OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

2013 YEAR OF THE LUSO-ECONOMY

June 2013

Janet Yellen for Fed Chairman

Consensus-builder is better than the others

Meghnad Desai, Chairman, Advisory Board

Janet Yellen is the best bet to head the Federal Reserve when Ben Bernanke steps down as expected in January. She has steady hands and will be a consensus-building chairman.

There is a story that she is a dove on inflation. This despite her record as having been chairman of the Council of Economic Advisers when the budget was balanced. In the probable circumstances of the US and world economy in coming years, dovishness may not be a bad thing.

Japan after all is deliberately trying to raise the inflation rate. The days when inflation was the bogey and hawks were the favoured birds are gone, for the time being at least. The need for now in the western economies is to get a sustained recovery. Fiscal tools have been blunted, as a result of the debt burden. It will be a clever monetary policy that will do the trick. Yellen can deliver it.

What would it take Barack Obama not to nominate Janet Yellen? Would it be that he actually thinks any of the other names mentioned – Timothy Geithner, Lawrence Summers – are better? Or is it that she will hit the handicap from which women often suffer: of being undervalued?

I got to know Yellen when she had a two year stint at the London School of Economics. George Akerlof, her husband, and later a Nobel Laureate in economics, had been made Professor of Money and Banking, in succession to Alan Walters. It was a surprising but imaginative appointment. George is a genius but knew little about money and banking. He was superb. Janet on the other hand was the real monetary economist in that family but was undervalued by the LSE and was given only a Lectureship.

Yellen's subsequent career has shown how wrong the LSE was. She has a first class brain and an unblemished record as a policy leader, whether as CEA chairman in 1997-99, as president of the San Francisco Federal Reserve Bank in 2004-10, or latterly as Fed Vice Chairman.

(continued on page 10..)

OMFIF RENMINBI FOCUS 2013

OMFIF initiative on Chinese monetary and financial policies

As part of the OMFIF 'Year of renminbi focus', a number of reports on Chinese monetary policies and financial markets will be produced in coming months. **SEE FORTHCOMING ARTICLES.**

Contents

ENABLING PUBLIC-PRIVATE LEARNING

China upgrade

Improving plumbing

Peter Norman, Advisory Board

China needs to take steps to upgrade its mechanisms for financial market clearing and settlement as part of efforts to modernise its economy, promote renminbi internationalisation and develop Shanghai as a global financial centre to challenge London, New York, Hong Kong and Singapore.

China weathered the financial crisis better than many other countries. But because of the controls surrounding its financial markets, it is unlikely that China's post-trade infrastructure has been subject to the same stress levels as the frameworks in North America or Europe.

Financial reform will be of vital importance as China sets about improving its society and economic structure. As part of OMFIF's 'Year of renminbi focus', I have analysed a lesser-known but crucial part of China's financial system: the infrastructures that supply the 'plumbing' or post-trade clearing and settlement for capital markets.

(continued on page 10...)

Official Monetary and Financial Institutions Forum

One Lyric Square
London W6 0NB
United Kingdom
t: +44 (0)20 3008 8415
f: +44 (0)20 3008 8426

New directions

Initiatives in Brazil and China

David Marsh, Chairman

OMFIF is heading in new directions in June 2013 with a landmark seminar in Brasilia with the Central Bank of Brazil and a mission to China to explore the ramifications of Beijing's monetary policy and its impact on the rest of the world. Both of these initiatives stem from the OMFIF decision in January to baptise 2013 the 'Year of the Luso economy', highlighting the importance of Portuguese-speaking nations for the world economy, and also as the 'Year of renminbi focus'.

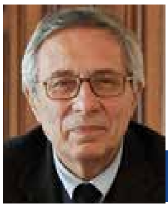
We welcome back to London Gerhard Schröder, the former German chancellor, who – even more than during his last visit in February 2012 – epitomises the new self-confident spirit of Germany as it seeks to maintain its competitive advantage in an ever more challenging world economic environment. Schröder, an initial sceptic about the single currency when the euro was introduced under his chancellorship in January 1999, launched the Agenda 2010 reform programme in 2003-05 which has made Germany an uncomfortably high-performing member in the otherwise struggling euro bloc.

These three issues are inextricably interlinked. The freshly-revived bonds between older and newer Portuguese economic and business cultures around the world symbolise the manifold shafts of the world economy as one-time colonial powers now become increasingly reliant on flows of economies from formerly undeveloped economies progressing rapidly to a greater stage of industrial prowess. The strides made by China in economic and monetary modernisation are a sign of how the world's second largest economy – despite the trials of this year's growth slowdown – is setting standards for international investment behaviour. And Schröder's presence in London is a reminder of Europe's need to stay on top of the reform process if the Old Continent is to preserve its position on the world stage and not drift into irrelevance or oblivion.

In this month's edition, Meghnad Desai and Darrell Delamaide deliver a reminder of another sort – that it would be very difficult for Barack Obama to bypass Janet Yellen as the next chairman of the Federal Reserve when the President decides on the replacement to Ben Bernanke, expected to stand down in January. Peter Norman looks at the need for further renewal of China's already impressive financial market clearing and settlement as an intrinsic part of the country's overall bid to reinforce its economic and financial structures. Franco Bassanini analyses the need for pension funds and other long-term investors – including from developing countries – to channel more funds to infrastructure, in what he hopes will accompany effort to restart world growth. Efraim Chalamish examines sensitivities over sovereign funds' investment in international energy assets. Trevor Greetham explores turbulence in Japan over latest bond market hiccups greeting prime minister Shinzo Abe's attempts to stimulate the economy. Darrell Delamaide describes how the Federal Open Market Committee is stressing flexibility rather than a desire for 'tapering' in its approach to quantitative easing, blurring the distinction between doves and hawks.

On the European front, Simon Tilford calls for Germany to accept higher inflation to ease some of the continuing imbalances in the euro area. Brigitte Granville, Hans-Olaf Henkel and Stefan Kawalec approach the euro's travails from another angle, saying that France must pave the way for more growth by leaving the euro. Gabriel Stein dwells on parallels between breakdowns of past European monetary unions and lessons for today. Gerhard Schröder decries any sense of fatalism about Europe's future and says the sole answer to nagging questions about the Old Continent's place in the world lies in deeper integration – even though this may solidify a 'two-speed 'Europe.

David Marsh



Long-termism for infrastructure

Emerging market investment should pave the way

Franco Bassanini, President, Cassa Depositi e Prestiti

Long-term investors from both the public and private sector can play a big role in returning the world to sustainable growth by stepping up investment in infrastructure. Big changes are underway, especially in emerging market economies. This is part of a necessary switch towards long-term investment, away from the bank-orientated, short-term, pro-cyclical approach that dominates the international regulatory culture.

Financial markets worldwide are still relatively underdeveloped, posing at least a short-term constraint on the availability of capital to meet the demand of infrastructure.

At least in the high public debt countries, resources for funding long-term investment can no longer primarily come from governments, squeezed by fiscal imbalances, or from banks, being restructured and under pressure from Basel III. In particular, European banks, which have been prominent in global project finance, are deleveraging. So institutional investors are increasingly important.

Of global institutional investors' assets of $90tn (according to the OECD), around 3% ($2.3tn) is invested in infrastructure. Long-term assets in infrastructure held by bodies such as pension funds, life insurance companies, sovereign funds and national or multinational development banks may grow to about $4.5tn (5% of total assets), according to a HSBC study. Best practice countries include Canada and Australia, where pension funds and insurance companies invest up to 15% of their assets in infrastructure projects. Financial markets worldwide are still relatively underdeveloped in long-term financing, posing at least a short-term constraint on the availability of capital to meet the demand of infrastructure. Banks in emerging market economies are building up their capabilities for project finance, but more needs to be done. The market for project bonds and hedging instruments such as long-dated currency swaps is modest.

One important requirement is to develop stronger pools of institutional investors from emerging countries, which account for less than 20% of total institutional assets. With higher growth rates and the emergence of an important middle class in the developing world, the quota of emerging market economies' savings going to long-term institutional investors is expected to rise sharply over the next 20 years. Emerging market governments are developing capabilities to structure public private partnerships and carry out tenders in a sustainable manner. This will take time to materialise, but we will see much more capital intermediation between advanced and emerging economies.

In global infrastructure finance, leverage will be much lower than in the past, decreasing equity returns and making equity less attractive. Long-term equity funds such as Marguerite and InfraMed were created to provide the market with non-speculative internal rates of return and longer durations, with the aim of stimulating private equity and institutional investor participation. New instruments and agencies will be needed to mitigate risk and face the credit crunch. They should work as catalysts of institutional investor participation in infrastructure financing through credit enhancements, and leave the senior part of debt to pension funds and insurance and by attracting co-investments on the equity-side of projects. The Project Bond Initiative launched by the EU follows in this direction.

Further, regulatory and policy risk must be controlled and mitigated. Political and legislative stability, fast and streamlined administrative procedures, low regulatory and bureaucratic burdens, a swift and reliable judicial system, and an efficient and technically-capable public administration are key factors in investment decisions. Measures aimed solely at ensuring financial stability have pushed the financial crisis into a double-dip economic recession, thereby thwarting, at least in a good portion of Europe, efforts to restore financial health and achieve fiscal consolidation. In a modern market economy, financial stability, growth and social cohesion are inextricably intertwined. Investment is a key factor not only for growth and competitiveness, but for the stability of financial institutions and rebalancing public finances. While this should have been acknowledged earlier, the trend now underway is better late than never.

Germany needs higher inflation

Euro won't survive without more adjustment

Simon Tilford, Centre for European Reform

Everyone accepts that persistently high inflation can damage economic growth and arbitrarily punish some groups in society while benefiting others. But, in Europe, the risks of excessively low inflation are often ignored. In the face of chronically weak demand, the euro area faces the prospect of deflation. If the single currency is to survive, it needs much higher inflation than at present, especially in Germany.

When inflation falls very low, consumers and firms tend to sit on cash rather than spend it, in the case of consumers because they expect prices to fall further, or in the case of firms because they fear a further weakening of demand. This is what economists mean by a 'liquidity trap'. Households do not want to spend and firms do not want to invest, making a prolonged recession self-fulfilling.

Headline euro area inflation turned negative over the second half of 2009, before rebounding and averaging almost 3% over the second half 2011, well above the European Central Bank's (ECB) target of 'close to 2%'. The apparent strength of inflation was used to rebut those who argued that the euro area needed lower interest rates and more fiscal stimulus to counter the downturn.

The ECB persistently used above target inflation to justify its refusal to cut interest rates further or launch unorthodox forms of monetary stimulus such as quantitative easing (QE). But much of the inflation over this period reflected higher energy (and food prices) and crucially, increases in administered prices and value-added-tax, as governments have attempted to fight fiscal deficits.

Many euro area policy-makers appear to welcome low inflation in the struggling euro countries. Only by ensuring that their costs rise less slowly than Germany's can they hope to rebuild competitiveness. But they need some inflation to gradually erode the real value of their debts and ensure their debt burdens are sustainable. Were German inflation running at 3-4%, the struggling economies might be able to reconcile these conflicting pressures. But German inflation stood at just 1.1% in April, making adjustment very difficult.

The European Commission likes to laud the narrowing of current account deficits in the peripheral countries as evidence of progress in boosting competitiveness. But this is largely due to collapsing demand for imports, not wage restraint or structural reforms. For example, Spanish imports were 20% lower in 2012 than in 2007; Italy's fell 12% over the same period.

Normally, when faced with such pervasive economic weakness and mounting deflation pressures, central banks would be doing whatever it took to raise inflation expectations. If interest rates were close to zero, this would mean unconventional measures aimed at loosening monetary policy, such as QE, and committing to run a very loose monetary stance for a prolonged period of time. The ECB reduced interest rates by 0.25 points to 0.5% at its May meeting, but there is little indication that it is planning an aggressive monetary relaxation. The ECB could launch QE so long as it concentrated its asset purchases on the euro area assets as a whole rather than on particular member states. And it could commit to keep interest rates at their current lows until 2015.

The choice for Germany is not between the status quo or higher inflation but between large euro debt defaults (and a possible dismantling of the bloc) on the one hand or higher inflation on the other. The least painful of these would be higher inflation, even if it were unpopular with German savers. Default was manageable in Greece, but defaults by Italy and Spain would pose an incomparably sterner test. The euro's collapse, even ignoring the political fall-out, would be economically very painful for Germany: the country's real exchange rate would rise very strongly.

The choice for Germany is not between the status quo or higher inflation but between large euro debt defaults (and a possible dismantling of the bloc) on the one hand or higher inflation on the other.

France must show the way

Splitting the euro is Europe's hope of salvation

Brigitte Granville, Hans-Olaf Henkel and Stefan Kawalec

Between the Treaty of Rome in 1957 and the Single European Act in 1986, Europe's governments brought about the one great peaceful revolution the continent has seen in its long and troubled history. The single European currency was designed to build on this remarkable success. It was to be the next vital step to greater unity and prosperity. But the economic crisis in southern Europe shows that the euro system, at least in its current form, has become a mortal threat to both.

Greece, Spain, Portugal, Italy and Cyprus are trapped in a recession. They cannot restore competitiveness by devaluing their currencies. The euro area's northern economies have had to join in repeated bail-outs and put aside their notions of prudent finance. A vicious circle of resentment and populism in the south and strengthening nationalism in the north is tearing the union apart.

France is sinking into a grave economic slump. Like the southern countries, it must restore its competitiveness; like them, it lacks the means. The single European currency was expected to smooth the functioning of the European economy. By fixing the nominal exchange rate and eliminating currency risk, the euro would achieve convergence between the stronger and weaker economies. In fact, the single currency entrenched – indeed, worsened – the competitiveness gap caused by differences in inflation rates and unit labour costs.

With devaluation ruled out, the resulting current account imbalances can be addressed in only two ways: through cross-border transfers or 'internal devaluation' – under which deficit countries restore competitiveness by reducing government expenditure and increasing taxes, weakening domestic demand. Unless there is an offsetting increase in external demand – with surplus countries, notably Germany, undertaking reflation – such austerity will undermine economic growth and hence public finances. There is no prospect, however, of Germany and economically similar countries agreeing such stimulus.

The main alternative is transfers. Deficit countries can cushion their contraction with transfers from surplus countries, rather than internal devaluation. The problem is that such transfers will no longer be painless. Many debtor governments would prefer their transfers in the form of money printed by the European Central Bank (ECB), with fewer, if any, strings attached. French officials have said as much explicitly. But the best they can hope for is ECB purchases of short-term government bonds (known as Outright Monetary Transactions). If they happen at all, these will be subject to tough fiscal conditions.

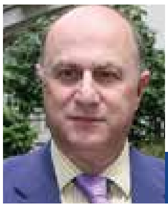
So the outlook for the euro area debtor nations is one of relentless fiscal tightening and years of deficient demand. This will result in shrinking or, at best, stagnating output and living standards. Meanwhile, anti-EU and specifically anti-German sentiment is building.

Could a United States of Europe save the day? Greater labour mobility might be one feature. One could imagine the populations of depressed countries such as Greece, Portugal, Spain and Italy migrating to rich Germany and Finland. In this scenario, whole countries could end up resembling depopulated rural regions.

Something has to give – and it will have to be the euro system itself. To preserve the EU, the monetary union must be dismantled. The all-too-relevant historical parallel is the defence of the gold standard in the interwar period, which came close to destroying democracy. Only one country can take the lead in advocating a controlled segmentation of the euro system by means of a jointly agreed exit of the most competitive countries. That country is France.

A splitting of the euro system would be in the best interests of both France and Europe, as it would speed the EU's return to economic growth. This is the only sure guarantee of European stability and unity.

Only one country can take the lead in advocating a controlled segmentation of the euro system by means of a jointly agreed exit of the most competitive countries. That country is France.



The tale of monetary divorces

Breaking up can be hard to do – or unexpectedly easy

Gabriel Stein, Chief Economic Adviser

There are essentially two kinds of monetary unions. One is where national currencies are locked together but still exist, such as the Scandinavian and Latin Monetary Unions (SMU and LMU) of the late 19th and early 20th centuries. The second is rarer, with only one currency circulating in more than one country. Examples are the Austro-Hungarian empire – two countries with one currency – and the short-lived Czech-Slovak monetary union following the breakup of Czechoslovakia itself in 1993. The common ground is that most of these monetary unions, over the passage of time, have broken up. All this has lesson for economic and monetary union (EMU) in Europe.

Monetary unions work only if no part insists on creating money or having its own monetary policy. What the European Central Bank today calls the 'singleness' of monetary policy is an existential condition. For this to happen, countries must be willing to give up sovereignty – a step that is still very difficult for many countries.

There is another lesson, too, from the break-up of the Czech-Slovak monetary union in 1993, as described by the authors of a seminal paper on the issue: 'While the formation of a monetary union is a tedious job taking many years, its dissolution can occur quickly and does not need to be very costly. The temptation to secede is higher if the expected cost of exit …. is small.'*

In the 19th century, SMU and LMU show great interest in monetary unions at the time, promoted by globalisation and the belief that standardising currencies would benefit exports. A monetary union would do away with foreign and domestic currency instability. Standardising currencies would be simplified by the move to more 'scientific' decimal currencies and metal-backed coinage – generally silver, more rarely gold.

The idea was to harmonise currencies on the basis of a common unit, based on a precious metal – such as the French five franc silver coin or the Scandinavian 10 crown gold piece. But monetary unions were intended to be more than that. The currencies – including divisionary coinage – were meant to be interchangeable and accepted in all countries of the union. Therefore, there had to be rules governing the issue of coinage, including divisionary coins, as well as for the return of coins from other countries.

There were concerns (in the case of the LMU, strongly articulated by the Banque de France), that members with weak public finances would destabilise the union. This was an important factor behind its eventual dissolution. The LMU's founding members in 1865, France, Belgium, Switzerland and Sardinia, wished to expand the union; this was one of the reasons why they switched to a gold standard in 1867. But only two countries ever joined: the Papal States, later expelled for cheating, and Greece, admitted on the condition that its coins were minted in France, under French supervision.

Further attempts at expansion were stymied by British and American opposition, partly based on unwillingness to adjust even minimally the gold content of their own currencies to conform to the LMU standard. Another half dozen countries unilaterally aligned their currencies. In theory, LMU lasted until 1927, but, in fact, was broken up by the First World War, with members going off gold amid significant economic divergence.

The Scandinavian Monetary Union formed in 1873-75 was a 'true' monetary union. The currency – the crown – was the same, there was cheque clearing, paper money was included and all coins were legal tender in the union. But its aims were much more limited than that of LMU, and its life was rather calmer, until its eventual demise after the First World War. With war, countries suspended gold convertibility and – in some cases – banned gold exports.

Monetary unions work only if no part insists on creating money or having its own monetary policy. What the European Central Bank today calls the 'singleness' of monetary policy is an existential condition.

In the case of the LMU, most of its members had to abandon fiscal and monetary probity, issuing large amounts of paper money which was not considered part of the 'union money'. Silver coins were melted down and exported to pay for imports. This led to a massive overhead of paper money following the war, which could not be redeemed in silver.

The dissolutions of the LMU and the SMU were simplified by the continued existence of national currencies. Upon dissolution, they were no longer legal tender in the other union countries. A more complicated break-up was necessary in the case of the Austro-Hungarian monetary union, which was formed as the result of Austrian weakness following the Empire's defeat by Prussia in 1866. This provided Budapest's Magyar elite with an opportunity to wrest major concessions from the Austrian Hapsburg Empire by threatening secession.

To prevent this, Vienna and Budapest agreed the 'Compromise of 1867', a constitutional treaty that recognised the sovereign autonomy of Austria and Hungary under a single monarch – the Austro-Hungarian Dual Monarchy. With a common currency and common national bank, the dual monarchy had all the trappings of monetary union. Somewhat ominously, its combination of independent sovereign political and fiscal arrangements, along with joint monetary structures, has notable similarities to the euro area.

The euro area is a voluntary convergence of states with new common monetary arrangements. The Austro-Hungarian monetary union was the outcome of a political separation that resulted in independent sovereign states, while preserving existing common monetary arrangements. Yet we see similar challenges and dilemmas.

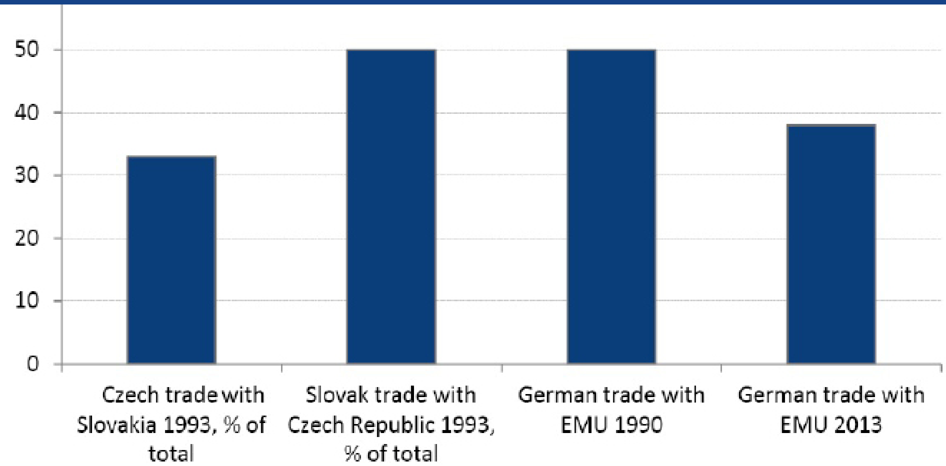
The 1867 Compromise established a two-tier fiscal system, with a 'confederate-level' and a 'country-level' – as with Europe today. At the 'country-level', each national government decided its own expenditures and taxes as voted by its parliament. The country budgets were not required to balance. Initially, both countries ran large and volatile deficits, funded by borrowing, leading to a significant build-up of debt.

The British scholar Richard Roberts points out that, while contemporary investors did not monitor debt to GDP ratios, a concept that had yet to be invented, they carefully watched the quantity and quality of government tax revenues as well as levels of spending and public debt.** It appears likely that by 1890 Austria and Hungary had reached the limits of their ability to tap international investors. Recognition that deficits and borrowings were becoming unsustainable seems to have complemented the concern about currency volatility in the early 1890s, prompting financial reforms in 1892-1896. Following these and until the outbreak of war, the country-level budget deficits of both countries tended to be in the range of up to 5% of GDP.

The unwinding of the dual monarch's monetary arrangements had several dimensions: the separation of outstanding Austro-Hungarian crown notes into national holdings; creation of successor-state currencies; establishment of successor-state central banks; liquidation of the Austro-Hungarian Bank; and stabilisation of successor-state currencies.

Currency separation and the creation of successor-state currencies proceeded in two stages: the stamping of Austro-Hungarian crown notes, and the exchange of stamped crown notes into national currencies. The peace treaties after the First World War specified that the successor states should stamp Austro-Hungarian Bank notes and then introduce their own notes within a year. In February 1919, 37.6bn paper Austro-Hungarian crowns were in circulation, but successor states'

Trade integration: Czechoslovakia vs Germany with EMU



claims regarding circulation in their territories totalled 44.9bn. The separation of pre-Armistice crowns among the successor states was negotiated, taking account of populations and stamped banknotes, with the total reduced to 29.1bn crowns.

During 1919 and early 1920, in uncoordinated succession, Yugoslavia, Czechoslovakia, Austria, Romania and Hungary, stamped the Austro-Hungarian Bank banknotes in circulation in their territories with a national emblem, converting the crown notes into national currencies. The process was complicated by the successor states imposing varying conversion taxes or forced loans on the stamped notes. There was widespread avoidance of the levies by forgery of national stamps. Many holders initially withheld notes from stamping, seeking the most favourable terms, resulting in substantial illicit cross-border flows of unstamped crown notes. A further complication was the substantial circulations of other paper currencies.

Czechoslovakia led the way in the exchange of stamped Austro-Hungarian Bank banknotes into the national currency, a new Czech crown, in 1919. Yugoslavia and Romania undertook currency exchanges in 1920, the former at four crowns per dinar and the latter at two crowns per leu. Austria and Hungary initially persevered with stamped Austro-Hungarian crowns and subsequently introduced new currencies, respectively the shilling (1925) and the pengö (1927). Afterwards came the stabilisation of successor state currencies. Newly-created Czechoslovakia, comprising the most economically developed regions, led the way. The Czech central bank was prohibited from lending to the government. This immediately stabilised the new Czech currency, since the driving force behind monetary expansion had been removed. Austria and Hungary, the defeated and impoverished aggressors, faced much greater challenges including huge budget deficits and hyperinflation. Stabilisation was achieved in the 1920s through international reconstruction loans issued under the auspices of the League of Nations.

The end of Austro-Hungarian monetary union supports those who argue that such break-ups are messy, costly and drawn-out. However, dissolution of the Czech-Slovak monetary union, following the 1992 ‘velvet divorce’ decision to end the two countries’ union, illustrates an orderly, relatively inexpensive and swift process – even though it was not initially planned. The two successor states initially decided to maintain a monetary union. Because the Slovak Republic was perceived to have a weaker and less developed economy than the Czech Republic, it was assumed that the new Slovak currency would depreciate upon establishment, so capital flowed from Slovakia to the Czech Republic.

The Czech-Slovak monetary union was run by a monetary committee with equal representation from both nations. There were provisions for dissolving the union if either state had a budget deficit above 10% of GDP; if foreign exchange reserves fell below one month’s exports; if an inter-republic capital transfer was over 5% of bank deposits; and if agreement could not be reached on fundamental issues. The two economies were well-integrated. Half of Slovakia’s foreign trade was with the Czech Republic; one-third of the Czech Republic’s foreign trade was with Slovakia, representing much more trade integration than within EMU.

For a monetary union to work, there must be intra-union fiscal transfers. As with EMU today, the countries transferring funds must feel that political, economic or other advantages outweigh the costs. In Czech-Slovak monetary union, the Czechs making the transfers did not see these advantages. The flood of capital from Slovakia to the Czech Republic turned into a torrent. Slovak debtors to the Czech Republic hastened to pre-pay their invoices, while Czech debtors postponed paying theirs. The run on Slovak banks unnerved the Czechs, who soon decided to break the union in 1993. In the intervening period, the border was closed, currencies were exchanged and notes stamped, with limits imposed on bank withdrawals in both countries.

Because only 4,000 crowns could be exchanged in cash, people were encouraged to deposit money in banks. Cash is not as important as often stated. About 90% of all cash circulating in any advanced economy is used in the black or illegal sector. By far the greater volume of transactions of any kind is cashless – electronic, with credit cards or other methods. One frequently-raised objection to dissolving a monetary union – the need to create new notes and coins and reprogramme vending machines and cash registers – is actually minimal. The costs are not substantial enough to stop an otherwise desirable process. In 1993 Czech GDP fell by 1% and Slovak GDP by 4% – a relatively painless transition by the standards of southern states suffering multi-year recessions in the euro area. Both countries began to recover by 1994.

**Jan Fidrmuc, Július Horváth, Jarko Fidrmuc, Center for European Integration Studies, University of Bonn, Stability of Monetary Unions Lessons from the break-up of Czechoslovakia, ZEI Working Paper B 17, 1999.*

***Richard Roberts, Lombard Street Research Special Report EMU – Fuse or Split, October 2010.*

Janet Yellen for Fed chairman *(... continued from page 1)*

Lawrence Summers, though senior to Yellen, bears the responsibility, along with Robert Rubin, for the abolition of the Glass-Steagall act, which brought about the financial meltdown within 10 years – and also had to resign under a cloud as Harvard president.

Timothy Geithner survived the banking crisis as the president of the New York Federal Reserve Bank. But his tenure as Treasury Secretary cannot be said to have been shining, not as long as the US economy stagnated, and doubts persisted about American recovery.

Yellen's appointment, which I hope will be announced in the next few weeks, will be highly welcome. The least important aspect is that the US will catch up with Malaysia, South Africa and Botswana in having a woman as head of the central bank.

Possible Fed chairman has exemplary record

Darrell Delamaide writes from Washington: It would be hard to compile a better CV than Janet Yellen's for heading a central bank. As my colleague Meghnad Desai has described, she has the most impressive credentials. She studied under Nobel laureate James Tobin when she got her doctorate in economics at Yale University. She has done research at MIT and taught at Harvard, the London School of Economics, and the University of California at Berkeley, where she is professor emeritus.

Yellen, 66, is in her fourth position at the Fed, including a stint as a research economist in Washington in 1977-78. She was appointed to the Board of Governors in 1994 and served three years before becoming Bill Clinton's chief economic adviser. In 2004, she began a six-year term as president of the San Francisco Fed and, in 2010, was named to her current position. Yellen is a clear favourite in the handicapping for Bernanke's successor. Former Treasury Secretary Timothy Geithner, another potential nominee, is reliably understood to not want the job. Other potential contenders – such as former Treasury Secretary Larry Summers and former Fed vice chairmen Roger Ferguson and Alan Blinder – are considered long shots at this point.

President Barack Obama would no doubt be happy to appoint the first woman chairman of the Fed. She is a dove – although with a no-holds-barred, take-no-prisoners nature, who doesn't suffer fools gladly (not that there are any of those on the FOMC). She is certainly ready for hard times ahead – she has spoken plentifully in private conversation about the potential risks (for example, to banks' balance sheets) of the Fed's inevitable ending of quantitative easing.

Yellen is a Democrat. Yet there is a fair chance she could win Senate confirmation even in these fractious times for Washington politics. In 2010, when the Democratic majority in the Senate was larger than now, she easily won approval in committee and was confirmed by the full Senate in a voice vote. Some Republicans who are unhappy with Bernanke's easy money policy may object to a nominee widely seen as being even somewhat easier, but they will have the consolation that Bernanke is not being re-nominated. If Yellen sounds some sufficiently hawkish notes at – or, perhaps even more appropriately, before – her confirmation hearings, she is likely successfully to run the gauntlet.

China upgrade *(... continued from page 1)*

The resulting report – 'China's challenges in clearing and settlement: Helping the renminbi become a world currency' – finds much to commend in China's relatively sophisticated post-trade infrastructures and the way they complete trades in equities, derivatives, bonds and other instruments in the country's financial markets.

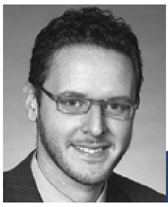
The report pays particular attention to China's futures markets, where the Chinese leadership is seeking a 'qualitative improvement', notably in the commodities field, for the financial sector five year plan covering 2011 to 2015. New futures products are in preparation and there are plans to open the markets to foreign participation.

My suggestions for upgrading the plumbing of China's futures exchanges diverge from the 'vertical silo' approach to post-trade processing of exchange traded derivatives dominant in most developed countries. Instead, the report proposes a horizontal solution modelled on the clearing infrastructure of the US traded options market, centred on Chicago's Options Clearing Corporation (OCC).

While vertical integration has much to offer owners of for-profit exchange groups, its benefits for society are more debatable. Verticalisation – where an exchange group provides services along a chain from trading to clearing to settlement in the same corporate entity or group – can lead to anti-competitive monopoly practices which allow the owners of an exchange and its infrastructure to harvest rents.

An OCC-type structure would serve derivatives markets more in tune with China's socialist market economy than the vertical, for-profit structures that emerged in the west as a result of the demutualisation of exchanges and their infrastructures during the past 15 to 20 years. The strengths and specificities of China's economic model are another reason why the OMFIF report does not suggest that China slavishly copy the predominant post-trade infrastructures in developed economies.

There are lessons that the West could learn from China. The report describes one infrastructure – the China Futures Margin Monitoring Center – that helps safeguard investors in China's futures markets and is being copied in the US. The report touches on an idea that helped spark this study. In January 2013, Prof Xiang Songzuo, chief economist of the Agricultural Bank of China and a member of OMFIF's advisory board, outlined the vision of a China-led payments and settlements infrastructure for east Asia. The OMFIF report sets Prof. Xiang's ideas in the context of post-trade initiatives already underway in the region.



Energy sensitivities loom larger

New guidelines spell tougher treatment for sovereigns

Efraim Chalamish, Advisory Board

Sovereign financial institutions and state-linked entities have been looking into energy assets globally since they started to invest directly in companies in foreign markets. A good example is the takeover of Canada-based Nexen by Chinese entity, CNOOC, likely to lead to further Chinese investments in Canada. These investments fit sovereign institutions' long-term investing models and the need to secure energy resources for related sovereign entities. In turn, energy companies gain access to strategic investors and liquidity.

Sovereign institutions' investment in energy assets is often politically sensitive, so such transactions will continue only if there is an appropriate economic policy and regulatory environment. A previously widespread mood of protectionism against sovereign investment has become much less intense since 2006, when the Dubai Ports World controversy spurred calls for stringent global regulation of sovereign funds and state-owned entity (SOE) interventions in foreign markets.

However, many potential energy assets and companies are located in jurisdictions which have made it more challenging for foreign SOEs and sovereign funds to make such investments. These rules are driven by the need to balance open market policies against internal political pressure to secure national natural resources and employment. Central banks and sovereign financial institutions need to be aware of these developments. Such investors sometimes assume that foreign governments will welcome their investments in strategic energy assets. The true picture is more complex.

In the US, any potential control of a US business by a foreign party requires a 30-day initial review by the Committee on Foreign Investment in the US (CFIUS), the governmental screening body. However, where the foreign acquirer is a government-controlled entity (with certain exceptions), CFIUS must conduct a 45-day investigation. These rules are relatively new, but there is enough experience to assess the impact. Deals are delayed, a higher price is required as a premium, the stock price of the target company declines, and sovereign financial institutions suffer reputational costs when transactions fall through.

Some North American sovereign funds express concern that foreign governments in emerging markets will react by preventing western funds from investing in their energy markets. Sovereign financial ownership is a key factor in US approval procedures, according to annual Congress reports, yet the process is ambiguous and non-transparent – a big deterrent for such transactions. Chinese officials have expressed concern over Australia's classification of all state-owned Chinese companies as extensions of government, leading to limits on the combined number of shares they can own in an Australian company.

As part of the approval of the CNOOC-Nexen deal in Canada, the government adopted new rules on sovereign investment in energy assets, including oil sands. State-owned enterprises' acquisition of oil sands businesses will be approved only exceptionally. The Canadian government will adopt a more strict approach to such companies' acquisitions in other spheres. In May, the Canadian government proposed amendments to the Invest in Canada Act, the foreign investment regulatory mechanism, that broaden the definition of state companies to include 'influence' by a foreign government. The way the administration would apply such legislation is unclear. Such policies could promote a 'race to the bottom' where potential investments head towards more lax jurisdictions with limited screening.

A rise in energy and infrastructure investments is apparent in places such as Latin America, where blocking of foreign governments' investment is less frequent. Yet an apparently softer approach in certain countries may not represent the full picture. Illustrating another facet of 'resource nationalism', such countries may encourage sovereign entities to enter their markets without too many restrictions, under the assumption that, when the right moment comes, these investments can be nationalised or expropriated by the host government.

Investors sometimes assume that foreign governments will welcome their investments in strategic energy assets. The true picture is more complex.

Global upturn with setbacks

Forecasts for China are being revised down

Michael Holstein, DZ Bank

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
USA	1.8	2.2	2.0	3.0
Japan	-0.5	2.0	2.0	1.8
China	9.3	7.8	8.0	8.5
Euro area	1.5	-0.5	-0.5	1.1
Germany	3.0	0.7	0.4	2.2
France	2.0	0.0	-0.2	0.8
Italy	0.5	-2.4	-1.2	0.4
Spain	0.4	-1.4	-1.9	0.9
UK	1.0	0.3	0.6	1.4
Addendum				
Asia excl. Japan	7.6	5.9	6.3	7.1
World	3.8	2.9	3.0	3.8
Consumer prices (% y/y)				
US	3.2	2.1	2.1	2.7
Japan	-0.3	0.0	-0.1	1.5
China	5.4	2.7	3.0	4.0
Euro area	2.7	2.5	1.8	2.0
Germany	2.5	2.1	1.9	2.4
France	2.3	2.2	1.4	1.8
Italy	2.9	3.3	1.9	2.1
Spain	3.1	2.4	2.1	1.7
UK	4.5	2.8	2.6	2.7
Current account balance (% of GDP)				
US	-3.1	-3.0	-2.9	-3.0
Japan	2.0	1.0	1.1	1.5
China	2.8	2.6	2.4	2.1
Euro area	0.1	1.2	1.9	2.0
Germany	6.2	7.0	6.0	5.5
France	-1.9	-2.3	-1.7	-1.8
Italy	-3.1	-0.7	0.9	1.1
Spain	-3.7	-1.1	1.0	2.0
UK	-1.3	-3.7	-3.4	-2.6

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

Euro area GDP growth figures for the first quarter of 2013 turned out weak. The economies of the crisis-hit countries are still shrinking even if the pace of the contraction has slowed slightly in some countries.

France, where economic policy is making no detectable progress, is in recession. Although Germany reported a positive quarter-on-quarter change (+0.1%), the economy has lost much of its impetus.

The global economy is still headed higher, albeit at a lacklustre rate and with some setbacks. While the US economic upturn appears to have stabilised, it remains relatively weak. Japan is finding its way out of recession, but its new course harbours considerable risks. Whether this 'shock therapy' will succeed in pulling the country out of its 20 year old structural crisis is far from certain given the mountain of debt Japan has accumulated.

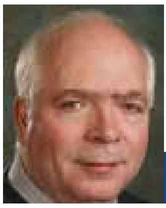
In China, the anticipated pick-up during the second quarter seems to be less dynamic than expected. The upturn in China this year is much more hesitant than we predicted. The IMF and the OECD revised their growth predictions for China at the end of May: the IMF now sees just 7.7% this year and 8.2% in 2014; the OECD expects 7.8% this year and 8.4% next year.

The new political leadership in Beijing is devoting more attention to the Chinese economy's structural weaknesses: this includes a resolute campaign against corruption. The government has turned down pleas for new stimulus packages for now and has pointed to the provinces' high levels of debt. They have acknowledged that excess capacity is a problem in several industrial sectors.

No one disputes that these reforms are needed to secure the country's rapid growth over the long term. While true that these initiatives are not genuinely new, the fact is that the previous leadership basically only paid lip service to them. The new top team appears to be following its promises with action, and is presumably willing to accept slower near-term growth as the price of real change.

Despite all the difficulties, we should not overlook the positive factors – even in some places in the euro area. Consumer confidence has improved continuously since last November, despite problems caused by debates over economic policy and soaring unemployment.

Although the EU Commission's barometer is still stuck at a low level, private households even in crisis-hit Spain, Portugal and Greece are no longer quite as pessimistic about the economy and their financial prospects than six months ago.

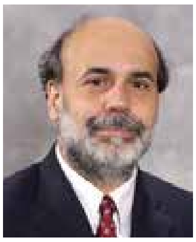


Fed emphasises QE flexibility

Line between hawks and doves increasingly blurred

Darrell Delamaide, US Editor

Federal Reserve officials laboured last month to switch their messaging about quantitative easing from one of tapering to one of flexibility. As the economy emitted mixed signals about the next developments on growth and inflation, the demarcation line between Fed hawks and doves is becoming increasingly blurred.


Ben Bernanke

Fed Chairman **Ben Bernanke (voter)** signaled the change in congressional testimony on monetary policy when he discussed the future of the Fed's asset purchase programme, currently running at $85bn a month. 'A step to reduce the flow of purchases would not be an automatic, mechanistic process to end the programme,' Bernanke said.

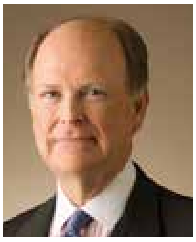
The chairman insisted on the one hand that a premature move to make monetary policy less accommodative could sabotage the recovery, while admitting on the other hand that the Fed might start reducing its purchases in a few months if economic conditions warranted it.


William Dudley

But, as New York Fed chief **William Dudley (voter)**, vice chairman of the Federal Open Market Committee, spelled out, this would be a two-way street: the Fed might reduce purchases with signs of improvement but increase them again if the economy faltered.

'I believe we should be prepared to adjust the total amount of purchases to that needed to deliver a substantial improvement in the labour market outlook in the context of price stability,' Dudley said in a speech to the Japan Society in New York. 'Because the outlook is uncertain, I cannot be sure which way – up or down – the next change will be.'

The new emphasis on flexibility tempered the growing signs that continued improvement in the economy will lead to a reduction in the purchases sooner rather than later. Hawks like Philadelphia Fed chief **Charles Plosser (non-voter)**, who opposed the latest round of asset purchases from the beginning, would like start reducing them this month already, while even a dove like San Francisco Fed president **John Williams (non-voter)** opined at one point that the volume could decrease sometime this summer.


Charles Plosser

'I believe that labour market conditions warrant scaling back the pace of purchases as soon as our next meeting,' Plosser said at an event in Stockholm, referring to the next FOMC meeting on 18-19 June. 'Moreover,' Plosser added, 'unless we see a significant reversal in current trends that jeopardises my forecast of a near 7% unemployment rate by the end of this year, then I anticipate that we could end the programme before year-end.' San Francisco's Williams largely concurred with Plosser, on the condition that the economy continues to improve.

'It will take further gains to convince me that the 'substantial improvement' test for ending our asset purchases has been met,' he said in a speech in Portland, Oregon. If the data indicate steady improvement in the labour market, Williams said, 'we could reduce somewhat the pace of our securities purchases, perhaps as early as this summer. Then, if all goes as hoped, we could end the purchase programme sometime late this year.'


John Williams

In a subsequent interview, however, Williams made it clear that he is totally on board with flexibility. 'We can adjust it down some, watch how things progress from there, and then adjust it again one way or the other,' Williams told Bloomberg. 'You could even imagine a scenario where we would adjust it downward based on good data and then adjust it back,' said Williams.

Hawks and doves converge on QE

In the absence of inflationary pressures, in fact, the debate over the timing and volume of asset purchases is blurring the line between hawks and doves on the FOMC. Chicago Fed President **Charles Evans (voter)**, a confirmed dove, raised the possibility of bringing the asset purchases to a sudden end.

'Another approach, which doesn't get talked about that much, is that we could continue to go with $85bn a month until we decide that absolutely we've seen enough improvement, and then bring it to a quick conclusion at that time,' Evans said to reporters after a speech in Chicago.

That is not likely to be clear before the autumn, if then, Evans added. 'I think at the moment the key issue is whether or not it is extremely likely that this [improvement] is going to be maintained over the next few months,' he said. Meanwhile, Minneapolis Fed chief **Narayana Kocherlakota (non-voter)**, who is traditionally hawkish but has been sounding dovish on QE, acknowledged that a low-interest rate environment can give rise to financial instability, especially in increased volatility for asset prices.

In the absence of inflationary pressures, in fact, the debate over the timing and volume of asset purchases is blurring the line between hawks and doves on the FOMC.


Charles Evans

'But for now, given how far the Fed is from meeting either its employment or inflation targets, the tradeoff remains decidedly in favour of maintaining an accommodative policy', he said in response to a question at a panel discussion in Chicago.

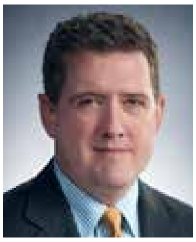
'Currently, the gains from tightening related to improving financial stability are both speculative and slight,' Kocherlakota said. 'In contrast, the losses from tightening – in terms of pushing employment and prices even further below the Federal Reserve's goals – are both tangible and significant. I conclude that financial stability considerations provide little support for reducing accommodation at this time.'


Narayana Kocherlakota

Anchoring inflation expectations

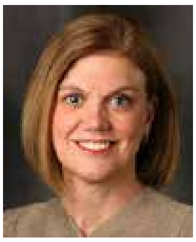
In recent speeches and in an extensive interview with the OMFIF Bulletin last month, centrist **James Bullard (voter)**, president of the St. Louis Fed, has argued that the risk of deflation is a reason for maintaining an accommodative policy or even increasing the monetary stimulus. 'Before I would be in favour of tapering I would like to see some reassurance that inflation was going to move back towards target,' Bullard said in a CNBC interview, noting that the current rate of about 1% is well below the Fed's 2% target.

'I am concerned about this inflation number and we are only a little ways out from the June meeting,' he said, 'so I don't quite see how that is going to turn around in a few weeks.'


James Bullard

Other FOMC members seem confident that inflation expectations remain firmly anchored at the 2% level in spite of the current downward trend. In his Japan Society speech, for instance, Dudley affirmed that current inflation expectations in the US are 'consistent' with the Fed's objectives.

But he went on to caution: 'Keeping inflation expectations anchored at levels consistent with the central bank's medium-term inflation objective – 2% on the personal consumption expenditures deflator in our case – is vitally important. Once deflation expectations become well entrenched, it is very difficult to change them.'


Sandra Pianalto

New recommendation for Fed mandate

The task mandated by the Dodd-Frank reform legislation of maintaining financial stability must be given specific contours by the Fed and other regulators, Cleveland Fed president **Sandra Pianalto (non-voter)** suggested. As with the Fed's dual mandate of fostering maximum employment and maintaining stable prices, it will take some time for this de facto third mandate to be defined.

'Congress established maximum employment and stable prices as the goals for monetary policy,' Pianalto observed at a conference on financial stability in Washington. 'This dual mandate is not specific; however, over time, the FOMC has come to recognise that making our goals more explicit can help us to achieve those goals.'

Similarly, she said, 'this mandate is also non-specific; nevertheless, I believe it will become more meaningful if financial regulators make it more explicit over time.'

A question of balance

Keynes's asymmetry still a force in global economy

Charlie Bean, Deputy Governor, Bank of England

The euro area is by far Britain's largest trading partner – accounting for nearly half of UK exports – and those direct links are supplemented by close financial ties between our domestic banking system and the continent. So it is hardly surprising that the Monetary Policy Committee has singled out developments in the euro area as a key risk to the UK outlook.

Restoring the euro area to strong and balanced growth requires not only dealing with the accumulated financial imbalances, but also restoring competitiveness and rebalancing the structure of demand and production.

Although the euro area has been in rough current account balance since the introduction of the euro, there have been substantial intra-euro area imbalances. In the run up to the crisis, periphery countries ran persistent current account deficits financed in large part by borrowing from core countries, especially Germany. As a result, the net international investment position of Spain has deteriorated by around 60% of GDP since 2000, while for Greece and Portugal the number rises to around three quarters of GDP.

On the other side, Germany's net international investment position has improved by around 40% of GDP. Initially these imbalances were seen as the benign consequence of an underdeveloped periphery catching up with a richer core. But on top of that were less benign influences. First, perceptions of supply potential in the periphery appear to have been over-optimistic; subsequent revisions to the IMF's estimates of spare capacity bear witness to that.

Second, credit conditions loosened substantially, supported by a sharp compression in perceived long-term risk-free rates, which was only unwound when markets began repricing in the risk of bank and sovereign default in the periphery. The decline in interest rates in the periphery in the pre-crisis period suggests that it was a case of capital being pushed into the periphery, rather than it being sucked in by a high rate of return as conventional analysis would suggest.

The consequence of all this was an increase in demand in the periphery, much of it in construction, financed by borrowing from the core. This is illustrated in the contrasting experiences of Spain and Germany. Domestic demand in Spain consistently outstripped output growth pre-crisis, while the opposite was true in Germany. These growing external imbalances were accompanied by increasing internal imbalances, as the non-tradable sector in Spain expanded at the expense of the tradable sector, driving up unit labour costs in the former relative to the latter.

Restoring the euro area to strong and balanced growth requires not only dealing with the accumulated financial imbalances – the excessive banking and sovereign debts in the periphery – but also restoring competitiveness and rebalancing the structure of demand and production.

On the face of it, that rebalancing is under way, with a narrowing in the current account deficits of the periphery. However, much of that is attributable to the substantial fall in imports associated with the collapse in domestic demand, rather than a rise in exports (although to the extent that there was excess demand before the crisis part of that decline in imports will be warranted).

Moreover, the necessary sectoral reallocation of resources is harder to achieve in a currency union than in a country with its own currency, as the exchange rate is not free to adjust to expedite the necessary adjustments in prices and quantities. Absent a supply-side miracle to raise productivity in the periphery, the necessary reversal in the movements in relative unit labour costs needs instead to come about through wage and price adjustment, which may require a sustained period of spare capacity in the periphery together with excess demand in the core.

There is an inherent asymmetry, noted long ago by Keynes, that when credit flows dry up, adjustment is compulsory for the debtor but only voluntary for the creditor. Moreover, not only does the creditor lack the urgent need to adjust, the creditor may also feel that the debtor ought to bear more of the burden of adjustment on moral grounds. Consequently the pressure for austerity is greater in the periphery, than it is to boost demand in the core. So, while the euro area authorities have been making substantial progress in constructing the economic architecture to support the monetary union, the adjustment process taking place in the periphery is likely to continue to weigh on euro area demand prospects for some time. That will also act as a headwind to the recovery in the UK.

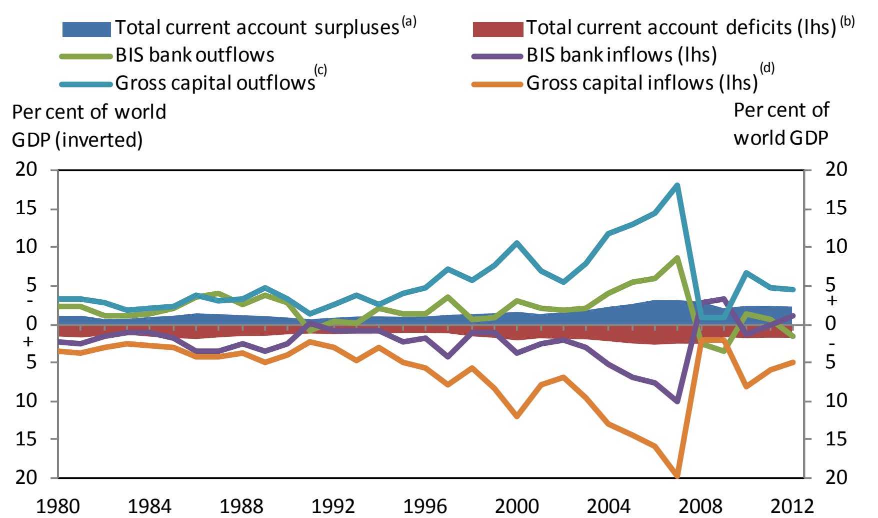
Regarding the global picture, we can see that during the build-up to the financial crisis, significant international payments imbalances emerged. On one side were the advanced economies, most especially the US, running large and persistent current account deficits. On the other side were the emerging economies – most notably in Asia – and latterly the oil exporters, showing large current account surpluses. In the decade prior to the financial crisis, for example, the US current account deficit widened from under 2% of GDP to 5%, while the surplus in China rose from 4% of GDP to 10%.

That constellation of international payments flows, with emerging economies exporting capital to advanced economies, was the opposite of what conventional economic models would predict. Normally one would expect countries in the catch-up phase of economic development with temporarily high investment levels to import the necessary savings from overseas. But a combination of limited household safety nets and underdeveloped domestic financial markets generated unusually high private savings rates. In addition, some emerging economy governments engaged in the accumulation of foreign reserves, both to sustain export-led development and to insure against sudden capital outflows of the sort seen in 1997-98. So capital flowed uphill, rather than downhill as in the euro area. Moreover, there was a strong desire to hold these savings in safe assets, such as US Treasuries.

The counterpart to this 'savings glut' was downward pressure on the interest rates on those safe assets in the advanced economies. Faced with these lower returns on safe assets, investors then sought to generate higher returns in other ways, including packaging securities in ways that appeared to combine yield with safety. And a long period of benign economic outcomes – the Great Moderation – lulled investors into a false sense of security. The consequent buoyancy in asset prices and easy availability of credit helped sustain demand. But all this came to an end when investors realised the true nature of their exposures, leading to a scramble for safety, a drying-up of credit and a sharp reduction in spending by households and businesses.

The pre-crisis leveraged search for yield resulted in an unprecedented expansion of debt within and across countries' financial systems, as the chart below shows. Much of this 'banking glut' can be traced to the advanced economies: around half of the gross inflows into the US just before the crisis came from European institutions, rather than emerging economies. Global capital flows of this nature can be valuable. They help to oil the wheels of the international financial system. But by increasing the linkages between financial systems, they can also increase systemic vulnerabilities.

Global current account imbalances and gross capital flows



Sources: Bank for International Settlements, International Monetary Fund World Economic Outlook and Bank calculations.
(a) Sum of global current account surpluses.
(b) Sum of global current account deficits.
(c) Sum of global net purchases of foreign assets by residents.
(d) Sum of global net purchases of domestic assets by foreigners.

In this case, banks became dependent on short-term funding from overseas, rather than their traditional domestic deposit base. When investors retrenched, that funding dried up and banks struggled to find viable alternative sources of funding. Ensuring gross capital flows are not excessive is just as important as avoiding excessive net capital flows.

Surplus countries should take steps to boost domestic demand. Deficit countries should implement credible strategies to support private savings and restore fiscal sustainability.

Moving to a sustainable equilibrium requires a narrowing in the international payments imbalances. And we have indeed seen such a narrowing since the start of the crisis. The IMF expects a US current account deficit of just under 3% of GDP this year, while the Chinese surplus is expected to have fallen to around 2½%.

But, as with the euro area, the crucial question is how much of this narrowing is simply a reflection of the cyclical weakness in the deficit economies or whether it represents a more durable shift in the pattern of demand in both deficit and surplus economies. If it is down to the former, then the imbalances can be expected to re-emerge as recovery proceeds.

The answer to this question depends very much on the degree to which the substantial shortfall, relative to pre-crisis trends, of activity in the deficit economies represents a permanent impairment of supply potential as a result of the financial crisis and subsequent recession, or whether it will ultimately be reversed. The evidence on this issue is presently inconclusive.

What sort of policies would facilitate the required adjustment without relying on sustained weakness in the indebted countries? First, surplus countries should take steps to boost domestic demand. Second, deficit countries should implement credible strategies to support private savings and restore fiscal sustainability. Third, exchange rates need to be allowed to reflect underlying fundamentals. Fourth, financial regulation and supervision should be strengthened to prevent the re-emergence of financial sector excesses. Fifth, structural reforms should be pursued, not only to boost long-term growth but also potentially to boost demand in the short run.

This sounds straightforward, but why has it in practice proved so difficult to achieve? First and foremost, the actors have not always shared the same diagnosis of the underlying problems. Second, in circumstances like the present, when there is still a significant margin of spare capacity in many economies, an expansion in activity in one country generates beneficial spillovers onto other countries (the opposite would be the case if there was excess demand and overheating). But policy-makers typically do not take account of these spillovers when judging how much to stimulate their economies.

Implementing such a coordinated outcome turns out not to be so easy. In part that follows from the inherent asymmetry noted above, namely that the pressure to adjust is always greater on the debtor than the creditor. In addition, because multiple actions by multiple actors are needed, there is a genuine difficulty in ensuring that agreements are stuck to and free riding is avoided. And that is more of a problem, the weaker are the political ties between countries.

For these reasons, examples of successful macroeconomic policy coordination are few and far between and have most often occurred when everyone is pulling in the same direction, such as at the time of the London G20 Summit in 2009.

But I do not wish to offer too downbeat an assessment of attempts to achieve a better economic outcome through international policy coordination. At a minimum, exchanges of view and a better understanding of country positions may help to avoid even worse outcomes. And some aspects of the international policy process have worked well. A good example is provided by the redrawing of the scope of financial regulation. So, despite the modest progress in restoring our economies to strong, sustainable and balanced growth, policy-makers can claim some successes.

This is an edited extract from a speech by Prof. Bean to OMFIF in London on 29 May.

BoJ sweeteners not the answer

Bond buying won't calm interest rate expectations

Trevor Greetham, Advisory Board

World stock markets have been unsettled by signs that Japan's massive quantitative easing programme is running into problems. Bank of Japan governor Haruhiko Kuroda's indication that the BoJ would buy more bonds if yields rise too much is like promising sweets to a hyperactive child in the hope that it calms them down.

What the market needs is a Bernanke-style pre-commitment that the BoJ discount rate will stay low for many years.

The BoJ has said its bond purchases are part of the mechanism to double the monetary basis and so create inflation. More bond buying isn't the way to calm interest rate expectations. What the market needs is Federal Reserve-style pre-commitment that the BoJ discount rate will stay low for many years.

The 7% decline in the Nikkei index on 23 May that set off the slide in Japanese stock prices was triggered by a brief move in 10 year Japanese government bond yields above the symbolically important 1% level. The fear of higher Japanese yields is starting to undermine equity sentiment, especially for Japanese REITs, which have been under constant selling pressure over the last month after an eye watering rise in price. Market volatility in Japan is habitually high and it is unclear whether this is a lasting or a temporary correction. Strong economic data will most likely turn stock prices higher again but the right policy actions would settle the markets sooner.

The danger from bond market volatility is that an uncontrolled rise in yields could undermine all three arrows of Japan's 'Abenomics' strategy to shift the economy onto a positive growth path. Higher yields limit the stimulus effect of the BoJ's promise to double the base money supply. Higher yields could lead some commentators to argue, wrongly, that the market is reacting to an unsustainable fiscal position and that stimulus plans should be scaled back. A persistent sharp fall in stock prices could reduce support for prime minister Shinzo Abe's administration in July's elections and threaten the structural reform programme.

It is important that Japanese politicians don't misdiagnose the rise in yields as a comment on fiscal policy. If they hold back on the promised stimulus or talk up next year's consolidation, then growth expectations could be damaged with negative consequences. Fiscal easing is a critical part of the policy mix aimed at delivering stronger nominal growth and rising loan collateral values. Japan is in a balance sheet recession and it is important that the government doesn't attempt to shrink its own balance sheet at the expense of the private sector. Europe has shown how counter-productive austerity policy can be in these circumstances.

The task of influencing the bond market falls to the Bank of Japan. It is natural for bond yields to rise during an economic recovery and this isn't usually a problem for stocks. To keep bond yields contained Governor Kuroda needs to learn from the Fed and promise to keep the discount rate low over the medium term.

US 10 year Treasury yields fell sharply after Ben Bernanke's August 2010 speech announcing the Fed's intention to buy government bonds but, against expectations, they rose by more than a percentage point once the central bank purchases began as the market focused on the improved odds of economic recovery. In raising long term interest rates, this kind of market reaction reduces the effectiveness of quantitative easing. The Fed learned by its mistake and starting from summer 2011, it has explicitly pre-committed on the path of Fed Funds, keeping long term yields in a low range even when growth expectations have improved.

The BoJ needs to do the same and urgently, given the strength of the recovery likely in the Japanese economy. What is needed is a communication strategy that gives the market confidence that the discount rate is likely to stay close to zero over a longer horizon than the initial two-year 'qualitative and quantitative ease' (QQE) window.

The BoJ has said the current policy will continue until 2% inflation has been reached 'in a stable manner' but this is too vague. The market needs to see a long-term commitment to ultra-low rates subject to specific economic data thresholds. There may also be some value in explaining that a 'stable' 2% inflation trend is likely to take several years to attain, even if hitting the target for the first time is possible and desirable in the shorter two-year time frame the BoJ is targeting. This is all the more relevant as part of the inflation rise in the next two years will be artificial, coming from a potentially damaging rise in consumption tax.

BoJ ease will be ineffective if the market worries prematurely about tightening. The most certain means of keeping the long end of the bond market under control is to keep the short and medium end under control as the Fed has done: through influencing expectations of future policy action rather than by increased intervention in the bond markets.

You could say what is required is undeclared financial repression: a commitment to low rates despite what is likely to be a strong near-term recovery. Without this in place, a rise in Japanese bond yields could undermine the economic recovery programme, particularly if the sell-off in REITs raises concerns that Japanese property prices are set to continue their multi-decade decline.

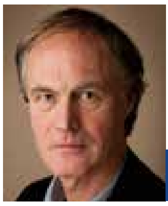
Japan was first into the debt trap but last to take serious action to address the root causes of weak nominal growth. There is a last mover advantage. You can learn from the mistakes and successes of others.

JGBs are following the Fed's QE2 path

Source: Datastream, May 2013

Notes on contributors

Franco Bassanini is President of Cassa Depositi e Prestiti
Charlie Bean is Deputy Governor at the Bank of England
Stefan Bielmeier is Chief Economist and Head of Research at DZ Bank
Brigitte Granville is Professor at the School of Business and Management at Queen Mary University of London
Trevor Greetham is Asset Allocation Director at Fidelity Investments International
Hans-Olaf Henkel is Professor at University of Mannheim and former President of the Federation of German Industries
Michael Holstein is Head of Macroeconomics at DZ Bank
Stefan Kawalec is Chief Executive Officer of Capital Strategy and former Vice Minister of Finance in Poland
Gerhard Schröder is former German Chancellor
Simon Tilford is Chief Economist at the Centre for European Reform



Shifting Netherlands fortunes

Rutte problems signal fall from grace

Roel Janssen, Advisory Board

The Netherlands provides a prime illustration of the unpredictably shifting fortunes of the euro area. Only two years ago, prime minister Mark Rutte demanded that the European commissioner for economic and monetary affairs be given extraordinary powers to discipline governments that failed to comply with European budgetary rules. Now, the tables have been turned with a vengeance.

Rutte says he won't abide with Rehn's demands, foreshadowing considerable wrangling with the Brussels Commission.

Olli Rehn, the mild-mannered but steely Finnish commissioner, has sternly reminded the Netherlands that it must make stringent efforts to get the budget deficit down in 2014. Lecturing others on fiscal discipline is clearly not enough. Rutte says he won't abide with Rehn's demands, foreshadowing considerable wrangling between the Brussels Commission and what has habitually been one of the euro area's most economically orthodox members.

The looming row over state finances coincides with a weakening of the position of finance minister Jeroen Dijsselbloem as the chairman of the Eurogroup of finance ministers. Dijsselbloem, a frugal Social Democrat, has faced veiled criticism from his peers over some undiplomatically blunt remarks on the Cyprus rescue in March. Now, German chancellor Angela Merkel and French president François Hollande, have suggested that his successor will no longer be a national finance minister, but a permanent chairman with his own staff. This is a view habitually proposed by France but opposed by the Dutch. Germany's apparent espousal of the French line is a blow to the Netherlands' diminished status in Brussels, belying its position among the euro area's few remaining triple A-rated countries.

On first sight, Rehn showed leniency in the Commission's annual review of fiscal governance. As expected, he allowed the Dutch government to exceed the 3% deficit-to-GDP ratio for 2013. But next year the deficit, estimated to reach 3.8%, will have to be brought down a full percentage point. This means an additional €6bn adjustment – on top of €45bn of tax hikes and expenditure cuts already in the making. The Brussels recommendations call for combined adjustments of almost 9% of GDP until 2017.

For the Dutch government, the Brussels announcement comes at a highly unfavourable time. Previous spending cuts are starting to hurt. The Dutch economy is in its third recession since the outbreak of the financial crisis in 2008, unemployment (now at 8%) is rising rapidly and private consumption is faltering. Tax receipts are much lower than expected, while social security outlays are rising. Rutte's government is an unusual coalition of his Conservative party and the Social Democrats. Earlier this year, the government managed to agree on a package of labour market reforms with unions and employers, and a deal on health care reforms. In return for concessions by the unions, the government waived additional measures to reduce the deficit in 2014 and abandoned a wage freeze for health care employees. The new demands by Brussels may risk these compromises unravelling.

A third reform package, on housing and the tax treatment of mortgages, has been widely criticised as inadequate to end the severe crisis in the Dutch real estate market, that provides a prime reason for economic weakness and low consumer confidence. The Commission says the achievement of reforms is no excuse for breaking deficit-cutting promises. While acknowledging that the nationalisation of SNS Reaal, the fourth largest bank in the Netherlands, caused a one-off spending overshoot in 2013, Brussels will not accept this as a reason for further missing targets in 2014.

Rutte and Dijsselbloem are in an awkward position. Additional expenditure cuts or tax rises could damage agreements reached with the unions. A faster dismantling of tax deductions on mortgage interest may further weaken the housing market, while pension reforms will again undermine confidence. Rehn has reminded the Dutch that budgetary stability must begin at home – and that Brussels has a bigger say over national policies than Rutte has hitherto admitted.

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

OMFIF Advisory Board

ADVISORY BOARD

Meghnad Desai
Chairman

John Nugée
Deputy Chairman

Frank Scheidig
Deputy Chairman

Paola Subacchi
Deputy Chairman

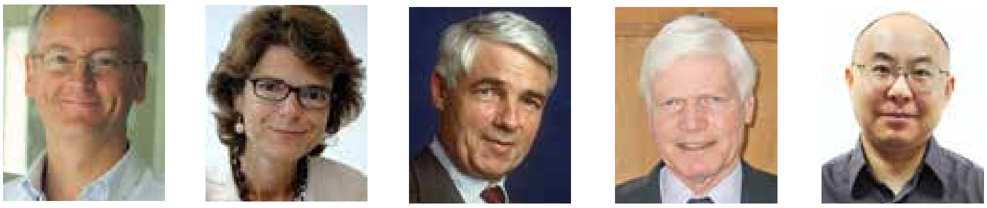
Gabriel Stein
Chief Economic Adviser

Songzuo Xiang
Deputy Chairman

EDITORIAL & COMMENTARY

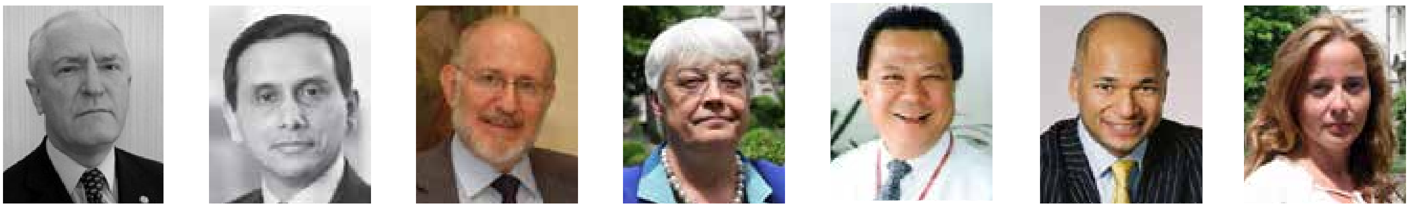
Paul Betts, Nick Bray, Peter Bruce, Darrell Delamaide, Jonathan Fenby, Stewart Fleming, Haihong Gao

Harold James, Roel Janssen, William Keegan, Joel Kibazo, Peter Norman, Ila Patnaik, John Plender



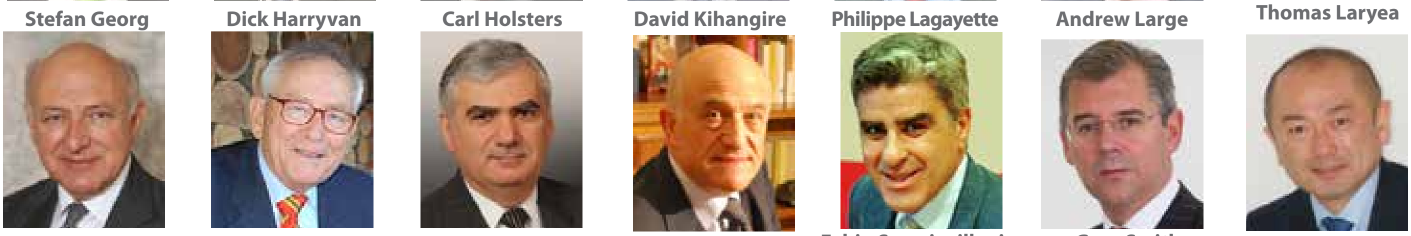
Robin Poynder, Vicky Pryce, Michael Stürmer, David White, Lifen Zhang

BANKING

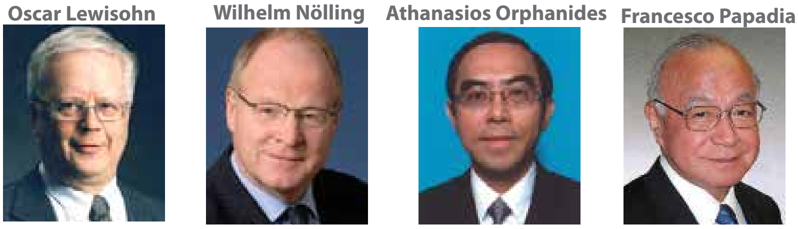


John Adams, Jai Arya, Mario Blejer, Consuelo Brooke, YY Chin, Moorad Choudhry, Aslihan Gedik

Stefan Georg, Dick Harryvan, Carl Holsters, David Kihangire, Philippe Lagayette, Andrew Large, Thomas Laryea



Oscar Lewisohn, Wilhelm Nölling, Athanasios Orphanides, Francesco Papadia, Fabio Scacciavillani, Gary Smith, Takuji Tanaka



Jens Thomsen, Ernst Welteke, Derek Wong, Makoto Utsumi

OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome five new members to the Advisory Board, taking the total number to 140.

Efraim Chalamish, Attorney of Counsel, Dorsey & Whitney

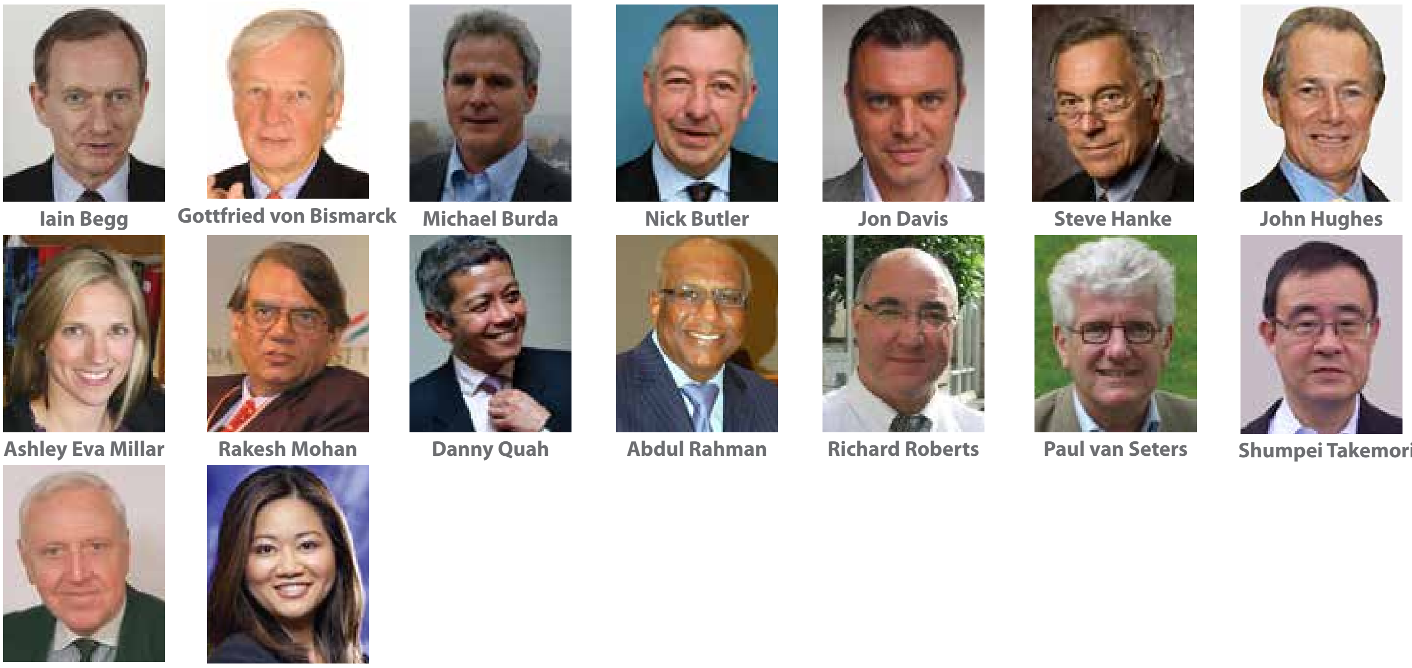
Peter Gray, Chairman, Berkeley Capital

Vicky Pryce, former Joint Head, UK Government Economic Service

Fabio Scacciavillani, Chief Economist, Oman Investment Fund

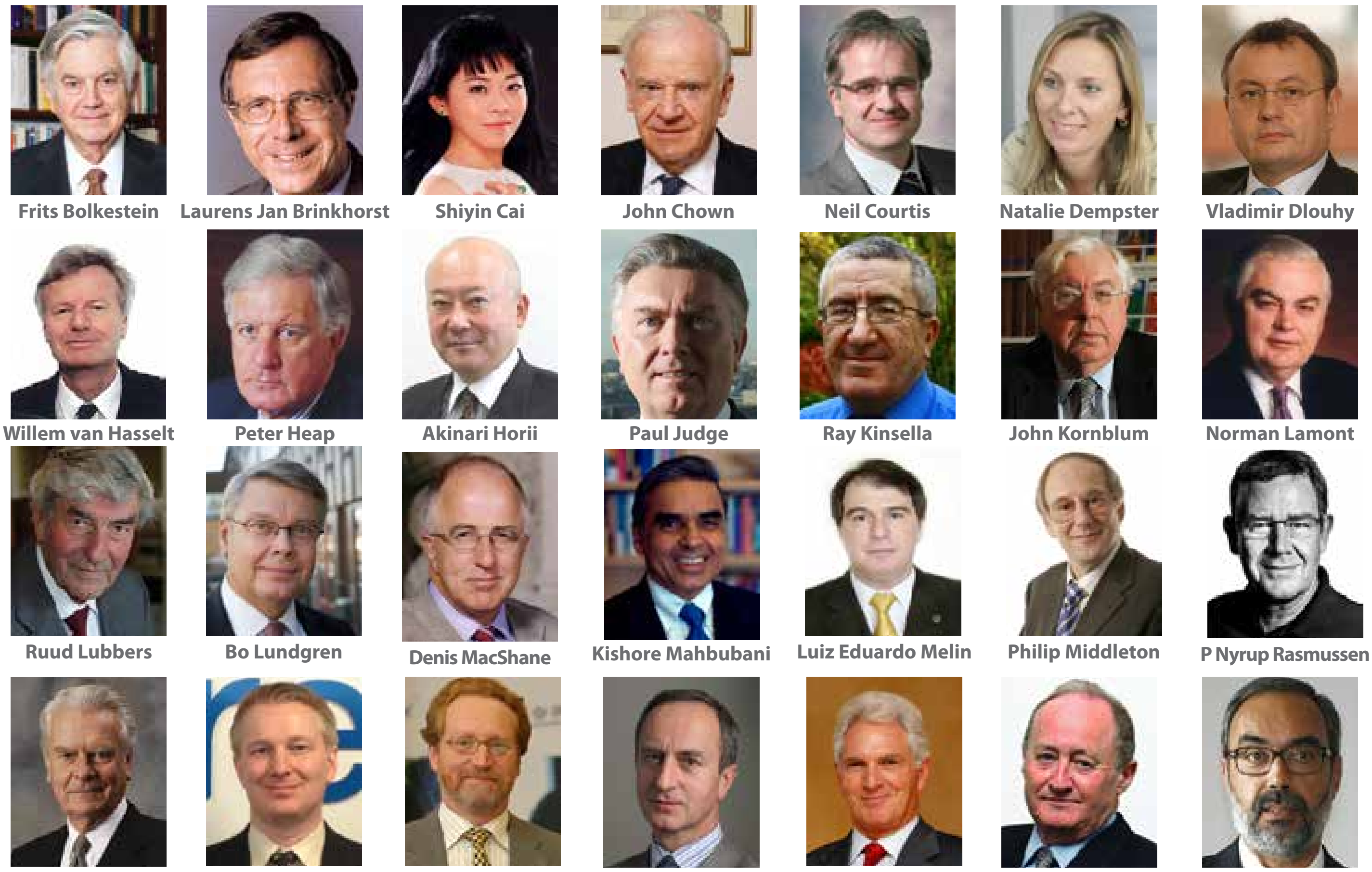
Gary Smith, Global Head of Official Institutions, BNP Paribas Investment Partners

EDUCATION



Iain Begg, Gottfried von Bismarck, Michael Burda, Nick Butler, Jon Davis, Steve Hanke, John Hughes, Ashley Eva Millar, Rakesh Mohan, Danny Quah, Abdul Rahman, Richard Roberts, Paul van Seters, Shumpei Takemori, Niels Thygesen, Linda Yueh

PUBLIC POLICY



Frits Bolkestein, Laurens Jan Brinkhorst, Shiyin Cai, John Chown, Neil Courtis, Natalie Dempster, Vladimir Dlouhy, Willem van Hasselt, Peter Heap, Akinari Horii, Paul Judge, Ray Kinsella, John Kornblum, Norman Lamont, Ruud Lubbers, Bo Lundgren, Denis MacShane, Kishore Mahbubani, Luiz Eduardo Melin, Philip Middleton, P Nyrup Rasmussen, David Owen, Jukka Pihlman, Martin Raven, Janusz Reiter, Nasser Saidi, Christopher Tugendhat, Jorge Vasconcelos

How to make debts sustainable

Commission plans are no answer to euro problems

Stefan Bielmeier, Advisory Board

Is there such a thing as good and bad debt? As long as debt does not exceed a certain volume, then perhaps: if one invests and thus increases the future growth and income base, one may argue that today's deficits are more than covered by future growth. But if one borrows in order to finance higher consumption, then one will have to tighten one's belt all the more in the future.

In the EU, this is the question. Many countries are sitting on a mountain of debt and should be following a strict savings under the Maastricht rules and the Stability and Growth Pact. The European Commission is apparently mulling over a more flexible interpretation with regard to public sector deficits; a country's investment expenditure could be deducted from its deficit. This would make it easier for crisis countries to meet agreed saving targets. Statements from the Commission point in this direction. The German government and the European Central Bank have expressed opposition to such a softening.

At the root of this discussion is the question of whether we wish to vehemently continue with austerity in Europe, even though this policy is keeping the southern states in a deep recession. The increase in unemployment, especially among young people, underlines the forcefulness of adjustment. One could ease the timetable for implementing necessary measures, but this is no reason to remove certain types of spending from the deficit calculations. Nothing would be gained by such an approach.

The sustainability of member states' debt is of central importance. Debt sustainability basically depends on the amount of debt and growth potential, which in turn dictates future tax revenues. The debt crisis in Europe reflects doubts about debt sustainability of some euro members.

The ECB with its OMT programme and the European governments with the EFSF and the ESM have made important contributions to restoring investors' confidence. Both these programmes use the high credit standing of the stronger euro area countries to bolster confidence in the euro area as a whole. The asset-backed securities programme being discussed by the ECB – with the goal to revive lending to companies in southern states – follows the same principle. Here, too, this programme would rely on the credit standing of northern countries.

This model cannot be extended at will. The guarantees that accrue over time could become too heavy a burden even for Germany. This would be the case especially if hoped-for economic growth in southern countries is weaker than expected. Nor can the state of the banking sectors in the euro area be described as good. Therefore, the number of smaller transfer mechanisms is limited and the responsibility for restoring the crisis countries' debt sustainability lies with the countries themselves.

The OMT programme of the ECB, the ESM and the very low interest rates at central banks worldwide have reassured the financial markets and have brought down yields for Spain and other countries. European politicians are therefore falling back into outdated patterns of thought. Admittedly, the financial markets do not seem to be reacting to euro area bad news, as they trust the statements from the ECB and programmes that have been put in place. But debts do not simply disappear. Each country has to face the reality that its borrowing capability inevitably hits certain limits.

One should bear this in mind in the discussion about the calculation of the deficit figures. Ultimately, there is no such thing as good debt. Investors invest where they can expect a risk-appropriate return with a high level of certainty. For this reason, the structural and savings measures that have been launched are indispensable if the euro area is to be stabilised on a sustainable basis.

Ultimately, there is no such thing as good debt. The structural and savings measures that have been launched are indispensable if the euro area is to be stabilised on a sustainable basis.

RESEARCH & ECOMOMICS

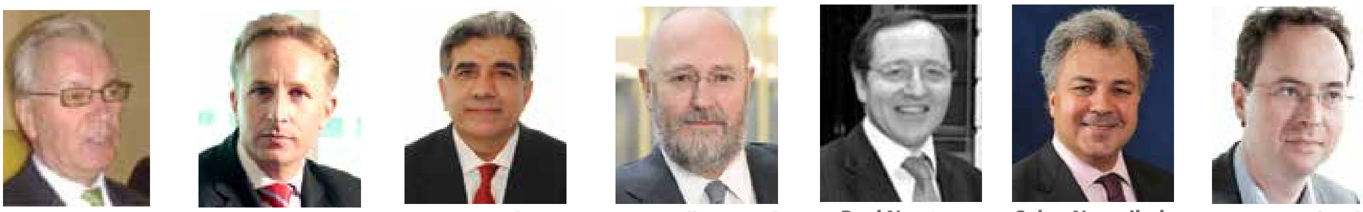
Katinka Barysch | Robert Bischof | Paul Boyle | Albert Bressand | Efraim Chalamish | MA Del Tedesco Lins | Stephane Deo

Hans-Olaf Henkel | Hemraz Jankee | Robert Koehler | Pawel Kowalewski | Gerard Lyons | Mariela Mendez | Isabel Miranda

Michael Oliver | Anthony Robinson | Vilem Semerak | Song Shanshan | David Tonge | Peter Walton | John West

CAPITAL MARKETS

JC Bastos de Morais | Stefan Bielmeier | Stefano Carcascio | Hon Cheung | John Cummins | Peter Gray | Trevor Greetham



Frederick Hopson | Matthew Hurn | Mumtaz Khan | George Milling-Stanley | Paul Newton | Saker Nusseibeh | Bruce Packard

Colin Robertson | Marina Shargorodska | Hendrik du Toit | Sushil Wadhwani | Jack Wigglesworth | Paul Wilson

Looking ahead – 2013 diary dates

Golden Series Lecture
Boris Vujčić, Governor, Croatian National Bank
4 June, London

OMFIF Future of the International Economy Dinner
Gala Dinner with German-British Forum
Gerhard Schröder, former German Chancellor
6 June, London

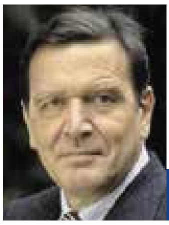
Golden Series Lecture
Stanley Fischer, Governor, Bank of Israel
13 June, London

First OMFIF Main Meeting in Latin America
Latin America's place in the new international financial monetary architecture
17-18 June, Banco Central do Brasil, Brasilia

Golden Series Lecture
Atiur Rahman, Governor, Bangladesh Bank
21 June, London

Economists Club Meeting
Lars Rohde, Governor, Danmarks Nationalbank
24 June, Copenhagen

A regular round-up on international monetary affairs



Two-speed Europe now a reality

Why we must renew European structures

Gerhard Schröder, former German Chancellor

The crisis affecting the euro is less a currency crisis than a crisis of European policy. To solve the basic problem of the euro, we must change the structures of European institutions. The fundamental mistake of monetary union is that there is no coordination of economic and financial policy in the euro zone. We must create this coordination in the future.

The direction of European economic and financial policies must move away from pure austerity and towards growth-oriented policies. National economies risk being strangled by strict austerity measures. We need budgetary discipline and structural reforms, but we also need growth.

I welcome the sensible decision by the European Commission to allow certain countries more time to meet deficit-reduction targets – but at the same time to carry on with intelligent reforms to strengthen their economies.

Renewing structures is difficult in a European Union with 27 member states and a monetary union with 17 countries. But we must change course if both the euro and the EU itself are to remain sustainable. Evidently, there is a Europe of 'two speeds'. A core Europe, that grows together more quickly politically, and a fringe Europe wishing greater autonomy.

These are two very different visions. There are those who imagine Europe as a political union; and those who think of Europe only as a single market, while the political process should remain largely national. Europe must decide between these two positions. The gap has widened between countries that can and wish to integrate quickly and those that want to move more slowly, such as the UK. Countries in the euro zone will integrate more than the countries that are not part of this.

In the debate over austerity and growth, we see a return of issues of ten years ago. At the time, the then French president Jacques Chirac and I, as German chancellor, worked together to reform the European Stability and Growth Pact. This reform did not weaken the criteria for budget deficits, but gave more flexibility to a set of rules that was too rigid.

When the European Commission gives countries like France more time to meet the deficit criteria, this is comparable to the situation in Germany at the time of the Agenda 2010 reforms that I introduced in 2003-05.

Evidently, there is a Europe of 'two-speeds'. A core Europe, that grows together more quickly politically, and a fringe Europe wishing greater autonomy.

Without the Pact's reform, it would have been politically impossible to save billions of euros through budgetary cuts, and at the same time implement difficult and controversial labour market and social security reforms.

Today, many European countries, especially France, face similar challenges to the ones Germany did a decade ago. Structural reforms are necessary because of excessive debt, as well as demographic developments and international competition.

From our experience with the Agenda 2010, we learned that it takes a few years for the effects to work through to producing visible success.

As well as economic and social pressures, there are also strong geopolitical reasons for greater European integration, above all the rise of rapidly-industrialising countries. The US is no longer focused on Europe, but rather on Asia.

A multi-polar world is emerging. Two poles are already clear: the US, which is and will remain the superpower; and Asia, led by China, which, I am sure, will assume a responsible international role.

Between these two poles lies Europe, which was once a continent of proud, affluent and powerful states. The present reality speaks for itself.

The economic shifts in future will be still graver. We need to make the right decisions today. This means more, not less Europe.

Of course, 'more Europe' needs to be defined. There are many important, proud, cultured, dynamic and varied European countries outside monetary union which make a great contribution to European politics, economics and society. The 'more Europe' that I wish to see has to be rich, varied and successful enough for these countries to be fully part of.

Europe can use the crisis to grasp the opportunity to achieve a sustainable model of European integration. A model that will remain a beacon and a blessing for the world: a role model for other regions, and a cornerstone of the world economy.

The case for Europe is not merely based on the question of war or peace – but on weakness or power. Only a united Europe can stand a chance in a globalised political and economic world.

This is an abridged version of a speech to the OMFIF-GBF Gala Dinner on 6 June.