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OMFIF SUMMIT CONFERENCE REVIEW P.34-36

Risks, risks everywhere
Banking vulnerability heightened by euro measures

John Plender, Management Board

When the European Central Bank embarked on its long term refinancing operations last December, the move was applauded in the markets as a master stroke by the ECB's new boss Mario Draghi. Seven months later, with Spanish government bond yields at danger levels, and speculation of a Greek euro exit increasing, recognition has dawned that the ECB move has actually intensified incestuous relationship between over-indebted euro area sovereign debtors and undercapitalised banks.

This has increased risks on the asset side of the banks' balance sheets. Less well understood has been the deterioration in the liability side of that balance sheet following the Greek and Spanish bail-outs and the ECB's moves. This vulnerability remains despite the vaunted results of the end-June European summit, which set up a mechanism for direct capitalisation of ailing banks yet also greatly increased hostility to it from the leading creditor countries of Germany, the Netherlands and Finland.

Intense controversy about banking throughout Europe, epitomised by the growing fall-out of the Libor rate-fixing scandal in the UK and the lengthening shadows over Spanish institutions, represents an unpropitious backcloth for politicians' discussions on centralising supervisory arrangements and forging a banking union across the continent.

European banks have long been more vulnerable in terms of liquidity than their counterparts in North America and Japan. *(continued on page 6 ...)*

Denis MacShane is 100th advisory board member

Denis MacShane, former UK Europe minister (left), who has become the 100th member of the OMFIF Advisory Board, gave a rousing welcoming speech at the OMFIF summer party on 4 July in London, which marked the arrival of Gabriel Stein (right) as OMFIF Chief Executive. **SEE ADVISORY BOARD, P. 30-32, SUMMER PARTY, P. 37**

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Spanish steps
Stressful exercise

Michael Lafferty, Deputy Chairman

Spain's banks are being subjected to extraordinary scrutiny by consulting and accounting firms. First came a series of stress tests orchestrated by the Bank of Spain. On 11 July, it emerged that further tests might be imposed by the Troika authorities following the transfer of supervisory power from the Bank of Spain to the European Commission, IMF, European Central Bank and European Banking Authority.

The first set of tests were part of an effort by the Bank of Spain to show that additional capital requirements of the country's banks will be no more than the worst case €52bn to €62bn estimated on 21 June by 'top-down' stress test consultants Oliver Wyman (OW) and Roland Berger (RB).

Answers to the question of whether the Big Three banks – Santander, BBVA and La Caixa – were adequately capitalised will come only when external auditors complete their work in early autumn. In the meantime, there are signs that markets are running our of patience, with expectations rising that Spain will soon apply for a full-scale bail-out.

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Letter from the chairman

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(see p. 30-32 for more details)

Summer of strife

Trepidation laced with tension

David Marsh, Chairman

There's no evidence of a summer lull. The controversy over the wrong kind of interest rate fixing by London banks, the yo-yo fluctuations on forging banking union in Europe, America's advance towards the debt cliff and evidence of a further slowdown in the Chinese economy have kept financial markets on edge. This month's double edition embodies a selection of news and views marking the mood of the moment.

Trepidation is laced with tension. The euro may be a convenient scapegoat blamed by governments in different countries for their domestic ills, but the negative effect of the European sovereign debt crisis has now become a real world-wide issue. John Plender, who has become a member of the OMFIF management board in this month's strengthening of our team, describes how the European authorities' well-intentioned effort to break the nexus between sovereign debt and banking health has had the opposite effect. Michael Lafferty, who has become deputy chairman, portrays the parlous state of Spanish banks and the setbacks to the supervisory regime of the Bank of Spain. George Hoguet says emerging market economies, for all their resilience during the west's downturn, cannot function as a locomotive to pull the world out of its economic difficulties.

Meghnad Desai relaunches his long-running campaign to bring in a 'gold lining' to a refashioned Special Drawing Right. Michael Kaimakliotis focuses on the impact of economic uncertainties on the gold price, outlining trading strategies to take advantage of the euro's ups and downs. Gabriel Stein shows how currency pegs have once again come back into vogue, but warns they are no guarantee of long-term stability.

We bring two seminal statements by European central bankers. Jens Weidmann, the Bundesbank president, lays down his principles for restoring euro confidence. Peter Praet, board member responsible for economics at the European Central Bank, sums up how EMU has led to increased heterogeneity within the euro area – and what institutional changes are needed to deal with this.

Delivering a more gloomy interpretation of the end-June European summit, Stefan Bielmeier says the agreements have made a euro area collapse more not less likely. Pilar L'Hotellerie-Fallois provides a compelling account of how Spain has been brutally affected by the shift in balance between creditor and debtor nations. Zuzanna Gromiec and Pawel Kowalewski describe how European countries are shifting trading ties beyond the continent's borders.

In his monthly commentary on the Federal Reserve, Darrell Delamaide reports on frustration that the Fed is still sitting on its hands over possible further stimulus. Gus O'Donnell and Andrew Large outline their own somewhat differing recipes for combining monetary and financial stability. With regard to the overall financial market climate, corporate governance is an area of interest, too. Gerry Grimstone sets down his views on improving standards. We bring an overview of the proceedings of the OMFIF World Banking and Finance Summit on 26 and 27 June, where Gerry and others spoke.

One again, there are poems, from Meghnad Desai and John Nugée. And William Keegan supplies his traditional postscript, this time on the way that central bankers are condemned during a period of semi-recession to do no more than 'pushing on a string', a name, he says, which could be applied to a racehorse. We must hope that the summer does not see too many runners fall at the fences.

David Marsh

Emerging markets are no locomotive

Euro crisis casts long international shadow

George R. Hoguet, State Street Global Advisors

Risks to global economic activity are to the downside. The Great Recession has enhanced the relative position of emerging markets and their investment appeal, but they still are not large enough to serve as a locomotive for the world economy.

In a world of volatile capital market flows, piecemeal euro area policy and pre-emptive policy easing, emerging markets need to enhance domestic demand, strengthen fiscal positions, promote reduce reliance on exports and develop 'decoupling'.

The euro area crisis is exerting an increasingly negative impact. In a world of volatile capital market flows, piecemeal euro area policy and pre-emptive policy easing by emerging central banks, emerging markets need to enhance domestic demand, strengthen their own fiscal positions, promote aggregate supply to reduce reliance on exports and develop a long-term approach to 'decoupling'.

Emerging economies are expected to grow 4.5% in 2012, or more than four times as fast as developed economies, but Europe's widening recession and eclectic policymaking cast a growing shadow. According to the Taylor rule, monetary policy in most emerging economies is too loose, and real interest rates, as in the developed world, are negative. However, output gaps are substantially less in emerging markets.

Many emerging market central banks, which had been tightening policy in 2010 and early 2011, unlike their developed market counterparts, have effectively reversed course. Brazil, China, Turkey, Indonesia, India and Thailand have all eased policy this year.

This phenomenon, combined in some cases with exchange rate weakness caused by capital outflows from emerging markets as part of the 'risk off' trade, will probably lay the basis for future inflation in emerging markets. India, for example, reduced its repo rate by 50 basis points in April to 7.75%. But the latest year-on-year CPI reading registered 10.2%, and the rupee has fallen roughly 27% over the past 12 months.

The euro area sovereign/banking crisis negatively impacts emerging markets both in terms of the real economy and financial flows. The various channels include: trade, commodity prices, finance and the exchange rate/monetary transmission channel. Euro area output is now expected to contract by 0.5% this year.

So far, the feedback loop between sovereign and banking crises has yet to be broken. Not surprisingly, the Europe/Middle East and Africa region is the most heavily impacted. Both Hungary (-1.2%) and the Czech Republic (-1.1%) are in recession, and output growth in South Africa has slowed to 2.5%, versus 3.1% in 2011.

Regarding commodity prices, the Dow Jones AIG commodities index has fallen by roughly 12% from its February peak for the year.

A recent study by UBS suggests that major commodity exporter Brazil is, as measured by the Sov-X CDS index, one of the most heavily exposed countries to the euro area crisis, and that Latin America is the second most exposed region, after EMEA.

Of course, many factors other than euro area weakness have contributed to the recent sharp drop in crude prices. While emerging Asia benefits, Russia is negatively impacted. For example, the 2012 Russian budget assumes a Urals crude price of roughly $120 a barrel, versus the current price of roughly $90.

The finance channel includes banking flows, portfolio flows, direct investment and, of course, the potential for financial contagion. Some estimates suggest that euro area banks must reduce their balance sheets by roughly $2tn over the next 18 months. In its March 2012 Quarterly Review the Bank for International Settlements reports that asset shedding by euro area banks has reduced trade credit in Asia and Latin America.

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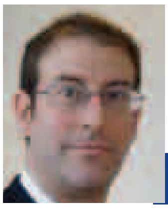

How euro crisis affects bullion

Strategies to profit from European certainty

Michael Kaimakliotis, Quantum Global Wealth Management

Holding gold strategically has been good advice since the start of the financial crisis. Beyond the strategic case for owning gold there are tactical issues that investors should consider. These can be especially important if the euro crisis escalates.

One issue that struck many investors by surprise last time we had a peak in financial stress, in 2008, was gold's performance. The yellow metal had rallied consistently since 2000, from $255 per ounce to $1002.9 on 17 March 2008, the day after Bear Stearns signed a merger agreement with JP Morgan Chase that effectively sealed its collapse. However, gold dropped 29% to mid-November 2008, when it bottomed. It rebounded, but took until September 2009 to surpass the level of March 2008. Prices have since skyrocketed

There were several reasons for intermittent weakness. Gold investors were forced to deleverage as margin requirements were increased and credit lines were cut. Much retail demand that had supported gold demand dried up. This was exacerbated by doubts about exchange traded funds, which investors had been using to gain exposure. Finally, the dollar strengthened sharply, rising more than 20% against the euro during the period when gold fell nearly 30%.

Let us recall: the crisis emanated from the US in 2008. Yet the epicentre is in Europe this time around. Investors might therefore be concerned that these factors could combine in even greater force to reduce the gold price if the euro crisis intensifies. Such tactical issues should be considered, even while the strategic investment case remains well-supported by the fundamentals. Gold should be buoyed as central banks continue to expand their balance sheets to ease the debt burdens which define the crisis.

Investors can consider several strategies – benefiting from the price decline from $1920 to $1570. First, they should consider financing gold exposures through euro rather than dollar funds, for example, by selling euros to purchase dollars and then buying gold. It can also be accomplished by selling euro/dollar forwards or futures and buying gold futures at the same time. This effectively gives the investor exposure to gold denominated in euros and not dollars.

Another strategy is to increase gold purchases as the price falls and take profits as it rises. This implementation strategy potentially allows the investor to gain access at an average price below the current levels. This strategy can be approximated by a put-selling strategy where the investor agrees to purchase at a price (say $1500) in 6 months. If gold falls below that level then the investor purchases the Gold at $1500 but also received the premium for selling the option which can reduce the entry price further.

There are several more sophisticated strategies that institutional clients find attractive. These take advantage of gold's high positive correlation to the euro/dollar rate – and markets imply that the correlation should remain positive. Investors expecting the euro to decline as the crisis intensifies but for gold to rally in response to the heightened financial stress can purchase options which pay $100 if gold rises while the euro falls on a six month outlook. The cost of these options is around $20. Investors can achieve a 500% return if that scenario materialises. (They lose the entire investment if it does not).

Other investors might consider looking at the implied correlations of gold to the euro/dollar rate. This correlation has fallen sharply during recent periods of stress. Indeed, it reached -0.42 last September before jumping back to nearly 0.80 earlier this year. The average correlation this year has been about +0.4. Markets are pricing in a correlation of +0.2 over the coming 6 months. Investors who expect the euro to fall but gold to rise can express that view tactically by selling the correlation. They will have positive returns if the realised correlation is less than 0.2.

Investors can gain exposure to gold denominated in euros and not dollars. Another strategy is to increase gold purchases as the price falls and take profits as it rises.

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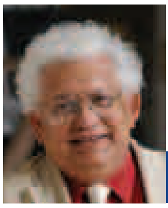


Preparing for a dollar shock

Gold could provide the contingency the world needs

Meghnad Desai, Chairman, Advisory Board

The world needs contingency planning to prepare for possible twin shocks at the end of 2012 from the dollar and the euro. It is fashionable to dismiss gold as a relic of the past or as an inadequate hedge against inflation. But the dollar and gold correlate negatively. No other reserve currency seems safe from the dollar shock. Gold will become pivotal if the dollar collapses in December under the weight of US budgetary problems.

Gold will become pivotal if the dollar collapses in December because of US budgetary problems. The world will race to safe havens. Gold may be the only one.

The world will race to safe havens and, by the New Year, gold may be the only one. It would make sense to prepare. Reform of the Special Drawing Right has been much mooted, but nothing has been done. I favour extending the SDR to include the R-currencies – renminbi, rupee, real and rouble plus gold. Gold would not need to be paid out, but its dollar or rouble equivalent would be if SDR had a gold content. By moving counter-cyclically to the dollar, gold could improve the stabilising properties of the SDR.

Time is of the essence. A large SDR issue improved by some gold content and the R-currencies is urgently required. In its absence, we may face a huge liquidity crunch as the US election produces an outcome beyond the nightmares feared about a Greek euro exit, and investors abandon the major currencies.

The background is made worse by the euro crisis. At each stage, we believe that the latest summit or the newest technical measure will produce a solution. And each time, it gets worse. The end-June summit came up with a package on banking union that will be very difficult to implement. Recapitalisation of Spain's Bankia failed to assuage anxiety. The Greek elections delivered a coalition government but no market confidence. The G20 sent forth a hopelessly ambiguous message as to what should be done. Anyone for Eurobonds? Not in Angela Merkel's lifetime. And she appears quite healthy for the time being.

In worrying about the euro, the world seems to be pretending that everything else is fine. This is not true. The deeper structural problem that brought us into this crisis should not be left unsolved. This is the problem of global imbalances.

The truth is this. China and Asia over-saved, partly because the IMF failed to come to their help in the 1997-98 Asian crisis. They piled up huge surpluses that they lent back to the US and the West. This lending triggered a low interest rate-fed bubble in western real estate. The money was not demonstrably invested in any other productive channels. Now that the boom has collapsed, the West must repay the debt. It has few productive assets to ease the repayment burden. If it relies on innovations to trigger the next long boom, it needs access to investment. Yet who will invest in western economies in such a precarious state?

In the meantime we have flooded our markets with cash – QE. But reforming the international system has been left undiscussed. The dollar is still the currency with exorbitant privileges which lie at the root of the global imbalances. The euro which could have formed a rival reserve currency has been badly hit. It has not depreciated as much as the headline 'euro woes' news would warrant, yet it is unlikely to replace the dollar as the key currency.

Trouble is bound to come once the US presidential election is over, if not before. This is because of the US debt situation. We may witness another cliff-hanger between the President and the Congress about extending the debt ceiling mid-year or have it start in November with a (lame duck?) president and an angry Congress. When that happens, the dollar will come under severe pressure. There is no reasonable way the US can face up to its debt problem. The economy may seize up if the Bush tax reforms lapse due to a lack of agreement between the White House and the Hill. The depression that would follow would be a huge one.

Be watchful. Something may happen. And gold could provide a way out.

Risks, risks everywhere (... continued from page 1)

Their ratio of loans to retail deposits rose from around 120% before the crisis to around 130% soon afterwards. It has more or less stuck at that level ever since. Yet with official lenders replacing private sector lenders as trust has evaporated in wholesale markets, the liability side of euro area bank balance sheets has become more risky in a different way – one, moreover, which threatens to turn the unsecured sector of the bank debt market into a no-go area for private sector investors.

Part of the problem lies in the subordination of debt held by private sector investors to official creditors such as the ECB, the national central banks (NCBs) and the European Investment Bank. This arises for example, from Greece's voluntary debt exchange. The €100bn rescue for Spanish banks could exacerbate the position of unsecured bank creditors if channelled through the European Stability Mechanism, which enjoys preferred creditor status second only to that of the IMF. The consequence of such a retrospective change in creditor status would be to increase credit risk on private sector holdings of government bonds.

This comes amid growing asset encumbrance in euro area banking. Banks have been forced to pledge more of their assets as collateral for new debt issues. These assets are no longer available to banks' unsecured debt holders in the event of failure. As the Bank for International Settlements points out, this leads to a vicious circle where the riskiness of unsecured debt makes collateralised debt even more attractive to investors. If private funding sources withdraw, banks have to use collateral to get official support, further encumbering their balance sheets.

The Greek banking sector provides an extreme example of this syndrome. The ratio of encumbered to total assets rose tenfold between 2005 to 2011 to one-third of the overall balance sheet. For Italian, Portuguese and Irish banks, the ratio more than doubled over the same period. This has systemic consequences. The higher the proportion of pledged assets, the more vulnerable a bank becomes to margin calls if the value of the collateral depreciates. A system-wide shock would force many banks to replenish collateral simultaneously, so weakening the intermediation capacity of the system. Not surprisingly, the supply of high quality collateral has been shrinking, encouraging banks to re-hypothecate, or pledge the same assets, several times. This can do further systemic damage by reinforcing the adverse impact of simultaneous margin calls.

All of this underlines a fundamental point. Aggressive monetary easing and the use of central bank balance sheets for financial stability are necessary to buy time. Yet they can make the task of balance sheet repair and rebuilding confidence in the banking system harder. The task is doubly difficult when equity markets are signalling that for them to act as a deus ex machina for undercapitalised banks is out of the question.

Spanish steps (... continued from page 1)

Seven advisory firms are involved in different forms of stress-testing. OW and RB, headquartered in London and Munich respectively, were commissioned to 'simulate the impact of two macroeconomic scenarios on the credit portfolio of 14 Spanish banks for the years 2012 to 2014'. Promontory, a consulting firm composed largely of former bank supervisors, was engaged by the Bank of Spain 'to provide assistance, advisory services, and expert judgement on the… stress tests performed by OW and RB'.

Meanwhile, the Big Four audit firms are undertaking a 'bottom-up' exercise 'to independently verify the accuracy of the financial conditions of individual banks.' Boston Consulting Group has been appointed as a project manager of the four audit firms and is seemingly happily working together with the other entities 'to conduct a comprehensive, independent analysis of banks' credit portfolios.'

In a strangely elongated process, OW was to use the audit firms' work 'as a new input for a second… stress-test exercise to identify bank-specific capital needs'.

For this it would seem that it will only need to look at the 11 smaller banks. One might be forgiven for getting the impression that the Bank of Spain was orchestrating this over-elaborate process to provide answers that it would be comfortable with.

Emerging markets are no locomotive (... continued from page 3)

In another example of a 'relocalising world', some euro area banks are divesting parts of their emerging market operations. Banco Santander contracted to sell its operations in Colombia, a country it previously identified as a growth market.

In general, as the downgrades of euro area banks and sovereigns continue to accumulate, the relative position of Chinese banks is enhanced. Net portfolio inflows to emerging equities surged to roughly $96bn in 2010, as world trade rebounded. But in 2011 and 2012, as the Greek situation deteriorated, flows turned negative.

As the euro area crisis has intensified and the dollar has increasingly assumed safe haven status, emerging currencies have depreciated sharply against the dollar. For example, over the past 12 months, among the larger markets, the Brazilian real has fallen roughly 30%, the rand 25%, and the rouble 19%. And of course the renminbi's pace of appreciation has slowed.

Emerging markets are more than ever subject to the 'risk on/risk off trade'. While individual countries vary, emerging market assets cannot, in general, serve as a safe haven for investors. If economic activity in the euro area weakens further, the prospect of QE3 in the US grows more likely. With nominal yields in emerging markets well above those in developed markets, flows to emerging markets debt and equity are likely to accelerate. This may well be storing up problems for the future.

The future of currency pegs

Poised between inflation and deflation

Gabriel Stein, Chief Executive

Foreign exchange regimes come and go in waves. Since different standards have different effects and consequences, their popularity tends to be formed by past events. Are we currently seeing such a shift in attitudes?

The question of exchange rate pegs has again come to the fore, from three different directions: Switzerland, Denmark and Hong Kong.

In the post-war era the world has passed through a number of waves, from devotion to fixed exchange rates (Bretton Woods) to full floating. Over the past 20 years, there has been wide divergence. Some countries – notably members of economic and monetary union (EMU) – have moved back to fixed exchange rates and monetary union. Others, e.g. the Nordic countries and the UK – have experimented with pegs and ultimately abandoned them. A further group, notably some emerging economies such as China and its hinterland, remains committed to pegs of different kinds.

The question of exchange rate pegs has again come to the fore, from three different directions. Last year, the Swiss National Bank (SNB), announced it would set a ceiling of 1.20 Swiss francs per euro. The SNB remains an inflation-targeting central bank (aiming at below 2% inflation). What would happen if defending the peg led to a rise in inflation? For the moment, the desire to stop the franc's rise means that the peg takes precedence.

A second casualty of the euro crisis is Denmark. The krone is pegged to the euro. However, capital seeking a safe haven is flowing in, putting upward pressure on the currency and leading the central bank to contemplate negative interest rates to stem the tide.

Third, the architect of one of the more successful recent pegs, Joseph Yam, former chief executive of the Hong Kong Monetary Authority, has published a research paper where he questions whether the peg between the Hong Kong and the US dollars is still the best foreign exchange regime for Hong Kong, suggesting a possible peg to the renminbi instead. Although emerging Asia tends to be characterised by currency pegs, the assumption been that these eventually will disappear. Dr. Yam's paper raises the issue whether currency pegs will in fact be perpetuated, although they will need to change according to circumstances.

The answer depends on the aim of monetary policy. For most exporters, the level of the exchange rate matters less than its stability. For a small export-dependent economy, this can be provided by a currency peg. The Danish case shows the peg can become a cause of instability if it is perceived to involve a one-way bet with upside and no downside. Moreover, a currency peg involves adopting the monetary policy and inflation of another country. That may be suitable if the two countries are similar or have closely intertwined economies – one reason behind the Danish peg or a potential HK$/RMB peg – but not if they differ substantially. Past pegs between sterling and the dollar or the D-Mark show this

The larger and more important an economy becomes, the less suitable it is likely to be to take on the monetary policy of another country. This is perhaps even more the case now, when the relative importance of emerging markets is growing, and when heavily indebted countries – including the world's largest economies – may be tempted to inflate away their debt. It is one thing to peg to the dollar – directly or indirectly via the renminbi – or the euro if the Fed and the European Central Bank can be relied upon to keep inflation down. Should they – however unlikely and politically suicidal – choose the inflation route, the pegs would quickly prove dangerous – and be abandoned.

Pegs may function as temporary expedients. But, ultimately, if a country wishes to remain in charge of its own monetary policy, they are unworkable. Moreover, as the Chinese example shows, an attempt to maintain a persistently undervalued exchange rate can lead to political rancour with trading partners. In a fixed exchange rate arrangement either the overvalued country deflates or the undervalued one inflates. So they are no guarantee of long-term stability.

A more stable euro framework

Question marks remain over way forward

Jens Weidmann, President, Deutsche Bundesbank

The crisis has exposed the weaknesses of monetary union. Some member states experienced severe unsound developments in their financial system, their national financial policies or their economic structures. These were developments which the institutional framework both failed to prevent and underestimated in terms of their impact. The foundation of monetary policy proved to be too weak. This means the foundation must be strengthened and deepened so that the euro area remains a stability union and once again engenders confidence.

We need clarity how this objective should be achieved. This refers to the depth of intended integration and on any concomitant transfer of responsibilities from the national to the European level. We must find a coherent framework that clearly allocates responsibilities. This requires political consensus which in turn makes necessary the approval of the public for the design of the treaties and constitutions.

In principle, there are two approaches to achieving a stable monetary union. First, the member states could return to the principles stipulated in the Maastricht treaty and in their current constitutions. Emphasis must be put on both sides of individual responsibility, whereby the member states make their own decisions and bear the consequences themselves.

The guiding principles here are national sovereignty and subsidiarity. In this option, fiscal and economic policy would remain chiefly a national responsibility, as does the stability of national banking and financial systems. Strong incentives would be in place for member states to pursue stability-oriented policies: a strict overall policy framework and interest rate premiums on these countries' capital market debt that reflect the soundness of public finances. In such a scenario, there is no place for a system of far-reaching joint liability.

To implement this approach, the current framework should be strengthened by intensifying crisis prevention measures further. This comprises, in particular, a macroeconomic surveillance procedure, as it is just being established, and tighter restrictions for fiscal policy, including improved monitoring and implementation.

It would continue to be up to member states to lower deficit and debt ratios, enabling public finances to absorb macroeconomic shocks without endangering a state's solvency.

Furthermore, the financial and banking system would have to be made much more robust to limit contagion despite ever closer financial ties. Increasing resilience to future shocks necessitates further improvements to regulation and financial supervision. If properly designed, a crisis resolution instrument, such as the ESM, could provide a vital contribution to stabilisation.

At present, I see the danger that the increase in joint liability threatens to overstretch the existing institutional framework. We are reaching a degree of mutualisation of risks that goes well ahead of the possibilities for necessary control and intervention – posing an acute threat to the balance between liability and control.

Because of this tendency, we have to consider an alternative to a 'return to Maastricht'. This alternative is the transition to a true fiscal union, now the subject of intense debate. This idea is not new. This issue was a topic of debate at the Bundesbank long before monetary union was established.

The concept of a 'fiscal union' is difficult to pin down and can take a number of forms. If it is adequately structured, a fiscal union can be the cornerstone of a coherent institutional framework for monetary union.

Increasing resilience to future shocks necessitates further improvements to regulation and financial supervision. If properly designed, a crisis resolution instrument, such as the ESM, could provide a vital contribution.

However, even a fiscal union can by no means solve the problems that many countries are facing today such as financial imbalances, low growth, high unemployment or a lack of competitiveness. The need for adjustment via ambitious consolidation measures and structural reforms would still exist. In the end, a fiscal union would probably require an even closer oversight with regard to macroeconomic imbalances in the member states. Above all, however, the transition to a fiscal union would by no means guarantee a stability union. Of utmost importance is a common European stability culture truly shared by everybody.

Precisely those countries which face acute financing problems and a severe loss of confidence in their own policies are calling most loudly for joint liability.

The focus of the debate has been the issue of joint liability. The idea that simply introducing joint liability could solve all current problems is just as delusional as the belief that the single currency would automatically guarantee economic prosperity. Such measures may help to cover up unsound economic developments, but they are not the answer to reform fatigue in Europe. The disciplining effect of the financial markets would be undermined; and reform incentives would diminish.

Eliminating an important corrective for national economic policy would not only counter stability-oriented monetary policy; it would also deal a severe blow to Europe's economic outlook in a globalised world, where a host of countries are quickly gaining ground on the advanced economies.

Furthermore, the creditworthiness of the countries providing assistance would be put at risk. Joint liability can be introduced only at the end of the integration process of a fiscal union, not at the beginning. Especially in a fiscal union, joint liability must be coupled with measures to maintain and strengthen incentives for economic reform and fiscal consolidation. Liability and control must be brought into line, and a fiscal union must be structured to promote not undermine stability.

This principle holds equally true with regard to a financial market union. In general, efforts to further improve banking supervision are welcome and important. Centralised supervision at the European level could be an important element of a more integrated EMU framework. But here – as with a fiscal union – design and sequencing are crucial. In any case, a recapitalisation of banks with European funds would have to be embedded in a new institutional framework for banking supervision.

A mutualisation of existing risks would transform the balance of liability and control. Recapitalising banking via European funds will only be possible if an effective European supervisory structure is established, and investors and, where necessary, national member states have assumed full responsibility for existing risks.

Many questions regarding the design of a new regulatory structure are still unanswered. In my view, a banking union has to be accompanied by more integration in the economic and fiscal realm. Not doing so would mean to ask too much of the new supervisor. And, if indeed the ECB were to assume this role, additional challenges arise in terms of conflicts of interest and legitimate claims for parliamentary control over supervisory decisions.

Not surprisingly, precisely those countries which face acute financing problems and a severe loss of confidence in their own policies are calling most loudly and emphatically for joint liability. Equally understandably, the aim is supported by the European institutions, which, by their very nature, advocate greater European centralisation.

It is worth noting that advocates of joint liability are often from those countries which are the most opposed to surrendering national sovereignty on fiscal policy. It is clear that joint liability promises to deliver benefits and extend a country's room for manoeuvre, whereas fiscal union could restrict a government's policy scope. As understandable as such a stance may be, a stable union cannot be founded on this basis. My impression is that Germany is much more open to surrendering national sovereignty than many partner countries.

To establish a stability-oriented fiscal union, I believe euro area countries need to do two things: submit to strict budgetary rules; and hand over sovereignty in some areas to a central authority that effectively monitors compliance with the rules and, crucially, enforces them.

If these conditions are met, it would be acceptable, though not necessary, for countries to bear some financial risks on a joint basis. But again, the sequencing is crucial. The different steps towards building such a mechanism for joint risks have to be taken in the right order, to guard against the whole process coming undone.

How might a stability-oriented fiscal union be structured? There are many options, depending on how far capacity is shifted to the European level, revenue and spending powers are centralised and transfer elements are extended. My thinking is based on extrapolating the status quo: in other words, as much subsidiarity as possible in the form of national fiscal and economic policy responsibility.

This gives rise to a number of minimum requirements for a stability-oriented fiscal union, making allowance for a range of economic policy cultures in the member states, There are, after all, major differences in that respect, even between Germany and France. In Germany, government spending is 46% of nominal GDP, whereas the figure for France is 56%. And while Germany has responded to the demographic challenges with a phased increase of the retirement age to 67, France is now, in some cases, reversing a recent increase in the retirement age from 60 to 62.

The core element of such a fiscal union limited to the absolute essentials consists of strict and effective budgetary rules with a ceiling on national borrowing. Given the experience of the past few years, this would not be monitored by the European Commission or the Ecofin Council, but ideally by a new, independent euro area institution. Where a country does not abide by the budgetary rules, national sovereignty would be automatically transferred to the European level to ensure compliance.

Jean-Claude Trichet, the former ECB president, describes this as 'federalism by exception'. One option would be for the euro area institution itself to carry out tax increases or spending cuts, not simply to call for them. As long as the country in question complied with borrowing and debt limits, it would largely retain national sovereignty and fiscal policy decision-making capability. In that kind of framework, consolidation paths would be safeguarded at the European level even if no majorities were to be found in the relevant national parliament.

Along with the credible establishment of such a framework which reliably safeguards compliance with the fiscal rules, a joint liability of euro member states could be introduced, say, by issuing jointly guaranteed bonds.

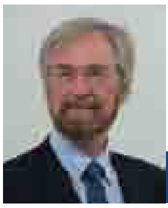
Before reaching such a stage, important obstacles would have to be overcome. A fiscal union would need comprehensive democratic legitimacy. It is a matter of a quantum leap. European integration involves handing over national sovereignty and self-determination. This can only happen with the approval of the general public.

All this takes time because the process is lengthy and has to be made transparent. An opaque fiscal union, introduced by circumventing existing regulations and standards, or left to the whims of everyday politics, would be built on sand, and not sustain a stability union. The recent past shows that, in monetary union, Germany's interests are protected by existing treaties and a German veto. In future processes, Germany believes in the crucial condition of a consensus framework for a stability-oriented fiscal union that is secure and cannot be overturned by majority decision.

By outlining these caveats, I am by no means arguing against deeper integration, quite the opposite. But just as the existing decentralised framework of the euro area has had its shortcomings, deeper integration by itself is not a guarantee of a stable monetary union – especially not if you take the second step before the first. A stable monetary union does not depend on the 'United States of Europe'; but without a stable currency and a matching fiscal framework there will be no permanent stable political union.

This article is based on a revised, edited and abbreviated version of the address by Mr Weidmann to the ZEW Economic Forum in Mannheim on 14 June 2012.

A stable monetary union does not depend on the 'United States of Europe'; but without a stable currency and a matching fiscal framework there will be no permanent stable political union.



Effects of heterogeneity

Euro gave rise to moral hazard

Peter Praet, Executive Board Member, European Central Bank

When the euro was introduced, many critics claimed that economic and monetary union (EMU) would not work because euro area countries' business cycles and economic structures were not sufficiently similar. But does economic integration really need to imply economic uniformity? I do not think so. This can clearly be seen in the US.

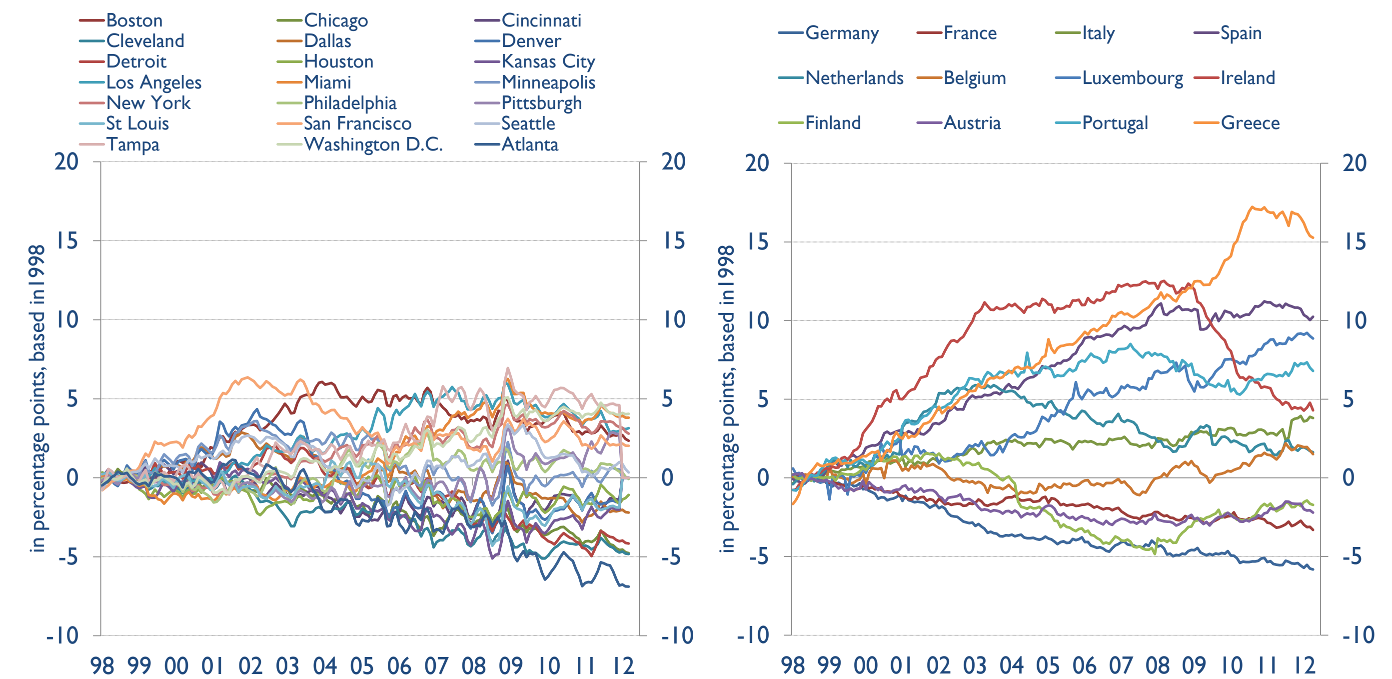
Regional economies are hit by different economic shocks and perform differently owing to their differing economic structures, even over extended periods. At the same time, institutional safeguards are required to ensure that heterogeneous developments do not become self-reinforcing and pose a threat to overall macroeconomic stability.

In the euro area, we have to acknowledge that economic conditions have become increasingly heterogeneous. But this does not imply that a common currency cannot succeed. We need to address the institutional shortcomings and weaknesses of EMU to allow the euro area to cope with heterogeneous economic developments and large asymmetric shocks, as is the case in the US. There, too, economic and monetary union did not occur overnight; it was a long process.

Since the introduction of the euro, many of us have been aware of institutional deficiencies, both in terms of the prevention of imbalances and regarding the management of such imbalances in the event of a crisis. The crisis is now forcing us to address these issues. In doing so, we need to look at how and why imbalances arose in the euro area and how the ECB's monetary policy responded to them.

Before the financial crisis, euro area countries achieved a very high degree of convergence in financial conditions. At the same time, large macroeconomic and financial imbalances were gradually accumulating. With the advent of the euro, euro area banks were able to trade with one another in a unified money market. Consequently, there was significant convergence in the interest rates that banks charged households and firms. Indeed, these are necessary conditions for a single monetary policy that affects all economic agents in the same way.

Chart 1: Persistent inflation differentials – euro area against US



Source: Eurostat, Centre for European Reform.

However, the sovereign bonds of the various euro area countries were also priced at rates that were very similar. These rates bore little relation to countries' fiscal and macroeconomic fundamentals. With the benefit of hindsight, this is a puzzling outcome.

Clearly, a single monetary policy should imply a single money market interest rate, as well as a single long-term risk-free interest rate. And with inflation expectations converging across the euro area, sovereign bond yields could be expected to become less dispersed.

However, despite the single monetary policy, differences in the credit risk of individual countries, consumers and firms remained. But financial markets were less wary of such risks, thereby establishing improper incentives for public and private sector borrowers.

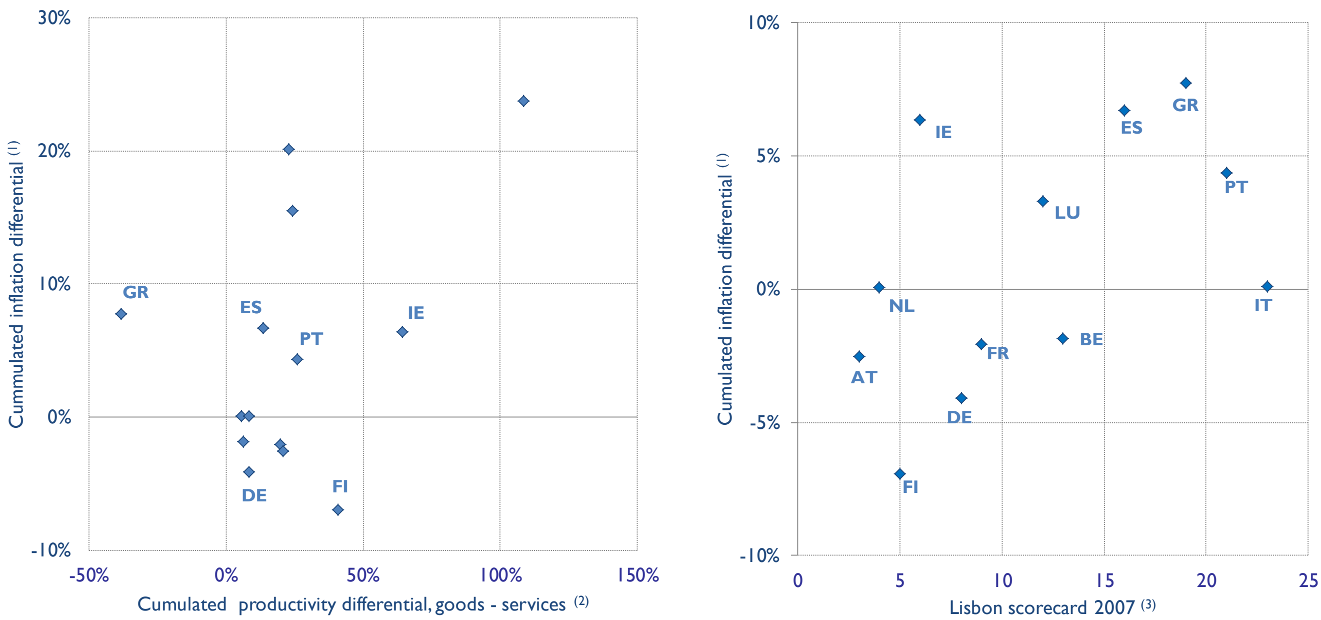
One simple summary indicator of the degree of economic heterogeneity is cross country inflation differentials. These reflect differences between countries in the business cycle, productivity growth and the functioning of labour and product markets. They also affect countries' real interest rates, as well as the international price competitiveness of their goods and services. Monetary union resulted in inflation differentials in the euro area falling to a level comparable to the US. However, although the two areas had similar inflation differentials, they were more persistent in the euro area. As a result, euro area inflation differentials led to a divergence of relative prices that was twice as large as in the US [Chart 1, p. 11].

The main reason behind these persistent inflation differentials reflected differences in implementation of structural reforms especially in product and labour markets. Consequently, wage growth exceeded productivity growth and prices rose faster than in other countries [Chart 2, below]. These inflation differentials led to divergent developments in international competitiveness and contributed to unprecedented current account imbalances in the euro area [Chart 3, p.13].

In a number of countries, this led to economic activity gradually shifting away from the export-oriented manufacturing industry towards the domestically-oriented construction sector. Because sectoral reallocation is typically slow, adjusting these countries' economies is very challenging. In addition, in most countries there is a high degree of downward wage rigidity, which is a further impediment to rapid adjustment.

Moreover, persistently higher inflation rates in some countries implied persistently lower real interest rates, particularly in light of the high degree of convergence in terms of nominal lending rates. Countries with lower real interest rates experienced stronger credit growth and housing booms, which placed further pressure on wages and prices [Chart 4, p.14]. Lower real

Chart 2: Sources of inflation differentials – euro area against US



Notes:
1.HICP, 2000 to 2007.
2. Productivity based on total employment, 2000 to 2007, total industry (excl. construction) vs a selection of services.
3. This measures the implementation of the Lisbon strategy. The higher the score, the less the strategy has been implemented.

Source: Eurostat, Centre for European Reform.

interest rates allowed governments to borrow on easier terms, slowing fiscal consolidation.

Governments did not adopt sufficiently counter-cyclical policies to limit their own accumulation of debt or to counteract the accumulation of debt in the private sector. In fact, because those economic booms were based on stronger domestic consumption and rising property prices, they led to improvements in cyclical fiscal balances as long as the boom went on, so that governments had few incentives to tighten fiscal policy before the bust set in.

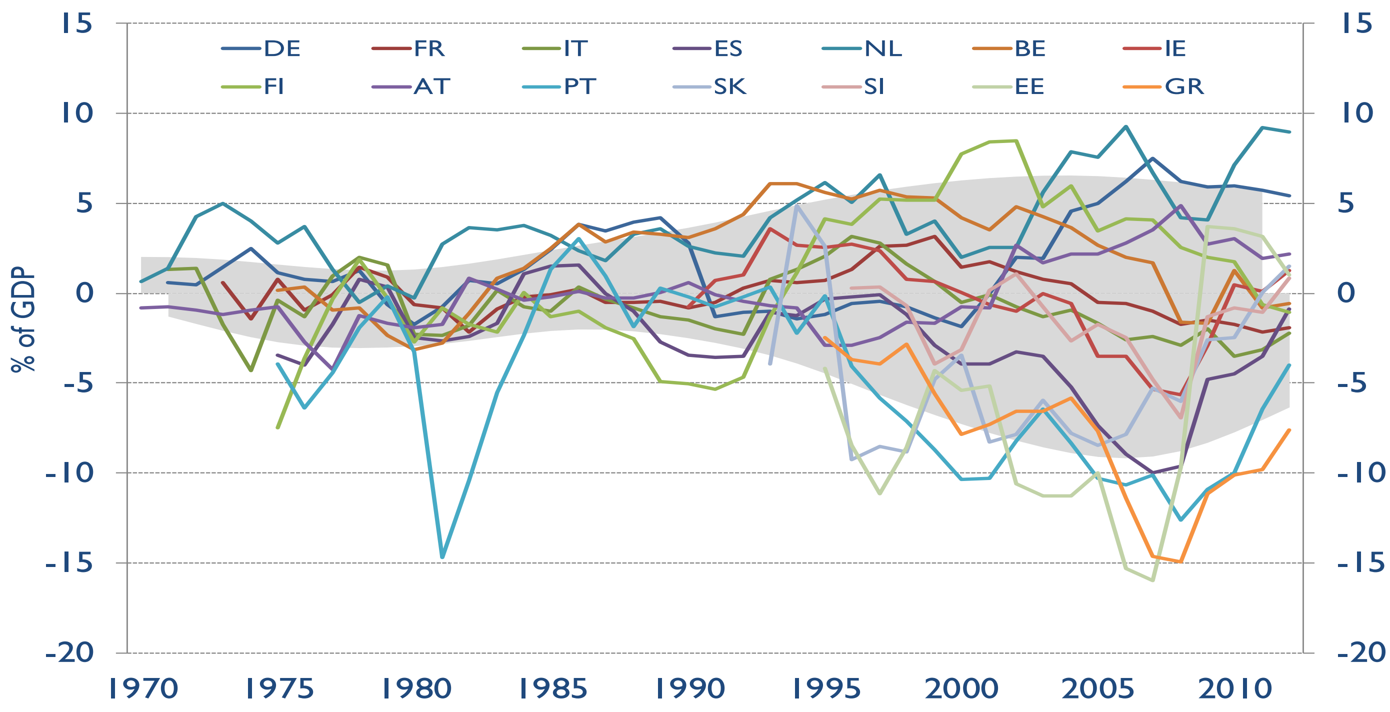
The institutional design of the euro area has clearly given rise to moral hazard and lacked the capacity to engage credibly in measures to prevent rising imbalances. Although there was an unseen accumulation of debt in some euro area countries, financial markets set financial conditions in such a way that private and public sector borrowers in those countries could continue to borrow at the same interest rates as borrowers in countries with much sounder fiscal and macroeconomic fundamentals. As a result, financial flows ran from countries with strong productivity growth to countries with weak productivity growth, fuelling a persistent economic boom based on the accumulation of debt. To be efficient, financial flows should instead have run towards countries with higher levels of productivity growth.

The financial crisis has led to a strong increase in heterogeneity within the euro area. The re-emergence of cross-country differentials in financial conditions has prompted further divergence in macroeconomic and financial fundamentals. Conversely, these heterogeneous financial conditions mainly reflect persistent fiscal, macroeconomic and financial imbalances, as well as persistent structural problems in several countries.

The first dimension of heterogeneity concerns real economic developments. Some countries have recovered well while others continue to be affected by persistent structural problems. Some macroeconomic imbalances have begun to adjust. Competitiveness has improved in countries where labour costs persistently exceeded the euro area average. The second – and most evident – dimension of heterogeneity applies to the sharp divergence observed in financial conditions in euro area countries. During the crisis, secured and unsecured money markets have become increasingly impaired, especially across national borders. Countries' sovereign bond yields have diverged significantly. Corporate bond markets have experienced tensions. Overall, there is ample evidence that country-specific factors have become more important in driving yields.

Fragmented euro area financial markets emerged in the aftermath of the Lehman Brothers' default and intensified with the sovereign debt crisis in May 2010. Financial integration came to a halt and was partly reversed. Non-bank debt securities were increasingly purchased domestically, with non-domestic euro area holders selling these bonds [Chart 5, p.15]. Euro area countries' financial sectors retreated within national borders.

Chart 3: Current account as percentage of GDP – euro area



Note: The grey area represents the difference between the HP filtered trend of the 90th and 10th percentile of the current account balances across countries.

Source: OECD and ECB calculations.

As a result of those fragmented financial conditions, the transmission of the ECB's monetary policy stance was increasingly impaired. Banks in countries with strained government finances faced restricted access to the money market and other sources of financing, given the interconnectedness between banks and sovereigns. Had this been allowed to continue, these funding restrictions would have hampered growth in credit to households and non financial corporations, resulting in a credit crunch in several parts of the euro area, with negative consequences for the economy and price stability.

In reacting to this, the ECB's monetary policy remained guided by the objective of ensuring price stability for the euro area as a whole. Key ECB interest rates have been reduced significantly. Non-standard measures were adopted to support the functioning of the monetary transmission mechanism by bringing back liquidity to dysfunctional markets.

Overall, banks' recourse to refinancing operations has been particularly strong in countries most affected by the crisis. While open to all, the ECB's non-standard measures have been used most intensively in countries facing financial stress. Cross-country differences in non-standard measures have largely reflected heterogeneity in financial conditions across the euro area.

The extent of the heterogeneity in banks' financing needs can be inferred from national central banks' balances in Target 2. These balances reflect the national central banks' net claims or liabilities resulting from commercial banks' cross-border payments. Increasing net liabilities of some national central banks mainly reflect funding stress in individual banking systems, with financial outflows compensated for by increased recourse to Eurosystem refinancing operations [Chart 6, p.15].

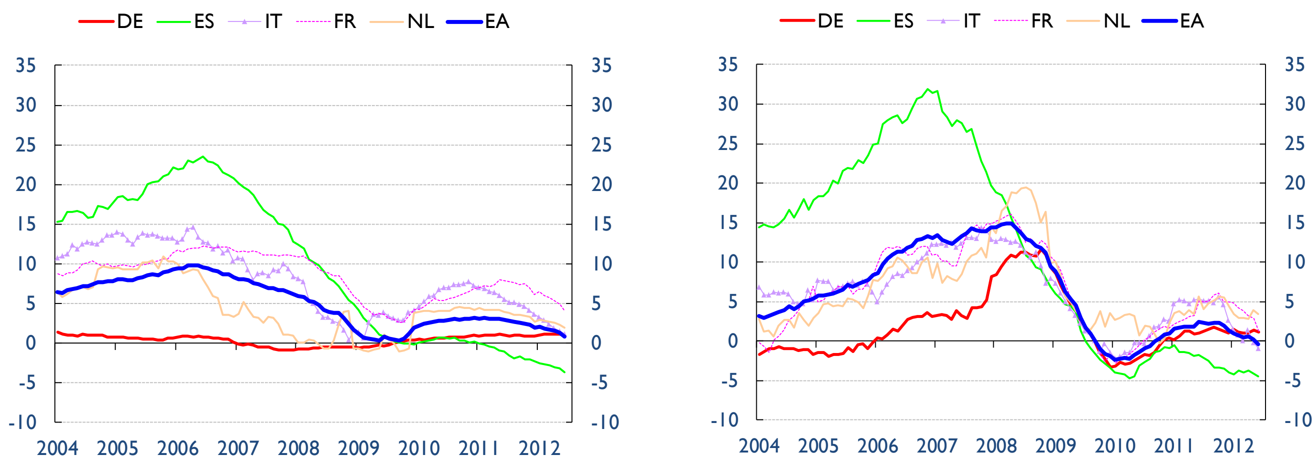
Our policy measures have increased the ECB's intermediation between banks. Looking at the interbank market, reduced willingness to lend, especially across borders, has hampered the distribution of liquidity to those banks that most need it. Increases in deposits held with the Eurosystem in financially strong countries reflect money market disintermediation [Chart 7]. Banks in such countries tend to be recipients of cross-border payment flows and therefore need less central bank liquidity than banks in countries facing financial stress.

The surplus of central bank liquidity in banks in financially stronger countries has raised concerns that such liquidity could fuel asset price bubbles in parts of the euro area, potentially posing a threat to price stability. These concerns are currently not justified. Thus far, only a moderate recovery has been seen in asset prices. As regards housing markets, developments in money and credit – traditionally good leading indicators of booms in house prices – have remained subdued. However, we will continue to pay close attention to such developments.

Looking ahead, further steps will be needed to supplement the single monetary policy with a more integrated framework for bank supervision, resolution and deposit insurance, as well as far more extensive coordination of government policies affecting competitiveness. If we are to achieve this, euro area countries will inevitably need to surrender more national sovereignty and increase policy coordination. The global economy is becoming increasingly integrated and the importance of national sovereignty has been waning. In an integrated world, countries cannot decouple themselves from developments elsewhere.

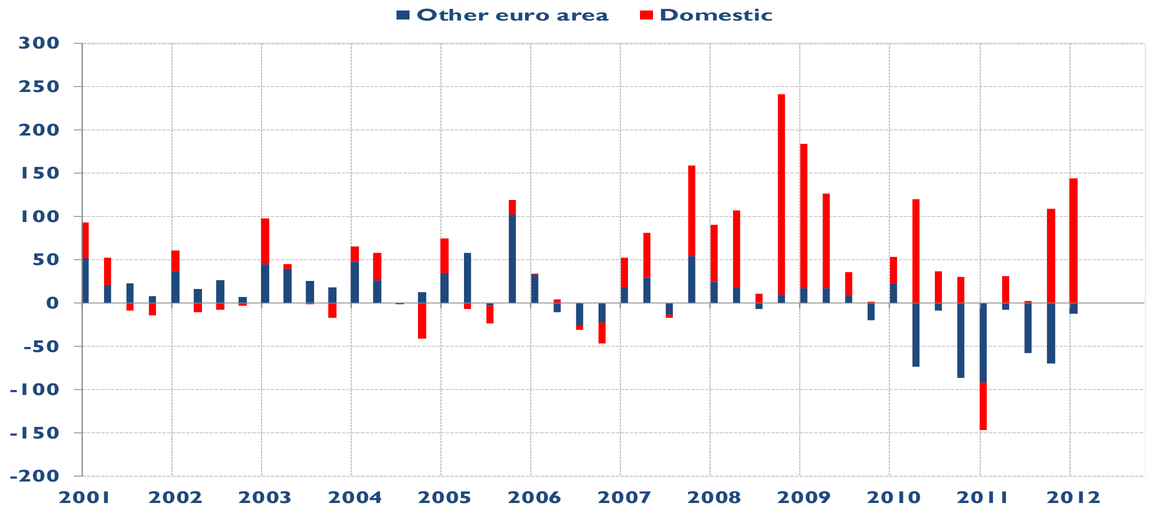
This article is based on an abbreviated version of the address by Mr Praet to the ECB and its Watchers Conference on 15 June in Frankfurt.

Chart 4: Lending to non-financial corporations and households in euro area



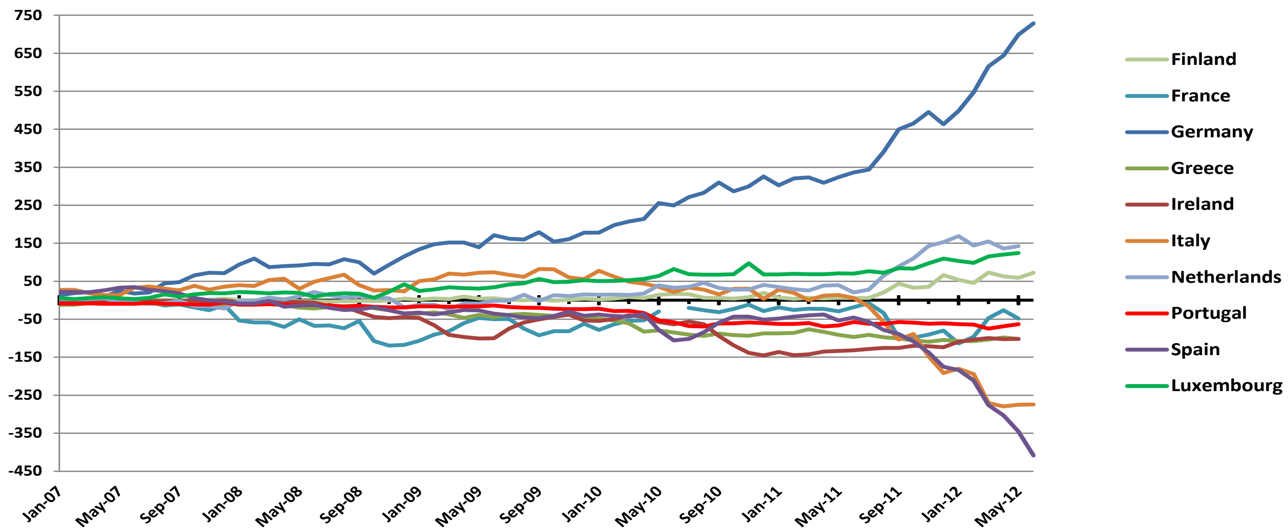
Note: Latest observation is for June 2012.
Source: ECB and ECB calculations.

Chart 5: Financial Flows – domestic versus other euro area



Notes: "Domestic" shows purchases by MFIs in a euro area country of government and (non-bank) private sector debt issued by that country. "Other euro area" shows purchases of such debt by MFIs in other euro area countries.
Source: ECB and ECB calculations.

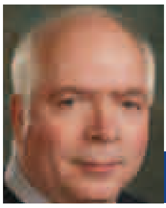
Chart 6: Net balance with the Eurosystem / Target-2 – €bn (updated with June 2012 figures)



Source: Institute of Empirical Economic Research - Universität Osnabrück

Chart 7: Eurosystem's deposit facility

Note: Latest observation is for June 2012.
Source: ECB and ECB calculations.

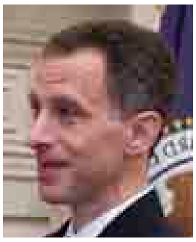


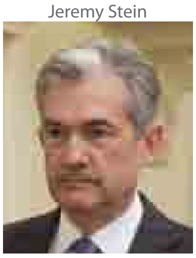
Fed disappoints on stimulus

Stronger action may be taken soon

Darrell Delamaide, Board of Contributing Editors

The decision of the Federal Open Market Committee at its June to meeting to take only the modest action of extending Operation Twist – the gradual extension of maturities in the Fed's portfolio of securities – for another six months frustrated Fed watchers who felt the US central bank's vaunted new communications effort had indicated a stronger accommodative action. Further Fed comments in early July have heightened the mood of uncertainty about the central bank's next move.


Jeremy Stein


Jerome Powell

'It strikes me as sloppy communications strategy,' complained one who thought officials had indicated that deterioration in the growth forecast with moderating inflation data and more downside risks would bring stronger action.

So the focus has now shifted to the two-day meeting ending on 1 August and whether the FOMC will decide on a new round of quantitative easing if conditions continue to deteriorate. Some even saw the June action as a 'soft launch' for QE3, paving the way for a formal announcement in August. Easing action early in July by the European Central Bank, the Bank of England and the People's Bank of China could pave the way for further Fed moves.

The seven members of the Board of Governors and the heads of all 12 regional Fed banks take part in the monetary policy meetings of the FOMC, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation.

With the addition of two new governors, **Jerome Powell (voter)** and **Jeremy Stein (voter)**, the Fed board was represented on the FOMC at full strength for the first time since 2005, Chairman **Ben Bernanke (voter)** said. He said the two new members were in a 'listening mode' at their first meeting. They both approved the Fed's action and statement. In fact, the only dissent came from Richmond Fed chief **Jeffrey Lacker (voter)**, who opposed the extension of Operation Twist.


Ben Bernanke

Bernanke defends stance at press conference

Reporters' frustration was evident at Bernanke's press conference as questioner after questioner bored away at the fact that unemployment was forecast to remain well above levels the Fed considers acceptable while inflation remains well below those levels. So why wait?

Bernanke's response was that the extension of Operation Twist was a 'significant additional step' and that the Fed was ready to do more if necessary. He added that these unconventional monetary measures have 'costs and risks' associated with them. 'I don't think they should be launched lightly,' he said.

In other responses, Bernanke suggested that the May jobs report, which showed a disappointing addition of only 69,000 jobs, 'may have been exaggerated by issues related to seasonal adjustment.' Many economists suspect that this year's mild winter spread out the spring hiring rush over several months so that the normal seasonal adjustment is over-correcting this year. The committee may want to see the underlying trend more clearly.


Janet Yellen

Doves raised expectations

It was a speech by Fed Vice Chairman **Janet Yellen (voter)** in early June, just after the release of the May jobs report, that led many Fed watchers to expect stronger action at the meeting later that month.

'Recent labour market reports and financial developments serve as a reminder that the economy remains vulnerable to setbacks,' she said at a Boston Economic Club dinner. 'In our policy deliberations at the upcoming FOMC meeting we will assess the effects of these developments on the economic forecast.'

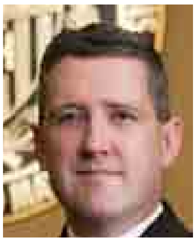
She went on to say that if the committee found that recovery is unlikely to proceed at a satisfactory pace (they did seem to find this), or that the downside risks to the outlook had become sufficiently great, or that inflation appeared to be in danger of declining notably below its 2% objective, then: 'I am convinced that scope remains for the FOMC to provide further policy accommodation either through its forward guidance or through additional balance-sheet actions.'


John Williams

Pessimistic view from Williams

On the same day as Yellen's speech, San Francisco Fed chief **John Williams (voter)** also made remarks that were seen as bullish for monetary accommodation. His review of the economic outlook was on balance somewhat pessimistic. 'In sum, I see the Fed falling short on both our maximum employment and inflation mandates for some time,' he said at an event in the Bellevue suburb of Seattle, and that's why the Fed has forecast low short-term interest rates through 2014. 'We must also stand ready to do even more if needed to best achieve our statutory goals of maximum employment and price stability,' he said.

After checking off a list very similar to that of Yellen's, Williams concluded that continued deterioration would mean that 'additional monetary accommodation would be warranted.' However, Williams specifically mentioned 'further purchases of longer-maturity securities' – an extension of Operation Twist – as an effective tool in this context.


James Bullard

But hawks express caution

Yellen and Williams are among the FOMC's confirmed doves, so it is perhaps not so surprising that their speeches did not represent the entire panel. Dissenter Lacker, a confirmed hawk, issued a statement after the meeting explaining why he voted against extension of Operation Twist.

'I dissented on this decision because I do not believe that further monetary stimulus would make a substantial difference for economic growth and employment without increasing inflation by more than would be desirable,' Lacker said. For him, what counts is that inflation is currently close to 2%. While some Fed officials expect that rate to slow down, Lacker clearly wants to wait until it actually does. 'Should a substantial and persistent fall in inflation emerge, monetary stimulus may be appropriate to ensure the return of inflation toward the committee's 2% goal,' he said in his statement.

But well ahead of the meeting, **James Bullard (non-voter)**, the head of the St. Louis Fed, who is often middle of the road, was more cautious about the need for stimulative measures just on the basis of the May jobs report. 'The recent non-farm payrolls report was disappointing, but not enough to substantially alter the contours of the US outlook,' he said in St. Louis. He pointed specifically to the seasonal adjustment issue, noting that the raw data showed year-on-year growth stronger this year than in the previous two years. He repeated essentially the message at an OMFIF Golden Series lecture in London on 10 July.

Fed wary on Europe but keeping hands off

Fed officials routinely mention Europe in their speeches these days, showing more or less concern, but uniformly taking a hands-off stance. In that St. Louis presentation in early June, Bullard said that while the global problems are being driven by the continued turmoil in Europe, 'a change in U.S. monetary policy at this juncture will not alter the situation in Europe.' In congressional testimony, Bernanke contrasted the situation in Europe with the slowing of the Chinese economy to make the point that the euro zone crisis has greater potential to harm the US economy (a more sluggish Chinese economy could actually help the US by depressing oil prices). He emphasised, however, that if the situation in Europe worsens, the Fed 'remains prepared to take action.'

Chicago Fed chief Charles Evans (nonvoter) told a business group in New York that the debt crisis in Europe posed 'definite downside risks' but he remained optimistic that the situation 'won't knock us off our current US growth projection.'

San Francisco's Williams is wary about the 'significant threat' Europe's continuing crisis poses to the global banking system as global economic growth slows down. 'While the global financial system is stronger than it was three years ago, it remains vulnerable,' Williams said at an Asian financial conference at the bank. The European crisis, he warned, 'could undermine the financial improvements in North America and Asia.'

Finding ways of spurring growth

No time to compromise on stability

Andrew Large, Advisory Board

If we want to restore growth and avoid social collapse we need skilful actions. People will have to accept that some austerity is necessary. Deleveraging is the vital building block back to restoring consumption and investment.

There will be pressure to bring in elements of debt monetisation. So retaining long-term integrity of the monetary authorities is of fundamental importance. The seeds of crisis are not just sown in times of exuberance. Attempts to rekindle growth may add to vulnerability. So don't let us take our eyes off the stability goal.

We all recognise that leverage was too high. A shock caused confidence to collapse. Until leverage comes down I see no way that confidence will be rekindled. Yet that rekindling is what is needed to re-establish the confidence that will restore consumers to spend and businesses to invest. When I was Deputy Governor at the Bank of England and on the monetary policy committee, I always worried about rising leverage. My economist friends told me not to worry because that debt was just a residual. Now, it is a major determinant.

The longer we leave the issue of leverage unaddressed the greater will be the pain of austerity. There are several factors that reduce the need for adjustment only through cuts. It helps if you have a reserve currency. This may explain the lack of US urgency about the debt time bomb. If the euro area was a credible political union, it would gain such benefits. It helps, too, if you can devalue, and monetise the problem to some extent. But you have to develop credible plans to deleverage to prevent continuing bond vigilante activism. As long as that persists as Spain and Italy show there is little hope of confidence returning. Such credibility requires a combination of fiscal consolidation and bank deleveraging as well as tackling supply side constraints. The one form of debt that vigilantes may accept is well-crafted infrastructure spending, where a tangible return is anticipated.

The spectre of social collapse and political extremism is on the horizon. Apart from human misery this would produce still worse economic outcomes. Little wonder that forms of monetisation are on the agenda. The prospect of moderate inflation may appeal. If you have 5% inflation for five years you bring 100% debt to GDP down to 75%. And maybe our confidence in the ability of monetary policy to anchor expectations and prevent a runaway inflation turns minds to this. In the euro area, the idea of Germany inflating so the periphery can get out of its problems is no longer completely unacceptable. Despite potential impact of higher interest rates, this sounds like a better option than socially damaging austerity, and certainly better than default.

But there is a longer term issue too. We have begun to see the emergence of macroprudential policy frameworks and macroprudential authorities which seek to prevent crises from occurring. The gap in policy which we spotted from the failures leading up to 2008 is fortunately being addressed. That's why policy frameworks like the Financial Policy Committee in the UK and other institutional set-ups in many jurisdictions are being developed. However, policy in this area is very tough. Definitions are hard, and objectives hard to pin down. Which instruments to use is difficult enough; their calibration is uncertain. And such policy frameworks are unpopular. They stunt growth, to the despair of politicians. They thwart bonus capture by bankers. And slowing down credit is disliked by the creditors.

I worry that the process may get hijacked. The idea of giving the macroprudential authority a dual objective emerges: to stop crises on the one hand, and to foster growth on the other. This would be a disastrous outcome. If macroprudential policy needs to take account of growth, this must be subsidiary to stopping crises. A single authority with dual objectives is a recipe for confusion. It would undermine legitimacy, and make accountability all but impossible. How much of each should be achieved? The danger is that both policies would be compromised.

The idea of a dual objective for the monetary authority has emerged: to stop crises on the one hand, and to foster growth on the other. This would be a disastrous outcome.

Need for accountability

Wider objective needed for Financial Policy Committee

Gus O'Donnell, House of Lords

The financial crisis has exposed weaknesses in financial structures in the UK and many countries around the world. It is right to give the Bank of England control over macroprudential regulation, but this is not without severe dangers for the Bank, the governor and the economy.

In the economy and finance, Britain needs legislation that will endure for the long term. We should not be fixated by today's problems, important as they are.

The new arrangements concentrate a lot of power in the Bank. With power goes the need for accountability. The Treasury Select Committee has done an excellent job of holding the Bank to account. The Joint Committee of the two houses of parliament has done a good job of pre-legislative scrutiny. However, I believe that we should make one further change to the accountability structure. We should set up a new standing joint committee, under the chair of the Treasury Committee, to assess the effectiveness of the new arrangements once they are established.

The new committee would combine the advantages of the democratic legitimacy of the Commons with the undoubted expertise that lies in the House of Lords. In particular, it would look at how well the Bank's proposed oversight committee was operating.

It is important not to lose sight of the overall objective, which is to enhance the well-being of the country by having a financial system that is both stable and supportive of the whole economy. This will inevitably involve judgments on how to balance the need to have enough capital to withstand shocks with the need to support British industry. The Bank of England Act calls on the Bank to hit an inflation target but, subject to that, to support the Government's economic policy, 'including its objectives for growth and employment'.

Similarly, the Financial Policy Committee should have the objective of financial stability but, subject to achieving that, it should be required to support sustainable growth and employment. A healthy financial sector that makes a fair contribution to the tax base, supports all sectors of the economy and has a sensible, more symmetric remuneration system would be a real asset to this country. We have a comparative advantage in this area. But never again should taxpayers pay for the consequences of failure when the rewards of success are concentrated in the hands of so few.

There is an important imbalance between the resources available to the financial sector, the Bank and the Treasury respectively. The Treasury is in danger of being swamped by the pressures placed upon it. The Treasury's personnel turnover rate is far too high and its pay levels too low.

It is in everyone's interest that the Treasury is able to continue attracting the best people and retaining their skills and experience. To avoid this being at the expense of the taxpayer, perhaps the part of the Treasury dealing with financial services and stability should be funded in the same way as the Bank and the Financial Services Authority, namely by the financial industry which benefits from their work. Otherwise, the Treasury is in danger of cutting off its arms as well as its nose to make its hair shirt fit.

In the field of economy and finance, Britain needs legislation that will endure for the long term. We should not be fixated by today's problems, important as they are. We need a principles-based system that is not over-prescriptive. It must allow the accountable individuals to have the freedom to tackle crises in what might be a very different and fast-changing environment. That is why we should concentrate on getting the objectives right and sorting out the accountabilities for those whose job it is to handle whatever this dynamic and volatile world throws at them.

This article is an edited version of Lord O'Donnell's maiden speech in the House of Lords on 12 June.

Heightened political and economic risks

Fresh worries take toll in core Europe

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013
US	1.7	2.0	2.0
Japan	-0.7	2.3	1.5
China	9.2	8.2	8.8
Euro area	1.5	-0.1	0.6
Germany	3.0	1.4	1.5
France	1.7	0.5	0.8
Italy	0.5	-1.8	-0.2
Spain	0.7	-1.3	-1.2
UK	0.7	0.5	0.5
Addendum			
Asia excl. Japan	7.3	6.8	7.5
World	3.6	3.3	3.6
Consumer prices (% y/y)			
US	3.1	2.4	2.6
Japan	-0.3	0.2	0.2
China	5.4	3.0	3.4
Euro area	2.7	2.4	2.4
Germany	2.5	2.2	2.4
France	2.3	2.4	2.4
Italy	2.9	2.9	2.4
Spain	3.1	1.8	2.2
UK	4.5	2.9	2.4
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.1	2.4	2.8
China	4.1	3.2	3.4
Euro area	0.0	-0.1	0.0
Germany	5.1	4.7	4.3
France	-2.2	-2.2	-2.0
Italy	-3.2	-2.6	-2.2
Spain	-3.5	-3.0	-2.8
UK	-2.5	-3.0	-2.0

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

Europe's economic prospects are suffering increasing damage from political quarreling and inconclusive crisis management. The European economy is paying the price of failure to make any real progress on a permanent solution to the debt imbroglio. Euro area business confidence has continued to deteriorate in recent months. Latest surveys show manufacturers' production expectations falling to their lowest level in almost three years. Respondents rate their orders backlog as worse than at any time since June 2010.

Consumers are especially nervous about the economic outlook, making them more fearful about losing their jobs.

However, sentiment has not deteriorated further in most of the crisis-afflicted countries of southern Europe. Italian business confidence, which slumped dramatically in May, picked up slightly in June. Companies demonstrate a minor improvement, but consumer confidence has fallen further. The barometers of Spanish and Portuguese sentiment have also rallied slightly – albeit from a very low level.

By contrast, the survey findings from core Europe show that no country is immune to the consequences of the debt crisis. German business confidence is at the lowest for more than two years, and sentiment also deteriorated markedly in June in France, Austria and Belgium. Taken together, the latest data point to a continuation of euro area economic weakness, with no recovery on the horizon.

We have accordingly adjusted our euro area GDP forecast lower again. Economic output probably contracted in the quarter just ended, and we expect the third quarter to bring stagnation at best. We now predict an even deeper recession in Italy in particular. The EMU-wide economy will probably shrink by 0.3% this year.

In China, growth momentum remains subdued. Industrial production – accounting for nearly half of China's gross domestic product – has continued to rise at a significantly below-average rate. The construction sector downturn has continued. Although consumption was stable in real terms, it is still not contributing enough to GDP to balance out the loss in industrial growth.

There was positive news on China's foreign trade. Latest figures show a visible revival. Exports to the euro area expanded at an above average rate. Despite this, the outlook remains muted with business confidence deteriorating again in the last few weeks. Beijing will presumably continue to relax its monetary policy stance in the months to come. Fiscal stimulus measures are also conceivable – at least as long as new economic data demonstrate threats to China's economic growth. Either way, we think that the Chinese government will manage to stabilise GDP growth at about 8% this year, with the second half producing slightly faster expansion.

Risk of collapse has increased

EU summit brings only temporary calm

Stefan Bielmeier, Advisory Board

The European summit agreements at the end of June will not provide the hoped-for solution to the European debt crisis. The risk of a euro area collapse has, if anything, increased. Softening the criteria and controls for stricken countries will not lead to stabilisation

Particular care should be taken to avoid overloading the ECB and particularly to avoid raising doubts about its independence. Strict limits must be imposed on its role.

At first, the summit agreements were positively received in the markets. However a more sober view soon took hold. One realisation is that the burdens on Germany from transfers, support payments and guarantees cannot be allowed to grow without limit from either an economic or a political perspective. Governments agreed on centralised banking supervision under the European Central Bank. The EFSF bail-out fund will then be authorised to provide ailing banks with capital directly. The aim is to have achieved this by the end of 2012.

Other agreements were reached to ease interest rate payment on Italy and Spain. Although Spanish banking aid will flow initially from the EFSF, it will then be transferred to the ESM, the planned permanent bail-out mechanism, which will then waive its preferential creditor status. Italy requested that countries that adhere to rules on debts and budgets will not be under the control of the so-called Troika of the EU, the ECB and the IMF if they were to apply to the bail-out fund. Instead they would implement the recommendations of the EU Commission. Intervention by the EFSF and the ESM in the sovereign bond markets would then be possible.

These important demands were made against German opposition. Assistance for banks will remain separate from national debt. The EFSF and ESM bail-out funds will be used 'more flexibly' to stabilise sovereign bond markets. An impression has gained ground that conditions will be relaxed.

No further decisions were taken on the long-term target of a 'fiscal union'. Nor was there any decision on Euro bonds. The decisions relating to the EFSF/ESM represent a move away from previous German positions, but we do not regard them as a 'bursting of the dam'. Progress towards deeper European integration must continue. However, this will require the consolidation of public budgets and closer fiscal unity with clearly defined control mechanisms and sanctions.

The decisions have taken the euro area another step in the direction of a transfer union. However, there are limits to the creditor states' capacity. The decisions on a single banking supervisory authority are not productive either, even though the precise structure still remains unclear. A 'banking union' can only be meaningful after a fiscal union has been created. Otherwise we are putting the cart before the horse.

Particular care should be taken to avoid overloading the ECB and particularly to avoid raising doubts about its independence. Strict limits must therefore be imposed on its role, particularly in relation to the restructuring of the banking sector. The agreement on 'banking union' and more flexible EFSF assistance has paved the way for a EU growth pact, for which €120bn is to be made available for investment (around 1% of EMU GDP). Almost half of the volume will come from so far unused money in the EU structural fund, and the other half by increasing the capital of the European Investment Bank.

The growth pact will not provide any significant impetus, at least in the short term. Its volume is insufficient to do this, particularly since it is not yet clear whether the total sum of will actually be achieved. It seems at least doubtful whether unutilised EU structural funds can actually be redesignated. And the sum of €50bn from the EIB, to be raised from private investors, is initially only a target figure. We do not expect any significant positive impact on crisis-ridden countries before 2013.

Instruments of diversification

Titans of ETF market offer choice and liquidity

Irene Bauer, Twenty20 Investments

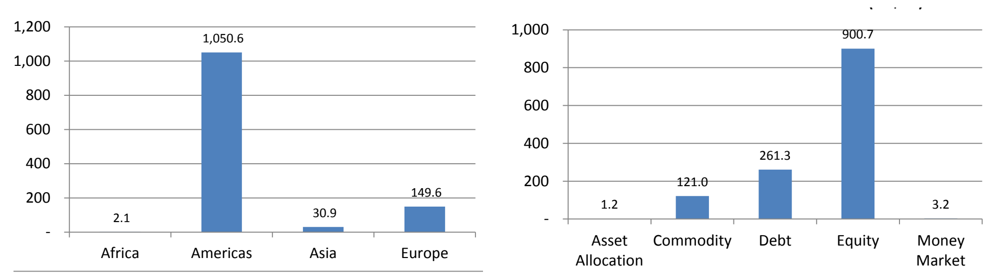
Exchange trade funds (ETFs) are progressively becoming the investment of choice of many investors because these instruments are low cost, transparent, liquid, and offer diversification within and across asset classes. The number of ETPs now exceeds 4,500 and the market itself is over $1.6tn. An advantage that ETFs have over hedge funds and other investment funds is that the cost of investing is in many instances significantly lower. Moreover, a portfolio of ETFs can be managed on an active basis with the aim of outperforming a given benchmark.

The large number of ETFs worldwide suggests that there is now enough diversification and liquidity in ETFs to allow investors to build portfolios solely using ETFs and index funds. ETFs are used by institutional and retail investors alike. The question is whether there is enough liquidity in ETFs to be used by larger players like central banks and sovereign wealth funds. A simple rule followed by many institutional managers is to invest only up to 10% in any fund or ETF. If we look at the titans of the ETF market, namely ETFs with more than $1bn in assets under management (AUM), this gives us more than 230 ETFs. These 230 titans make up the lion's share, $1.2tn or 80% of the overall ETF market, suggesting that these ETFs alone could provide capacity to the institutional market of $120bn.

Most large ETFs are US-domiciled as the development of the US ETF market is some years ahead of the rest of the world. Europe and Asia are catching up, providing 56 and nine ETFs from the 230 titans list, with AUM of $150bn and $31bn respectively in those regions. For institutional investors, the domicile and exchange of the ETF often play a less important role than factors like the size and liquidity of the ETF market and how well the ETF tracks its benchmark index.

The large number of ETFs worldwide suggests that there is now enough diversification and liquidity in ETFs to allow investors to build portfolios solely using ETFs and index funds.

Regional and asset class breakdown of ETFs – AUM $bn



The largest market share in the ETF market is still in equities. The largest of them all is the SPY ETF, namely the SPDR S&P 500 ETF from State Street, with $107bn in AUM. The sheer magnitude of this ETF and its fairly low total expense ratio of 9.45 basis points seems to make this ETF unstoppable in attracting new AUM. It is often the most liquid ETF with the highest average daily traded volume.

In the case of large and highly traded ETFs, these funds can often be more liquid than their underlying stocks or bonds. Small to medium-sized orders can often be matched on the secondary market, thus reducing the trading cost for both sides. A maybe less known feature is that an ETF is, by design, usually at least as liquid as the underlying securities in the benchmark index. For a larger order, if one cannot find enough buyers or sellers in the secondary market, one can create or redeem new units in the fund, thus providing a mechanism by which an ETF's net asset value (NAV) is kept in line with its fair value. The bid-ask spreads of the underlying securities provide an indication for the upper bound of the bid-ask spread of the ETF.

In view of the market conditions of the last few years, ETFs investing in physical gold have attracted a significant market share with the second largest ETF being the SPDR Gold Trust from State Street. These same turbulent market conditions have also helped the rise of fixed income ETFs. AUM in debt and money market ETFs out of those top 230 ETFs now stands at more than $260bn. With interest rates at their current low levels, and with the rate of US inflation recently peaking at 3.9% in September 2011, the iShares Barclays TIPS Bond ETF has become the largest debt ETF. The continued quest for yield has also seen the two largest high yields bond ETFs from iShares and State Street surge to 5th and 6th place in the top 10 of fixed income ETFs with a combined AUM of $25.6bn.

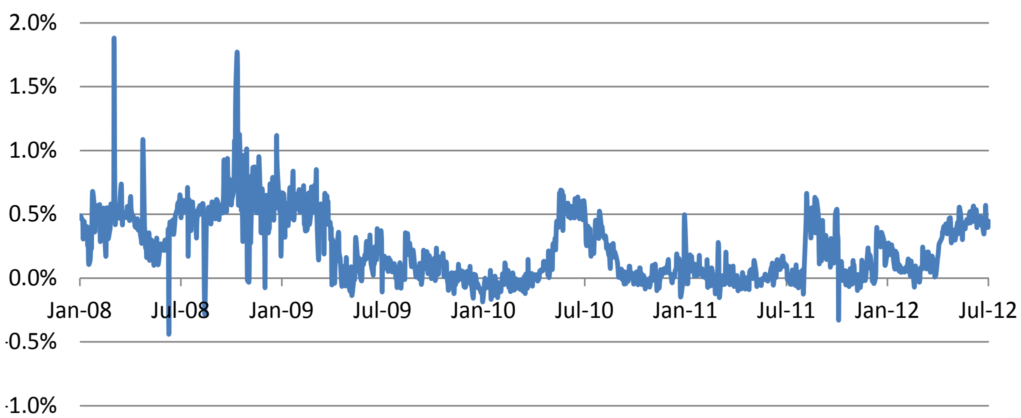
Top 10 Equity and Fixed income ETFs

Top 10 Equity (&Commodity) ETFs	AUM ($bn)
SPDR S&P 500	107.4
SPDR Gold Shares	65.7
Vanguard MSCI Emerging Markets	50.8
iShares MSCI EAFE	34.1
iShares MSCI Emerging Markets	33.8
PowerShares QQQ Nasdaq 100	32.7
iShares S&P 500	30.3
Vanguard US Total Stock Market	21.5
iShares Russell 1000 Growth	15.7
iShares Russell 2000	15.3

Top 10 Fixed Income ETFs	AUM ($bn)
iShares Barclays TIPS Bond	22.9
iShares iBoxx $ Inv Grade Corporate Bond	22.8
Vanguard Total Bond Market	17.4
iShares Barclays Aggregate Bond	15.4
iShares iBoxx $ High Yield Corporate Bond	14.8
SPDR Barclays Capital High Yield Bond	10.8
iShares Barclays 1-3 Year Treasury Bond	10.6
iShares Barclays 1-3 Year Credit Bond	9.7
Vanguard Short-Term Bond	8.5
iShares Barclays Intermediate Credit Bond	5.5

In the case of large and highly traded ETFs, these funds can often be more liquid than their underlying stocks or bonds. Small to medium-sized orders can often be matched on the secondary market thus reducing the trading cost for both sides. A maybe less known feature is that an ETF is, by design, usually at least as liquid as the underlying securities in the benchmark index. For a larger order, if one cannot find enough buyers or sellers in the secondary market, one can create or redeem new units in the fund, thus providing a mechanism by which an ETF's net asset value (NAV) is kept in line with its fair value. The bid-ask spreads of the underlying securities provide an indication for the upper bound of the bid-ask spread of the ETF.

Premium/Discount for iShares FTSE 100 ETF

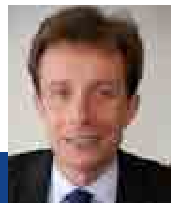


In some instances an ETF can trade at a level that is cheaper than the market price of a basket of the underlying stocks that comprise the index. The iShares FTSE 100 ETF is a good example of how supply and demand on the secondary market can affect the trading cost of the ETF. If sellers outweigh buyers, the ETF often trades close to its NAV. This has been the case, for example, in the first half of 2011 as shown in the chart above. If one were to buy all the stocks in the FTSE 100 one would have to pay the stamp duty of 50 basis points, whereas the ETF could be bought around its NAV, saving the stamp duty. On average, the iShares FTSE 100 ETF traded at a premium of 23 basis points since the start of 2008, saving the investor on average 27 basis points in trading cost.

For large and highly traded ETFs, these funds can often be more liquid than their underlying stocks or bonds. Small to medium-sized orders can often be matched on the secondary market.

The changing face of Europe

Effects of globalisation across the continent



Zuzanna Gromiec and Paweł Kowalewski, National Bank of Poland

European economies are becoming a lot less European. The diversification of German exports away from members of economic and monetary union (EMU) towards emerging market economies and faster-growing European countries has attracted much attention. But we see, too, the same tendencies in German import data. What happens with the largest euro area economy sets the scene for the rest of the continent.

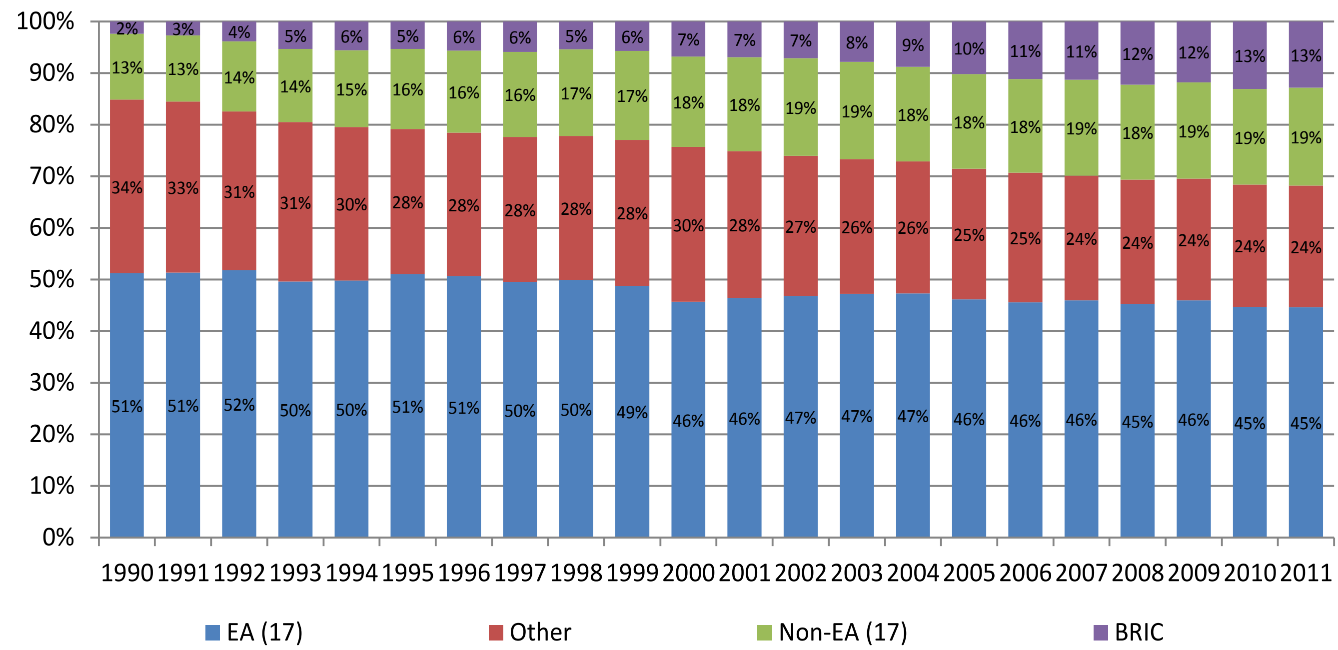
The ascent of the so-called BRIC countries (Brazil, Russia, India, China) is not confined to Germany. The largest economy in central and eastern Europe, Poland displays similar tendencies, part of the impact of globalisation on Europe as a whole. This emerging tendency may have far-reaching consequences for European Union (EU) attempts to design a common economic policy.

As in the case of exports, exact import patterns are distorted by the so-called Rotterdam effect, under which trade data are distorted by the amount of merchandise shipped through the Dutch entrepot. However a number of important factors are at work in diversifying German trade patterns.

If we look at German imports, they underwent a great geographical restructuring during last 20 years. The role of euro area (EA-17) diminished by 6 percentage points to 45% in 2011. At the same time the importance of other EU-27 countries rose by 6 percentage points to 19% in 2011. The role of BRIC countries grew even stronger (by 11 percentage points) to 13%. [See Chart 1]. Germany is diversifying away from its euro area partners towards new EU members and BRICs, with the latter (led by China) in the lead.

For the last 16 years the Netherlands have been the No. 1 exporter to Germany, partly the result of the Rotterdam effect. France took up a strong second position, was displaced by China by a small margin in 2010 but returned to second place in 2011. [See Table 1.] Since China's entry to the World Trade Organisation in 2001, it jumped from 10th to 3rd position in German imports. Apart from the US at No. 10 and Russia at No. 8, China was the only non-EU supplier the in top 10. In the top 20, non-EU partners included, too, Switzerland, Japan, Norway and Turkey. Seven out of top 20 suppliers to German market belonged to the euro area and five of them (the Netherlands, France, Belgium, Italy and Austria) were in top 10. The only new member state in the top 10 list was the Czech Republic. In 2011, the top 10 exporters to Germany market accounted for almost 62% of all imports, while the top 20 import partners supplied nearly 84%.

Chart 1: German imports – shares of group of countries



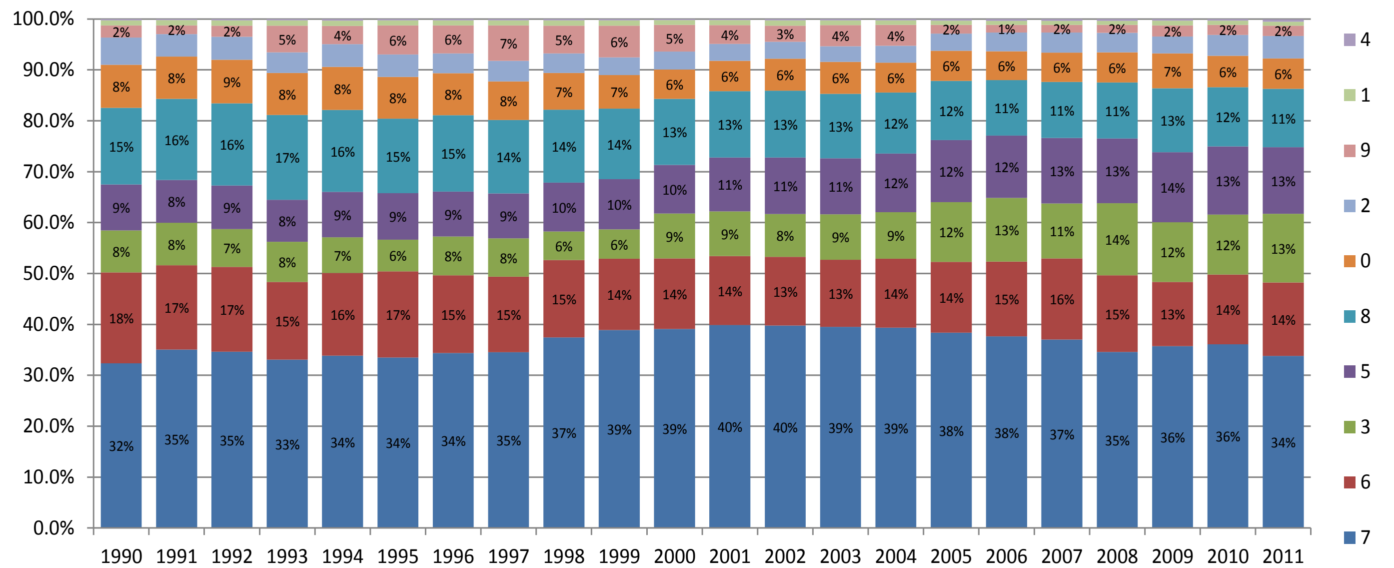
Source: Eurostat.

Table 1: German export partners, 2001 – 2011			
Partner/Period	2001	2011	2001/2011 Difference
Netherlands	11.2%	13.8%	2.7%
France	9.4%	7.6%	-1.8%
China	3.3%	7.1%	3.8%
Belgium	6.0%	6.3%	0.3%
Italy	6.4%	5.4%	-1.0%
United Kingdom	6.9%	4.8%	-2.1%
Austria	4.0%	4.4%	0.5%
Russia	2.6%	4.2%	1.6%
Czech Republic	2.7%	4.1%	1.4%
United States	7.0%	4.0%	-3.0%
Switzerland	3.9%	3.9%	0.0%
Poland	2.5%	3.8%	1.3%
Spain	2.7%	2.5%	-0.2%
Norway	2.0%	2.1%	0.1%
Hungary	2.1%	2.0%	0.0%
Japan	3.6%	2.0%	-1.6%
Sweden	1.6%	1.6%	-0.1%
Denmark	1.7%	1.4%	-0.3%
Slovakia	0.8%	1.3%	0.5%
Turkey	1.2%	1.2%	0.0%

Source: Eurostat.

The commodity structure of German imports is more complex than that of exports [See Chart 2]; 90% of imports to Germany are made of six, not four commodity categories, as in the case of exports. The main group of products is in the 7th section of SITC (Standard International Trade Classification), machinery and transport equipment, accounting for 34% of all imports. This was 6 percentage points higher at the beginning of the 21st century.

Chart 2: German imports commodity structure in SITC nomenclature



0: Food and live animals, 1: Beverages and Tobacco, 2: Crude materials, inedible, except fuels , 3: Mineral fuels, lubricants and related materials, 4: Animal and vegetable oils, fats and waxes, 5: Chemicals and related products, n.e.s., 6: Manufactured goods classified chiefly by material, 7: Machinery and transport equipment, 8: Miscellaneous manufactured articles, 9: Commodities and transactions not classified elsewhere in the SITC

Notes: SITC stands for Standard International Trade Classification.
Source: Eurostat

In case of the BRICs, the rise of this category of German imports is even more pronounced: from 12% at the beginning of the 1990s, through 21% in 2000, to 34% in 2011. This process took place at the cost of the 8th SITC section (miscellaneous manufactured articles), which comprises technically less advanced commodities. In both manufactured products sections (7 and 8 SITC) China was responsible for around 90% of the BRICs' performance in 2011. The significant drop of 6 percentage points of the 7th SITC section in BRICs' exports to Germany in 2011 was due to the value rise of the 3rd SITC section (mineral fuels, lubricants and related materials).

German import data reveal that cooperation with euro partners is decreasing, which is not offset by trade elsewhere in the EU. The growing BRICs role, especially in more advanced products, underlines a reversal of European economic integration. Significantly, Germany plays an important role in the foreign trade of new member states such as Poland, the Czech Republic or Slovakia, especially in categories which show sharp growth in China-German trade.

Exports commodity structure

Germany's most important export category is the 7th SITC section – machinery and transport equipment, as shown in Chart 3. Since 1990 this has constituted around 50% of German exports. The share dropped from 53% in 2002 to 48% in 2011.

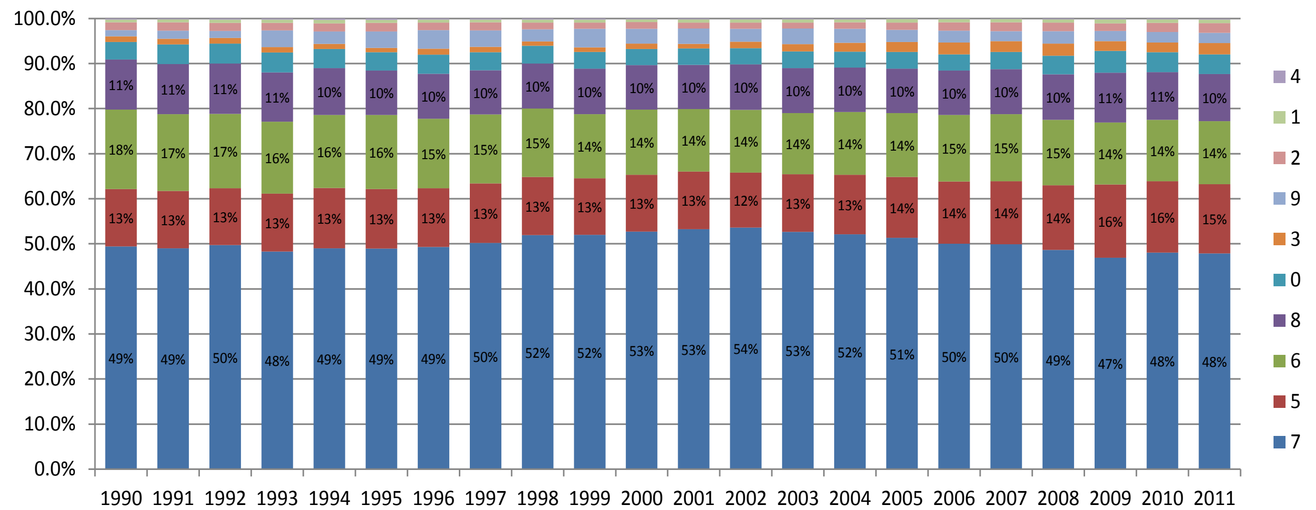
Depending on the trade partner, this share was even higher with developing countries like China (around 70-75%) and the BRICs as a whole (60-65% during the whole period). At the same time the importance of this category in exports to the euro area decreased from 46% to 40% in 2011.

The most important destinations for these products were France (a fall from 13% to 10% in last 20 years), China (rise from 1% to over 9%) and the US (ranging from 13% to 9% during the period). The next two categories constituting German exports were the 5th and 6th SITC sections, which accounted for about 15% each, although the importance of the latter category has diminished. In the case of exports of chemicals to the euro area, the role of this category rose from 11% to 17.5% while in case of BRICs it stayed constant at around 11%.

The most important export markets for this category in 2011 were the Netherlands (9%), Belgium (9%), France (8%) and the US (7%). Considering the 6th SITC section, its share diminished with all groups of trading partners. The main destinations were France, Austria, Netherlands and Italy.

Another important SITC section in German exports were miscellaneous manufactured articles (8 SITC), which accounted for about 10% of all exports. Main Germany's export partners in this field were France, Austria and Netherlands. All four sections accounted for nearly 90% of German exports.

Chart 3 – German exports commodity structure in SITC nomenclature



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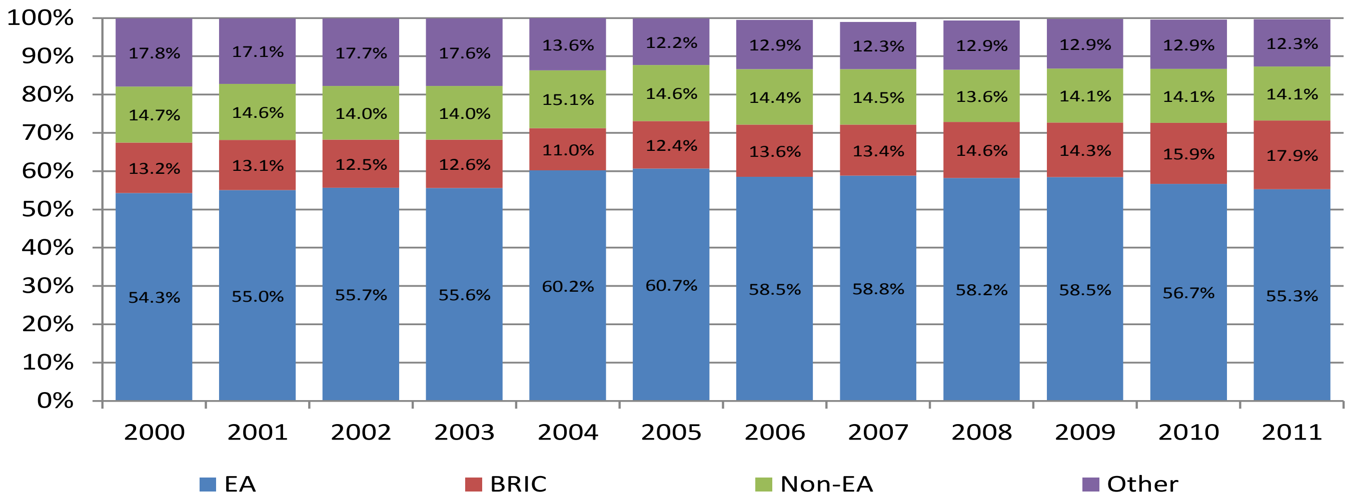
Notes: SITC stands for Standard International Trade Classification.
Source: Eurostat

POLAND

Polish imports are dominated by EU countries (around 70%). During last 10 years, the BRICs share rose significantly from 13% in 2000 to 18% in 2011 [see Chart 4]. The biggest growth was in imports from Russia (especially 3 SITC) and China (7 SITC). In 2011, the main Polish import partners were Germany and Russia (together almost 40%). During the last 10 years, Germany has been Poland's most important supplier. However since Poland's adhesion to the EU its share is diminishing, while the role of other EU countries as suppliers to the Polish market has also fallen.

Chart 4: Polish imports – shares of group of countries



Source: Eurostat

Table 2: Polish main import partners, 2000 - 2011

Partner/Period	2000	2011	2000/2011 Difference
Germany	23.9%	27.6%	3.7%
Russia	9.5%	12.1%	2.7%
Netherlands	3.5%	5.7%	2.1%
Italy	8.3%	5.1%	-3.2%
China	2.8%	5.1%	2.%
France	6.4%	4.2%	-2.2%
Czech Republic	3.2%	4.1%	0.9%
Belgium	2.6%	3.1%	0.5%
United Kingdom	4.4%	2.8%	-1.7%
Slovakia	1.5%	2.5%	1.0%
Austria	1.9%	2.3%	0.4%
Sweden	2.9%	2.3%	-0.6%
Spain	2.4%	2.0%	-0.5%
Hungary	1.6%	1.9%	0.3%
Korea	1.5%	1.6%	0.1%
United States	4.5%	1.5%	-3.0%
Denmark	1.6%	1.4%	-0.2%
Ukraine	1.0%	1.3%	0.3%
Norway	0.8%	1.2%	0.4%
Finland	1.8%	0.9%	-0.9%

Although its role is decreasing, the seventh section of the SITC was the most important part of Polish imports. Germany's share of trade in these goods was the largest in the EU (31% in 2011, a rise from 27% in 2000). The other large partners were China (9% in 2011, a rise from 3% in 2000), Italy (7% in 2011, a drop from 10% in 2000) and the Netherlands (7% in 2011, a rise from 3% in 2000).

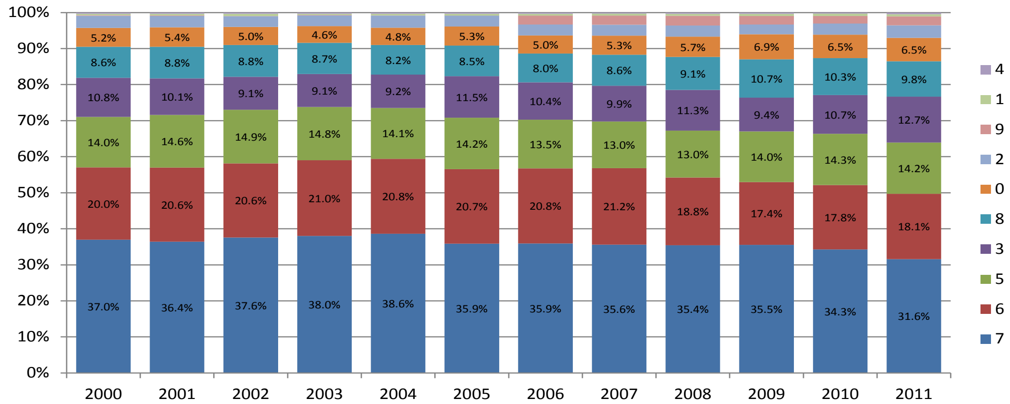
The second most important group of commodities was the sixth section, with Germany again dominating over extra EU 27 suppliers with a share 33%, followed by Italy (7%, a drop from 12%), Czech Republic (6%) and China (5%, a rise from 2%).

In fifth section, Germany's share was 33%, followed by France (8%, a fall from 10%), Netherlands (almost 8%), Belgium (7%). In the third section, Russia's share was largest (70%), followed by Germany (7%) and Norway (4%).

In the eighth SITC section: Germany had 34%, followed by China (12%), Korea (7%, a rise from 1% in 2000), Italy (5%, a drop from 13% in 2000) and Netherlands (5%).

No matter what is the exact explanation, some leading European economies, under the influence of globalisation, are increasingly diversifying trade patterns away from Europe.

Chart 5: Polish imports commodity structure in SITC nomenclature



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Notes: SITC stands for Standard International Trade Classification.
Source: Eurostat

A decreasing role for Italy and rising shares of China in Polish imports may signal worsening Italian competitiveness in less advanced sectors. The rising role of Russia may be due to geographical proximity and a change of perception about Russia in Poland. No matter what the explanation, leading European economies, under the influence of globalisation, are increasingly diversifying trade patterns away from Europe.

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Lord Gus O'Donnell was Cabinet Secretary from 2005-11

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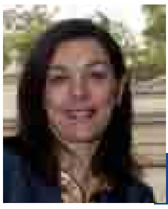

Combining growth and deleveraging

Changing roles between creditor and debtor countries

Pilar L'Hotellerie-Fallois, Bank of Spain

In the decade before the collapse of Lehman Brothers, debtor countries found it extremely easy to cover their financing needs. The 2008 crisis interrupted this, triggering substantial deleveraging by global investors and a sharp contraction in cross-border capital flows. Beyond this, the global economy is adopting new patterns that will change the future positions of creditor and debtor countries.

Higher investment rates and lower savings could lead to upward pressure in real interest rates. For advanced economies, this will make growth and deleveraging even more challenging.

One would have expected mature advanced economies to be in surplus and to export capital towards less developed economies. Instead, many advanced economies became debtors and emerging economies became creditors. Large, persistent and widespread current account imbalances, built around large US current account deficits and large Chinese surpluses, became prevalent. When global capital flows collapsed, most countries experienced sudden stops of foreign investments. There were three changes in the aftermath. First, global imbalances substantially diminished. Debtor countries which had financed their growth with massive inflows could no longer finance themselves and had to adjust. Creditor countries, in particular, emerging economies, have expanded domestic demand.

Second, the factors behind advanced economies' imbalances shifted from the private to the public sector. This happened mainly in debtor countries where the private sector had accumulated debt, mostly from abroad, to support private consumption and investment booms. With the crisis this pattern was reversed, and the public sector has in part filled the gap. In debtor countries like the US, the UK and Spain, the public sector is now the main driver of net financing needs. In creditor countries the pattern has not changed that much. Many of these countries are emerging economies where the public sector is the main capital exporter through sovereign wealth funds and reserve accumulation.

Third, we have seen a retrenchment of global capital flows. They have not recovered pre-crisis levels. The pattern has been uneven. At the end of 2011, the level of capital flows was still less than half of the pre-crisis level in advanced economies, but in emerging economies capital flows have recovered much more quickly. In some regions, like Latin America, they have already surpassed pre-crisis levels.

The previous level of financial globalisation, boosted by massive trades in sophisticated complex instruments, was unsustainable. There was been a redirection of a globally smaller pool of capital flows to emerging countries, whose relative attractiveness in terms of risk-return considerations has greatly improved.

Developments in economic and monetary union (EMU) mirror, in magnified form, those of the world economy. EMU exerted an extraordinary boost to financial integration. Net financing imbalances increased as some countries generated large financing needs on the back of very low financing costs. Those financing needs were covered by countries with excess savings and low returns, leading to the build-up of large debtor and creditor positions.

But this story of successful financial integration turned sour. Integration came to an abrupt reverse, and opened a period of rapid financial retrenchment, partly driven by underlying problems in EMU debtor economies, but also reflecting perception of mismanagement of the euro crisis and doubts about EMU governance.

Some changes will persist. We will see a more pronounced shift towards emerging economies, which will consolidate their larger share in international capital markets. These developments will impact on external financing positions and on global interest rates. The combination of higher investment rates and lower savings could lead to upward pressure in real interest rates. For advanced economies, this will make ensuring growth during the deleveraging process even more challenging.

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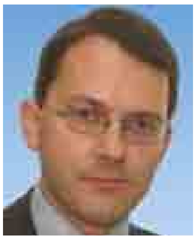
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Mumtaz Khan


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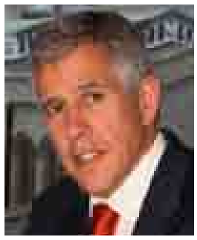
Marina Shargorodska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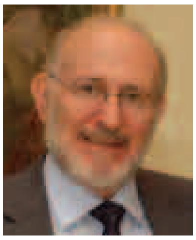
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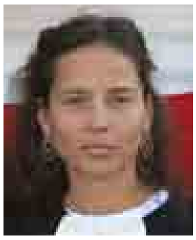
Consuelo Brooke


YY Chin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Dick Harryvan


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David Kihangire


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Andrew Large


Oscar Lewisohn


Wilhelm Nölling


Frank Scheidig**


Jens Thomsen


Ernst Welteke


Derek Wong

OMFIF welcomes new members to the Advisory Board

In addition to Denis MacShane, seven new members have joined the OMFIF Advisory Board. They are: Shiyin Cai, Chief Executive, Dialogue in the Dark; Professor Wilhelm Nölling, University of Hamburg, former Deutsche Bundesbank board member; Professor Michael Oliver, director and co-founder of Global Partnership Family Offices; Richard Roberts, Professor of Contemporary British History, King's College, London; David Tonge, managing director, IBS Research, Istanbul; and Jorge Vasconcelos, chairman, New Energy Solutions. They take the total number of Advisory Board members to 101. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

EDITORIAL & COMMENTARY


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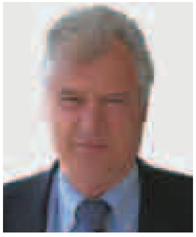
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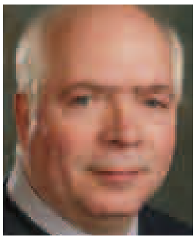
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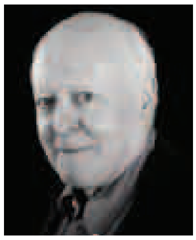
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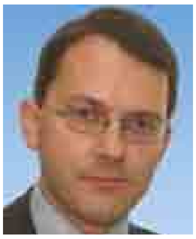
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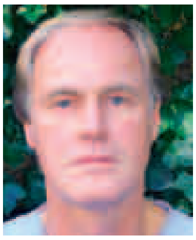
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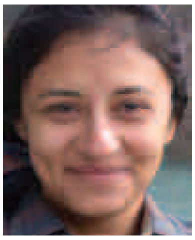
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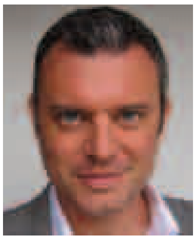
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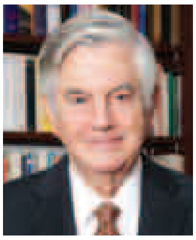
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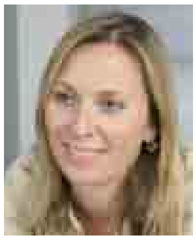
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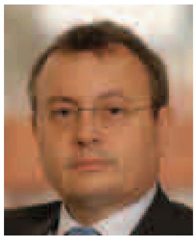
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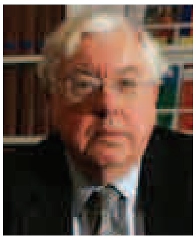
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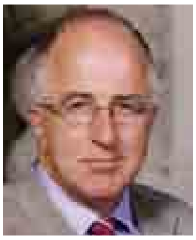
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John Nugée**


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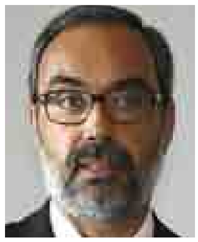
Akinari Horii


Christopher Tugendhat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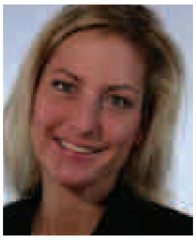
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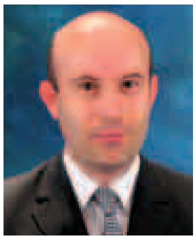
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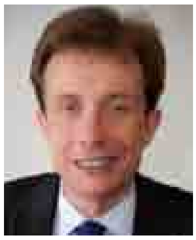
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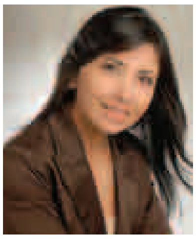
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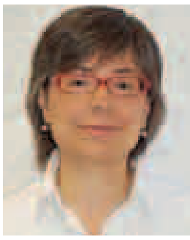
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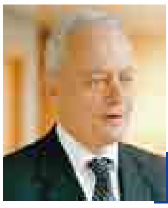


Making sense of remuneration

Balancing risk and reward in financial services

Gerry Grimstone, Chairman, Standard Life

Standard Life is one of the leading savings and investments businesses in the UK, with around £200bn of assets. Our subsidiary Standard Life Investments is extremely prominent in corporate governance. We are one of the leading and more constructively assertive investors in what has been called, in the UK, the Shareholder Spring.

I welcome more sophisticated and diverse measures of value – intangible as well as tangible – to provide the right incentives.

Remuneration has a high profile in the media and in parliament, as well as in the boardrooms and remuneration committees where it belongs. Votes for and against remuneration reports have become headline news. Why has there been such a shift in the balance of power from companies and their boards to shareholders? I believe shareholders are up with what they see as the egregious behaviour of some companies and remuneration committees.

What's caused this shift in gear? I would identify the impact of the UK Stewardship Code which now has over 200 signatories, as well as the easier way, against a very challenging economic backdrop, in which rewards for failure and excessive risk-taking can be identified. Fund managers' clients, for example pension fund trustees, are much more interested in the votes being cast on their behalf: institutions realise that they can determine events.

Also, some remuneration committees have failed to consult effectively, or to be sufficiently sympathetic to the wider economic conditions. Politicians and regulators are focusing more on institutional investors' behaviour, including their role in moderating risk in financial institutions. The UK Government, has come up with a sensible set of policies including a binding triennial vote on forward-looking remuneration policies requiring a 50% majority and an annual advisory vote of how pay policies have been implemented. New share-based incentive schemes will continue to be subject to separate votes

Long-term incentive plans produce such a changing kaleidoscope that it's no wonder some commentators feel bemused. One-third of FTSE-100 companies changed their performance criteria last year. Total shareholder return (TSR) is the primary measure in more than 75% of plans but there's a marked tendency to also use other measures, including cash flow, profit, revenue, sales or return measures such as return on capital employed. In addition, 11 plans have a non-financial measure covering things like customer strategy, strategy, brand reputation, R&D or environmental impact.

I welcome more sophisticated and diverse measures of value, intangible as well as tangible, to provide the right incentives. A well thought out plan, with appropriate emphasis on risk, is the HSBC plan introduced in 2011, with performance assessed over one to three years based on a balanced scorecard of financial and non-financial metrics. The time horizons covered by incentive plans are lengthening in some cases, driven partly by risk considerations. Too long-term time horizons may have weaknesses as well as strengths and may not serve the purpose. The secret lies in striking the right balance.

Having independent remuneration committees acting on behalf of shareholders, with their actions subject to scrutiny and accountability, is one of the best ways to set remuneration and to take into account its relationship to risk. The role of such committees is vital. They must be independent and strong-willed. And they must be conscious that they are there to nurture entrepreneurial leadership through sensible remuneration policies tailored to the company's circumstances that provide appropriate rewards for success and do not reward failure. To ensure checks and balances, I feel company chairmen should not sit on remuneration committees but should be in attendance.

And, of course, in major financial institutions such as Standard Life it's absolutely sensible that the chief risk officer and the risk & capital committee provide additional oversight to ensure that remuneration structures are not incentivising inappropriate risk behaviour.

This article is an abridged version of an address at the OMFIF Summit on 26 June

World Banking and Finance Summit

26-27 June, Drapers' Hall, London

'Past excesses will take time to correct. A period of deleveraging is inevitable.'
Professor Josef Bonnici, Governor, Central Bank of Malta

'The ability of economic-based reasoning to influence events is gradually declining.'
Miroslav Singer, Governor, Czech National Bank

'Even though there is a blueprint for renminbi internationalisation, there are divides in China over the renminbi as a reserve currency.'
Dr. Gerard Lyons, Chief Economist, Standard Chartered

'There are very clear limits to what central banks can do.'
Dr. Monde Mnyande,
Chief Economist,
South African Reserve Bank

Panel during the third session of the World Banking and Finance Summit

R-L: Dr. Vladimir Vysokov, Chairman, Bank Center-Invest; Edoardo Reviglio, Chief Economist, Cassa Depositi e Prestiti; Andrew Hilton, Director, Centre for the Study of Financial Innovation; Dr. Monde Mnyande, Chief Economist, South African Reserve Bank; Sir Andrew Large, former Deputy Governor, Bank of England; Olivier Mareuse, Chief Financial Officer, Caisse des Dépôts

'I do not feel we are moving towards a multipolar reserve currency system.'
István Tötöcskei,
Chief Executive Officer,
Hungarian Government Debt Management Agency

'Consumers are at a disadvantage... they do not understand what is being done with their money.'
Peter Norman,
Minister for Financial Markets,
Government of Sweden

'In 15 years, we will crash our banking system. Life goes on, we forget, and we will do it again.'
Gabriel Stein, Chief Executive, OMFIF

'What will be the memory of the crisis? The fear of debt, or the unemployment?'
Lord Christopher Tugendhat, former Vice-President of the European Commission, House of Lords

Celebrating achievement at OMFIF

4 July, Stationers' Hall, London

OMFIF, Lafferty Group and Lombard Street Research combined forces for a summer party in the City of London that brought together members, friends and supporters of the three firms

Denis MacShane speaks at the OMFIF Summer party.

L-R: David Marsh, Fiona Stein, Gabriel Stein, Denis MacShane, Charles Dumas (hidden), Michael Lafferty

Guests at the OMFIF Summer party

OMFIF
Official Monetary and Financial Institutions Forum

An occasional foray into monetary problems set in verse

Austerity rules in Europe

Art is often born from tragedy, and the euro crisis is no different

The Austerity - A Dialogue of the Deaf

By Meghnad Desai

Keynes, Keynes, they cry
As they try
To sell Plan B to Barack O
Or change the mind of Osborne G
Why not end this Austerity?

No way, No way the answer comes
We dare not lose the Ratings War
Moody, Fitch or S&P
Will grade us down, O can't you see?
How can we end Austerity?

You are mad, you are bad and fashioned old
Why Maynard told us to borrow bold
To multiply he bade us spend
And get back on the previous trend.
Why not end this Austerity?

You are mad, you are bad, you reckless lot
Your Brown and Bush emptied the pot
As the Sun shone they ate the honey
To repair the roof now there's no money
How can we end Austerity?

It's Merkel, it's Monti and Sarkozy
Who brought euro to this state sorry
Papas-Andreou and Demos two
Will rue the day they obeyed you
Why not end this Austerity?

How can we, have you seen the Debt?
The structural deficit will higher get
Deleverage now and then some more
Keep running till our feet are sore
How can we end Austerity?

Will Angela Merkel buy
François Hollande's French Fry?
The dangerous EMU fault line
Lies always on the Rhine
What if they don't end Austerity?

Caja caja Naked Maja
Bankrupt banks and broken casa
Spain and Portugal, Greece and Eire
The future's here and it is dire
How can we end Austerity?

The Lament of the Islanders

By John Nugée

We joined a Common Market
And don't want anything more.
Oh why can't the Europeans
Be more like the Brits.

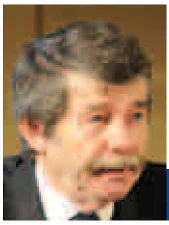
We're terribly fond of tradition
And don't like change at all.
Oh why can't the Europeans
Be more like the Brits.

We're wary of elaborate unions
And like our room to move.
Oh why can't the Europeans
Be more like the Brits.

Our language skills are perfect -
We speak English without a flaw.
Oh why can't the Europeans
Be more like the Brits.

We don't have any answers
But offer advice all the same.
Oh why can't the Europeans
Be more like the Brits.

We're the only ones who understand,
The only ones in step.
Oh why can't the Europeans
Be more like the Brits.



Rising to the challenge

Mervyn King and the black cloud

William Keegan, Chairman, Board of Contributing Editors

It was, I believe, my fellow financial journalist Christopher Fildes who first drew Sir Mervyn King's attention to the existence of a racehorse called Quantitative Easing. Rising to the challenge, the Bank of England governor managed, shortly afterwards, to insert a neat reference to the horse in one of his elegant speeches.

Descriptions of the concept, and practice, of Quantitative Easing (QE) often include the phrase 'unconventional measures'. But for those of us who have been around a long time much of the discussion of QE has been needlessly confusing.

QE is essentially a synonym for 'open market operations', a central banking practice about which every student of economics was told very early on in the syllabus. In open market operations, the central bank sells short-term government bonds if it wishes to shrink the money supply and buys them if it wants to expand it.

What has happened under the QE policy of the past few years is that the Bank has extended the range of securities in which it conducts such operations, and done so on a sensationally large scale.

Mercifully, we are not, as yet, talking about selling securities to shrink the money supply, but buying them to put more liquidity into circulation. Thanks to the good work of Federal Reserve chairman Ben Bernanke and others, at least one lesson of the 1930s has been learnt: when a nation is in the middle of a banking crisis, dramatic reductions in the flow of money and credit are only calculated to deepen the crisis.

Now, in the coverage of economic and financial news, whether by journalists or market analysts, fashion is always at a premium. I have lost count of the number of times a bad piece of economic news has been followed by speculation about another round of QE, as if QE is the be-all and end-all of solutions to our long-lasting economic crisis.

As for the efficacy of QE – well, that is a very open question. I once went to a briefing on the subject at the Bank of England and, in common with other attendees, emerged none the wiser. In his book The Bank – Inside the Bank of England, Dan Conaghan quotes Deputy Governor Charles Bean as telling a group of accountants that 'we will probably never know exactly how effective the policy of Quantitative Easing has been, for the simple reason that we can never know with precision what would have happened in its absence.'

At all events, the announcements by chancellor of the exchequer George Osborne and Sir Mervyn at the traditional Mansion House Dinner in June constituted a pretty good admission that whatever the existing programme of QE had achieved, it was not enough. Hence the widespread judgement that the Governor had conducted a 'U' turn in agreeing to a new package of measures, under which the banks are being encouraged to make more and cheaper loans to businesses and households.

The 'U' turn accusation concerns the fact that Sir Mervyn, he of 'moral hazard' fame, had previously insisted that the Bank's liquidity operations should be at 'penal rates'. Sir Mervyn spoke of an 'ugly' outlook and of a 'black cloud' dampening animal spirits. 'The result is,' he said 'that lower spending leads to lower incomes and a self-reinforcing weaker picture for growth.'

Yes indeed. But whether cheaper funding for the banks will encourage them in this 'deleveraging' atmosphere to lend more, and take the risk, is yet another open question.

My fear is that, because they are so wedded to their policy of fiscal contraction, Bank and Treasury are, in that traditional criticism of monetary policy in such circumstances, 'pushing on a string' – an oft-cited phrase from the 1930s, frequently attributed to Keynes.

Come to think of it, if I ever have the money to buy a racehorse myself, I could do worse than name it 'Pushing on a String'. I would hope that it would just about get to the finishing line.

Looking ahead – 2012 diary dates

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

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

Second OMFIF Meeting in Africa
Bank of Mauritius
5-7 November, Port Louis

Second Asian Central Banks' Watchers Conference
Bank Indonesia
13 November, Jakarta