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Greek rendezvous is Hollande's test

Bank manager image for France's new president

Paul Betts, Member of the Board of Contributing Editors

Forget the jibes (or the hopes) that France's new leader will bring in radical socialism. President François Hollande will portray a middle-of-the-road bank manager image in dealing with Germany and other European partners as he confronts the triple task of shoring up French growth, Franco-German ties and the euro area.

The rendezvous with reality over Greece's membership of the euro makes Hollande's job all the more difficult. Hollande repeated criticism of German-led austerity during the election campaign. One of the first statements of his new foreign minister, Laurent Fabius, was to call for more emphasis on European employment. But Hollande will have to join with Chancellor Angela Merkel in affirming that Greece must stick to the budget cuts agreed with its creditors if it wishes to remain in economic and monetary union (EMU).

For all the aggressive and populist stance adopted before the 6 May poll, Hollande's bite is likely to be far softer than his bark. A far cry from the impetuous radicalism of his late mentor François Mitterrand 31 years ago, Hollande will preside over mainstream social democratic policies. This is what most voters seem to want after the polarisation and fireworks of Nicolas Sarkozy. Surrounded by experienced advisers and ministers, Hollande is neither a one-man-show like Mitterrand nor a Sarkozy-style control freak.

Merkel, who is under growing political strain at home after election defeats and losses of key political allies, will have to grit her teeth and welcome Hollande's impetus on resolving the European debt problem and tackling growth challenges.

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Delors says European Central Bank shares blame for euro malaise

Jacques Delors, former European Commission president, says members of the European Central Bank council should have pointed out potential threats to EMU financial stability earlier in the 2000s. Pointing to failure to speak out by central bank governors 'They did not say anything, nobody said a word. Therefore, they too are responsible for this situation. So, this is no time for them to lecture others.'

SEE DELORS ARTICLE, P. 14-15, FRANCE & GERMAN PERFORMANCE, P. 16-21.

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Darrell Delamaide, Advisory Board

To most Americans, the election of a Socialist as French president does not seem like progress. Many will assume that a Socialist president will make the debt situation in Europe worse. Greece, meanwhile, confirmed its perception as a basket case by producing a hung parliament on 6 May and planning new elections to try to overcome the stalemate. The only problem is that no one thinks it's possible

US policy-makers are more nuanced. They realise that François Hollande is a moderate, pragmatic Socialist, in the mould of François Mitterrand in his later years – not the nationalising, big-spending ideologue who became the first left-wing president in the Fifth Republic in 1981. In fact, in his emphasis on the need for economic growth to balance austerity, Hollande could make himself an ally of Obama, more in line with the policies advocated for Europe by US Treasury Secretary Timothy Geithner than by Nicolas Sarkozy or Angela Merkel.

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Things happen faster

Dornbusch moment nears

David Marsh, Co-chairman

One of the most oft-quoted phrases on the euro crisis is attributed to the late German economist Rüdiger Dornbusch: 'In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could.' Following the Greek and French elections, a Dornbusch moment appears to be approaching. Not a good time for JP Morgan, the US bank that appeared to weather the financial upheavals better than most, to announce a trading loss of (at least) $2bn from trading in credit derivatives. It forced a grovelling apology from its chief executive and the dismissal (or 'retirement' as they like to call it) of some top New York bankers.

Everything about the euro crisis is predictable and was predicted years ago by many serious people. In this issue, we try to get to the heart of the matter. Neil Courtis probes the real causes of the financial crash. Following the unsurprising election results in France and Greece, where both electorates showed disgruntlement with austerity but still voted for outcomes that are unlikely to change matters substantially, imbalances in the euro area are with us again, this time in the capital account, not the current account. Paul Betts analyses the choices facing François Hollande following his 'getting to know you' visit to Angela Merkel on 15 May and the unveiling of his government on 16 May, containing a pleasing combination of youth and experience.

Two prominent members of the new Paris administration, foreign minister Laurent Fabius [January 2011, p. 14-16, 'Germany faces Doppelmark danger'] and employment minister Michael Sapin [February 2012, p. 10-11, 'In defence of seriousness', have featured in past issues of the OMFIF Bulletin. In addition to his regular article on the Federal Reserve, Darrell Delamaide looks at how the change of leadership in Paris has gone down in the US. In a contribution mercifully free of the usual self-serving humbug frequently on display from euro leaders, one of the fathers of the single currency, Jacques Delors, writes perceptively on the true causes of the malaise. Patrick Honohan, who has good reason to claim the title of the 'W.B. Yeats of the ECB council', weighs recent ECB policy announcements against the lessons of history.

As pressure mounts for a Greek exit from the euro (for which there is no blueprint), John Nugée takes a dispassionate look at the country's predicament and says it has only itself to blame. Our global analysis surveys the broad sweep of relations and performance among France, Germany and Italy since the victory of François Mitterrand in 1981 – and finds that, inexorably, the German have been in the ascendancy. Gene Deetz explores the Target-2 imbroglio and says the European Central Bank needs to be more transparent.

As a quid pro quo for Germany's better growth performance, Stefan Bielmeier asks whether German inflation really is on the rise. Gabriel Stein surveys inflation scenarios from an international perspective and records the absence of perceptible danger signals. Jason Lee examines the rise of Asian bond markets. John Kornblum looks at historic shifts in the US as the election approaches.

In a prescient article penned before the JP Morgan losses surfaced, Michael Kaimakliotis investigates the failure of the well-known volatility indices to pinpoint the true level of risk in the capital markets. Allan Lane highlights the potential of Exchange Traded Funds to enable asset managers to harness beneficial features of different stages of the economic cycle. In his traditional postscript, William Keegan recalls the heady moment when Hollande's late mentor François Mitterrand swept to victory 31 years ago, recounts the lessons earned since then – and wonders whether it will all end in tears.

David Marsh

Asking the right questions

Greece must take responsibility for its predicament

John Nugée, Deputy Chairman, Advisory Board

After the French and Greek elections, those who feared that the euro area respite was only temporary appear vindicated. Across economic and monetary union (EMU), the sense of immediate crisis lifted in the first few months of 2012. Now, it has returned.

In the first quarter, the Greek government's actions in successfully pursuing a major debt reorganisation and partial default, the renewal of Greek fiscal support from the European Union and International Monetary Fund, and the European Central Bank's liquidity help for the banking system all materially eased the financial situation in EMU. But few believed the problems were over.

Greece's inconclusive election results brings little change to the country's outlook. The rest of the EMU periphery, too, faces a tough economic environment.

Greece remains trapped in extreme austerity, from which it is difficult to see any near term path to sustainable growth. The inconclusive election brings little change to the outlook. The rest of the EMU periphery, too, faces a tough economic environment. There are still question marks over Portugal's ability to service its debt, let alone return to the public capital markets in the envisaged timescale. Spain, Italy and Ireland still have much restructuring ahead of them before they can compete on equal terms with the euro core. For the peoples of the periphery, the travails are far from over.

One of the weaknesses of the EU's response has been a tendency to see everything through the prism of debt. The five weaker states have too much debt, ergo, they must reduce their deficits. This mantra from Brussels has the advantage of simplicity. But – like so much of the EMU project – it stands open to the accusation of being a 'one size fits all' solution; or, as the critics have memorably rephrased it, 'one size fits none'.

The root causes of the periphery's problems are, in fact, different in every state. In Ireland, a flexible and competitive economy was overwhelmed by a one-off debt burden when the state was forced to take on the banks' debt. In Spain, despite some innovative and well-regarded banking supervision from the Banco de España, the issue has been over-reliance on real estate to drive the economy, and a housing bubble that has not been fully cleaned up. In Portugal, the problem is one of competitiveness: the economy has been running a large balance of payments deficit for over a decade. In Italy, the challenge is a bureaucracy that has stifled the economy: there has been almost no net economic growth since EMU started.

Each of these is a serious challenge. But each of these four countries is different; each economy is unbalanced in its own way. The single solution of austerity cannot be optimal for all these very different problems; worse, in causing hardship while not addressing the root cause of each country's weakness, it risks being deeply damaging and alienating local populations.

And what about Greece? Here the problems are different again. The 20th century was hard for Greece: external wars, occupation, a civil war and a military dictatorship. The Greek people have struggled to build a functioning government and a civil society in the style of their EU partners. This – not the euro, not debt levels, not Brussels – is the root cause of Greece's weakness. It may sound harsh, but responsibility for this state of affairs rests almost entirely with the Greek people themselves.

Greece will not recover until the Greek people change and modernise their society. They cannot do this until they accept their role in creating their predicament. The real tragedy of the austerity package imposed by those providing Greek funding is that is that it gives Greece an external actor to blame for its woes. As long as the Greeks continue with this and see themselves as the victims, they will remain trapped in a dysfunctional state, and they will never be able to return to prosperity.

Greece will be Hollande's first test *(... continued from page 1)*

Showing her quixotic resolve to turn bad news into good, she termed a 'good omen' the lightning strike on Hollande's jet as he journeyed to Berlin on 15 May.

As expected, Hollande's prime minister is Jean-Marc Ayrault, head of the socialist party parliamentary group in the national assembly and the mayor of Nantes. At 62, he is considered a safe pair of hands, even though his critics say he lacks charisma (in short supply with Hollande too).

A German teacher before moving into politics, Ayrault speaks fluent German. Ayrault has already warned of the difficulties in the Franco-German relationship. Given latest economic sabre-rattling on both sides of the Rhine, he would be in a good position to engage in constructive if complex dialogue with the Germans.

Having won the presidential race with a slim 51.7% majority, Hollande needs his socialist party and its allies to win a majority in the national assembly elections in June to avoid the embarrassment of a cohabitation with the right. But since the far left's candidate, Jean-Luc Mélenchon, did less well than expected in the first round of the election – he scored only 11%, when at one stage he was expected to poll 15% or more – Hollande no longer needs to worry about his left flank.

He consequently left out of his cabinet Martine Aubry, the party's secretary general, daughter of Jacques Delors, and a former minister responsible for the introduction of the 35 hour working week. Aubry, a confrontational and outspoken personality, ran against Hollande in the socialist party primaries last autumn, when she did not hold back her punches and her insults against her socialist rival.

Pierre Moscovici, former Europe minister and Hollande's campaign director, becomes minister of finance and economy, a consolation prize for not gaining the foreign ministry portfolio. Fabius, the new incumbent, a former socialist prime minister and finance minister, has been behaving for some weeks as if he was already at the Quai d'Orsay, according to Alain Juppé, the former minister.

Fabius brings a steely line on the euro, having voted against the European constitutional treaty in 2005 and repeatedly criticised German economic policy in recent years. Michel Sapin, a key member of Hollande's campaign team with previous ministerial experience – justice, finance and economy, and public sector minister in various socialist governments – takes over the employment ministry. Hollande has jumped a generation by promoting one of the party's younger stars, Manuel Valls, as interior minister. Backed by scores of socialist-leaning civil servants all educated, like Hollande, at the elite ENA college, this government has more weight than some have suggested.

Hollande and his team could give some certainty to the message of stability broadcast around Europe's capitals by the likes of Fabius and Hubert Védrine, the former socialist foreign minister and now an advisor to Bernard Arnault, the LVMH luxury goods tycoon.

They all emphasise this is no repeat of Mitterrand's victory in 1981 when the socialists initially took an unorthodox course of high spending and nationalisations until, under the stewardship of Fabius and Delors, economic reality sunk in.

Emphasising the pro-growth shift in their European commitment, the socialists, for instance, are not talking about Eurobonds but euro project lending through bonds to stimulate Airbus-style pan-European industrial and infrastructure programmes. Of course, this will not save Greece. But that's another story.

American sceptics *(... continued from page 1)*

Hollande is being given a warm welcome by President Barack Obama, but he starts on the back foot. Socialism is something of a dirty word to most Americans. France is already viewed by many as the quintessential European welfare state antithetical to the rugged individualism and free enterprise that have made America great.

Because the result in France was largely expected, the indecisive Greek election unsettled the picture more, pushing it to the forefront of US investors' concerns. The situation in Greece is so volatile that it is seen as an existential threat to the euro. US policy-makers are less outspoken on Europe than in Britain, where both the prime minister and central bank governor have made deeply negative remarks.

However, there is little confidence in Washington that the European Union currently has the tools or the political will to contain any contagion from a financial collapse in Greece or its exit from the euro.

In a presidential election year, the impact of the European crisis on the US campaign is the main focus for American analysts, and the concern is that European political turmoil will exacerbate that impact.

A new recession in Europe would be a further drag on a US recovery already showing signs of stalling. This could be bad news for Obama's re-election hopes. Even Hollande's embrace of stimulus could boomerang against Obama, as his opponents could say that his 'failed effort at deficit spending truly was an anti-market 'socialist' policy as they always claimed.

The Federal Reserve under Chairman Ben Bernanke has made it clear that the US central bank will take further measures to stimulate the economy if it takes a turn for the worse.

Otherwise, the best hope for the US administration is that Hollande and Chancellor Angela Merkel can agree on a strategy including some growth stimulus both to ease some of the political backlash and to reverse a renewed recessionary slide.

Aiming at globalisation victims

Obama will win if he can channel voter anger

John Kornblum, Advisory Board

Do today's American political confrontations – the polarisation over the Federal Reserve might seem to be one example - endanger the US political system? However bitter contemporary debates appear, they are nowhere near as confrontational as in the 1960s and 1970s.

The debates of 2012 are not the result of a failed system, but rather the continuation of fundamental readjustments which began after the Second World War. The American method of dealing with such uncertainty is to debate our nation's story in public. The result is not always satisfactory, but America has no secrets from itself or from the rest of the world. That is one reason why everyone somehow feels part of us.

The debates of 2012 are not the result of a failed system, but rather the continuation of fundamental readjustments which began after the Second World War.

Today's polarisation began in the 1960s with two transformational events: the rise of the civil rights movement, which demanded rights denied African Americans since the Civil War, and the appearance of a large, new generation of Americans who had no memory of war and depression. Following close behind were the Vietnam war, Watergate and a 10 year-long depression. That was enough to make anyone angry.

Today's dramas may seem disturbing, but they bear little resemblance to the near total confrontation between Baby Boomer dissidents and an angry establishment which led to violence and destruction, political assassinations and the collapse of four consecutive presidential administrations between 1965 and 1980. One major change in the American story usually leads to the birth of another. So even as young radicals were upsetting the existing order, a new conservative movement was forming to defend the old one. Its first standard bearer was Senator Barry Goldwater, the Republican candidate in 1964, whose rhetoric was harsher and less forgiving than that of classic Republicans such as Dwight Eisenhower.

US president are often assumed to serve two four-year terms. But in the two decades between Dwight Eisenhower and Ronald Reagan, not a single president achieved this goal. George Bush could not win re-election despite his victory in a popular war. And although he officially did serve two terms, George W. Bush's credibility was so weakened that his second administration was nearly devoid of initiative or achievement.

Barack Obama's chances of success in 2012 must be seen against this background. Obama is fighting the growing tendency of American voters to abandon a president who does not continuously gratify their need for reassurance. Never mind that Obama inherited two wars and the worst economic crisis in 75 years. Voter impatience is stoked by a 24 hour news cycle which lives from the new and the dramatic. The spectacle of Republican candidates searching desperately for ways of making yet another outrageous attack on each other says it all.

When Obama was elected, many Americans hoped his 'Yes we can' attitude would unite the country. This has not happened. Whether the reason is the magnitude of the task, a brutal opposition or his own limitations, Obama is approaching his second campaign on a virtually equal basis to his challenger, Mitt Romney. His prodigious campaigning skills will help him against the more wooden personality of his Republican opponent. But the mountains of money donated to Democrats in 2008 seem to be drying up. Romney can count on many Americans who believe that Obama is too left-wing, or too black.

Obama may represent the next chapter of the American story. By 2045 the US will no longer have a majority of European-origin residents. Globalisation is closing in rapidly; rural whites and industrial workers are playing a smaller role each year. Millions of voters from those two constituencies will vote in line with their anger about the way their way of life is being destroyed. The candidate who best reaches these groups is likely to win.

Diversity to combat groupthink

No one size fits all for world central banking

Rakesh Mohan, Advisory Board, former Deputy Governor, Reserve Bank of India

History suggests that there is no constancy in the practice of central banking. We have to keep changing central banking functions as the need changes. Central bankers around the world, and those who oversee them, need to acknowledge this and act accordingly. We need different horses for different courses.

This principle applies to a large number of issues ranging from policing financial stability to managing reserve assets. Emerging market economies (EMEs) and developed countries have very different preoccupations and these need to be borne in mind when devising strategies for their functioning. This is especially so as the EMEs have generally emerged from the trans-Atlantic financial crisis in better shape than the established industrial nations: their precepts and experience should therefore be heeded more in future than hitherto.

Emerging market economies have generally emerged from the trans-Atlantic financial crisis in better shape than the old-established industrial nations. Their precepts and experience should be heeded.

What are the lessons from what went on? The costs of this economic crisis are consistent with those suffered by other countries in the past, but this time the fall-out has been concentrated on the core of the world economy in the US and Europe. Poor countries or EMEs like India can ill-afford the severe consequences that typically emanate from the eruption of systemic financial instability. Thus, for EMEs, the maintenance of financial stability assumes greater significance in the ordering economic policy objectives.

All this has an impact on central banks' real or perceived independence, but we need a proper debate on this. We shouldn't see the independence of central banks as an objective in itself, but much more as a means toward some end. The addition of various new responsibilities, particularly related to financial stability, is seen as a problem because it could erode the perceived independence of central banks. However, the subject is more complicated than this and needs more discussion and clarification.

As one example, it is clear now that a great deal of financial innovation in the West was misguided, and central bankers should have developed the tools to keep this under control. Loose monetary policy and very low interest rates were responsible for the search for yields that led to a great deal of innovation that has been neither economically nor socially useful.

There was rare academic unanimity on the neatness of inflation targeting and light-touch financial regulation over the 15 years preceding the crisis. Much of this view came from a belief in the rationality of financial markets that we now know (and some of us knew all along) was wholly misplaced.

The experience of the Reserve Bank of India (RBI) is noteworthy and worthy of emulation. In the years before the trans-Atlantic financial crisis, the RBI followed a course of active policy intervention, both in monetary policy and in active and intrusive financial regulation. This went against the received wisdom of the time and was viewed critically by many foreign observers, but this policy has now largely been vindicated.

In contrast to the prevailing approach of laisser-faire liberalisation, the RBI demonstrated the value of independent thinking in the face of the groupthink that was characteristic of monetary policy and financial regulation around the world. Such an eclectic approach has a long tradition. Pragmatism in the interest of maintaining financial stability has been the RBI's hallmark, with the former governor, Y. Venugopal Reddy, playing an invaluable role in the pre-crisis period.

Not surprisingly, rethinking is now under way on what is best practice in macroeconomic management, encompassing fiscal, monetary, and financial policies. The narrow monetary policy fixation on consumer price index-based inflation targeting is being questioned, as is the phenomenon of the Great Moderation itself. This was a period of massive credit expansion along with an eventually unsustainable asset price boom.

Not only is the wisdom of light-touch financial sector regulation being questioned but, as a result of the huge fiscal expansion worldwide, fiscal policy is back at the centre of economic policy-making. We have been in an extended era of zero interest rates. This policy has been instituted to stimulate lending so that economic growth can be revived. However, is it possible that interest rates below a certain level actually lead to lower lending? The huge expansion of central bank balance sheets, accompanied by near zero interest rates has so far not led to expansion in lending. Below a certain level, there is no incentive for banks to take the risk that lending implies. It is better for them to buy so-called risk free treasury bonds and central bank deposits, especially if they are interest-bearing.

We viewed the barrage of financial innovations, ostensibly to aid risk management, with caution. Opening of the capital account was pursued with great circumspection.

Partly as a result of this, quantitative easing in the US, the UK and in continental Europe has brought attention back to the symbiosis between national treasuries and central banks, shifting the previous trend towards 'purity' of independent monetary policymaking. The European Central Bank has had to abandon its declared policy of no bail-outs for sovereign debt in order to preserve European financial stability. Additionally, the orthodox doctrine of free cross-border capital flows is being reconsidered in the light of global imbalances. Inflation differentials between developed countries and EMEs have persisted. This implies a corresponding nominal interest rate differential, leading to arbitrage capital flows that then put further upward pressure exchange rates. Is there any alternative for EMEs than to practise regular foreign exchange intervention and capital account management?

Reserve accumulation in EMEs is often perceived as resulting only from precautionary motives. We must see the need for expansion of central bank balance sheets in the presence of 7%-plus real GDP annual growth (nominal growth of 12-15%) in some significant EMEs over a sustained period. Base money, and hence central bank assets, need to grow at a similar rate. If the EME is practising prudent fiscal policy, the supply of domestic securities may not be adequate for expanding the central bank balance sheet: hence the demand for foreign securities and foreign exchange reserves. When this happens with a large economy like China, the whole world feels the consequences. More needs to be done to expand the supply of risk-free foreign assets for central bank needs. As large EMEs like India and Indonesia, among others, join China in such a growth mode over the next couple of decades, the demand for such assets can only expand.

We must consider the background of the resilience exhibited by Asian and Latin American EMEs, and India in particular, in the light of the impact of the crisis on these economies during 2008-10. First, there was a sudden reversal of capital flows, which had been unprecedented in magnitude. This reversal had significant impact on the these countries' capital and foreign exchange markets. Second, the fall in global trade far exceeded the contraction in global GDP. In spite of these setbacks no significant banks or financial institutions in these countries exhibited substantial stress: few, if any, required a bail-out. The EMEs are now clearly on a strong recovery path that is pulling up the rest of the world.

Evidently, these countries have been doing something right since the various Latin American crises of the 1980s and 1990s, and the Asian crisis of the late 1990s. While much of the world increasingly insulated the central bank from financial sector and banking regulation, the RBI consciously viewed regulation as an integral tool of monetary policy-making, broadly interpreted, which also focused on financial stability. We viewed the barrage of financial innovations, ostensibly to aid risk management, with caution. Opening of the capital account was pursued with great circumspection, though much professional economic advice was to the contrary.

The consequence was that India escaped the worst consequences of this international crisis, as it had also done during the Asian crisis. It had been able to resume its pre-crisis growth path relatively quickly, and at relatively low fiscal cost, though some storm clouds have indeed appeared recently, primarily due to excessive continued fiscal expansion. Prior to the crisis, this cautious approach had merely been seen as one being pursued by non-modern, inadequately-informed, conservative policymakers.

The Indian approach is no longer an outlier. A cautious but consistent line on liberalisation seems to bring greater financial stability as well as economic growth. These are lessons to which the world should pay greater attention if it is to return to growth and prosperity.

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Market too sanguine on risks

Don't be fooled by lower volatility rating

Michael Kaimakliotis, Quantum Global Wealth Management

Indicators of financial market volatility are falling sharply. At the same time risks that had retreated from view seem likely to rise again. This disparity could point to trouble ahead for risky assets.

There are two main reasons to think risks are going to rise in the period ahead: the outlook for further quantitative easing, and politics.

The VIX index is derived from the levels of 'implied volatility' in option prices on trading in the S&P 500 index. Two factors may lead to a rising VIX: greater uncertainty about the future value of the S&P as well as greater risk aversion. The VIX is therefore a reflection both of current levels of 'fear' as well as of investors' views regarding the possible future values of the S&P – independent of their levels of risk aversion.

It is notable that the VIX fell to 14.26 in mid-April, the lowest since before the financial crisis. It stands at 16.24 as I write. These levels are not only low relative to recent years - they are low relative to average realised historical equity market volatility. Are we really in a low volatility environment?

If we look at other markets where there exist similar indices then the answer seems to be 'yes'. The MOVE index measures the level of implied volatility in options on US Treasuries. Once again this measures investors' uncertainty about where Treasuries will trade in the coming month as well as their desire to avoid the risk associated with the uncertainty. The MOVE index reached new post-crisis lows in late April, reaching 65.2 as I write – a level not seen since the first half of 2007

If these indicators were not enough to tell you that the world is safe, then perhaps it would help to know that the foreign exchange currency volatility indices tell an identical story: the G7 index has fallen to 9.07, the lowest since autumn 2007.

But there are two main reasons to think risks are going to rise in the period ahead: the outlook for further quantitative easing, and politics. The European Central Bank (ECB) and the Fed are unlikely to provide the markets with additional quantitative easing in the coming months. The Fed will probably stay on the sidelines until after the US elections in November. The ECB will push politicians to address the structural causes of the crisis, having compromised by enacting the Long Term Refinancing Operation (LTRO).

Don't expect further significant action, unless markets plummet as they understand the LTRO actually increases the susceptibility of the banks to sovereign risks if the funds are used to purchase sovereign bonds as has been the case in Spain and Italy.

Second, political risks are rising. This is true in the near term in Europe. But the likelihood of gridlock in the US if the Republicans are unable to wrest the White House from President Barack Obama and control the Congress is also of great importance.

If this results, the US will have a sizeable recession early next year as fiscal austerity is implemented automatically. Markets will begin to discount the outcome as the election results become clear – whether in the polls or on election day. Political risks in China are far less easy to grasp but could be the greatest of all

I see two implications from the disparity in risks and indices of implied volatility. First, options are relatively cheap. So investors can afford to protect themselves at lower cost than was possible in the past years. Second, index prices are based on the options expiring over the coming month. Longer term indicators such as futures on the VIX are trading at much higher levels. Indeed, the September VIX future trades at 24.3.

Market participants may be a bit too sanguine about near-term risks but they expect markets to become more volatile in the period ahead. They are right.

Riding the cycle with ETFs

Holistic approach for world economy

Allan Lane, Twenty20 Investments

In an unpropitious environment for asset management strategies, it is well worth pondering the reality that different asset classes react in different ways to the overall economic background. The historical performance of different asset classes in different economic phases can be used to guide investment decisions. Linking up these clearly discernible patterns with Exchange Traded Funds (ETFs) as implementation instruments provides a holistic asset management strategy that has a high chance of success across the economic cycle.

A major feature of the asset management scene in the last three years has been the bipolar behaviour of many market participants. In an era dominated more by fear rather than by greed, the mentality of the investment crowd has veered between 'risk on' and 'risk off'. As many active managers have underperformed, a trend to buy and hold strategies has re-emerged. But this relatively undemanding approach is now being challenged by strategies based on ETFs providing a highly relevant and more beneficial alternative.

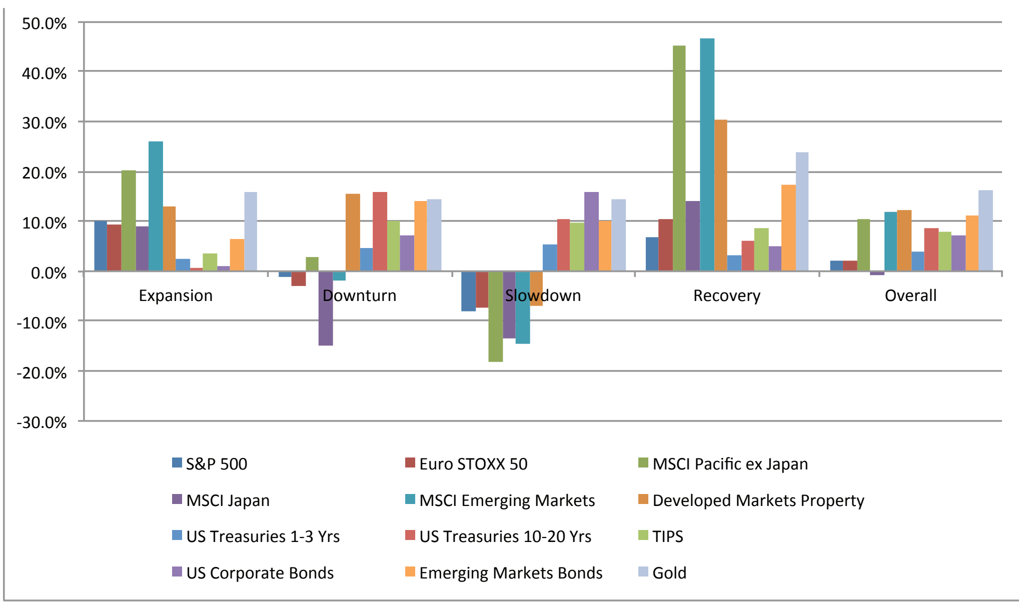
Of great importance is the extremely large range of ETF products. Well over 200 new ETFs have been launched in the US since the start of the year. The main providers are battling it out to produce an ever finer granularity of market exposures. If you want exposure to a specific market, there is almost certain to be an ETF available for you.

Our favoured methodology follows the principle of Occam's razor; this points to a simple but realistic framework. We employ the OECD's definitions of the four states of the economic cycle: from recovery and expansion to downturn and slowdown. Using these as our baseline, we measure the month-on-month performance of twelve representative market indices conditioned on those stages the economic cycle. For each of these markets, there are one or more ETFs available to gain that specific exposure.

Using data dating back to the end of 1999, the average performance of the various asset classes across those regimes can be compared with a pure buy and hold strategy. While the US economy has been fairly dominant in the past, not all regions of the globe will be in lock-step with that business cycle.

Buy and hold strategies represent a relatively undemanding approach. Constructive strategies based on ETFs provide a more beneficial alternative.

Figure 1 - Average annualised returns per OECD regime



Source: BlackRock, Bloomberg , 29 February 2012

For that reason returns are conditioned on the OECD cycle that is most appropriate for the index in question.

In figure 1 where we can see the average annualised returns across each of the 12 categories, some simple truisms of investing are evident for all to see. Average returns for bonds remain positive in all phases of the economy, unlike equities which offer flat to negative returns during a downturn and more pronounced losses during a slowdown. Gold seemed a good bet during any regime over that period, whereas property seems only really to suffer during the slowdown phase.

By looking at the average returns of short-dated versus long-dated US Treasury bonds one can see how the impact of a typical rising rates environment during an expansion phase affects the returns of longer-dated bonds over those from shorter-dated bonds. In a downturn, when rates are usually high and then falling to kick-start the economy, longer-dated bonds show very favourable returns. Another important fact is that inflation-linked bonds show stable returns during all economic regimes, being the best in a downturn when inflation is still high and only slowly falling.

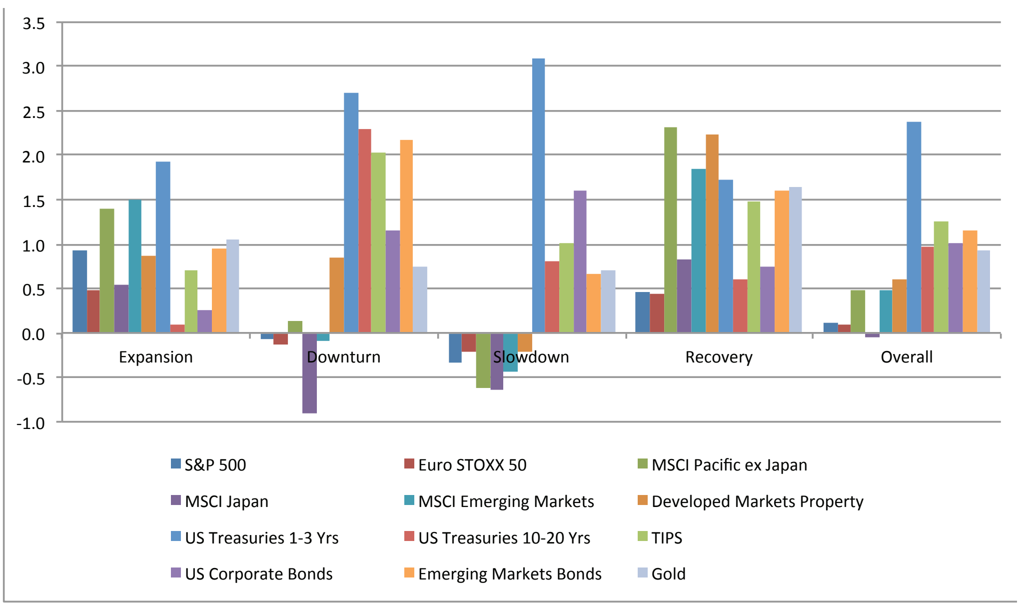
Looking at average returns will not shed any light on the riskiness of the investment; instead it is better to consider the Sharpe ratio which measures the returns per unit of risk, where the average monthly return is divided by the standard deviation of those same returns. Figure 2 strongly suggests that if one factors in the dispersion of the returns, bonds provide a much more reliable source of returns across all regimes.

This analysis, simple though it is, seems to support the widely-held view that choosing your asset classes depending on the different stages of the economy accounts for a significant component of one's performance. This framework directly can then be applied to the idea of choosing one's portfolio of ETFs by making a direct reference to the expected view of the business cycle.

As we look at the most recent OECD data from mid-February, the US, Japan and the global economy have moved into an expansion phase while Europe and Asia are still in a recovery phase. If the expansion for the global economy persists, then equities, both in developed and emerging markets, should do well. Implementing one's view of the economy can then be supplemented using short-term government bond ETFs to help adjust the risk profile of the portfolio. Similarly, inflation-linked and emerging markets bond ETFs provide a further degree of diversification and increased returns, as will a position in gold.

Implementing one's view of the economy can be supplemented using short term government bond ETFs to help adjust the risk profile of the portfolio.

Figure 2 - Average Sharpe ratio per OECD regime



Source: BlackRock, Bloomberg , 29 February 2012

Bernanke's unresolved dilemma

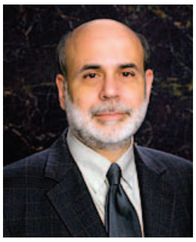
Fed has done enough easing … for time being

Darrell Delamaide, Board of Contributing Editors

Federal Reserve officials came roaring back from Easter break with a number of public speaking engagements leading up to the Federal Open Market Committee meeting in the last week of April and the quarterly press conference from the chairman.

All members of the Fed Board of Governors (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 FOMC, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. The overwhelming and still unresolved preoccupation is getting the balance right between competing concerns about inflation and unemployment.

The US Senate confirmed President Barack Obama's nominees to the Federal Reserve Board of Governors in mid-May -- Jerome Powell, 59, a lawyer and former investment banker, and economist Jeremy Stein, 51 -- bringing the board to its full complement of seven for the first time since April 2006.



Ben Bernanke

Bernanke takes on Krugman critique

Federal Reserve chairman **Ben Bernanke (voter)** was a little defensive at his press conference when asked why he wasn't willing as head of the US central bank to take the medicine he prescribed for Japan when he was a professor at Princeton. Bernanke has been under attack from Nobel economist Paul Krugman for not doing enough to spur the economy and boost employment. The Fed chairman is not following the advice he gave to the Bank of Japan in 2000 to 'abandon its excessive caution and its defensive response to criticism,' Krugman charged in a lengthy article in the New York Times magazine.

So when Times reporter Binyamin Applebaum asked Bernanke why, if the Fed has further tools to help the economy, it isn't using them, he left no doubt that he was a proxy for Krugman. 'And specifically, could you address whether your current views are inconsistent with the views on that subject that you held as an academic?' Applebaum asked.

'There's this view circulating that the views I expressed about 15 years ago on the Bank of Japan are somehow inconsistent with our current policies,' Bernanke said, backdating his paper a few additional years. He responded with what may have been his most definitive statement of the day: 'That is absolutely incorrect. My views and our policies today are completely consistent with the views that I held at that time.'

For one thing, Bernanke said, Japan faced real deflation, which is not the case in the US. After some more harrumphing, he brought his answer to the point: 'I guess the question is, does it make sense to actively seek a higher inflation rate in order to achieve a slightly increased pace of reduction in the unemployment rate? The view of the committee is that that would be very reckless.' The Fed has worked too hard establishing its credibility on inflation over the past 30 years to give it up for what would be 'quite tentative and perhaps doubtful gains on the real side.'

Krugman wasn't buying it. He immediately blogged that Bernanke was admitting he had been assimilated by the Fed 'Borg,' referring to the cybernetic organisms in Star Trek that assimilate other species to control them.

'Japan had nowhere near as high unemployment as we do, and his analysis back then was not simply focused on ending deflation,' Krugman harrumphed right back. In his answers to other questions, Bernanke made it clear that he thought the Fed has done quite enough for the time being – though of course it remains ready to spring into action if the US economy falters on its current growth path.

Narayana Kocherlakota

Kocherlakota sees tightening this year

Whether it's a Fed Borg or just Bernanke's need to reach a consensus on the FOMC, it's clear that inflation worries are key to any further accommodation by the Fed.

While there was only one dissent in April's FOMC statement that still forecasts tightening of monetary policy only at the end of 2014, one **non-voter**, Minneapolis Fed chief **Narayana Kocherlakota** says it's possible the Fed could begin tightening screws much sooner.

'My own belief is that we will need to initiate our somewhat lengthy exit strategy sometime in the next six to nine months or so, and that conditions will warrant raising rates sometime in 2013 or, possibly, late 2012,' he said in a speech in southern Minnesota.

But even an inflation hawk like Kocherlakota acknowledged: 'If the outlook for inflation fell sufficiently and/or the outlook for unemployment rose sufficiently, then I would recommend adding accommodation.'

Pianalto thinks economic growth is so sluggish it will take years to bring down unemployment to normal levels.


Sandra Pianalto

Pianalto sees sluggish growth,

From the more dovish side, Cleveland Fed president **Sandra Pianalto (voter)** thinks economic growth is so sluggish it will take years to bring down unemployment to normal levels

'Our economy needs to grow at a rate of 2% just to absorb new entrants in the labour force,' she said at a banking event in Lexington, Kentucky. 'To repair the damage from the last few years and speed the pace of employment growth, the economy needs to grow at a faster rate.'

Pianalto is expecting growth of 2.5% this year, followed by a slight pickup to about 3% next year. 'At the pace of growth I am anticipating, it could take as long as four or five years for the unemployment rate to fall to the 6% rate that I judge to be consistent with maximum employment,' she said.

After tactfully reminding her listeners that her views on growth and inflation determine how she votes on the FOMC, she said she expects inflation to remain subdued, though gasoline prices are something of a wild card. 'Based on all the information I consider, my outlook is for inflation to remain close to 2% on average for the next few years,' Pianalto said.


Dennis Lockhart

Conditions for further accommodation

Middle-of-the-roader **Dennis Lockhart (voter)**, head of the Atlanta Fed, doesn't think any further accommodation is warranted at this time despite lower-than-expected job growth last month.

'I view it as a policy that would respond more to a fairly dramatic negative change of direction of the economy that could be evidenced by rising unemployment, evidenced by plummeting growth,' Lockhart told reporters on the sidelines of a Fed event outside Atlanta. 'I am still not convinced that another round in this time frame would achieve a great deal.
'

Lockhart said he would have preferred to see 'double' the number of jobs added. 'It was in that sense disappointing,' he said, according to news reports. But he added 'it was one month's number.' Weather could have had an affect and it may yet be revised, he said.

'So I think it is way too early to conclude the economy is sputtering and that the employment progress we have made is stalling out,' he concluded.

Postscript: The terms of Fed governors are a generous 14 years, in part to insulate the central bank from political influence. But very few appointees actually stick around for a full term so that new appointments usually are to complete unexpired terms.

This basic fact about the Fed seems to have escaped two Dutch analysts, who hypothesised at length in an article on the Foreign Affairs website that President Obama's influence on monetary policy will last until 2026 because of his appointments. In fact, the appointments are mostly for unexpired terms lasting as little as two or three years.

Obama's two newest appointments, as some keen-eyed reporters at the Wall Street Journal have pointed out – Jerome Powell and Jeremy Stein – have terms ending in 2014 and 2018 respectively, not 2026 as the Dutch experts claim.

Escaping the stranglehold

ECB, too, was partly responsible for the crisis

Jacques Delors, Founding President, Notre Europe

Economic and Monetary Union (EMU) is in a very difficult situation. The euro's problems overshadow the problems of the Union, to the despair of European parliamentarians who would also like us to talk about the European budget, environmental policy, energy, the common agricultural policy and many other subjects concerning our foreign policy.

EMU is in a stranglehold. On the one hand there is the fire still smouldering on the financial markets, and this is the main argument for those who wish to impose the fiscal compact, they have no other argument. On the other hand, there is the risk of stagnation which, apart from its dire consequences – unemployment, inequality, poverty – confirms, sadly, Europe's relative decline compared with the rest relative to the world as a whole.

I do not have a miracle cure. I simply support an approach which endeavours to resolve the contradiction between two elements: how to reconcile the necessary economic restructuring, demanded by those whom we call 'the markets', and the need to restore confidence in Europe, in its dynamism, in its growth and in its ability to create jobs, which in itself is the synonym for reduction of inequality.

The fire is smouldering, but we must not keep it burning. It is tragic and irresponsible when Spain, under a right-wing government, tries to reduce its budget deficit but is unable to reach the figure decided by technocrats. Immediately a government leader and a member of the Commission publicly sound alarm bells, at the risk of reactivating market anxieties. Such attitudes are appalling and irresponsible. We must be aware that risk exists but avoid fuelling it by such reflections, which, essentially are merely a way of salving our consciences. Spain is making a huge effort. Casting aspersions is tantamount to fanning the flames.

The recent call by European socialist leaders on ways out of the crisis marks the beginning of an offensive of social democracy in the broadest sense of the term. Social democracy is reacting to our current situation by speaking on behalf of its fundamental values, with the aim of reinforcing a united Europe. This is what is at stake. One key part of the approach is to inaugurate what the document calls 'a socialist reform that could constitute the basis of a new call to European citizens'. It will take two years of patient and focused work.

A wake-up call is essential. It is not simply a question of changing Europe. Each country must do what is necessary. I regret to say that today social dialogue is absent and lacks substance. That frustrates me, because social dialogue is, along with the parliamentary system, one of the cornerstones of democracy. Moreover, the most successful countries are those that have been capable of associating the forces of capital and labour with their reforms, as is the case in Austria and Germany.

What are the lessons from the past? First of all, let us take the Single Act. In a few months' time we are going to celebrate the 20th anniversary of the Single Market and, some argue, it is the alpha and the omega. I don't believe that is true. It was simply necessary. The Single Market was founded on three notions: competition which stimulates, cooperation which strengthens and solidarity which unites.

Then, there are the international causes of the crisis affecting the euro. Of course, it is easy for the US Treasury secretary to talk about the euro crisis, forgetting his own deficit and the domination of the dollar. But the international causes of the euro crisis still exist. These are, of course, linked to the excesses of financial ideology. I will quote you a single sentence that shocked me when I was talking to a leading French banker, who said to me: 'Jacques Delors, you understand nothing, the creation of value is essential.' I asked him: 'And what is the creation of value?' I asked him. I did not wait for his answer, as I already knew it: it is the increase in stock market prices.

The fire is smouldering, but we must not keep it burning. It is tragic and irresponsible when Spain tries to reduce its budget deficit, is unable to reach the figure decided by technocrats and immediately a government leader and a member of the Commission publicly sound alarm bells.

I am not saying that EMU would not have experienced a crisis if there had not been an international crisis. The increase in our debt was worrying. And it began long before the crisis started in 2007. But, all the same, it was quite reasonable, quite manageable. If you look at the evolution after 2007, we came to the rescue of banks to reduce the consequences of the crisis.

Now we come back to the crucial point: why did EMU function badly? There has to be an economic pillar and a monetary pillar. There was only a monetary pillar, the economic one did not exist. I thought coordination of economic policies would balance and complete the power of the central bank. Until 2007, EMU functioned well; it produced a growth rate of more than 2%, investment growth of more than 4%, 12m jobs in 10 years.

If there had been coordination of economic policies, if finance ministers had agreed to speak to each other frankly, EMU could have functioned. But to my knowledge, this was never the case. They sorted things out between them and sought the causes of their difficulties elsewhere. This explains why it was necessary to go to the top, to the heads of state and governments. However, if the finance ministers had wanted to get a clearer picture of the situation, they could have seen Ireland's extravagant behaviour with its banks, Spain's equally extravagant behaviour with mortgage lending, Greece's dissimulation of its real statistics. But they turned a blind eye. That is why I have always considered, since the beginning of the crisis, that the Eurogroup was morally and politically responsible for the crisis and that it should have reacted as early as 2008 to rectify its mistakes.

During this period the euro was a source of protection, not of growth. The EMU area continued to fall behind in terms of competitiveness, excepting Germany, of course. Moreover, the euro protected us from our own mistakes. Spain, Greece, Ireland, Portugal and others thought they could make mistakes protected by the euro. The trade balance between countries was disregarded. Nobody was concerned about that. Without doubt, this was the responsibility of the council of European finance ministers. But also, with due respect to Jean-Claude Trichet, it was (and is) also that of the ECB.

The ECB's only only goal was, and that was demanded by the Germans, to maintain price stability. But everybody knows that in today's world a central bank must also deal with financial stability, public debt as well as private debt. At what moment did the governor of the Bank of Ireland, the governor of the Bank of Spain or other governors tell the ECB governing council that something was wrong? They did not say anything, nobody said a word. Therefore, they too are responsible for this situation. So, this is no time for them to lecture others.

There can only be an EMU in as much as there is a balance between the economic and the monetary. I had proposed the coordination of economic policies in 1997, when I was no longer president of the European Commission but a simple French citizen. I had proposed this as a consequence of the 1987 Delors report. It was not taken up: instead, 'growth' was simply added to 'stability'. That is typically French: the French adore formal requirements. They returned home happy because 'growth' had been mentioned. How irresponsible. Or what a fraud?

Nothing is possible without shifting the balance between economic policies and monetary policies. But how far should we go? The problem is complicated. It was simple at that time: they should have given finance ministers responsibility for coordinating economic policies, but they did not do it. Knowing that we could not go any further with federalism, I believed in cooperation – in the context of the triptych: 'competition, cooperation, solidarity'. I believed in cooperation and I was wrong. During this period, the Single Market with the Single Currency had given rise to an increasingly large diversification, specialisation of production, to the benefit of countries such as Germany, and to the detriment of others.

We know now the strength of Germany and I am absolutely appalled when I hear economists talking about comparable competitiveness as if it were possible to club together in the same model Germany, Portugal and Greece. Europe is founded on the concept of diversity. Can it live with this diversity or will it have to accept the implicit domination of Germany and its rules?

At what moment did the governor of the Bank of Ireland, the governor of the Bank of Spain or other governors tell the ECB governing council that something was wrong? They did not say anything, nobody said a word.

France and Germany – plus ça change

Hollande has less time to adjust than Mitterrand

German confidence in the economic policies of the newly-elected French socialist president was shaken to the core. The monetary situation in Paris was worsening dramatically. The Bundesbank president told central bank colleagues, in a behind-closed-doors meeting in Frankfurt, that monetary stabilisation policies in France and Italy would bring only temporary respite. After the fall of the conservative Paris government, France was 'a key problem,' the Bundesbank president said. Advocating a 'suspension' of French participation in the monetary system, he called on France and Germany to devalue. He asked: 'How long can the French hold on, what do they really want?'

The querulous Bundesbank chief was Karl Otto Pöhl; the new French president, François Mitterrand, shortly after his historic victory to become the first socialist leader of the Fifth Republic. The comments – revealed in previously unpublished transcripts – were made in May 1981, but the chronicle reads like a preview of May 2012 following the victory of François Hollande in the presidential elections on 6 May.

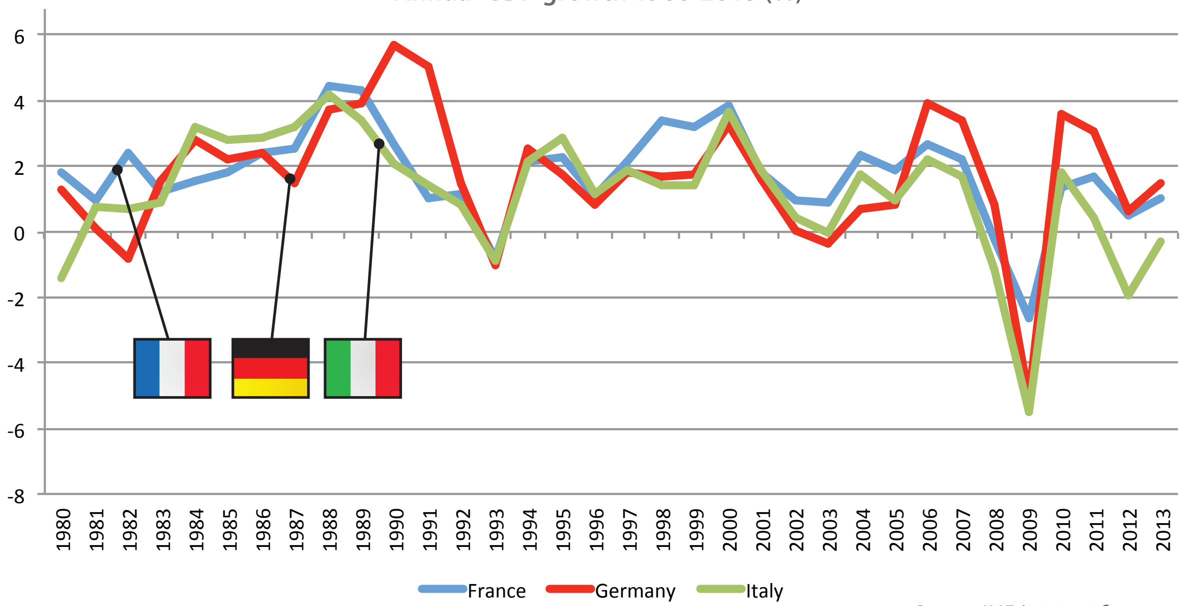
Today's French president-elect has vowed to temper the European austerity policy of the German government and the Bundesbank. These policies, representing a major reason for President Nicolas Sarkozy's ejection, echo Franco-German discord three decades ago. The stage is set in coming weeks for a clash between France and Germany on the economic leadership of Europe. But the controversy this time is far more public, and will bring more virulent political repercussions, centred on the future of economic and monetary union (EMU).

Newly-released documents from several official European archives, above all from the Bundesbank, reveal large-scale German scepticism towards Mitterrand's unorthodox pro-growth, pro-spending shift in French economic policy. The archival findings underline some parallels between the current problematic state of the European single currency and the explosive position 31 years ago, when the forerunner of EMU, the European Monetary System (EMS), was weathering a period of unrest. Unlike in 1981, when the discord was mainly aired in secret meetings and exchanges of governmental messages, today's Franco-German divergences are paraded in the full glare of international media attention.

Policy discrepancies between the two largest economies in EMU focus on similar questions to three decades ago. Just as in the early 1980s, France is unhappy about plans to transfer budget and tax powers to European institutions. German-led austerity was as unpopular then as it is now. And France has now become still more concerned about sharply reduced competitiveness against its powerful eastern neighbour, expressed in the five-fold increase in France's trade deficit with Germany since the early 1980s, from a level that Mitterrand already termed 'catastrophic'.

German GDP growth forges ahead of rivals

Annual GDP growth 1980-2013 (%)



Source: IMF (2012-13 figures are projections)

President Mitterrand regarded his socialist programme of reflation and nationalisation in 1981 as a matter mainly for France, with little heed to the international consequences. Hollande's radicalism is much less extreme, and – conscious of the difficult international environment – he will wield it with sensitivity, particularly vis-à-vis German Chancellor Angela Merkel. But, in contrast to Mitterrand, he will be visibly throwing down the gauntlet, with big European implications. Reflecting France's poor growth and high unemployment, one of Hollande's first actions will be to write to fellow European heads of government, requesting a new growth pact to complement the fiscal discipline treaty and for a dialogue with the European Central Bank on ways to finance 'the real economy'.

Mitterrand's hostility to German economic policies emerged only slowly during two presidential terms that ended in 1995, shortly before his death in 1996. France's criticism now – that the Federal Republic follows a 'go-it-alone' approach taking too little account of its European partners – is more open. Mitterrand's early radicalism included nationalising France's 36 top private banks and five large industrial enterprises, cutting working hours and the retirement age and raising social security payments. The actions exacerbated the economic overheating and double-digit inflation bequeathed by Mitterrand's predecessor Valéry Giscard d'Estaing – weakening the franc, swelling the budget deficit and increasing the French economy's lag with Germany.

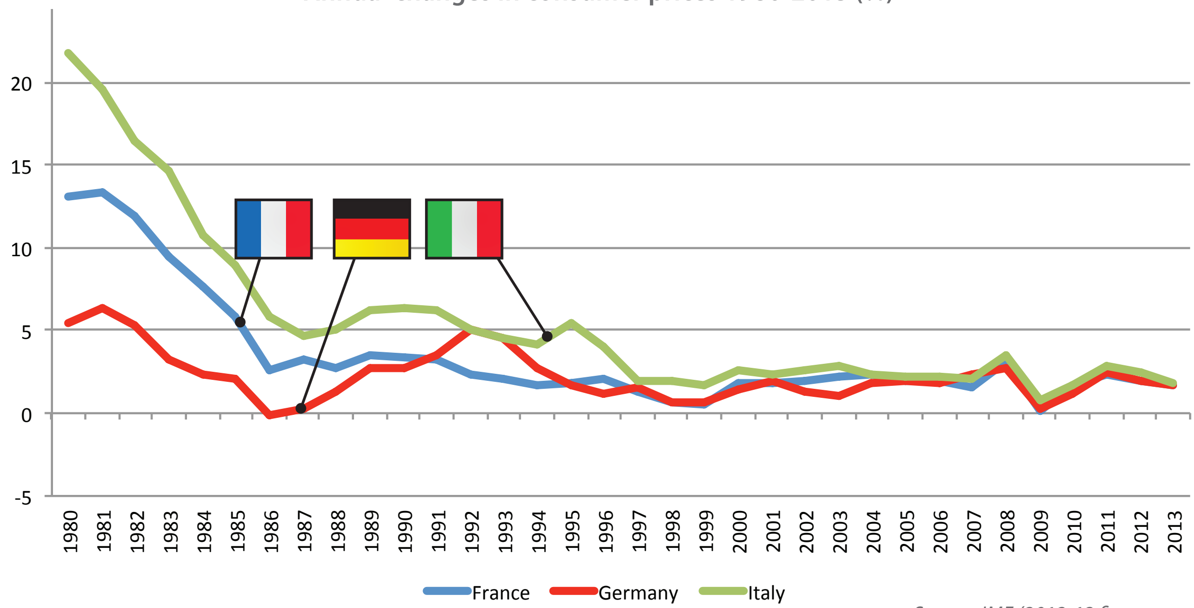
Although his policies are more moderate, Hollande's call for a 'new Europe' of 'solidarity, progress and protection', his drive to water down the EMU fiscal pact, his refusal to follow Germany's line on debts and deficits and his espousal of reflation represent a more explicit challenge to Germany. Hollande is well aware of the dramas and disappointments of the post-1981 period. As an adviser to officials and ministers in the Mitterrand administration, Hollande was never close to power – a characteristic that Nicolas Sarkozy sought to define as a source of weakness during the election campaign – but he knew what was going on. In different ways, both he and Mitterrand, born 41 years apart – the former never holding ministerial office, the latter a frequent component of unstable Fourth Republic governments before Charles de Gaulle became president in 1958 – have been late developers frequently underestimated by their rivals.

After Mitterrand's victory, West Germany's social democrat Chancellor Helmut Schmidt at first took a conciliatory view of the new socialist leader. But his frustration came to a head five months later – three days after the first of a series of French franc devaluations in October 1981 – when Schmidt told Mitterrand brusquely: 'You have chosen a different path. I hope you succeed. But your means and your methods are such that we cannot harmonise them.'

German officials say Hollande's campaign attacks on Germany have partly been pure electoral rhetoric. They affirm that Merkel will come to an arrangement with Hollande, just as she did with Sarkozy. Certainly, in one key area, French divergence with Germany now is less extreme: with both countries in EMU, inflation differences are much smaller. In 1981, French prices were rising by an annual 13%, against 6% in Germany. (The Italian inflation rate was even higher at 20%). Inflation 31 years later in both countries is around 2%. Yet, elsewhere, the imbalances have widened. In 1981, both France and Germany ran small current account deficits, of 0.8% and 0.7% of GDP respectively. The German current account deficit, together with the Federal Reserve's stringent monetary policies and high US interest rates, was one of the reasons for severe D-Mark weakness against the dollar in 1981, a serious preoccupation for the Bundesbank.

Inflation convergence since birth of EMU

Annual changes in consumer prices 1980-2013 (%)



Source: IMF (2012-13 figures are projections)

By contrast, in 2012 Germany is expected to show a current surplus of 5.6% against a deficit of 1.9% for France. Unemployment differences have persisted, with the French jobless rate 7.4% in 1981 (against 4.8% for Germany), compared with 9.9% in France now (against 5.6% in Germany). Most important, 23 years after the fall of the Berlin Wall, Germany is reunified. Having overcome most of its post-unification problems, Germany is now registering sustainably higher economic growth than France, opening up what looks like a permanent gap. Between 1995 and 2005, France's growth outpaced Germany's for 11 years in succession.

In 2006, the story changed. For six consecutive years since then, following economic reforms enacted under Chancellor Gerhard Schröder (who lost office in 2005 partly because of these measures' unpopularity), Germany has outgrown France every year, with the sole exception of the recession year of 2009. Even though Germany is expected (by the International Monetary Fund) to expand GDP at a lacklustre 0.6% this year, this is still ahead of the expected 0.5% in France.

In the wake of the Hollande victory, and depending on the tactics by both sides, the scene could be set for a replay of the fraught atmosphere of spring 1981. Bundesbank chief Pöhl, a former finance ministry official and Schmidt confidant, had taken up the presidency of the Frankfurt central bank only slightly more than a year earlier. Pöhl was fighting on two fronts. Both the French and his own government were pressing the West German central bank to relax its tight monetary policies.

Tension increased after Mitterrand secured a clear victory on 10 May 1981 over Giscard d'Estaing. Far more than Sarkozy and Merkel, who formed a fragile marriage of convenience after a rocky start to their relationship, Giscard and Schmidt were kindred spirits. Schmidt clearly backed Giscard for re-election – although, in sensible contrast to Merkel's support for Sarkozy in 2012, he refrained from making this a public issue.

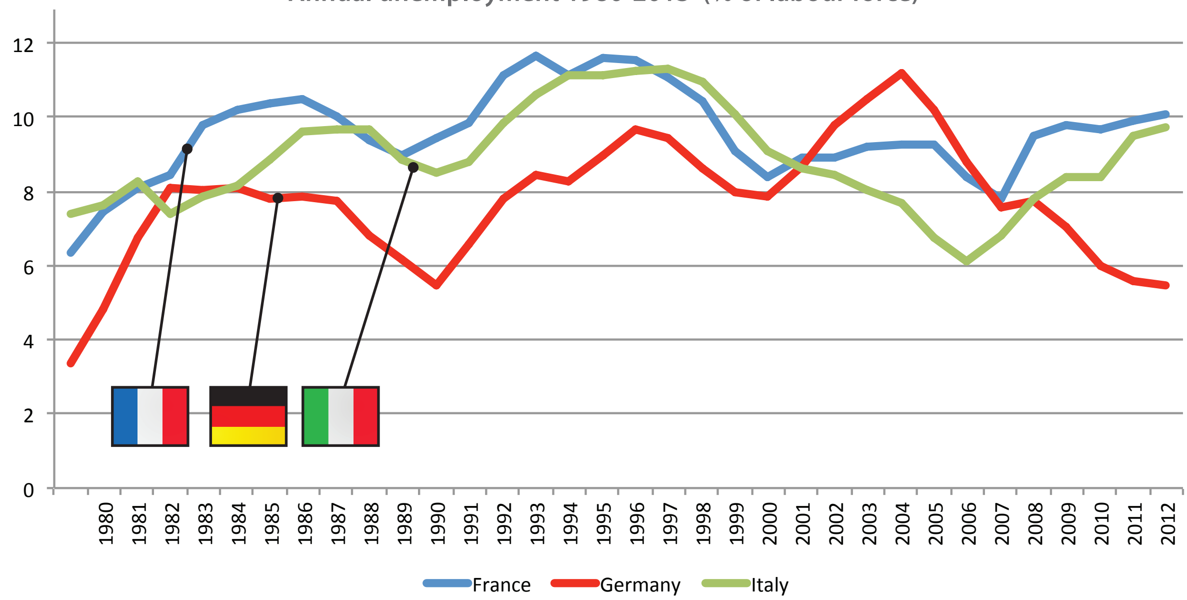
In early 1979, Schmidt and Giscard had inaugurated the EMS as a zone of European monetary stability designed to represent a 'home' for the French franc after France had twice been forced to quit the earlier version of the EMS, the so-called 'snake', in 1974 and 1976.

To support Giscard and his prime minister Raymond Barre, the West German government, then based in Bonn rather than Berlin, agreed in April 1981 – despite strong misgivings from the Bundesbank – to a French plan for joint Franco-German loans on the international financial markets. In an attempt to boost the flagging economy in both countries, Schmidt persuaded Barre to write him a letter asking the Bundesbank to lower German interest rates, which Schmidt then promptly arranged to be leaked to the press.

Through Bundesbank documents, full details can now be revealed. On 23 April 1981, at a meeting of the Bundesbank's policy-making council on the 13th floor of its Frankfurt headquarters, Pöhl voiced his annoyance: 'It is unusual that this letter from the Chancellor was then made known to the public. We do not have to justify our policy to French government… I hope we can limit the damage.' Axel Herbst, Germany's ambassador to Paris, wrote a prescient dispatch on 5 May that, whoever won the second round of the election on 10 May, changes in France's European policies would follow.

After Schröder reforms, German unemployment outperforms the others

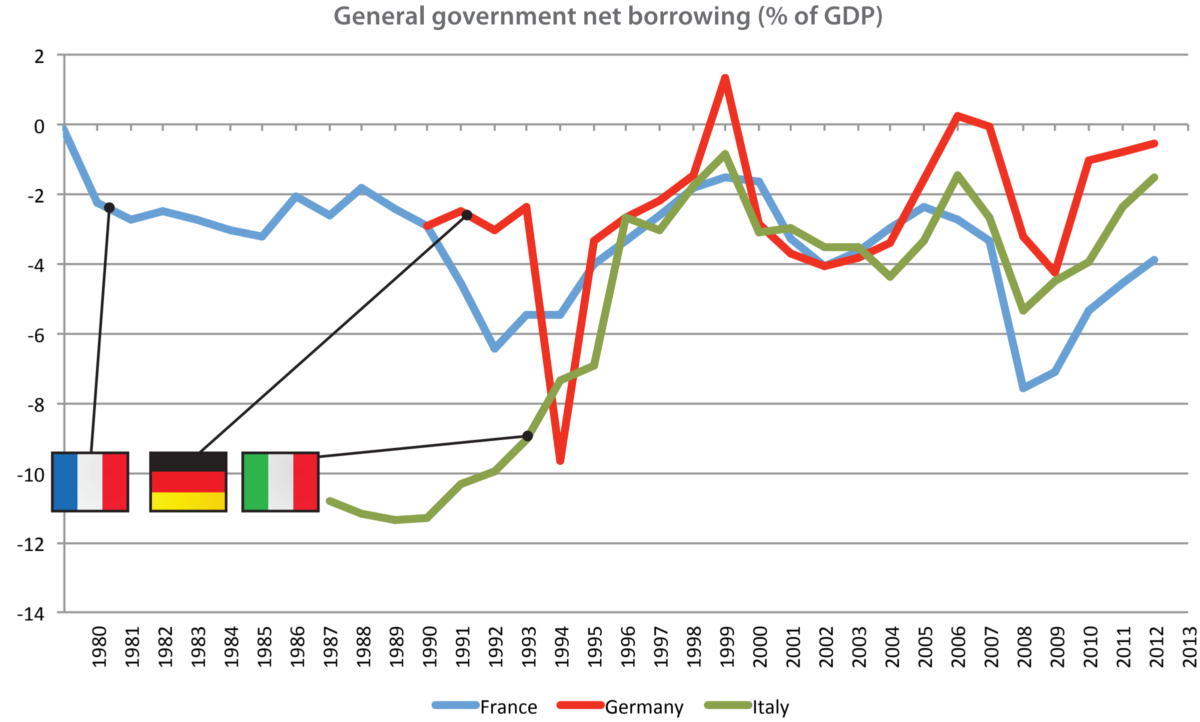
Annual unemployment 1980-2013 (% of labour force)



Source: IMF (2012-13 figures are projections)

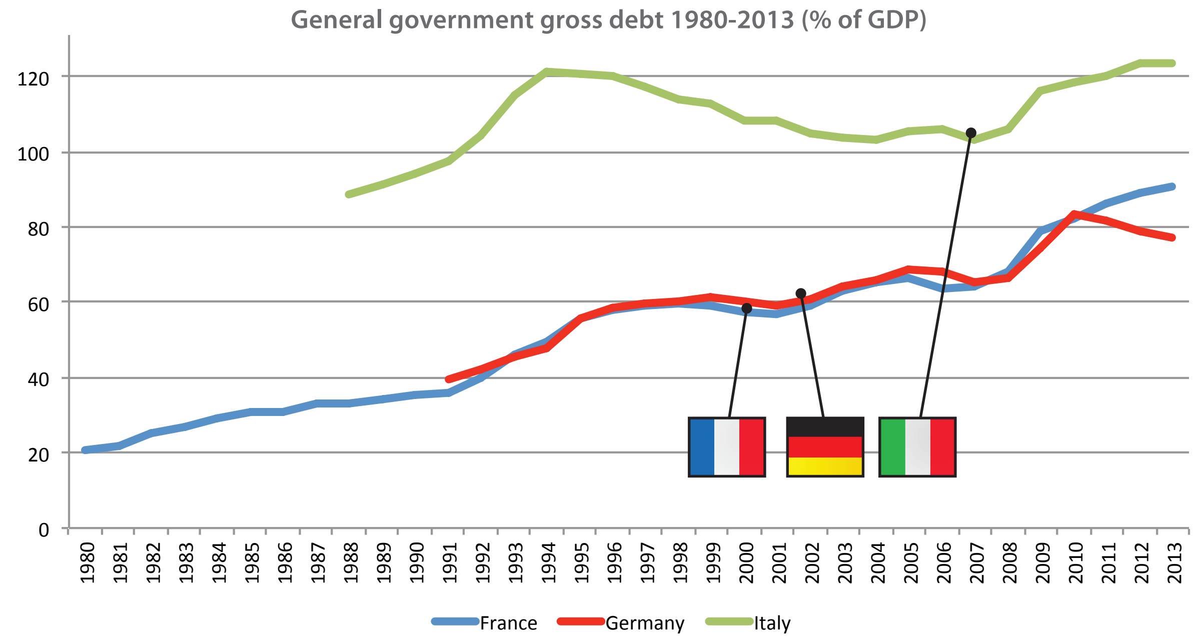
After Mitterrand's election on 10 May 1981, the potential for damage continued to grow. Herbst informed his political masters on 12 May that, in view of their inexperience of power, the French Socialists had neither a full government programme nor a list of cabinet members. An understated briefing note from the Foreign Office in Bonn recorded on 19 May: 'The change of president is serious. We should neither dramatise it nor play it down. We can expect changes in economic and social policy.'

Germany gets government deficits under better control than the others



Data series for Germany and Italy starts from 1991 and 1988 respectively.
Source: IMF (2012-13 figures are projections)

Sharp rise in German, French government debt, stabilisation in Italy



Data series for Germany and Italy starts from 1991 and 1988 respectively.
Source: IMF (2012-13 figures are projections)

A report from the British foreign office on 13 May warned of a possible franc devaluation within the EMS or a possible departure 'presumably temporarily'.

The note added: 'If France embarks upon an expansionary economic strategy, at a time when its major partners are moving slowly or in recession, there is likely to be a deterioration of the French current account and thus in the position of the franc within the EMS. Mitterrand may wish to counter this by high interest rates and exchange controls and possibly import restrictions. But he may be obliged, or prefer, to allow the franc to fall.'

Both the British and German governments gave restrained judgments on Mitterrand. The new president was described by the British Foreign Office as: 'Not a doctrinaire socialist. Keen on books and painting and addicted to writing, he seems to be mostly a humanist with egalitarian interests and a sense of public responsibility but he is by nature aloof. He has few personal friends and is not much inclined to share confidences. He has remained a tough and ruthless politician capable of biting criticisms of his opponents. But this side of his character has been little in evidence lately. During the election campaign he managed to appear very calm and self-possessed.'

A document from Bonn described him as 'rather old-fashioned' – 'not a manager, with a classical, historical and literary education, relatively little international experience, no foreign language skills, French-orientated traditional thinking. Personally rather aloof, inaccessible, even for his staff; in his rhetoric, traditional, emotional, even sentimental. He is sensitive, probably over-sensitive, his personal style increasingly shrouded in the aura of a prophet and doomsayer, combining an intellectual touch with a leaning to the bohemian.'

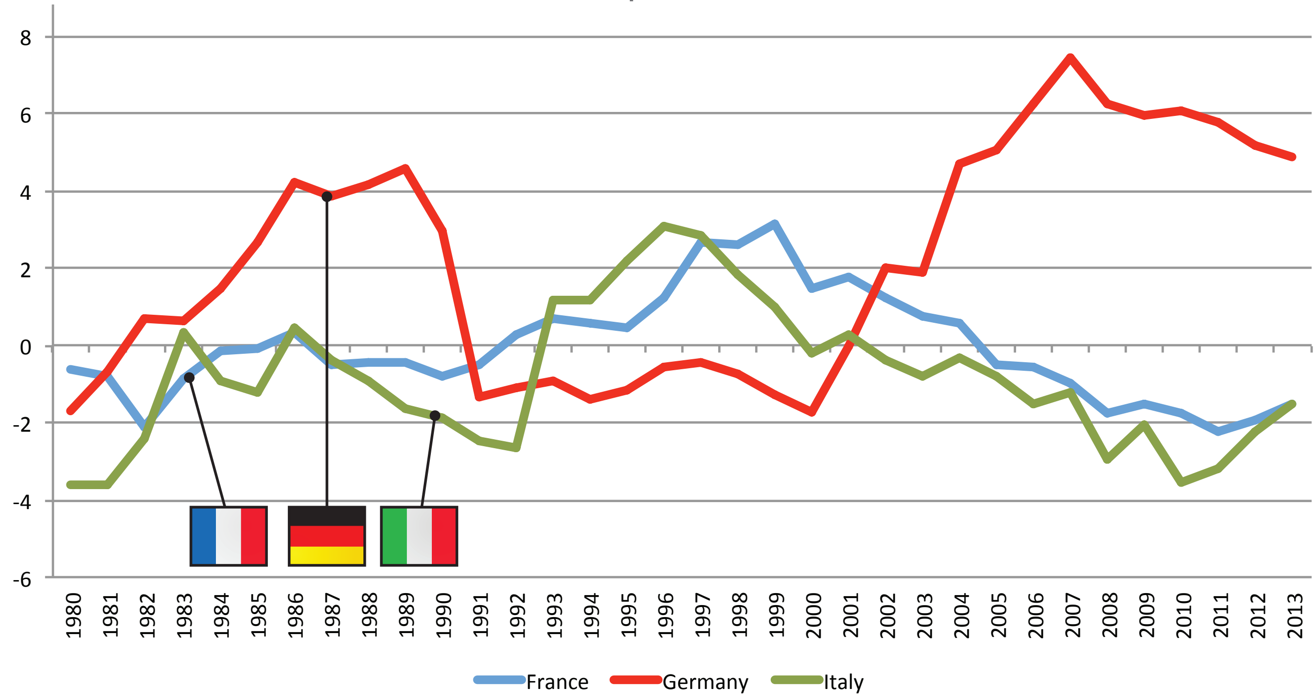
The message added disparagingly: 'There is some doubt whether he is capable of intensive, concentrated deskwork. The danger in the past was that he made decisions on the basis of intuition and also tends towards impromptu remarks.'

Similar questions were in the air on 21 May in Frankfurt, when the Bundesbank council met for the first time since Mitterrand's election. Reporting massive French capital outflows from France, Pöhl expressed his perplexity over the new French leadership's real intentions. 'People are moving out of the French franc for political reasons. It could be that the French will introduce foreign exchange controls, which would not help much.' Noting that central bank intervention to support the franc was leading to large monetary infusions into Germany which were inflating liquidity and the money supply, Pöhl stated, 'We must draw monetary policy conclusions from these political decisions. We cannot accept additional liquidity.'

Meeting a month later, just before the first round of parliamentary elections in France that led to a socialist landslide, Pöhl told the Bundesbank council on 16 June that crisis measures in Italy and France were nothing more than stopgaps. Pöhl labelled Italy's decision to restrict imports through a cash deposit scheme as 'problematic'; French foreign exchange controls were 'not satisfactory'.

German current account surplus compares with France, Italy in deficit

Annual current account surplus/deficit 1980-2013 (% of GDP)



Source: IMF (2012-13 figures are projections)

The same was true for a drastic increase in French money market interest rates. 'The effectiveness of these French and Italian is only temporary. High French interest rates cannot be permanent. They [the French] want to pursue an expansionary course, then they have higher rates of inflation, and the interest rate is no longer appropriate. In the EMS we have the calm before the storm.'

Pöhl added, 'Over the longer term we cannot accept a fixed exchange rate with two countries with 20% inflation. Something has to happen. So far we have kept quiet, in view of the [French parliamentary] election. We are seeking a change in exchange rates against the French franc and Italian lira as soon as possible. The Belgians will join in. The only question is when and how?'

Pöhl informed his colleagues about a recent meeting with Renaud de La Genière, governor of the Banque de France. 'He asked me what would be better: the freeing of the exchange rate or realignment. I said that from an economic point of view and in line with our interests, suspension [of French EMS membership] would be the right measure.' Reflecting on the 1974 and 1976 French departures from the 'snake', Pöhl said: 'I know how hard it is, when one has left, to enter again. I would say that a suspension would be the end of the EMS. I'm not too sad about this.'

With any eye on Horst Schulmann, state secretary on the Bonn finance ministry, who was attending the meeting (and argued later in the meeting that Germany should support 'moderate' political forces in France), Pöhl said: 'I must say that this is a decision that the government has to meet in the first place... The development of dollar is of paramount importance ... If a freeing of the exchange rate is not to be considered, then we should plan for a realignment in early autumn.'

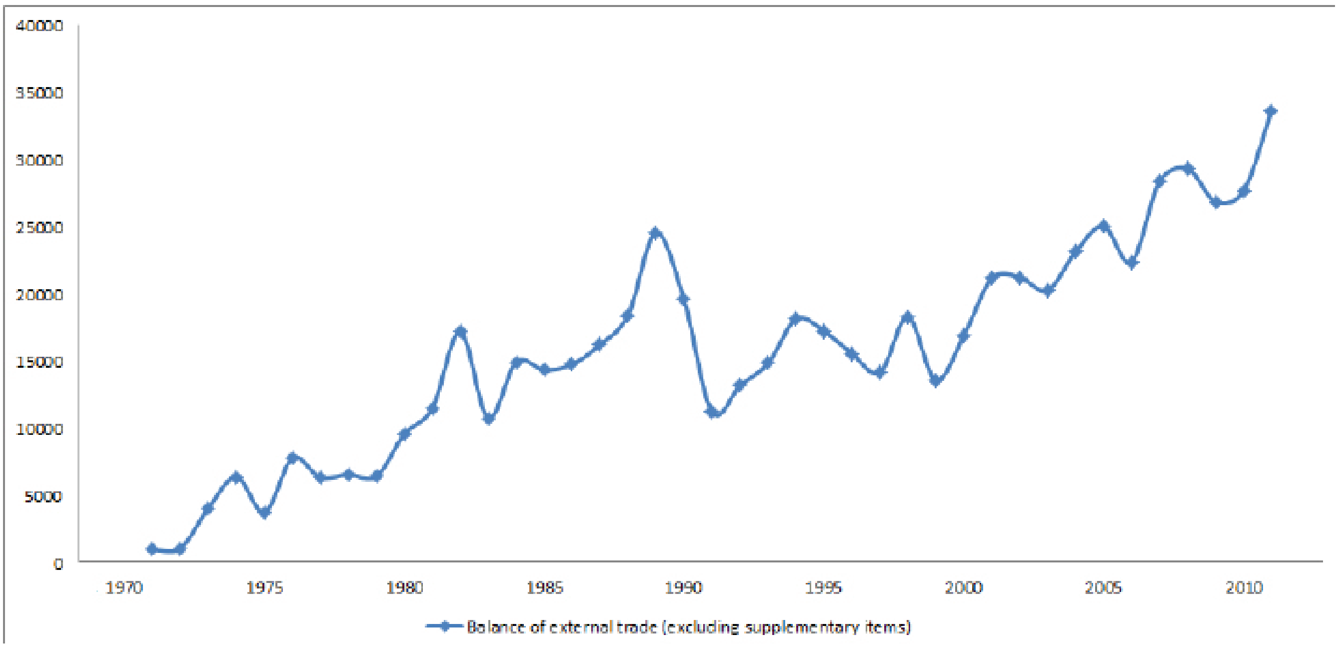
Pöhl's implicit forecast proved correct. At the largely ceremonial German-French government summit in Bonn in July, discussion on the EMS was largely anodine. 'It functions well; we will maintain it in the future and work to develop it further.'

At a German embassy lunch in Paris at the end of September, it was clear that pressure on France was intensifying. A German diplomat said that France should have devalued the franc by 10% in August. 'The position was now becoming impossible. They were playing a game of poker with the German government.' When the eventual EMS realignment came on 4 October, with an overall 8% parity change between the franc and the D-Mark, everyone was reasonably satisfied. Even the normally critical Pöhl told his central banking colleagues on 8 October, 'The realignment was better prepared than the last one. ...Germany and France are in full agreement.'

That was the prelude to another 18 months of in-fighting between France and Germany incorporating two more de facto French devaluations, in which Mitterrand gradually adjusted his policies to economic realities. The countdown started to many more bruising Franco-German political battles over the establishment of EMU.

German trade surplus with France grows continually over 30 years

Balance of trade between Germany and France, 1971-2011



Source: Deutsche Bundesbank statistical information

A plea for more transparency

Accounting analysis applied to central banking

Gene Deetz, Managing Director, Navigant Capital Markets Advisors

Since the onset of the sovereign debt crisis in 2009-10, the European Central Bank and national central banks (NCBs) have had to take proprietary risk to support the peripheral states of the euro area and their banks. As commercial banks and investment funds know to their cost, the management and reporting of market and credit risks is a challenge for any organisation. The Eurosystem is a diverse network of central banks with complex risks. Ensuring common standards of underwriting is a difficult task.

Despite this development, the Eurosystem does not offer sufficient risk information to aid financial markets' understanding of the overall position. The treatment of the Target-2 balances is a sign of insufficient transparency. The ECB has a crucial role to play in leading the euro area out of the crisis, harnessing austerity with growth. It needs the support of market participants on an international basis. This will be forthcoming only if it offers greater openness about its risks and their management.

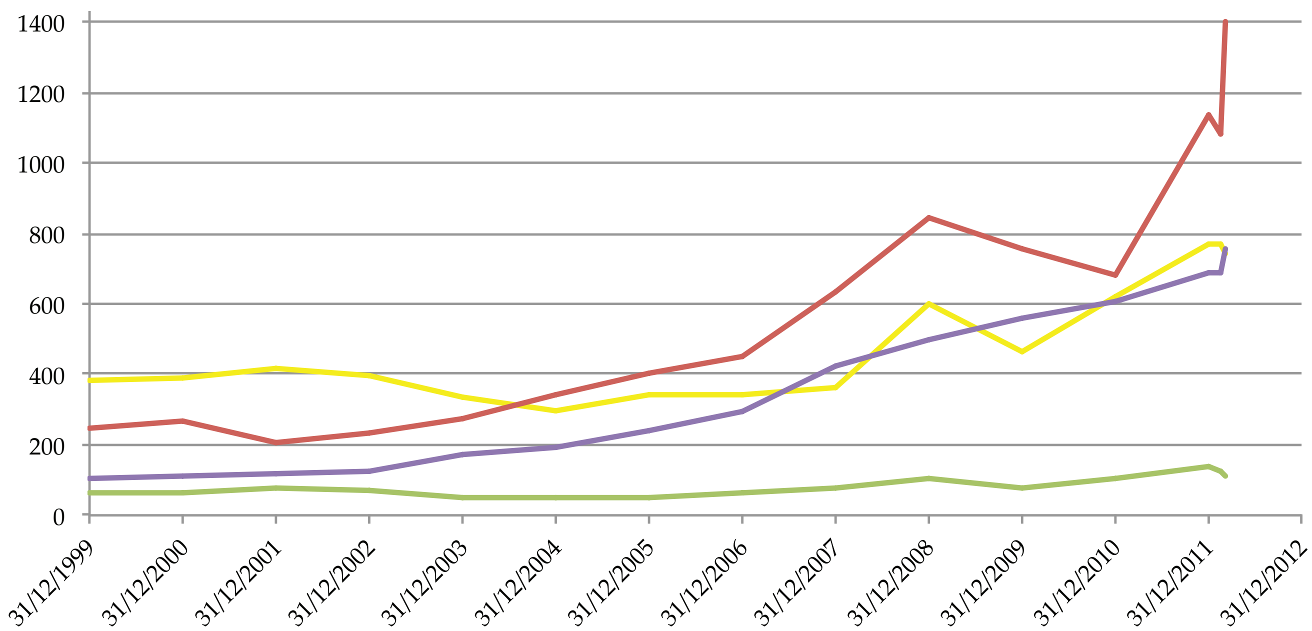
Europe seemed a less scary place in April 2012 compared with November 2011, although a sense of crisis has now returned after the inconclusive Greek election result. The restructuring of Greek debt and the spreading of liquidity through the banking sector by Eurosystem central banks (the ECB and 17 NCBs) were positive developments. The banks repaid the compliment by purchasing substantial amounts of Spanish and Italian government debt.

The heroes have been the ECB and the NCBs. Perhaps they are reluctant heroes, forced to throw their balance sheets at the euro area's problems whilst the lumbering political process tries to merge the EFSF and the ESM rescue funds.

The concern is that the ECB is no longer just setting interest rates, managing the Eurosystem's foreign exchange and gold reserves and conducting some government banking business. It is using its capital to support the banking sector and the stressed peripheral states (collectively Greece, Ireland, Italy, Portugal and Spain - the 'GIIPS'). The change in activity is immediately apparent from the Eurosystem's balance sheet. [Figure 1]

The Eurosystem does not offer sufficient risk information to aid financial markets' understanding of the overall position. The treatment of the Target-2 balances is a sign of insufficient transparency.

Figure 1 – Eurosystem balance sheet – asset growth December 1999-March 2012.



Source: ECB

Since 2007, its assets have doubled to over €3tn while capital and reserves have only risen by 20%. What do we know about the risks arising from this increase?

Market operations have skyrocketed due to the Securities Market Programme (SMP) and the Long Term Refinancing Operation (LTRO). The SMP consists of €283bn in sovereign bonds of the GIIPS and covered bonds. The ECB has not disclosed the issuers, any mark-to-market gains/losses or standard risk measures. As of the end of February 2012, we estimate that (a) the economic loss on this portfolio is about €33bn and (b) the economic capital to hold this portfolio would be €9bn.

The LTRO represents €1.1tn of three year loans to euro area banks which have given collateral – so the risk of loss requires both the counterparty and the collateral to fail. Again, the counterparties and the nature of the collateral are not known. We have estimated that over 70% was taken down by banks in the GIIPS. We further estimate that 20% of this amount is likely to have been collateralised by non-marketable securities. These securities are either valued by NCBs using a model or, bizarrely, the outstanding amount of the issue and then discounted based on collateral type. However, 'non-marketable' assets cannot readily be converted into cash to act as collateral and hence there is unlikely to be any surplus collateral in case of default. A simple model for collateralised lending portfolios without surplus collateral suggests that €4bn of economic capital should support this book.

At the same time as these positions are causing concern, the crisis has revealed, with the emergence of additional information on Target-2, a basilisk in the plumbing of monetary union. This represents money owed by the central banks of the peripheral states (over €750bn, as illustrated in Figure 3) to the ECB and then owed by the ECB to the northern states. Whether this is due to trade flows or capital flight is subject to debate, but such a potentially huge transfer of capital was not envisaged at the creation of the euro, is not subject to any political process (compare the agony of setting up the EFSF/ESM) and represents a considerable risk to the ECB's balance sheet.

The ECB argues that these imbalances are standard in a currency union and will fall due only if the system becomes non-unity, i.e one or more members leave. The ECB line is that, in due course, the Target-2 imbalances will right themselves with the ebb and flow of economic development. We argue that, should one or more of the GIIPS leave the euro area, the amount due to the ECB would not be recoverable. The risk of a country leaving the euro area is clearly not zero – we would argue that a 10% capital requirement of €75bn would not be unreasonable.

This back-of-the-envelope exercise creates a capital requirement for nearly €88bn and unrecognised mark to market losses of €33bn. The simple functional Eurosystem balance sheet in Figure 2 shows €83bn of equity to support the monetary policy, banking and currency issue operations. The revaluation reserves are shown to support the unhedged risk of the foreign exchange and gold reserves of the Eurosystem.

Figure 2 – Eurosystem Balance Sheet – Equity by Function

€bn	Central Banking	Gold & FX	Total
Gold & FX reserves		**673**	**673**
Monetary policy operations	**268**		**268**
Banking and investments	**406**		**406**
Issuing currency	**-591**	**-279**	**-870**
Total	**83**		**477**
Revaluation accounts		**394**	**394**
Capital and reserves	**83**		**83**
Total			**477**

Adjusting the capital and reserves for the losses of €33bn gives available capital of €50bn (83-33) compared to a requirement of €88bn, implying an undercapitalisation of €38bn. Our review has not even looked at the other assets/liabilities in the banking book of some several hundred billion.

The ECB does not provide information to enable an assessment of its risks. The weekly balance sheet for the Eurosystem has limited supporting information. A comparison can be made to the US where litigation forced the Fed to disclose recipients of financial assistance. The lack of transparency does not stop at counterparty and market data. Under Target-2, the ECB is assigned daily balances arising between each NCB and acts as a central counterparty. Accordingly, the ECB has a series of separate receivables and payables as of the end of each day. When the ECB draws up its standalone accounts, it nets these balances disclosing a single debtor or creditor.

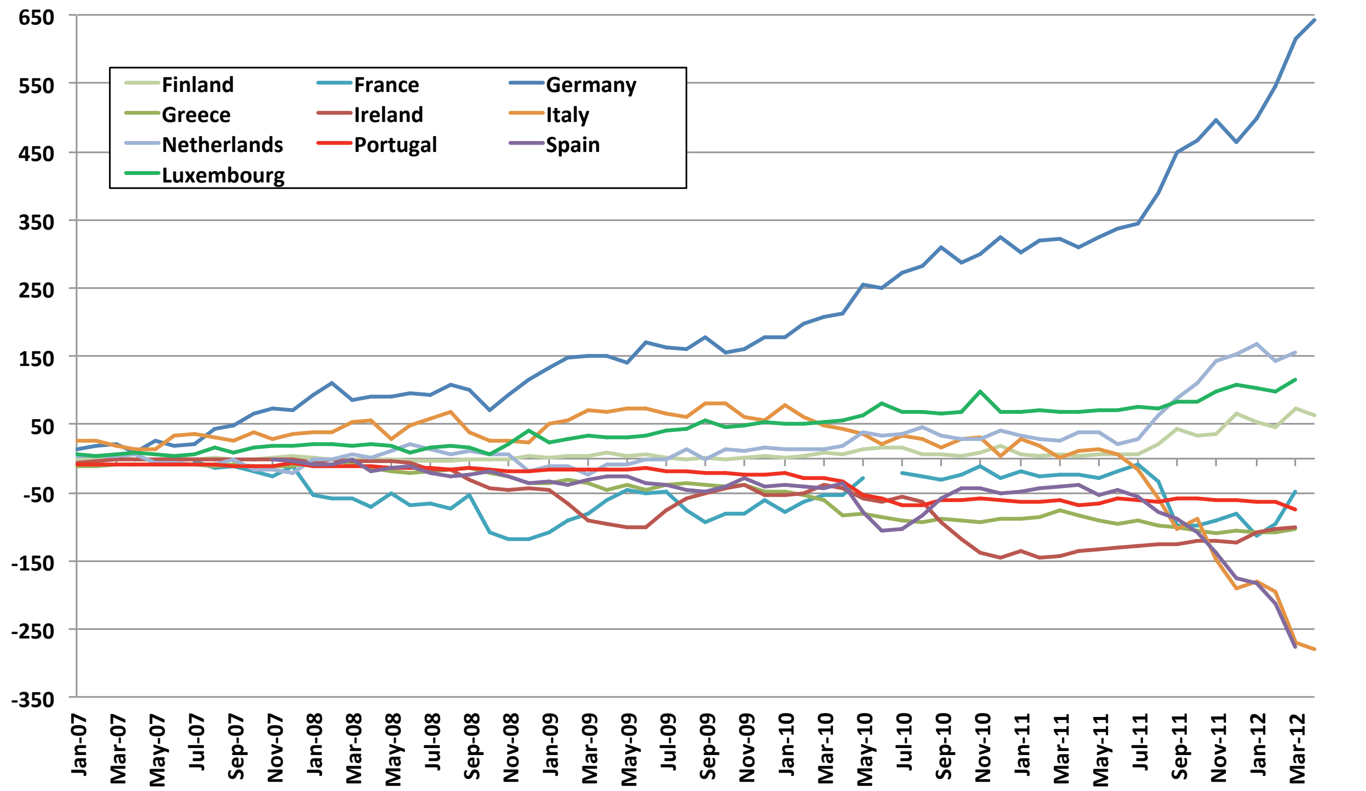
This treatment is specifically forbidden under IAS 32 which requires disclosure of gross balances by individual counterparty in the absence of a legally enforceable agreement to net. Netting of loans to and from 17 counterparties with significantly different credit ratings is simply not permitted elsewhere. The Target-2 balances are not subject to explicit disclosure by the ECB.

The concern is not the absolute amount of capital in the Eurosystem, which after all can print taxpayer's money, but the process by which the ECB puts this money at risk to support market participants and sovereign states. This should be subject to the same accountability as funds dispensed by elected institutions which are not protected by the mantra of independence. The ECB is the glue holding monetary union together. Its role must not be weakened by lack of trust.

ECB is the glue holding monetary union together. Its role must not be weakened by lack of trust.

For monthly Navigant insights and research into the euro crisis please email: travis.taylor@navigant.com

Figure 3 - Net balance with the Eurosystem / Target - €bn



Source: Institute of Empirical Economic Research - Universität Osnabrück

Why crises happen

The drawbacks of limited liability

Neil Courtis, Advisory Board

To aid US lawmakers considering financial reform legislation, the US Congressional Research Service has produced a paper in table form listing the most commonly cited causes of the financial crisis. The list runs to 26 possibilities. Most of these causes invite more questions. Why was risk generally underestimated? Why did 'sophisticated investors' accept rose-tinted ratings of dodgy mortgage securities? Why were so many able to be so wrong for so long without the invisible hand of the market guiding them back to reason?

Limited liability for corporations is so common as to seem part of the fabric of the market economy. In fact it is a recent phenomenon, adopted in the UK and US only in the second half of the 19th century.

Sometimes the answers to are hiding in plain sight. One reason the employees, management and shareholders of banks were so willing to drive the economy over a cliff was that they knew they would not be falling with it. The banks at the heart of the crisis are joint-stock corporations with limited liability whose losses are transferred to creditors and (it turned out) to governments who bailed them out.

Limited liability for corporations was adopted in the UK and US only in the second half of the 19th century as it became clear that capitalising on economics of scale in industrial production would require large investments from diverse shareholders. Limited liability was the turbo-charged legal sweetener devised to draw out risk-averse capital. Adam Smith, not a notorious socialist, famously criticised the idea. He argued that hired managers would lack the 'anxious vigilance' of owners, concluding of limited liability firms, that '… negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company'.

By and large history shows Smith to have been pessimistic. Capitalist societies have mostly managed to find ways to monitor and constrain their limited liability companies. Less so their banks. But why? We must recognise that banks are different. First, as the source of money and credit, they provide the raw material on which the economy runs. Second, as operators of the payment system, they provide the infrastructure of trade. And because governments are loath to see the economy operate without these functions, large banks typically operate under an implicit government guarantee. A large industry of regulators, auditors, institutional investors and others exists to try and keep banks in check.

Why do banks seem to get into trouble so much? A huge research project is underway in academia and the official sector to try and answer this question. Increasingly this research views financial instability and cycles of overleverage as intrinsic to banking, particularly when interest rates are low. The ability of bank management, employees and shareholders to enjoy upside gains, but be protected from downside losses by limited liability, underpins all these kinds of analyses.

This is not to argue that bank shareholders and directors should routinely be thrown into debtor's prison. However, the continued extension of the special privilege of limited liability should not be unquestionable. Until relatively recently, investment banks functioned reasonably happily as partnerships. At various times the capital of joint-stock companies has been only partially paid-up, meaning that shareholders could be called upon for a multiple of their initial investment in the event of difficulties.

What is important is that the use of limited liability structures – whose social purpose is to fuel economic growth in the face of high monitoring costs and investor risk aversion – should not be a given. Limited liability is a distortion of the free market accepted in an explicit trade-off. Just as society does not allow nuclear power companies a free hand to build power stations, but walk away when they go wrong or need to be decommissioned, so policy-makers should weigh carefully whether the negative externalities of large-scale crisis-prone global banks qualify them for the ultimate capitalist perk.

For US Congressional Research report, see http://www.fas.org/sgp/crs/misc/R40173.pdf)

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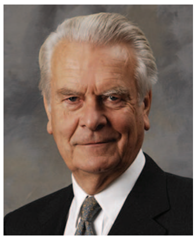
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Standardised programme beckons

Guide to growing Asian bond markets

Jason Lee, Office of Regional Economic Integration, Asian Development Bank

Asian local currency bond markets have grown significantly in the last 15 years, with bonds outstanding in 2011 around 40 times higher than1996. However, intra-regional financial flows have remained relatively small. A more active intra-regional bond market would contribute to channeling more regional resources into regional investments, helping sustained and balanced economic growth.

Maintaining this long-term vision of deep and liquid intra-regional bond markets in Asia, the members of the Asian Multi-Currency Bond Issuance Programme (AMBIP) are planning to develop standardised bond issuance across the region. AMBIP will make possible bond issues in participating economies with standardised documentation and disclosure procedures. It will allow buying and selling across borders among qualified investors, regardless of their locations within the participating economies.

Successful introduction of AMBIP requires a common understanding and mutual recognition among regulatory authorities and policy-makers. AMBIP will focus on professional markets or exempted markets, including the private placement market, where full disclosure requirements for ordinary public offering would be waived for professional investors or qualified institutional buyers.

AMBIP plans to facilitate cross-border, intra-regional issuance by the end of 2013, including pilot bond issuance.

A miletone along the route to this goal was the publication in April of the ASEAN+3 Bond Market Guide, aimed at encouraging more cross-border bond issuance and investment. This was a key part of the output of ASEAN+3 Bond Market Forum (ABMF), containing detailed statistics on local currency bond markets in economies including China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

ABMF, established in September 2010, consists of public and private sector experts, including regulatory organisations, depository and exchange institutions, ASEAN+3 market associations and international market players. It aims to foster standardisation of market practices and regulations and is part of the Asian Bond Markets Initiative (ABMI) set up by finance ministers in 2003. ASEAN+3 comprises the 10 nations of the Association of Southeast Asian Nations, plus China, Japan and Korea.

Since its establishment, ABMF members and experts have met quarterly and studied detailed aspects of regional bond markets and the legal and regulatory infrastructures. The Guide has been produced and published in collaboration with the Asian Development Bank, as the first regional bond market guide endorsed by ASEAN+3.

The Guide provides a comparative analysis on market infrastructures including legal and operational systems, regulations and market practices in the region, together with individual market guides of 11 economies. It includes detailed information on bond transaction flows including technical information on matching, settlement cycle, numbering and coding, and others.

The Guide is expected to narrow information gaps and establish a common understanding on how bond markets in the region operate. The aim is to overcome information asymmetry that has led to hesitancy among many investors to participate in Asian bond markets.

The ASEAN + 3 Bond Market Guide is available from http://goo.gl/v1uC8)

How the Asian bond market has grown

End-year figures for bonds outstanding ($bn)

Date	Total Govt	Total Corp	Total
1995	**99**	**27**	**126**
1996	104	40	145
1997	128	48	176
1998	247	57	304
1999	346	69	415
2000	493	343	836
2001	554	393	948
2002	711	456	1167
2003	884	465	1349
2004	1181	519	1700
2005	1510	597	2107
2006	1910	757	2666
2007	2463	929	3393
2008	2749	947	3696
2009	3113	1291	4404
2010	3591	1610	5200
2011	3774	1897	5671

Political and economic risks prevail

Election results reinforce 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	-0.8
UK	0.7	0.5	0.5
Addendum			
Asia excl. Japan	7.4	6.8	7.6
World	3.6	3.3	3.7
Consumer prices (% y/y)			
US	3.1	2.4	2.6
Japan	-0.3	0.1	0.2
China	5.4	3.0	3.4
Euro area	2.7	2.4	2.4
Germany	2.5	2.2	2.4
France	2.3	2.4	2.4
Italy	2.9	2.9	2.4
Spain	3.1	1.7	2.2
UK	4.5	2.9	2.4
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

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

After easing temporarily in the first quarter, the markets' nervousness and uncertainty over Europe's grip on its debt crisis have intensified again in recent weeks. Besides the unclear perspectives after the Greek elections and worries concerning new French president Hollande's political agenda, markets; concerns are increasingly concentrated on Madrid.

Spain's economic problems are ballooning. It stands no chance of hitting its agreed austerity targets and faces the dilemma of having to attempt to do so through even deeper cuts and higher taxes. Spain's government bond spreads have accordingly widened markedly again, while the latest downgrades of Spain's sovereign ratings risk exacerbating the situation further. The possibility that Spain will have to call on an official assistance package later this year can no longer be excluded.

This resurgent anxiety is reflected in the euro area's economic confidence surveys. Both private households and companies expressed greater pessimism in April compared with the previous month, while the aggregate economic climate indicator has fallen back to December's low level. Sentiment has again deteriorated most significantly in Italy. Germany has registered a slight downturn in the economic climate, according to the latest figures, though its national measure remains very comfortably above the multi-year average.

We remain confident that the German economy will perform distinctly better than most other euro countries this year and will manage to record growth of something over 1%.

The latest economic data confirm that the US economy is still suffering from considerable structural problems and that a dynamic recovery is off the agenda for some time. The labour market is still short of around 5m jobs (relative to the position prior to the Great Recession), and long-term unemployment is assuming frightening proportions. The housing market remains in deep crisis, and despite some positive new data a comprehensive market recovery remains over the horizon. Finally, the pressing need to consolidate government finances (i.e. pay off debt) is set to become the priority after the presidential election – if not before. We are accordingly maintaining our cautious forecast for the US economy.

In China, the economy has slowed further in the opening period of this year. The first quarter annual GDP growth rate of 8.1% was the lowest in nearly three years. The final quarter of 2011 saw growth of 8.9%. This relatively weak expansion was well within the range of our expectations, however. We maintain our forecast that the Chinese economy in 2012 will slow to its lowest annual growth rate in more than a decade. We reckon, however, that the Chinese economy has probably now effectively reached the low point of the current cycle. We thus do not expect the current second quarter to bring a further slowdown.

Getting the timing right

ECB statements and lessons of history

Patrick Honohan, Governor, Central Bank of Ireland

In the old days, central banking used to be about surprises. The distinctions used to be between anticipated and unanticipated events. Only the unanticipated mattered if policy was to improve on a supposed unemployment-inflation trade-off. So surprises were all-important. It is worthwhile looking at some historical examples, and compare these with recent policy actions by the European Central Bank.

The first lesson of central banking announcements is that missing the moment for the decisive surprise intervention may place you in a very bad position.

After the era of 'central banking surprises', we saw a period where the approach to monetary policy emphasised limited ambitions, predictability and – by and large – no surprises. But some of the great pivotal moments in the history of central banking are about shock tactics. The timing, their potential impact and the communications around them provide three key lessons.

When it comes to such surprises, timing can be everything. Better not be late. During the 1907 crisis the New York Times wrote: 'Knickerbocker will be aided; President Barney quits and financiers promise to support the Trust Company; JP Morgan & Co. help.' But JP Morgan didn't help enough and the Knickerbocker Trust Company suspended payment for five months.

Next day the Trust Company of America was duly saved, but it was too late to prevent the fallout from permitting the crisis in the first place. Bank suspensions and a sharp economic contraction followed. This is Lesson 1 of central banking announcements. There may be no second chances. Missing the moment for the decisive surprise intervention may place you in a very bad position.

Another great epochal change came on 15 August 1971 with the end of the Bretton Woods regime of fixed but adjustable exchange rates. President Richard Nixon announced: 'Let me lay to rest the bugaboo of what is called devaluation.' A bugaboo, according to Merriam-Webster, is 'an imaginary object of fear' or 'something that causes fear or distress out of proportion to its importance'. Well, imaginary or not, the ending of the Bretton Woods system did have consequences. The closing of the gold window (announced by Nixon as temporary) became permanent. In each of the next two decades US prices doubled. Lesson No. 2: Surprise announcements can have long-run effects.

Although widely cited, former Federal Reserve Board vice chairman Alan Blinder famously did not say, 'The last duty of the central banker is to tell the public the truth.' What he did do, it seems, was conduct a survey of central banker attitudes, in which officials had ranked 'a duty to be open and truthful with the public' last among criteria on why credibility was important. Well, that's even worse, though it's not Blinder's view; it was the view of many central bankers he surveyed in 1999. Devaluation denials may have been an obvious reason for this, and it's perhaps unsurprising that regimes such as the disastrous Exchange Rate Mechanism, which create such pressures for disinformation, can be among the most ineffective.

Statements around devaluations have had a tendency to weaken central bankers' and other public officials' credibility. The Irish finance minister was reported as saying, in the Irish Times on Thursday 28 January 1993: 'I want to assure the people in London who are putting around the rumours that we are going to devalue today or tomorrow that they are wrong.' True enough, no devaluation occurred on the Thursday or Friday … but it did on the Saturday.

Lesson No. 3 is thus: Central-banking-by-surprise makes candid communication extremely difficult. Yet we all agree that credible communication is essential for lasting policy success. So this appears to be a particular problem with fixed but adjustable exchange rate regimes.

Floating exchange rate regimes with inflation targeting (or some variant) are quite different in this respect. This is one important reason why their adoption has become relatively widespread. With inflation targeting (any variant, soft or hard), the sudden surprise announcement is not a prominent part of the policy arsenal. Instead the market's expectation of official action (on interest rates, for example) is gently nudged towards the policymakers' intentions by small steps, speeches, hints and graduated open market operations. This is a very different policy environment where, instead of dissembling before major actions, the whole aim of policy communication is towards having no surprises at all. Perhaps the most extreme example is represented by the Federal Reserve pre-commitments of recent months.

My overall message is that the crisis has brought back centre stage the role of dramatic announcements with far-reaching effects.

Let's think of the two major recent ECB policy surprises: the Securities Market Programme in May 2010 and the Long Term Refinancing Operation in December 2011. How do we rate them considering the three lessons? The SMP announcement occurred at a time of great market tension. Sovereign risk contagion from Greece had just begun, and there was the additional background of the unnerving flash crash. The danger that sovereign spreads would spiral away, undermining monetary transmission as well as a lot of other things, seemed real, especially as the funding firewall that was quickly agreed at political level would take several months to become a reality. ECB intervention in secondary debt markets looked like a sensible and urgent action needed to nip things in the bud. A moment analogous to that seized by JP Morgan in 1907.

For some, the SMP may have looked like something close to the dreaded monetary financing, but the European Treaty is pretty clear on these matters, and buying plainly in the secondary market is not monetary financing. Any student of the history of central banking knows how often central banks have been loaded up with unremunerated paper by spendthrift governments.

And what about the longer run? Well there have been consequences, but not those imagined at the outset. Sovereign spreads widened again. Although the programme was used again with varying degrees of vigour, it cannot be said by any means to have eliminated the cross-country variations which are indeed impeding the smooth functioning of the monetary transmission. And it has not avoided the large debt exchange with large write-downs for Greece, the original biggest target of the programme. Lesson 3 is, I think, confirmed. Communication around the SMP introduction, and the well-known differences of opinion which surrounded it, tended somewhat to undermine the coherence of communication by central bankers generally and was, I would say, problematic. The jury is still out on whether the policy has been a lasting success.

Let's hope that the LTRO, brought in once again in response to financial market pressures, not only on sovereign bonds, but especially on bank funding, does have the lasting effects that are widely hoped for it. Certainly it was well-timed (Lesson 1), though some observers will have hoped for this or more at an earlier stage. One can note that, despite its scale and duration, it has not brought, for example, Irish sovereign spreads below the levels that triggered the bail-out in November 2010. Let's hope that Lesson 2 applies, and that it will be of lasting value. As for Lesson 3, this time the measure seems to have been relatively trouble-free on the communications front.

But perhaps it's too early to say. The critics of large Target-2 balances may eventually start to drown out more welcoming voices and ask awkward and destabilising questions about intra-zone credit risk. Instead, I prefer to think that the reason the LTRO was trouble-free was that it went with the grain. This action corrected the market's misapprehension that the ECB was indifferent or 'didn't get' the existential worries that were prevalent in the market. As much as the technical aspects themselves, this favourable signalling function of the LTRO announcement reassured and stabilised markets. My overall message is that the crisis has brought back centre stage the role of dramatic announcements with far-reaching effects. It is important to get the timing right. Too late, and a lot of damage can be done. Too soon, and the side-effects may be worse than the hoped-for effect (if the source of the problem has been exaggerated or misdiagnosed). And the communications issues are more challenging than the finely-honed practice of monthly announcements by inflation-targeting central banks.

This article is based on a speech to OMFIF in London on 8 May

German inflation lowers imbalances

Capital losses loom for bond investors

Stefan Bielmeier, Advisory Board

A debate is growing in Germany on the dangers of nascent inflation - and not just since the 6.3% pay rise agreed for public sector employees over the next 18 months. Although the German economy is deeply affected by the euro debt crisis owing to its great reliance on exports, relatively speaking it is in fine fettle.

This year the German economy will be back to normal capacity utilisation. Many other European countries are in the throes of a consolidation crisis.

This year the German economy will be back almost to normal capacity utilisation. Many other European countries are in the throes of a consolidation crisis as they try to reduce budget deficits and improve competitiveness.

Economic theory lays down a relatively close link between countries' production shortfalls and price trends. The higher the capacity utilisation, the stronger the inflationary pressures. This link is known as the 'Phillips curve' in relation to the labour market, whereby a low rate of unemployment goes hand in hand with higher inflation and vice versa.

The European Central Bank has pointed out that the link between production shortfalls and inflation is not always symmetrical. In past recessions euro area inflation did not fall as fast as would be expected from falls in production. This was partly caused by wage rigidities stemming from long-standing collective bargaining agreements and the like. Nevertheless, in EMU member states the countries with the highest unemployment rates currently face the lowest inflation. By contrast, the inflation rate in countries where the labour market is still rosy is relatively high.

The sharp differential between performance of EMU members in positive business cycles (such as Germany) and those of the southern periphery poses an immense challenge to ECB's monetary policy. Its policy must remain focused on the majority or the weighted median.

While Germany is the largest member state in terms of economic muscle, the ECB council has to give Germany the same weight as everyone else. The greater the difference between Germany's economic trend and those in other EMU members, the more problematic this arrangement may be. This problem is no new problem. Yet relations have turned round completely. At the start of monetary union, Germany lagged behind other countries' growth. Spain and Ireland were outperformers. For them, the then level of ECB interest rates was far too low, heating up their economic booms and contributing to ever-greater imbalances.

Today, Germany leads the rankings on growth and unemployment. There is the risk of an inflationary trend that monetary policy cannot combat. Real interest rates are clearly negative at both the short and long ends, something that has not happened for decades, at least as far as capital market yields are concerned. The inflation rate in Germany is expected to exceed the EMU average in coming years and move at least in the direction of 3%. Higher inflation will trigger trade union demands not just for securing real wages and participating in an economic upturn, but releasing pent-up demand from the earlier days of wage restraint. The ECB will not be able to respond appropriately to a gradual price/wage spiral. On the contrary, the ECB is likely to come under more pressure to foster growth.

The German economy will grow above-average, but at the price of losing part of its competitive edge. All this will contribute to necessary reduction of euro area imbalances. The diversified economic trend among individual countries makes the ECB's role harder, but it also means that upturns and downturns in the euro area are not mutually reinforcing and are thus less extreme. However, the next few years will spell real losses for many investors in money market-related instruments and low interest government bonds. Voters and investors alike will have to regard this as well-nigh inevitable.

OMFIF
Official Monetary and Financial Institutions Forum

No danger from money numbers

Why we shouldn't worry about inflation

Gabriel Stein, Lombard Street Research

Unconventional monetary policies in the main industrial countries have raised concerns that inflation may be on the way back. Thus could happen either as a inadvertent consequence of central bank policies, or as a deliberate policy by governments attempting to ease their debt burden.

These concerns are almost certainly misplaced. For signs of accelerating inflation, we need to look at broad money growth. And here, in the principal countries, there are no signals of danger ahead.

The moderation of inflation over the past 20 years has been a great monetary policy success. Partly this is thanks to the shift towards independent inflation-targeting central banks. Partly it reflects downward price pressures exerted by globalisation. Low and stable inflation and interest rates have historically been conducive to financial crises. The Great Recession was very much due to excessive debt in a number of countries. It has left households still over-indebted in many places and government debt ballooning. In many countries central banks are operating quantitative easing (QE).

QE has massively boosted the monetary bases (cash and banks' reserves with the central banks). But the relationship between the monetary base and inflation is tenuous at best. The relationship is stronger between broad money and inflation – but even in countries where broad money growth has accelerated lately (e.g. the US), it remains below rates consistent with medium term trend output growth, let alone with rapid and accelerating inflation. Unless broad money growth rises to double digits for a sustained period, there is little likelihood of inflation taking off.

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Moreover, for inflation to work in the sense of wiping out liabilities, it has to come as a surprise and constantly accelerate faster than expected. But since rapid inflation will first be signalled through rapid broad money growth, it should not come as a surprise. In addition, if inflation began to exceed targets in any country or countries, and the monetary authorities did not attempt to bring it down, market interest rates would rapidly rise until they were positive in real terms. Far from easing government (and other) debt problems, this would exacerbate them. Most central banks now have explicit and mandated (or at least self-declared) inflation targets or tolerance levels. So recourse to rapid inflation to wipe out debt would demand that these targets were abandoned, either secretly or openly.

Secretly abandoning inflation targets implies that central bankers are prepared to break the law (and suffer the consequences). Given the importance attached to inflation targeting over the past 15-20 years, openly abandoning it would cast doubt on any future central bank policy. Central banks have spent a long time building credibility. Building credibility is difficult – losing it can happen very rapidly. If they abandoned inflation targeting, central banks would have to make a convincing case that a new policy was superior. A tall order.

Rapid inflation could indeed work by wiping out the value of government (and private sector) debt. But this also means wiping out the value of the assets of those holding that debt. In the case of private sector debt, this primarily means banks. We have recently seen that eroding the banking system's balance sheet is not a good idea. In the case of public sector debt, the holders are (in addition to banks) frequently pension funds and other asset managers. In essence, this would involve telling millions of pension savers – and voters – that their governments intend to wipe out the assets on which they hope to retire. To say the least, that would be foolhardy.

Of course, inflation is not forever dead. It may be a problem over the longer term. But in the near or medium term it is neither a solution nor a danger.

A regular round-up on international monetary affairs

More than window-dressing

Hollande must learn right lessons from past

William Keegan, Chairman, Board of Contributing Editors

When François Mitterrand won the French presidential election in 1981 there was huge excitement, both in Europe and in the land to which France had, all those years ago, donated the Statue of Liberty. Why, the International Herald Tribune marked the event with a major conference in Paris, with keynote speakers from the Mitterrand entourage, and many eager listeners from the press, including your correspondent.

Yes, it was to be the best of times… But not for long.

References to the perceived failure of the 1981-83 Mitterrand Experiment cropped up all over the place, before, during and immediately after the election of François Hollande to the presidency.

Far too many of these references drew the wrong inferences – at least to my mind. The 1981-83 episode has gone down in history as a failed Keynesian experiment.

Yet, quite apart from the fact that it took place in a hostile monetarist world, it was accompanied by so many hostages to fortune – don't forget that the Communists had helped Mitterrand to gain power – that Keynesianism was handicapped from the start.

And while we are on the subject of the monetarist atmosphere of the times, let me share with readers a priceless quotation from the arch-priest of monetarism, Professor Milton Friedman, himself.

In the lunch with the FT series – whose longevity the paper has recently been celebrating – Friedman was taken to a San Francisco restaurant in June 2003, where he recanted the doctrine he had preached to such willing disciples as Margaret Thatcher: 'The use of quantity of money as a target has not been a success… I'm not sure I would as of today push it as hard as I once did.' How is that?

One of the jokes to emerge from that period was the statement: 'I believe in sound money and lots of it.'

Well, what we got was sound money during the heyday of the inflation-targeting regime earlier in this century and we know where it landed us.

Now, the central banks are flooding the system with money, but the widespread complaint is that it is not getting through to businesses or the consumer.

This has led some commentators to argue that quantitative easing (QE) has been a failure. Certainly its proponents and practitioners tend to tie themselves in knots when trying to explain how it works. Nevertheless, one's suspicion is that the depression could be even worse in the absence of QE.

My real concern is not with central banks' attempts to ease monetary conditions, but with their obsession with fiscal tightening at a time such as this. And this is where the behaviour of the Hollande administration in practice will be so important.

Many market commentators argue for fiscal tightening while simultaneously expressing concern about the effect of austerity on growth, and hence revenue.

These same commentators have been reassuring themselves, and trying to reassure us, by maintaining that most of Hollande's campaign programme was just 'rhetoric'. Hollande, after all, we are told, worked for Mitterrand at the time, so will have learnt the lesson.

But times are different – very different. These are pretty close to the worst of times – at least, of peacetimes. If Hollande bows to so-called 'reality' and opts for a growth programme that is merely window-dressing, then the European economic crisis is likely to get worse, and worse, and worse.

Looking ahead – 2012 diary dates

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

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

Lecture with James Bullard
President, Federal Reserve Bank of St. Louis
10 July, London

Lecture with Prasarn Trairatvorakul
Governor, Bank of Thailand
12 September, London

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

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