OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

October 2010

'Bash Beijing' mood grows stronger

Embattled Obama wakes up to Chinese realities

Jonathan Fenby, Board of Contributing Editors

As the Beijing-Washington gulf over the renminbi becomes ever more evident, the next chapter of the Sino-American currency saga will probably unfold in the US domestic political arena – a recipe for volatility that could lead to protectionism on both sides.

Somewhat ironically, a further rise in monetary controversy has coincided with the Chinese currency at last beginning to appreciate in the second half of September following the People's Bank of China move in June to allow the renminbi more flexibility.

Far from being seen as the welcome start of a trend, the 1.8% rise of the renminbi between June and late September seems likely to be followed by an intensification of US pressure ahead of the IMF/World Bank annual meetings in Washington, bringing in other G20 members and raising the temperature on Capitol Hill.

In the run-up to the change in Chinese leadership at the end of 2012, Prime Minister Wen Jiabao has launched an intriguing debate about the need for political reform to provide a new framework for the economy. But that does not mean that China is preparing any concessions on the international front, either on the currency or in spats such as the row with Japan over a detained trawler captain in September – a confrontation that has repercussions in engendering monetary tensions between Beijing and Tokyo.

The Obama administration may finally have accepted that – as I have consistently argued [OMFIF September Bulletin, p.4] – China's currency policy will vary only at the margins. The New York Times reported on 24 September that 'few foreign policy problems took the Obama administration more by surprise this year than the rapid escalation of tensions with China', including the renminbi issue alongside North Korea, Iran and military relations. If that is the case, the administration has been living in an unreal world. Now that it has woken up, it has to decide how far to go along with the 'bash Beijing' lobby and play to domestic politics on trade restrictions linked to the currency. [See article by Darrell Delamaide on p.3.]

The departure from President Barack Obama's team of Larry Summers, who visited China in September as an administration envoy, will remove a voice arguing the free trade case. The danger is that action by the US on Chinese imports could spark off retaliatory action in Beijing.

Obama pressed Wen on the issue when they met on 23 September on the fringes of a UN session in New York. At the same time, Treasury

(continued on page 4 ...)

Contents

Changing faces

Dealmakers' comeback

Peter Kinahan, Senior Editor

The nominations of Bob Diamond and Stuart Gulliver as chief executives at Barclays and HSBC consolidate the ascendancy of investment bankers at some of the world's largest universal banks – just one element in a remarkable renaissance of investment banking.

The two appointments mark an extraordinary resurgence in confidence by businesses badly singed by public and political flak after the financial crisis. The elevation of Diamond – termed earlier this year by then UK business secretary Peter Mandelson as 'the unacceptable face of banking' – appears to lay down the gauntlet to the UK government as it launches an inquiry into the possible break-up of large banks. The nomination the more low-key Gulliver, part of a management reshuffle following the departure of HSBC chairman Stephen Green to take a government trade post, does not embody the same brusque symbolism.

(continued on page 4 ...)

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Uncertainty in the air

Politics spills over into economics

David Marsh, Co-chairman

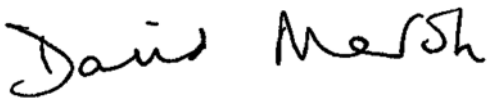
Ahead of the annual IMF/World Bank meetings in Washington, the world is again in a febrile state. There is not, it must be said, the sense of calamity that attended the same gatherings two years ago, in the immediate aftermath of the collapse of Lehman Brothers. But uncertainty hangs in the air, made worse by the doubts over the sustainability of the US recovery following a collapse in poll ratings for President Barack Obama and a stream of announcements of the departure of erstwhile trusted aides.

The four main economies – the US, China, Japan and Germany – continue to be pummelled by political controversies with considerable repercussions in the financial and monetary sphere. Whether it is the row between China and Japan over a detained Chinese trawler captain, the Sino-American spat over trade and the renminbi or Germany's controversies with its neighbours over the long-term future of euro governance, politics spills over into economics. The same is true, but with opposite direction of causality, in the world of investment banking: economics spills over into politics.

The October edition of the Bulletin attempts to put all this into perspective. Jonathan Fenby and Darrell Delamaide look at the two sides of the US-Chinese equation. Peter Kinahan examines the impressive resurgence of investment banks and the march to the top of the men behind them. On the prime theme of improving the governance of the euro area, Lorenzo Bini Smaghi sets down in this month's OMFIF Essay the main lines of the European Central Bank's thinking, while John Nugée outlines his own proposals for a European Fiscal Solidarity Fund to take over from the European Financial Stability Facility. Roel Janssen points out crucial differences between the approaches of two countries that normally agree with each other – Germany and the Netherlands.

Andrew Rozonav contributes a thoughtful article on some fundamental constraints on the role and behaviour of state-owned investment groups, for which he continues to favour the term 'sovereign wealth funds' rather than 'sovereign funds' as suggested in the September OMFIF Bulletin. We agree with Andrew that differences over terminology are less important than interchanges on ideas.

Malan Rietveld suggests that, to keep pace with the changing environment, central banks and other official institutions need a shot in the arm in the field of education and training. Stefan Bielmeier in his monthly column looks at the paradox of high public debt driving the yen higher. William Keegan delves further into terminology, pointing out some important 'inexactitudes' over monetary policy in the recent memoirs of former UK prime minister Tony Blair which he suggests even deserve the description 'whoppers'. We hope the subtle and not-so-subtle differences between these two terms will not be lost on our readers.



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US stalemate extends to Fed policy

The prevarications of Thomas Hoenig

Darrell Delamaide, Board of Contributing Editors

Thomas Hoenig appears to have a guilty conscience. The president of the Kansas City Federal Reserve Bank has 'powerful regrets' about not dissenting more often under Fed chairman Alan Greenspan when low interest rates allowed dangerous asset bubbles to develop, Bloomberg Business Week reports, citing Hoenig's friend Richard Fisher, president of the Dallas Fed, as a source.

So Hoenig is making up for it now. His lone dissent in the September meeting of the Federal Open Market Committee was the sixth in a row for Hoenig, who is a voting member this year of the committee that determines US monetary policy. The Fed official has maintained, even in the face of a fairly dramatic deterioration in economic conditions, that the Fed should think about raising rates so as not to encourage another round of easy credit and rampant risk-taking.

For his colleagues on the FOMC and for most economists, Hoenig wants to close a barn door on an empty stable. There is no horse trying to get out of that gate as credit remains intolerably tight. The country is still feeling the full impact of the most recent downturn. But Hoenig seems prematurely and unduly worried about a new cycle of easy money eventually leading to a fresh bout of recession and unemployment.

Perhaps Hoenig, who has headed the Kansas City Fed since 1991 and worked there since 1973, is right in nurturing an uneasy conscience. But his go-it-alone prevarications are now undermining the Fed's effort to time further monetary stimulus for an economy on the brink of a new downturn or even a deflationary spiral. In an FOMC depleted by three empty seats on the Fed Board of Governors, Hoenig's dissent as one of the five voting regional presidents is a huge drag on the consensus to push through a new round of quantitative easing that many economists recommend and financial markets seem to crave.

Hoenig's go-it-alone prevarications are undermining the Fed's effort to time further monetary stimulus for an economy on the brink of a new downturn or even a deflationary spiral.

The Fed would have been reluctant in any case to act before the Nov. 2 mid-term elections in the US, but the political paralysis that currently grips the country in the growing polarisation ahead of the vote now seems to be affecting the Fed, too, after totally hamstringing Congress. It is perhaps no coincidence that the Bloomberg profile* of Hoenig begins with an anecdote of him addressing a Tea Party conference in Kansas City, even though the insurgent Republican movement wants to abolish the Fed altogether.

The imminent departure of President Barack Obama's chief economic adviser, Larry Summers, has exacerbated the policy vacuum in the White House, following the exit of two other top advisers in recent months. Washington's rumour mill, nourished on fairly explicit leaks from the White House, says Obama wants to appoint a woman corporate executive, such as former Xerox CEO Ann Mulcahy, to replace Summers. This ignores the anomaly that the president's top economist would not be an economist. Summers or Mulcahy, economist or not, the administration has virtually no room left for maneuvre in any case. Obama had his one shot at a fiscal stimulus and won't get another. At this point, he cannot get any legislation through before the election and will have to deal with a new set of political priorities in a lame-duck session after the vote.

The non-nomination of Elizabeth Warren to set up the Consumer Protection Finance Agency without actually being named director is perhaps the ultimate example of the contortions this forces the administration to go through. Because the system of Senate confirmation is effectively broken – the three nominees for the Fed board were appointed in April and are still awaiting confirmation – the administration feared a long delay in getting Warren approved as director, and instead made her an adviser to the White House and Treasury. While this may seem pragmatic, it also means she does not have the autonomy guaranteed in the legislation creating the new agency. *(continued on page 4 ...)*

** http://www.businessweek.com/magazine/content/10_40/b4197074540076.htm*

'Bash Beijing' mood grows stronger *(continued from page 1 ...)*

Secretary Timothy Geithner said the renminbi valuation would be a key agenda item at the G20 meeting in November and the House Ways and Means Committee sent forward a bill allowing the US to impose duties on goods with undervalued currencies.

Even if the House passes the legislation, it is likely to run into opposition in the Senate, but 'Beijing bashing' is now firmly on the agenda ahead of the mid-term elections in November. This could run through to the 2012 presidential and legislative campaigns if the US economy fails to pick up and unemployment stays high.

For its part, China has stuck firmly to its guns as it has done through the Bush and Obama administrations. Financial market analysts and many other commentators failed to see at the time that the 'flexibility' announced by the People's Bank of China in mid-June did not betoken appreciation, just a different form of currency management. On his New York visit Wen insisted that the time was not ripe for a significant increase in the currency's value. At home, Chinese media have been full of economists' commentaries arguing that the renminbi has nothing to do with the US trade deficit, and that America has to work out its domestic problems without harping on about the Chinese currency.

The authorities in Beijing have other priorities. They have to engineer a soft landing from the runaway growth of early 2010. They need to bring the property market under control without provoking a crash that would alienate middle-class home buyers. They have begun to launch policies to stimulate domestic consumption through wage rises in order to rebalance the economy away from investment and exports. They are busy at work completing the Five Year plan which will set the broad economic policies for 2011-15 and will be reviewed by a Communist Party plenum in the second half of October.

Then comes the Economic Work Conference in December. At a difficult time for the Obama administration, Washington has to take account of Chinese realities. The message from Beijing is that priorities are set in China and nowhere else.

Changing faces *(continued from page 1 ...)*

But by appointing investment bankers as their chiefs, the two premier UK banks join a pattern already established by Deutsche Bank, UBS and Credit Suisse. The move coincides with preliminary sabre-rattling over whether some of the UK's largest banks might move their headquarters abroad if Britain's independent banking commission recommends separating banks' retail and investment banking activities. Likewise, defensive action on behalf of the short-term cash bonus culture is now picking up momentum as investment bankers seek a return to 'business as usual'.

This surge in confidence is all the more remarkable given the relative performance of investment banking at the larger universal banks, as evidenced by the UK banks' half year results. Research from UK broker Seymour Pierce indicates that, at £75bn, cumulative investment banking losses at UK banks over the past two and a half years are some five times higher than those of retail – and this is before write-downs in respect of acquisitions such as HBOS and ABN AMRO.

The pleas against break-up made by many UK bank chief executives who contend that investment banks could not operate without retail bank division funding are reflected in segmental analysis of the UK H1 figures. 'Our concern is that universal banks are recouping investment banking losses by expanding margins to retail and small business customers,' says the Seymour Pierce report. This thesis is backed up by a report from Standard and Poor's, which noted that retail banking performance in 2010 'improved across the board', something it expects to continue while 'capital market and wealth activities are likely to remain more subdued'.

The better performance by the retail banking divisions does not seem to cut much ice in banks' boardrooms where, as John Kay in the Financial Times notes, the investment bankers, 'more political, better paid, and generally abler, have usually come out on top'.

It remains to be seen whether in the UK at least, investment bankers' efforts to counter the likely leanings of the independent banking commission will be successful. Whatever the outcome of those deliberations, expect the energetic fight by investment bankers to maintain their top dog positions.

US stalemate extends to Fed policy *(continued from page 3 ...)*

Warren will be under the thumb of Treasury Secretary Timothy Geithner, who was widely reported to have opposed her for this job. Small wonder amid this disarray in Washington that China feels comfortable pushing back new calls for revaluation of the renminbi. Opposition to China might be one of the few issues that US lawmakers on both sides of the aisle can agree on.

So legislation calling for reprisals against countries manipulating their currency rates easily passed a House committee on a bipartisan vote and may come to the floor of the House of Representatives before the November election. But like most legislation, this bill is expected to die a slow death in the Senate.

In the administration, Geithner may be the last man standing from Obama's original economic team, but in dealings with the Chinese he has the stature of a paper tiger. Obama himself pressed Chinese premier Wen Jiabao to revalue the renminbi when the two met at the UN.

But if fewer than half the American public approves of Obama's performance, why should the Chinese pay him any great attention?

Great leap in economic governance

Europe must learn lessons of springtime turbulence

Lorenzo Bini Smaghi, Executive Board, European Central Bank

We need a leap forward in the governance underlying the economic policies in the member states of the euro area. Whatever is decided for the euro area could conceivably also apply to the rest of the EU, but the discussion among all 27 members should not water down what is necessary for the euro area.

We need to learn the lessons of the springtime turbulence in economic and monetary union (EMU) – a crisis that had effects spreading far beyond Europe's borders. At the beginning of May, as the result of worries over the possible default of one or more EMU members, the global financial system was on the verge of a meltdown similar to, if not worse than, the one after the failure of Lehman Brothers. Markets would indeed have collapsed if European leaders had not agreed to establish a European Financial Stability Facility to support countries in difficulty and if the European Central Bank had not decided to intervene directly in some securities markets to restore their proper functioning.

The actions succeeded in preserving the integrity of the euro area – stopping the speculative rout and forcing market participants that had taken short positions against the euro and some sovereign assets to bear losses. However, unless the weaknesses that were exposed are definitively addressed, new bouts of instability may arise. The task force of European finance ministers under EU president Hermann Van Rompuy has the mandate to produce concrete proposals aimed at closing all the loopholes in the institutional construction of the euro. Any change in the institutional structure of the euro should start by avoiding three great simplifying assumptions made in the past.

The May actions succeeded in preserving the integrity of the euro area. However, unless the weaknesses that were exposed are definitively addressed, new bouts of instability may arise.

The first is to think that markets are always right and are able to discipline countries and their debts. Markets made mistakes in the past in under-pricing risk. They are probably doing so again now in over-pricing it. And they will also make mistakes in the future. We cannot leave to markets the task of disciplining budgetary policies and inducing member states to take corrective actions. If we really want to prevent and correct imbalances, in particular fiscal imbalances, we need stronger institutional mechanisms, across the euro area and within countries. This means more rules and automatic sanctions.

The second mistake is to think that crises can be prevented altogether. Crises have occurred in the past and might occur in the future, also because of contagion. We have to be prepared for them and be able to manage them efficiently. The third mistake is to think that there are easy or 'orderly' solutions to crises. Crises are messy, contagious and have unintended consequences.

The ECB's proposals to address these issues do not change the fundamental nature of the euro area, in particular with respect to budgetary policy, which remains in the hands of the national authorities. There is no need to have a single budgetary policy. No need for a so-called transfer union. However, national budgetary policies have to be conducted in a framework consistent with a single currency.

Significantly, the institutional framework can be strengthened within the current European Treaty, fully exploiting the possibilities of secondary legislation. There is no need for a treaty change – and there is also no time. Financial market doubts about the resilience of the system need to be answered quickly. At the EU level, the ECB favours a strengthening of the fiscal framework geared to five important measures:

- More streamlined and effective procedures in the assessment of fiscal developments
- Reversal of the burden of proof, making it more difficult for the European Council to overturn in its decisions the assessment of the Commission

- More independence in the collection, verification and assessment of the fiscal data and fiscal analysis at the level of the Commission
- More emphasis on public debt developments, as the Treaty foresees
- Quasi-automaticity of sanctions in case of breaches of the rules, including the provision of both so-called procedural and financial sanctions

One reason for the urgency is that the interconnections created by the single currency have transformed what appeared to be a relatively limited problem affecting the Greek economy, which represents less than 3% of euro area GDP, into a systemic issue. This explains why, as markets started to doubt Greek solvency, the speculative positions aimed at minimising losses or maximising profits associated with such an event also affected the valuation of other sovereign assets and of the euro itself.

The creation of the EFSF ultimately averted financial collapse. The question now is how to create a management mechanism that avoids crises without creating moral hazard. This is not a new issue. It has been dealt with by the International Monetary Fund and consists of attaching strong conditions on structural and fiscal policies for financial support for a country in difficulty.

There is no need for Europe to reinvent the wheel. We can learn from IMF experience. History shows that countries are not particularly keen to get financial support from the Fund, precisely because of its tough conditions.

There is no need for Europe to reinvent the wheel. We can learn from IMF experience.

Permanent fund for Europe

Strengthening the continent's fiscal governance

John Nugée, Deputy Chairman, Advisory Board

The measures enacted in spring this year to counter Europe's sovereign debt crisis are impressive and extensive – but they represent only a temporary solution, buying time for a more permanent and far-reaching arrangement. Such an arrangement will have to include a much greater and more formal degree of fiscal integration among euro members.

What form should this take? On the one hand, authoritative voices such as Niels Thygesen have argued [OMFIF September Bulletin, p.8] for market discipline to rein in spendthrift governments. Indeed, the extreme lack of market discipline in 2003-2007 (when Greek bonds traded only a few basis points over German bonds) contributed to an environment in which less financially responsible governments aggressively expanded their fiscal spending.

On the other hand, now that the market has realised that not all EU sovereign credits are of equal standing, there is a definite sense – especially in Brussels and Frankfurt – that they have overreacted. Such thinking lies behind the natural desire of other states to help those facing what many see as unwarranted market attack.

How should the EU address this? Market discipline is necessary, and should not be evaded completely (as for example would be the consequence of a joint-and-several liability for all state debts or a blanket EU-level guarantee). But equally, markets cannot be allowed a free rein to punish weaker states unjustifiably harshly.

Increasingly, there are calls for fiscal co-ordination at the policy formation stage. Dominique Strauss-Kahn, the managing director of the IMF, called in a speech in Brussels in September for a central fiscal authority to set EU member states' fiscal stances and allocate resources from a central budget.

While this might be a step too far towards federalism at this juncture, there is a clear requirement for a mechanism simultaneously to co-ordinate Europe's fiscal policies, strengthen the sanctions element of the Stability and Growth Pact (SGP), and remove the SGP's Achilles Heel, namely that its limits can be broken more or less with impunity.

(continued on page 7 ...)

Linked to this is the question of private sector involvement in crisis resolution. Public money should not be used to bail out private sector organisations that have taken the wrong decisions. This would be the case if the money provided by the crisis management framework were used to reimburse the private sector for its losses, eliminating all its risks.

This issue was considered in the context of IMF reform after the 1997-98 Asian crisis. The discussion showed that it is very difficult to design a simple mechanism which would make restructuring mandatory. The reason is simple. The solvency of a state is a different concept from that of a company or a financial institution. It ultimately depends on the economic and political sustainability of achieving and sustaining a given level of primary budget surplus to stabilise and reduce the debt.

If a country commits to a certain recovery programme which justifies the financial support of the other partners, it cannot be considered insolvent and unable to reimburse its debts. Why should it in such cases restructure them? On the other hand, if debt restructuring is made too easy, or too 'orderly' – to use a fashionable term – market participants may consider it the easy way out and might be tempted to take speculative positions from which they would profit in case of default. In other words, a restructuring mechanism, if too simple, could lead to moral hazard. Furthermore, the very nature of the markets would mean contagion spreading immediately to the other countries, as participants would start guessing which other country might need to undergo restructuring.

If debt restructuring is made too easy, or too 'orderly', market participants may consider it the easy way out.

To sum up, in today's advanced economies default is unnecessary, undesirable and unlikely, as a recent IMF document stated. It is naïve to think that there is such a thing as an orderly debt restructuring mechanism.

(... continued from page 6)

One way of achieving these objectives would be to set up a permanent European fund that would borrow in the collective name of the euro states and use the proceeds to lend up to a pre-agreed limit to the individual governments. This fund could evolve directly from the European Financial Stability Facility set up as a result of the euro crisis in May. Indeed, it could be called the European Fiscal Solidarity Fund to preserve the initials EFSF. In doing so, the Fund would encompass three aspects:

- An annual meeting of euro area finance ministers would agree the borrowing limit of the Fund and the individual limits that countries can borrow from it.
- The Fund would borrow from the market, and states would then borrow from the Fund to finance their budgets. The rate would be 'cost plus an element for administration'. Bonds issued by the Fund should be both more liquid and better credit than bonds issued by any single state, even Germany, and so should probably be lower-yielding.
- If any state wants or needs to borrow more than their Fund limit they can do so directly from the market – without the protection of the joint guarantee and so at higher cost.

The net result is a mechanism that offers

- a peer review process with a purpose
- cheaper borrowing for those that stick to the plans agreed with their peers
- genuine but not crippling sanctions on those that exceed them (a state exceeding its Fund limit would only pay the greater interest rate costs on the excess over its Fund borrowing)
- greater flexibility than the SGP's mechanistic fixed numerical limits (so that in times of stress the finance ministers' review process can allow for this and temporarily higher borrowings can be agreed)
- a real chance to create a 'Euro-Treasury' market to rival the US Treasury market for size and liquidity

Assuring that such a solution is compatible with the various treaties (and with rulings of the German Constitutional Court in Karlsruhe) creates some complex challenges. In addition, collective resolve will be needed to ensure that EU states do not abuse their common credit standing by over-borrowing through the Fund. Nor would this solution completely remove the issue of moral hazard or, ultimately, the spectre of default for countries that show persistent fiscal incompetence. Perhaps the biggest challenge of all will be to address a residual feeling in some European states that it is not right to build formal arrangements that will structurally benefit less well-off states at the expense of others.

These are indeed challenges. But Europe has faced more difficult issues in the past and overcome them. The prize of sound finance to go alongside the sound money of the euro is surely worth it.

What is the solution then, if we want to avoid moral hazard and unduly bailing out the private sector? The best way to involve the private sector is to ensure that a country which experiences financial difficulties implements a credible adjustment programme, which convinces markets to invest again. Experience shows that successful programmes – with 'success' being measured by the policies which have been implemented – have ultimately made it possible to regain market confidence. It may take some time, and some re-profiling of official financial support, but in the end access to markets was regained.

Many doomsayers fail to understand that the debt problem is the biggest incentive for Greece to remain in the euro area.

Doubts about the sustainability of the debt in countries like Greece are only part of a wider problem. Although deficits are expected to start narrowing gradually next year, the fiscal burden remains huge. Government debt levels in advanced economies are expected to increase further and approach 100% of GDP. The IMF estimates that by 2015 the general government gross debt will reach 110% of GDP in the US and 95% of GDP in the euro area. This represents an almost doubling in the US and a 40% increase in the euro area.

The analysis of the sustainability of sovereign debt has largely been based on the experience of developing or emerging market countries. It is now applied to advanced economies, starting with Greece. We often hear that, to address the Greek debt problem, Europe should learn from the Brady bond experience – under which in the late 1980s Latin American countries issued bonds named after the former US Treasury Secretary to convert existing bonds to help restructure debt.

However, we should bear in mind that, in many debt crises of the past in emerging market economies, the fiscal problem was not necessarily the main cause of the crisis. More usually, the crisis originated in the combination of an unsustainable exchange rate peg and foreign denominated debt. The devaluation of the currency would raise the stock of the debt in relation to GDP, which in turn would further contribute to make the peg more difficult to sustain and thus fuel speculative attacks against the currency, in a vicious circle.

Under these circumstances, if a peg could not be sustained, the devaluation would have to be accompanied by a restructuring of the debt or a partial default. This is not the case in most advanced economies, either because the debt is generally denominated in domestic currency or because the peg is a 'super-hard' one, as in Greece's case. Certainly, if Greece were to exit the euro – a hypothesis that I make just for the sake of reasoning, but which I consider absurd – its debt burden would de facto worsen given that it is denominated in euro, and partial default or restructuring would in that case be unavoidable. However, thanks to the irrevocable nature of participation in the euro, the debt trap is avoided. Many doomsayers fail to understand that the debt problem is the biggest incentive for Greece to remain in the euro area.

Special facility now in operation – but when will someone borrow from it?
OMFIF commentary
Portugal und Ireland – the two countries which together with Greece have really got heir backs to the wall – are still in deep trouble on the capital markets. Interest rates on their new borrowings, in both longer- and shorter-dated bonds, are now well above the crisis levels of the springtime, and spreads compared with prime-rated German bonds have shot up to well above 4 percentage points. Not just for Greece, but also for Portugal and Ireland, bond prices are now signaling that investors expect debt restructuring some time.

Neither these countries' governments nor the European Commission nor the European Central bank wishes such an outcome. They fear it would lead to an ever-deepening spiral that could end in EMU's breakdown. Since interest rates on the problem countries' borrowing have now breached the 5% level that was supposed to trigger EFSF deployment, all indications would seem to point to the Luxembourg facility not being used.

The EFSF is trapped in a crux of Catch-22 dimensions. Unless it raises ammunition in pre-emptive financing, the capital markets will doubt whether it has the wherewithal to support errant EMU members. On the other hand, if the fund does start to issue bonds, the Germans feel that this could cannibalise other European states' issues.

Second, in many previous crises in emerging market economies, the debt issued by the country was largely held by foreigners. A restructuring of the debt thus mainly hit foreign citizens and was thus, from a political and economic viewpoint, relatively less costly for domestic residents. In advanced economies, the difference lies in the fact that domestic wealth is more relevant in relation to GDP and is partly composed of domestic debt instruments, including government bonds. A debt restructuring or default thus has an immediate and direct impact on the value of the residents' wealth and thus on the real economy. The larger the impact of a (partial) default on the financial and real economy of the country, the more costly a (partial) default would be.

Additionally, the wealth effect depends not only on the direct effects of a default or restructuring of the public debt, but also on the chain of events that would be triggered throughout the entire banking and financial system. Owing to the role of advanced economies as lenders of last resort to their own financial system, a debt problem at the level of the state would cripple the economy as a whole. This is often ignored by those who claim that there can be such a thing as an 'orderly' debt restructuring mechanism for the public debt of advanced economies.

We should also guard against the notion that rising interest rate differentials between different issuers of foreign debt are a sign that global financial markets are functioning properly in allocating resources and setting relative prices. These differentials appear to tell us that the probability of sovereign default is becoming significant and widespread.

But what scenarios open up if advanced economies' sovereign debt assets are no longer perceived as risk-free assets? How would this affect the functioning of financial markets? There is no doubt that there would be some direct spillover to all other assets. The riskiness of the global portfolio can be expected to rise more than proportionately. Indeed, if the public sector is itself over-leveraged, who can back up the public sector? It can be expected that higher yields and lower asset prices would exert downward pressure on economic activity through increases in the costs of external finance, negative wealth effects and negative effects on confidence.

A world without default-free assets would have great implications for economic activity since these are the prototype of 'information-insensitive' instruments, i.e. they serve as 'money' and provide the basic functions of money when the opportunity cost of holding money is too high. Information-insensitive assets are an important source of collateral. The disappearance of 'good' collateral would reduce credit supply and impair economic activity.

Higher solvency risk also increases other risks at the macro level, such as the risk of financial repression. As public debt rises to unsustainable levels, domestic financial institutions may be 'encouraged', if not forced, to hold domestic sovereign debt in their portfolios. This would lead to inefficient allocation of capital, high costs of financial intermediation and thus lower growth. Finally, in the case of reserve currencies, higher solvency risk would potentially hamper the stability of the international financial system.

The EU's efforts to create a strong governance framework is part of a necessary global undertaking to lower the possible impact of current and increasing levels of public debt in advanced economies, which raise problems that affect many dimensions of the global economy. Neither the widening of spreads on government bonds, or the current very low yields on some favoured countries' bonds, can be seen as a comforting sign. My impression is that investors may be confusing relative and absolute concepts of risk. And such a mistake could entail very high costs for our societies.

A world without default-free assets would have great implications for economic activity since these are the prototype of 'information-insensitive' instruments providing the basic functions of money.

Mr Bini Smaghi elaborated further on these themes in a speech on 'What future for financial globalisation?' to the joint conference of the ECB and the Journal of International Economics, Frankfurt, 9 September 2010, and a hearing of the European parliament's Committee on Economic and Monetary Affairs on 'Improving the economic governance and stability framework of the Union, in particular in the euro area', Brussels, 15 September 2010

German-Dutch split on errant states

Netherlands takes softer line on euro exits

Roel Janssen , Board of Contributing Editors

A split has opened up between the Netherlands and Germany – habitually the two members of the euro area with the closest montary and financial ties – over the best means of controlling errant members of economic and monetary union (EMU). Despite the broad level of traditional Dutch support for German monetary policies, there is no sympathy at the Dutch Finance Ministry or the Nederlandsche Bank, the central bank, for recent suggestions by German government officals that, as a last resort, member states could be expelled from EMU. The issue underlines how even some of Germany's closest monetary allies believe it is over-playing its hand on significantly tightening euro rules.

Well-informed European officials say that a majority of the ECB Council is now against the appointment of Weber as president of the ECB.

In another example, Olli Rehn, the Finnish Commissioner for monetary affairs in Brussels, has come out against the plan put forward by Wolfgang Schäuble, the German finance minister, for countries facing financial difficulty to 'make a fresh start' through undergoing voluntary insolvency procedures. Rehn believes that a change in European governing treaties would be needed to authorise such sweeping adjustments to European rules – something the Commission wants at all costs to avoid.

In similar vein, Nouk Wellink, the Nederlandsche Bank president, opposed the decision by Axel Weber, the Bundesbank president, to criticise publicly the European Central Bank's decision on 10 May to buy bonds issued by the weaker euro countries. Even though they sympathised with some of the reasons for Weber's decision, other 'hard money' European central bankers have also complained privately about Weber's stance, declaring that it weakened the ECB's hand at a crucial moment.

Well-informed European officials say that a majority of the ECB Council is now against the appointment of Weber as president of the ECB after the incumbent Jean-Claude Trichet retires at the end of October 2011. Instead, a majority would probably vote for Mario Draghi, Governor of the Banca d'Italia.

With regard to the German suggestion of expulsion of states from EMU, Dutch officials believe the idea is not acceptable politically. Moreover, they say it would not help avoid future crises. Instead, these officials say it is more important to strengthen the rules for budgetary discipline and to improve macroeconomic surveillance of euro members. Here, the Dutch take side with the Germans, and the European Commission, arguing that tough fines against member countries that fail to keep their fiscal house in order are desirable. If participation in the euro area could be severed, however, it would turn the monetary union into nothing more than an intergovernmental group with voluntary membership, they say. 'Throwing one member country out of EMU would inevitibly mean the end of monetary union,' according to one official. 'The remedy would be worse than the disease.'

These issues will be hotly debated in Brussels in coming weeks in the task force of finance ministers examining European economic governance under EU president Herman van Rompuy. The Dutch favour surveillance using a limited number of indicators, in addition to the traditional convergence criteria of EMU: the current account of the balance of payment, credit expansion and housing prices. European rules for budgetary discipline should be embedded in national policies, and should be perceived not as a 'diktat' from Brussels but rather as prudent budgetary policies in the national interest.

With regard to the recent decision of the Slovak government not to participate in the European Financial Stability Facility, the Dutch authorities, along with those of other euro countries, have expressed their strong disapproval. Although they complain at lack of Slovak solidarity, Dutch officials accept that, since the EFSF is a intergovernmental agreement, euro members cannot be forced to participate. 'There is nothing you can do about it, but they [the Slovaks] are withdrawing from common responsibility to solve the problem. If all countries would act in the same way, there wouldn't be a euro,' one official said.

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'Trilemma' over sovereign wealth

State funds face their own impossible trinity

Andrew Rozanov, Head of Sovereign Advisory, Permal Group

Some commentators [OMFIF September Bulletin, p.23] have proposed refining the nomenclature describing sovereign wealth funds or SWFs. While the term may not always be appropriate, it has firmly entered the standard financial lexicon. Moreover, the funds themselves have officially accepted it, seen by the establishment of the International Forum of Sovereign Wealth Funds (IFSWF) last year. There is now a clear definition of what constitutes an SWF. At least 24 institutions officially use this term to describe themselves.

Many state funds are revisiting some of the key tenets of modern portfolio theory as well as their institutional and governance arrangements.

We should focus on coming up with fresh ideas to provide innovative solutions, not quibbling over terminology. It would be helpful to define a framework for analysing sovereign wealth funds' objectives and challenges in the light of the financial crisis, which tested many assumptions and practices. Many state funds are revisiting some of the key tenets of modern portfolio theory as well as their institutional and governance arrangements.

One potential blueprint might be gleaned from the world of central banking. The so-called 'Impossible Trinity' states that no monetary authority can simultaneously sustain a fixed exchange rate, freedom of capital movements and an independent monetary policy. Trying to pursue all three goals at once can lead to disastrous macroeconomic and financial consequences. The equivalent of the 'Impossible Trinity' in the SWF world may contain the three typical policy objectives of achieving stabilisation, promoting long-term saving and supporting economic development. A state-owned fund may be successful in pursuing two, but rarely, if ever, all three of the objectives.

A classic stabilisation fund needs to invest in very safe and liquid assets, thus missing out on long-term liquidity and risk premia. This foregone return differential is the price it pays for assured liquidity and low volatility. A classic long-term saving fund, on the other hand, typically takes the opposite side, providing liquidity at times of distress and earning various risk premia by maintaining a disciplined, contrarian asset allocation. These two policy mandates push in opposite directions. The worst outcome is to chase after yield in the good years and scale back risk dramatically during the bad years.

Some examples among the larger and more established funds suggest, however, that the two mandates can be successfully combined. ADIA of Abu Dhabi and GIC of Singapore are, first and foremost, long-term investment and wealth management vehicles. But they are very large, they include multiple asset classes, and maintain a sizable allocation to liquid assets as part of their investment strategy. If required, both can step in at times of dislocation to provide stabilisation for the local economy. Neither fund has a development mandate. This is left to other sovereign entities, like Mubadala and Temasek, which have a dual mandate: strategically supporting the local economy and corporate sector, and optimally managing entrusted wealth, by maximising long-term risk-adjusted returns.

There are some relatively rare examples of combined stabilisation and development mandates. China's Central Huijin Investment was set up in 2004 to recapitalise local banks – a stabilisation operation. It was subsequently mandated with restructuring systemically important banks and developing the local banking system. Another example is the French Strategic Investment Fund, set up to stabilise and support strategically important local companies during crises, with a view to helping their long-term development.

Significantly, Ireland's and Kazakhstan's SWFs – the former geared to long-term saving, the latter with a stabilisation/saving mandate – were unexpectedly tapped during the crisis to bail out local banks and, in the case of Kazakhstan, support local companies. These funds were pushed to take on all three policy functions simultaneously. Most observers would agree, however, that the resulting set-up is unsustainable and that some reformatting will occur. This is a good example of how the postulated 'trilemma' works in practice – and demonstrates how more work needs to be done to fill in gaps in our analysis.

US slowdown weighs on world outlook

Room for further spending programmes is highly constrained

DZ Bank Economic Forecasts			
GDP growth			
	2009	2010	2011
USA	-2.6	2.5	2.0
Japan	-5.2	3.0	1.7
China	9.1	10.2	8.5
Euro area	-4.0	1.5	1.0
Germany	-4.7	3.3	1.6
France	-2.5	1.6	1.4
Italy	-5.1	1.0	0.8
Spain	-3.7	-0.5	0.0
UK	-4.9	1.3	0.8
Addendum			
Asia excl. Japan	6.1	8.6	7.2
World	-0.7	4.3	3.7
Consumer prices (% y/y)			
USA	-0.3	1.6	1.5
Japan	-1.3	-1.1	-0.3
China	-0.7	3.0	3.7
Euro area	0.3	1.5	1.3
Germany	0.2	1.1	1.1
France	0.1	1.7	1.6
Italy	0.8	1.5	1.2
Spain	-0.2	1.6	1.1
UK	2.2	3.1	2.8
Current account balance (% of GDP)			
USA	-2.7	-3.0	-3.1
Japan	2.8	3.7	3.5
China	6.5	5.7	5.3
Euro area	-0.6	0.1	-0.2
Germany	4.9	5.5	5.6
France	-2.2	-2.5	-2.5
Italy	-3.2	-3.0	-2.9
Spain	-5.1	-4.7	-4.6
UK	-1.1	-1.2	-1.0

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

The US economy is likely to slow down further in H2 2010, with quarterly growth rates around 1.0 to 1.5% (annualised). Growth was still quite robust in H1 2010 on the back of a massively expansionary fiscal policy. Positive one-off factors such as inventory replenishment are losing influence. The positive impact of last year's big fiscal package probably reached its peak in the middle of this year – and there is little scope for new expenditure.

The sluggish growth trend is likely to continue beyond the end of the year, especially as job creation remains anaemic, which is curbing consumer spending. We have lowered our forecast for US GDP growth in 2011 to only 2%, which puts it below the current consensus. Although the US is managing to avoid a double-dip recession, for the time being it is staging a jobless recovery. Inflation will remain very moderate, given that consumer spending is growing so sluggishly. We put the headline rate for 2010 at 1.6%, and in 2011 it is likely to be even lower.

In China, too, the ample fiscal measures deployed to overcome the economic crisis are gradually coming to an end and tighter restrictions are again being put on the generous lending seen during the past year. As a result, the Chinese economy has slowed somewhat during the summer. What's more, private investment in residential building will probably contract significantly in the next few months as Beijing applies the brakes to slow excessive growth in the property market. Foreign trade is also unlikely to provide much stimulus for economic growth in the coming year given the weaker economic performance of China's most important export markets. Although China's economy will still manage to post double-digit growth again this year thanks to the strong start it made at the beginning of the year, in the coming year it is only likely to grow by 8.5%.

Following the extremely vigorous recovery in the winter half year 2009/2010, the Japanese economy clearly lost a lot of momentum in the second quarter. While private consumer spending has stagnated recently, exports have slowed considerably. They are suffering owing to the appreciation of the yen, at a 15-year-high against the dollar in August. The fiscal headroom to provide further support for the economy is rather restricted due to the state's record debt. The domestic price climate is still deflationary, so the central bank will continue to maintain generous liquidity.

In the euro area there are signs that the economy is weakening because of less dynamic export growth and the repercussions of various consolidation programmes, especially in the heavily-indebted countries. The German economy continues to benefit significantly from the global economic recovery thanks to its strong export sector. Nevertheless, here too growth rates will be notably lower in the coming year.

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The paradox of the yen

Different effects of debt on Japan and Europe

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

Mid-September brought the Japanese central bank's first interventions in the foreign exchange markets for around six years – aimed at weakening the national currency. The yen has been appreciating strongly – especially against the US dollar – since early May, and it was fear for the competitiveness of Japan's exporting industry that compelled the central bank to act – despite the uncertain prospects of success.

Considering the euro's fall from grace over the same period, we feel obliged to ask: are the financial markets applying double standards in valuing these two currencies? While the ballooning government debt of individual euro area member states is seen as the cause of the euro's present weakness, apparently Japan's much higher indebtedness 'is not really a factor' in the markets.

At first glance, this is paradoxical: the euro is falling because of the sovereign debt crisis – the yen is rising despite sky-high sovereign debt. IMF statistics tell us Japan's (gross) debt ratio for 2009 was around 218% of gross domestic product (GDP), almost double that of Greece (115%).

Of course, there are valid explanations for the yen's recent surge. The first is that the yen, like the Swiss franc, enjoys a halo effect in the markets as a 'safe haven' currency. Money floods into the country in times of turmoil, causing the exchange rate to rise. To an extent also, China has an interest in keeping the yen strong since this means China's competitive situation in the Asian region will not deteriorate even if the Chinese currency strengthens. It is therefore no surprise that China's central bank has diverted more of its currency reserves into yen in recent months. A third factor, and this is probably the crucial difference from countries such as Greece and Portugal, not to mention the US, is that Japan is not dependent on foreign capital to balance its government deficit.

For many years now, Japan has consistently reported current-account surpluses averaging more than three percent of GDP that have helped build the world's second-biggest pool of foreign-currency reserves. This is not the least reason why the bulk of Japan's sovereign debt (95%) is domestically held, with the Japanese government controlling around 50% of the total. The equivalent ratios for countries such as the US or Greece whose current accounts are in chronic deficit are significantly lower (respectively 52% and 37% of government debt in domestic hands). Japanese insurers and pension funds, banks and private households are all still willing to invest in Japanese government bonds despite their ultra-low yields.

But how much longer can this pattern hold in the face of Japan's demographic trends? There is no doubt that, longer-term, the ageing of the population will significantly reduce demand for JGBs from pension funds and private households. The Japanese will tend to become net sellers of government debt. This could eventually lower bond prices, since it is doubtful whether foreign buyers will fill the demand shortfall at the present yield level.

The ageing population will significantly reduce demand for JGBs from pension funds and private households.

Does this mean that a significant medium-to-long-term yen depreciation is on the cards? Very probably. And not only that: when Japan's domestic savings gradually erode, this will eventually and inevitably trigger a reversal in national fiscal policy. Record high debt levels and still considerable primary budget deficits cannot be a sustainable foundation for fiscal policy. This is the lesson that several eurozone countries are learning at painful cost right now.

Although interest rates are bound to rise in Japan and the government will be forced to impose harsh economies, at least the yen exchange rate will then no longer be the most urgent problem facing Japan's economic policy makers. After all, the strong appreciation of the yen in the run-up to the early 1990s crash was one of the principal causes behind the subsequent long downturn.

New challenges for central bankers

Finding a way to break down silos

Malan Rietveld, Chief Economist

The global financial crisis has fundamentally changed the role and the perception of central banks in society. In the years leading up to the crisis, central banks appeared increasingly comfortable in their role as dispassionate monetary policy agencies, staffed by learned technocrats who operated at a comfortable cruising altitude above the political fray.

This benign scenario is rapidly fading from view as central banks are called upon to perform an ever more complex, contentious and cheerless set of tasks: deciding which institutions are saved and which fall by the wayside (and on what terms); tightening monetary policy while unemployment rates remain at very high levels; determining which financial institutions are allowed to do what; acting as a market-maker and debt-buyer of last resort. The list can be extended.

Central banks are being asked to perform an ever more contentious and cheerless set of tasks.

Amid this remoulding of the art of central banking, high-level and academic debates on the changing role of central banks in this new world rarely pay heed to the sweeping implications for the leadership and personnel development of these institutions. Yet the manner in which central banks respond to the need for continuous renewal and retooling will determine their success in meeting their daunting challenges.

Dynamic central bank leaders are guiding their organisations by developing their human capital along the following parameters:

- **Acquiring new skills** – Central banks have always been economist-heavy institutions – and this is unlikely to change. However, the tasks before central bankers in the aftermath of the crisis require greater expertise in the practical realities of modern banking and finance. Given that most of the new financial reforms require central banks to fill in the details of the new regulatory system – to do the 'rule making' – they will require a greater number of legal experts, as well as seasoned political operators and expert external communicators.

- **Understanding 'the supervised'** – The guardians of the financial system need to learn a lot more about the culture, practices and methodologies of the banks and other financial entities that they oversee. Of course, central banks and supervisors can always call in the bankers, grill them and go through their books with a fine tooth-comb. But, beyond this, official institutions need to make more extensive use of methods of achieving interaction, learning and dialogue with the private sector.

- **Looking beyond silos** – Although the trend is already underway in many central banks, there is an urgent need to move away from the silo mentality that typically defines most of these institutions' organisational culture. Senior managers need to be able to see the 'bigger picture', understand the full scope of the central bank's functions and remain fully aware of how the institution's various tools can be used in different and rapidly evolving circumstances. This can't be done if leaders care only about their own unique field.

- **Political savvy** – Independence remains critical to the operation and formulation of monetary policy. But central banks' role in financial stability, regulation and resolution is by definition political and inter-institutional (not only in moments of crisis, but also in times of relative calm when they are under pressure to relax standards). Also, monetary policy, financial oversight and fiscal policy have become more interconnected as a consequence of the policy response to the crisis, necessitating closer and more effective coordination between central banks, supervisors, political administrations and legislative bodies. More ominously, central bank budgets and the appointment of senior officials are already attracting more political "heat" than they did before the crisis. Central banks simply cannot afford to view themselves as above the political fray. Central bank leaders need to understand the political process and engage in it actively.

- **Strategic thinking** – In recent years, leading central banks have adopted cutting-edge strategic plans. While this development is to be applauded, it is not done widely enough and often lacks meaningful 'buy-in' at the highest level. Training programmes for central banks tend to focus on narrow policy issues, rather than on operational aspects such as goal-setting, organisational efficiency and strategic planning. The challenges facing central banks – and their institutional and organisational response to them – require a strategic approach.

For better or worse, central banks tend to resist change. A conservative culture and a highly guarded approach promote consistency in policymaking and helps central banks from getting caught up in temporary fads. But the flip side is that central banks can be overwhelmed by events unfolding around them. The nature of central banking has fundamentally changed since the start of the crisis. To confront this new reality, central banks need constantly to educate their staff, adapt to the need for developing new skills and build leaders that run their central banks as flexible, responsive institutions.

Blair's terminological inexactitudes

Former PM rewrites history with a vengeance

William Keegan, Chairman, Board of Contributing Editors

Tony Blair's memoirs – A Journey – took the UK by storm early in September. The advance publicity promised a scathing attack on his chancellor of the exchequer and successor as prime minster, Gordon Brown, and the public was not disappointed.

Until the last-minute publicity, the conventional view had been that Blair's memoirs would be boring. Blair and his wife are considered by their enemies to be greedy and venal, so when they announced that the proceeds would be given to charity, the cynical interpretation was that they were assuming poor sales. Yet the memoirs proved to be a best-seller, helped by the way the major book chains cut the cover price drastically within 24 hours of publication.

Many a political memoir is disingenuous. Our leaders want to go down well in history, and, after they have made it – or failed to – they naturally wish to put the best face on their efforts. Winston Churchill, a far more formidable figure than Blair, and a far better writer, made no secret of his object in this regard. We owe to Churchill that great euphemism 'terminological inexactitude' to describe a bare-faced lie. Two terminological exactitudes relating to monetary policy crop up in A Journey.

One concerns the origins of the New Labour government's decision to grant operational independence in monetary policy to the Bank of England. The other relates to British policy towards the euro. They are related, in the sense that when the Bank was granted independence, this was interpreted by some as a step towards euro membership. But it would have been less a step, more of a giant leap. The Labour Party that had nationalised the Bank of England in 1946 could conceive of making it independent in 1997. But handing over monetary policy to the European Central Bank was not a measure that Gordon Brown was prepared to countenance – or allow his boss Tony Blair to decide.

Regarding the terminological inexactitude about the Bank's independence, Blair claims that it was his idea, although Brown claimed the credit. My understanding, having talked to most of the participants, is that it was Blair's idea only in the limited sense that – when presented with it by the formidable team of Brown and Ed Balls, then Brown's economic advisor – Blair did not demur. Brown did not come to his decision lightly. Chancellor Nigel Lawson had wanted to make the Bank independent in 1988-89, but Mrs Thatcher dismissed the idea. Her successor John Major believed that interest rate decisions should remain with elected representatives. But when Ed Balls joined Brown's staff (in Opposition) in 1992, he consistently pressed the case for Bank independence, and finally won Brown round – but only after Brown had consulted many experts, including his European counterparts and Alan Greenspan, then chairman of the Federal Reserve.

With regard to the Blair version of policy towards the euro, I cannot resist moving on from Churchill's 'terminological inexactitude' to the word 'whopper' – a word used towards members of my generation when schoolmasters or parents believed we were not telling the truth. In A Journey, Blair gives the impression of not being too concerned about Britain not joining the euro. Yet in fact for a long time Blair wanted to 'go down in history' as the man who finally decided Britain's place in Europe.

Brown, for his part, together with Labour's lost leader John Smith, had passionately supported UK membership of the European Exchange Rate Mechanism and, eventually, the euro. But he changed his mind after Britain was forced out of the ERM in September 1992, partly because of Balls' strong influence. Whether or not we should join the euro took up a huge amount of ministerial and official time. Brown went to labyrinthine lengths to pretend it was a serious objective, whereas in his mind it most certainly was not. When Tony Blair plays down the monumental importance that he once saw in this question, this is a substantial 'whopper'. Blair has been rewriting history with a vengeance – vengeance towards Gordon Brown, among others.

Blair gives the impression of not being too concerned about Britain not joining the euro. Yet he wanted to 'go down in history' as the man who finally decided Britain's place in Europe.

Looking ahead – 2010 diary dates

Germany's New Role within EMU
7 October, New York
Patricia Mosser, Federal Reserve Bank of New York
Joachim Nagel, Deutsche Bundesbank and others (with DZ Bank)

Growth, Debt and Rebalancing
8 October, Washington
Mary J. Miller and Charles Collyns, US Treasury (with Atlantic Council)

Europe – The Way Forward
9 October, Washington
Lorenzo Bini Smaghi, ECB and others (with DZ Bank)

EMU Werner Plan Lecture
14 October, London
Yves Mersch, Governor, Luxembourg Central Bank

OMFIF Meeting in Middle East
31 October – 2 November, Abu Dhabi
H.E. Sultan bin Nasser Al-Suwaidi, Governor, Central Bank of the U.A.E.

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