



Heroes missing in age of turmoil Wanted in Europe: de Larosière-Volcker inspiration

Stewart Fleming, Board of Contributing Editors

As the spectre of default stalks international markets, Europe encounters acute turbulence, global imbalances return and the International Monetary Fund engineers a fraught transition, the world needs a few monetary heroes. Time, perhaps, to summon inspiration from Jacques de Larosière, one of the two true eminences grises who have helped steer the world economy through great tribulations in the past three decades.

The other is Paul Volcker, the former Federal Reserve Board chairman who, behind the scenes, was an influential adviser to freshly-minted President Barack Obama when he took office in January 2009, the year of the Great Recession. For it was their virtuoso double act, beginning in 1982 when de Larosière was IMF managing director and Volcker well into his first crisis-engulfed term as Fed

chairman, which prevented the Latin American sovereign debt crisis from degenerating into a global financial meltdown. De Larosière stands for quietly resilient teamwork buttressed by principled stubbornness, characteristics that in many ways are now out of fashion. They were displayed to the full



Jacques de Larosière



Paul Volcker

during extraordinary periods of public service at the French Treasury, IMF, Banque de France, European Bank for Reconstruction and Development and, latterly, advising European leaders on strengthening the regulatory framework after the banking crisis.

Back in the 1970s, de Larosière and Volcker made an incongruous duo. The quintessential French mandarin, dapper and slight of build: in public, guarded and austere, behind-the-scenes, skilled in the deft art of string-pulling. And the giant, outgoing, wise-cracking American, a man whose personality, not just his huge frame, dominated any room he entered.

Together, they forged the closest of bonds, not just in office hours, but on fly-fishing working vacations in the former frontier lands of the western US. It was the workaholic Volcker's passion, which de Larosière came to share. The 'muddle through' strategy they followed in the Latin American debt crisis was typical Volcker. He recognised that there was no 'silver bullet' for a quick solution to save the over-extended American banks from insolvency.

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Talmudic logic Force and free will

Mario I. Blejer, Advisory Board

To find a resolution to the impasse about the treatment of Greek debt, we need to go back to the Talmud, the ancient repository of Jewish law. Numerous passages applied to issues such as sales, divorces and offerings specify that acts related to them are legally valid only if a person performs these acts voluntarily. And yet, under certain circumstances, courts are allowed to exercise force on an individual until he says that he is, indeed, willing.

One we understand this, we understand how Greek debt may be restructured. A centralised and well-managed process, taking a lead from the Talmudic sages, could lead to all parties being better off than under the chaotic alternative of a messy default. This could also reduce the time and energy to engineer a path through legal procedures – a process that would otherwise lead to an ever-larger proportion of Greek debt ending up in the hands of the public sector through the European Union and International Monetary Fund.

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Real life financial thriller Euro's all-encompassing pall

David Marsh, Co-chairman

The international monetary scene remains in thrall to swirling developments that appear to have leapt from the pages of a financial thriller into real life. Shortly after digesting the repercussions of the International Monetary Fund's then managing director indulging in extra-curricular activities in New York, financial markets are having to grapple with the strong possibility that Greece, a developed country and a member of economic and monetary union (EMU), will default on its debts.

Such a thing, we have been assured by the technocrats, could, should and will never happen. But when centrifugal forces bear down on objects that never seemed destined to be in harmonious constellation – on the one hand, a massive block of Greek debt, on the other, an equally immovable volume of obduracy among creditor countries ill-disposed to give money to hard-up southerners – there is only one way for the saga to end. The OMFIF Bulletin would dearly like to put the euro story to one side and concentrate on matters of more positive import for the world economy. But we are drawn back to it, partly in a effort to put today's European upheavals in the context of past periods of strain for world banking and finance.

Jacques de Larosi re and Paul Volcker are both due to take part in OMFIF activities in London during the summer. It seems reasonable, as Stewart Fleming does in our front page article, to look at their legacy of helping resolve the Latin American debt crisis 30 years ago, in the light of the strains over sovereign debt in Europe. In Archive Insight, we highlight the prescient warning by de Larosi re 36 years ago that monetary union could engender give rise to permanent disequilibrium in current account payments – a state of affairs that would require massive internal credits to hold the system in place. Among the modern generation of civil servants charged with making the euro work, this form of icily realistic logic was seldom on display, as William Keegan points out.

Is it in hope or desperation that we turn back to the ancient texts? Mario Blejer takes a leaf from Talmudic law to explore how the lines between 'voluntary' and 'forced' can blur in the field of debt restructuring. Meghnad Desai's provocative advice to the Greek people is to hold a referendum to establish whether they wish to repay their debt. Miroslav Singer, governor of the Czech National Bank, which seems to have organised its affairs with some success outside the euro area, says Greece and the euro area need to re-establish Greek competitiveness – inside or outside the single currency. Brendan Brown says EMU as presently conceived suffers from three fatal flaws. He calls for Angela Merkel and Nicolas Sarkozy to start afresh with a new set of rules. Darrell Delamaide – alongside his regular monthly survey of Fed policies – asks what America makes of European disarray. The answer seems to be 'Not much.'

The pall of the euro is all-encompassing, yet we look, too, at the wider world. Sabrina Wong and Michael Kaimakiotis explore the growing trend to reserves diversification in both the advanced and emerging market countries, a development encouraged by uncertainties impinging on the dollar and the euro. Steve Hanke blames Keynesian fiscalists for what he calls a continuing slump in the US economy. Franco Bassanini and Edoardo Reviglio look at a counter-productive effect of tighter post-crisis regulation – negative effects on investment in long-term infrastructure projects by long-term investors including insurance companies and pension funds. Malan Rietveld surveys the Bank for International Settlements' findings on global imbalances. The central bankers' bank says these are likely to stay with us – and the onus is on the deficit countries to adjust. Back to the old days, it seems. Did they ever really go away? ☒

David Marsh



How Greece can learn from Iceland

Concentrate creditors' minds: hold a referendum

Meghnad Desai, Chairman, Advisory Board

As the euro drama descends into melodrama and then possibly into farce, Greece should learn from the example of Iceland, which went bankrupt two years ago. Like Ireland, Iceland ran into problems with its private banks which built up excessive liabilities by offering above-market interest rates on deposits and then crashed when Lehman Brothers went down. The debt – which were the deposits taken by the banks operating abroad – was left with the Icelandic Treasury. But in a referendum the Icelanders voted to renege on the debt and forced the creditor countries – mainly the UK and the Netherlands – to renegotiate.

Not being in the euro, Iceland could let its currency depreciate – a painful exercise, but one that lets individual citizens make their own adjustments to inflation. Now, two years on, Iceland is on track for annual growth above 2% this year and next after a cumulative 10% fall in output in 2009 and 2010. Iceland has returned to the international capital markets and can borrow at 5% – a rate the Greeks can only dream of.

There is a lesson for the euro area here. Not every creditor deserves a break. They should have known it was risky to lend to Greece. Let them bear the cost. I believe Greece should hold a referendum on whether its citizens are willing to pay back the debt. That should concentrate minds – both in Greece and among the creditor countries – and might make a contribution to resolving the issue.

A referendum would certainly be better than the other options that are feared – a revolution or even a military coup. But Greece is used to such shocks – and has a long history of reneging on its international obligations. The Papandreou government is fast running out of options. It's hoping for respite from privatising many Greece's assets. But this is a tricky political decision for an ostensibly Socialist Party. Even if the government decides to sell, it may not get its hands on the money for while. And a fire-sale will be counter-productive.

The tragedy is that even if Greece eliminates the deficit with great fiscal pain, its debt would only stop rising, not disappear. The debt needs to shrink to at least half its current level of 157 % of GDP. Germany went through a decade of austerity after it absorbed the dysfunctional East German economy. The Germans succeeded in pulling through with their economic health restored. That's why they have no sympathy for the Greeks, who they think are lazy, retire too early and pay no taxes.

Tragedy No. 2 is that the International Monetary Fund has chosen the wrong candidate as managing director to fix the euro crisis. While she was French finance minister, Christine Lagarde's backers said only a European can heal the euro. This argument is not only racist; it is also wrong. Euro decision-makers including Ms Lagarde have tried to deal with each problem euro country one by one. And one by one they have failed. France and Germany, the euro's leading powers, have different views. France wishes to tie economies into a tighter control grid with budgetary coordination under centralised oversight. For a long time Germany wanted all euro members to be as prudent and fiscally responsible as the Germans. Then it switched priorities to saving German banks with big positions in euro area debt. Now German finance minister Wolfgang Schäuble says that he wishes restructuring in the form of write-downs for private bondholders.

Next steps will not be simple. Jostling for position are the European Commission, the ECB, the Council of Ministers, the Euro-Group and then, on top, the IMF. Schäuble's resolve on making private creditors pay has been watered down by Chancellor Angela Merkel after meeting President Nicolas Sarkozy. Of course, Greece should never have been allowed to join the euro. But then political considerations demanded maximum membership. Gross irregularities in Greece's national accounts were ignored. Now everyone is dancing to the Greek fiddle. Wait for the Greek people to speak. The music may suddenly speed up. ☐

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Heroes missing in age of turmoil *(continued from page 1 ...)*

So over an eight year period, Latin America's 'lost decade' of growth, he and de Larosière worked to heal the financial wounds the likes of Mexico and Argentina, Citibank and Chase Manhattan had inflicted on themselves. This kind of crisis management has been resurrected to cope with the no less threatening but still more complex and daunting euro sovereign debt disaster. Unfortunately, nowhere on the horizon is anything remotely resembling the verve and resolution of the de Larosière-Volcker team.

In late 1986, with French economic policies made more complex by President François Mitterrand's cohabitation with his conservative prime minister Edouard Balladur, the government announced de Larosière was coming home from the IMF. Just as decisive steps were due on the road to

economic and monetary union (EMU), de Larosière carried out a job swap with Michel Camdessus, governor of the Banque de France, who took over as IMF incumbent in Washington. De Larosière returned to Paris believing that the central bank would soon be made independent. This was a principle he supported as a member of the committee under Jacques Delors that set down a path to EMU.

At around the same time Jean-Claude Trichet was made Treasury director, on a career path towards his present job (from 2003) as European Central Bank president. In April 1989 Trichet made a ceremonial protest against de Larosière's pitch for Banque de France independence. Yet the two men were instrumental in steering France through a crucial period of economic convergence with Germany.

Ironically, Trichet in 1993 inherited the policy and an independent central bank, when de Larosière was shunted quickly to London to take over at the EBRD after the fall from grace of Jacques Attali. In 1998, de Larosière returned to France, retreating into semi-retirement. Yet as the debt crisis exposed the inadequacies of the European Union's patchwork of economic governance and financial regulation, in October 2008 de Larosière was called by the European Commission to chair a group charting a course to a sounder financial sector. When the de Larosière Group's report was released in February 2009, it was widely criticised both for going too far, and for not going far enough. Surely, though, de Larosière was aiming for the middle ground, the place where incremental change lays down stronger foundations for a better future. ☐

Talmudic logic *(continued from page 1 ...)*

The relevant verse in the Talmud says, literally, 'We (the court) force him until he says that he is ready to do it willingly'... 'and you find this in divorce cases when (if the man refuses to grant the divorce) we exercise force on him until he says "I want to do it voluntarily"'. The same holds true for a sale. If a person is forced by a court to sell his property the sale is valid because, at the end, it is considered to have been done voluntarily.

How do we reconcile this apparent contradiction? Over the ages the sages have given various interpretations. Two are preponderant. The first more ruthless version argues that compulsion could be convincing. Under this explanation, it is claimed that when a court forces an individual until the point that he surrenders and says he wants to follow orders, his actions are then considered voluntary because, ultimately, he has made the conscious decision to agree.

The second interpretation is more benign and visualises the court as instrumental in leading toward a superior welfare equilibrium. It is based on the collective action principle. Individuals know fundamentally what is good for them and for society. But

they are often hesitant to follow suit as a result of fear, embarrassment or because they believe their actions may not be worthwhile in isolation.

The court could then provide the coordinating mechanism, eliminating free riders, and forcing all parties so that the outcome makes everybody better off. In this case, individual decisions, although made under pressure, become, when assessing the outcome, truly voluntary. These issues are germane to the involvement of private bondholders in the rescue package for Greece. It is argued that, to postpone a default, creditors should be made to agree to maintain or extend their current exposures. But how do you compel the private sector to accept what is obviously an implicit financial loss without triggering a credit event, a rating event, or, more directly, the very default that you want to avoid?

One can use Talmudic logic to recognise the existence of mechanisms to pressurise the parties to obtain superior voluntary outcomes. In practice, both the original German government proposal (that maturities on Greek debt should be voluntarily extended for several years) and the European

Central Bank concession (the voluntary rolling over of existing commitments as they mature) are only voluntary under the ruthless interpretation. In both cases agreement would be obtained reluctantly and pressure could provoke harsh responses. Rating agencies are right in considering them a 'selective' default that is bound to result in contagion and, eventually in widespread restructuring.

The alternative is to seek a cooperative resolution, consistent with the benign interpretation of forced willingness. This can be achieved adopting some features of the 'Vienna Initiative' used in central and eastern Europe in 2009. Three pillars of that model are pertinent. First, all parties need to be involved in designing the programme. Second, there should be provision of proper incentives for participation, including direct financing from bondholders' governments. Such resources used today to finance the transfer of peripheral debt from private to official hands could be better used to provide debt relief through properly incentivised rollovers. Third, appropriate efforts have to be made to encourage all bondholders to participate in formal pre-commitments. ☐



Competitiveness is the key Euro area must choose Greek way forward

Miroslav Singer, Governor, Czech National Bank

There are important lessons for the euro area from the collapse of the Bretton Woods system in the early 1970s. To resolve crises, there is no substitute for predictable, credible, co-ordinated and well-communicated policies. The Czech authorities learned these precepts – often the hard way – first, over the split of Czechoslovakia in 1993, later during the financial and currency turmoil that hit the Czech Republic later in the 1990s.

Since the single currency was established in 1999, euro mechanisms have supported economic divergence rather than convergence. The rules governing its operation are manifestly and wilfully ignored, regardless of their quality. The public debt-to-GDP ratio of euro members exceeds the Maastricht debt criterion by one-half. The euro area public sector deficit is almost twice as high as that set by Maastricht. The belief that, after accession, euro membership leads to discipline has proved unsubstantiated.

During the sovereign debt crisis, the European authorities have changed policies numerous times. The list of U-turns include policies on bank bail-outs, on relaxation of monetary policy, on the state of the EU financial sector, on the no-bail-out clause, and on the adequacy of the Greek rescue package. In addition, several false myths have been propagated, for example on the consequences of Greek bankruptcy for the German and French banking sectors. We sometimes hear that the euro cannot survive a Greek default. Why not? Is the euro area as a whole insolvent? Are trade and investment flows between Greece and other members so large that Greek bankruptcy would have a devastating impact?

The cost of insuring Greek debt measured by credit default swaps has risen considerably compared with a year ago, but the euro has strengthened against the dollar. The markets do not appear to think that the Greeks are fundamentally important to the euro's survival. We must have no illusions about the other struggling countries, too. Their debt difficulties are a symptom of the underlying problem, which is that these countries are not competitive.

The upshot of so many U-turns is that financial markets are completely confused. For Greece, there is a lack of clarity about the desired outcome. There is no readiness – either in Athens or among the other governments – to allow Greece to leave the euro, restore its own currency and depreciate to a competitive exchange rate. But at the same time the other countries show no willingness to support Greece sufficiently so that it can overcome its malaise while staying in the euro.

There are two ways for Greece to restore competitiveness. The first option would be for Greece to stay in monetary union, agree debt restructuring and rigorously enforce fiscal discipline. Currently proposed structural reforms do not extend far enough to restore competitiveness within a relatively short period. In addition, tens of billions of euros in aid would have to flow from the strong economies to Greece. This aid would have to be broad, generous and general. The second option would be for Greece to resort to the 'classic' prescription of the International Monetary Fund, through a mixture of fiscal discipline, debt restructuring and currency devaluation – to be accomplished by a departure from the euro and a return to the drachma. To make such a scenario easier, some aid would be desirable at least in the form of support for the drachma to avoid overshooting after a euro exit.

Whatever solution Greece and the rest of the euro area choose has to be carried out in an orderly way. There is an increasing risk of a run on Greek banks, as well as fear that the Greek crisis will spread dramatically to other countries. Instead of the current muddling through, one of these two routes should be chosen and clearly and credibly communicated to markets, voters and the international community. Otherwise, we face a further loss of credibility for everyone involved, with significant economic and political consequences. ☒

This article is based on a talk given to OMFIF in London on 28 June 2011.

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Cornerstone still after all these years Gold back in limelight as anniversaries beckon

George Milling-Stanley, Advisory Board

A range of actions by the official sector in the past two years appears to signal that the official sector is reawakening to the relevance of gold as a reserve asset. There are two complementary strands to this development. First, emerging market economies that have been experiencing rapid economic growth have been substantial buyers of gold. Second, European central banks holding a significant amount of gold in their external reserves have shown a reduced appetite for sales – in spite of (or perhaps also because of) the financial crisis. The combined effect of these two trends has been sharply to reverse the flow of gold on to the market – an important support for the bullion price.

These important shifts on the gold market coincide with two key anniversaries for the yellow metal. In September it will be 80 years since Britain's forced departure from the classical gold standard in 1931. The country found that winning the First World War was just the beginning: paying for victory was another matter altogether. And just when it seemed the UK might at last be emerging from more than a decade of austerity, along came 1929 and the Great Depression, and Britain was forced to abandon the link between sterling and gold.

The second anniversary falls in August. It was 40 years ago, in 1971, that President Richard Nixon closed the gold window in the US, ending the automatic convertibility of dollars into gold for the central banks of other nations. That system was known as the gold exchange standard, and it replaced the classical gold standard around the end of the Second World War. Under the gold exchange standard, the dollar was valued in terms of gold, and other currencies were valued in terms of the dollar. This system was brought down by the inflation caused by yet another war, this time in Vietnam. With the stroke of a pen, Nixon cut the last formal link between gold and money.

For hundreds of years up to that time, the dominant global currency was gold. It came in the form of the first gold coins, struck on the orders of King Croesus of Lydia, in present-day Turkey; or as the Roman aureus coins, Venetian ducats, Spanish doubloons and pieces of eight, English golden guineas and sovereigns. Later there was an explicit formal link between a paper currency and gold, with the paper being exchangeable on demand for gold. The international monetary system evolved in a variety of ways, but gold remained the cornerstone until the system formally disappeared in 1971.

Despite the unravelling of the system under Nixon, gold remains a fundamental component of the international monetary system. De facto rather than de jure, bullion remains a cornerstone reserve asset for the central banks and government monetary authorities that comprise the official sector. Indeed, even as external reserves grew from \$2tn to \$10tn between 2000 and 2010, official sector allocations to gold remained at 13% of total reserves (taking into account the rise in the gold price during that period), while over these 10 years allocations to the US dollar declined from 62% to 53%.

As a group, the official sector holds almost one-fifth of above-ground stocks of gold. However, gold holdings are not equally distributed among nations. The advanced economies of Western Europe and North America typically hold over 40% of their total external reserves in gold, largely as a legacy of the gold standard. Developing countries, by contrast, have no such historical legacy. They have much smaller gold reserves with on average 5% or less of their total external reserves in gold.

However, the last two years have seen a significant change in reserve-holding patterns. Among the emerging market economies that have become substantial buyers of gold have been China, India, Russia, Thailand and Mexico in the past two years. The primary reason for this has been a desire to move toward restoring a prior balance between foreign

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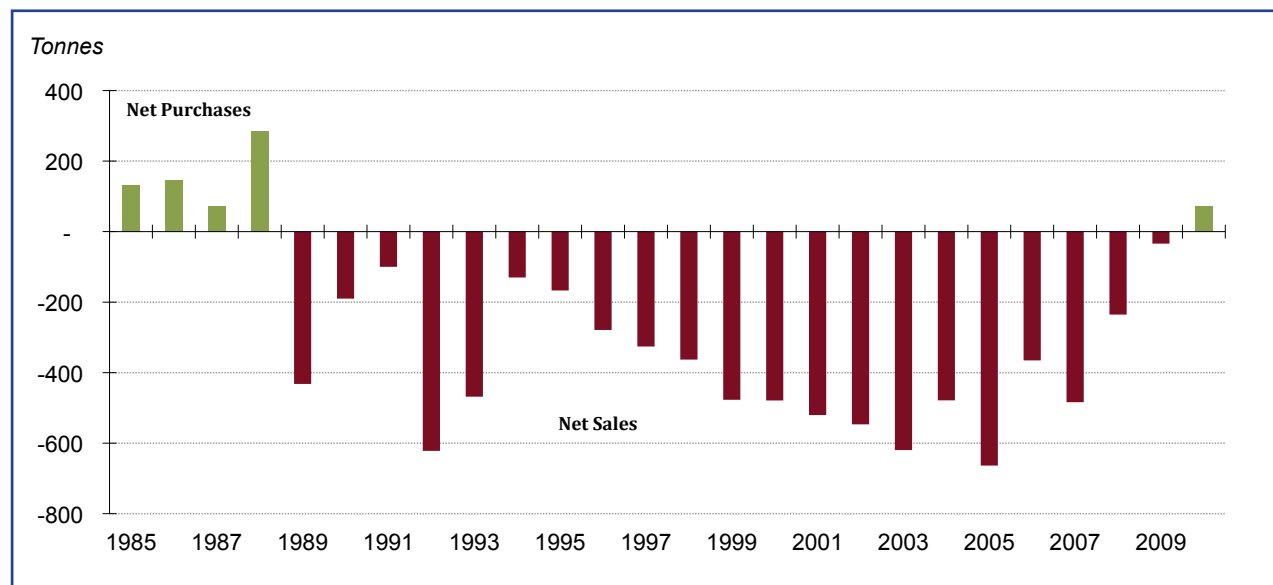
currencies and gold that had been eroded by the rapid increase in their holdings of foreign currencies, principally the dollar. Additionally, for this group of countries, gold has become an increasingly attractive means of diversifying external reserves. As a result, emerging market purchases of gold have made a significant impact in reducing the quantity of gold the official sector had earlier been supplying to the market.

Another factor acting in the same direction has been the reduced appetite after the crisis for gold sales by European central banks holding a significant amount of the metal in their external reserves. Prior to the financial crisis, several European central banks initiated gold sales programmes to rebalance their external reserve portfolios and increase their foreign currency holdings. However, as the financial upheaval deepened and ultimately developed into a major sovereign debt crisis, European central banks have shown a sharply diminished leaning towards gold sales, which have effectively come to a halt over the past three years.

These two forces have reduced the total supply of gold to the market and have turned central bank activity back toward net buying. As central banks were a significant source of supply over the past two decades, this has had a significant impact. Most importantly, the official sector has transmitted to the international community a ground-breaking signal: a market-based solution seems the most effective way to help resolve the problems faced by the international monetary system. As we recognise important anniversaries of a time when gold played a formal role in the international monetary system, it is appropriate that the official sector has shown renewed attention to gold reserves as part of a new financial architecture that once again includes gold at, or very close to, the centre-stage. ☐

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Official sector net gold purchases since 1985



Source: GFMS and World Gold Council

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Convergence in currency holdings

Liquidity constraints on emerging market assets

Sabrina Wong, Advisory Board

Central banks have increased their focus on investment returns, behaving in a somewhat similar manner to private sector asset managers. The recent acceleration of reserves accumulation and steady development of financial markets have prompted a gradual change in reserve management practices. Central banks are enjoined to ensure adequate liquidity to safeguard the local currency against financial shocks and generate reasonable returns, subject to risk and liquidity constraints, over the medium and longer term. Within those limits, central banks have expanded their array of suitable investments by turning to a greater variety of assets with acceptable liquidity yet higher yields.

Reserve entities now have a higher tolerance for market and credit risk, and to a lesser extent, liquidity risk – illustrated by the inclusion of longer duration assets, corporate debts, or even equities. Many established central banks have reduced gold holdings in terms of portfolio weightings. They have used the deepening of derivatives markets to push out the risk-return frontier. More than 70% of central banks now outsource reserve management to external fund managers. There has also been a move towards the creation of investment vehicles in the myriad forms of sovereign funds. These allow for the separation of a portion of the reserves into tranches with different objectives such as returns relative to liquidity.

Central banks have traditionally diversified their reserves into various currencies to mitigate event risk and international inflation differentials. Criteria have been factors such as a country's pattern of international trade, its exchange rate regime, currency composition of its own debt and the liquidity and market depth of the investment currency. A representative central bank would concentrate on the leading four currencies: the dollar, euro, yen and sterling. The Swiss franc has recently risen again, profiting from safe haven status.

Influenced by factors such as the persistent strength of Asian currencies, central banks' foreign exchange reserves continued to grow rapidly. Emerging and developing economies' reserves have increased from \$600bn in 1998 to \$6.1tn at end 2010. This, coupled with low interest rates in developed nations, has resulted in sub-optimal returns from the traditional currencies of the industrialised West. Reserve managers face immense pressure to enhance returns to offset this cost. One way is to diversify to include higher yielding currencies, particularly those from emerging market countries. However, this can be done only gradually, as markets may not possess the required liquidity. Up to end 2010, the aggregate share of the dollar and euro remained fairly stable at around 60% and 30%.

The IMF has an established guide, the Special Data Dissemination Standard (SDDS), whereby member countries voluntarily submit reserves data for publication in their annual reports or websites. Disclosure practices are country-specific. Most central banks subscribe to the SDDS, and some break down their reserves assets into asset allocation and currency allocation. Examples are Reserve Bank of Australia, Swiss National Bank, Banco d'Italia, European Central Bank and Central Bank of Russian Federation. Entities with a larger pool of assets will be more reluctant to disclose details. Disclosing the composition of reserves could adversely affect their positions or the functioning of certain financial markets. Since reserve assets are tilted towards the medium to longer term, a trend could be derived from a historical set of reserve composition data which could hamper investment objectives.

Countries with very tight exchange rate regimes will be more reluctant to disclose currency composition. Policies on intervention in the local currency could be derived from changes in currency composition. Countries with floating exchange rates are more likely to disclose currency composition. However, central banks may be reluctant to disclose their detailed reserve holdings because of reputation risk. For example, central banks holding Icelandic debt in 2008 would have lost a degree of public and political trust if their holdings were made public. All these issues are part of the global evolution of reserve management practices that OMFIF will be watching carefully in coming months. ☐

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The costs of accumulation

China reserves policy approaches tipping point

Michael Kaimakliotis, Quantum Global Wealth Management

China has accumulated a vast stock of foreign reserves, now more than \$3tn, through currency intervention by the People's Bank (PBoC) over the past decade. Beijing is forced to issue bills and other instruments to 'mop up' money created by currency intervention. These sterilisation activities come at a considerable cost. Evidence is hardening that the losses, real and potential, from reserves accumulation are mounting. We may have reached a tipping point in Chinese reserves policy. China seems set on increasing the proportion of its reserves in higher return investments, with significant implications for investors.

In May, China Business News reported estimates by Prof. Huang Yiping from Peking University's National School of Development that the cost of foreign reserves exceeded Rmb1tn from 2003 to 2010. Prof. Huang calculated that from 2003 to 2010 interest payments on central bank notes issued reached Rmb743.7bn. Additionally, China was rapidly increasing the required reserve ratio at banks, with interest paid on additional bank reserves costing Rmb339.4bn.

We need to consider, too, the investment of foreign reserves. Perhaps surprisingly, Chenying Zhang, of the Wharton School at the University of Pennsylvania, finds that China's investment returns significantly exceeded costs between 2003 and 2010. China invests primarily in US Treasury and agency securities. Interest rates on these securities collapsed and bond prices soared, resulting in strong returns over the period. The renminbi did not appreciate as quickly against the dollar as many expected, as the 2005 breaking of the dollar-renminbi peg was suspended in 2008. However, the dynamics of the various factors that have contributed to relatively benign outcomes for accumulation and sterilisation policies are likely to reverse, which could increase the cost of building up reserves.

The net costs of the policy are dependent on the size of the current account surplus; the degree of sterilisation; the split between sterilisation through Treasury bill issuance and reserves build-up by the banking system; the rates of interest paid by the PBoC; and its returns on invested reserves. Unless we experience another global financial crisis, China's current account surplus is on trend to total at least \$200bn annually. Last year's surplus was \$305bn. Since the first quarter surplus was only \$29bn according to Chinese data (which often differ from international statistics), it seems prudent to assume a lower level. But this will still bring significant pressure to build up reserves.

In the past, in view of low inflation, the PBoC probably did not need to sterilise all incoming funds, which would have reduced costs. Now, however, with inflation reaching 5.5% in April, the bias has shifted towards increased sterilisation. For example, the required reserve ratio has now been raised to 21.5%, a record high. The interest rate on T-bills is about 3% while that on excess reserves is only 0.72% – giving China an incentive to carry out sterilisation through reserve requirements. However, raising reserve requirements immediately shifts a significant proportion of bank reserves from excess reserves to 'required' – on which the PBoC pays a higher interest rate. Since higher reserve requirements seem to be having an onerous effect on lending to small and medium size businesses, China is unlikely to raise these rates aggressively – shifting the emphasis to higher cost-Treasury bill issuance.

Crucially, China is unlikely to earn positive returns on US Treasury securities in the future – especially after adjusting for dollar depreciation. China appears to have shifted away from purchases of Treasury securities in the first four months of 2011. I expect this shift to continue. The dollar and US Treasury bonds may weaken structurally and alternative investments may begin to benefit from Chinese demand. This could support the euro as well the yen and sterling which with the euro make up the Special Drawing Right – the composite unit that China believes could become the basis for a global currency. Eventually, China could shift further into equities and emerging market bonds and currencies – a broadening of investment horizons that could open a new era in reserve currency management. ☐

Eventually, China could shift further into equities and emerging market bonds and currencies - a broadening of investment horizons that could open a new era in reserve currency management.



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Antagonists back in driving seat US euro scepticism on display again

Darrell Delamaide, Board of Contributing Editors

Frustration and pessimism about the way the Europeans are handing the euro crisis are on display in Washington. When the project started in 1999, there was no shortage of American voices saying it wouldn't work – scepticism that was quelled but not eradicated during the single currency's initial years of relative success. Now that the euro is on the rocks, some of that old antagonism seems to have regained the upper hand, tempered by disquiet that, if the euro encounters a major upset, the whole of the world's financial system will be hit.

Federal Reserve chairman Ben Bernanke was his usual diffident self when addressing the problem in his late June press conference. He did say, somewhat hopefully, that European officials recognise the 'incredible importance' of resolving the crisis in Greece and other peripheral countries. What's at stake, Bernanke made clear, is financial stability not only in Europe, but across the globe. Perhaps less hopefully, Bernanke appeared to accept the strong possibility of a Greek default or worse, affirming that America could take such an episode in its stride, since the exposure of US institutions to the peripheral countries was not worrisome.

Treasury Secretary Timothy Geithner was a good deal less polite in remarks at a Wall Street Journal event in Washington after another weekend of European dithering and backtracking. Geithner's comments underlined how the Treasury in recent months has taken a considerably more hard-nosed stance on the euro compared with the ever-diplomatic Fed. 'It would be very helpful to have Europe speak with a clear, more unified voice and strategy,' Geithner said. 'It is very hard for people who invest in Europe to understand what that strategy is. The simple rule of crisis management is you want to have a simple, clear, unified, declarative strategy. That would be helpful.'

Geithner couldn't resist giving the Europeans a few lessons in the art of weathering financial turmoil. The European Union had set up a 'substantial financial arsenal'. The Europeans should make sure that it's deployed effectively 'to make this work.' Geithner knows a thing or two about crisis management. He cut his public policy teeth as a Treasury official during the Asian financial crisis in the late 1990s, and was New York Fed chief during the Lehman Brothers collapse. Geithner has been openly pessimistic about the challenge faced in Europe. In congressional testimony in March, he said that Europe's issues were 'enormously difficult, incredibly tough things to fix.' Not to put too fine a point on it, Geithner continued: 'When you dig yourself that deep a hole...there's no easy way out.'

As to the underlying problem, some euro sceptics in the US are seeing their original fears vindicated about establishing a single currency without greater economic integration. Ted Truman, a former Fed and Treasury official, now at the Peterson Institute of International Economics, noted at a Brookings Institution seminar that the 'asymmetric shock' creating the crisis has been internal in nature.

'The establishment of the euro zone with a single currency was not enough' to achieve economic integration, Truman said. 'It facilitated the emergence of intra-European, euro zone imbalances, and policies and the political narrative have not kept up.' In particular, Germany benefited by keeping its exchange rate lower than it would otherwise have been, increasing the current account surplus. 'However, the German political elite failed to explain to the general public that these benefits might not be permanent and that they might involve a cost that might have to be paid later,' Truman said. He says Europe faces a difficult choice. 'Either Europe should move forward towards greater economic and financial and political union,' he said, noting that signs of movement in that direction are not convincing. Or: 'Europe should move back towards a closer form of economic and financial confederation including the reintroduction of exchange rates.' That's a realistic assessment as Washington watches how the Europeans confront their moment of truth. ☐

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QE3 still in the dock

Fed remains wary on economic front

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. Latest indications from the Fed show a policy of no change on the broad monetary front with the economic recovery neither fully convincing nor sufficiently imperiled to warrant a further bout of easing.

No QE3 as deflation risk subsides, Bernanke says

Federal Reserve officials don't have a 'precise read' on why the US economy continues to flounder, chairman Ben Bernanke said at his second regularly scheduled press conference following the June meeting of the FOMC. The Fed planned to let its programme of asset purchases, called QE2, expire on schedule at the end of June but will continue to reinvest proceeds from maturing securities to keep its balance sheet at the present level as it monitors the economy and inflation.

The Fed sees no need at the moment for a third round of asset purchases, Bernanke explained, because the risk of deflation the central bank perceived last August no longer exists and the situation in the labour market, while far from ideal, has improved, he said.

But the Fed remains wary and will not proceed with any tightening measures for several months, he indicated.



Richard Fisher

Enough is enough, Dallas Fed chief says

One regional Fed chief left no doubt that he opposes any further quantitative easing. Dallas president **Richard Fisher (voter)** told local Chartered Financial Analysts that the Fed has done enough.

'The worst outcome of all would be for the Fed to continue monetising the debt,' Fisher said in a speech in Dallas. 'We've been doing that since November.'

Fisher, one of the more hawkish FOMC members, has been an outspoken opponent of quantitative easing and of monetary accommodation in general.

'Our job is to provide liquidity,' Fisher told his Dallas audience. 'I believe our job is done.'

There is ample liquidity in the banking system and what is inhibiting credit is uncertainty about economic policy. It is up to politicians to remove that uncertainty, Fisher said. 'My very strongly held view is that it's time for the elected officials of this country to do their job,' he said. 'We have filled the tanks.'



Janet Yellen

Housing continues as drag on US economy, Yellen says

Fed vice chairman **Janet Yellen (voter)** focused on how the housing market is dragging down the economy. Distressed home sales, foreclosures, delinquencies and tight mortgage conditions mean that 'recovery in the housing market likely will be a long, drawn-out process,' she said in a speech in Cleveland.

She said the Fed is working with other government agencies help resolve the existing stock of vacant properties and prevent even more properties from entering foreclosure. Measures include changes in local lending rules that give banks favorable consideration in their examinations if they participate in stabilisation activities. The Fed is also assisting in the development of national servicing standards for the proper handling of both performing and non-performing loans.

Yellen also warned that even as regulators move to tighten conditions on mortgage lending, it's important not to disqualify too many borrowers. 'Looking forward, I unfortunately can envision no quick or easy solutions for the problems still afflicting the housing market,' she said. 'With the pipeline of delinquent and foreclosed homes overflowing, the inventory of empty and unsold homes will likely stay elevated for some time, which will maintain downward pressure on house prices and damp construction of new homes.'



Daniel Tarullo

Tarullo stirs markets with proposal on SIFI capital

When bank regulators these days speak of SIFI they are not of course talking about the science fiction genre (commonly abbreviated Sci-Fi) but about systemically important financial institutions. There's a lot of talk about SIFIs as the Basel Banking Committee discusses extra capital requirements for these global mega-institutions.

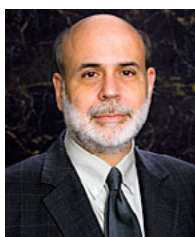
Fed governor **Daniel Tarullo (voter)**, who heads up banking regulation for the US central bank, startled the industry and the markets in an early June speech in which he suggested that the capital surcharge for SIFIs might end up doubling the 7% basic capital requirement enshrined in Basel III.

In a long disquisition about methodology, Tarullo, a former law professor at Georgetown University, suggested that one metric for determining the appropriate surcharge would be the potential impact of the failure of a SIFI.

'For example, if the loss to the financial system from the failure of a SIFI would be five times that resulting from failure of the non-systemic firm, then the SIFI would have to hold additional capital sufficient to make the expected probability of failure one-fifth that of the non-SIFI,' Tarullo said. 'The enhanced capital requirement implied by this methodology can range between about 20% to more than 100% over the Basel III requirements, depending on choices made among plausible assumptions.'

The uproar that followed this suggestion that the surcharge could reach 7% prompted Fed communicators to go into high gear reassuring markets that the widely discussed 3% surcharge would be sufficient in the eyes of the US central bank. This is the market consensus about the likely result even as banks continue to lobby fiercely against any surcharge.

Tarullo dismissed banks' objections, agreeing that higher capital requirements would indeed lower return on investment but would they would also lower risk and thus market expectations for ROI. It is not a punishment for being big, he said, but a discipline for banks to prove that the economies of scale they say are needed actually do pay off in terms of ROI.



Ben Bernanke

Bernanke: Reduce the deficit, but raise the debt ceiling

Though fiscal policy is supposedly the bailiwick of the politicians and monetary policy the province of central bankers, Fed chairman **Ben Bernanke (voter)** did not hesitate in a Washington speech to preach the necessity of a long-term fiscal plan for the US federal government.

His main purpose was to warn politicians away from holding an increase in the US debt ceiling hostage for budget cuts. Several members of Congress are urging the Republican majority in the lower house to block any increase in the debt ceiling unless their spending cut demands are met.

'Failing to raise the debt ceiling in a timely way would be self-defeating if the objective is to chart a course toward a better fiscal situation for our nation,' Bernanke warned. 'Even a short suspension of payments on principal or interest on the Treasury's debt obligations could cause severe disruptions in financial markets and the payments system, induce ratings downgrades of US government debt, create fundamental doubts about the creditworthiness of the US, and damage the special role of the dollar and Treasury securities in global markets in the longer term.'

But, commenting generally on fiscal policy, the Fed chief also said that 'maintaining the status quo is not an option.' He urged Congress to set a debt-to-GDP ratio and gradually lower that ratio over time. ☒

Though fiscal policy is supposedly the bailiwick of the politicians and monetary policy the province of central bankers, Bernanke did not hesitate in a Washington speech to preach the necessity of a long-term fiscal plan for the US federal government.



Money matters in slumping US

Keynesians' advice to Obama comes unstuck

Steve H. Hanke, Advisory Board

The US recession officially ended in June 2009, but a normal post-recession boom failed to materialise. Instead, we have seen an unwelcome slump. Since the recession bowed out, the average annual GDP growth rate has been a paltry 1.6% – well below long-run trend growth of 3.1%. The Obama administration's policy prescriptions – contrary to the president's assertions – have failed to mitigate the damage from the Panic of 2008-09. Rather, they have kept the patient in sick bay.

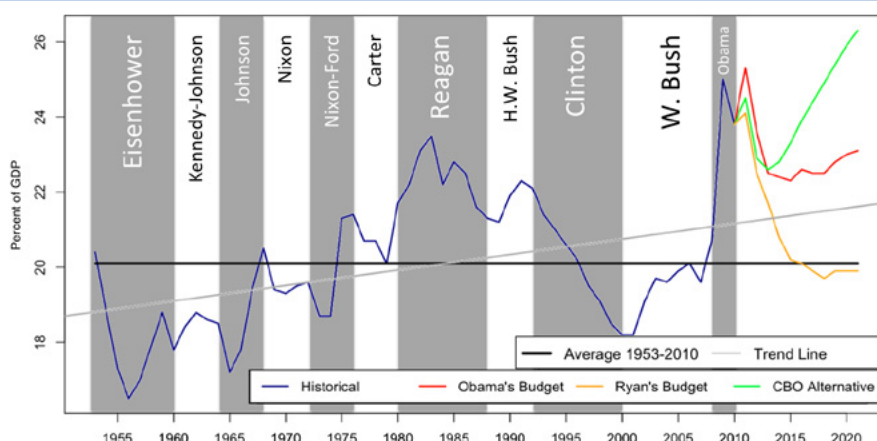
The first misguided advice was peddled by the Keynesian fiscalists who dominate the stage in Washington. According to them, increased government spending, accompanied by fiscal deficits, stimulates the economy. That dogma doesn't withstand factual verification – underlined by former President Clinton's massive fiscal squeeze. During his time in office between 1993 and 2000, government expenditures fell from 22.1% of GDP to 18.2%, as the chart shows. During his final three years, the federal government generated fiscal surpluses. Clinton was confident enough to claim in his January 1996 State of the Union address that 'the era of big government is over.'

President Clinton's squeeze didn't depress the economy. Instead, his display of Victorian fiscal virtues boosted confidence, and the economy boomed. Yet Clinton clearly didn't anticipate the uncontrolled government spending that accompanied George W. Bush's eight years in office and the truly shocking two years' worth of government spending under Obama. These two administrations have added a whopping 5.6 percentage points to government spending as a proportion of GDP. Current federal government outlays are at a high of 23.8%, well above the 20.1% average. The surge in government spending – coupled with President Obama's anti-market, anti-business and anti-bank rhetoric – does not inspire confidence.

In addition, it is important to stress what the fiscalists refuse to acknowledge: money dominates. When fiscal and monetary policies move in opposite directions, it is monetary policy that will dictate the economy's course. During the Clinton era, fiscal policy was tight, confidence was high and monetary policy was accommodative. The economy boomed. Since the Panic of 2008-09, fiscal policy has been ultra expansionary, while the growth in the money supply (M3) fell from a peak annual growth rate of over 15% to an annual rate of contraction of over 5%. No surprise that the economy suffered a serious recession and then only a modest and fragile recovery. In view of the current anaemic money supply growth rate (1.8%), it looks like the slumping economy will, unfortunately, be with us for the foreseeable future. Money matters. ☐

The growth in M3 fell from a peak annual rate of over 15% to an annual rate of contraction of over 5%. No surprise that the economy suffered a serious recession and then only a modest and fragile recovery.

Federal expenditures as % of GDP



Graphic applies to President Obama's 2012 budget compared with Congressman Paul Ryan's budget and Congressional Budget Office alternative



Basel peril for infrastructure funds

New approach needed for long-term investment

By Franco Bassanini and Edoardo Reviglio

Demand is growing for long-term investment in both advanced and emerging countries. For the ultimate benefit of future generations, we need to invest efficiently through the cycles over the longer term. In mature countries, there is a pressing need to finance infrastructure, innovation and environmental programmes, as well as to prepare for the consequences of an ageing population. In developing countries, the catch-up process requires vast investment in infrastructure. All this brings intense competition for long-term finance. Against this background, Europe needs to face up to the immense difficulties caused for the long-term asset management sector of the new Basel III rules. Although well-meaning, these rules as applied to long-term investors would have a highly negative impact on investment needed to improve the sustainability of our economies.

An alliance is needed between politicians, regulators and the investment industry – in both the private and public sectors – in advanced and industrialising countries. International accounting rules play a crucial role in this. It is vital that the relevant international accounting bodies are brought into the debate on this matter. After the crisis, regulators and policy makers have focused on strengthening the financial system. But such strong action on stability should not hinder the capacity of banks and other investors to serve the economy.

Long-term investors' asset allocation processes differ from those of generic asset managers. For a long-term investor, the concept of risk diversification requires diversification in the period of investments, in addition to diversification of the assets themselves. Measuring their solvency on the basis of short-term values is incompatible with the need for investment in assets that, while risky, are less volatile by nature, secured through high underlying loan-to-value ratios and yield very positive average long-term returns. Such short-term constraints are not only prohibitively costly, but are also mostly irrelevant for long-term investors that do not face short-term solvency concerns. This stands in contrast to banks, where the risk of withdrawal of deposits justifies the short-term focus. Solvency II is likely to lower institutions' appetite for buying and investing in long-term financial instruments.

It is widely accepted that the EU has no powers to decide in this matter, since it relates specifically to exceptions and additions to rules under Basel III and international accounting standards. But the rules of Basel III must be implemented in Europe by a European Union directive (CRD IV), while Solvency II is itself a European directive. As for the international accounting standards, though they are defined by the International Accounting Standards Board, they can be effective only if implemented under European and national jurisdictions.

Within this context, accounting rules should be also partially revised to increase long-term investors' potential. Current accounting standards involve two conceptual difficulties: in the IAS Board's philosophy, a company's assets and liabilities must be valued – in general – separately and independently; second, in many cases this valuation must be based on current values (mark to market). This specific valuation approach (IAS 19 and IAS 39 for instance) is damaging for long-term investors. It attributes instant market values to assets whose value is based on years of economic functioning. Under this procedure, market volatility is immediately transferred to an investor's balance sheet and profit-and-loss account. Moreover, the current accounting reporting system does not make it possible to check the quality of the fit between assets and liabilities. The accounting rules set up for trading activities do not take into account financial institutions' different business models. This short-term horizon would strongly constrain the capacity of these types of long-term investors to hold stocks and other types of long-term infrastructure-based assets.

Accounting criteria are needed that reflect long-term investors' specific business models, distinguish between different temporal durations/matching liabilities and investments, and take into account future long term cash flow values. Appropriate accounting rules for long-term investors would help stabilise financial markets and reduce short-term volatility. ☐

Accounting criteria are needed that reflect long-term investors' specific business models; distinguish between different temporal durations/matching liabilities and investments; and take into account future long term cash flow values.



BIS warns on growing imbalances Deficit countries will have to move first

Malan Rietveld, Chief Economist

At the height of the global financial crisis, there was a general consensus that the debate on the great 'global imbalances' would fade as the financial world grappled with more immediate concerns and the world returned to greater economic equilibrium.

But imbalances have returned to the top of the agenda. The Bank for International Settlements (BIS) addresses the issue extensively in its annual report published on 26 June. 'With the waning of the crisis,' the BIS says, 'the discussion is returning to the risks posed by current accounts.'

The BIS urges a focus not only on trade and net capital flows but also on gross financial flows. 'Gross financial inflows and outflows are substantially larger than the net flows associated with the current account and are often large even where current account balances are negligible,' the report observes. 'It is these gross flows, not the net, that must be accommodated by the receiving financial sector; and a sudden stop of gross flows risks economic crisis in the receiving economy.'

The reports adds a detailed discussion of how gross financial flows in turn contribute to 'vulnerabilities in the interconnected balance sheets of financial institutions, firms and households around the world.' So the BIS connects the somewhat esoteric debate on global imbalance with the more practical issue of how to conduct macro-prudential supervision.

Three further points are of note. First, unlike other global financial institutions, the BIS does not believe that international trade and financial imbalances will somehow resolve themselves in the post-crisis environment. To the contrary, it warns: 'Because much of the reduction in current account balances during the crisis was a cyclical phenomenon, rather than structural, future increases are likely....The size of the problem suggests that, without coordinated action, gridlock and growing imbalances may last for many years.'

Second, the BIS joins the International Monetary Fund in softening its position on the use of capital controls. Although it describes them as a 'last resort, to be used in extraordinary circumstances', the BIS notes that 'capital controls might be used as a stop-gap measure to temporarily address some risks of large gross financial inflows.'

This is hardly an unqualified embrace of capital controls, but is nevertheless a nod in the direction of a policy that was fiercely rejected by pre-crisis orthodoxy. The point is that many emerging market economies that have seen their currencies appreciate rapidly as capital fled the advanced economies in search of yield in recent years will feel more comfortable imposing capital controls, given the more approving stance adopted by Washington and Basel over their potential role.

Third, the report argues that it is the deficit countries – in particular, the US – that will have to move first to end what the 'gridlock' between surplus and deficit countries. There is more than a touch of Realpolitik in the BIS's analysis. 'Surplus economies can resist nominal currency appreciation as long as they are willing to continue accumulating – and bearing the cost of carrying – foreign exchange reserves,' the BIS notes. 'Thus, in general, deficit countries are the ones that are eventually forced to adjust.'

This represents an intriguing counterpoint to the debate in the 1970s that has dogged international monetary discussions ever since: whether the 'asymmetry' in the world monetary system, under which the deficit countries face much greater pressure to adjust than the surplus nations, needs to be overturned. The deficit countries, it seems, like the poor, are always with us. And the judgment from the BIS, and the experience in places like Greece, suggests that – whatever may be the implicit unfairness – the forcefulness of pressure from the financial markets and elsewhere will not be changed any time soon. ☐

The deficit countries, it seems, like the poor, are always with us. And the judgment from the BIS, and the experience in places like Greece, suggests that the pressure from the financial markets and elsewhere will not be changed any time soon.

Signs of weakness in Europe and US

Chinese economy remains robust

DZ Bank Economic Forecasts

GDP growth

	2010	2011	2012
US	2.9	2.5	2.7
Japan	4.0	-1.7	2.5
China	10.3	9.2	8.7
Euro area	1.7	1.8	1.5
Germany	3.6	3.0	1.8
France	1.4	2.0	1.7
Italy	1.2	0.8	1.1
Spain	-0.1	0.5	0.7
UK	1.3	1.1	1.6

Addendum

Asia excl. Japan	9.3	8.0	7.7
World	4.8	3.9	4.1

Consumer prices (% y/y)

US	1.6	2.9	2.3
Japan	-0.7	0.0	0.3
China	3.3	5.2	3.4
Euro area	1.6	2.6	2.0
Germany	1.2	2.4	2.1
France	1.7	2.4	2.2
Italy	1.6	2.5	1.8
Spain	2.0	3.0	1.7
UK	3.3	4.0	2.1

Current account balance (% of GDP)

US	-3.2	-3.1	-3.2
Japan	3.6	1.8	3.2
China	5.2	4.8	4.5
Euro area	-0.3	-0.7	-0.6
Germany	5.7	4.9	4.7
France	-2.2	-2.4	-2.6
Italy	-3.0	-2.9	-2.5
Spain	-4.7	-4.6	-4.0
UK	-2.5	-2.0	-1.8

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Large differences in economic performance between the core and periphery of the euro area remain in place. Aggregate economic output in the member states of economic and monetary union (EMU) grew vigorously at the beginning of 2011. Despite this robust output growth, employment hardly rose in the first quarter and in the labour market as a whole a clear divide has opened up between the core and the periphery. Euro area domestic demand is benefiting only modestly from any rise in consumer spending.

The US economy is showing clear signs of weakness. Industrial output stagnated in April and May, the number of new jobs created in May was much smaller than anticipated by financial markets, and the unemployment rate rose to 9.1%. Moreover, consumers may become markedly more reluctant to spend in the near future, as shown by the steep decline in consumer confidence. High oil prices and the spike in headline inflation are biting into households' purchasing power. Production cutbacks in the Japanese automotive industry have had visible effects in the US, where Japanese manufacturers hold sizeable market shares. These cutbacks, however, may turn out to be temporary and will not drag the American economy back into recession. None the less, we stick to our cautious view that the US will grow by only 2.5% this year.

In Japan, the recession may extend well into the summer. While reconstruction has begun, there are still supply-side bottlenecks. Energy supplies in the peak hot summer months are not yet guaranteed. Japan will in the future have to import more goods (energy, base metals, etc.) to support speedy reconstruction, while its exports, especially in the automotive sector, may take some time to regain the pre-crisis levels. A larger rebound in economic activity is to be expected only later this year.

Next year we will probably see a full-scale drive towards re-establishing a fully functioning economic structure and this will provide a strong boost to gross domestic product.

China, by contrast, continues to show economic resilience. While in recent months leading indicators have pointed to dwindling growth momentum, industrial output in the second quarter showed only a slight dip – primarily in the automobile industry. Strains from production shortfalls in Japan have been less pronounced than initially expected. However later in 2011 and above all in 2012 we believe growth rates in China will weaken.

Sooner or later the far more restrictive tilt to monetary policy – with a further tightening seen in June – will exert a toll on the effervescent construction industry and on the well-above-average volume of loans approvals. Since the inflation rate will continue to climb in the next few months, this will not be the last tightening of the monetary screw this year. ☐



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How to repair euro's three big flaws

Merkel and Sarkozy should meet on emergency plan

Brendan Brown, Chief Economist, Mitsubishi UFJ Securities

Economic and monetary union (EMU) as created by the Treaty of Maastricht is beset by three grave flaws. One big problem has been the lack of any monetary constitution that would constrain the European Central Bank to run a monetary policy confined by rules with the monetary base at the pivot, as had been the case for the golden years of the Bundesbank and the D-Mark. A second one has been the failure to prohibit the ECB from expanding its balance sheet for the purpose of so-called 'emergency liquidity' or 'lender of last resort' financing. A third issue is the absence of any pre-established legal provision for a member country to leave EMU.

In particular, investors and borrowers should have been fully aware of the possibility that a member country could leave EMU, that its private and public sector debts and assets could be converted into a new national currency according to a set procedure, and this conversion would not be a legal default. Without these three flaws, EMU would not now be threatened with ultimate extinction. The European credit bubble with its effects on real estate markets and on the sovereign credit boom-and-bust cycle in the peripheral countries would have been less marked. Greece would have had to leave EMU in early 2010 at the latest. The IMF would have been called in to help stabilise the new Greek currency after having fallen by say 50%. There would have been no credit default, but a big currency loss suffered by foreign holders of Greek paper - and domestic holders would have suffered a big inflationary write-off.

That, though, is all water under the bridge. If EMU is to survive as an institution, the old flawed EMU has to be buried. A new EMU, with the three flaws corrected, has to replace the old. I suggest that President Nicolas Sarkozy and Chancellor Angela Merkel should meet for a secret Franco-German summit to rebalance Europe's monetary arrangements. The get-together should take place at an undisclosed airbase, in the best style of General de Gaulle crisis meetings. The two government leaders would acknowledge that the present EMU is in deep crisis. They would reaffirm their devotion to monetary union as essential to long-term peace in Europe. And they would outline an emergency plan of succession if the present flawed EMU were to crumble under the impact of capital flight from weak banks and weak sovereign borrowers.

The emergency plan would have France and Germany agreeing to form a new monetary union with the three grave flaws corrected. They should issue immediate invitations for all other old EMU member countries to join. The constitution would have to be drawn up in due course. But in the immediate aftermath the members would establish a ruling monetary council headed jointly by France and Germany and the ECB would be 'invited' to continue running (under instruction) the interbank clearing and monetary base operations. The peripheral countries would most plausibly not apply for membership. With the three flaws corrected, market pressures would cause them to be ejected them in less than 24 hours. Italy would probably join too. Interest rates in Italy would be well above rates in the rest of the union until confidence could be built that Italian membership was sustainable.

Air base or no air base, there is no chance of such a secret Merkel-Sarkozy meeting taking place any time soon. More likely, muddling through will continue at growing cost for all, including ultimately the US taxpayer. We must understand that Europe faces a currency crisis, but this is being suppressed by huge quantities of taxpayer funds from the financially strong EMU countries. Ultimately, private investors in sovereign and other peripheral country debts will pay a substantial proportion of the costs. They will get back much less in the eventual debt recovery process than if there had been a prompt EMU exit. In general, currency crises do not bring down the world economy or the financial system (unless they lead on to extraordinary monetary disequilibrium as occurred in the US during 1931-32). A suppressed currency crisis, as now being administered in Brussels, Frankfurt, Paris, Berlin and Washington, has much greater potential for damage. ☐

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Jon Davis



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Stephane Deo



Jonathan Fenby



Stewart Fleming



Steve Hanke



Dick Harryvan



Carl Holsters



Frederick Hopson



Matthew Hurn



John Hughes



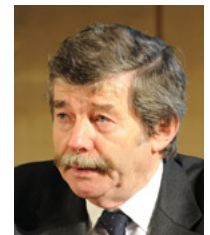
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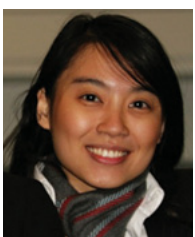
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Advisory Board members perform a variety of tasks including participation in seminars and speaking engagements for OMFIF's clients and members. For details contact secretariat@omfif.org

** Chairman*

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Looking ahead – 2011 diary dates

**OMFIF Lecture with
Miroslav Singer
Czech National Bank**
28 June 2011, London
The Czech View of EMU

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

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

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

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

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

 **A monthly foray into monetary secrets hidden in archives**

A prescient forecast of the euro's plight

How de Larosière's warning of 'balances in permanent disequilibrium' were ignored by Europe's monetary technocrats

The mid-1970s were not happy times for European monetary cooperation. The breakdown of the fixed-rate Bretton Woods system in March 1973 was followed by a sharp rise in the oil price after the Fourth Arab-Israeli war in October 1973. The European Community's 'Werner Plan' (named after the then Luxembourg prime minister) for economic and monetary union (EMU) by 1980 was put on hold as France and Germany reacted in traditional, diametrically-opposed fashion to international economic uncertainties. The former enacted a drive toward reflation. The latter followed a more orthodox route, under the leadership of the Bundesbank, to rein in price increases through tighter credit.

Beset by opposing pressures, in July 1975 Jacques de Larosière, director of the French Treasury, produced a brilliant analysis of the possible perils of premature introduction of monetary union among states that remained economically heterogeneous. He pointed in particular to the danger that countries within a monetary union could become permanently uncompetitive and register international payments 'in permanent disequilibrium' as a result of durable divergences in productivity and prices.

De Larosière's findings, buried in archives for more than three decades, provided a clinically incisive warning of the problems that eventually hit EMU in 2010-11. Tragically, though perhaps not surprisingly, de Larosière's scholarly admonitions were ignored by a future generation of European economic technocrat once monetary union got under way. With one or two honourable exceptions, they joined wholeheartedly in the prevailing belief that, within EMU, balance of payments deficits did not matter because they would always be financed by an inherent clearing mechanism among member states. As history subsequently showed, this turned out to be a monumental illusion.

Back in the early 1970s, storm clouds resulting from that old hallmark of Europe – a distinct lack of uniformity in economic policies – were already building up across the continent. France withdrew in January 1974 from Europe's semi-fixed exchange rate system, the European Snake, after the Banque de France's foreign exchange reserves came under heavy pressure. There was general international unease over inflation, which rose to 24% in Italy, 16% in the UK, 12% in the US and France and 7%.

The French government saw in the growing importance of the D-Mark a problem of a similar magnitude to the long-running dollar challenge during the Bretton Woods era. The Snake had shrunk from a central European Community policy instrument to an informal mechanism among central banks. In September 1974, President Giscard's finance minister Jean-Pierre Fourcade proposed a 'European monetary relaunch' involving a basket of Community currencies as a new unit of account to counterbalance the D-Mark. However Germany and other European partners rejected the plan, partly because it would involve an unwarranted extension of credit facilities.

France was desperate to counter a separate initiative for the Swiss franc to join the Snake, as a hard currency substitute for the French franc. De Larosière concluded that revived momentum for EMU could head off the threat of a bilateral German-Swiss deal. In a detailed briefing paper for Fourcade and Giscard, de Larosière spelled out France's fears of European monetary isolation. 'As one sees with present discussions on the reintegration of the [French] franc into the Community exchange rate mechanism and on the association of the Swiss franc with this mechanism, this risk is real, involving a group of European states with a strong currency and a balance of payments in equilibrium or in surplus.'

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De Larosière underlined the drawbacks from a French viewpoint. 'The constitution of such a bloc would be prejudicial for us from several points of view. Our balance of payments difficulties, and a propensity to relatively high inflation compared with our northern neighbours, without affecting our national credit, could none the less give rise to a permanent tendency for a depreciation of our currency.' De Larosière cast an acerbic eye over the potential drawbacks of forging EMU at a time of incomplete economic convergence. His conclusion was that the enormous efforts required to enable monetary union to function acted as an effective block on its realisation.

He set down a warning of dire consequences if countries moved towards EMU without thoroughgoing convergence. He pointed to the threat of permanent payments disequilibrium. And he spelled out the need for massive credits to support such imbalances. Since currency adjustments within monetary union were impossible, 'The evolution of the exchange rate of the European currency compared with other world currencies will affect the competitiveness of member states' products in different ways. If, globally, the Community has an interest in fixing its rate of exchange at a certain rate, the interest of each member state taken in isolation could be different. The creation of a European currency in no way causes the disappearance of the notion of the commercial balance and the balance of payments between member states. Some of these balances could be in permanent disequilibrium as a result of divergent evolutions in productivity and prices. A system of extremely well developed long term credits will be necessary to support these evolutions during a certain period. But such credits can hardly be permanent and growing.'

Three decades later, with the euro area in disarray, de Larosière's precisely-targeted forecast has come to bear with full force. Even before, during negotiations on the Maastricht treaty that was agreed in 1991 and signed in 1992, the provision for mutual balance of payments assistance that had existed in the European Community arrangements since 1958 was removed from the arrangements for the new monetary union framework. This reflected both the German-led view that monetary union should embody optimal discipline for member states, as well as the belief that, once the euro had started, financing of current account deficits within the euro area would no longer present difficulties.

In August 2007 – the month when the trans-Atlantic credit crisis erupted internationally with the bursting of the bubble that had been building up in the sub-prime mortgage sector of American housing loans – the ECB published a 12-page article devoted to global imbalances in current account surpluses and deficits, saying, 'The issue is important, as a potentially disorderly unwinding could pose a risk for the global economy and the stability of the international financial system.' The article focused on the rise in the US current account deficit 'to unprecedented levels' as well as on the surplus countries of Japan, China, Saudi Arabia and Russia. But it wholly failed to mention the imbalances within the euro area, on the grounds that the current account position of the EMU countries had been 'broadly balanced' and had even contributed to international adjustment by moving to a small deficit in 2006. In its myriad statements and publications, the ECB habitually gave prominence to financial and economic statistics on the euro area as a whole, virtually ignoring data from individual members.

In an unwitting prophecy of the unrest sparked by Greece two years later, the ECB wrote in August 2007, 'It is hard to define which countries are systemically important: some past financial crises have been triggered by relatively small economies.' However, unmentioned, euro members in 2006 recorded some of the world's largest balance of payments disequilibria. Greece, Portugal and Spain respectively ran up deficits of 11 %, 10 % and 9 % of GDP, while Germany and the Netherlands earned surpluses of 6.5 % and 9 %. In all cases, these imbalances were even larger than in the US, with a current account deficit of 6 % of GDP that year. The ECB maintained its insouciance. In a 10th anniversary Monthly Bulletin published in May 2008, the ECB made light of differences in wage costs and competitiveness throughout the euro area, saying that this was a natural part of the 'catch-up' between richer and poorer economies. It warned that 'accumulation of internal imbalances... could dampen output and employment' – but gave no hint of the financial time-bomb that, largely unnoticed, was gradually gaining in explosive power. ☒

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A regular round-up on international monetary affairs



Of leaders and leadership

Strong men may follow where weaker ones fail

William Keegan, Chairman, Board of Contributing Editors

Unlike some of his more controversial successors – no names, no pack drill – at the International Monetary Fund, Jacques de Larosière never sought the limelight. When in Washington as managing director, he acquired a reputation for being more than happy to go home to lunch. But he has been an active participant in some stirring times. While long respected by those of us on the circuit, he passes, no doubt, unrecognised on the streets of London.

The former governor of the Banque de France is a reminder that, sometimes, those who achieve greatness not only do not seek it, but also seem vaguely unaware that they possess it. It arrives upon them, barely noticed. But it is there, all the same. I first encountered him when he took over at the IMF in 1978, after the kerfuffle over the IMF loan to the UK in 1976, and on the eve of the Latin American debt crisis of the early 1980s, in the resolution of which he is widely recognised to have played a major role.

De Larosière's style of leadership is courteous, meticulous, polished and urbane. During one of the dry-runs for what eventually became the European Monetary System and the single currency, he manifested wise prescience way back in 1975, saying, 'The creation of a European currency in no way causes the disappearance of the notion of the commercial balance and the balance of payments between member states. Some of these balances could be in permanent disequilibrium, as a result of divergent evolutions in productivity and prices.'

How those words ring true now, as Germany, the great gainer from the euro in balance of payments terms,

faces up to the corollary of those gains, namely that it is seen as the main euro area source of funds for rescuing the losers such as Greece, Portugal and perhaps Spain. There is publicly displayed political leadership, and there is leadership shown in the background by civil servants and diplomatists. It is a subtle relationship, because by definition civil servants are servants, yet the great ones can exert enormous influence. If and when they become, as seems to be the French system, central bankers, then their role becomes more manifest.

The generation of leaders trying to cope with the consequences of Kohl's and Mitterrand's action is widely criticised for being too weak.

As Banque de France governor, de Larosière was a key member of the Delors Committee, and famously agreed with the Germans that what duly became the European Central Bank should be fully independent, while agreeing that it should be counterbalanced by an 'economic government'. This battle is now being fought out in almost full public view, as modern leaders face up to the intrinsic fault in the euro's structure: the existence of a monetary union unaccompanied, as yet, by a fiscal union. The irony is that, after the fall of the Berlin Wall and the fears that arose about a reunited Germany, the single currency was forced through by very strong leaders, namely Helmut Kohl and Francois Mitterrand, who willingly gave up national sovereignty in the field of European money.

Two decades later, the modern generation of leaders trying to cope with the consequences of that action is widely criticised for being too weak. The different patterns of leadership are displayed, too, by Perfidious Albion – on the sidelines of the euro

tumult, happy, in its own self-interest, to contribute to rescuing one member of the euro area, namely Ireland, but reluctant to shell out for others. It was a determined leader, Prime Minister Edward Heath, who achieved British membership of the then European Community – helped to no small degree by his excellent relationship with President Pompidou.

Heath was strong on this issue, but proved relatively weak when trying to cope with Britain's trade unions. Mrs Thatcher, widely considered to be

another strong leader, was the beneficiary of Heath's failure. As the 'Iron Lady' she took on all around her – the trade unions,

Russian communism, General Galtieri of Argentina, and – in a long running battle – 'Europe'. Many people have forgotten how unpopular Mrs Thatcher was in the UK, and how she might well have lost the 1983 election but for victory in the Falklands.

An intriguing insight into her style of leadership came from Lord Gilmour, who as a Foreign Office Minister under Lord Carrington noted her reaction to the substantial progress the two had made in negotiating a 'rebate' for Britain's EU budgetary contribution. Gilmour realised: 'Her objection was to the fact of the agreement, not to its terms.' To her the grievance was more valuable, as a diversion from unpopular policies at home, than its removal.

That kind of thinking would be anathema to the coolly calculating mind of Jacques de Larosière, who took his principles with him to the bargaining table, but was acutely aware that capacity to find an agreement rests on the skilful weaving of compromises – an art in which he excelled. ☐