidity does nothing to solve competitiveness or sovereign solvency problems but it does reduce the risk of a sudden bank failure. To the extent liquidity boosts growth, it could also help push the euro crisis back into remission by offsetting some of the effects of fiscal austerity. Fortunately, the ECB is not acting alone in this regard. The Federal Reserve and Bank of England are printing money, the Bank of Japan has doubled its asset purchase programme, the Chinese authorities are easing credit conditions and some central banks are fortunate enough to be cutting interest rates the old-fashioned way.

The wave of stimulus is taking effect. Our global growth scorecard turned positive in February for the first time since June 2011. A US economic recovery is under way and indicators of front end consumer demand are particularly encouraging. The Investment Clock is moving into the equity-friendly recovery phase.

This fundamental analysis is supported by technical factors. Financial markets are themselves an excellent real-time indicator of economic activity. We construct a risk asset momentum indicator which turned positive in early February, adding to the impression that the business cycle has troughed. The last few weeks have been a good time to buy equities and commodities in multi-asset funds, with these assets moving to overweight versus our benchmarks for the first time since July 2011. After such a strong run up a correction in stock prices is inevitable, but stocks tend to outperform bonds until the cycle peaks once more.

So when is the current economic upswing likely to peak? Over the last 40 years, upturns in the OECD's lead indicator for G7 industrial production have lasted an average of nine months. What makes us nervous is the fact that, at six months, the 2010-11 upturn was one of the shortest on record. A premature curtailment of central bank liquidity due to a rise in inflationary pressures could lead to another downswing in global growth and stock prices as we saw in the second half of 2011.

Geopolitical tensions have driven oil higher in recent weeks and some measures of break-even inflation are already approaching the levels of early 2011. However, the Federal Reserve's favoured five year, five year forward measure of inflation remains muted. With fiscal policy set to tighten everywhere in 2013, there is room for hope that central banks have learnt their lesson and will keep monetary policy loose.

Fed chairman Bernanke can point to the Fed's newly articulated 2% inflation target and the degree of slack in the US economy to justify looking through any short term rise in inflation. And FOMC members are now publishing their expectations for the long-term path of Fed Funds, so the Fed has both the motive and the means to signal continuing monetary support should the economy show signs of faltering.

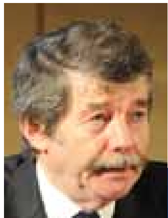
US equities still look more attractive than their European counterparts. Differences of emphasis over the importance of budgetary consolidation and the impact of the euro crisis on consumer and business confidence are creating the most pronounced economic divergence between the US and Europe since the German reunification boom in the early 1990s. US service sector confidence is robust, car sales are booming and home-builders report an increase in the traffic of potential buyers.

Unemployment claims are making new post-recovery lows. Meanwhile, euro area activity is sub-par, confidence in Spain and Italy is at recessionary levels and euro area unemployment has risen to a 15 year high. This in spite of a post-reunification low in the German unemployment rate.

German strength is a positive. A boost to wages in the North is a far more effective form of rebalancing than the misguided attempts to deflate the South into competitiveness. An improving global backdrop could further boost Germany and push the euro crisis into remission for a few months. However, austerity and political uncertainty will limit the upside for Europe's economies and any stock market outperformance is likely to be limited at best.

Time will tell whether America follows Europe into austerity after November's presidential elections. My suspicion and my hope is that by then the economic debate will have resolved itself in favour of continued fiscal support rather than the depressionary policies of default and deleveraging. Let the ratings agencies fume and bluster, truth will out.

A regular round-up on international monetary affairs



Learning (or not) from the past

A tortuous tale of Weber, Trichet and Draghi

William Keegan, Chairman, Board of Contributing Editors

The handover at the European Central Bank from Jean-Claude Trichet to Mario Draghi – and not to Axel Weber, who voluntarily withdrew from the race – has been accompanied by high drama and much controversy. But it merits, too, a little historical reflection.

Way back in the 1980s, when François Mitterrand's 1981-83 growth experiment fell foul of the financial markets, the French adopted a 'franc fort' policy. 'Keynesianism in one country' was deemed a failure, and Jacques Delors went off to Brussels to become a high profile and most effective champion of the proceedings leading to the eponymous Delors Report and, ultimately, the single currency.

I remember well the announcement of his appointment to the Commission. There I was, in the Bourgogne et Montana Hotel in Paris, ready to set off to interview the French finance minister, when Delors' office rang to say he had resigned.

Now, although the overwhelming motive for the speed with which the Maastricht treaty was signed and the euro inaugurated was political, those of us who followed these things closely knew that there were underlying economic motives too. The French saw the operation as a way of reining in the power of the Bundesbank – the common (in several senses) expression at the time was 'putting their fingers in the Bundesbank till.' And the Germans, while doing their best to ensure that those fingers would be squeezed, saw the opportunity to prevent Italy, in particular, and other EU countries from periodically devaluing to regain international price competitiveness.

One of the great ironies of subsequent developments was that, although the French fought hard for a French president of the ECB, when he was eventually allowed to take over, Jean-Claude Trichet – an official I have always liked and admired, while often dissenting over policy – 'went native'. He did not approach his duties in the way that the 'fingers in the till' brigade had hoped.

Nevertheless, in the face of the persistence of the financial crisis – which, via the collapse of confidence among financial market participants hastened the onset of the euro crisis – Trichet was accommodating enough to incur the displeasure of the then Bundesbank president about the way things were going. I myself have always suspected that Axel Weber is more of a Keynesian than he appears; yet the Bundesbank remains the Bundesbank.

The LTRO initiative has been criticised as a form of financial sticking plaster. This seems to me to have some validity. But real, unmetaphorical sticking plaster has saved the situation for most of us at some stage in our lives. It is not to be derided.

However, Trichet's accommodating approach was regarded by the markets as not accommodating enough, and it seems to have taken the remarkable LTRO initiative (long term refinancing operation) under his successor Draghi to prevent a serious credit crunch. There are those who say the work for this was under way before Draghi took over, but it is evident that he is being accorded the credit (as it were). Certainly, Draghi has impressed many with his championship of the LTRO cause.

But he has also aroused controversy. Frankly, the criticism that concerns me least is the widespread view that this hundreds of billions (in whatever currency you care to denominate it) refinancing operation is wildly inflationary. To my mind the spectre haunting Europe continues to be deflation and associated unemployment.

Which bring us to another criticism: that all the LTRO initiative has done is to counteract to some extent the collapse in the supply of money and credit brought about by the deleveraging of the banking system, but that it is essentially a form of financial sticking plaster.

This seems to me to have more validity. But I should emphasise that real, unmetaphorical sticking plaster has saved the situation for most of us at some stage in our lives. Sticking plaster, real or metaphorical, is not to be derided.

The problem is that sticking plaster only works for relatively minor damage, whereas the damage caused to the euro area by the combination of the financial crisis and monetary union's inherent contradictions is huge. To put it bluntly: those French fingers have become stuck in the Bundesbank till, and the inability of the Italians and others to devalue over the years has caused serious fractures in the entire system.

Policy has not been applied symmetrically, with the result that the deflationary bias persists, and the lack of competitiveness of the 'Club Med' is all too apparent. Monetary transfusions allow us to show that one lesson of the 1930s has been learned. But fiscal retrenchment under way across the euro area underlines that another has not. I fear not only for Europe's monetary union but also for the health of modern capitalism. ☐