OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

April 2012

These BRICS are made of straw

We must rely on US to pull us out of the mess

Meghnad Desai, Chairman, Advisory Board

The heady days of the early 21st century are over. The overblown claims attending the gathering of the so-called BRICS countries (Brazil, Russia, India, China, South Africa) in New Delhi on 28-29 March shows us one thing: the BRICS were once the future, but the dream has started to dissolve.

I am sorry to say it, but the tragic-comedy over the leadership of the World Bank, just as was seen last year with the International Monetary Fund, demonstrates that these BRICS are made of straw. We once thought the emerging economies would pull the global economy through its morass. But we are no more out of it than three years ago. The US will pull out of the mire, but no thanks to the BRICS. The euro area will stagnate. No one can help Europe unless it shows better leadership. We may well have to rely on the US, once again, to show its leadership qualities.

The world has to get back to fundamentals of economics and not expect political economy manoeuvres such as the BRICS construct to get us out of the mess. This means fiscal responsibility and good growth. The constant interplay of politics with economics may occasionally give us what masochists call fun, but it gets in the way of clear thinking. The notion that Brazil, Russia, China and India constitute a homogenous group is the result of a PR stunt by Goldman Sachs and its former chief economist Jim O'Neill.

Then they threw in South Africa, just to increase the heterogeneity. South Africa is not in the vanguard of African growth. It's there because of its size. To think this bunch can cohere is, well, not very coherent.

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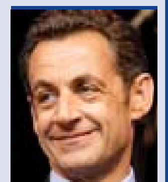
European Central Bank propelled into election fray

President Nicolas Sarkozy (right) and his main challenger, Socialist leader François Hollande, have propelled the ECB into the French election fray. Sarkozy said there should be 'no taboo' on the central bank supporting growth, while Hollande affirmed the ECB should have 'massively' bought government debt. Both statements will discomfort Germany. **SEE ARTICLE ON FRENCH ELECTIONS, P. 6,7.**



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Brazil headway

Real growth concerns

Vivienne Taberer, Investec

Brazil seems to be making some headway in what Guido Mantega, the country's combative finance minister, has termed 'an international currency war' over the disruptive depreciation of the dollar. The real has fallen to a 1.82 to 1.83 range against the dollar from the 1.70 level at which the authorities are prone to intervene to prevent the currency's undue appreciation.

However, the currency turnaround has itself been due to worries that Brazilian growth will tail off this year, triggered by confirmation of China's slowdown and speculation of fresh commodity price weakness that will cause general emerging market problems. Amid an intensification of Mantega's rhetoric in recent weeks, President President Dilma Rousseff complained directly to President Barack Obama in Washington on 9 April that accommodative US monetary policy was promoting currency 'manipulation' through a weak dollar.

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Letter from the chairman

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Monetary déjà vu
We have been here before

David Marsh, Co-chairman

A strong sense of déjà vu envelops the world economic and monetary scene. Europe is mired in wangles over high-sounding concepts of political sovereignty and plain old-fashioned dispensation of taxpayers' cash over the never-ending sovereign debt crisis. Emerging market economies are castigating the West, led by the US, for shamelessly following cheap money policies that raise the exchange rates of ostensibly stronger nations and thus drag them down to the same level.

Commonality between the so-called BRICS countries seems at a low ebb as, once again, the US pushes through its candidate (this time, just to be different, a Korean-American health expert) as head of the World Bank. And, in an election in France, candidates are battling for power with a selection of policies that are all diametrically opposed to those of its great partner, Germany. Surprise, surprise. Somehow, I believe we have been here before.

Meghnad Desai, expanding on the BRICS theme, calls the idea a Goldman Sachs public relations stunt and says it's time to recognise how different these nations are. Vivienne Taberer and Malan Rietfeld from Investec Investment Management ponder inflows into Brazil and ask whether foreign exchange intervention and draconian controls are the right way to curb the country's structural problems. Michael Kaimakliotis of Quantum Global Wealth Management looks at the intractable difficulties of economic and monetary union (EMU) and predicts that, whatever happens, years of pain are in store.

Jonathan Fenby sees a relatively smooth ride for the Chinese economy as it adjusts to a less volatile mix of higher domestic and lower foreign demand. Stefan Bielmeier asks what this means for Germany and concludes that the new balance in China could be good for German exports. Paul Betts analyses the French election and says it reminds him of the Tour de France. Roel Janssen examines signs of government instability in the Netherlands, a vital bulwark among the creditor nations of EMU. Darrell Delamaide investigates the impact of US unemployment on the Federal Reserve.

Andrew Large lists the lessons central banks and regulators have learned over macroprudential policies. We produce a short summary of the core OMFIF meeting at the Bundesbank in mid-March, including some intriguing charts. (Those who have not seen the full summary should contact the Secretariat). William Keegan brings us back to basics with an account of the tussle over the succession at the Bank of England. The winner, he says, will be the candidate with the fewest enemies. Plus ça change.

David Marsh

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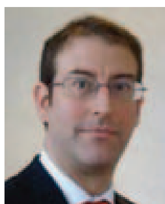

Built-in strife as Europe struggles

Two more years of opposition and pain lie ahead

Michael Kaimakliotis, Quantum Global Wealth Management

Resolution of the crisis in economic and monetary union (EMU) requires measures that will run into massive opposition, either in the deficit countries that are undergoing painful deflation, or in Germany, Europe's principal creditor. Unfortunately, necessary wrenching adjustments have only just started. Whatever happens, the euro area is confronted with the prospect of two more years of growing strife and tension.

Mario Draghi, the European Central Bank president, has suggested the worst of the crisis is over. But it will be resolved only when the factors which led to the build-up of large current account deficits in the southern periphery are eliminated. Resolution doesn't depend on reducing the debt burdens of countries like Greece which was already insolvent. This has been the (relatively) easy part.

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A lasting solution requires one of three alternatives. The first is that relative prices within Europe adjust to improve the competitiveness of the peripheral nations versus the North – primarily Germany. This requires either prolonged deflation in the periphery or inflation in Germany (possibly both.) The second option is that relative prices between the euro area and the rest of the world adjust to make the periphery (and indeed all of Europe) more competitive. This requires a large euro depreciation. If neither adjustment takes place, then only a perpetual transfer union will save EMU from disintegration.

The least costly outcome would be a combination of the first two alternatives, through deflation in the periphery, stronger wage growth in Germany and a weaker euro. As well as requiring citizens of peripheral countries to accept prolonged austerity, and the Germans (at least temporarily) to give up their aversion to inflation, it would be necessary for the ECB to out-print its counterparts in the US, Japan and even China.

I have maintained for some time that the citizens of the peripheral countries were likely to lose patience with austerity and eventually vote for regime-change. With unemployment rising and the peripheral economies mired in recession, the outlook remains bleak. Not only the risks of an Irish referendum No on the fiscal compact, and the possibility of a victory by François Hollande, the Socialist candidate, need to be borne in mind. In addition, the anti-austerity Independent Greeks party is gaining ground ahead of Greece's elections, Mario Monti's technocrat government in Rome faces mounting problems and prime minister Mariano Rajoy has already rebelled against the European Commission's budget deficit targets for 2012.

If the periphery accepts austerity, might Germany accept inflation? Germany's IG Metal trade union is doing its best to ignite wage-push inflation, demanding a 6.5% increase in pay this year. While unions normally settle for wage rises well below initial demands, this year could be different. Wages in Germany have lagged, unemployment has fallen sharply, and corporate profitability has rebounded strongly following the 2009 recession. Monetary policy may remain easy even if inflation starts to quicken in Germany, as policy-makers recognise that a little inflation could be healthy. Don't expect anyone to admit this publicly.

A depreciating currency is probably the least painful way for Europe to adjust. Yet policy-makers in the US (and Japan) would also welcome a weaker currency. Therefore, the race to the bottom could require more liquidity injections. Might Mario Draghi win the battle? In the US at least, the likelihood of further easing in the near term is actually quite low unless economic conditions deteriorate dramatically. The ECB, in contrast, may be pushed to ease liquidity if economic growth disappoints or sovereign spreads rise again. With available collateral at banks dwindling, the ECB may be forced to reduce collateral standards further: difficult, since standards have already fallen so far already. The climb to salvation will not be easy.

These BRICS are made of straw *(... continued from page 1)*

The BRICS were once Rapidly Growing Economies. The Southern Engines of Growth. The description is no longer apt. India has slowed down from its 8.5 %-plus growth rate to below 7 % and is going down. China has decided as a policy measure to go for 7.5 % rather than double digit figures. As for the other three, they do not even clear the 5 % bar.

So where do we see the BRICS' commonality? One aspect became clear at New Delhi: their anti-US foreign policy posture. On Iran, they don't like American bullying. On Syria, they are happy for President Assad to go on killing his people as long as the Americans are against him.

The one economic issue which came up is their intense dislike of quantitative easing, or a 'monetary tsunami' as Brazilian president Dilma Rousseff called it. The BRICS see it as an exchange rate war, shifting the developed economies' problems offshore. Indian prime minister Manmohan Singh complained about volatility in capital flows, though India's current problems are as much home-grown as due to QE.

The relevance of BRICS lies in the group's negative force. It thrives as long as the US is uncertain about its economic strength. The presidency of the World Bank has bubbled to the surface thanks to the persistent anomaly of the post-war settlement on the Bretton Woods institutions' leadership. At the IMF, a lukewarm coalition threw up a rival to Christine Lagarde but lost. Now with the World Bank presidency, President Obama has played a blinder, pushing through a Korean-American health expert Dr. Jim Yong Kim. The ploy is so clever, it's almost unfair.

With Jim Yong Kim's victory, US hegemony has been well and truly reasserted. After all, we now see the US at probably the weakest it has been in recent years. I predict the US will be back in good growth territory by mid-2013. The BRICS, on the other hand, will be struggling to prove they're anything more than an uncomfortably anti-US Cold War remnant.

As we all know, 'It's the Economics, Stupid!' The BRICS had a good run, but have now halted their onward march. China is having a difficult transition. We don't know whether there was an attempted coup by the friends of Bo Xilai, but the Maoists have always harboured opposition to liberalisation. Similar forces in India within the Congress Party have been inclined to obstruct economic reforms.

The BRICS as a group have passed their zenith. They don't provide the answer to the world economy's many unsolved problems. If you want leadership, don't grasp at straws.

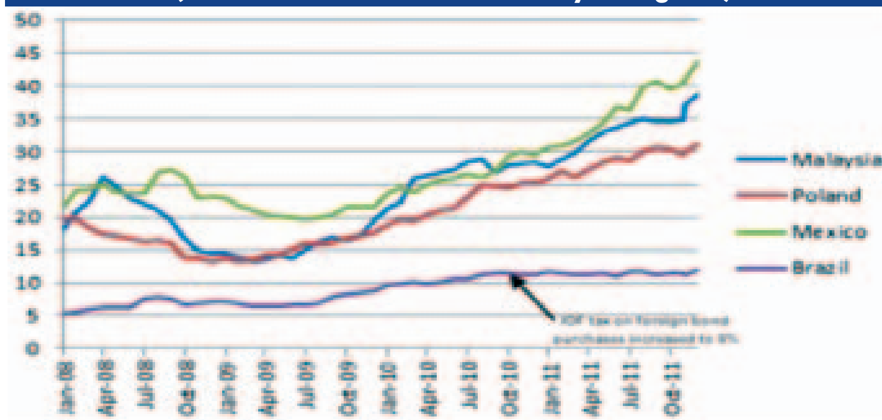
Brazil headway *(... continued from page 1)*

The war against the appreciation of the real waged by the Brazilian finance ministry and central bank consists of intervention in the currency markets (typically once the real breaches 1.70/$ mark) has been complemented with an increasingly complex and penal structure of macroprudential measures. This includes most notably the IOF tax on foreign debt purchases, aimed at stopping what the authorities perceive as a dangerous inflow of short-term capital.

Both Mantega and the president have reaffirmed that a strong currency hurts exports and that exchange rate policy is geared to boosting competitiveness. With very low interest rates in the main industrialised countries, inflows into the real have been generally boosted by high interest rates set to damp consumer price inflation, with the benchmark Selic rate remaining at 9.75% in recent weeks in spite of forecasts that it might be cut soon to 9%.

On the wider issue of the usefulness of Brazil's currency policy, Brazil arguably has the strongest case for intervention among the leading emerging market economies. Its currency is significantly overvalued on a real effective exchange rate basis.

Inflows into emerging market debt markets (Shares of domestic debt held by foreigners)



Source: Bank of America Merrill Lynch

The Brazilian authorities believe their measures are working. Comparing the non-resident holdings of Brazilian bonds to other emerging markets, it is evident that the increase in the IOF tax to 6% in October 2010 has curtailed foreign investment, particularly into the short end of the curve, at a time when foreign ownership soared in other emerging markets. The willingness of the Brazilian authorities to step into the market does have a material impact on the behaviour of currency and bond traders and investors. Trades in the currency market are no longer a one way bet, and bond market inflows in recent weeks have slowed to a trickle. But intervention clearly needs to be consistent with the underlying fundamentals and risks inherent in the market.

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Liberalisation moving forward

PBOC not in mood for credit easing

Jonathan Fenby, Board of Contributing Editors

The People's Bank of China (PBOC) has tamed inflation, at least for the time being, but China's central bank does not seem to see the need to swing towards major monetary easing. There was widespread expectation at the turn of the year that the People's Bank would move from the brake pedal to accelerator as the annual rise in consumer prices dropped below 4%. But easing, in the form of reductions in the reserve ratio requirement for banks, has been slow.

PBOC Governor says strength of China's banks means conditions are 'basically ripe' for moves towards interest rate liberalisation.

No loan target was set for this year at the Government's annual economic work conference in December and the new loan volume in the first two months of the year was less than anticipated. Meanwhile restrictions on the property market designed to curb speculation and bring down prices to make entry easier for first-time buyers remain in force. They are unlikely to be lifted until the second half of the year.

This is all part of a macroeconomic policy that is ready to accept growth below the runaway levels of 2010-11. The central government's annual target is now 7-8%. That is certainly in line with the desire to move to a more sustainable expansion pattern, avoiding the asset bubbles of China's boom years.

In its latest statement, the PBOC highlighted the need to keep prices stable, pledging 'prudent' monetary policies, while maintaining a 'reasonable' level of social financing. This is the measure enabling the authorities to keep tabs on the credit flow: bank lending, loans from trust companies, corporate bond issuance, equity fund-raising by non-financial companies. In February, it amounted to Rmb1.04 tn ($165 bn), up from Rmb 956bn in January, an increase of Rmb 391bn from a year earlier.

The question is whether this approach can be maintained if Chinese exports are hit by sluggish western demand and companies come under growing cost pressure especially from wage rises that are central to the government's efforts to boost consumption. The pressure for easing will rise if the data turn bearish. But the March purchasing managers' index (PMI) data showed a rise from February. That argues against excessive easing.

However talk of change is evident. Wang Yang, Communist party secretary of Guangdong, China's richest province, who is likely to be promoted to the Politburo standing committee at the party congress (probably in October or November) has been talking about the need for a new economic model less fixated on crude GDP growth. But poorer inland regions are still bent on major expansion. The fall of Bo Xilai, the formerly fast-rising star, is unlikely to slow the growth of his former bastion of Chongqing. This is because his political demise was the result of personal factors rather than the outcome of a policy dispute.

As the party congress nears, belief that changes are afoot is underscored by PBOC Governor Zhou Xiaochuan's statement that the strength of China's banks means that conditions are 'basically ripe' for moves towards interest rate liberalisation. He gave no timetable and, as always, progress is likely to be gradual. But, with the added spur of renminbi internationalisation, there is a clear recognition of the need for reform. Economist Li Daokui, who has just stepped down as a member of the PBOC's monetary committee, spoke in March of the state banks as 'dinosaurs' which can fend for themselves. 'Banks have high profits,' he said. 'We don't need to worry about protecting them.'

Hu Xiaolian, PBOC deputy governor, added to sense of movement by talking of establishing a deposit insurance system, a precondition for interest rate liberalisation, offering stability in the event of competition among banks. Higher payments for depositors would reverse the trend of negative interest rates and 'financial repression' of households which has marked China's growth. But it will all take time. One official spoke of a 15-year plan – and we are only in year one.

Poll takes anti-German tone

Shades of Mitterrand in election of extremes

Paul Betts, Board of Contributing Editors

The first round of the French presidential elections on 22 April will be eagerly watched for clues that could bring solutions to the European sovereign debt crisis. On present reading, it will make things worse. The campaign has been dominated by calls for an end to austerity and for a go-for-growth strategy that is anathema to Germany.

In an apparent re-run of the 1981 election that brought in President François Mitterrand with economic policies directly opposed to Germany's, whoever wins in the second round on 6 May is likely to be, economically, on a collision course with France's eastern neighbour. In many ways, the election is looking more and more like the Tour de France. Like the headline-grabbing cycling marathon, it has been full of surprises, provoked endless controversy in the media, and whipped up its fair share of scandal and sleaze. Furthermore, the outcome will be in suspense until the last moment.

The thrills and spills include the last-minute decision by President Nicolas Sarkozy to breach an agreement with his European allies by bringing the European Central Bank into the election campaign, calling for the ECB to adopt policies to support growth. Sarkozy's intervention underlines why the somewhat bizarre earlier plan for German chancellor Angela Merkel to join him on the election trail was conspicuously dropped. The campaign has highlighted differences rather than consensus between France and Germany on key economic themes.

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François Hollande, the Socialist candidate, who despite a Sarkozy revival is still favourite to win in the second round, has urged European leaders to add a 'growth annexe' to the newly-agreed (though not yet ratified) fiscal pact. This is supposed to impose budgetary discipline among members of economic and monetary union (EMU). Seemingly resigned to the prospect of an Hollande victory, Merkel seems to have accepted that, as a price for French ratification, some element of a 'growth strategy' needs to be built into the pact.

Two other leading candidates, Jean-Luc Mélenchon on the far Left, whose meteoric rise has been real surprise of the campaign, and Marine Le Pen on the far Right, who has been fading, both offer diametrically anti-EMU policies. Mélenchon is a latter day equivalent of Georges Marchais, the outspoken French Communist leader who helped Mitterrand win 31 years ago.

One big difference with the Tour de France is that the campaign has not provoked the same popular enthusiasm. The latest opinion polls suggest a record number of blank votes in the first round with around one third of the electorate abstaining. Other polls suggest that, for all the candidates' heady rhetoric, about 66% of voters are simply not interested.

Initially, Sarkozy's chances of re-election looked practically non-existent. Hollande looked set to dominate the race from start to finish with the commanding presence of US cycling star Lance Armstrong. But Sarkozy never gave up, launching a spirited and aggressive campaign against Hollande and assuming a more stridently populist (and anti-European) stand to outflank Le Pen. And so, like the legendary cyclist Jacques Anquetil, he started climbing back the slope. Some polls now suggest that Sarkozy could win the first round although the incumbent still trails Hollande by a significant 8 to 10 points in the second round.

Sarkozy continues to portray his socialist rival as a ditherer, a dreamer, and a man without the necessary presidential clout to handle a crisis, be it economic or social. He is no reformist in the mould of former German chancellor Gerhard Schröder, Sarkozy keeps thundering. Last month's shootings in south-west France provided Sarkozy with a platform to display leadership qualities. For a week or so, this boosted his poll ratings.

Often sounding like an opposition politician rather than the man who has been in charge for five years, Sarkozy has won support with a policy line on Europe that increasingly challenges German-style orthodoxy. At a rally in Paris on 15 April, Sarkozy said ECB support for growth was 'a question we cannot avoid.' Signalling the end of a pact agreed in November with Merkel and Italian prime minister Mario Monti not to place the ECB under overt pressure, Sarkozy declared truculently: 'We cannot have taboo subjects.'

Jean Pierre Jouyet, head of the AMF, the French financial market regulator, has emerged as a pivotal figure. If Hollande wins, Jouyet may play a crucial role in a new Socialist administration or as secretary general at the Elysée Palace.

Placing himself in the vanguard of those who had shored up EMU during the gruelling crisis of the past two years, and reinforcing his criticism of free-market liberalism, Sarkozy enshrined long-running Franco-German differences. 'If the central bank does not support growth, there will not be enough growth. I know the difficulties that surround this subject but we have the duty to reflect on it because it is a major problem for the future of Europe.'

Jean-Luc Mélenchon

Both Sarkozy and Hollande have faced pressure from Mélenchon, a gifted and provocative orator promoting fairy tale anti-globalisation promises. He says incomes over €350,000 would be taxed at 85%, making Hollande's proposal of a 75% tax on earnings above €1m (except footballers perhaps) seem timid. Mélenchon wants to increase the minimum wage to around €1,700, reinstate the pension age of 60, renationalise large companies and banks and scrap all current treaty negotiations on greater budgetary discipline and European integration.

Mélenchon is credited with around 15% of the vote in the first round, well ahead of Le Pen and the languishing centrist candidate Francois Bayrou. Mélenchon's breakthrough has forced both Hollande and Sarkozy to toughen their rhetoric. Sarkozy has been forced to emphasise the economic crisis and France's own interests in the European and global community. Law and order, tackling terrorism and insecurity have faded as vote-winners.

François Mitterrand

If, as expected, Sarkozy and Hollande fight it out in the second round, much will hinge on their respective performances in their long-awaited television debate. Hollande is no pushover. During a first round debate with Alain Juppé, the foreign minister and one of the Sarkozy government's most respected representatives, Hollande won the day. Since then, Juppé, a former prime minister, has disappeared from Sarkozy's campaign. While the two main contenders continue to battle for the votes on the political fringes, they know that, in a fundamentally conservative and centralised country, the outcome hinges on the centre. For all his invective against the rich and his claim that his real enemy is finance, Hollande knows that he cannot succeed without the support of the establishment, including finance, industry and media. He needs a high proportion of Bayrou voters switching to him rather than Sarkozy in the second round.

Sarkozy has been called the president of the CAC40 because of his friendship with many heads of corporate France. But Hollande has been quietly developing his own business and establishment network. He did go to the celebrated ENA grande école and was part of the now famous Promotion Voltaire. There he mixed with the likes of Ségolène Royal (the defeated Socialist candidate in 2007 and Hollande's former partner), Dominique de Villepin, Henri de Castries, Michel Sapin and Jean Pierre Jouyet.

The latter, head of the AMF, the French financial market regulator, has emerged as a pivotal figure: one of the most influential civil servants in France but also a lawyer and a politician. He was Jacques Delors' right hand man in Brussels and later chef de cabinet of prime minister Lionel Jospin. He later became director of the French Treasury and, in 2007, as a symbol of Sarkozy's overture to the left, was appointed minister for European affairs.

Last September Jouyet became one of Hollande's most active and outspoken supporters. If Hollande wins, Jouyet may play a crucial role in a new Socialist administration or as secretary general at the Elysée Palace. During a recent visit to London, the first thing Hollande said when he stepped down from the Eurostar train was 'I am not dangerous'. At a recent Parisian dinner, Jouyet insisted, 'I am not dangerous too.' The financial markets, and no doubt chancellor Merkel too, will be checking nervously whether this is true.

The shadow of euro political risks

May elections spark financial market concerns

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013
US	1.7	2.0	2.0
Japan	-0.7	1.8	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	0.5	-1.2	0.0
Spain	0.7	-0.8	-0.4
UK	0.7	0.7	0.5
Addendum			
Asia excl. Japan	7.4	6.8	7.7
World	3.6	3.3	3.7
Consumer prices (% y/y)			
US	3.1	2.4	2.6
Japan	-0.3	0.0	0.2
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	2.9	2.1	2.3
Spain	3.1	1.4	2.1
UK	4.5	2.7	2.3
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.1	2.5	2.8
China	4.1	3.2	3.4
Euro area	-0.4	-0.5	-0.4
Germany	5.1	4.7	4.3
France	-2.4	-2.3	-2.0
Italy	-3.3	-2.9	-2.8
Spain	-3.7	-3.5	-3.2
UK	-2.5	-3.0	-2.0

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The first quarter of 2012 brought a turn for the better after the weakness that marked the final quarter of 2011, both in the financial markets and in terms of economic growth. Stock prices have risen strongly – especially in Germany – while euro area sovereign bond spreads tightened markedly in many cases until the end of March. The global economy has stabilised, shown by the improvement in confidence indicators for Germany's export-oriented manufacturers.

In the euro area, the success of Greece's debt restructuring, and subsequent calming of financial markets, have allowed the earlier horror scenarios that predicted an economic slump on the scale of the post-Lehman-Brothers collapse to recede into the background – at least for a while. However, the outlook for the euro area economy is far from plain sailing. Most economies of southern Europe are mired in deep recession, made worse in some cases by the need for governments to implement austerity measures. European-level agreements and investors' expectations rule out any deviation from the path of fiscal rectitude as an option for the countries concerned, however big the political challenges this austerity course presents for their governments.

This means that the coming elections in Europe will be a possible cause of tension. The first round of the polling to elect the president of France is scheduled for 22 April. Socialist candidate François Hollande intends to renegotiate the euro area fiscal pact, a prospect unlikely to be greeted with celebrations in the other chancelleries of Europe or on the financial markets. Greece is scheduled to elect a new parliament on 6 May, while Ireland's referendum on the fiscal pact is provisionally planned for the end of May. Germany is due to hold two more state parliament elections in May (Schleswig-Holstein on 6 May and North Rhine-Westphalia on 13 May) that will be crucial for the Berlin coalition. Although presumably no one would seriously question Germany's approval of the euro area fiscal pact, early federal elections could still spoil matters.

Shifting the scene to Asia, China intends to prioritise quality over quantity in its future economic growth. This message was reinforced by a token reduction of this year's official growth target from 8 to 7.5%. This target should not be regarded as a specific aspiration – it represents more of a growth floor: China has consistently exceeded its respective targets in recent years, but has never fallen short. However, we can also interpret this move as a signal that the Chinese government is quite prepared to tolerate slower growth without instantly launching massive economic-policy measures to counter the downturn. All this leads us to conclude that our present slightly cautious forecast is still appropriate – namely that the Chinese economy will expand by just 8.2% this year, which will be the slowest growth rate in more than 10 years. Gradual political support initiatives, such as expansion of the lending framework or further minimum reserve cuts, will probably be enough to cause growth to pick up slightly again from mid-year.

OMFIF
Official Monetary and Financial Institutions Forum

Moving in step with China

Germany, too, may shift to greater domestic demand

Stefan Bielmeier, Advisory Board

The desired realignment of the Chinese economy and the slowdown in expected growth is the core of the Five Year Plan to 2015 agreed in March 2011, aimed at improving living standards and turning China into a consumer and service society. One intriguing question is how this will affect Europe's biggest economy, Germany, which like China is strongly reliant on foreign trade.

Per capita income in China has now reached a middle-income level and the country is gradually losing the advantages of being a cheap manufacturer. The World Bank has warned China that it should not get stuck in the 'middle-income trap' that has snared other developing countries and emerging markets, but instead establish a new growth model. China's longer-term problems make this necessary, too. Owing to the one-child policy, the workforce will soon peak. Chinese society is ageing fast. Moreover, high economic growth has resulted in immense ecological destruction. Chinese industry's high energy requirements are no longer sustainable.

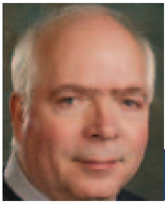
The plan is to boost consumption through wage hikes, also by combating inflation. Social welfare will be expanded, primarily by reforming the health and pension system, while unemployment insurance has hitherto not been broached. However, the government is not curbing public investments. It is first and foremost planning measures to improve rural infrastructure to reduce the differential between the conurbations on China's east coast and the hinterland.

In Germany, as in China, the ratio of exports relative to total economic output has risen steadily over the last 20 years. Last year for the first time this topped 50 %. Especially since EMU's foundation in 1999, Germany's exports have expanded faster than imports, leading to a rising balance of trade surplus. The German export surplus peaked in 2007 at about €170bn or 7% of GDP. Since 1999, more than a third of German economic growth is attributable to foreign trade. On balance, German goods exports have since 1999 risen annually by slightly more than 6%. Exports to other EMU member states have climbed on average 6% and thus lagged slightly behind. Exports to the growth regions of East Europe, Asia and the OPEC countries have surged by comparison, posting growth rates of around 10%. Exports to China have been especially dynamic. While imports from China have since 1999 risen by slightly less than 16% annually, exports have increased by 20% per year. In 2011 China accounted for more than 6% of German exports and 9% of imports.

In view of China's importance, a realignment of economic policy wll have an impact. However, this need not necessarily mean that trade between the two countries will develop to Germany's detriment. After all, China's imports from Germany have accelerated in recent years. Should China's economic model focus less on exports and more on consumption and domestic infrastructure, German companies could continue to benefit. The German trade deficit with China could switch to a surplus in four to five years. In the short term the losers would probably be China's trade partners in Asia which supply simple semi-finished products for Chinese exporters.

In the medium term, Germany's export sector will not be able to contribute such a large slice to German economic growth. Exports to today's boom regions will lose dynamism. Germany will not be able to rest on the laurels of its current economic success. German economic policy is coming under growing pressure within the EU and from international organisations. Germany is being asked (similar to demands made on China in recent years) to reduce its foreign trade surpluses by strengthening the domestic economy. The changes in China will increase pressure further in this regard. The German economy should not lose its competitiveness but a growing shift to domestic demand can meet international requirements and create a more stable German business cycle. In these fields, China and Germany could move in step.

The German economy should not lose its competitiveness but a growing shift to domestic demand can meet international requirements and create a more stable German business cycle.



Fed mulls options on unemployment

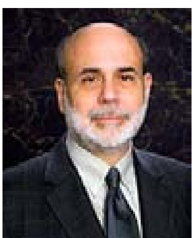
Debate centres on limits to monetary stimulus

Darrell Delamaide, Board of Contributing Editors

President Barack Obama's nominees for the two current vacancies on the Federal Reserve Board of Governors moved closer to taking office in the last week of March when the Senate Banking Committee approved them for a floor vote. However, under Senate rules, any member can block that vote and Louisiana Republican David Vitter did just that. So any vote to approve Harvard University economics professor Jeremy Stein, a Democrat, and former private equity executive Jerome Powell, a Republican, was put off until after the Easter recess at the earliest.

All members of the Board (currently five with the two unfilled positions) and all 12 heads of the regional Fed banks take part in the 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.

Bernanke focus on jobless rate sharpens monetary debate


Ben Bernanke

The debate at the FOMC seems to turn on the question of unemployment. The question is not whether unemployment is too high – that is clearly the case. Nor does anyone question that the Fed has a legal mandate to maximise employment. Rather, the issue seems to be whether monetary policy can do anything further to remedy the employment situation in the US.In minutes of the Fed's latest policy meeting, released just before Easter, only two FOMC members cited the need for further monetary stimulus if economic recovery weakens.

This more hawkish outlook, which contributed to the dollar's firmer tone at a time of fresh worries about Europe, contrasted with recent somewhat more accommodative comments from Fed chairman **Ben Bernanke (voter)**. Earlier, in a speech at a conference of the National Association for Business Economics in Washington on 26 March, Bernanke reawakened hopes of a third round of asset purchases when he expressed concern that the economy was not growing fast enough to reduce unemployment.

Bernanke said the improvement in the unemployment rate from more than 9% last year to 8.3% recently may be due only to a reversal of layoffs during the recession. Further reduction in the jobless rate may be hard to come by, he said, at current rates of growth. 'What will lead to more hiring and, consequently, further declines in unemployment?' he asked rhetorically. 'The short answer is more rapid economic growth.' The chairman's remarks gave a bounce to markets, with some analysts seeing it as a sign that QE3 was not off the table, and almost everyone agreeing that Bernanke at least will not be in a hurry to tighten the monetary screws.

Narayana Kocherlakota

But other FOMC members question whether the Fed can do anything more about unemployment. Minneapolis Fed chief **Narayana Kocherlakota (non-voter)** took the opportunity of the Hyman P. Minsky lecture at Washington University in St. Louis to reiterate his belief that further monetary stimulus cannot remedy the drop in labour demand.

In Kocherlakota's analysis, the current employment situation results from dual shocks to both product demand and labour demand. Monetary accommodation can spur a recovery in output, but can go no further.

'Monetary policy can offset the impact of the product demand shocks on employment, but it cannot offset the employment loss due to the fall in labour demand and any associated slow real wage adjustment,' Kocherlakota said in his presentation. 'As a result, the level of 'maximum employment' achievable through monetary policy is less than the 'full employment' of labour resources.'

James Bullard

Hawks and doves, in short, are taking sides as to how robust the economic recovery will be going forward, and how active the Fed needs to be. Bernanke seems to believe the economy could need more help and the Fed should be ready to provide it. He sees growth as too slow – it needs to speed up to make further inroads against unemployment.

St. Louis Fed president **James Bullard (non-voter)**, however, thinks the present pace of recovery is fine, and that there would have to be a serious downturn for the Fed to contemplate further action.

'I think QE3 would require the economy to deteriorate somewhat from where it is right now,' he said in a television interview. 'The basic story on the US economy is that we've had good news over the last six months or so, especially compared to the recession scenario that was being painted in the August-September time period of last year.'

Bullard, in fact, may be ready to turn those monetary screws. In a speech earlier last month in Hong Kong, he had suggested the US central bank may already be at a turning point and should take stock of what it needs to do next, given the long timeframe for Fed actions to have an impact.

'As the US economy continues to rebound and repair, those policy actions may create an over-commitment to ultra-easy monetary policy,' he cautioned. 'The ultra-easy policy has been appropriate until now, but it will not always be appropriate.'

William Dudley

Bernanke ally **William Dudley (voter)**, head of the New York Fed and vice chairman of the FOMC, warned that the current favorable economic trends may not last. We've seen it all before, he suggested.

'While these developments are certainly encouraging, it is far too soon to conclude that we are out of the woods,' he said in a speech on Long Island. 'To begin with, the economic data looked brighter at this point in 2010 and again in 2011, only to fade as we got into the second and third quarters of thoseyears. This year, in particular, warm weather may be playing an outsized role, he said. When households and businesses spend less on heating, they have more disposable income for other economic activity.

Asked specifically about QE3, Dudley, according to news reports, responded: 'It all depends on how the economy evolves. It's about costs and benefits, and if we get to a point where we think the benefits of another programme of QE outweigh the costs, then we'll certainly do so.'

To sleep, perchance to dream

Whatever his concerns about unemployment, Bernanke is now sleeping easier than he did a year ago. ABC television anchor Diane Sawyer asked the Fed chairman that very question as he accompanied her on a walkabout through Fed headquarters in Washington.

'I have been sleeping better,' Bernanke responded. 'Things are moving in the right direction.' The financial system is more stable, banks are lending more, Europe is somewhat less worrisome – all this makes it easier to sleep at night, he allowed. 'But again, I think it's really important not to be complacent,' Bernanke hastened to add. 'We have a long way to go, a lot of work to do, and we're going to keep doing that.'

Richard Fisher

Breaking up is hard to do

Dallas Fed chief **Richard Fisher (non-voter)** continued his crusade to break up the big banks. Having targeted the five big US banks in recent speeches as still too big to fail, or TBTF in common parlance, Fisher gave free rein to a staffer in the bank's normally anodyne annual report to advocate for breaking them up.

'The TBTF institutions that amplified and prolonged the recent financial crisis remain a hindrance to full economic recovery and to the very ideal of American capitalism,' Fisher wrote in introducing the piece. 'In my view, downsizing the behemoths over time into institutions that can be prudently managed and regulated across borders is the appropriate policy response.'

In the article, entitled 'Choosing the Road to Prosperity: Why We Must End Too Big to Fail—Now,' research director Harvey Rosenblum said the nation's biggest banks must be broken into smaller units. 'Taking apart the big banks isn't costless,' he wrote. 'But it is the least costly alternative, and it trumps the status quo.'

Fisher wrote, 'In my view, downsizing the behemoths over time into institutions that can be prudently managed and regulated across borders is the appropriate policy response.'

OMFIF Advisory Board

Akinari Horii, Sahoko Kaji, Shumpei Takemori, Sushil Wadhwani and Linda Yueh join

Five new members have joined the OMFIF Advisory Board. They are Akinari Horii, former Deputy Governor, Bank of Japan, now Member of the Board of Directors at the Canon Institute of Global Affairs; Sahoko Kaji, Professor of Economics, Keio University, and Deputy Director of the EU Studies Institute; Shumpei Takemori, Professor of International Economics, Keio University; Sushil Wadhwani, CEO, Wadhwani Asset Management and former member of the Monetary Policy Committee, Bank of England; and Linda Yueh, Economics Editor for Bloomberg TV and Fellow in Economics at Oxford University. They take membership of the board to 92. (Further members are listed on p.14)

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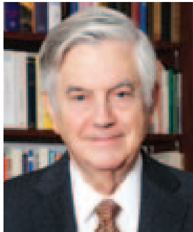
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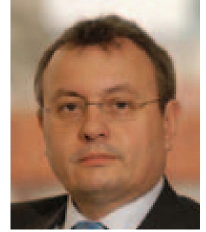
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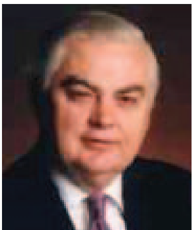
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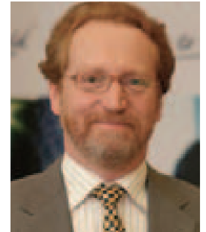
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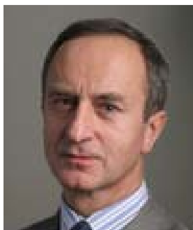
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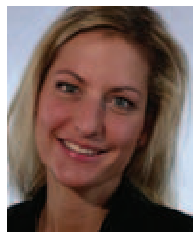
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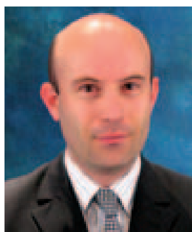
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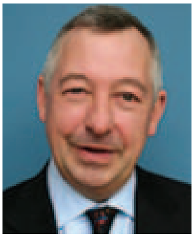
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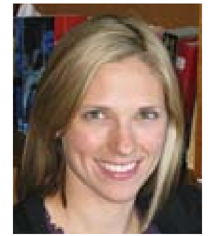
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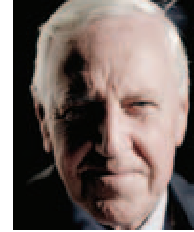
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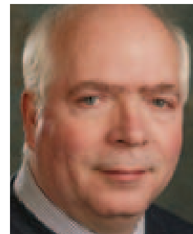
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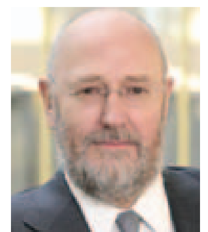
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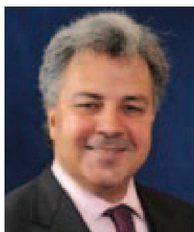
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Looking ahead – 2012 diary dates

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

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

Lecture with José Manuel González-Páramo
Board Member, European Central bank
18 May, Armourers' Hall

Lecture with Fabrizio Saccomanni
Director-General, Banca d'Italia
21 May, Armourers' Hall

Deutsche Bundesbank-OMFIF Economists Club
Roundtable and Lunch
30 May, King's College London

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

De Nederlandsche Bank-OMFIF Economists Club
Roundtable and Lunch
9 July, De Nederlandsche Bank, Amsterdam

Lecture with Carlos Costa
Governor, Banco de Portugal,
26 September, London

Banque de France-OMFIF Economists Club
Roundtable and Dinner
9 October, Banque de France, Paris

Lecture with Marek Belka
President, National Bank of Poland
Golden Series, 23 October, London

2nd OMFIF Meeting in Africa: Bank of Mauritius
Trade flows and Global Growth
5-7 November, Bank of Mauritius, Port Louis

Lecture with Stefan Ingves
Governor, Sveriges Riksbank
20 November, London

International Financial Centres Conference
Challenges to the Established Order
27 November, Bank Negara Malaysia, Kuala Lumpur

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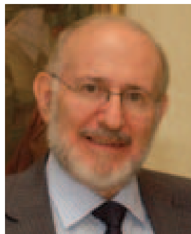
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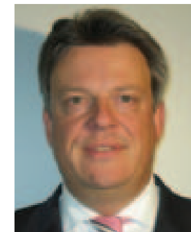
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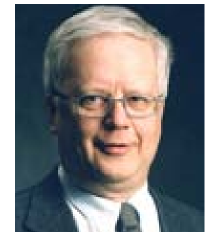
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Building macroprudential policy

Why there was no euro early warning

Andrew Large, Advisory Board

The progenitors of economic and monetary union (EMU) failed to put into place an early warning system that could have built in policy responses to mitigate the effects of asset bubbles. Assembling macroprudential policy tools, for example, through regular assessment of the overall health of the euro area's banking system, would have had a major impact in forestalling the crisis that has now broken out.

The euro area was not the only mature regulatory jurisdiction where such shortcomings became evident. But the repercussions have been particularly problematic. The reason for the failure lies in European decision-makers' widespread pre-2008 credo that monetary policy was key, any other concepts were a distraction and financial crises belonged to the past. Elsewhere in Europe, too, there was no sense of urgency to find a solution. In the UK, for example, in 1997 the authorities neglected a macroprudential focus (and financial stability issues in general) when the Bank of England was given operational independence. Asia, on the other hand, was more alert after weathering its own crisis in 1997-98.

It takes a crisis to concentrate minds. So now we see frameworks being built at a national and European level with the creation of the European Systemic Risk Board. Additionally, debt and leverage are now seen as determinants of instability, not just the residuals. So there is more resolve to formulate a policy that makes sense, and then implement it.

Some elements of the past failure are, however, still haunting us. The definition and objectives of financial stability were often thought as 'too difficult' and therefore neglected. But it is vital that regulators and central banks work out what they mean by financial stability and set down concrete objectives that will allow them to measure progress (or lack of it).They need, too, a mechanism to handle the conflicts of objectives which inevitably arise.

Governance should not be a monopoly of any one institution. Engagement is needed among several important functional areas. The main stakeholders are the fiscal authority, which is likely to be called upon in a crisis; the central banks as creators of money, a vital ingredient to restoring confidence; and the supervisors with relationships to individual institutions. The big question is how to bring in the appropriate governance processes to accommodate these three players, each with their own specific approaches and aims, and ensure their constructive engagement. The right way to do this is by clarifying objectives in detailed fashion, ensuring that politics do not interfere with assessment and decision-making and safeguarding the independence of the central bank.

Implementation is the toughest part. Judgments need to be made on what instruments to use, whether will they work, and what powers are needed for their deployment. This requires experimentation and then a difficult process of calibration, building up knowledge all the time from what is admittedly only a slender base.It's helpful to think about a new system of macroprudential policy in terms of two key areas of focus, at different ends of the spectrum. These are what I would term as 'conjunctural' issues (questions of leverage, cost of credit, assessing whether a set of arrangements 'feels comfortable') and 'resilience', that is, how strong the system should be. There is plainly a trade-off between the two.

It's essential to realise that solutions are necessary at the level of the individual jurisdiction, where fiscal resources and legal power reside. Macroprudential policy won't be popular and it must be seen as legitimate. The ESRB has belatedly recognised this. It takes political will to create macroprudential frameworks, and confer legitimacy upon them. This was done earlier for monetary policy, but the issues are more difficult, and there is more at stake. In monetary policy, if you get it wrong, you can try again next month. In the case of financial stability, being a month out is too late.

It is vital that regulators and central banks work out what they mean by financial stability and set down concrete objectives that will allow them to measure progress (or lack of it).

Dutch political crisis looms

Prime Minister loses one seat parliament majority

Roel Janssen, Board of Contributing Editors

The Dutch government is entering a highly uncertain phase that further clouds support for economic and monetary union (EMU) in Europe's No. 2 creditor country. In late March, the government was deprived of its one seat majority in parliament, as a prominent politician defected from Geert Wilders' anti-euro PVV party that supports the minority government of prime minister Mark Rutte. It's not clear how long Rutte will be able to muster sufficient support in parliament. Meanwhile, the coalition parties and the PVV are struggling with measures to lower the budget deficit, currently at 4.5% of GDP, to 3%. Budget cuts of at least €9bn are needed to meet the European Commission's fiscal demands for 2013.

A few weeks earlier, the PVV presented a report from Lombard Street Research (LSR), a London based financial consultancy firm, on the benefits of the euro for the Netherlands. The publication's impact was blunted by the authors' acknowledged eurosceptic position. Charles Dumas, LSR chairman and chief economist, in a technical explanation on the report's presentation on 5 March, stated: 'We said it [monetary union] would not work. And it has become clear that it has not worked.'

The report stresses that the crisis has not been caused by budgetary deficits, but exclusively by balance of payments problems. It highlights how the one-sized-fits-all monetary policy and differences in economic performances have undermined weaker countries' competitiveness and caused an undervalued euro exchange rate for strong countries like Germany and the Netherlands. The report argues that EMU membership has depressed Dutch growth and purchasing power compared with Switzerland and Sweden. It underlines the huge cost of continued support for the southern members and Ireland and says there is a high probability that EMU will break up. Claiming that Lombard Street had proven that a Dutch exit was economically possible and politically desirable, Wilders called for a referendum on a return of the guilder. He labelled 'fear mongerers' those warning of the dire consequences of exiting the euro. It wasn't clear if Wilders understood all the complex graphs presented by Charles Dumas, but he echoed Dumas' remark that the monetary union suffers from the flaw 'one size fits none'.

In Dutch public opinion, the report attracted more criticism than approbation. Critics bemoaned the lack of quantifiable proof that leaving EMU would actually be profitable and contested the income comparisons with Sweden and Switzerland. Specific Dutch aspects that have hampered growth in recent years, like the housing bubble, and the pension crisis and the lack of labour market reforms, were simply ignored. Ivo Arnold, a respected professor of monetary economics at Rotterdam Erasmus University, stated that he would have failed any student who handed in the report as an academic paper.

The Socialists, fierce defenders of the national welfare state, critics of financial markets and opposed to euro rescue mechanisms, are scoring strongly in opinion polls.

Politicians of all parties except the PVV dismissed the report's results. Even the Socialist party, critical of the euro and like the PVV against pouring Dutch money into Greece, distanced itself. The Socialists, fierce defenders of the national welfare state, critics of financial markets and opposed to euro rescue mechanisms, are scoring strongly in opinion polls. After elections, the party might well turn out to be the second largest party, possibly entering the next government.

Rutte meanwhile shrugged his shoulders, while a leading opposition politician challenged Wilders to present the presumed benefits of reintroducing the guilder in the political negotiations on budget cuts for next year. Beyond the Lombard Street froth, however, the problems for Rutte's government have not subsided. After the loss of its majority, mustering a majority for euro support and budget cuts will become ever more of a struggle. The appointment of a new, vigorous leader of the Social Democrats, currently the main opposition party in parliament, who is unwilling to offer unconditional support to the government in European affairs, adds further to the imbroglio.

World economy remains on knife edge

Little confidence that US, German recovery will hold

The third main meeting of OMFIF in Europe, attended by delegates from 56 institutions, 37 countries and 35 central banks (including multinational organisations) at the Bundesbank in Frankfurt on 14-15 March concluded that the world economy remains on a knife edge. Europe's political crisis, the 'Arab Spring,' the political and economic rise of Asia and the emerging nations (including in Africa) are equally momentous events.

However, the next move could easily be another downward lurch into protectionism, political and economic instability and recession. There was only a modest amount of confidence that signs of recovery in the US and Germany, an easing of the strains from Europe's sovereign debt crisis and progress towards stronger economic governance signalled the beginning of a wider upturn underpinned by financial stability.

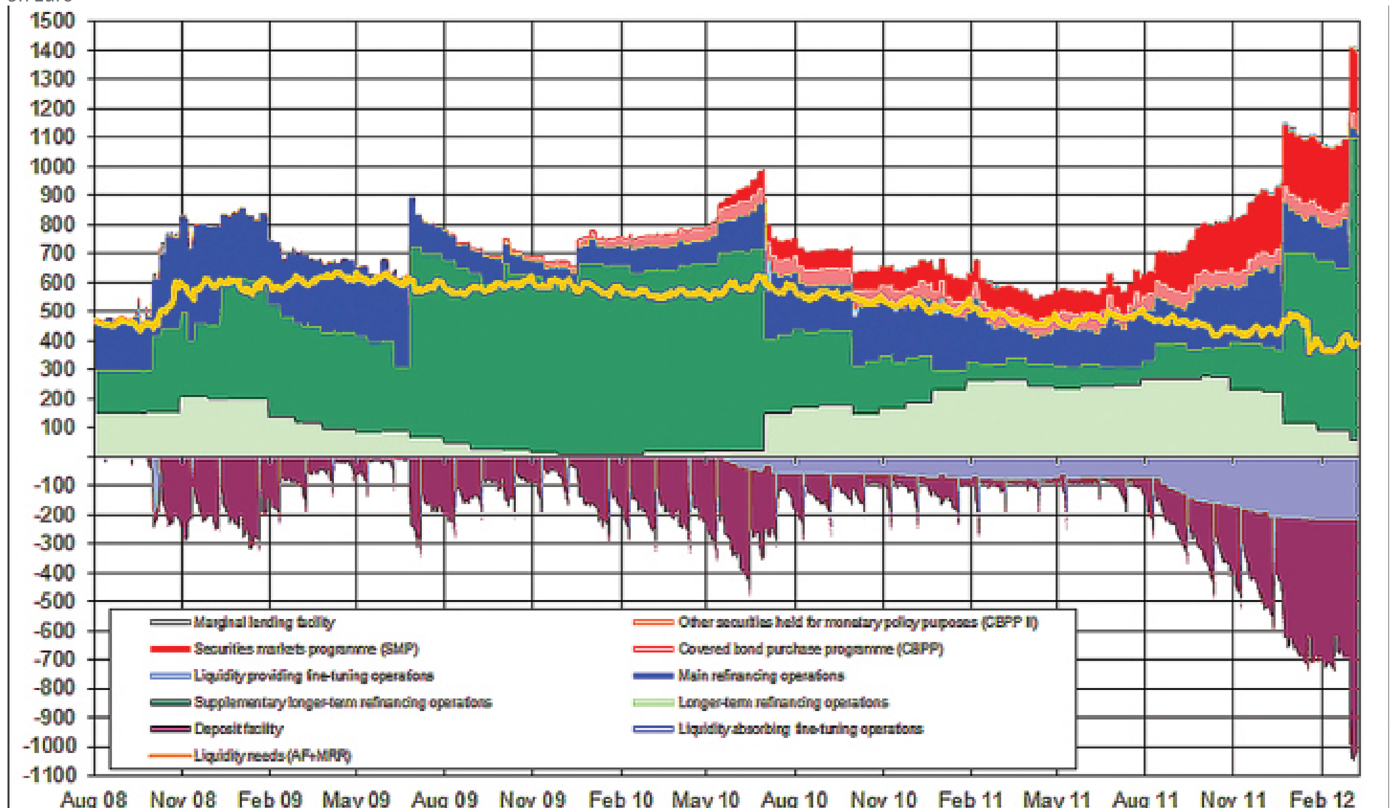
It was argued that globalisation had changed the nature of many of the old economic laws and principles underpinning the way economies work. There was considerable discussion of the different approaches to monetary policy in the US and Europe. Although large-scale quantitative easing had been politically controversial in the US, there was general recognition that it had achieved positive results. In Europe, the still more massive liquidity had also unleashed dissent on the European Central Bank council, with the Bundesbank in the lead among the central banks openly articulating concern.

There was general recognition that central banks in the US and Europe had been propelled to the front-line of economic policy action in a way that could, if it backfired, risk their independence. With regard to the positive and negative aspects of 'quantitative easing' (QE), one senior participant stated that central banks should be, like dentists, called in only when painful action was needed. They had now become too visible. It was now 'time to retreat from public view.' The economic crisis has unleashed potentially disintegrative forces in the European Union where the disruptive potential has yet to be contained. Despite some positive signals from the landmark restructuring of Greek debt, the problems in EMU were stated to be the largest downside risk overhanging the world economy.

General worries over the world economy focused on the risks of negative spillovers from the policies of the trans-Atlantic economies, particularly the low interest rates and higher levels of liquidity being created by central banks. On the one hand, participants pointed out that – particularly in the US – quantitative easing (although politically controversial) had worked by helping to avoid prolongation of the 2009 downturn and prevent a double-dip recession in 2011-12.

On the other hand, it was argued that globalisation had changed the nature of central banking and many of the old

Full-allotment policy and longer-term refinancing operations have changed the ECB maturity structure



economic laws and principles had now broken down or were no longer valid. This was just one indication of how handling world economic problems had become more fraught and less controllable.

The apparently inexorable trend towards the deeper integration of the world economy, which many began to take for granted a few years ago, is in doubt. 'Globalisation is at risk, many of our clients are pulling in their horns, rebalancing their operations back to the safety of their home nation state by, for example, sweeping liquidity back to headquarters every day,' according to one participant.

One delegate asked whether, in a few years time, the revolutions in Middle Eastern countries would still attract the positive epithet 'Arab Spring.' Oil-importing countries run the risk of hampered access to the region's vast energy reserves, amid risks to the stability of the region and of the authoritarian regimes running key oil-producing countries, which up to now had assured a degree of stability to supplies and price of energy.

Another symptom is the complex politics of inequality. As one participant pointed out, inequality, particularly in emerging market economies is a threat which cannot be ignored - it has been a major factor behind the 'Arab spring' revolutions - and in many cases it can be linked directly to gender inequality with unemployment in some countries four to five times higher for women than for men. Participants showed considerable unease how this inequality within and between nations could be resolved without a major and possibly disruptive change in the world economic order.

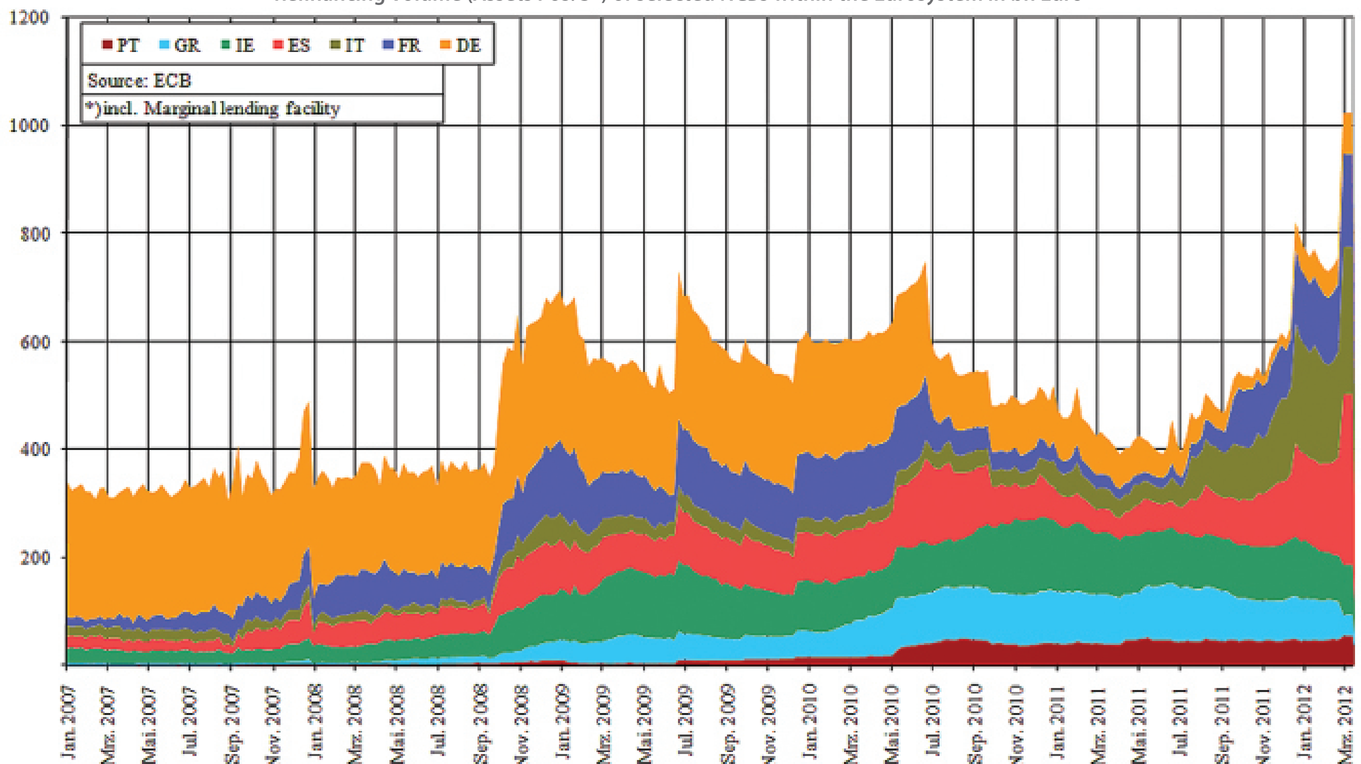
Emerging market participants showed concern regarding the impact of the extraordinary monetary policy initiatives adopted by the trans-Atlantic central banks. As one said: 'Credit easing is now the most important cycle for the world economy and it could be very dangerous. Among other things it threatens emerging market economies with imported inflation.' This view was endorsed by a European official: 'Monetary policy needs to go back to normal or we will have another bubble.'

In response to concerns about the outlook for the Chinese economy, one Asian participant rejected suggestions that China is heading for an economic 'hard landing.' He conceded that the country does have significant structural problems, but the growth slowdown needed to be out into perspective. This was falling from the 9-10% rate of recent years, with the government expecting growth below 8%, probably around the 7.5% mark. Already, he suggested, there is evidence that the official aim of increasing domestic consumption is being achieved. With personal income growing, personal consumption is making a much bigger contribution to growth than has been the case in recent years, and not all of this increase is being picked up in the statistics.

With regard to Asia's other leading emerging market economy, India, caution is a key word in the vocabulary of policymakers. The meeting learnt that, not least because of what it has witnessed in the trans-Atlantic region, India is being very careful in keeping a tight rein on investment banks and not letting them move 'into the mainstream' even if this means that innovation in the banking sector is held back. 'That is a price worth paying,' one official remarked.

Regional break down of refinancing operations

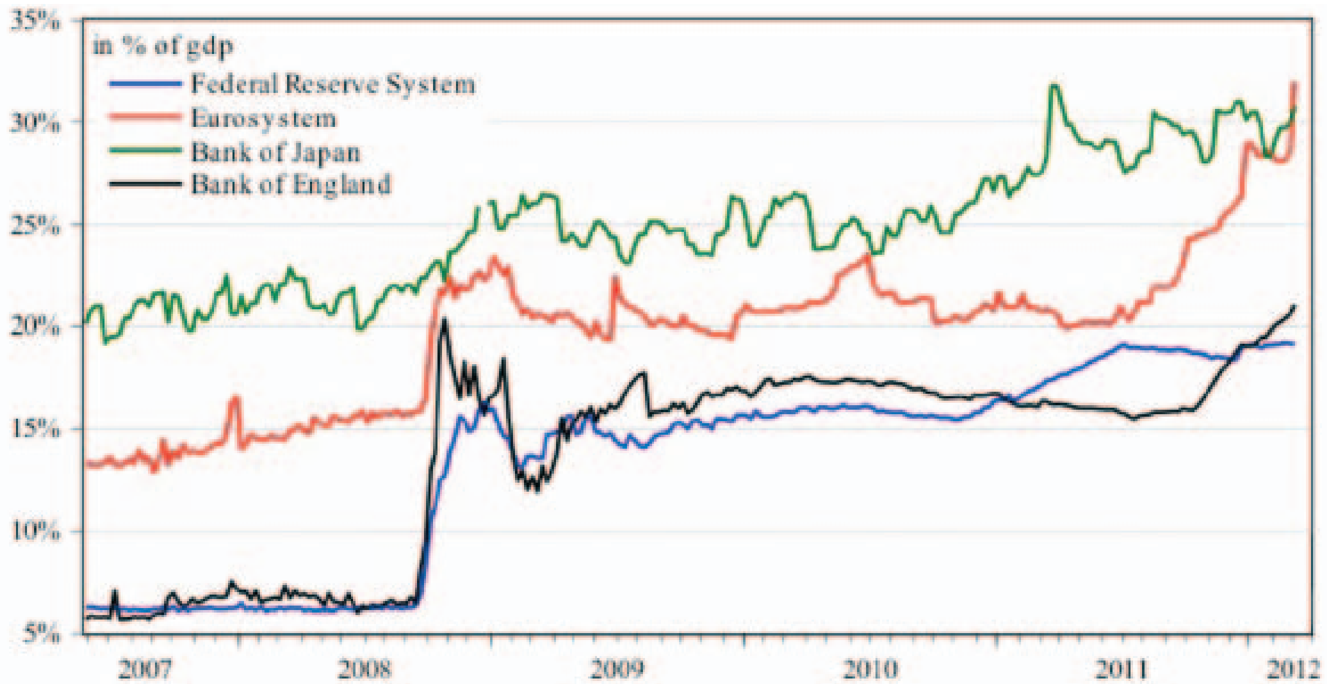
Refinancing Volume (Assets Pos. 5*) of selected NCBs within the Eurosystem in bn Euro



Source: ECB

How the financial crisis has put central banks' operations under strain

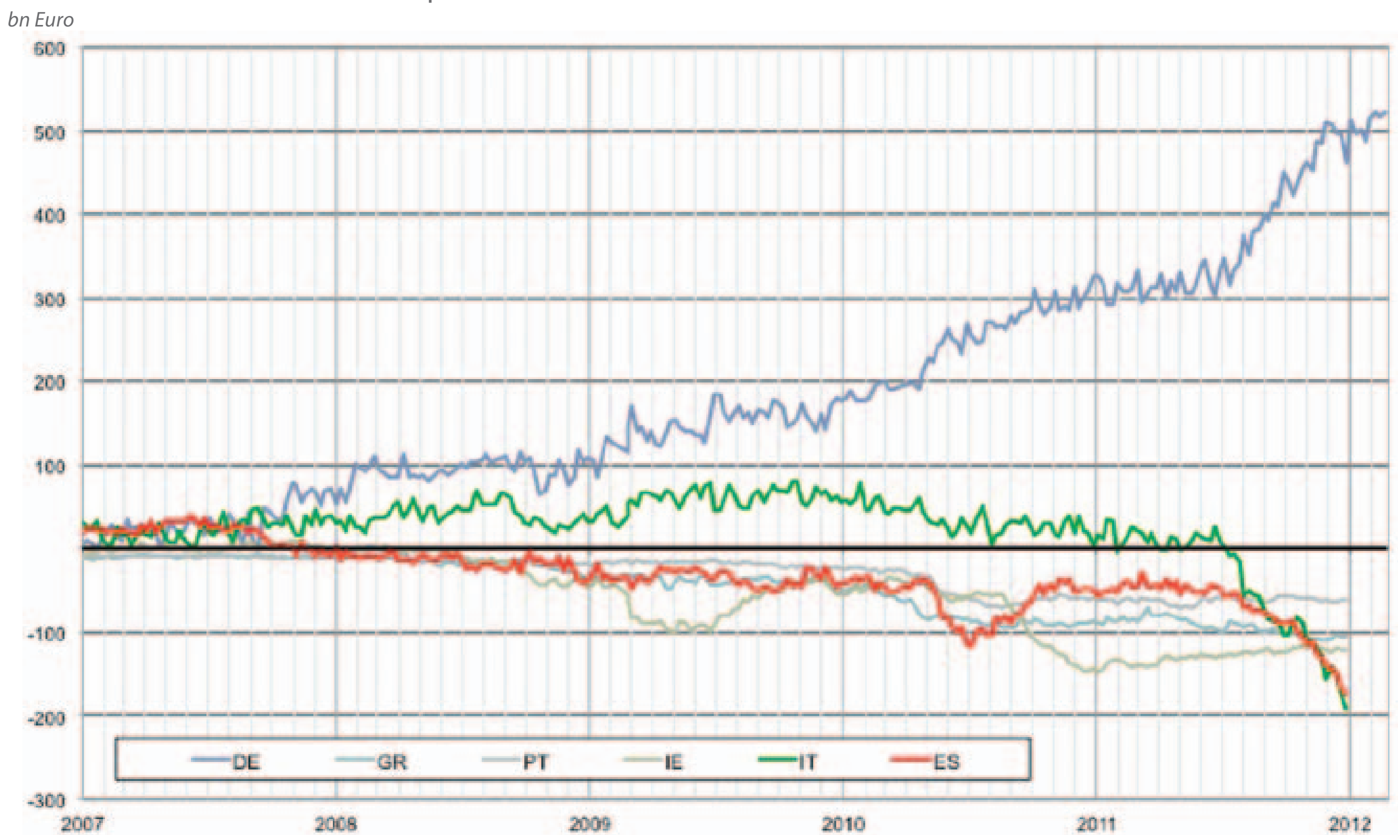
Central banks' balance sheet in comparison



Source: Bloomberg, Bundesbank

Increased TARGET2-balances

Development of TARGET2-balances of selected countries within the EMU



Source: ECB

A regular round-up on international monetary affairs

Succession in Threadneedle Street

Outsiders and insiders at the Bank of England

William Keegan, Chairman, Board of Contributing Editors

An insider, or an outsider? That is the question which recurs, under British governments of whatever colour, whenever the subject of the succession at the Bank of England comes up. To indicate how the pendulum swings, I need to do no more than reflect on the sequence of incumbents at the Old Lady of Threadneedle Street since 1963, when I first joined the Financial Times.

In illustrating this question of outsiders and insiders, I must pass a warm tribute to my old friend Sir George Blunden, who died on 3 March at the ripe old age of 89. Sir George, a lifelong Bank insider, was recalled from retirement in 1986 to be Deputy Governor under Robin Leigh-Pemberton when the government of Margaret Thatcher could not decide between the relative merits of rising stars Eddie George and David Walker.

The Deputy Governorship has always been especially important when the Governor, as in the case of Leigh-Pemberton, is an 'outsider'. When New Labour reorganised the Bank, and two deputy governors were appointed, George Blunden remarked to me, 'I see they now need two people to do my job.'

The Governor in 1963, Lord Cromer, was a Bank outsider, but not a City outsider, in that he hailed from the merchant bank Barings. He had a fraught relationship with the first Wilson government of 1964-66 and neither sought, nor expected, to be reappointed in 1966, when the job went, much to his surprise, to the Bank insider and Deputy Governor Leslie O'Brien. O'Brien told Chancellor Callaghan, who offered him the job, that he thought he was going to be asked to carry on as Deputy to another 'outside' Governor. Lord O'Brien of Lothbury, as he became, was a safe pair of hands but was himself succeeded by an outsider, in the majestic shape of Gordon, later Lord Richardson, from the merchant bank Schroeders. The dating of the sequence of Governors from then on is easy: the number to remember is 'three'. Richardson was Governor from 1973 to 1983; Robin Leigh-Pemberton, later Lord Kingsdown, from 1983 to 1993, and Eddie 'Steady Eddie' George from 1993 to 2003.

Leigh-Pemberton was another Bank outsider, from NatWest. Eddie George was very much an insider, but one might call him an 'outsider's insider' because he was so widely respected in the City of London – and, indeed, became a popular figure throughout the land, and many parts of the world.

We then come to the period 2003 onwards, when Professor, now Sir Mervyn King was appointed. Despite having served within the Bank since 1991 first as Chief Economist and later as Deputy to Eddie George, King is more often regarded as an 'academic' than a banker. In the general view he has been a mixture of insider and outsider.

After a happy start with New Labour, with whom he was on close terms for a long time, King fell out with the government over his initial response to the Northern Rock collapse, and the Chancellor at the time, Alistair Darling, has made it quite clear that King was offered reappointment in 2008 only because the government could not find a suitable replacement.

His reappointment ensured that remembering the 'threes' was still a valid aide memoire, because his second term is due to expire at the end of June 2013.

Which leads us to an interesting question. In my experience, the press normally begins to speculate about the succession in the December of the previous year, and the announcement is made early in the year of succession.

But this time the speculation has begun far in advance, and it is no secret that the government has for some time begun thinking of possible successors.This makes one wonder whether the 2003 to 2013 rule will work. It may not be beyond the bounds of possibility that if the powers that be decide on what they regard as a suitable 'outsider' then they and the present Governor may come to an arrangement for him to leave early.

I stress that I have absolutely no knowledge of such an arrangement. But with so much speculation going on, and talk of many banking names, you never know. There is also talk of an overseas outsider, bringing up memories of the time Chancellor Howe flirted in the early 1980s with the idea of appointing Sir Philip Haddon-Cave, then Hong Kong Financial Secretary.

I fear that I shall disappoint readers by not speculating about which of the many illustrious and not so illustrious names being touted will eventually be appointed. My old-fashioned training at the FT led me to the cautious approach of predicting only when you actually know.

At the time of writing things are undecided. It is by no means clear whether the choice will be for the 'insider' favourite, one of the two deputy governors, Paul Tucker, or a possible insider 'outsider', former Cabinet Secretary Sir Gus (now Lord) O'Donnell, or a real 'outsider' from the City or overseas.

A final word. If there is one iron rule, it is that the field tends to be narrowed down to the candidate who has fewest enemies.