ECB post would constrain Germany
Smaller state candidate would suit everyone

David Marsh, Co-chairman

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However, much political wrangling lies ahead. [See The OMFIF Essay by John Nugée, p. 5 – 11]. Christine Lagarde, the French finance minister, said on 9 July she did not rule out Weber as Trichet’s successor but pointed out there could be ‘two or three’ candidates.

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Attrition ahead

Renminbi-euro questions

The People’s Bank of China’s announcement of the switch to a ‘flexible’ currency regime and the use of a basket of currencies to replace the peg to the dollar resolves far less than many thought.

While the currency spat is largely conducted between Beijing and Washington, the fall-out from the PBoC declaration on 19 June may be felt most keenly in Europe. The Chinese central bank’s statement said pointedly that flexibility means the renminbi could go down as well as up. If the euro continues to slide against the dollar, the chances of Beijing not revaluing but devaluing its currency could become significant.

As Europe faces a toxic combination of economic austerity and a banking crisis, the Chinese are worried about the potential for a further euro decline. If that happens, it would not be in their nature to refrain from remedial action.

(continued on page 4 ...)

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Economic clouds gather
A vista of setback and reform

David Marsh, Co-chairman

The world economic picture has become cloudier during the summer in the northern hemisphere. Worries have risen about a slowdown in breakneck Chinese expansion while the threat of a double-dip recession – though still fairly small – has not disappeared in the US and Europe. The European Central Bank has recovered some of its poise after the setbacks over Europe’s sovereign debt woes earlier this year.

One bright spot is that activity has picked up in Germany, just at the time when Europe’s largest economy has been incurring the irritation of President Barack Obama by unveiling a plan for cutting government spending. Germany and Britain, inside and outside the euro, are moving in step in the quest for lower budget deficits.

We reflect these global issues in our coverage for a special July-August edition. Stewart Fleming looks at the European Central Bank’s incursion into the field of economic reform traditionally pursued by the politicians. This is a departure from the norm that is earning the Frankfurt-based institution opprobrium and praise in equal measure.

Jonathan Fenby casts an acerbic glance at what really changes following the trumpeted renminbi move. Not much, he says – predicting that pressures for more thoroughgoing changes to lower China’s trade surplus with America will increase. Malan Rietveld, our new chief economist, in the first of his monthly commentaries, takes a look at prospective changes at China Investment Corp.

John Nugée sweeps magisterially across the political and economic vista of Europe and asks whether Franco-German consensus is breaking down. The historical parallels are revealing. Michael Kaimakliotis is sceptical whether current financial market pricing adequately accounts for possible inflationary pressures in Europe. Tim Young, a former member of the foreign exchange division at the Bank of England, asks whether the euro has now sacrificed its opportunity to step into the D-Mark’s shoes.

Patrick Honohan, Governor of the Central Bank of Ireland, produces a brilliant analysis of the interactions between banking imprudence and state finances that have contributed to Ireland’s economic problems – difficulties from which the Irish are now making exemplary efforts to recover. Roel Janssen shows how eurosceptical forces are building in the Netherlands – with no effect on parliamentary support for bail-outs up to now.

As a summer distraction for our readers, the ever-inventive William Keegan reveals hitherto unknown heavenly correspondence on celestial and non-celestial economic issues between Keynes and Einstein. Meghnad Desai pays tribute to our friend Peter Walker, who died in June.

With best terrestrial wishes for a reflective July and August.

Quote of the month

‘The balance of economic power is moving from West to East. We’ve all heard of the emerging economies. My new name for the euro area is the “sub-merging” economies.’

Lord Meghnad Desai, Chairman, OMFIF Advisory Board
Before the trans-Atlantic crisis struck in 2007, Jean-Claude Trichet used to tell listeners that the euro had established the same credibility in financial markets as the strongest of the national currencies it replaced, the Deutsche Mark.

The European Central Bank president knew that, while this was technically true, leading economists and financial market experts had long identified vulnerabilities in the euro’s foundations which cast doubt on the validity of the comparison. On 10 June, in a remarkable intervention into a politically-charged controversy, the ECB published its own ideas about how to address some of these sources of weakness. The ECB said its proposals were aimed at changes ‘needed for a sustainable functioning of economic and monetary union.’

Two particular weaknesses – both well-understood by the euro’s founding fathers – have been exposed by three years of crises. One is the lack of a fiscal transfer mechanism that would have been used to provide support from stronger to weaker countries. This is a commonplace in unitary states, but such a ‘bail-out’ of one euro area member by another is explicitly forbidden under the treaty creating the single currency. Instead it was hoped that rapid economic convergence and a fiscal discipline mechanism, the Stability and Growth Pact, would ensure that bail-outs would not be needed.

Another vulnerability was that robust systems were not in place to deal with cross-border banking crises. Indeed, banking regulation and supervision remain in large part a national prerogative, not least because, if bank rescues were needed beyond liquidity support, national finance ministries would be the lenders of last resort. The founding fathers blanched at the idea that, in a euro crisis, French taxpayers, for example, might be expected to help bail out German banks.

Early efforts to give the ECB a role in supervising cross-border banks were rebuffed in the vain hope that such a major cross-border or systemic euro area banking crisis would never happen. The trans-Atlantic banking disaster of 2007 exposed these interlocking fiscal and financial market frailties. The past three years have demonstrated that fiscal discipline alone would never be enough to ensure convergence and stability. Sovereign debt and member states’ payments imbalances and competitiveness still matter.

The ECB’s proposals aim to address these problems. They call for much tougher surveillance of EU budget policies, earlier and tougher implementation of rules, including the application of ‘quasi-automatic’ sanctions such as suspending a member state’s euro area voting rights, more rigorous macro-economic surveillance focused on boosting competitiveness, and a strengthened crisis management framework.

This, the ECB says, should be based on the new €440bn European Financial Stability Facility, headed by Klaus Regling, a former top German finance ministry, EU Commission and International Monetary Fund official. Access to the EFSF’s money would be available only on penal terms. The ECB’s suggestions will feed into a report expected to be published in October by the increasingly influential Herman van Rompuy, the President of the European Council, proposing far-reaching reforms to the economic governance of the EU and the euro area.

Well before the Greek crisis and its aftermath, the EU had begun efforts to strengthen financial market regulation. These had been launched in February 2009 by a report by another specialist committee of experts led by Jacques de Larosière. Just how radical the new banking oversight mechanisms will be, in particular how much authority EU member states will have to surrender to new cross-border EU regulatory authorities, is now being contested between and within the European Council and the European Parliament.
the ECB Council for badly damaging the central bank’s team spirit. In fact, by putting distance between himself and the Council majority, Weber may have been indirectly signalling his lack of interest in the top ECB job.

German commentators and politicians who make the link between Mr Weber’s candidature and the stability of the currency are missing the point.

Giving the Germans the top monetary job would probably inflame north-south divisions in Europe. Yet Germany would have a greater chance of enforcing policies it supports if it continued present arrangements with two “ordinary” representatives on the ECB Council, rather than seeing one of these people taking over the presidency.

The days are, sadly, gone when European politicians could claim that members of the ECB Council represent the whole euro area rather than their individual countries. One of the side-effects of the nearly three-year-old credit crisis has been to generate economic policy nationalism around the world. The ECB and the euro are no exception.

Even in 1998, selection of the first ECB president, Dutchman Wim Duisenberg, was heavily politicised. It was overshadowed by horse-trading between France and Germany over the French candidate, Mr Trichet, taking over from Mr Duisenberg on expiry of a truncated term that eventually ended in November 2003. In-fighting this time round will probably be still more intense.

In the wake of the May decision, the Bundesbank is already subject to conflicts of interest. With the largest government bond dealing department among euro area central banks, it is carrying out the lion’s share of the weaker country bond purchases, which are now tailing off but have totalled more than €50bn so far.

More disagreements on the Council are near-inevitable as the ECB grapples with the enormous monetary challenges of austerity and rising debt in the southern euro members and export-led growth among the strengthening northern creditor states. In 2012, the year after the new ECB president takes charge, Greece is forecast by many experts as seeking more way of binding the Germans and export-led growth among the stronger northern creditor states. This would only be of marginal value in fighting inflation. Wage pressure now being seen in exporting provinces such as Guangdong makes China back from the kind of significant appreciation the world would like remain as strong as ever.

The decline of the euro and the prospect of falling growth in the euro area next year – despite the better-than-expected showing in 2010 of the German economy – can only strengthen China’s concern not to lose its currency advantage.

The renminbi has appreciated sharply against the euro this year. The Chinese are not amused at the prospect of declining demand in the European region that accounts for 20% of China’s trade. President Hu and Prime Minister Wen Jiabao are dealing with excess capacity export industries, such as steel, by removing tax incentives to sell abroad and by moves to consolidate domestic industry.

Some politicians around Europe see the general rise in influence of German-style fiscal discipline as evidence of a German take-over of Europe. It is far more likely, however, that strategic thinkers in the weaker countries (including France) would favour Weber’s accession as one more way of binding the Germans into a project that has never been popular with the German public. For all these reasons, the presidency of the ECB is a poisoned chalice that the Germans should avoid.

History may indicate an acceptable compromise. In the years before the birth of the euro in 1999, the formative voice in preparations for the ECB was Hans Tietmeyer, the then Bundesbank president. Duisenberg’s tenure showed the value of a well-respected president from a smaller country. After Trichet’s reign, it may be time for a small country to take over again at the helm of an ECB Council that looks likely to become ever more publicly exposed.
The European sovereign debt crisis has become the dominant issue not just in European markets, but in global finance. The world is watching with fascination and concern as European governments struggle to bring stability back to their national finances. The fate of the euro – as a European and global currency, and as a sizeable component of the world financial system – hangs on their efforts.

The challenge in analysing the crisis in Economic and Monetary Union (EMU) and predicting the future is not so much in understanding the economic issues, which in themselves are fairly straightforward. Much more difficult is to interpret them against the wider political backdrop. The position of Germany – Europe’s strongest economy, its paymaster and largest creditor – is peculiarly sensitive, with the political and economic circumstances in Germany adding their own elements to the resolution of the euro crisis. In particular, the constitutional requirement for balanced German budgets by 2016 – a reflection of the national belief that the main cause of Europe’s problems lies in errant public sector budgetary policies – is a highly conservative stance that makes it challenging for the German electorate to accept any framework for the planned budgetary consolidation in other EU countries that is notably less austere.

Economically, it is indeed clear that several EMU countries – notably Greece, Portugal, Spain, Ireland and Italy – have been running excessive public deficits for some time. In some cases, this has been combined with excessive private sector borrowing caused by interest rates that have been too low for these countries’ domestic requirements.

The exact reasons for these deficits and large debt levels differ, but whatever the causes, the financial markets recognise that the status quo is unsustainable. By any normal analysis Greece has already reached the point where debt rescheduling is inevitable. Some of the other states are not far behind.

However, circumstances in Europe are not comparable with a ‘normal’ sovereign default such as Argentina’s in 2002, because a default by Greece or any of the other southern states would be a default in Europe’s single currency. And if Greece, for example, were to default, the main losers, after the Greek people themselves, would be the banking systems of France, Germany and Belgium, all of which have lent substantial amounts of money to Greek borrowers.

In effect Germany and the other creditors have been engaged in a huge exercise of vendor finance. For about 10 years now, German banks have been lending Greek consumers the money to buy German exports. If these loans go sour, Germany would lose most of its future exports to Greece (the Greeks won’t be buying many more Mercedes), and much of the value of its past exports.

The build-up of lending among euro members is a direct consequence of monetary union. Intra-EMU loans across national boundaries are far in excess of what any regulator or supervisor would have allowed in the absence of the single currency.

Euro area growth has been slightly slower than in the US

Note: Real GDP (1999=100); EA denotes Euro average
Source: IMF and IMF projections (WEO, April 2010)
such large balancing transfers in the EU and the counter-balance has therefore been in the form of private sector bank loans.

The banking exposures are in fact large enough to threaten the banking systems of the creditor states. The result is that the effect of a Greek default would be felt in the finance ministries not only of the debtor states but also of the creditors, as the latter would be forced into rescuing their banks. The rest of Europe has therefore been prepared to go to almost any lengths to avoid declaring Greece formally in default. This explains both the size of the rescue package assembled by European governments, the International Monetary Fund and the European Central Bank (ECB) on the weekend of 8-9 May, and also the fact that it has been put together as a loan. This latter feature is more usually the solution for an illiquid borrower, and is almost never the right solution for one which is insolvent. Indeed, for insolvent borrowers, lending more money merely threatens to increase the size of the eventual rescheduling.

The rescue package was accompanied by the landmark ECB decision, announced in the early hours of 10 May, to buy government bonds outright, and therefore accept principal risk. It was publicly opposed by the Bundesbank, which is increasingly at odds with the ECB’s leadership. The decision raised the spectre that the ECB may, if a state defaults, make principal losses, which in any other state-like structure would be considered fiscal in nature. The decision also generated some critical remarks from financial market participants, alleging that the euro would weaken as a result of a potential lessening of the ECB’s anti-inflation resolve. [See commentaries in boxes on p. 8-9 and 10-11 from Michael Kaimakliotis and Tim Young.]

Germany is well aware that the stakes are high and rising. That is why the German government is determined that, alongside the new loans and guarantees for Greece (and possibly other southern countries), there are very strict deficit reduction requirements and the strongest possible measures to make sure the debtors stick to the agreed repayment schedules; schedules that are highly onerous and possibly untenable. The EU-endorsed austerity package includes a 4% tightening of fiscal policy in each of the next three years; but even if the Greeks stick to this, their debt to GDP level is expected to reach 145% by 2014.

Many commentators have drawn two conclusions from this. First, the Greeks will struggle to fulfil the programme. Second, even if they fail, the attempt to do so will cause a serious recession.

And what happens if the Greeks look as though they are not keeping to the austerity plan? This is where politics and history start to enter the analysis.

Broadly speaking Europe has twice in the past faced debt crises of this magnitude, after the First and Second World Wars. And it was not only the vanquished that faced huge debts and (in Germany’s case in the 1920s) official reparations: even the victors faced debt to GDP levels well above 200%. But the response to these two post-war crises could not have been more different.

In the 1920s and 1930s, Europe joined with most of the rest of the world in believing in fixed exchange rates (to the gold standard) and a
general orthodoxy that government budgets should be broadly balanced. In this environment the natural course for a nation facing fiscal stresses – i.e. devaluation – is officially resisted, and the only other course of action is fiscal retrenchment, austerity and a deflationary depression. The idea was that debts would be paid off ‘the hard way’, i.e. in real terms, and this was largely achieved, albeit at the cost of much social unrest and hardship.

In the 1950s and 1960s, on the other hand, Europe had become overtly Keynesian, and the policy recipe contained devaluations, demand management through fiscal actions, and inconvertible currencies protected by exchange controls. Not surprisingly the result was a multi-decade inflation that remains unmatched in peace-time history. The many national debts were in effect paid off ‘the easy way’ by being inflated away, with incomparably less social unrest and hardship than in the 1920s and 1930s. The burdens of adjustment were borne by the creditors, whereas 20 years earlier they had been faced by the debtors.

We need to recognise one important point. European policy-makers made a conscious policy decision to allow inflation as the way of reducing post-Second World War debts. The experiences of the 1930s were still extremely fresh. No-one wanted to recreate the vicious cycle of bank failures, fiscal strains, austerity measures, deep recession and social conflict that had resulted in many developed European countries surrendering their democratic systems. The roll-call is sombre indeed: by 1938 Greece, Bulgaria, Romania, Hungary, Yugoslavia, Poland, Latvia, Lithuania, Estonia, Italy, Spain, Portugal, Austria and notably Germany were all either partially or fully under military dictatorship.

Looking at the present crisis, we see that in almost every way – with regard to the fixed currency backdrop, the preference for balanced fiscal budgets and the proposed austerity regimes – the outlook for highly indebted euro member states is closer to the 1930s than the 1950s. This flies in the face of the post-Second World War consensus. Given that the 1950s solution worked and the 1930s one palpably didn’t, why is this? The key to the puzzle lies in Berlin.

Germany is now at an awkward period in its political and economic history, for several reasons. First, during the 1950s and 1960s, Germany was able to reintegrate itself into the European family as a partner not a threat. Europe in turn was able to enjoy a period of peace it had not known since the initial rise of a unified Germany in 1870. The collapse of the Soviet Union and the re-unification of Germany upset the European equilibrium. One of the answers to this was the formation of EMU.

Second, Germany has now completed a long, painful and costly reconstruction of the eastern states after reunification in 1990, and has emerged lean and extremely competitive economically. In addition, German industry – by embracing globalisation more comprehensively than companies in much of the rest of Europe – are now carrying out an increasing amount of trade outside EMU, by building up commercial ties with the fast-growing emerging economies.

Lastly and not without importance, Germany has a new generation of leaders, including a Chancellor who is from the old East Germany and who was never part of the (West) German post-war self-denial consensus.

Competitiveness divergences driven by excess growth in unit labour costs

Note: Competitiveness calculated on the basis of Unit Labour Costs, relative to Germany Q4 2000 = 100. Source: Eurostat
Quarterly data up to 2010 Q1 for Germany and Spain, 2009 Q3 for Ireland and 2009Q4 for the other countries, except for Portugal which is based on annual data (up to 2009). The ULC indices are set to 100 in the last quarter before the euro area accession of Greece. The ULC developments presented for Greece and Portugal might differ from the calculations made by the National Central Banks. The quarterly pattern in Greek ULC is affected by substantial volatility in quarterly compensation of employees figures; EA denotes Euro average

Excessive credit growth in some countries ...and very slow in others

Note: Loans to the private sector (average 1999-2008) Source: ECB
In short, Germany is a normal country again, and is becoming much more willing to defend its national interests. This need not be a bad thing – other nations do so all the time – but in a continent with still-vivid memories of German war-time overlordship, it risks touching on raw nerves and requires a political deftness from Berlin that is not always to the fore.

In the previous two debt work-outs in Europe, the winners and losers were very clear. The 1930s saw a transfer of real wealth from debtors to creditors. In the 1950s, inflation transferred real wealth from creditors to debtors. Today Germany is the largest creditor, and naturally seeks to protect and preserve the real value of its assets. When this is coupled with the Germans’ legendary aversion to inflation as a result of their experiences in the early 1920s, Berlin’s stance that ‘the debts must be paid and the debtors must pay’ is both understandable and inevitable.

Thus the challenge for Europe is to make the austerity programmes demanded by the creditors stick. Here Europe’s political failings loom large: the political underpinnings of the EU are incomplete and weak, and the Union remains a federation of sovereign states with most relationships between them still very largely at bottom based on international treaties. The EU is of course not the first federation to face this issue, and it is hard not to draw parallels with the US, which faced the same existential question of the sovereignty of the individual member states in 1860. That was after over 80 years of federation, in a country with a young history prior to the formation of the Union. The EU is not yet 55 years old and is attempting to bring together countries which in some cases have centuries of history as independent sovereign entities.

As a result of all these circumstances, the ‘federal’ authorities in Europe (to use the US parlance) perpetually have to struggle to impose their will on the member states. The most egregious failure surrounds the Stability and Growth Pact, which was widely ignored.

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**Surmounting a crisis – Measuring the gap between policy-makers and the people**

*Michael Kaimakliotis, Head of Investments, Quantum Global Wealth Management*

The speed with which financial turbulence evolved from concerns over a single fairly small country (Greece) to a full-blown currency crisis took many by surprise. Faced with the dramatic circumstances of the last few months, to avoid the worst effects investors need a more sophisticated approach. In particular, this involves understanding the psychology of how different countries’ financial options are affected by the complex interplay between the feelings of the population at large and the leanings of policy-makers.

Many market participants failed to understand the interdependence between different segments of the financial markets. Instead, they chose to simplify the world and opt for convenience by assuming independence.

Already in 2008, investors learned that, in a crisis, investments which are assumed to be independent may become highly correlated. A prime example was the behavior of emerging markets (where fundamentals were solid) and developed markets (where the fundamentals were weak). Another example was across asset classes. Correlations of hedge funds and commodities with equities approached one at the peak of the crisis. In each case the asset returns became correlated as a result of their dependence on underlying economic factors and the ability of market participants to take risk.

The lessons of early 2010 are rooted in a different form of dependence. We have seen asset prices become more dependent upon the interplay between various social, political and institutional structures. Take the case of Greek 10 year bonds which traded at yields of less than 5% at the end of 2009 and trade near 10% in July 2010. Fundamentally, the idea that a country can pay its debts and that a country will choose to pay its debts are two different things. The willingness to pay is determined in the end by the people. In other words in a democracy it is the people who decide and not the policymakers.

(continued on page 9 ...)

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**Growing current account deficits in higher-cost euro members**

![Growing current account deficits in higher-cost euro members](chart.png)

*Note: 2010 is forecast (EC May 2010); current account in % of GDP*

*Source: EC*
even before being unceremoniously abandoned in all but name when it suited the larger states to do so.

The solution, for those that believe in the fundamental concept of Europe and the EU, is ‘ever closer union’, a phrase which is almost as old as the EU itself but which in the current crisis is being interpreted as ‘ever closer control of national finances from the centre’. And, with Germany as the main driver of events, this is becoming more and more synonymous, for the debtor countries, with having a German veto over their actions – an outcome which may prove increasingly unpalatable.

What will happen next? The crisis is reopening wounds and feelings that Europe had hoped were consigned to history, and at the extreme, threatens to undo the whole of the post-war consensus. The probability is that Europe will recoil from the abyss, but this is not guaranteed.

The nightmare scenario would be a combination of three outcomes:

- Debtor nations do not stick to the austerity plans.
- The ECB is forced further to compromise its ‘no bail-out’ policy.
- In spite of the softening of the ‘no bail-out pledge’, one or more of the debtor nations defaults.

The result would cause a major banking crisis, not least at the ECB itself. This could push the Germans over the edge and encourage them to ‘wash their hands’ of the feckless southerners.

Defenders of the euro, when challenged about the potential for EMU break-up, are quick to observe that there is no formal way to leave the euro, and no

### How some market participants were wrong-footed on central banking independence

The view that policy decisions would be made independently of the people was at the heart of bond prices back in late 2009 and early 2010; prices for Greek and other peripheral country bonds indicated little likelihood of a default. Market prices now show that investors believe that the decision over whether to repay outstanding debt or default will rest with the people of the respective nations.

In the case of Greece, the risk premium being charged is a strong indication that investors do not believe the people will withstand the austerity measures being implemented under the EU/IMF rescue programme. Rather, market prices reflect the likelihood that policy makers will eventually take their cue from the people. What was once considered independent is now priced as dependent.

The reason why the concerns centered on Greece were transformed into a full currency crisis reflects a similar dependence. Originally policymakers reassured markets that there was no merit in any country leaving the euro. However, it soon became apparent that the people of Germany were not happy to bail out their southern European neighbours. Market prices began to reflect the possibility that, as pressures of various kinds rise, the German population might prefer to see economic and monetary union collapse (or be substantially altered) than shoulder the burden of the more profligate members.

A third area of assumed independence that was shown to be false applies to central banking activities. The European Central Bank was clearly at odds with policy-makers regarding various aspects of measures to combat the crisis. Yet in several cases strong ECB policy announcements gave way to U-turns as the ECB faced up to the pressure of events. It has appeared as if the ECB’s much-prized independence has been preserved at times when it has been irrelevant, but has weakened when the going gets tough.

This holds important lesson for investors. Financial markets are still pricing currencies as though monetary policymakers are independent of fiscal realities. According to this approach, central banks are unlikely to allow even moderate increases in inflation. This may be a mistake; coming months will show whether or not this assumption is justified.
The OMFIF Essay

‘We had to burn the euro to save it’

By Tim Young, former member of Bank of England foreign exchange division

Faced with a sovereign debt crisis that threatened to spread from Greece to at least Portugal and Spain, the euro area authorities this spring progressively relinquished constraints designed to maintain the ECB’s solvency and detachment from fiscal policy.

The adjustments have threatened to undermine the euro by weakening the ECB’s balance sheet and setting precedents for similar accommodation in future. Investor perceptions of the euro may never be the same again.

The euro was conceived as a hard currency. Part of the motivation for EMU was the desire of Germany’s EU partners to emulate German post-war economic success. This owed much to a hard D-Mark that drove German industry to seek ‘real economy’ solutions to problems like the 1970s oil shocks, rather than the inflation and devaluation palliatives tried by others.

Until the latest turbulence, the ECB had largely followed the D-Mark model. Up to this year the euro was gaining ground as a reserve currency as the more accommodating stance of the Federal Reserve and the deterioration of the US net international investment position raised doubts about the future value of the dollar.

Unfortunately, the spreading of the financial crisis to the debt of weaker euro members has severely tested the ECB’s resolve. These countries had got into trouble because, since adopting the euro, they had taken advantage of lower interest rates to expand borrowing while failing to rein in labour costs. Countries like Spain which had not run increased public sector deficits during the good times faced fiscal problems as their economies were depressed by a mix of private sector debt and corporate uncompetitiveness.

The ECB seems to have been inclined to acquiesce in measures to hold down marginal countries’ bond yields and to err on the easy side in monetary policy to minimise their incentive to secede from EMU.

The first ECB concession was in collateral requirements for lending to euro area banks. These were set in terms of agency credit ratings, no doubt to distance the ECB from the task of having to differentiate between the creditworthiness of euro governments.

(continued on page 11 ...)
currency would be very strong and a number of other stable, northern states would find it very attractive to join. Indeed the countries that split off from the southern bloc might specifically declare that the appellation ‘euro’ remained with the states that were left behind, obviating any need for redenomination of contracts affecting their assets and liabilities.

Such a development would of course raise important political questions. The very heart of the post-war European project, the alliance between Germany and France, would be called into question.

The crystal ball goes cloudy at this juncture. But many believe that an increasing weight of opinion, both within and outside Germany, will be drawn to analysing whether such a state of affairs is the most likely outcome.

The graphs accompanying this article are taken from the presentation ‘Imbalances and Sustainability in the euro area’ by Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the conference ‘The ECB and its Watchers’, on 9 July 2010 in Frankfurt. OMFIF would like to thank Mr Bini Smaghi and the ECB for their assistance.

Unwise decision on Greek bail-out to avoid large losses for euro area banks

The inevitable consequence was that a credit rating agency decision could render a country’s debt ineligible as ECB collateral at an inconvenient time. On 25 March, however, the ECB said that investment grade debt would be accepted for an indefinite period. And on 3 May, with the prospect looming that Greek government debt could be downgraded to junk status, the ECB agreed to accept Greek government debt regardless of its credit rating.

The most spectacular U-turn took pace on 10 May with the ECB’s bond purchase programme. This was presented as a technical initiative ‘to ensure depth and liquidity in those market segments which are dysfunctional’. But the programme potentially compromises the ECB’s ability to hold down future inflation. The concern is not so much the money-creating effect of government debt purchases, as the ECB undertook to sterilise this by introducing a week-long deposit facility, but rather that the programme effectively represents an additional source of funding for euro governments. The retreat is disappointing because it represents a missed opportunity for Europe to interrupt the sequence of bailouts that have characterised the financial crisis since the September 2008 Lehman Bros demise. The ECB would have been able to differentiate the euro as a reliably hard currency even in adverse circumstances.

Many commentators claim that Greece was bailed out to avoid large losses or bankruptcy for euro area banks holding Greek debt. If so, this was an unwise decision.

First, bailing out a country means saving all its creditors – an inefficient way to protect banks.

Second, unless banks are formally bankrupted, it is difficult to make full use of their shareholders’ and junior creditors’ money to absorb losses, making bank failure more costly for the taxpayer.

And in Europe especially, bankrupting a bank need not involve disruptive closure and complete liquidation; it is easier to nationalise such a bank in Europe compared with America where the public is more hostile to state ownership. As it is, the danger is that bank losses on sovereign debt are offloaded to the euro member states, increasing their indebtedness and intensifying the pressure on the ECB for further accommodation.
Clarifying sovereign fund principles
What China can learn from the others

Malan Rietveld, Chief Economist

The prospective change of strategy at China Investment Corp illustrates an essential but unpalatable fact of life for sovereign funds. In their own interests and that of their shareholders, they have to develop a set of coherent policies and objectives – and do a better job at explaining these to countries that are recipients of their investments, as well as their own domestic constituencies. The news that Beijing is examining extricating CIC from its role in the Chinese banking sector indicates that China’s best-known state fund is embarking on a welcome change in direction.

The CIC faces a confusion of objectives and pressures inside and outside China, for reasons that lie partly in forces it cannot control. Sovereign funds – in particular in view of the public and political attention they face – are often in a highly unenviable position, where judgments on their performance are likely to be more negative than positive, largely reflecting factors not of their own making. However, CIC’s position has not been helped by the incoherence in its structure since its inception in 2007, which has served neither fund nor country well.

The move to put CIC’s house in order is overdue. In a sense, the fund has had the worst of all worlds. Its murky blend of objectives has impeded clear-cut judgment and analysis of its investment decisions. At the same time, these shortcomings have raised tensions in countries that should be welcoming its investments – and have undermined its credibility among its various stakeholders in the People’s Republic.

The track record of other sovereign funds underlines the need for clarity. Sovereign funds that articulate their investment horizon, benchmarks and strategic vision have managed to avoid damaging conflicts between competing objectives and generated higher returns for their shareholders. Although they differ greatly regarding the extent and timing with which they publish the details of their investments, the four most successful and established sovereign funds – the Norwegian Pension Fund, the Abu Dhabi Investment Authority, and the Singaporean funds Temasek Holdings and the Government Investment Company – share one common theme: the power brokers that preside over them have a clear understanding of the funds’ role as long-term investors pursuing commercial objectives. The same is true for smaller funds with more focused development objectives such as Malaysia’s Khazanah Nasional.

This has not only kept recipient-country concerns at bay, but also – more importantly – has helped these funds largely avoid panic buying and selling, and built a critical degree of understanding among domestic constituents about what the funds are there for.

Sovereign funds have the rare potential to ride out – and even capitalise on – cyclical market fluctuations. Sovereign funds typically don’t manage assets that are explicitly linked to liabilities, nor do they need to churn out financial results for their shareholders every quarter. They have a beneficial platform from which to invest for the long term: whether they are pursuing opportunistic, countercyclical strategies, collecting illiquidity premiums or restructuring former state-owned enterprises on a commercial basis.

Sovereign funds that have become leaders in their class and survived various episodes of financial market turbulence have stuck to these principles. And, because they have done so, their political masters for the most part understand that these funds should not be criticised for short-term losses that are within an acceptable range.

Of course, not all sovereign funds should try to be clones of the funds of Abu Dhabi, Norway and Singapore. There is much room for countries with different risks, levels of financial sector and infrastructure development and trade and investment exposure to give their sovereign funds a more developmental or stabilising objective. China Investment Corp. may be moving towards the mainstream model. Hopefully, the Chinese authorities have now seen the light about the proper way to operate their country’s premier state fund.
A special correspondent

Beijing’s apparent move to strip the China Investment Corp. (CIC) of significant equity stakes in China’s domestic banks represents a moment of truth for the country’s premier sovereign fund. Repositioning CIC towards more foreign investment would give the institution much more clarity in its investment strategy. And it might add greater focus to China’s long-running efforts to find better-value routes than dollar foreign exchange reserves for investing the country’s burgeoning foreign assets.

Under the stewardship of Wang Qishan, vice-premier for finance, China appears to be considering transferring ownership of Central Huijin, a bank holding company for the state’s shares in a number of the country’s largest banks, away from the CIC and placing it under more direct control of the State Council, the supreme legislative body.

Control and ownership of Huijin, set up in 2003 as a mechanism for reforming and restructuring China’s biggest lenders, has proved to be a bone of contention between Beijing’s rival institutions. Its initial establishment as part of the People’s Bank of China was perceived as a coup for the central bank, limiting the finance ministry’s influence over a thriving, privately-owned Chinese banking system.

However, with the creation of the CIC in 2007, Huijin’s assets were moved on to the fledgling sovereign fund’s balance sheet, accounting for roughly a third of the $200bn under CIC’ management. Given that the CIC operated under the auspices of the State Council, the central bank then seemed to have lost the initiative again.

What has this political tug-of-war over Huijin meant for the CIC? The Huijin assets have been both a blessing and a curse. Lou Jiwei and Gao Xiqing, the duo at the helm of the CIC, will no doubt have mixed feelings about shedding the Huijin assets.

On the one hand, they may welcome the reduction in political ‘heat’ – both domestically and internationally – that will accompany the CIC’s withdrawal from the domestic banking system. The fate of Chinese banks and the pace of reform have been contentious issues on Beijing’s agenda in recent years. The CIC’s role brought an unusual degree of attention from domestic observers. And in the US, the CIC was classified as a bank holding company on the basis of its Huijin assets, which placed it under the comparatively strict supervision of the Federal Reserve and restricted the type of investments it could make in American financial institutions.

A second concern was that the CIC’s holding of the Huijin assets blurred the fund’s focus. Critics argued that the CIC faced potentially conflicting objectives and that its central role in the domestic Chinese banking system distracted from its efforts to develop the institutional focus, skills and expertise required effectively to manage its foreign investments. The CIC developed into something of a hotch-potch institution: part commercially-driven sovereign fund, part domestic stabilisation fund, and part financial sector development fund.

Yet, despite these potentially negative aspects, Jiwei and Xiqing would lament the loss of the Huijin assets, since they have been the best-performing parts of the CIC portfolio. A number of the CIC’s high-profile foreign investments have backfired against the background of the global financial crisis that started within months of the CIC’s founding, most notably its much-publicised investment in Blackstone. But its stake in the Chinese banking system has kept the CIC’s fortunes buoyant and its domestic critics at bay.

Generating robust returns from the start has been critically important to the CIC, not least because it faces two performance hurdles that most other sovereign wealth funds do not.

First, the CIC was capitalised through debt – the central bank was compensated for the transfer of its foreign reserves and Huijin assets to the CIC with money the Chinese government raised through bond issuance. So Beijing implicitly demands that the sovereign wealth fund generates a minimum 6% annual rate of return in order to cover interest payments.

Second, the CIC is locked in combat with other aspirants to the title of Chinese premier state-owned investment company. Challengers to the CIC’s throne include not only the domestically-focused state investment firms, such as Chengtong, State Development Investment Corp. and the newly established Guoxin Asset Management, but also the central bank’s investment arm, SAFE, and the National Social Security Fund.

A key question is how and when the CIC will be compensated for any eventual sale or transfer of the Huijin assets. It seems possible that the CIC could gain a substantial and sudden windfall of new cash for investment abroad. In view of the challenging nature of the performance hurdles, the sovereign fund would not sit on that cash for very long. The forthcoming reinvention of China Investment Corp. will be fascinating to behold – and critically important, not just for China but also for the rest of the world.
The delicate balance between the financial health of the state and that of the banking system has never been so well exemplified as in the current crisis – and nowhere so vividly as in Ireland. Uncomplicated by mispriced derivative instruments, or even by egregious mis-selling of mortgages, the Irish credit boom is a textbook example of this interaction.

In the upswing, fiscal policy encouraged credit expansion, while the credit-fuelled boom in turn induced a fragility in the structure of taxation. In the bust, the losses of the banks imposed a heavy burden on the state, even as fiscal correction added to loan-loss pressures on banks. Thus, as they bloated the property and construction boom of 2003-2006 with credit financed from abroad, the banks indirectly contributed to the public finances becoming dangerously skewed towards reliance on what were bound to be transient forms of revenue – including stamp duties and capital gains taxes on property transactions. Yet fiscal policy, rather than restraining this bubble, actually contributed to it, through the scale of budgetary deficits and the design of tax incentives for construction.

As a matter of fact, the Irish government was not a major borrower in those years. The debt to GDP ratio – previously a major source of concern in the 1980s – had long been brought under control. Furthermore, the government accounts were in surplus, with 1% of GDP being added each year to a sovereign wealth fund invested almost entirely abroad. It was the banks that were borrowing – adding over 50 percentage points of GDP to their net foreign position between 2003 and 2008.

In Ireland’s case, the reversal began to be seen first in the fiscal accounts, soon after property prices peaked around the end of 2006. Already before the collapse of Lehman Bros, the budget had slid into a sizable deficit, and the government began to plan aggressive corrective action. When international money markets seized up in September 2008, the Irish banks, with their heavy reliance on foreign borrowing and their exposure to the correction – already well under way – of what had been the largest of property bubbles, could not continue without government support.

The Government, not fully recognising the underlying solvency issues in a couple of the banks, responded promptly with a blanket guarantee of the locally controlled retail banks – extending even to some of the subordinated debt. This slowed the outflow of funds from the banks. However, the growing realisation that heavy loan losses were unavoidable, and recognition that the government would have to fill any eventual hole in the banks’ capital, started to weigh on markets, starting from soon after the banking guarantee was put in place. Coming on top of the predictable erosion of the transient taxes, and the surge in automatic stabiliser spending, which together had effected a sharp reversal in the run of fiscal surpluses, this apparent threat from banking losses added to the pressures on the spread of Irish government debt during the first half of 2009.

The strategy adopted to restore confidence had three main elements:

• First, spending cuts (including cuts in nominal pay rates in the public sector) and a restoration of tax rates to achieve a sustainable medium term balance (borrowing of 3% of GDP by 2014);

• Second, a de-risking of the balance sheets of the banks by sale of their largest property-related loans at deeply-discounted, market-related, prices to the National Asset Management Agency (NAMA);

• Third, a recapitalisation of the banks, to be completed, in compliance with the requirements of the Central Bank, by end-2010.
Ireland & Europe

This third element followed a detailed and systematic stress test exercise to determine the capital needs consequential on the crystallisation of loan losses on their sale to NAMA, as well as the predictable further loan losses that can be foreseen in the rest of the banks’ portfolio. The latter derived from the deep recession which the Irish economy is suffering as construction activity plummeted and the rest of the economy suffered knock-on effects from this, from the global downturn, and from the necessary fiscal contraction.

In order to generate the required capital levels, the banks are divesting non-core activities, and have received sizable injections from the state. Part of the required additional capital was raised by one of the largest two banks in a rights issue in June 2010. There is great severity in the stresses embodied in the recapitalisation exercise, which envisages that the banks will hold 8% core tier 1 capital in the base case, taking account of the deep recession – and 4% even in an extreme stress. Despite this, the call on government funds is manageable.

Some of the government’s injections (financed by diverting some of the sovereign wealth fund into equity in the two main banks) will be remunerated. Most of what is unrecoverable (of the order of €25bn) relates to one bank, Anglo Irish, now under government control, for which a comprehensive downsizing and restructuring proposal is being scrutinised by the European Commission.

Some of this has already been accounted for in government borrowing (adding almost 3% of GDP to the 2009 borrowing figures). The remainder will also result in additions to government borrowing, which need to be netted out of annual borrowing figures in order to avoid a misleading impression of the speed of convergence to the 3% objective.

By measuring and delimiting in this way the costs being imposed on the government’s accounts as a result of the banking mishaps, the viability of the government’s overall fiscal strategy has thus been confirmed. Were it not for the sovereign debt crisis recently afflicting Greece, and with some contagion effect on other members of the euro area resulting in a widening of spreads once more since the spring of 2010, the favourable impact on market confidence would be more evident by now.

As things stand, though, we currently observe a further illustration of the interaction of fiscal and banking conditions. The pressure on the government bond market has a knock-on effect across the euro area on bank liquidity and on the cost of longer-term funding. But as conditions for stability improve in Ireland and across the euro area, we expect this pressure to diminish over time.

Ireland shows roller-coaster changes in public debt levels

Were it not for the sovereign debt crisis recently afflicting Greece, and with some contagion effect on other members of the euro area resulting in a widening of spreads once more since the spring of 2010, the favourable impact on market confidence would be more evident by now.
An occasional look at the great characters of world finance

J.M. Keynes Letter from Heaven
Maynard and Bert converse on what is going wrong on Earth and how
a year is ‘a long time in economic policy’

William Keegan, Chairman, Board of Contributing Editors

THE FOLLOWING DOCUMENT HAS RECENTLY LANDED IN WILLIAM KEEGAN’S IN-TRAY

It is some years since I have been asked to write a letter home. I used to communicate with the World Bank’s house journal, but all good things come to an end, and the Editor moved on. In those days the great preoccupation up here was what Alan Greenspan was up to down there. I have to say Bert and I were not surprised when that good thing came to an end. By ‘Bert’ I refer, for readers unfamiliar with the World Bank’s house journal, to Albert Einstein who has become, as it were, my bosom companion up here. So when the enterprising young David Marsh got in touch with me via the Vatican, and asked what I made of current events on Earth, I naturally suggested a drink with old Bert. I think it was E. M. Forster who quoted someone as observing ‘How do I know what I think until I see what I write?’ Anyway, in these celestial heights I usually find that Bert, who arrived here some nine years after me, is very good at getting me going.

The scene was one of our favourite watering holes, the Nectar Lounge of the Ambrosia Hotel.

Keynes: Well, Bert, how are things?

Einstein: Not so bad, Maynard. I note with interest from Earth News that there’s a lot of talk down there about what it would be like if scientific breakthroughs enabled people to live forever.

Keynes: Well, for one thing it would make it less crowded up here.

Einstein: Yes, funny, isn’t it? We’ve got all this space, and yet we immortals will insist on crowding together, just as they do down there in cities.

Keynes: Talking of crowds, here comes the six o’clock cocktail rush. Lucky that I ordered this bottle.

Einstein: What is it by the way?

Keynes: Chateau Kirwan 1999 – a superb Margaux. You will not be disappointed.

Einstein: You know, Maynard, I was always intrigued by the New Testament story of turning water into wine, but up here the authorities can turn absolutely nothing into wine. It makes Relativity seem child’s play.

Keynes: Bert, I’ll come straight to the point, I’m depressed.

Einstein: Why? Only last year you were telling me with not so quiet satisfaction that your teachings were back in favour down there.

Keynes: They were. But a year is a long time in economic policy, and there has been a change of government in the UK. From accepting the need for what they flatteringly referred to as a ‘Keynesian stimulus’, they are retrenching all over Europe.

Einstein: According to the Earth Correspondent of Paradise News, they are worried about financial market confidence.

Keynes: You are aware, Bert, that these are the very same financial markets that produced the crisis?

Einstein: Didn’t I also read that European policy-makers want to cut back government spending to make room for the private sector?

Keynes: There’s plenty of room for the private sector. It’s just that the whole system is virtually stagnant, at well below full employment.
Einstein: But they talk of recovery.

Keynes: Insofar as there is a recovery, it has been greatly assisted by the stimulus. And now they are withdrawing that stimulus.

Einstein: But at least the stimulus prevented the Great Recession from becoming another Great Depression.

Keynes: So far it has. But they are now deliberately cutting back public spending and raising taxes while confidence is still perilously low.

Einstein: Aren’t they – the markets – worried about some countries not being able to service their loans?

Keynes: They are – but those same markets are now worrying about the ability of governments to service their loans if the cutbacks they have been urging lead to even bigger deficits.

Einstein: What is the mechanism, Maynard? Remember, I am a simple scientist.

Keynes: Simply the best! But, to answer your question, tax revenues fall during a recession and the cost of unemployment and so on rises. They end up chasing their tails.

Einstein: Mrs Merkel says that, at a time of austerity, everyone must cut back.

Keynes: But that makes the problem even worse. It’s what I call ‘household economics’. I spent my entire career trying to get across to people that what makes sense for the individual household or firm does not make sense for the nation.

Einstein: So who finances the continuing deficits you seem to want?

Keynes: The savers who are not spending. The situation is such that the Earth down there is awash with savings. That’s why long term interest rates are so low. Until there is a proper recovery deficits are not the problem, they are the solution – albeit the temporary solution.

Einstein: Temporary?

Keynes: Yes, they should keep stimulating until they get reasonable growth, then the revenues will come rolling in, contra-cyclical disbursements will fall, and they can balance their budgets once again.

Einstein: But it doesn’t look as though that’s the way policy-makers are thinking?

Keynes: It certainly doesn’t.

Einstein: I seem to remember Maynard that you wrote, many moons ago, that you hoped the economic problem would have been solved by now.

Keynes: Hope springs eternal – especially up here.

Einstein: What we need is another bottle. By the way, is it true that your last words on earth were, ‘Wish I’d drunk more champagne?’

Keynes: It is. But not after claret. Same again?

Einstein: I can see there’s life in the old dog yet.

Keynes: After-life, my dear Bert.
All eyes on inconclusive Dutch
Political wrangling over budget cuts
Roel Janssen, Board of Contributing Editors

In pondering the future of the euro, Europeans and non-Europeans alike have their eyes on the Germans. Maybe they should be looking at the Dutch, too. The Netherlands has a current account surplus that is roughly the same in terms of economic size (5.4% of GDP last year against 5% for Germany, according to the OECD).

With a population of only one fifth of Germany, the Dutch rarely attract criticism for fostering excessive domestic saving and damping consumption elsewhere. However, a swing to euroscepticism in the otherwise inconclusive 9 June elections make the Netherlands a place of increasing hostility to bail-out measures for weaker members of the single currency. After more than a month of efforts to build a coalition, no new government is in sight, with Jan Peter Balkenende, the defeated prime minister, staying on as caretaker.

Earlier this year, in a rare unanimous vote, the previous parliament rejected outright any Dutch financial support for a crisis solution to deal with Greece. Opposition against channelling Dutch taxpayers’ money to Greece was broadly shared among the population, amid general indignation about Greek mishandling of public finances. The Netherlands is preparing to raise the retirement age from 65 to 67, so there is scant sympathy for Greece where people retire at 55 or even less.

Somewhat inconsistently, when the €440bn rescue scheme was agreed in Brussels in early May, it was approved by a large parliamentary majority. But the population is highly suspicious about future European financial rescue programmes – exemplified by the swing to the right in the election.

The Freedom Party (PVV) of Geert Wilders, a politician campaigning on a virulent anti-immigration platform, is especially hostile towards Europe. The PVV, the biggest winner of the elections and with 24 seats the third-largest party in the new parliament, is ferociously against a ‘European super-state’ and nostalgic about a return to the Dutch guilder.

Mark Rutte, leader of the conservative VVD party that emerged from the elections with a one-seat margin, is known to admire UK Tory leader David Cameron and the way Cameron and Nick Clegg formed a coalition government in just a weekend. But Rutte’s election promise to form a new government by 1 July has proved untenable.

Formation of a coalition government has been unusually complicated because the new parliament includes 10 parties, none with more than 20% of the seats. Although Dutch politicians are renowned for compromises, finding consensus on issues like European policy and fiscal consolidation has so far stretched patience to the limit.

Budget consolidation will plainly have to wait. The budget deficit currently stands at 6.6% of GDP. All main parties acknowledge the need to trim the deficit; they differ, though, about the speed and amount. The Central Planning Agency, a government economic think-tank, has recommended adjustments totalling €29bn by 2015, particularly on health care, in order to make Dutch public finances ‘ageing-proof’. The social democrats, however, opt for about €10bn (a little over 1.5% of GDP), the conservative party for €20bn (3% of GDP) in the next four years, both with promises of more to come. It is assumed that these two parties will form the core of the future government, but before that happens, they will have to hammer out their differences.

A constitutional amendment aiming at budget balance, like the Schuldenbremse adopted in Germany, is not on the agenda in the Netherlands. But following tough budgetary action in Germany, the UK, France and other EU countries, any future Dutch government, whatever its political composition, will come under considerable pressure to keep in line and take equivalent measures.
A tribute to Lord Peter Walker

Peter Walker
Lord Walker of Worcester 1932–2010

Peter Walker, a friend of OMFIF in its early days and a member of its Advisory Board, died on 23 June 2010 at the age of 78.

Peter Walker had a brilliant career in the City and in Parliament. He was an MP for 31 years from 1961 to 1992 and was elevated to a Peerage in 1992.

He was a rare person in combining political and financial savvy – which took him from an adventurous banking enterprise with Jim Slater, which was an early victim of the 1973 crash, on to chairmanship of companies such as Kleinwort Benson and Allianz Insurance.

His political career was no less glittering. He became the first Cabinet Minister in a newly created super Department when Edward Heath was Prime Minister during 1970-1974. This was the first Environment Ministry anywhere in the world and Peter Walker led a campaign for cleaning up waterways. He was then President of the Board of Trade.

Peter Walker was a ‘one nation Tory’ and a strong Heath supporter with a strong interest in Europe as well as in wider foreign affairs. He founded the Tory Reform Group and was Chairman of Carlton Club.

Despite this, he went on to serve in Margaret Thatcher’s Cabinet in various capacities for 12 years. He started as Cabinet Minister for Agriculture, Fisheries and Food (1979-1983), Energy (1983-1987) where he became involved with the miners’ strike, and then as Secretary of State for Wales (1987-1990). He left the Government before Margaret Thatcher’s resignation.

Peter Walker took a great deal of interest in the hospice movement and urged people to take up voluntary action on its behalf.

Walker played a significant part in British political life and in the Conservative Party for nearly 50 years and he will be remembered as a Centre Right liberal progressive Tory. His rare mix of financial acumen, humane concern and political astuteness made him one of the more effective members of his generation.

Meghnad Desai
OMFIF Briefing

Looking ahead – diary dates

Pierre Werner Memorial Lecture
14 October 2010, London
Yves Mersch, Governor, Luxembourg Central Bank

OMFIF Meeting in Middle East
31 October – 2 November 2010
Central Bank of the U.A.E., Abu Dhabi

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