OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

October 2011

How to end Europe's hijack of IMF

Fund must revamp facilities and privileges

Mario I. Blejer, Advisory Board

The world's premier official financing body is still called the 'International' Monetary Fund but, in practice, it has been hijacked by Europe. The IMF plays a junior role within the 'troika' managing the bailouts for Greece, Ireland and Portugal. Yet its financial commitments to Europe, relative to its size, are staggering.

The IMF would be well advised to consider solutions to this impasse. The Fund should limit its seniority as a creditor. Furthermore, it should reduce its direct lending and open instead an IMF-sponsored guarantee facility.

Revamping its facilities and legal privileges are necessary to help the Fund regain its credibility, in view of an imbalance under which about 80% of IMF credit outstanding for all members has been allocated to European countries. Of programmes currently active, Greece, Ireland and Portugal account for two- thirds of total non-precautionary IMF commitments. Adding other current European programmes, the European share exceeds 83%. And this does not yet reflect the expected IMF contribution to the second Greek bailout decided in July.

Astounding but true: 28 poor countries have IMF programmes under the Poverty Reduction and Growth Trust. The total makes up only 2.6% of IMF commitments – and represents just 10% of the commitments to Greece. In future, we may see a shift in the sources of funding, based on latest indications – catalysed by the near-collapse and rescue of Franco-Belgian bank Dexia — that European governments may be about to recapitalise European banks. Such a step was proposed last month by Christine Lagarde – a call initially rebuffed by the Europeans.

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Divisive and disruptive, Eurobonds are not the answer

In an ideal world, Eurobonds would be matter of fact, as safe and unexciting as the bonds that represent the whole of Germany from the booming villages of Baden-Württemberg to the meadows of Mecklenburg, *writes Michael Stürmer, Advisory Board.* If trust could be restored, Eurobonds would be as good as gold. in the real world, Eurobonds are divisive, controversial and potentially disruptive for the whole euro area. In the short run, they will not happen. Muddling through will continue. *(continued on page 4 ...)*

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Asia contagion

Euro decoupling illusion

Sabrina Wong, Advisory Board

As Europe struggles to contain the twin challenges of sovereign debt difficulties and banking weakness, emerging markets are being badly hit by the backlash from the euro's woes. Hopes that the rapidly-growing economies can decouple from the euro area slowdown and potential shock in the financial system are wishful thinking. According to EPFR Global, investors have pulled out roughly $1.7bn in a week, after 25 weeks of consecutive inflows into emerging markets.

The sell-off has been indiscriminate. All 25 of the largest emerging market (EM) currencies weakened against the dollar in the last week of September, coinciding with $7.5bn of inflows into developed market bond funds. National stock exchange data to mid-September show net foreign outflows from stocks in Taiwan ($9.1bn), Korea ($6.3bn) and Thailand ($892m), with foreign outflows accelerating in recent weeks. Recent weeks have seen the largest net outflows from Indonesia as well as nervousness throughout the Asian region.

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Moment of truth

Europe in a global perspective

David Marsh, Co-chairman

Denouement, moment of truth, endgame, time of decision – call it what you will, a turning point is about to occur in the long-running, many-sided stand-off between Greece and its creditors from the private markets and official lenders. There's no great secret about the outcome – a massive restructuring of Greek debts. But there's a great deal of uncertainty on the ramifications for other problem-hit members of economic and monetary union (EMU) and the banks which will need recapitalisation as they wake up to the certainty that the government bonds in their portfolios are not risk-free.

At the annual meetings of the World Bank and International Monetary Fund (IMF) in Washington last month, sentiment was split between the doomsayers and the realists who opine that one way to find out the result of a Greek default is to let it happen. I liked the comment from Gao Xiqing, president of China Investment Corporation (CIC), who told an IMF seminar that just because people like George Soros thought a Greek default could bring 'the end of the world', that didn't mean that it wouldn't happen.

This month's Bulletin looks at the implications of the euro malaise across a wide range of areas. Mario Blejer puts forward ways of mitigating the 'hijacking' of the IMF by European sovereign borrowers. Sabrina Wong reports how emerging markets have become the latest victims of contagion. Michael Stürmer rules out Eurobonds. David Owen calls for enshrining the 'Non-Eurogroup' to counter the idea that euro membership is the end-goal of all EU members. Pawel Kowaleski dwells on the lessons of European football competitions for the euro area. John Kornblum says the leaders of France and Germany are showing how Europe still hasn't got over the Second World War. And Stefan Bielmeier prepares the world for 'a new Ricardian age' where growth will crucially depend on reducing fiscal deficits.

William Keegan laments the Greeks' ability to learn from their ancient sages. Darrell Delamaide investigates the diverse pressures on Ben Bernanke. Casting his eye on a leading representative of the emerging markets, Malan Rietveld highlights how South Africa's economy enjoys characteristics that would be the envy of many finance ministers in Europe, yet needs widespread supply-side action to rescue the country from the trap of high unemployment and poverty. Europe's problems indeed take on a different hue when seen in a fully international context.

David Marsh

Looking ahead – 2011-2012 diary dates

OMFIF Lecture with Vítor Constâncio
Vice-President, European Central Bank
26 October 2011, London
The Future of the Euro System

OMFIF Meeting with Deutsche Bundesbank
13-14 March 2012, Frankfurt
The World Economy at a Turning Point

OMFIF Conference First Asian Central Banks' Watchers Conference
1 November 2011, Kuala Lumpur
Asian Perspectives on World Finance

OMFIF Lecture with Philipp Hildebrand
President, Swiss National Bank
26 March 2012, Edinburgh
The Swiss franc's Role in World Money

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How EMU can learn from football

Merits of 'hard Ecu' currency co-existence

Pawel Kowalewski, Advisory Board

For an answer to the European debt crisis, we may seek inspiration by looking at past currency systems. But we should also consider practices followed in another organised European competition with great national and international appeal – football.

Several key principles are worth following. On several past occasions, the European Monetary System, the forerunner of economic and monetary union (EMU), was suspended, and had its rules relaxed, to allow for structural changes within and outside it. Currency systems require flexibility to follow national economic exigencies, and also as much comparability and interaction as possible at a higher international level, to enforce competition and promote higher standards, for example over monetary and fiscal control.

This twin-track approach is well illustrated by football's European Champions League. The pan-European competition is part of an overall system coexisting with domestic football leagues, in a compromise that provides benefits for all. Each component contributes to the sum of the parts. Combining the regional or domestic flavour with international aspects is of great importance. It would disastrous for European football to confine the game only to the higher European stage. Manchester United and Liverpool have to be integrated into a set-up that includes much less high-performing domestic clubs. Not all European clubs can play in the Champions League, and domestic competitions offer socio-politically attractive and economically sustainable means for countries to stage the game at a different level. The basic point is that not everyone can be a winner – as we see in EMU today.

History teaches some useful lessons – and so does football. They should be borne in mind by politicians as they ponder Europe's future monetary framework.

It is evident that the system in place up to now for monetary union has insufficiently combined national and international aspects. A country like Greece hit by a current account deficit and a sharp recession needs a nominal devaluation. Adjusting the economy by deflation may end in social tensions that will not produce the desired result. To go back to its domestic currency, the country might wish to withdraw from monetary union. Or can the two concepts be combined? The 'hard Ecu' proposal put forward in 1990 by former UK prime minister John Major offers some useful hints. Its author advocated it as a currency for business or personal transactions as an alternative to a single currency across the whole of Europe, for which he foresaw 'enormous difficulties and enormous dangers.'

During the half-century-long quest for monetary integration, the goal of exchange rate stability in Europe suffered a number of setbacks. These included the departure of Britain, Italy and France from the European currency Snake during the 1970s, as well as the 1992-93 turmoil within the exchange rate mechanism of the EMS which resulted (again) in the exit of the UK and Italy and in the emergency August 1993 widening of exchange rate bands. A lesson from these experiences is that it is better to abandon a project at the height of turmoil and wait for better times, allowing a later return to original plans. Applying this concept to the present, if countries can afford to use the euro, they should be encouraged to do so. But if using the euro goes beyond their economic capacity, they could be entitled to bring in a new domestic currency accompanying the euro: a two-tier system that would persist until they were willing and able to re-introduce full euro membership.

History shows the importance of a domestic currency as a sign of sovereignty, along with the national anthem, coat of arms and the flag. In the aftermath of the disintegration of the Soviet Union and Yugoslavia, the newly-emerged countries quickly reintroduced national currencies. Of course, in the case of Greece, bringing back the drachma would be expensive and complicated. Possibly, national euro notes and coins – which have some distinguishing features compared with other countries' euros – could exist side by side with 'international' euros. Although these are significant considerations, they are technicalities. The important thing to realise is that history teaches some useful lessons – and so does football. They should be borne in mind by politicians as they ponder Europe's future monetary framework.

How to end Europe's hijack of IMF *(continued from page 1 ...)*

The new IMF managing director would like to wield more clout. However, her influence on the international agenda is weakened by the Fund's enormous financial bias towards Europe, which is rattling emerging markets, undermining the organisation's legitimacy and setting off a proliferation of initiatives around the world to foster regional monetary funds.

In addition, these massive IMF transfers are not working. The programmes have not restored market confidence and prevented contagion. Peripheral Europe cannot return to the private sector capital markets. Yields on government debt exceed pre-programme levels – although those for Spain and Italy, are artificially contained by ECB intervention.

It seems very unlikely that further burdening the IMF balance sheet with additional claims on European sovereigns would restore market access and alleviate global uncertainty. But two possible modifications – limiting the Fund's seniority and reducing its direct lending – might help rectify the situation.

Fund seniority means that, in a default, the IMF must always be paid first and in full. An increasing proportion of peripheral euro member debt is being transferred to official hands, so seniority is an obstacle to these countries' return to private market borrowing. As a result, to stimulate market access, the case for restricting Fund seniority is compelling. Moreover, exposing the Fund to credit risk would provide incentives for better programme design and would help avoid the unreasonable concentration of exposures observed today.

The second modification relates to the type of facilities the Fund offers. Relying solely, as today, on direct lending does not necessarily reduce risk aversion. An alternative for maintaining liquidity flows without massive disbursements would be to create an IMF-sponsored guarantee facility. The Fund has preferred to use only direct lending because, by controlling huge resources, it enhances its clout and power. But a Fund-backed guarantee scheme would reduce borrowing costs, would not substitute for private creditors, and would be more effective in attracting foreign capital and facilitating rollovers.

Divisive and disruptive, Eurobonds are not the answer *(continued from page 1 ...)*

For the time being, take the advice that Alice in Wonderland received from the Cheshire Cat. Alice asked where she should go. So the cat asked: 'Where do you want to go?' Alice replies: 'I don't know'. So the Cheshire Cat finally says: 'If you don't know where you want to go, any path will take you there'.

Eurobonds are the latest in a series of proposals that reveal the critical state of the euro area. Countless are the admissions, right from day one, that without a certain fiscal and social harmony the common currency would be bound to come apart at the seams.

The concept of Eurobonds has been firmly resisted by the German government. The present debate results from the conspicuous loss of confidence in the common currency and its future. It also signals a dangerous loss of confidence in government that could, if not handled and repaired, eventually lead to a crisis of democracy within the nation states and open rebellion against the Brussels Eurocrats.

Germans are haunted by a new kind of Angst: After nuclear annihilation and Waldsterben in the 1970s and 1980s, it is now the currency that was never very much liked anyway. What happened to the Mastricht criteria? The independence of the Bundesbank? The no bail- out clause? Gone with the wind – together with trust in government.

Eurobonds are not the beginning of the transfer union; they are the transfer union. They would transfer credibility from stable, solid countries to those who lack both stability and solidity. Those with sound finances pay higher interest rates: easy spenders pay less than what they should. It is a system that puts a premium on moral hazard and is bound to destroy itself.

Euro decoupling illusion *(continued from page 1 ...)*

Addiontally, in the year to 16 September, foreigners sold a net R51bn of South African bonds. Emerging markets' vulnerability to developed markets' problems stems from a combination of financial market integration and traditional export linkages. Despite the rise in intra-Asia trade, EU and US demand still heavily influences exports from Asia.

On the capital markets, Indonesian and Malaysian bond markets saw foreign holdings rise to a record high in 2010, with approximately 30% of total outstanding government securities held by foreigners. There were also high foreign direct investment inflows from the euro area into Thailand (1.7% of GDP) and Malaysia (1.8% of GDP) in 2010.

Indonesia, India and Malaysia's exports are the most exposed to a euro area slowdown. Since 2003 Malaysia, Thailand, the Philippines, Korea, India, Singapore, Taiwan and China all show a correlation coefficient of 0.70 or more between their own GDP growth and that in the euro area. The euro area is China's biggest trade partner, and is also an important export destination for India and the Philippines. Some products are more cyclically-orientated than others, especially commodities such as fuels, where prices are largely determined by demand patterns in the US and EU. Countries with a high share of these products in their export basket, such as Indonesia (where fuels accounted for 30% of total export value in 2010) could see export volumes declining at the same time as growth slows in developed markets.

Emerging markets can weather currency volatility in the short term given high foreign exchange reserves, particularly in Asia. However, if weakness persists, emerging market growth will be dragged down in the slipstream.

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Much ado about doing nothing

Bedevilled by stability fears, Europe can't act

John Kornblum, Advisory Board

For the fathers of the euro, the end of the Cold War in 1990 was a time for worry as well as celebration. As they looked to the future, they were obsessed with the continent's bloody past. Would a new Europe, and especially a reunified Germany, reawaken old nationalist sentiments and lead again to the danger of war?

Germany's Helmut Kohl and France's François Mitterrand saw a common currency as essentially a political project, meant to cement European unity and remove that danger. For them, a world without the euro would have been a world threatened by conflict. Because of these fears, the euro was rushed through without agreement on the common political institutions that would have turned Europe into a truly unified economic zone. Each country follows its own economic policy. Greece spends, while Germany saves. Markets have been quick to focus on the weakest links, threatening the project with the possible bankruptcy of countries such as Greece and Portugal.

The latest impasse over possible further expansion of the European rescue fund has been encapsulated by Slovakia's last-minute voting confusion. Together with comments by Germany's coalition leaders indicating that Greece will default, this illustrates Europe's underlying dilemma. My own view is that the dramatic predictions of war were greatly over-played. War would not have come to Europe, with or without the euro. A 1997 prediction by Harvard economist Martin Feldstein seems closer to reality. He argued that the euro would lead to major friction within the European Union, because the problems in maintaining a common currency would create confrontations and a rebirth of nationalism.

The latest impasse over possible further expansion of the European rescue fund, encapsulated by Slovakia's last-minute voting confusion, illustrates Europe's underlying dilemma.

Feldstein was right. The euro crisis has frayed nerves so much that Europeans have become more aggressive and even nationalistic again. The polite tone cultivated for decades by EU partners has disintegrated into a tirade of insults. Germans have called the Greeks lazy, corrupt and just plain stupid. German politicians have suggested that Greece sell islands to repay its debt. In return, Greeks have pulled out the Nazi card, claiming that the Germans owe them billions in wartime reparations. The other fear in 1990 was that, without the euro, a reunified Germany would again dominate the continent. The euro would keep Berlin tied to Europe. German Chancellor Angela Merkel never tires of repeating this mantra — 'If the euro fails, the entire European project will be at stake' — when she calls for another bailout. But, in the past 20 years, the Germans seem to have become emancipated. They reformed their economy. Today, instead of being controlled by the French, they are acting independently as they call the shots in an EU of 500m people.

German exporters have profited most from other Europeans' profligacy and ability to suck in German-made consumer and capital goods. The German banks, of course, are highly exposed to peripheral countries' debts built up to finance these purchases. But there is great reluctance to take action to protect the banks with a further-reaching credit mechanism that would add debt to debt. Before and during the IMF/World Bank meetings in Washington, US Treasury Secretary Timothy Geithner has been encouraging the Europeans to look at fresh debt, through 'leveraging' the EFSF rescue fund. He met a frosty response.

Geithner's mistake was to think that European ministers have been talking primarily about banking or deficits — or about money at all. They were really still talking about the war and the same fears of instability that motivated Kohl and Mitterrand. European meetings on the debt crisis have not been about action but about how best not to do anything drastic. Instead of acting decisively, as Geithner demanded, European governments feel limited by their commitment to 'Europe' to taking small steps that will not endanger the EU internal balance. This overwhelming fear of internal conflict has burdened the EU since its birth in 1957. European politicians may not be experts on finance, but they do know their voters. Doing nothing is better than risking hard-won stability. It's a legacy of the Second World War that is proving hard to shake off.

European treaty amendment

The following represents an illustrative description of how present European Treaty language could be changed to accommodate changes pertaining to the Eurogroup. This proposal contains an abridged version of the two key Treaty Protocols and is intended as a draft indication of possible amendments rather than as a binding proposal

PROTOCOL (No 14)
ON THE EUROGROUP
THE HIGH CONTRACTING PARTIES,
DESIRING to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,
CONSCIOUS of the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro, ~~pending the euro becoming the currency of all Member States of the Union,~~
HAVE AGREED UPON the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

Article 1
The Ministers of the Member States whose currency is the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is the euro and of the Commission.

Article 2
The Ministers of the Member States whose currency is the euro ~~shall elect a president for two and a half years, by a majority of those Member States~~. **shall appoint as president for their informal meetings the President of the European Council.**

PROTOCOL (No 15)
ON THE NON-EUROGROUP
~~ON CERTAIN PROVISIONS RELATING TO THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND~~

THE HIGH CONTRACTING PARTIES,
DESIRING to promote conditions for stronger economic growth in the European Union and, to that end, to develop ever-closer coordination of economic policies within the euro area,
RECOGNISING that **any Member State in the Non-Eurogroup** ~~the United Kingdom~~ shall not be obliged or committed to adopt the euro without a separate decision to do so by its government and parliament,
~~GIVEN that on 16 October 1996 and 30 October 1997 the United Kingdom government notified the Council of its intention not to participate in the third stage of economic and monetary union,~~
~~NOTING the practice of the government of the United Kingdom to fund its borrowing requirement by the sale of debt to the private sector,~~

CONSCIOUS of the need to lay down special provisions for enhanced dialogue between the Member States whose currency is the euro,

HAVE AGREED upon the following provisions, which shall be annexed to the Treaty on European Union and to the Treaty on the Functioning of the European Union:

1. The Ministers of the Member States whose currency is not in the euro shall meet informally. Such meetings shall take place, when necessary, to discuss questions related to the specific responsibilities they share with regard to the single currency. The Commission shall take part in the meetings. The European Central Bank shall be invited to take part in such meetings, which shall be prepared by the representatives of the Ministers with responsibility for finance of the Member States whose currency is not in the euro and of the Commission.
~~Unless the United Kingdom notifies the Council that it intends to adopt the euro, it shall be under no obligation to do so.~~
2. The Ministers of the Member States whose currency is not in the euro shall appoint as president for their informal meetings the President of the European Council.
~~In view of the notice given to the Council by the United Kingdom government on 16 October 1996 and 30 October 1997, paragraphs 3 to 8 and 10 shall apply to the United Kingdom.~~
3. T~~he United Kingdom~~ **All Member States in the Non-Eurogroup** shall retain its powers in the field of monetary policy, **including fiscal regulatory and bank rate policy,** according to national law.
4. Articles 119, second paragraph, 126(1), (9) and (11), 127(1) to (5), 128, 130, 131, 132, 133, 138, 140(3), 219, 282(2), with the exception of the first and last sentences thereof, 282(5), and 283 of the Treaty on the Functioning of the European Union shall not apply to the ~~United Kingdom~~ **Non-Eurogroup Member States.** The same applies to Article 121(2) of this Treaty as regards the adoption of the parts of the broad economic policy guidelines which concern the euro area generally. In these provisions references to the Union or the Member States shall not include the **Non-Eurogroup** ~~United Kingdom~~ and references to national central banks shall not include ~~the Bank of England~~ **those central banks of the Non-Eurogroup.**
5. ~~The United Kingdom~~ **Non-Eurogroup of Member States** shall endeavour to avoid an excessive government deficit.
Articles 143 and 144 of the Treaty on the Functioning of the European Union shall continue to apply to the ~~United Kingdom~~ **Non-Eurogroup**. Articles 134(4) and 142 shall apply to the ~~United Kingdom~~ **Non-Eurogroup** as if it had a derogation.
6. The voting rights of the ~~United Kingdom~~ **Non-Eurogroup** shall be suspended in respect of acts of the Council referred to in the Articles listed in paragraph 4 and in the instances referred to in the first subparagraph of Article 139(4) of the Treaty on the Functioning of the European Union. For this purpose the second subparagraph of Article 139(4) of the Treaty shall apply.

Emboldened = new wording.
The text is an abridged version of the relevant protocols. For a fuller version please contact the OMFIF secretariat.

Forward with Non-Eurogroup

Instrument for unity rather than divisiveness

David Owen, Advisory Board, and David Marsh, Co-chairman

The two-year old euro sovereign debt crisis is entering an acutely dangerous phase. Whatever happens in the stand-off between debtors and creditors, the relationship between the European Union's members and non-members of economic and monetary union (EMU) seems set for far-reaching change. It's time for Britain, Poland, Sweden and the other EMU non-adherents to formalise their position by establishing the Non-Eurogroup (NEG) as a central, constructive element of the EU.

The non-euro states can play a vital role in galvanising Europe to overcome its economic and political difficulties. In a cooperative and fair-minded manner, they should be allowed to get on with that task.

This move to enshrine the 10 EU countries outside the euro in a definitive grouping would bring many benefits. On the whole, these are well-run economies, at least as stable as those in the euro. The UK, Sweden and Denmark have lower long-term interest rates than most euro area countries; Sweden's 10 year government bond yield is lower than Germany's. The Czech National Bank has lower short-term interest rates than the ECB. Poland's growth record in recent years is the best in the EU.

Setting up the NEG would establish rights and responsibilities for non-euro area members, ending the long-held European position that non-membership of the euro represents some form of second-class EU citizenship. It would protect these countries from political and economic discrimination. It would allow a formal mechanism for countries to move backwards and forwards between the two groups, calling a halt to the absurd interpretation that if a country like Greece were to leave the euro, it would have to quit the EU altogether. A separate grouping for the non-euro states would not mean that they would remain permanently outside the euro. It would not be meant to divide the EU. Yet it would recognise the reality that non-EMU membership may last for longer than earlier thought.

Bringing together central banks and governments from 10 countries in a secure framework that could be buttressed by central bank swap lines and other credit facilities, the NEG would provide a stabilising mechanism for the whole EU. The NEG would help Europe better withstand euro strains. It would be a source of unity, in contrast to the divisiveness of the present set-up. If euro-adherent EU partners wish to take the route of formalising the Eurogroup, the non-euro members should impose some conditions. A useful way forward would be to press for changing the language of Protocols 14 and 15 in the European Treaty which suspend non-euro states in an unsatisfactory half-way house en route to ineluctable adoption of the euro. [See Box on p. 6]. Instead, the Non-Eurogroup would be given proper status as an essential part of the EU, equivalent yet also linked to the Eurogroup. None of this would detract from the non-euro states' ability to participate fully in economic reform efforts and in European integration in the areas of competition policy, trade relations, research policies and everything else associated with the internal market.

There is a chance to introduce the principles of the NEG in the next few months, as the result of a decision by the 17 euro area states that Herman Van Rompuy, president of the European Council, should chair at least two summits a year of euro area leaders. This is part of what French president Nicolas Sarkozy and German chancellor Angela Merkel call a (not-yet-defined) 'economic government'. The euro area needs a new system of governance. But we must not forget that the president of the Council is enjoined under Article 15.5 (c) of the Treaty to 'endeavour to facilitate cohesion and consensus within the European Council.' Any new position for the president should be authorised by Treaty amendment. To preserve necessary balance, Van Rompuy (or his successor) should also chair a summit at least twice a year of non-euro area countries. This would establish the legitimacy in every respect of the non-euro EU states and the role of the president as serving the interests of all EU states with no hint that non-euro area status is somehow imperfect.

The non-euro states can play a vital role in galvanising Europe to overcome its economic and political difficulties. In a cooperative and fair-minded manner, they should be allowed to get on with that task.

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Keeping politicians at bay

South Africa must act on supply side

Malan Rietveld, Chief Economist

South Africa this year has become the fifth member of the 'BRICS' club, but the economic picture provides few grounds for celebration. A triple threat looms over the economy. Supply-side reforms, not changes in monetary policy, are the answer.

The first area for concern is lower consumer spending, resulting from falling confidence, over-extended household balance sheets and declining real wages Second, the country faces continued weakness of external demand, particularly in view of a potential slowdown in China, which has has become South Africa's biggest trading partner, as well as the malaise in Europe. Third, government efforts at budgetary tightening are starting to take their toll as the public sector tries to balance its books after large deficits caused by the global recession.

The post-apartheid government has implemented a largely sensible, middle-of-the-road set of economic policies – with the exception of its labour laws, which are more fit for a wealthy Scandinavian country than one in which at least a third of the labour force is unemployed. The result has been stable, if somewhat underwhelming, growth rates of 4-5%, stable inflation (within the South African Reserve Bank's 3-6% target range), sound public finances – and no major economic disasters. However, a tipping point may be approaching. At current growth rates the South African economy is not creating enough jobs to absorb the country's chronically poor and unemployed. Populist sentiment is growing fast, giving rise to all sorts of dangerous economic ideas, led by the much-maligned mining nationalisation issue. In the face of these imponderables, monetary policy is on the sidelines. In the past, the resolutely independent Reserve Bank has come under immense pressure to cut interest rates and/or weaken the currency. Neither option is now plausible. At 5.5%, policy rates are at a 35-year low, and could well remain at these levels for years to come. The charge that overly tight monetary policy is holding back the economy back simply does not stick – and has, in fact, largely been dropped by the Reserve Bank's critics.

The rand – the world's most-traded emerging market currency – is a slightly different matter. Its phenomenal strength over the past two years has more to do with global appetite for emerging market debt and the search for yield than with specifically South African factors. Like the Australian and Canadian dollars, the rand has also been labeled a 'commodity currency'. But the tide could well be turning. With the appetite for emerging market risk and commodities dissipating, the rand has reversed course, falling by some 15-20% against the major currencies in a matter of days. This will provide a welcome boost to exporters, and the Reserve Bank will no longer be implored to 'ease it down'. Pravin Gordhan, South Africa's straight-talking finance minister, has even suggested that interest rates may be too low. 'There is a view among some economists that low interest rates are incentivising the wrong kind of investment in the economy,' he said in a speech in early October. A South African finance minister asking for higher interest rates: now that's something you don't hear every day!

The debate over the rand and monetary policy is something of a smokescreen for the myriad of other structural, or supply side, problems that cause bottlenecks once the economy grows at around 5%. These include electricity rationing, limited export-orientated rail capacity, a chronic shortage of skilled labour, restrictive labour laws and high real wages. The Reserve Bank's policies have very little to do with problems that beset the South African economy – and can make little impact on curing them. Until South Africa makes necessary structural changes on the supply side, it will remain – at best – on a path recently described by Cees Bruggemans, chief economist of First National Bank as 'a steady, if uninspiring, course'. Most western governments would love to have their economies described as 'steady'. But much more will be needed if South Africa's restless politicians and unemployed youth are to be kept at bay.

The debate over the rand and monetary policy is something of a smokescreen for the myriad of other structural, or supply side, problems that cause bottlenecks once the economy grows at around 5%.

Compromise, complaints, confusion

Fed twists, Bernanke shouts at Chinese

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation.

At the September meeting, three of the four rotating regional chiefs dissented from the statement announcing further monetary accommodation through Operation Twist – swapping out shorter term securities against longer term Treasuries. Only the Chicago Fed president joined New York Fed chief William Dudley and the five board governors. Two of the seven board positions remain unfilled and the fact that the board tends to follow the lead of the chairman might explain why. The level of dissent is probably even higher as some of the non-voting regional heads have publicly opposed further accommodation. None the less, Bernanke continues to defend the Fed stance and in congressional testimony in early October pointed to a faltering economic recovery as a reason for the Fed to remain ready to act

Ben Bernanke

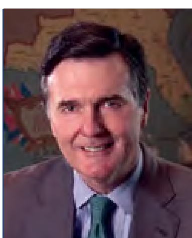
Fed rebuffs political pressure – for now

In a rare intervention to bring political pressure on the US central bank, the Republican congressional leadership sent a letter to Federal Reserve chairman **Ben Bernanke (voter)** warning him off any further quantitative easing just before the September meeting of the Federal Open Market Committee.

'Respectfully, we submit that the board should resist further extraordinary intervention in the US economy,' said the letter, signed by Senate minority leader Mitch McConnell of Kentucky, Sen. Jon Kyl of Arizona, House Speaker John Boehner of Ohio and Rep. Eric Cantor of Virginia. The lawmakers urged the Fed to take no further action until there was 'ample data' showing that quantitative easing benefited the American people. 'To date, we have seen no evidence that further monetary stimulus will create jobs or provide a sustainable path towards economic recovery,' these politicians, not previously known for their mastery of monetary policy, wrote.

The unusual warning came a month after Republican presidential candidate Gov. Rick Perry of Texas said that Bernanke would get treated 'pretty ugly' in his state if he were to buoy the economy with easy money. His implication was that a Fed decision to boost the economy would be a politically motivated effort to support the Democratic administration. The FOMC proceeded anyway with its 'Operation Twist,' a plan to swap out its shorter-dated securities holdings with longer-term Treasuries and so drive down medium and long-term interest rates. But a political intervention like this works in the same manner as a tennis champion's temper tantrum in an important match. The idea is not to get the umpire to change his ruling on that play – something they will rarely do – but to intimidate the official and make him or her think twice before ruling against the champion the next time. So the real test of Bernanke's imperviousness to political pressure will come not now but in the months ahead.

For his part, the Fed chief did not hesitate to wade into the political arena with critical remarks about Chinese currency policy. Bernanke couched his criticism in the context of the US economic recovery. 'The Chinese currency policy is blocking what might be a more normal recovery process in the global economy,' Bernanke said in congressional testimony in early October. China's policy of keeping the renminbi undervalued is leading to a 'two-speed recovery,' with industrial economies remaining sluggish and emerging economies growing more rapidly, he said.


Dennis Lockhart

Keep expectations low, Lockhart says

As for the 'twist' itself, Atlanta Fed chief **Dennis Lockhart (non-voter)** says expectations should be modest because the financial mechanisms for transmitting monetary policy to the real economy are not functioning very well right now. 'I share the view that the transmission mechanism for monetary policy remains somewhat impaired,' Lockhart said in a speech in Jacksonville, Florida, 'and for this reason I am not expecting large gains from the Fed's most recent action.'

Lockhart explained that lower interest rates won't stimulate much new activity because many consumers are still paying down debt. On the business side, many larger firms already have lots of cash while banks continue to keep a lot of their liquidity on the sidelines.

Fed should not set fixed dates for policy actions, Bullard says

James Bullard

St. Louis Fed chief **James Bullard (non-voter)** isn't happy with the FOMC's recent tendency to commit itself to specific monetary policy actions for a fixed period, whether it's the amount of time it will make asset purchases or a fixed date, currently mid-2013, for maintaining low interest rates. 'This has been at odds with notions of optimal monetary policy developed over the last several decades,' Bullard said in a speech in San Diego, California. 'The Committee in the past did not contemplate announcing several hundred basis point interest rate moves with a fixed end date. Yet that is how the Committee behaves today.'

Bullard draws cautionary lessons from experiences in Japan and Europe. In Japan, for instance, promises of near-zero interest rates for longer and longer periods of time have encouraged markets to expect a mild rate of deflation. In Europe, unemployment has been persistently high. If that is now becoming the case in the US, then it would be futile for Fed policymakers to keep monetary policy accommodative to aid job creation. 'Monetary policy could be pulled off course for a generation,' Bullard said.

In Japan, for instance, promises of near-zero interest rates for longer and longer periods of time have encouraged markets to expect a mild rate of deflation. In Europe, unemployment has been persistently high.

Not so fast, says Fed Governor Raskin

Sarah Bloom Raskin

One of the newest members of the Board of Governors, former Maryland state bank regulator **Sarah Bloom Raskin (voter)**, defended the practice of setting dates. 'Conditional forward guidance' can be an effective communications tool, she said, especially when the Fed has little room for maneuver on the interest rate front. In indirectly countering some of Bullard's arguments, Raskin provided a taste of the debate that must be going on at the FOMC meetings.

'Forward guidance can provide monetary accommodation by leading investors to expect a longer period of low interest rates,' Raskin said in a speech in Washington. This downward shift in the expected path of the federal funds rate can generate a significant boost to consumer and business spending, she said, and this in turn, admittedly with a long time lag, will lead to new hiring. She acknowledged that the economy's response to monetary stimulus was more 'muted' than she had expected because of those functional impairments in transmission mechanisms. 'Even if the usual effectiveness of monetary policy is being attenuated,' Raskin said, 'that conclusion should not be taken as implying that additional monetary accommodation would be unhelpful. Indeed, the opposite conclusion might well be the case – namely, that additional policy accommodation is warranted under present circumstances.'

NY Fed's Dudley sees continued vulnerability

William Dudley

Regulatory reforms in the wake of the financial crisis have strengthened bank capital but the global financial system remains vulnerable, New York Federal Reserve President **William Dudley (voter)** said at a Bretton Woods Committee event. 'Although we have made progress in reforming how we oversee and regulate the financial system,' Dudley said in Washington during the IMF/World Bank meeting, 'our work toward achieving a more stable and dynamic system able to deliver its essential services to both savers and borrowers is far from complete.'

US and global regulators have successfully pushed banks to increase capital, he said, but requirements governing transparency and liquidity are still inadequate. Aside from improvements needed in how individual institutions are supervised, there remains much work to do regarding the global interaction of these firms, Dudley said. 'There has been little progress made with respect to reengineering the financial system so that the transmission mechanisms act to dampen rather than amplify shocks.' Likewise, while the Dodd-Frank Act in the US has set up a mechanism for seizing and winding down major financial institutions, 'a major challenge remains in implementing resolution effectively on a cross-border basis. 'The legal impediments to progress on this issue are 'significant.'

OMFIF Advisory Board

Five new members join OMFIF advisory board in September

They are: Natalie Dempster, Director, Government Affairs, World Gold Council; Sir Andrew Large, a former deputy governor, Bank of England; Luiz Eduardo Melin, director, Banco nacional do desenvolvimento of Brazil, and a career official at the Central Bank of Brazil: Prof. Abdul Raham, Telfer School of Management, University of Ottawa; Lord Tugendhat, former European Commissioner and former chairman, Abbey National. We look forward to working with them.

Meghnad Desai*

Songzuo Xiang**

John Nugée**

Frank Scheidig**

Katinka Barysch

Paul Boyle

Mario Blejer

Frits Bolkestein

Nick Bray

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Peter Bruce

Nick Butler

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Neil Courtis

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Hendrik du Toit

Jonathan Fenby

Stewart Fleming

Haihong Gao

Steve Hanke

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Matthew Hurn

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Harold James

Roel Janssen

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William Keegan

Mumtaz Khan

Joel Kibazo

David Kihangire

John Kornblum

Pawel Kowalewski

Philippe Lagayette

Norman Lamont

Andrew Large

Thomas Laryea

Oscar Lewisohn

Ruud Lubbers

Gerard Lyons

Luiz Eduardo Melin

Mariela Mendez

Ashley Eva Millar

George Milling-Stanley

Isabel Miranda

Rakesh Mohan

Paul Newton

Peter Norman

Saker Nusseibeh

David Owen

Bruce Packard

Ila Patnaik

John Plender

Robin Poynder

Danny Quah

Abdul Rahman

Poul Nyrup Rasmussen

Martin Raven

Vilem Semerak

Paul van Seters

Marina Shargorodska

Michael Stürmer

Paola Subacchi

Jens Thomsen

Niels Thygesen

Christopher Tugendhat

Makoto Utsumi

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Ernst Welteke

Derek Wong

Sabrina Wong

Further weakness in Europe and US

Consolidation needs weigh on economic outlook

DZ Bank Economic Forecasts

GDP growth	2010	2011	2012
US	3.0	1.5	1.7
Japan	4.0	-0.8	2.0
China	10.3	9.0	8.2
Euro area	1.7	1.6	1.1
Germany	3.7	3.0	1.4
France	1.4	1.7	1.2
Italy	1.2	0.8	0.5
Spain	-0.1	0.6	0.5
UK	1.4	1.0	1.4
Addendum			
Asia excl. Japan	9.3	7.6	7.2
World	4.9	3.7	3.6
Consumer prices (% y/y)			
US	1.6	3.0	2.1
Japan	-0.7	-0.2	0.2
China	3.3	5.6	3.4
Euro area	1.6	2.5	1.8
Germany	1.2	2.4	1.8
France	1.7	2.2	1.9
Italy	1.6	2.4	1.9
Spain	2.0	2.8	1.4
UK	3.3	4.2	2.1
Current account balance (% of GDP)			
US	-3.2	-3.1	-3.2
Japan	3.6	2.0	2.8
China	5.2	4.5	4.3
Euro area	-0.4	-0.7	-0.6
Germany	5.7	5.1	4.7
France	-1.8	-2.2	-2.2
Italy	-3.3	-2.9	-2.5
Spain	-4.7	-4.6	-4.0
UK	-3.2	-2.5	-3.0

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

Sentiment indicators in the industrialised countries are continuing to weaken and an economic slowdown looks ever more unavoidable. The Europen Commission's economic sentiment indicator for the euro area fell to its lowest level since the end of 2009 in September and is now once again well below its long-term average. Unsurprisingly, the mood is particularly negative in Greece, but it is also at crisis levels in Cyprus and Portugal. We have revised our growth forecasts for the euro area down again and are now forecasting growth of just 1.1% in 2012.

As in Europe, in the US the economic indicators also paint a picture of feeble growth, although most of them do not herald a recession. The labour market is particularly difficult and there are no signs of a significant improvement any time soon. The chances of President Obama's $447bn stimulatory fiscal programme being enacted are relatively low owing to Republican opposition in Congress. There is much evidence to suggest that the US economy will remain weak in the year ahead and that we will continue to wait in vain for a more vigorous recovery.

In Europe, persistent uncertainty on the Greek debt crisis, and in particular about the size of the hit that private creditors will be forced to take, is filtering through ever more clearly into business sentiment. Our forecast for the coming quarters has therefore become more cautious. We expect an even sharper slowdown in euro area growth rates at the turn of the year.

Economic growth will again be driven by the core countries in 2012, with the peripheral countries continuing to act as a drag. We expect the Greek and Portuguese economies to carry on contracting in the year ahead as a result of the drastic deficit-cutting measures being implemented by these countries. In Portugal the deficit reduction measures announced for next year alone amount to around 3% of GDP, while in Greece they are likely to be even more extensive. In spite of fiscal tightening in all member states and a significant decline in annual deficits, in our view the only country in which the debt to GDP ratio will fall in both 2011 and 2012 is Germany. As debt levels continue to rise in a number of euro area countries next year, we expect the debt to GDP ratio for the euro area as a whole to remain unchanged at around 89% in 2012.

We are a little more optimistic for the German economy than for the euro area as a whole, but the decline in business confidence, as reflected for example in the IFO business climate index, probably presages a significant slowdown. While growth is likely to have been robust in Germany in the third quarter, we now expect it to stagnate in the final quarter of 2011. We see a gradual economic recovery in the course of 2012 and are forecasting GDP growth of 1.4% for the year. Thus we continue to believe that a recession is not on the cards.

OMFIF
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Imperatives for Ricardian age

Reintroducing growth in developed world

Stefan Bielmeier, Advisory Board

In coming years, the dominant theme in the global economy will be the problem of sovereign debt. To overcome the sovereign debt crisis in the short term, different rescue mechanisms such as Europe's EFSF (later ESM) will have to be furnished with a very large amount of capital or guarantees. In the long term there is no way the euro area can avoid reducing sovereign debt on a lasting basis. Likewise, in the US there is no ignoring the excessive federal government debt burden any longer, irrespective of what decisions the rating agencies may take. Japan will equally have to square up to the problem. China is the only major economy that still has a chance of driving economic development without incurring exaggerated government debt. However, the Chinese government must already now start putting state expenditure on the path of little or no growth.

The age of the 'sovereign debt illusion' has ended. The Keynesian notion that government deficit financing can sustainably boost income across the entire economy no longer appears to function. Instead, we appear to be at the beginning of a 'Ricardian' age.

The proposition that economic actors discern that the process of government indebtedness leads to higher taxes, and will therefore not make them richer over their lifetime, was first made by British economist David Ricardo (1772-1823). For many years, economists rejected the Ricardian argument with Keynes's renowned riposte: 'In the long run we are all dead.' This assertion assumes that people are indifferent to the wellbeing of later generations, which no longer sits easily with the values that prevail today. Moreover, the negative impact of excessive sovereign debt affects the present, and not just the next, generation, as the scale of government debt has already passed a critical level in many countries.

The debt illusion has dissipated not only among citizens and taxpayers, but also on the financial markets. Behind us lies a phase in where precisely this illusion helped fuel a long phase of steady growth. At the time, there was a deceptive calm in the markets for euro treasury bonds. The markets had relied on the community preventing the default by a member state. However, once default risk emerged after the US sub-prime crisis and the Lehman bankruptcy, investors started worrying about the creditworthiness of state borrowers, too. The resulting rise in interest rates for 'bad' debtors triggered a spiral of self-fulfilling expectations.

In the future 'Ricardian Age', the fiscal scope for government will shrink enormously unless they take action to cut debt to levels that are feasible in the medium term. The venerable Maastricht criteria (government debt of a maximum 60% and a current deficit of a maximum 3% of gross domestic product) remain a useful pragmatic corridor. And a debt cap such as has been introduced in Germany, or a version of it, is consistent with sound fiscal policy. What counts is above all that fiscal policy should be reliable as a means of restoring confidence,

In the future 'Ricardian Age', the fiscal scope for government will shrink enormously unless they take action to cut debt to levels that are feasible in the medium term.

The major economies should lower debt levels to a level that can be meaningfully shouldered and keep current deficits on average at around zero across the business cycle. One this has been done, the attention of citizens, policy-makers and the financial markets can once again focus on other issues. Short-term growth may be stunted, but in the longer term governments should be able to return to a steady growth track.

In coming years industrialised nations' growth will remain lower than in the emerging markets, which is natural. However, the financial markets should not underestimate the developed world's ability to surprise us with robust and stable growth, as long as they maintain a healthy industrial base and bring about the means for the private sector to recover its poise.

A regular round-up on international monetary affairs

Pericles foresaw the perils

The real Greek tragedy is ignoring history

William Keegan, Chairman, Board of Contributing Editors

The Greeks gave us the word 'tragedy' and they are certainly participating in one now. It is a far cry from the ideal sketched out by Pericles in 431 BC, as told to us by Thucydides. What a pity it is that, before embarking on their perilous odyssey in the euro area, the Greeks did not go back to study the works of the historian of the Peloponnesian War.

The warnings were all there in the celebrated funeral oration. But, because they did not reflect on the wisdom of their great Classical forebears, the modern Greeks are now preparing for another great sepulchral event. 'We Athenians, in our own persons, take our decisions on policy or submit them to proper discussions...the worst thing is to rush into action before the consequences have been properly debated,' said Pericles. He went on to boast: We are capable at the same time of taking risks and of estimating them beforehand. Others are brave out of ignorance...'

I am afraid it gets worse: 'We make friends by doing good to others, not by receiving good from them. This makes our friendship all the more reliable, since we want to keep alive the gratitude of those who are in our debt by showing continued goodwill to them'. By contrast 'The feelings of one who owes us something lack the same enthusiasm, since he knows that, when he repays our kindness, it will be more like paying back a debt than giving something spontaneously'.

Yes, things have changed over the past 2,500 years. When Pericles spoke, Athens was a model to others, a veritable 'education'. But his distant successors have been learning the hard way. They most certainly rushed into the euro. They did not debate the prospect properly. The potential consequences were ignored amid the general rush to the head. And not just the Greeks: the Portuguese, the Spanish, the Italians too. And it was especially unfortunate that, way back in February 1997, Italy's Prime Minister Romano Prodi publicly chided the Germans, in Germany, about their putative ill-preparedness for the euro.

Pericles: 'We Athenians take our decisions on policy or submit them to proper discussions... the worst thing is to rush into action before the consequences have been properly debated.'

But perhaps the Germans, in fact, were not prepared. Their banks were evidently not sufficiently apprised of the risks they would take in lending to Greece and other peripheral euro countries. One wonders, too, whether any of the participants in the events that led to the threatened euro debacle had studied the impact of Dracon in 621 BC. He was entrusted with the task of codifying and rectifying the law, and is remembered by the widespread use of the epithet 'Draconian'. Some historians think Dracon's name has been much maligned, because codifying is different from laying down the law, and what Dracon did was to reveal to the Athenians just how harsh their laws already were. As the historian J. B. Bury put it, the idea that Dracon's laws 'were written not in ink but in blood' came (understandably) 'from the fact that certain small offences, such as stealing cabbages, were punishable by death'.

Certainly, a euro debtor might not be too keen on the way that, according to the Draconian Code, a creditor could 'claim the person of' – i.e. enslave – a debtor. More reassuring was the subsequent work of Solon the Lawgiver, in 594-591 BC.

As the financial pages are replete with endless discussion about 'haircuts', modern bankers and euro officials can reflect on what might be called the 'bald-headed approach' of Solon, who cancelled all debts and freed those who had been enslaved. At last month's annual meetings of the IMF and World Bank in Washington, Greek finance minister Evangelos Venizelos proclaimed that Greece would not 'be made a scapegoat'. Said with feeling: the original meaning of 'tragedy' in ancient Greek was 'goat-song'.

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