OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

June 2011

After DSK, the IMF process matters

Christine Lagarde debate exposes fault lines

Meghnad Desai, Chairman, Advisory Board

The leading industrial countries seem to be disregarding the growing concern about the manner in which the succession at the International Monetary Fund is being decided. Christine Lagarde is being shooed -in as a certainty by countries which hold nearly half the quotas.

The argument we have with such behaviour is not about the French finance minister's suitability. The issue is about the process by which the succession is conducted. Rules of good governance are well known; they are part of the tool-kit the developed countries have been exporting along with aid to developing nations. Even more, they are the basis for an equitable global order. Here is an opportunity to put in to practice what the IMF's majority shareholders have been preaching. The opportunity is long overdue. Now it is here.

To perpetuate the Europeans' 65-year-old monopoly of the IMF post, an argument has been made that the euro area's dire conditions compel the choice towards a European. I would argue exactly the opposite. The euro area was badly designed at the outset. The rules were badly implemented. No-one examined the accounts when Greece and other weaklings entered. Since the crisis broke in early 2010, six months were spent in denial. The year since then has been wasted in a series of moves which failed to solve the problem.

The now-infamous 'DSK', Dominique Strauss-Kahn, the former IMF managing director now awaiting trial in New York, let his French presidential ambitions cloud his judgment. The demands on Greece as conditions for official assistance were not consistent with resolving its problems. When Asia suffered its financial crisis in 1997, the IMF did not say it could master it only with an Asian at the helm. Ms Lagarde as a member of the group of European finance ministers was part of the problem. She cannot be presumed to be the solution.

The idea that only a European knows about Europe's problems and solve them is frankly racist. If the alternative was an American, no-one would say that (s)he could not know anything about Europe. Why, then, are we told such nonsense? There are urgent problems in the international monetary system. The task of designing a multilateral currency which will contribute to the solution of global imbalances is the most important. A reform of the voting structures is another. Europe is no longer sufficiently important. It is a liability of the international monetary system, not an asset.

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Euro problems

Reluctant Germany

John Kornblum, Advisory Board

As the euro saga unrolls, one thing is becoming clearer. The structure surrounding the euro has its weaknesses, but the crisis is not really about the currency at all. Pressure from financial markets has uncovered the growing ineffectiveness both of the EU's governance structures and of the political mentality behind them. This is a condition which cannot be mended with the plasters now being applied.

The euro crisis is only one of the several wake-up calls the nations of Europe have received in recent months. The Arab Spring, the proliferation of failed states, the widening internal EU divide and growth of political unrest, and even the growing American lack of interest in Europe have all sent messages that are too obvious to be ignored. When the crisis hit, EU governments were disorientated. EU and especially German leaders had apparently come to believe so completely in the inevitable success of the EU, that warning signals were ignored or considered too delicate to raise in ECB councils.

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Politics of the boudoir

Unpalatable decisions

David Marsh, Co-chairman

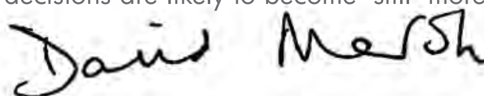
The politics of the boudoir have hit home in the parlours of central banking. Dominique Strauss-Kahn's departure from the International Monetary Fund under bizarre circumstances has reverberated around the world. By opening up a succession race at the IMF more quickly and more spectacularly than earlier anticipated, it has exposed a feeling of frustration mixed with powerlessness among the developing countries over stewardship of the organisation in charge of world finances.

The former managing director's demise has left a vacuum in European efforts to resolve the debt crisis, where over the past 15 months DSK's particular brand of high-voltage economics has added considerably to the momentum (although not necessarily to the efficacy) of European attempts to assist the debt-fuelled euro members to escape an increasingly vicious spiral. And the escapade has added further counterpoint to divergences in economic style in Europe. Irrespective of whether he is guilty of the charges against him, the spectre of Gallic low-living in high places is not likely to spark sympathy among voters in northern Europe asked to sacrifice living standards (or tax reductions) for the sake of their errant southern neighbours.

We explore all these issues in the June Bulletin. While Meghnad Desai unleashes an impassioned plea for the IMF to rethink its selection procedures, Paul van Seters and Ruud Lubbers come to terms with the likelihood of Christine Lagarde's nomination and say her most important priority will be international monetary reform. John Kornblum reflects on the crisis of governance in the euro area, while Lorenzo Bini Smaghi and Stefan Bielmeier analyse the background to the two-speed economic divide in Europe. Mario Blejer roundly accuses the European Central Bank of making a bad situation worse and expects an ECB U-turn on debt. Niels Thygesen, another doughty critic of the view that debt restructuring is automatically bad, says the measure is probably needed to open up the way for further bail-outs. Roel Janssen looks at the political background to the choice of a new Dutch central bank president to start the post-Wellink era.

Further afield, Julia Leung describes a development that she has no qualms in terming historic: the opening up of international markets in renminbi, while Malan Rietveld praises the realistic tilt to the World Bank's recent pronouncements on the Chinese currency's gradual rise to international importance. Marina Shargorodska and Michael Kaimakliotis, in the first of a series of regular commentaries (SK Global Analysis), explore supply-demand imbalances in emerging economy debt markets.

Jürgen Stark takes a long-term look at efforts to corral floating exchange rates and indicate strong scepticism not just about global attempts to impose fixed exchange rates but also on local initiatives at regional monetary union among nations which are not fundamentally in balance. One is left with the inescapable conclusion that – short of fully-fledged political union - fixing currencies is only really an option among nations that already have such a degree of homogeneity that they no longer need monetary union. The countries exhibiting large and enduring disparities with their neighbours, on the other hand, may desire monetary union but are never likely either to earn or to sustain it. William Keegan explains how a comparable dilemma faces Britain's Chancellor George Osborne, confronting the real likelihood that higher Bank of England interest rates may stymie economic recovery and throw his deficit reduction programme into reverse. Politics and economics are all about difficult choices. With DSK languishing under house arrest on charges that sympathisers and critics alike find unfathomable, decisions are likely to become still more unpalatable.



Threat of bubbles blowing

Demand for emerging market debt

Marina Shargorodska and Michael Kaimakliotis

Fixed income investors are enjoying another year of solid returns after the recent collapse in yields of US and euro government bonds. US and German government bonds now yield around 3%. However, with all financial assets, as prices rise, the outlook for future returns looks less enticing. Equity investors are often oblivious to this fact but it's quite clear to bond investors: if they hold a bond to maturity they will receive the yield and nothing but the yield, assuming the issuer does not default. When yields are low, hungry investors tend to move further out along the risk curve.

Traditionally fixed income managers increased risk by adding extra duration and credit risk to their portfolio. Then perhaps they bought some emerging market exposure and finally some foreign currency. At the riskiest end of the spectrum, they added emerging market currency risk. But priorities and perceptions about emerging market currencies now appear to be changing.

As the crisis in Greece and the other peripheral European countries enters another acute phase, investors continue to shun large parts of the western European fixed income markets. The data show consistent outflows of fund investments in the region. Of course people still flock to German government debt – and the peripheral countries' debt markets (excluding Spain) are actually quite small.

The main reason for the net outflows is that the financial sector typically accounts for much corporate issuance. Investors show little interest in sharing the burden of a sovereign default by financing one of Europe's banks

The main reason for the net outflows is that the financial sector typically accounts for much corporate issuance. Investors show little interest in sharing the burden of a sovereign default by financing one of Europe's banks. Instead, they are heading further out on the curve towards emerging markets. As fundamentals in emerging market economies improve and those in the developed world decline, the trend is almost certain to continue. The result is likely to be a bubble as the demand for securities is not matched by an equivalent supply.

The supply of securities is often overlooked by investors but it can play a critical role. In the 2007-09 financial crisis, China's demand for US Treasuries crowded out other large institutional investors. Faced with massive excess demand for high-quality short duration dollar-denominated paper, the banking industry transformed long-dated mortgages with dubious credit into instruments of apparently high quality (through credit tranching) and short duration (through swapping interest payments via special purpose vehicles which issued commercial paper). This serves a compelling reason to worry about supply 'bottlenecks' in capital markets.* A recent IMF Working Paper** notes that the supply of emerging market financial assets has not grown enough to meet demand from domestic savers, let alone that from foreign investors.

So, is there already a bubble in emerging markets? With spreads to US Treasuries in excess of 300 bps, the answer is No. And emerging market credit spreads have widened in recent months when risk-averse investors sold emerging market bond funds and equities - a sign that markets are behaving rationally. The one exception was in local currency debt funds where inflows have continued unabated. This makes sense, since real exchange rate adjustments are necessary to alleviate economic imbalances. And inflation is already uncomfortably high, so nominal appreciation is surely part of the solution. But the supply of local currency debt is even more limited than dollar-denominated debt. Therefore credit spreads in local currency bond markets will probably tighten compared with dollar bond markets. For investors intent on chasing bubbles, it may soon be time to break open the champagne.

**For an alternative view on the causes of the crisis, see the BIS Working Papers No 346 Global imbalances and the financial crisis: Link or no link?, by Claudio Borio and Piti Disyatat, May 2011*

*** Causes of Asset Shortages in Emerging Markets.*

After DSK, the IMF process matters *(continued from page 1 ...)*

The appropriate way to select the IMF managing directorship is to advertise the post stating the requirements for the job. There is no need to set down any preconditions. It is not appropriate that the selected candidate should be limited to a serving or former finance minister, or that the job should be region- or gender-specific.

Indeed, there is no need to exclude an academic. After all, the Federal Reserve and the Bank of England are headed by former professors of economics. A private banker is another possibility since they, too, have a global perspective; Chanda Kochar of India's ICICI would be a name to reckon with.

The process must be open and transparent. It is not right to hand it over to a behind-the-scenes group of 'wise men'. The rest of us should know who has applied, who makes up the short-listing committee and, when the committee has arrived at a short list, who is on it. The United Nations Development Programme adopted such a procedure a few years back when appointing its Administrator. The result was that Kemal Dervis, a former Turkish finance minister and senior official at the World Bank, got the job. Even the UN Secretary General's job, though ultimately decided by high-level power-play, had been widely discussed before Ban Ki-moon was selected. There are lessons from elsewhere that the IMF should apply. The time to apply them is now.

The new stars are in Asia and Latin America and in Africa. Let us make the world truly global.

Euro problems *(continued from page 1 ...)*

German leaders first blamed speculators and hedge funds, before it became clear that they had lost control of their fate to new sorts of global market dynamics for which EU structures had not been devised.

The strategy now seems to be to hope the leaks can be plugged either before the money runs out or before European public opinion calls a halt to the whole thing. Leaders have made clear there is no 'Plan B.'

As ECB board member Lorenzo Bini Smaghi told the Financial Times on 30 May: 'A debt restructuring or exiting the euro would be like a death penalty – which we have abolished in the European Union.' In other words, either Greece becomes like Germany (hardly likely) or the fundamental political and economic stability of Europe will be endangered.

What has gone wrong? Anyone who has worked with the EU over the years is familiar with the problem. The Rome Treaty in 1957 was designed to overcome war-time conflicts through consensus and stability.

The original EEC was designed for evolution rather than decision; for consultation rather than action. Its crises were ones of bureaucratic one-upmanship rather than strategic reality. That part was handled by the US. With the end of the Cold War, Europe no longer lived in an enclave protected by the US from the winds of change. It had to face fundamental strategic challenges to its interests which could not be papered over in late-night bargaining sessions.

But for leaders conditioned primarily to maintain equilibrium, the natural reaction after 1990 was to do more of the same, i.e. to devise new internal processes aimed at 'building Europe.' Just as the world was becoming more multi-faceted and ever faster-moving, the EU turned in upon itself and built an even larger and more unwieldy system of internal governance.

This isolated European leaders even more from what was happening elsewhere. As an Obama administration insider told the Politico website in Washington: 'There are a lot of forces trying to pull European attention inside. Obama is trying to make the case to both public opinion and the leaders that there are international challenges we can't draw away from.'

Angela Merkel's increasingly blunt language may upset some Europeans, but the Germans do understand the importance of the cutting edge of globalisation. They know better than most how ruthless the process of change has become. They know that they cannot maintain their export economy unless they continue to clear an ever higher series of global benchmarks.

Thus the euro crisis provides the spark for change that was coming anyway. It has given Germany and northern Europeans a justification to push relentlessly for new structures of governance which would have been unacceptable only a few years ago. Merkel has said publicly she is looking for an EU based on a consensus among nations rather than on integrated leadership from the Commission.

The irony is that the European movement was stimulated 60 years ago by a desire to ensure that German power never again dominated the continent. Six decades later even many Germans fear that it will again be the Germans who are calling the tune.

Increasingly, other Europeans expect the Germans to give a clear sign of how they wish to exert their new leadership role.

But German leaders are more fearful of their voters than of global dynamics. Decisions are likely to emerge not from the Chancellor's office, but from public debates in the press, the German parties and from the courts. As the emotional confrontation over nuclear power demonstrates, a long period of uncertain transition has begun.

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Lack of a corrective mechanism

The lessons from 'Bretton Woods II'

Jürgen Stark, Member of Executive Board, European Central Bank

The history of the international monetary system has been marked by repeated – often failed – attempts to establish different sorts of fixed exchange rate regime. In fact, the underlying belief that freely floating exchange rates are unambiguously an obstacle to international trade and domestic macroeconomic stability is based on a fundamental confusion. In Europe, we see that economies at a similar stages of development, with a high degree of real and financial integration and largely synchronised business cycles, benefit greatly from a common currency under a common monetary policy and in a common market.

At the global level, however, where the degree of convergence, integration and synchronisation is far less pronounced, countries at very different stages of development and with very different growth models stand to benefit instead from the corrective mechanism of fluctuating exchange rates. Fixing exchange rates globally has rarely benefited the global economy. Domestic policy objectives have too often proved to be incompatible with fixed exchange rate regimes. And domestic macro-policies have too often conflicted with the objective of external stability. The result has been the periodic emergence of domestic and external imbalances, which not infrequently were unwound in a disruptive manner.

One example has been the classical gold standard from the second half of the 19th century to the outbreak of the First World War. At first sight, this appears to have been a period of great stability and prosperity. Countries enjoyed low average inflation and steady economic growth. Exchange rates were fixed via parities to gold and the money supply was tied to gold reserves. Any balance of payments disequilibria would trigger changes in monetary conditions. External balance was thus easily restored through adjusting prices and production. The drawback was that this mechanism induced significant domestic economic volatility and substantial short-term welfare costs.

To accommodate adverse shocks, some countries temporarily abandoned the gold standard – for example, during the First World War - and resumed convertibility afterwards: an attempt that ultimately failed. The Bretton Woods agreement that framed the international monetary order after the Second World War was influenced by these failures and included some corrective elements. Exchange rates could be adjusted where needed and capital controls would limit speculative flows. The International Monetary Fund was established to finance exceptional balance of payments needs. Nevertheless, it was a system of fixed exchange rates, with the dollar as the vehicle currency, which in turn was convertible into gold at a fixed rate. The Bretton Woods system, too, was a gold standard and ultimately suffered from the same weakness: domestic policy objectives were incompatible with fixed exchange rates.

Bretton Woods contributed to a lengthy period of post-war prosperity and economic rebuilding, but expansionary economic policies in the core of the system led to inflationary pressures and rising doubts about the dollar's convertibility. Only by moving to flexible exchange rates could some countries avoid the 'Great Inflation' that shook the US. Yet the post-Bretton Woods monetary order did not encompass fully flexible exchange rates. Within western Europe, a system of soft pegs was introduced, the first step in a long process of convergence which led to the euro. Many emerging economies, instead, continued to peg their exchange rates to the dollar. For some countries, these pegs over time led to substantially overvalued exchange rates and massive indebtedness, often culminating in devastating currency upsets, such as the Mexican 'tequila crisis' or the Asian crisis of 1997.

Susceptibility to currency crises encouraged many emerging economies to continue pegging their currencies to the dollar, though this time at undervalued exchange rates. The emerging system - some observers called it Bretton Woods II - was again misperceived as a period of unambiguous stability and prosperity. The world economy grew on average almost 5% a year, accompanied by unprecedented financial globalisation. At the micro level, asymmetries in financial development facilitated large uni-directional financial flows from emerging economies to the core of the global financial system. At the macro level, large domestic imbalances were externalised to the global economy. Emerging surplus economies relied on an excessively export-led growth model. This necessitated artificially undervalued exchange rates which were pegged to the dollar by means of massive accumulation of reserves. And deficit countries relied on large capital inflows to finance excess domestic consumption and provide liquidity to the overleveraged financial system. Imbalanced domestic growth in both deficit and surplus countries and distorted global trade and financial flows were symbiotically linked through fixed exchange rates. A major vulnerability of the system was the absence of a corrective mechanism that would prevent the collapse we ultimately witnessed.

This article is an extract from Dr. Stark's address to OMFIF on 11 May 2011 in London

The real task for IMF chief

Lagarde should make reform a priority

Ruud Lubbers and Paul van Seters, Advisory Board

Whatever the criticism, Christine Lagarde's appointment as the next managing director of the International Monetary Fund now seems reasonably certain. The EU countries unanimously support the French finance minister's candidacy. It looks as if she can count on the US too.

Within the IMF the EU still has 32% of the votes, and the US another 16.7%. At the multilateral financial institutions, the EU-US bloc continues to rule the waves. One should not be overly cynical about this. Lagarde faces potentially a daunting task. European unanimity and American support are most welcome.

For years, EU-US dominance of the IMF has been contested. The succession to Dominique Strauss-Kahn brings this to a head. Given the new economic order, Europe is grossly over-represented. However, since the emerging economies seem to find difficulty in agreeing a credible joint candidate, perhaps we should shift the question away from personalities to the issue of what the new managing director should be doing. Assuming Lagarde gets the job, she will have to spend much time on tackling the euro area sovereign debt crisis, above all with regard to Greece. Her excellent record as finance minister for the past four years eminently qualifies her for that task.

However her second priority is perhaps more important than the first: reforming the global monetary system. The initiative is largely in the hands of the G20. Since the credit crisis deepened in September 2008, the 20 top economies have been preoccupied with restoring and securing financial stability. One way forward is through reforming the monetary system.

At the most recent G20 summit last November in Seoul, French president Nicolas Sarkozy announced he would do everything he could to achieve such reform during his G20 presidency, which lasts until the end of 2011. At the next G20 summit in November in Cannes, Sarkozy wants to unveil reform plans. As a close ally of Sarkozy for so many years, Lagarde is well suited to collaborate with the G20 president on international monetary reform.

Earlier this year a special advisory commission appointed by Sarkozy—the Palais Royal Initiative—came up with a list of 18 proposals for global monetary reform. That list may offer inspiration to the new IMF managing director.

To reform the international monetary system effectively, Lagarde will have to invest in collaborating with the emerging economies as well. The so-called BRICS countries (Brazil, Russia, India, China, and South Africa) are voicing their opinion on this matter loud and clear.

At their meeting in April in Hainan in southern China, the BRICS countries announced that they would start using alternatives for the dollar in international financial transactions, thus eroding the monopoly of the dollar as global reserve currency. Also in April, at the annual Boao Forum, Chinese officials similarly indicated that they were aware, and supportive, of Sarkozy's ideas about global monetary reform to be presented at the G20 summit in November in Cannes, including the use of Special Drawing Rights issued by the IMF as a new global reserve currency.

Sarkozy's agenda for Cannes is of the highest importance - not only for the old world of the developed economies but also for the new world of the emerging economies. Lagarde has little experience on collaboration on monetary reform with these emerging economies, especially the BRICS countries. But, if she gets the post, this may turn out to be the most important part of her job – and the most challenging.

To reform the international monetary system Lagarde will have to collaborate with the emerging economies. The so-called BRICS countries (Brazil, Russia, India, China, and South Africa) are voicing their opinion on this matter loud and clear.

Bernanke's star turn

Monetary leaders hoping against a reprise

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. With recovery still sluggish at most and employment data signalling no great momentum to the economy, the broad Fed consensus seems to be for expansionary monetary policy to remain more or less in force in coming months. But there seems little appetite for a further direct extension of quantitative easing under an occasionally-mooted 'QE3' programme.

Paul Giamatti as Ben Bernanke

HBO seeks to capture drama of financial crisis

It's extremely rare for Federal Reserve officials, living or dead, to be portrayed on the screen by well-known Hollywood actors. Can anyone name another instance? But Fed chairman **Ben Bernanke** gets a starring role in HBO's film version of Andrew Ross Sorkin's book, Too Big to Fail, and is admirably rendered by Paul Giamatti, an award-winning actor who has appeared in a number of hit films.

Bloomberg Businessweek's Bess Levin gave kudos to Giamatti – and perhaps indirectly to Bernanke – in her review of the film: 'Blessed with the Federal Reserve chairman's perfectly rounded forehead and jowls, Giamatti literally appears in the shadows—a nod to the Fed's éminence grise role…In one scene, Bernanke tells a room filled with congressmen and bank CEOs that they can either do what he and Paulson are telling them or trigger the next Depression. These fist-pumping moments cast a new light on the shy academic—who knew?—and provide some of the best moments in the movie.'

Timothy Geithner

Billy Crudup plays **Tim Geithner**, then president of the New York Fed and now **Hank Paulson's** successor as Treasury secretary, and successfully swings from toughness to helplessness in the face of the unprecedented situation facing U.S. officials in September 2008. For better or worse, the film, directed by Curtis Hanson, the Oscar-winning director of 'L.A. Confidential,' makes Paulson the hero of the story as he accepts the need to compromise his free-market principles to bail out the banks.

Paulson has retired to memoir-writing, while Bernanke and Geithner are still on the job. They are no doubt hoping that HBO will not have to do a sequel and have Giamatti and Crudup reprise their roles.

Dudley has caveats on the economy

William Dudley

New York Fed chief **William Dudley (voter)** remained cautiously optimistic when he went to upstate New York in mid-May to talk about economic prospects. He repeated the Fed line that commodity price rises are likely to be temporary and that core inflation is reliably showing that price rises are actually running a little behind what the Fed would like to see. Unemployment is declining more slowly than anyone would like, but it is declining.

None the less, Dudley had some caveat for his audience at the State University of New York in New Palz. Even if temporary, he said, the high prices for oil and other commodities are cutting into household spending and the depressive impact on consumer spending could be greater than he anticipates.

The continuing decline in home prices, affirmed in data released later in the month, also could dampen consumer spending and housing activity more than Fed economists expect.

And, not least, aggressive government spending cuts or tax increases could slow economic growth in the short and medium term, Dudley said, though he quickly added that 'a credible plan for medium-term fiscal consolidation is sorely required.'

James Bullard

James Bullard (non-voter), head of the St. Louis Fed, suggested that the FOMC might tread water on monetary policy until the economic picture grows clearer.

'Past behaviour of the FOMC indicates that the Committee sometimes puts policy on hold,' Bullard said in a pair of presentations in southern Missouri. 'This gives the Committee more time to assess economic conditions.'

In the current environment, Bullard said 'on hold' would mean the Fed funds rate remains near zero, the FOMC statement would continue to refer to an 'extended period' for keeping rates low, and the Fed's balance sheet remains at the same elevated level.

Hoenig still dissenting from Fed consensus on interest rates

Thomas Hoenig

Thomas Hoenig (non-voter), the long-serving head of the Kansas City Fed, is due to retire in October but he's not done with his swan song. He went on one of the Sunday morning talk shows – CNN's Global Public Square with Fareed Zakaria – to talk about how the Fed should raise interest rates now.

Hoenig said he shares the blame of FOMC decisions in 2003-04 in not raising interest rates in time. 'We erred,' he told Zakaria. 'We kept interest rates too low.'

It's because he's learned from that mistake that he is now urging a prompt rise in rates. 'Zero interest rates encourage consumption,' he said, because no one will save if they can't earn any interest on savings. And savings, he said, are what characterise great nations in history.

The market needs to know that the Fed is not going to support free-spending indefinitely, the dean of regional bank presidents said. Hoenig systematically dissented from FOMC decisions last year when he had a vote on the panel because he disagrees with the consensus view of maintaining easy monetary policy.

Narayana Kocherlakota

Somewhat more cautiously, Minneapolis Fed president **Narayana Kocherlakota (voter)**, speaking at the Chamber of Commerce in Rochester, Minnesota, suggested the Fed funds rate should be raised modestly, to 0.5%, toward the end of 2011.

In contrast to Hoenig's view, the majority view at the Fed was expressed by **Sandra Pianalto (non-voter)**, head of the Cleveland Fed, in a talk she gave in Columbus, Ohio.

Sandra Pianalto

Inflation, she said, is elevated for the moment but should fall back down below 2% in the next couple of years. 'Given this outlook, I think that the current accommodative stance of monetary policy, with short-term interest rates close to zero, is appropriate and supports the FOMC's dual mandate of stable prices and maximum employment,' she said.

While Pianalto acknowledged that the Fed's accommodative stance would have to be tightened eventually, she said it could take five years for unemployment to reach 'its long-run sustainable rate' of 5.5 to 6%, with economy growing at a modest 3% annually.

Lacker says monetary tightening could start early

Jeffrey Lacker

Richmond Fed chief **Jeffrey Lacker (non-voter)** clarified that monetary tightening could begin even while unemployment remained high. He noted that inflation ratcheted ahead in the wake of a recession in 2003-04 even amid a sluggish recovery.

Echoing Hoenig's remarks about learning from past mistakes, Lacker told an audience in the Washington suburb of Arlington, Virginia, 'I believe it will be important to remember the lesson of the last recovery – namely, that inflation is capable of rising even if the level of economic activity has not returned to its pre-recession trend. To prevent that, it may be necessary to initiate policy tightening well before the unemployment rate has fallen to a rate we would expect to see over the long run.'

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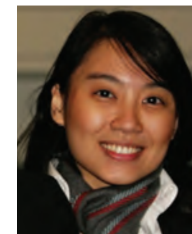
Sabrina Wong

Advisory Board members perform a variety of tasks including participation in seminars and speaking engagements for OMFIF's clients and members. For details contact secretariat@omfif.org

** Chairman* *** Deputy Chairman*

Looking ahead – 2011 diary dates

OMFIF Seminar with
Prof. Harold James
Official Historian, IMF
14 June 2011, London
Sovereign Debt Restructuring

OMFIF/Lafferty Conference
The World Banking Summit
29-30 June, London
New Models for Growth

OMFIF Debate with
Hans-Olaf Henkel
Georg Boomgaarden
12 July 2011, London
Which Way Forward for the Euro?

OMFIF Lecture with
Miroslav Singer
Czech National Bank
28 June 2011, London
The Czech Experience of 92-93

OMFIF Seminar with
Philipp Hildebrand
Swiss National Bank
4 July 2011, Edinburgh
Swiss Franc's Role in World Money

OMFIF Lecture with
Paul Volcker
Former Chairman, Federal Reserve
14 July 2011, London
World Economic Imbalances

OMFIF Dinner with
Jacques de Larosière
Former Managing Director, IMF
28 June 2011, London
Lifetime Achievement Award

OMFIF Book Launch
'The Euro' by David Marsh
Gus O'Donnell, Lord Lamont
11 July 2011, London
The Battle for the New Global Currency

OMFIF Meeting
Asian Central Bank Watchers' Conference
1 November 2011, Kuala Lumpur
Asian Perspectives on World Money

Effects ripple out from Japanese disaster

EMU core leaves periphery behind

DZ Bank Economic Forecasts

GDP growth	2010	2011	2012
US	2.9	2.5	2.7
Japan	4.0	-1.7	2.5
China	10.3	9.2	8.7
Euro area	1.7	1.8	1.5
Germany	3.6	3.0	1.8
France	1.4	2.0	1.7
Italy	1.2	0.8	1.1
Spain	-0.1	0.5	0.7
UK	1.3	1.1	1.6
Addendum			
Asia excl. Japan	9.3	7.9	7.6
World	4.7	3.8	4.1
Consumer prices (% y/y)			
US	1.6	2.9	2.3
Japan	-0.7	0.0	0.3
China	3.3	5.2	3.4
Euro area	1.6	2.6	2.0
Germany	1.2	2.4	2.1
France	1.7	2.4	2.2
Italy	1.6	2.5	1.8
Spain	2.0	3.0	1.7
UK	3.3	4.0	2.1
Current account balance (% of GDP)			
US	-3.2	-3.1	-3.2
Japan	3.6	1.8	3.2
China	5.2	4.8	4.5
Euro area	-0.3	-0.7	-0.6
Germany	5.7	4.9	4.7
France	-2.2	-2.4	-2.6
Italy	-3.0	-2.9	-2.5
Spain	-4.7	-4.6	-4.0
UK	-2.5	-2.0	-1.8

This table and commentary appear by courtesy of DZ Bank, a partner and supporter of OMFIF

Europe has a two-speed economy. The divide is between strong growth in the 'core' - Germany, France and their smaller neighbours – accompanied by crisis and minimal growth in the periphery, including Spain and Italy.

We see a mixed picture outside Europe, too, with the US recovery losing significant momentum in the first quarter of the year while the Chinese economy continues at full speed. The Japanese economy is bearing the brunt of the March earthquake and the aftermath.

So what does the summer hold in store for the world economy? The latest growth numbers have persuaded many observers in Europe, especially in Germany, to adopt a decidedly optimistic outlook and revise their growth forecasts sharply higher.

With an eye to the international risks and crisis hotspots however, we consider a more restrained scenario is more appropriate.

Although the German upturn will continue, it will lose perceptible impetus this quarter. The other euro area countries will similarly continue to suffer the consequences of the sovereign debt crisis as well as the dampening effect of high energy prices.

As a result, growth in the euro area will on average remain below 2% this year, while the US notches up 2½%. For the foreseeable future, growth will remain too weak in most countries sustainably to reduce unemployment.

Data from Japan give a first impression of the economic consequences of the earthquake, tsunami and nuclear meltdown. Japan's GDP fell by nearly 1% in the first quarter, and the slide will probably accelerate during the current quarter.

We are staying with our view, however, that we will soon see the first flowering of positive stimulus during the second half as reconstruction begins.

The slump of production in Japan has left its first mark on the Chinese economy. The latest numbers show relatively low Chinese imports, especially from Japan. Industrial output also looked weak, especially in the automotive sector.

This confirms our assessment that a slowdown is on the cards in China for the current quarter, though this should be followed by positive catch-up effects in the second half of the year.

In general, the Chinese economy is likely to lose momentum in the coming quarters – mainly as a result of tighter monetary policy. Inflation will go on rising until June and slow significantly only next year.

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Strains for creditors and debtors

Striking a delicate balance on new aid

Stefan Bielmeier, Head of Research and Chief Economist, DZ Bank

In today's two-speed Europe, the positions have been reversed. Between 1990 and 2007 Germany grew on average 2.4% a year, while Greece and Spain booked growth above 3% and Ireland managed 6.5%.

With the exception of Portugal, the peripheral countries achieved massive economic growth as a result of economic and monetary union, but did lit-tle to rectify structural shortcomings and low competitiveness.

By contrast, Germany did not profit from early harmonisation of euro area interest rates. For years it was at the back of the economic growth train. But it enhanced the efficiency of its economic and industrial structures and its social welfare systems. Its competitive edge became much sharper – at the cost of weak domestic demand.

That bargain is now paying off. The peripheral nations are at last facing up to the consequences of past mistakes.

Under 'normal' circumstances the consequences would be fairly simple. The countries in difficulties would undergo several years of struc-tural adjustments and consolidation, with weak growth but no fierce recession.

Germany and the other strong countries would book a structural dividend and, ideally, further reduce government debt.

However, owing in part to the global financial market crisis, the need for reform turns out to be much greater.

Additional government spending has already been enacted on bank rescue and economic turna-round programmes. And investors have become more risk-conscious, making refinancing more expensive if not impossible.

The evident need for reform necessitates hard-hitting measures. The steps taken in Greece are already harsh.

Greater severity could endanger political and social stability. Clearly, the reform process will take longer than initially assumed.

At the same time, the patience of the citizens and taxpayers in the countries providing the support is being sorely tried.

A rift is opening up between public opinion in the debtor and creditor states. The unpleasant notion of a 'bottomless pit' is doing the rounds.

Given these conditions, it is not surprising that Germany is now becoming more aggressive in recommending that other countries copy its own model, as a way of reconciling public opinion on the home front.

If this model is to be accepted by Greek politicians and population, restraint and sensitivity are in order.

The conclusion is clear. If the overriding objectives are to be reached, the form of additional assistance must pay attention not just to economic factors but to the burdens that respective societies can endure.

Germany did not profit from early harmonisation of euro area interest rates. For years it was at the back of the economic growth train. But it enhanced the efficiency of its economic and industrial structures and its social welfare systems.

Euro antidote to divergence

ERM-type scheme might have heightened disparities

Lorenzo Bini Smaghi, Member of Executive Board, European Central Bank

Considering the scale of the underlying problems and the time it will take to resolve them, the single monetary policy may have different effects in different parts of the euro area, leading to persistent differences in economic performance - even with the single policy stance established by the ECB's Governing Council.We are already seeing greater country variations than in the pre-crisis period. While the German economy appears to have recovered quickly from the recession, growing 1.5% in the first 2011 quarter, growth remains sluggish in those countries most affected by the sovereign debt crisis.

To some extent, these differences are a mirror image of those before the crisis. Countries which had more buoyant growth during the pre-crisis period have accumulated large financial imbalances. In the middle of the past decade, strong growth in household loans fuelled housing and construction booms in countries such as Spain and Ireland. Loan growth rates there peaked at annual rates of around 25%, compared with an area-wide peak of 10%. As a result of the crisis, these countries have been undergoing a painful adjustment, unwinding the imbalances created during the boom. The recessions affecting them have sometimes been much deeper, with GDP growth several percentage points below the euro area as a whole. Loan growth has fallen significantly.

Has the single monetary policy exacerbated these cross-country differences? The answer depends on the counterfactual scenario you choose. It is certainly possible to construct a theoretical counterfactual within which credible and independent national monetary policies would have ensured price stability in every country now in the euro area, rather than only at the average euro area level. In this scenario, cross-country inflation differentials would have been reduced, although I should emphasise that these have remained small in the euro area, even when compared with those in different regions of the US.

However, a more realistic counterfactual would envisage euro area countries being connected by some version of the old Exchange Rate Mechanism (ERM), with the policies of several countries in some way related to the policies implemented in particular by Germany and respective countries linked to the D-Mark. How might such a system have worked prior to the crisis? It may have made the divergences between countries more acute than those we have actually seen within the euro area. For example, policy interest rates determined by the Bundesbank on the basis of the outlook for price developments in Germany alone would probably have been lower before the crisis than those determined by the ECB for the euro area as a whole. Within an ERM regime, lower German interest rates would have been transmitted elsewhere in Europe, including to countries such as Spain or Ireland, where domestic inflation and house price developments would not have warranted such an easy policy stance. The resulting lower real interest rates and easier financing conditions might well have exacerbated the accumulation of financial and real imbalances by supporting even bigger asset and credit bubbles - and ultimately have led to a larger crisis as these bubbles burst.

During the crisis, monetary union has also helped to contain cross-country heterogeneity in bank credit conditions. And it has supported the availability of loans to the private sector. Not only have standard and non-standard monetary policy measures served to ease financial conditions on average, they have also helped to limit the dispersion of bank interest rates across countries. In sum, there are no clear reasons for believing that cross-country variation in euro area economic performance has been larger than if Europe had retained national monetary policies and not introduced the euro. But, equally, I do not think that cross-country differences in monetary union can or should be ignored – since they raise the potential for persistent divergence of economic performance.

There are no clear reasons for believing that cross-country variation in euro area economic performance has been larger than if Europe had retained national monetary policies and not introduced the euro.

This is an extract from Dr. Bini Smaghi's address to OMFIF and German-British Forum on 26 May 2011

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Muddling through will not work

Latin America lessons support case for default

Mario I. Blejer, Advisory Board

The European Central Bank, with its staunch opposition to sovereign debt restructuring in Europe, is making a bad situation worse. By threatening to withdraw support for banks in countries such as Greece if they restructure their debts, the ECB is practically inciting runs on banks. The argument that Greek state paper could no longer be used as collateral in such cases hardly justifies such a potentially destabilising step. The ECB is effectively the lender of last resort to such banks. If depositors believe it is about to pull out, then they will withdraw money from the banks - and we will face a self-fuelling downwards spiral.

Collateralised new bonds could be backed by direct liquidity and recapitalisation actions for the banks under similar conditions to the 2009 'Vienna model'.

The debt problem of peripheral Europe is structural. It cannot be solved by piling debt on debt. There is an analogy to a 'Ponzi scheme' under which more money is continually paid in to keep the pyramid-like edifice from collapsing. The debt/GDP ratio increases over time because new loans are given to pay old debt and to finance the remaining fiscal gaps. In addition, the share of the debt in official hands continues to increase and eventually taxpayers bear the complete cost of the adjustment. This may, however, take time and, since the pyramid is unstable, the construction could break down at any moment – a source of increasing uncertainty.

The International Monetary Fund so far has not performed well in peripheral Europe. It was a mistake to assume that a country like Greece can re-enter the private sector credit markets next year. This is impossible. It is even more difficult after 2013 under the perverse permanent bail-out scheme where protection for private sector creditors is progressively lowered. Programmes are based on illusory 'debt sustainability scenarios' which ignore that they lead to recession where countries have no chance of outgrowing their debt.

As for privatisation, this is a red herring. It is useful as a short-term stopgap and for improving productivity but a fire-sale of assets cannot solve the debt problem. If there is no demand for Greek debt, then there cannot be too much demand for Greek equity.

The Argentine experience during the first decade of the 21st century is instructive. So are the broader lessons of the Latin American debt restructuring in the 1980s and also that of Mexico in 1994. Fiscal adjustment and structural reforms are crucial and necessary conditions, and privatisation may play a small role, but there is no solution without debt relief, which means, without euphemisms, default. This should be non-confrontational and as amicable as possible. Collateralised new bonds (along the model of the Brady bonds initiative in the late 1980s) form the best procedure. This could be backed by direct liquidity and recapitalisation actions for the creditor banks under similar conditions to the 2009 'Vienna model' successfully used for central and eastern Europe. However, without significant write-downs of existing debt , there is no way out.

Contrary to the ECB's stated view, it is easier to regain credit market access after a significant reduction of the debt burden, as both Uruguay and Argentina showed. The latter did not handle the matter well until 2005 but corporations were soon back in the market. Today, while the issue is not fully resolved, Argentine borrowers can borrow at half the spread paid by Greece. With regard to the fear of contagion to other countries, explicit debt relief for the most-badly hit EMU members may actually relieve the pressure on Spain and others - as long as the money used today to pay bondholders is channelled directly to recapitalise and sanitise the banking system.

Regarding the ECB's opposition, I am convinced that the question is not whether but when the ECB will do a U-turn (as it did with purchasing bonds in the secondary markets in May 2010). There is a good argument for taking necessary decisions on debt restructuring sooner rather than later. Further 'muddling through' is a recipe for disaster. Unless a proper programme of coordination and adjustment combined with debt relief is decided soon, Europe faces the risk of becoming the next emerging market.

Irrevocable development

Right perspective for renminbi internationalisation

Julia Leung, Hong Kong Treasury under-secretary

China with its closed capital account is embarking on an important reform in the use of its currency – to make the renminbi 'tradable' for international trade and services and in overseas investments. This intention, enshrined in the wording of the 12th Five Year Plan, is of similar significance to the basic step of economic opening decided in 1979. I believe this is the first step in a process that will in the fullness of time lead to eventual capital account opening and full convertibility.

The pace of renminbi internationalisation may vary over time. This is a process measured by decades. But like the economic reform that went before it, this process is irrevocable. Hong Kong is playing an important role. For the first time, our strategic importance to the mainland is written into the Five Year Plan, positioning Hong Kong as the offshore renminbi centre. This reflects our status as the most open, most international financial centre, part of China, yet distinct and separate from mainland's own financial system. Convertibility can be tested in Hong Kong while a natural firewall is maintained to ensure the mainland's financial security.

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The development of the renminbi capital market could be a major spur to Hong Kong's growth as an international finance centre in years to come. This is comparable to 1993 with the historic listing of Qingdao Beer, the first mainland share in Hong Kong. The Hong Kong exchange went on to host nearly 600 listings from the mainland, and clinched the world's No. 1 title in IPOs. Now we see change of a similar magnitude. Hong Kong can develop as the offshore renminbi financing centre for multinational companies funding investments in China via bond issuance and even through equity listings. Since July 2010 we have seen new renminbi bonds amounting to Rmb45bn, equivalent to roughly 30% of new Hong Kong dollar bond issuance last year. Banks project new issuance of Rmb60bn this year.

All this has important repercussions for Hong Kong as a premier asset management centre. The Beijing authorities are encouraging an outflow in renminbi for overseas direct investment. We believe that, in a gradual, controlled manner, regulations on both inward and outward investments will be liberalised further to allow renminbi outflows – and Hong Kong would play an even bigger role in managing the mainland's wealth.

My confidence is built in part on the rapid but robust progress that has been achieved in just nine months since cross-border renminbi trade settlement was expanded and restrictions on transfer of funds in Hong Kong were removed. Hong Kong has played a central role in facilitating the national objective of using renminbi for cross-border trade settlement. This now accounts for nearly 7% of China's total trade, against only 2% a year earlier. This compares with 20% to 30% of Japan's trade settled in yen.

With reference to offshore renminbi liquidity, Hong Kong deposits have increased from Rmb60bn to more than Rmb450bn over this nine month period. Some projections put the total at Rmb700 bn to Rmb1tn by the end of this year. Furthermore, Hong Kong is witnessing the formation of a capital market in renminbi. Complementary to renminbi bonds are derivatives, bond funds and insurance policies in renminbi, the debut of renminbi REITs and dual currency stock IPOs.

I must stress too that risk management is under control. Any funds, hedge funds included, can buy and sell renminbi freely in Hong Kong, but their activities in Hong Kong are segregated from the mainland market. For such funds to cross the border, they are subject to tight scrutiny by relevant authorities. Currently fund flows between Hong Kong and the mainland are either bona fide trade under the current account, or subject to quota control under the capital account. So renminbi business hasn't turned Hong Kong into a base for hot money flows into the mainland. Nor will it threaten the mainland's financial security.

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Knot unties succession conundrum

No-nonsense name for post-Wellink era

Roel Janssen, Board of Contributing Editors

Klaas Knot, the designated new president of De Nederlandsche Bank, is no-nonsense name for a no-nonsense era. The surprise appointment of the 44-year-old economist, career public servant and banking supervisor came after months of haggling between the Dutch central bank and the finance ministry over the succession of Nout Wellink, the veteran central banker who leaves office on 30 June.

The heir apparent and Wellink's personal favourite to succeed him, Lex Hoogduin, was brushed aside. Disillusioned, he has resigned from the DNB's board. Together with Knot (pronounced K-not), a new director of banking regulation and supervision has been appointed. Jan Sijbrand, who holds a PhD in mathematics and works as the head of risk management at NIBC, a Dutch bank, is an expert on understanding complicated financial products. He becomes probably the first 'quant' to join the board of a major central bank. With Wellink, Hoogduin and Henk Brouwer (director of banking supervision, who is also retiring) all leaving, the Nederlandsche Bank will lack experienced insiders in European monetary affairs at a crucial time for economic and monetary union. The Netherlands, like Germany, is highly reluctant to continue financial support for Greece and other debtor nations. The board of the Bundesbank is also being shaken up. So the central banks of the two main creditor countries face major change at a sensitive juncture. Jens Weidmann, the new president of the Bundesbank, is aged 43. The main Dutch political parties hailed Knot's appointment as a new start for the central bank, while economists were predictably critical about his lack of monetary experience.

Knot was born in Onderdendam, an agrarian village in the northernmost part of the Netherlands. His mother worked as a local school teacher, his father sold fertilisers to farmers. After graduating he wrote his PhD on 'Fiscal policy and interest rates in the European Community'. In 1995, he started his career at the Dutch central bank and, with a year and a half's break at the IMF, he stayed there until 2009, working in different supervising positions. In 2005 he became a part-time professor at his alma mater, Groningen University, as Hoogduin's successor.

The generational shift is part of 'cultural change' at the central bank engineered by the Dutch government. The DNB was widely blamed for the 'loss' of ABN Amro, the venerated Dutch bank that was bought by a consortium of three foreign banks in 2007 and partly nationalised by the Dutch government in 2008 after the banking crisis. Wellink also got the flak for the collapse of the Icelandic internet bank Icesave in 2008 and of DSB Bank, a Dutch consumer credit bank in 2009.

Last year, after several critical reports, politicians requested Wellink's resignation. Leading economists claimed Wellink - a member of the DNB board for almost 30 years, half of it as president - had been in charge too long. The minority government that came to power with the support of the populist party of anti-immigrant politician Geert Wilders was determined to put an end to the 'ancien régime'.

Finance minister Jan Kees de Jager made clear Wellink could not seek a third term. He decided, too, that the future director of regulation and supervision would have an equal position to the president. When DNB discreetly suggested Hoogduin should take over, the government ignored the recommendation. The stalemate lasted for months. To his own surprise, Knot is now being presented as the perfect outsider - a representative of a new generation of pragmatic public servants.

In the current Dutch political climate international considerations carry little weight. The public mood demands more activist regulation and closer scrutiny of supervision by the government. Knot's appointment marks the final settlement with the Wellink era – and the opening of a new one.

In the current Dutch political climate international considerations carry little weight. The public mood demands more activist regulation and closer scrutiny of supervision by the government. Knot's appointment marks the final settlement with the Wellink era – and the opening of a new one.

National interest to the fore

The real forces behind reserve currency diversification

Malan Rietveld, Chief economist

The World Bank has injected some much-needed realism into the debate on international monetary reform and China's role in it. While the Global Development Horizons report requires some reading between the lines, it makes a number of frank and unequivocal predictions. And it frames the central conundrums of the international monetary order in refreshingly realistic terms.

One bold prediction is that under what the authors describe as the 'most likely scenario' for the future international monetary order, the dollar will 'lose its position as the unquestioned principal international currency by 2025.' The authors are clear on which currencies will take up the slack: the dollar's relative decline will see it 'making way for an expanded international role for the euro and a burgeoning international role for the renminbi.' Under this 'multipolar international currency scenario', the dollar, euro and renminbi are expected to be the 'three roughly equally important currencies.'

Nations with globally influential economies must be willing to accept the fact that their policy actions have important spillover effects on other countries.

The transition to a three-currency system is 'contingent upon China and the euro area successfully implementing financial and structural reforms and managing their fiscal and monetary policies in a way consistent with the international status of their currencies.' The point is that countries with reserve currencies need to adopt prudent policies – particularly when international consequences are taken into account, in addition to purely domestic ones. This message of international responsibility is reinforced by the report's statement that 'countries with globally influential economies must be willing to accept the fact that their policy actions have important spillover effects on other countries.'

The subtext relating to these 'spillovers' requires some guesswork. On the one hand it could be seen as finger-waving towards to the American response to the Great Recession. Clearly, the Federal Reserve's policy of quantitative easing has been enormously unpopular in a number of large emerging markets whose policymakers feel that the consequences of the Fed's actions include vast speculative capital flows into their economies.

On the other hand, it could just as easily be interpreted as a warning to Beijing that the renminbi is not a viable global reserve currency as long as other countries believe Chinese exchange rate intervention distorts global trade balances and competition. The on-off spat with US lawmakers grabs the headlines. But a greater barrier to the renminbi's ascent to the top of the international monetary order is the less-reported issue of complaints from other emerging markets that China's exchange rate policies cause adverse effects on others.

An enhanced role for the euro and renminbi will require not only prudent fiscal and monetary policies, but also greater consideration of what domestic policies mean for other countries. How likely is it that countries will adopt an appropriate spirit of compromise and agree to requisite reforms and sacrifices? This is where the report offers a valuable assessment of the economic and political incentives for reform in Europe and China.

The founding fathers of the euro have frequently stated their ambition to see the euro rival the dollar on the international stage. Now, the World Bank report adds, the motivations for reform have become existential. 'The incentive to undertake such reforms will be the desire to safeguard the gains of the long-running single market project.'

As for Beijing's motivations, the argument is sensibly framed in terms of China's self-interest, which includes most prominently a desire for stability. 'China will be motivated by the need to mitigate the significant risk of currency mismatch to which the country is currently exposed, as China's transactions with the rest of the world are denominated predominantly in dollars,' the report notes. The World Bank has injected healthy realism into the debate on international monetary reform and the role of renminbi politics. If countries wish to move forward the international currency dimension, national self-interest will be the motivating force.

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Osborne faces delicate balance

Obama diplomacy exposes competing pressures

William Keegan, Chairman, Board of Contributing Editors

George Osborne, the UK Chancellor, has been keen to gain approval for his deficit programme from authoritative voices abroad. He has scored two major successes, with glowing comments from Timothy Geithner, the US Treasury Secretary, and Angel Gurria, secretary general of the Organisation for Economic Cooperation and Development.

Geithner's support was quite a coup. It came not long after Geithner appeared fully supportive of those who argued that, whatever the medium term goal, it was important not to withdraw the policy stimulus prematurely. But Gurria also did Osborne proud, appearing with him at a press conference in March, and proclaiming: 'When you have a double-digit deficit, you have to move very fast, very decisively and let everyone know – leave them with no doubt whatsoever – what is your intention.'

However, late in May, during the week when the OECD celebrated its 50th anniversary, the British press reported that the OECD had downgraded its already rather cautious forecasts on economic recovery, to the point where the Financial Times announced: 'OECD rethinks its stance on deficit reduction.' And during the same week President Barack Obama's obvious enjoyment of his visit to London did not lead him to echo what his Treasury Secretary had said earlier. Far from backing the British government's approach, Obama stated diplomatically: 'We've got to make sure that we take a balanced approach and that there's a mix of cuts, but also thinking about how do we generate revenue.'

Whatever the Republicans think, Obama believes that the US has in due course got to face up to tax increases - but the President was not thinking of drastic action now, either in the US or elsewhere.

My interpretation is that, whatever the Republicans think, Obama believes that the US has in due course got to face up to tax increases - but the President was not thinking of drastic action now, either in the US or elsewhere. Moreover, keeping an eye on revenue generation must refer to the need to avoid aborting a recovery by precipitate tightening.
I believe that the OECD's position on the UK deficit is more subtle than the headlines suggested. But, plainly irritated by reports of the OECD's U-turn, the British Chancellor was hoist with his own petard. For until that moment Osborne's public position had been that the deficit must be reduced, come what may, although his officials, in Parliamentary testimony, had tried to cover the government's tracks by drawing attention to the usefulness of the 'automatic stabilisers'. If growth is slower than forecast, then tax revenues are likely to be less than budgeted, and disbursements will be greater because of higher unemployment.

The UK Treasury claims that this was the point the OECD's chief economist, Pier Carlo Padoan, was making in late May when the OECD downgraded its 2011 UK growth forecast to 1.4% from 2.5% in May last year. Padoan said: 'We see merit in slowing the pace of fiscal consolidation if there is not so good news on the growth front…so we are not saying just stick to it.' He added, "Especially given the fact that maybe monetary policy has less of a policy space to use because of the headline inflation story.'

This is the really interesting point. Fiscal consolidation can be slowed by allowing the automatic stabilisers to work, but also via deliberate postponement of a 'cuts' programme. Padoan added, 'I would not reverse the measures I have announced because that would bear down on credibility; I would rather slow down the pace of spending cuts.'

Significantly, the OECD was advocating that the Bank of England should embark fairly soon on 'normalising' interest rates. Osborne had been relying on very easy monetary policy as the counterpart to his cuts programme. Indeed, this was generally understood to be the quid pro quo for Bank Governor Mervyn King's enthusiastic endorsement of the deficit reduction plan. So far the majority on the Bank's Monetary Policy Committee has been resisting pressure to raise interest rates. In my opinion, given the fragility of the putative 'recovery', they have been right to do so. But if the situation changes, and the Bank embarks on 'normalisation', then the economy will require a 'Plan B' for fiscal policy. This would be a crucial test of Osborne's powers of presentation.

A regular European round-up by one of the Delors Commitee's 'Wise Men'

Adjustment requires debtors to persevere

Why restructuring cannot be ruled out for Greece

Niels Thygesen, Advisory Board

Crisis management in the euro area is in crisis. The assumption underlying the 2010 package for Greece was that an adjustment program with strict conditionality would permit the country's return to an element of private financing by 2012. This is now perceived as unrealistic. The Greek economy has been contracting faster than anticipated. Parts of the originally agreed programme are reportedly behind schedule. Tax revenues and privatisations are lagging.

Tensions arise from differing policy time horizons applied by national and European political authorities and, on the other hand, the financial markets. The former take a longer view and await in hope updates such as reports from the 'troika' (the European Commission, the European Central Bank and the IMF) or publication of the banks' stress tests. The latter look at the widening spreads on Greek and other weak-economy bonds, or at CDS prices, as indicators of deepening distrust - even though transactions in these markets are negligible. These indicators are highly sensitive to signs of opposition to adjustment in the debtor countries, and to perceived hardening of attitudes among creditors.

Recently, there have been reports of discord among troika members and between the ECB and some national governments, notably Germany's. A crucial aspect is the role of various forms of debt restructuring. Up to a few weeks ago, policy-makers seemed firmly set against private creditor participation in financing weak-economy sovereign debt prior to 2013, when Collective Action Clauses will make such outcomes legally unobjectionable. However, recently German officials as well as Jean-Claude Juncker, the Luxembourg prime minister and chairman of the Euro-Group, have hinted at debt restructuring in 'soft' or voluntary forms.

The ECB – along with most national officials – sees restructuring as risking major contagion in financial markets with only limited benefit for Greek public finance sustainability. The ECB has gone so far as to state that, if restructuring took place, it would stop using Greek bonds as collateral for lending, since the quality of such assets would drop below acceptable standards.

Tensions arise from differing time horizons of national and European political authorities and, on the other hand, the financial markets.

Is there, nevertheless, a case for preparing for the unmentionable ? The ECB's argument over unfavourable cost-benefit ratios is not the full story. The best outcome would indeed be for Greece to manage its painful adjustment so that it would not have to return to financial markets in 2012, or, indeed, until it had generated a primary surplus. That would seem to require additional funding later this year of around €30-60bn.

But for creditors as well as debtors to agree such action, measures to involve private creditors in sharing burdens appear necessary – always providing such restructuring doesn't immediately trigger the default provisions dramatised by some private market participants and the ECB. Together with additional public financing, efforts to involve private creditors could encourage the IMF to continue its involvement – which cannot be taken for granted, given other regions' growing claims on IMF resources.

There is much conjecture about restructuring in soft or voluntary forms, i.e. stopping short of outright debt write-downs. Such 'soft' action includes efforts to persuade banks and other investors not to sell their Greek or other downgraded sovereign bonds, as well as calls for debt holders to roll over their claims at maturity in 2012 or later. This is analogous to the so-called Vienna Initiative in 2009 under which Austrian and other banks successfully agreed to extend commitments to central and eastern Europe and the Baltic states. Persuading creditors to extend their commitments would be difficult, not least because they would face secondary status relative to official lending through the European Stability Mechanism in 2013. Along similar lines, major creditors could accept a lengthening of maturities and possibly a lower interest rate on outstanding bonds – an outcome that can be seen as closer to a voluntary scheme. New official funding from the euro area in 2012 and/or widening the EFSF mandate (allowing it to buy Greek bonds and exchange them with its own debt) would facilitate any such agreement with private creditors.

The main argument against these ideas is that they contribute insufficiently to sustainability of Greek public finances. Yet such experiments could be justified if they facilitate further public financing. Ultimately the fate of the adjustment for Greece and others will be determined by the debtors' capacity and political willingness to persevere. If they cannot or will not, wider debt restructuring will become necessary, as the markets now anticipate. This would require more intensive preparation by governments, leaving the way open to improvisation that could be destructive.