OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

October 2012

Euro creditors get ready to pay

Unlike 1920s, this time Germany's the creditor

David Marsh and John Plender

A battery of firepower assembled to shore up economic and monetary union (EMU) demonstrates that euro area creditors, led by Germany, are getting ready to do what they always do in the case of debt restructurings: pay up mighty sums to ensure peace and harmony.

Whether or not Germany, as well as the other big creditors, Netherlands, Finland and Austria, really will sanction large flows of funds to the cash-strapped debtors will be one of Europe's major questions, not simply in the campaign towards next autumn's German general election.

The stand-off between EMU surplus and deficit states partly resembles a rerun of the moral and economic arguments about Germany's payment of post-First World War reparations. This time, Germany is creditor, not debtor. Just as German reparations were not paid in the 1920s, it seems unlikely that, 90 years later, EMU debtors will have to pay anything like the full amount of their obligations.

The European Central Bank's initiative to buy weaker countries bonds through the so-called Outright Monetary Transactions programme, hotly opposed by the Bundesbank, illustrates how the illusion of creditor power is progressively being stripped away. The same is true for the plan, still in its early stages, of quadrupling EMU governments' permanent rescue fund, the European Stability Mechanism, to €2tn through extra infusions of aid money.

Buttressed by constant Germanic affirmations on financial orthodoxy, EMU's prevailing wisdom is that the burden of adjustment falls exclusively on the debtors, who are all subject to supposedly strict conditionality on bail-out packages.

(continued on page 10...)

Insights into 2012 Greek debt restructuring and past episodes of world hyperinflation

The October 2012 Bulletin contains insights into two sets of circumstances of seminal importance for world economics. These are the landmark Greek restructuring of 2012 – by far the biggest sovereign bankruptcy in history – and past episodes of world hyperinflation, compiled in a unique table. The articles are respectively by Philip Wood, Head of Allen & Overy Global Law Intelligence Unit, and Steve H. Hanke and Nicholas Krus from The Johns Hopkins University. **SEE ARTICLES ON HYPERINFLATION, P. 11-13, AND GREECE, P. 20-27.**

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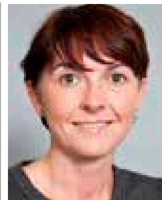

Debt wave

Corporates lead way

Victoria Harling, Investec

Corporate bond issues from emerging market economies so far this year have risen to a record $214bn, already above the previous full-year high of $211bn in 2010 and well ahead of year-to-date emerging market sovereign issuance of $67bn. Asian issuers, particularly from Hong Kong and China, have been the most prolific ($80bn), followed by Latin American companies ($65bn).

Following the first two waves of emerging market debt (EMD) – sovereign borrowing first in dollars and then in local currencies – investors are now riding corporate debt as the 'third wave' in the development of emerging market debt. This is an attractive new way of harnessing the structural investment benefits of emerging markets. The rise in corporate EMD reflects companies' efforts to replace traditional bank loans by funding in public debt, with the latter now relatively attractive thanks to quantitative easing and bank deleveraging.

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Japanese resilience

Pondering world interconnections

David Marsh, Chairman

The October 2012 annual meetings of the World Bank and International Monetary Fund in Tokyo are a time of change and challenge. Organised partly to show the resilience of the Japanese economy after the North East Japan Earthquake of March 2011, the meetings will certainly succeed, at least in part, in their aim.

But the clouds over Tokyo are heavy and difficult to disperse. This issue of the OMFIF Bulletin probes the interconnections – between the morass over Economic and Monetary Union (EMU) in Europe, the pre-election attempts to stimulate the US economy and the opportunities available in emerging markets.

The stand-off between debtors and creditors in EMU reminds us in some ways of the 1920s, but with the signs inversed. The European Central Bank has unveiled its Outright Monetary Transactions programme. But it is certainly not outright, there are doubts whether it is monetary, and so far we've not seen any transactions.

At the same time, Victoria Harling of Investec Asset Management reminds us of new flows into emerging market corporate debt as the result of the world-wide search for yield and diversification.

There are several notable reflections on historical events. Jens Weidmann, president of the Bundesbank, probes the influence of Goethe's Mephistophelean thought processes to back up his own ideas on how inflation arises. Prasarn Trairatvorakul, Governor of the Bank of Thailand, ponders what Europe can learn from the Asian financial crisis of 1997-98.

Steve H. Hanke, a member of our Advisory Board, and Nicholas Krus add to our understanding of world hyperinflation. A landmark article from Philip Wood of the Allen & Overy Global Law Intelligence Unit surveys the full import of the 2012 Greek debt restructuring, five times bigger than the previous largest sovereign bankruptcy in history – and almost certainly not yet over.

Gabriel Stein shows us why, despite all the qualms about quantitative easing, there is no significant inflation in the pipeline. Darrell Delamaide explains why Ben Bernanke's QE3 move, which has inevitably intruded into electoral politics in the US, will mark his legacy, one way or another.

Frits Bolkestein reflects on the changing role of Germany in Europe. Harold James investigates the real reasons for EMU and concludes, prosaically, that it evolved out of changing views about world monetary governance in the 1980s.

With the economic mood in Europe's industrial heartland, Germany, bow fading to match the damper spirits elsewhere on the continent, Stefan Bielmeier illustrates how the ECB's programme is not enough to resuscitate spirits. Ruud Lubbers and Paul van Seters see a chink of light from a possible upgrading of the European Investment Bank's role.

In his usual postscript, William Keegan looks at lessons from the life of Andrew Crockett and reveals a little-known episode germane to the present-day competition for the governorship of the Bank of England. I hope you find these contributions useful and relevant.

David Marsh

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Faustian pact over money

What Goethe teaches us about inflation

Jens Weidmann, President, Deutsche Bundesbank

Johann Wolfgang von Goethe analysed the core problem of today's monetary policy based on paper money, recording it in literature in inimitable fashion around 180 years ago. Goethe tackled a question which appears trivial at first glance but which, as experience has shown, is particularly difficult. What is money exactly? A succinct response from an economist would be: Money is what money does.

As money is defined by its functions, various instruments are fundamentally capable of acting as money, as long as they can be used as a medium of exchange, medium of payment and store of value. Shells were previously used as money in some countries, for example, as were furs, salt or pearls. Livestock could also serve as money – the Latin word for cattle is 'pecus' from which the word 'pecunia', meaning money, is derived.

Concrete objects have served as money for most of human history; we may therefore speak of commodity money. A great deal of trust was placed in particular in precious and rare metals – gold first and foremost – due to their assumed intrinsic value.

In its function as a medium of exchange, medium of payment and store of value, gold is thus, in a sense, a timeless classic. 'To gold they tend, on gold depend, all things!' says Margaret in the First Part of Goethe's Faust.

However, the money that we carry around in the form of banknotes and coins no longer has anything to do with commodity money. Money has no longer been linked to gold reserves since the ending of the dollar-gold exchange standard in 1971. Today's money is no longer backed by any real assets. Banknotes are printed paper. Coins are minted metal. Acceptance of banknotes and coins as a medium of payment in our daily lives partly reflects the fact that they are the sole legal tender. However, acceptance of banknotes is ultimately based on the public's confidence that it can use this paper money to make purchases.

In this sense, money is a social convention. It has no intrinsic value; instead, its value is created by its constant exchange and use as money. By the way, this recognition that trust is central, or even constitutive, for the properties of money is very old; it was already discussed in the 4th century BC by Aristotle in his Politics and Nicomachean Ethics.

In recent times, many citizens ask about the origin of money. Where do the central banks acquire the huge amounts of money that they need to give billions in loans to the banking system as part of monetary policy operations, or to make other purchases? Why this context do we often hear the refrain that central banks have virtually unlimited firepower? Central banks create money by granting commercial banks credit against collateral or by buying assets such as bonds. The financial power of a central bank is in principle unlimited; it does not have to acquire beforehand the money it lends or uses for payments, but can basically create it out of thin air.

The printing of money is an appropriate image here; from an economic perspective, the printing press is not necessary, as the creation of money primarily shows up on the central bank's balance sheet, in its accounts.

Here Goethe enters the equation. Let me remind you briefly of the 'money creation' scene in Act One of the Second Part of Faust. Mephistopheles, disguised as a jester, tells the Emperor, who is in severe financial distress: 'In this world, what isn't lacking, somewhere, though? Sometimes it's this, or that: here's what's missing's gold.' The Emperor finally responds to Mephistopheles' subtle attempt to persuade him. 'I'm tired of the eternal "if and when": We're short of gold, well fine, so fetch some then.' To which Mephistopheles replies : 'I'll fetch what you wish, and I'll fetch more.'

Mephistopheles tells the Emperor: 'Here's what's missing's gold.' The Emperor responds: 'We're short of gold, well fine, so fetch some then.'

In the commotion of the nocturnal masquerade ball, he persuades the Emperor to sign a document which Mephistopheles has reproduced overnight and then distributed as paper money. Those involved are quite taken by the initial success. The Chancellor is delighted to announce: 'See and hear the scroll, heavy with destiny, – (referring to the paper money that has been created) – that's changed to happiness our misery. …To whom it concerns, may you all know, This paper's worth a thousand crowns or so.'

A little later, Mephistopheles stirs up the general elation even further by saying: 'Such paper's convenient, for rather than a lot. Of gold and silver, you know what you've got. You've no need of bartering and exchanging. Just drown your needs in wine and love-making.' Those concerned are so overjoyed by this apparent blessing that they don't suspect that things could get out of hand.'

In the Second Part of Faust, the state can get rid of its debt. At the same time, private consumer demand rises sharply, fuelling an upswing. In due course, however, all this activity degenerates into inflation, destroying the monetary system because the money rapidly loses it value. It is very striking that Goethe throws light on the potentially hazardous connection between paper money creation, public finances and inflation – and thus on one core problem of uncovered monetary systems. This is all the more remarkable given that Faust and Goethe are not generally immediately associated with economics, especially not with such central areas of conflicting monetary policy priorities.

The fact that Faust can indeed be interpreted in economic terms has been demonstrated, not least, by Professor Adolf Hüttl, who used to be Vice-President of the former Land Central Bank in Hesse. In the mid-1980s Professor Hans Christoph Binswanger took a similar line. Binswanger's thesis is that Goethe was portraying the modern economy with its creation of paper money as a continuation of alchemy by other means. While traditional alchemists attempted to turn lead into gold, in the modern economy, paper was made into money.

Indeed, the fact that central banks can create money out of thin air, so to speak, is something that many observers are likely to find surprising and strange, perhaps mystical and dreamlike – or even nightmarish. If central banks can potentially create an unlimited amount of money out of thin air, how can we ensure that money remains sufficiently scarce to preserve its value? Does this ability to create money more or less at will not create the temptation to take advantage of this instrument to create additional leeway short term, even at the risk of highly probable long-term damage?

Yes, this temptation certainly does exist, and many in monetary history have succumbed to it. In history, this was often the reason for establishing a central bank: to provide those in power with free access to seemingly unlimited financial resources. However, such government interference in central banking, combined with the government's large demand for funding, often led to a strong expansion in the volume of money in circulation, causing it to lose value through inflation.

In light of this experience, central banks were subsequently established as independent institutions, with the mandate to safeguard the value of money, in order to explicitly keep the government from co-opting monetary policy.

The independence of central banks is an extraordinary privilege. It is, however, not an end in itself. Instead, its primary purpose is to use its credibility to ensure that monetary policy can focus unhindered on preserving the value of money. Independent monetary policy, combined with policy-makers possessing a well-functioning, stability-oriented compass, provides a necessary – but not a sufficient – condition for preserving the purchasing power of money as well as public confidence in it.

It is important that central bankers, who are in charge of a public good – in this case, stable money – bolster public confidence by explainingtheir policies. The best protection against temptation in monetary policy is an enlightened and stability-oriented society.

This is an edited version of a speech made by Mr Weidmann on 18 September at a colloquium of the Institute for Bank-Historical Research in Frankfurt.

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Inflation risks under control

Survey data point to pressure easing

Gabriel Stein, Chief Economic Adviser

Survey data say inflation will ease. Euro area inflation accelerated to a four-month high of 2.6% in the year to July. This marks the 24th month that the rate has been above the ECB's target of 'close to but below 2%'. Meanwhile, US core inflation has remained above 2% since August 2011. Amid concerns that central banks are implementing ever further 'unconventional measures' and 'printing money' and worries about financial repression, is there a danger of inflation accelerating?

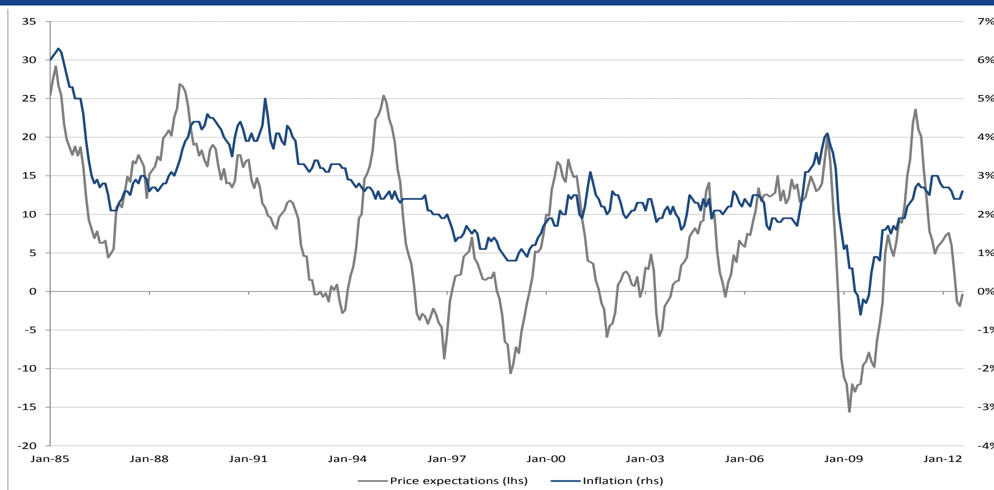
I pointed out in May ('No danger from money numbers, OMFIF Bulletin May 2012) that politics argued against inflation as a way out of current debt problems. So intentionally-produced inflation is unlikely. Is inflation likely as a by-product of current policies or because of overheating economies? Judging by inflation expectations, as expressed in business and consumer surveys, the answer is No.

Central banks, particularly inflation-targeting central banks, set great store by inflation expectations, devoting substantial time to estimating them by looking at break-even rates on index-linked bonds, judging market expectations and looking at survey data. In the short term, this is important. But, in the long term, inflation expectations matter less. Simply put, if the central bank's inflation-targeting has credibility, inflation expectations over any medium or long term have to be that it the inflation target will be reached. If they were otherwise, the central bank would change its policy so as to achieve that target.

However, in the short term, inflation expectations are still relevant. Moreover, there is usually a reasonable relationship between business and consumer surveys and eventual inflation. This is particularly true in the euro area. Among the monthly surveys conducted by the European Commission are a number of questions of future price expectations. All of these are diffusion indices, showing the balance of respondents expecting higher prices compared with those those expecting lower. A key index measures manufacturing sector selling-price expectations. The average reply to this question since the series began in January 1985 is +7.8. A balance of +10 is historically related to a euro area inflation rate of 2% or higher.

Is inflation likely as a by-product of current policies or because of overheating economies? Judging by inflation expectations, as expressed in business and consumer surveys, the answer is No.

Chart 1: Selling-price expectations in manufacturing (diffusion index) and HICP (12-month change, %)



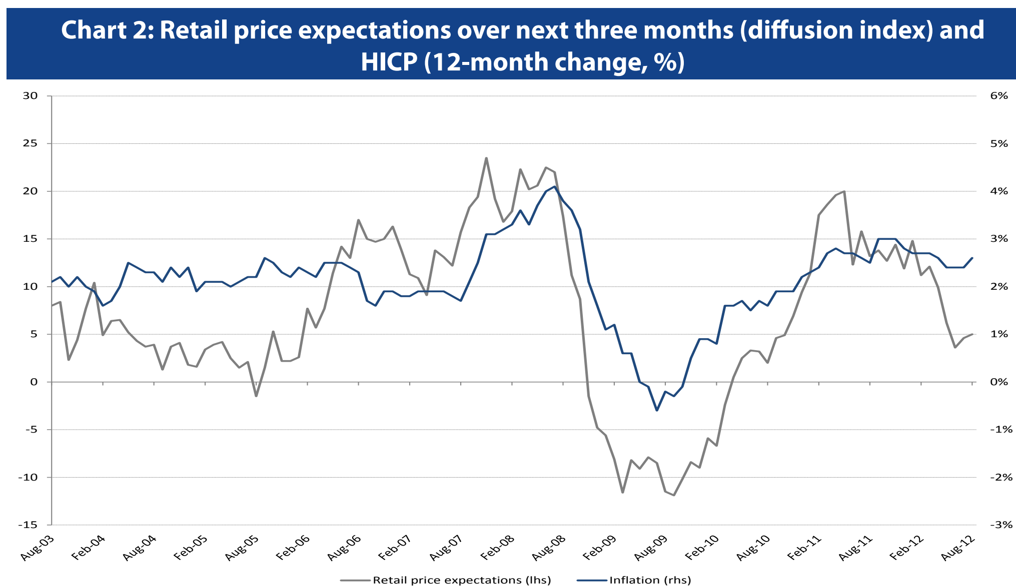
Source: European Commission for surveys and European Central Bank for inflation.

The Commission data show that answers in this series have been below +10 since July 2011(see Chart 1). The latest number (August 2012) was -0.4. Historically, this is more consistent with inflation of 1% than with 2%. More to the point, it is a powerful signal that euro area manufacturers see no likelihood of being able to raise prices in the near future.

The manufacturers' views are corroborated by data from the retail sector. Here, the question asked is retail price expectations over the next three months. While this is a very short period, the trend is nevertheless an important indicator of how retailers perceive the near-term price future as well as their pricing power.

This series registered a recent peak of +20 in April and May last year, just before euro area inflation edged up from 2.7% to 3%, where it remained from September to November 2011. It then fell to +4 in June this year, before picking up slightly to +5 in July and August. Unfortunately, this series only begins in 2003; but, for the period it is available, it shows a strong (though not surprising) relationship with near-term inflation developments. As Chart 2 shows, over the admittedly short period available, the latest data are consistent with an inflation rate of about 1%, confirming the message from the manufacturing sector survey.

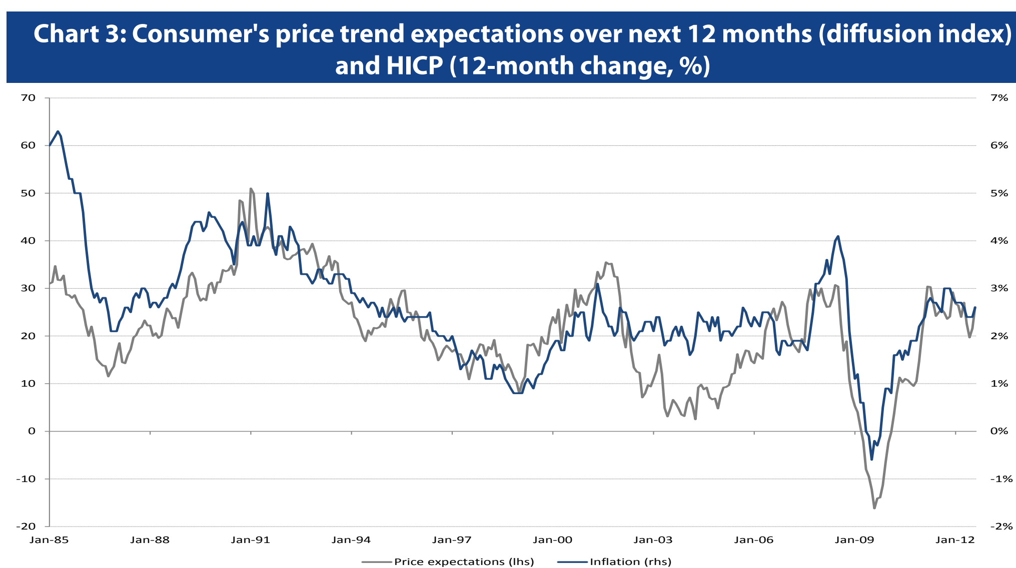
Chart 2: Retail price expectations over next three months (diffusion index) and HICP (12-month change, %)



Source: European Commission for surveys and European Central Bank for inflation.

Consumers represent the one group that is concerned with inflation, and worried that it is rising, This reflects the persistence of euro area headline inflation stubbornly above the ECB's target. The latest reading is +26, up from +20 in June, historically consistent with inflation in the 2½-3% range. However, as Chart 3 shows, this index is very much a coincident series. Although the question asked is what respondents believe about price developments over the next 12 months, it seems clear that the answer is very much an extrapolation of current trends. This is natural, given that consumers generally have little influence on the course of inflation and tend to be price takers, rather than price setters. But this also means that of the three series we have looked at, the consumer survey is less relevant in an attempt to gauge future price developments than the retail and manufacturer surveys whose data is leading.

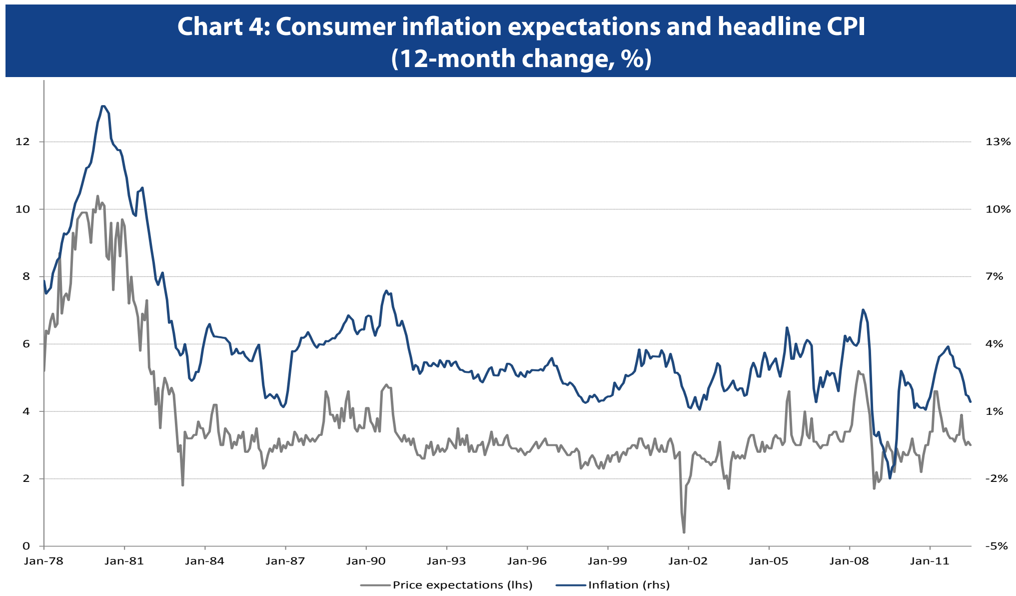
Chart 3: Consumer's price trend expectations over next 12 months (diffusion index) and HICP (12-month change, %)



Source: European Commission for surveys and European Central Bank for inflation.

By contrast, US consumer inflation expectations, as measured by the University of Michigan, are leading inflation developments, although the lead is best over a three-month period so not particularly long. In contrast with euro area consumer survey data, American consumers clearly expect inflation to fall, as Chart 4 shows, although this is probably related to the fact that it is already on a downward trend.

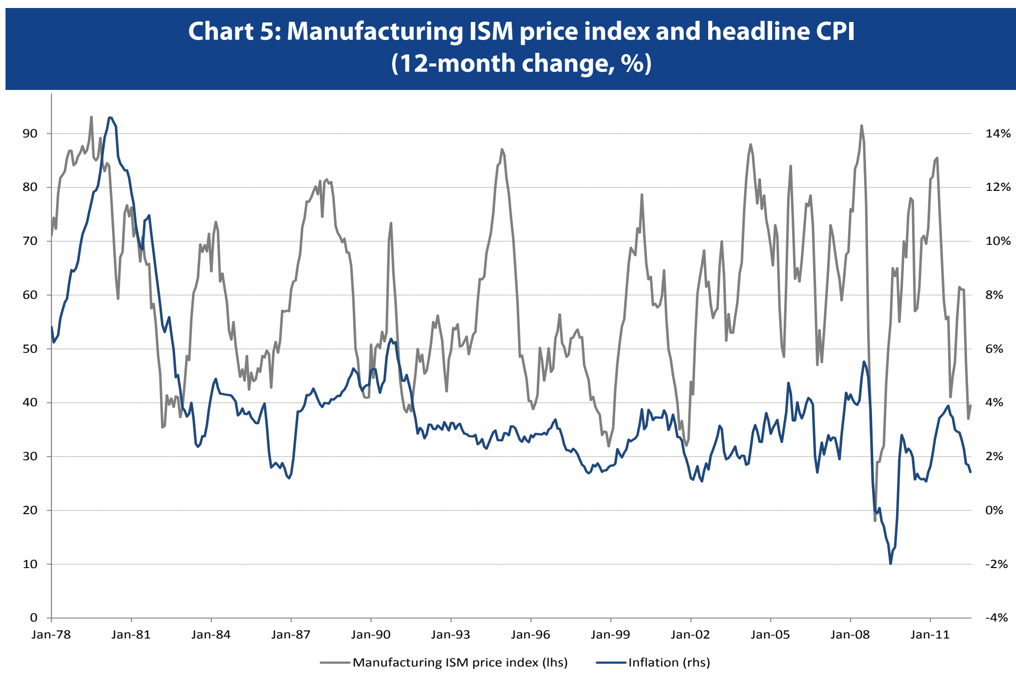
Chart 4: Consumer inflation expectations and headline CPI (12-month change, %)



Source: European Commission for surveys and European Central Bank for inflation.

The US differs from the euro area on another point. Where the relationship between European manufacturers' price expectations and eventual inflation was relatively good, the relationship between the manufacturing ISM price question and eventual US inflation is more tenuous. This is not a question about output price expectations, but about prices paid. Since much of this is likely to be commodity-related, the series is also highly volatile. There is a weak (r-squared of 21.8) but significant relationship between this series and the consumer price index 10 months later.

Chart 5: Manufacturing ISM price index and headline CPI (12-month change, %)

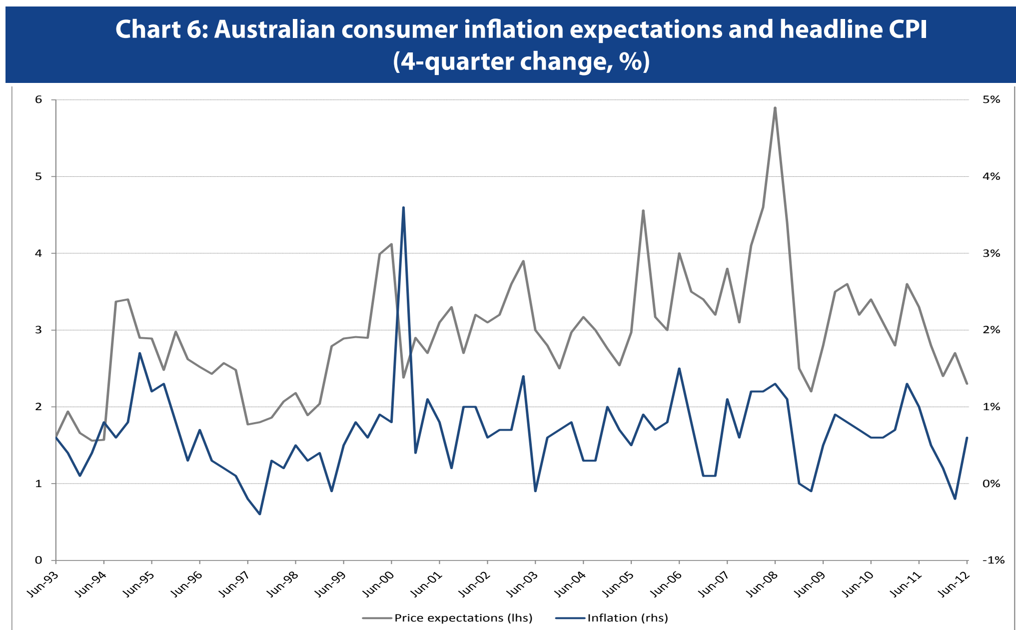


Source: European Commission for surveys and European Central Bank for inflation.

As Chart 5 shows, this series too points towards lower inflation, having already presaged the fall in US annual inflation from 3.9% in September 2011, to 1.7% in August 2012. Much of this is food- and energy-related. The US core index, which excludes those two groups, has remained flat at just over 2% over the same period.

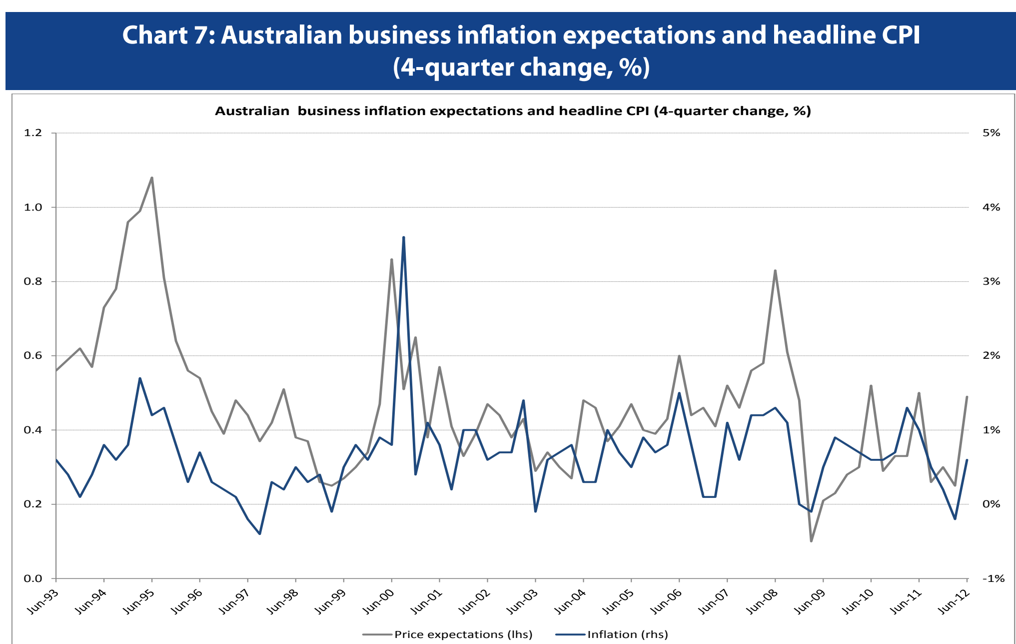
The picture is similar in other countries. In Australia, for example, we see the same pattern, namely that consumer inflation expectations show a very slight lead over actual inflation developments. Survey data (Chart 6) show that consumers expect the rate of inflation to come down further, in spite of a recent uptick in the four-quarter rate (Australian CPI is only published quarterly.). By contrast, as demonstrated by Chart 7, Australian business expects higher inflation in the near-term. However, the Reserve Bank's target is an inflation rate between 1% and 3% in two years. The latest number is 0.6% in the year to Q2 2012. Essentially, Australian business is assuming that the monetary authorities will succeed in bringing the rate of inflation to within target.

Chart 6: Australian consumer inflation expectations and headline CPI (4-quarter change, %)



Source: Australian Bureau of Statistics for inflation data

Chart 7: Australian business inflation expectations and headline CPI (4-quarter change, %)



Source: Australian Bureau of Statistics for inflation data

The thrust of the argument is clear. The world economy has still not recovered from the Great Recession. US GDP in Q2 2012 was less than 2% higher than its peak in Q4 2007. Euro area GDP was more than 2% below its Q1 2008 peak. The world is not suffering from lack of spare capacity. Worries about inflation arise solely because central banks are following policies which should boost the growth of broad money. This is ultimately inflationary. But broad money is not growing excessively in any advanced economy. There can be temporary price increases because of higher food or commodity prices (although the latter are coming down). But output and monetary data show there is no risk of inflation sustainably accelerating in the near-term. This is backed by business and consumer survey data. Inflation is not dead. But when it starts picking up again, it will be because the world economy has recovered. At that stage, monetary policy can safely be tightened.

Euro creditors get ready to pay *(... continued from page 1)*

The ECB's OMT plan, designed to allay fears about what ECB president Mario Draghi coyly calls the 'convertibility' (i.e. break-up) of the euro, is subject to conditionality. Yet it looks like confirming a future succession of transfers to EMU's distressed debtors.

Northern Europe has already incurred substantial losses on its loans to southern Europe and Ireland, which have yet to be fully recognised. To the extent that EMU rescue funds make loans on concessionary terms, this entails another implicit transfer. Much the same applies to the ECB's liquidity infusions and asset purchases, which hold down the funding costs of banks and sovereign debtors.

In effect, sovereign debtors are undergoing the equivalent of an International Monetary Fund programme without the devaluation that is necessary to shift resources into exports. Against the background of a weakening global economy, this formula ensures a worsening of the debtors' budget deficits – and a substantial increase in the amounts creditors ultimately have to pay to bail them out.

Germany, in particular, in the next 10 years may have to run down a large part of its net foreign assets to keep EMU going. Every classic account surplus country, with a permanent preponderance of exports against imports, constantly accumulates money claims on foreign countries. But loans to foreign buyers of German goods are never fully repaid; they are always written down, extended or rescheduled. This means that a the real net foreign assets of a surplus state like Germany is always well below the cumulative total of past current account surpluses. Within a monetary union, where the normal safety valve to reduce external imbalances, through currency realignments, no longer exists, the problem is particularly acute.

Sooner or later, one way or the other, the problem is solved. Theoretically, resolution could come by Germany running a high inflation rate, becoming uncompetitive, and running down its foreign assets through current account deficits. Alternatively, the deficit countries (or Germany itself) could leave EMU. If these two options are ruled out, then the only way out is through lenders writing off loans and debtors stretching out redemptions.

The rise and fall of Germany's net foreign assets before and after EMU illustrates these basic trends. In the years before reunification in 1990, West Germany accumulated net foreign assets of €250bn. Yet the number never grew astronomically. Extreme current account imbalances in Europe were avoided by repeated realignments within the European Monetary System. Around 1990, Hans Tietmeyer, the later Bundesbank president, far-sightedly predicted that West Germany would use it net foreign assets as a 'reserve army' to absorb the costs of unification. A forecast that proved true.

In the years leading up to the introduction of the euro, the net pile of cash and capital almost completely disappeared as a result of post-unity tensions in the German economy, manifested in several years of current account deficits.

Germany thus at the beginning of 1999 entered EMU with hardly any net foreign assets (according to Bundesbank statistics: €34m). Since then, reflecting shifts in euro states' competitiveness and consequent large current account imbalances, Germany's net foreign assets have risen sharply, topping €1tn in March 2012.

This is the high summit from which the Federal Republic must descend. From now on, quietly but inexorably, Germany will have to dig into its net foreign assets, even if the German current account surplus continues for a few years at a relatively high level.

Transfer payments to, and debt reduction measures by, the southern euro members can take us in only one direction. Some will call this a 'transfer union'. Others will say it's a clever adaptation to reality.

Debt wave *(... continued from page 1)*

While overall debt levels remain relatively stable, emerging market companies are locking in long-term funding at favourable rates, diversifying financing sources and reducing reliance on banks. These corporates are also building a track record in preparation for eventual equity listings.

Increasingly, companies are focused on issuing benchmark eligible bonds (minimum size $300m), improving the tradability of their bonds. The EMD corporate market, as measured by the JP Morgan CEMBI Broad Diversified Index has grown at an annual compounded rate of 32.5% over the past 10 years. While the market for $300m-plus bonds is over $500bn, the overall market valuation is close to $1tn, almost as high as the US high yield market.

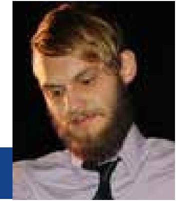
While benefiting from macroeconomic improvements, emerging market corporates more specifically take advantage of microeconomic developments, including the rise of emerging market consumers. Corporate EMD is recognised as a good source of diversification for those invested in both emerging and developed market credit. Investors can select investments to suit different growth scenarios among more than 350 issuers from around 40 countries.

In a world characterised by historically low interest rates, corporate EMD offers attractive yields relative to the fundamentals. Emerging market corporates have maintained more conservative balance sheets, with lower leverage and lower overall default rates than developed market peers, yet provide higher yields.

The yield on the EM Index (JP Morgan CEMBI Broad Diversified Index) is 4.8%, almost double the 2.9% on the US investment grade index (BoA Merrill Lynch US corporate Master index). There is a strong case for these yields to fall, reinforcing the case for future corporate EMD outperformance.

Tracking world hyperinflation

The data from Argentina to Zimbabwe



Steve H. Hanke and Nicholas Krus

Hyperinflation is an economic malady that arises under extreme conditions: war, political mismanagement, the transition from a command to market-based economy. There are barriers to the recording and publication of reliable inflation statistics. Overcoming these barriers is an arduous and painstaking process. This article and attached table – an abbreviated version of a Cato Working Paper – supply, for the first time, data on all 56 episodes of hyperinflation, including several which had previously gone unreported.

The literature on hyperinflation is replete with ad hoc definitions, vague, ill-defined terminology, and a lack of concern for clear, uniform metrics. We attempted to fill the void. The Hyperinflation Table is compiled in a systematic and uniform way. It utilises clean and consistent inflation metrics, indicates the start and end dates of each episode, identifies the month of peak hyperinflation, and signifies the currency that was in circulation, as well as the method used to calculate inflation rates. We soon learned why no such table exists. We frequently found leads suggesting new episodes, only to discover that the proper documentation of their source was lacking. Even in cases in which we thought replication would be straightforward, it was not.

The Hyperinflation Table is compiled in a systematic and uniform way. It utilises clean and consistent inflation metrics, indicates the start and end dates of each episode, and identifies the month of peak hyperinflation.

The former Soviet bloc countries were a particular source of frustration. The data had seemingly been lost in time. After scouring the Library of Congress and the Joint World Bank-IMF Library, as well as a variety of online databases, we finally came across a series of World Bank publications that ostensibly contained the requisite information. But, much of the data were not presented in a usable form. The challenges we faced with the Soviet Bloc were compounded as we looked to the Balkan States and began to investigate hyperinflation episodes of the 1990s. Bosnia and Herzegovina and the Republika Srpska posed the most difficult problems.

In another case, we were able to overcome data deficiencies in a different way. We knew that the Free City of Danzig engineered a currency reform in 1923, following inflationary developments similar to those that had visited Germany. Suspecting that this currency reform was enacted in response to a case of hyperinflation, we were forced to employ creative methods to estimate Danzig's inflation rate, using purchasing power parity (PPP) to overcome the obstacle.

One 'missing' case was easier to find. We discovered the data for the Democratic Republic of Congo's August 1998 hyperinflation using the IMF's International Financial Statistics database. Another largely unreported hyperinflation episode occurred in the Philippines. In 1942, during its occupation of what was then the Commonwealth of the Philippines, Japan replaced the Philippine peso with Japanese war notes. Over-issuance of these notes, dubbed 'Mickey Mouse money', resulted in a hyperinflation that peaked in January 1944. The US Army added a small amount of fuel to the Philippine hyperinflation fire by distributing counterfeit Japanese war notes to Philippine guerilla troops.

One of the biggest problems encountered when discussing hyperinflation is the extreme size of the monthly inflation rates. For example, in July 1946, Hungary had a monthly inflation rate of 4.19×10^{16} %. We included two metrics that help put hyperinflation into perspective: the equivalent daily inflation rate and the time required for prices to double.

After years of disorder in the study of hyperinflation, we can now, with The Hyperinflation Table, finally let the data speak for themselves.

This article and the table on p. 11-12 represent an abbreviated version of "World Hyperinflations, a Cato Working Paper" by Steve H. Hanke and Nicholas Krus, August 2012, available from Cato Institute, 1000 Massachusetts Avenue, N.W.Washington, D.C. 20001. Their working paper is available at http://tinyurl.com/worldhyperinflations. Steve H. Hanke and Nicholas Krus are respectively Professor of Applied Economics at The Johns Hopkins University and research associate at the Johns Hopkins Institute for Applied Economics, Global Health, and the Study of Business Enterprise. Contact: hanke@jhu.edu.

The Hanke-Krus Hyperinflation Table

Location	Start Date	End Date	Month with Highest Inflation Rate	Highest Monthly Inflation Rate	Equivalent Daily Inflation Rate	Time Required For Prices To Double	Currency	Type Of Price Index
Hungary	Aug. 1945	Jul. 1946	Jul. 1946	4.19 × 1016%	207%	15.0 Hours	Pengő	Consumer
Zimbabwe	Mar. 2007	Mid-Nov. 2008	Mid-Nov. 2008	7.96 × 1010%	98.0%	24.7 Hours	Dollar	Implied exchange rate
Yugoslavia	Apr. 1992	Jan. 1994	Jan. 1994	313,000,000%	64.6%	1.41 Days	Dinar	Consumer
Republika Srpska	Apr. 1992	Jan. 1994	Jan. 1994	297,000,000%	64.3%	1.41 Days	Dinar	Consumer
Germany	Aug. 1922	Dec. 1923	Oct. 1923	29,500%	20.9%	3.70 Days	Papiermark	Wholesale
Greece	May. 1941	Dec. 1945	Oct. 1944	13,800%	17.9%	4.27 Days	Drachma	Exchange rate
China	Oct. 1947	Mid-May 1949	Apr. 1949	5,070%	14.1%	5.34 Days	Yuan	Wholesale For Shanghai
Free City of Danzig	Aug. 1922	Mid-Oct. 1923	Sep. 1923	2,440%	11.4%	6.52 Days	German Papiermark	Exchange Rate
Armenia	Oct. 1993	Dec. 1994	Nov. 1993	438%	5.77%	12.5 Days	Dram & Russian Ruble	Consumer
Turkmenistan	Jan. 1992	Nov. 1993	Nov. 1993	429%	5.71%	12.7 Days	Manat	Consumer
Taiwan	Aug. 1945	Sep. 1945	Aug. 1945	399%	5.50%	13.1 Days	Yen	Wholesale For Taipei
Peru	Jul. 1990	Aug. 1990	Aug. 1990	397%	5.49%	13.1 Days	Inti	Consumer
Bosnia and Herzegovina	Apr. 1992	Jun. 1993	Jun. 1992	322%	4.92%	14.6 Days	Dinar	Consumer
France	May 1795	Nov. 1796	Mid-Aug. 1796	304%	4.77%	15.1 Days	Mandat	Exchange Rate
China	Jul. 1943	Aug. 1945	Jun. 1945	302%	4.75%	15.2 Days	Yuan	Wholesale For Shanghai
Ukraine	Jan. 1992	Nov. 1994	Jan. 1992	285%	4.60%	15.6 Days	Russian Ruble	Consumer
Poland	Jan. 1923	Jan. 1924	Oct. 1923	275%	4.50%	16.0 Days	Marka	Wholesale
Nicaragua	Jun. 1986	Mar. 1991	Mar. 1991	261%	4.37%	16.4 Days	Córdoba	Consumer
Congo (Zaire)	Nov. 1993	Sep. 1994	Nov. 1993	250%	4.26%	16.8 Days	Zaïre	Consumer
Russia	Jan. 1992	Jan. 1992	Jan. 1992	245%	4.22%	17.0 Days	Ruble	Consumer
Bulgaria	Feb. 1997	Feb. 1997	Feb. 1997	242%	4.19%	17.1 Days	Lev	Consumer
Moldova	Jan. 1992	Dec. 1993	Jan. 1992	240%	4.16%	17.2 Days	Russian Ruble	Consumer
Russia / USSR	Jan. 1922	Feb. 1924	Feb. 1924	212%	3.86%	18.5 Days	Ruble	Consumer
Georgia	Sep. 1993	Sep. 1994	Sep. 1994	211%	3.86%	18.6 Days	Coupon	Consumer
Tajikistan	Jan. 1992	Oct. 1993	Jan. 1992	201%	3.74%	19.1 Days	Russian Ruble	Consumer
Georgia	Mar. 1992	Apr. 1992	Mar. 1992	198%	3.70%	19.3 Days	Russian Ruble	Consumer
Argentina	May 1989	Mar. 1990	Jul. 1989	197%	3.69%	19.4 Days	Austral	Consumer
Bolivia	Apr. 1984	Sep. 1985	Feb. 1985	183%	3.53%	20.3 Days	Boliviano	Consumer

The Hanke-Krus Hyperinflation Table

Location	Start Date	End Date	Month with Highest Inflation Rate	Highest Monthly Inflation Rate	Equivalent Daily Inflation Rate	Time Required For Prices To Double	Currency	Type Of Price Index
Belarus	Jan. 1992	Feb. 1992	Jan. 1992	159%	3.22%	22.2 Days	Russian Ruble	Consumer
Kyrgyzstan	Jan. 1992	Jan. 1992	Jan. 1992	157%	3.20%	22.3 Days	Russian Ruble	Consumer
Kazakhstan	Jan. 1992	Jan. 1992	Jan. 1992	141%	2.97%	24.0 Days	Russian Ruble	Consumer
Austria	Oct. 1921	Sep. 1922	Aug. 1922	129%	2.80%	25.5 Days	Crown	Consumer
Bulgaria	Feb. 1991	Mar. 1991	Feb. 1991	123%	2.71%	26.3 Days	Lev	Consumer
Uzbekistan	Jan. 1992	Feb. 1992	Jan. 1992	118%	2.64%	27.0 Days	Russian Ruble	Consumer
Azerbaijan	Jan. 1992	Dec. 1994	Jan. 1992	118%	2.63%	27.0 Days	Russian Ruble	Consumer
Congo (Zaire)	Oct. 1991	Sep. 1992	Nov. 1991	114%	2.57%	27.7 Days	Zaïre	Consumer
Peru	Sep. 1988	Sep. 1988	Sep. 1988	114%	2.57%	27.7 Days	Inti	Consumer
Taiwan	Oct. 1948	May 1949	Oct. 1948	108%	2.46%	28.9 Days	Taipi	Wholesale For Taipei
Hungary	Mar. 1923	Feb. 1924	Jul. 1923	97.9%	2.30%	30.9 Days	Crown	Consumer
Chile	Oct. 1973	Oct. 1973	Oct. 1973	87.6%	2.12%	33.5 Days	Escudo	Consumer
Estonia	Jan. 1992	Feb. 1992	Jan. 1992	87.2%	2.11%	33.6 Days	Russian Ruble	Consumer
Angola	Dec. 1994	Jan. 1997	May 1996	84.1%	2.06%	34.5 Days	Kwanza	Consumer
Brazil	Dec. 1989	Mar. 1990	Mar. 1990	82.4%	2.02%	35.1 Days	Cruzado & Cruzeiro	Consumer
Democratic Re-public of Congo	Aug. 1998	Aug. 1998	Aug. 1998	78.5%	1.95%	36.4 Days	Franc	Consumer
Poland	Oct. 1989	Jan. 1990	Jan. 1990	77.3%	1.93%	36.8 Days	Złoty	Consumer
Armenia	Jan. 1992	Feb. 1992	Jan. 1992	73.1%	1.85%	38.4 Days	Russian Ruble	Wholesale
Tajikistan	Oct. 1995	Nov. 1995	Nov. 1995	65.2%	1.69%	42.0 Days	Ruble	Wholesale
Latvia	Jan. 1992	Jan. 1992	Jan. 1992	64.4%	1.67%	42.4 Days	Russian Ruble	Consumer
Turkmenistan	Nov. 1995	Jan. 1996	Jan. 1996	62.5%	1.63%	43.4 Days	Manat	Consumer
Philippines	Jan. 1944	Dec. 1944	Jan. 1944	60.0%	1.58%	44.9 Days	Japanese War Notes	Consumer
Yugoslavia	Sep. 1989	Dec. 1989	Dec. 1989	59.7%	1.57%	45.1 Days	Dinar	Consumer
Germany	Jan. 1920	Jan. 1920	Jan. 1920	56.9%	1.51%	46.8 Days	Papiermark	Wholesale
Kazakhstan	Nov. 1993	Nov. 1993	Nov. 1993	55.5%	1.48%	47.8 Days	Tenge & Rus-sian Ruble	Consumer
Lithuania	Jan. 1992	Jan. 1992	Jan. 1992	54.0%	1.45%	48.8 Days	Russian Ruble	Consumer
Belarus	Aug. 1994	Aug. 1994	Aug. 1994	53.4%	1.44%	49.3 Days	Ruble	Consumer
Taiwan	Feb. 1947	Feb. 1947	Feb. 1947	50.8%	1.38%	51.4 Days	Taipi	Wholesale For Taipei

What Europe can learn from Asia

Need for collective action and reform

Prasarn Trairatvorakul, Governor, Bank of Thailand

Fifteen years ago the Asian crisis forced us to go through painful adjustments and far-reaching economic and financial reforms. Our business sector had to deleverage and our bankers became much more prudent and risk-conscious. Today, the world is witnessing another not dissimilar crisis. Asia habitually looks to Europe as a role model and a benchmark in our integration efforts. However there are some lessons from the Asian crisis that can be useful for Europe too.

As Mark Twain put it, 'History doesn't repeat itself, but it does rhyme.' So despite the differences between the Asian and European crises, the underlying root causes are not dissimilar. Both crises, like many others, are associated with mispricing of risk and distorted incentive structures.

In Asia, we confronted both a currency and a banking crisis. We had to abandon the pegged exchange rate system which led to massive devaluations. With the corporate sector largely over-leveraged and loaded with foreign debt, currency depreciation technically bankrupted firms overnight. Banks' non-performing loans shot up and brought on the banking crisis. The region's 'original sin' was well beyond redemption. We borrowed in foreign currencies and used the loans to finance projects that did not generate foreign exchange to service the debt. In Thailand, the private external debt was over three times the level of international reserves. Given Thailand's healthy public finances (with nine years of fiscal surplus prior to 1997), expanding foreign private sector debt was interpreted as a sign of confidence in the emergence of new 'tiger economies'.

Europe saw a similar story of mispricing. Some peripheral nations were able to access financing at a much cheaper rate than the country's underlying credit rating would have permitted. A single currency and the risk rating convergence, like our fixed exchange rate, gave the market a false sense of security. This encouraged borrowing beyond the borrowers' means and without proper risk management.

Both crises occurred as a result of a failure to fulfil necessary preconditions. In Asia, these were preconditions for liberalisation; in Europe they were preconditions for integration. A number of Asian countries embarked on ambitious liberalisation programmes with insufficient safeguards and with inappropriate infrastructure and policy tools. Liberalising capital flows with a fixed exchange rate system ran up against the so-called 'impossible trinity': the country must eventually give up control over monetary policy.

Similarly, in Europe's currency union, countries entered with large diversities in economic development and competitiveness, and in the absence of fiscal and banking union. On the whole, these countries were victims of their own success.

The 'reckless optimism' prior to both crises led the countries concerned to similar consequences of severe market stress and capital flight, albeit with different symptoms: for Asia, losses incurred in the private sector's balance sheet, while, for Europe, public sector balance sheets were impaired.

Let's look at how Asia got out of the crisis. Are such conditions available for Europe? At the onset of the Asian crisis, Indonesia, Korea, and Thailand built up large private short-term external debt while high private credit growth fuelled bubbles in the stock and property markets. Once the crisis hit, these countries faced sharp capital reversal of up to 10% and 12.5% of GDP in 1998 for Korea and Thailand respectively. Massive currency devaluations soon followed. Some of us were forced to seek assistance from the International Monetary Fund or, in the case of Malaysia, to undertake rigorous self-reform and eventually follow unorthodox measures on exchange and capital flows. Notwithstanding the different approaches, these steps were all painful yet critical for economic recovery.

Europe saw a similar story of mispricing to Asia. Some peripheral nations were able to access financing at a much cheaper rate than the country's underlying credit rating would have permitted.

By 1998, the four countries' current account balances became positive. GDP growth returned to positive territory by the second quarter of 1999.

Two differences stand out between Asia and Europe. The first is policy flexibility. Devaluations helped restore Asian export competitiveness. However, this flexibility is not practical for Europe given its single currency setting and attendant political complexities. The second difference concerns the global economic environment, which was supportive for Asia and allowed us to export our way out of the crisis. Global GDP grew 4.7% growth in 2000, with advanced economies, the world's largest consumers, growing at 4.1%. In contrast, the global setting for the European debt crisis is nothing like as favourable.

There may be other success factors for Europe. But some of the success factors are not without costs. In the case of Asia, the sharp devaluations and swift export recoveries made the Asian economies addicted to large export volumes at low prices. In Thailand, with little incentive to invest in research and development to raise the products' value and enhance human capital, the average growth of labour productivity fell from the 1990s to 2000s.

There are three overall lessons for policy-makers. First, conventional policy prescriptions may not be appropriate for unusual circumstances and there is no one-size-fits-all solution. Asia was a case in point regarding ill-timed austerity measures. Public sector debt in Thailand then was less than 15% of GDP; yet the policy prescription for Thailand was to tighten fiscal policy and maintain tight monetary policy, resulting in interbank interest rates rising from 10% at the beginning of 1997 to over 20% at the end of 1997. With large private external debt beyond the ability of the country to service, the route should have involved debt restructuring with international creditors to give the country a breathing space and avoid the shock of sharp reversals in capital flows. This was possible only for Korea, which helped the country recover faster.

Second, policy-makers must be ready to take away the punch bowl. In the past we used to talk about monetary policy being on the alert to take away the punch bowl. Yet public policy in general needs to observe this principle. Fiscal policy must not fall into the populist trap. Financial supervisors need to watch for signs of excessive credit creation, and act pre-emptively. The costs of cleaning up the crisis far outweigh the brief euphoria and exuberance of the moment. Central banks must maintain independence and credibility to conduct appropriate policies that may not be politically favoured. I support empowering an international institution to oversee financial behaviour on a world-wide scale to ensure strict compliance with rules, uphold ethical codes and avoid double standards.

Third, continuous, collective reforms are vital. Crises are recurring phenomena. Through reforms after each crisis, the market may become more efficient. Crises provide a window of 'political feasibility' to undertake necessary structural changes. One should not waste a good crisis. I am pleased to see numerous improvements in key areas such as the use of macroprudential measures to complement traditional monetary policy tools. It is also more acceptable to require banks to provision in good times against losses in bad times, for most bad loans are made in good times. In addition to structural reforms, we need a change in mindset so as to challenge and correct some of our old beliefs. Let me name a few. Sovereigns are no longer risk-free. We have been taught to value economies of scale but we are now confronted with the 'too-big-to-exist' problem.

We saw spill-over in 1997 when turbulence spread from Thailand to South East Asia and to Russia, China and Brazil. The same thing happened in 2007 when the crisis widened from the US and Europe to the rest of the world. Imagine the pace in the next 10 years. Crises will grow in size and speed beyond the management capacity of a single nation, so real collective action is required.

In 2002, five years after the 1997 crisis, Asian economies had fully recovered. Thailand was able to repay the IMF some two years ahead of schedule. Today, four years after the Lehman Brothers crisis, the relative position is more difficult. At this critical juncture, policy-makers need to show clarity, commitment and credibility. Much work is still to be done.

This is an abridged version of Governor Trairatvorakul's speech to OMFIF on 12 September 2012.

I support empowering an international institution to oversee financial behaviour on a world-wide scale to ensure strict compliance with rules, uphold ethical codes and avoid double standards among nations.

The eternal euro debate

Single currency conspiracy theories and realities

Harold James, Advisory Board

Europe suffers from the ghosts of history. In the current euro crisis the spectres of past debates have come back to haunt present-day policy-makers and frustrate constructive solutions. Looking at the real history of the euro can clear up misconceptions, but also highlight the real problems that remain to be tackled.

A big obstacle to clear thinking lies in a propensity to develop myths about the origins of the euro. In one view – formulated by proponents such as the veteran German foreign minister Hans-Dietrich Genscher but also by opponents such as the economist Martin Feldstein – is that the currency union was a high-minded European political project that ignored economic realities. It was needed to stop the recurrence of war between France and Germany.

The mundane truth about the evolution of Europe's monetary order is that it was an outcome of global debates about currency disorder.

This theory is implausible. Americans are perfectly aware that they haven't had a war with Canada or Mexico recently (although in the long past there were indeed such conflicts), and that they don't need a currency union to improve relations with neighbours.

Then there is the conspiracy theory about a deep-seated German masterplan. Some of its earliest proponents were British (like Denis Healey), but now it circulating widely in southern Europe. Since Germany had lower rates of wage inflation than France and much lower rates than the Mediterranean countries, a locked currency would guarantee increased export surpluses, at the price of misery elsewhere.

This view seems as absurd as the first myth about peace and money. If this is what the Germans were aiming at, wouldn't other countries be able to get some whiff of the nefarious plot? And more importantly, if this were really a strategy it is a pretty short-sighted one (not really that much better than the disastrous Schlieffen Plan of 1914 to defeat both France and Russia at the same time).

Plunging one's neighbours into national bankruptcy is not a good way of building any kind of stable prosperity. The rather more mundane truth about the evolution of Europe's monetary order is that it was an outcome of global debates about currency disorder. European monetary integration appeared urgent in the late 1960s, as the Bretton Woods regime disintegrated, and in the late 1970s, when US monetary policy was subject to big political pressures and the dollar collapsed.

The most decisive push for a European solution to a global problem occurred in different circumstances. When the dollar was soaring in the mid-1980s, when American manufacturing was threatened and when there appeared to be the possibility of a protectionist backlash, the finance ministers of the major industrial countries pushed for exchange rate agreement. At the G-7 finance ministers Louvre meeting in 1987 they agreed to lock their exchange rates into a system of target zones.

In practice, nothing came of that global plan, but then Edouard Balladur, the French finance minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme. When German foreign minister Genscher appeared sympathetic, Europe's central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a plan for currency union.

Another ghost in present debates lies in Germany's particular attachment to monetary stability, and the extent of German willingness to compromise for the sake of the stability of the system as a whole. The Italian economist (then at the European Commission) Tommaso Padoa-Schioppa explained this point brilliantly in an admonitory letter to Bundesbank president Karl Otto Pöhl in 1982.

Padoa-Schioppa wrote: 'To couple the defence of monetary orthodoxy with that of the institutional status quo may lead to defeat in terms of both monetary stability and independence. Your "monetary constitution" has been too successful on the fight for stability. It will now either become the monetary constitution for Europe or be contaminated by the sins of the others. That is, by the way, a very "deutsches Schicksal".'

In 1982, faced with a new and socialist French President, the Bundesbank needed to work out a path of institutional reform that would make Europe stable. Pöhl responded to that demand and started to argue that the Europeans needed to move to what would later be known as 'corner solutions': either more flexible exchange rates, or a complete and irrevocable fixing.

Finally, there are the unsolved problems of the past. In the debates of the central bankers' group that Delors chaired in 1988-89, before the fall of the Berlin Wall, two issues were highlighted. The first concerned the fiscal discipline needed for currency union. There was an explicit discussion as to whether the capital market by itself was enough to discipline borrowers, and an agreement that market discipline would not be adequate and that a system of rules was needed. The influential Belgian economist from the Bank for International Settlements, Alexandre Lamfalussy, a member of the Delors Committee, brought up cases from the US and Canada as well as from Europe where cities and regions were insufficiently disciplined. Jacques Delors himself raised the prospect of a two-speed Europe, in which one or two countries might need a 'different kind of marriage contract.'

The second flaw was much more serious. In the original version of a plan for a central bank that would run a monetary union, the central bank would have overall supervisory and regulatory powers.

That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators.

The ECB was thus never given overall supervisory and regulatory powers, and until the outbreak of the financial crisis in 2007-08 no one thought that was a problem.

The objections to both of the central bankers' proposals that would have made the euro work better were deeply political. Didn't both the bold suggestions imply some sort of constraint on national sovereignty and democratic choice? These are dilemmas with which Europe is only just beginning to deal with.

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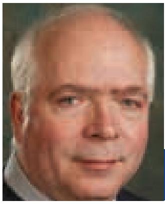
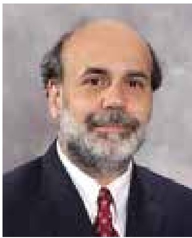


Bernanke sets uncharted course

Chairman sets legacy for better or worse

Darrell Delamaide, Board of Contributing Editors

Federal Reserve Chairman Ben Bernanke led the Federal Open Market Committee to adopt an unexpectedly aggressive stance to fight US unemployment. The panel's bold action even in the face of the pending presidential election is likely to cement Bernanke's legacy in one fashion or another.



Ben Bernanke

In the press conference announcing the long-expected new round of asset purchases and pledging an accommodative stance even well beyond the beginning of a sustained recovery, Bernanke made clear he takes very seriously the Fed's dual mandate to maintain price stability and promote maximum employment.

'The weak job market should concern every American,' the Fed chairman said. 'High unemployment imposes hardship on millions of people and it entails a tremendous waste of human skills and talents.' Bernanke bided his time to make the move, letting a sluggish economy and persistently high unemployment take the wind out of critics' sails. By the time of its August meeting, the FOMC clearly signaled that action was imminent, barring a sudden and dramatic improvement in the economy.

Bernanke ran into immediate political flak. Republican presidential candidate Mitt Romney criticised the Fed action, claiming it amounted to an indictment of President Barack Obama's economic policies.

'What Bernanke's doing is saying that what the president's saying is wrong,' Romney said on ABC-TV. 'The president's saying the economy's making progress, coming back. Bernanke's saying, 'No, it's not. I've got to print more money".'

Romney's running mate, Wisconsin congressman Paul Ryan poured his own scorn on the decision. 'Look, sugar-high economics is no substitute for pro-growth economics,' he said at a political rally in Virginia. 'What we don't need is more money-printing. What we need is more wealth creation, job creation and risk-taking.'

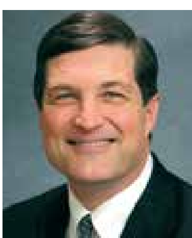
White House spokesman Jay Carney said the president doesn't comment on Fed actions and the Obam a campaign team likewise refrained from commenting.

Bernanke's unmistakeable signal at Jackson Hole

At the Fed's Jackson Hole meeting at the end of August, Bernanke gave an unmistakable signal. His spirited defence of the efficacy of 'non-traditional' monetary policy gave a different meaning to his repetition of the standard pledge that the Fed would act as necessary. 'As we assess the benefits and costs of alternative policy approaches, we must not lose sight of the daunting economic challenges that confront our nation. The stagnation of the labour market in particular is a grave concern not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years.'

After that,, markets would have been shocked if the FOMC had failed to act at the September meeting. The committee decided to embark on new purchases of mortgage-backed securities to the tune of $40bn a month, while continuing its reinvestment in longer-term Treasuries of $45bn a month.

The initial commitment was until the end of the year, Bernanke said, but unless there is substantial improvement on the jobless front, 'we will continue the MBS purchase program, undertake additional asset purchases, and employ our policy tools as appropriate until we do.'

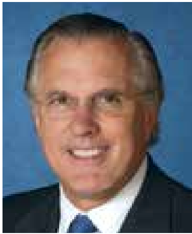


Jeffrey Lacker

In addition, the FOMC 'expects a highly accommodative stance of monetary policy to remain appropriate for a considerable time after the economic recovery strengthens.' To be clear, this means that 'exceptionally… low levels for the federal funds rate are likely to be warranted at least through mid-2015.'

There was only one official dissenter among the 12 voting members of the FOMC. The new action by the Fed was clearly Bernanke's show. Richmond Fed chief **Jeffrey Lacker** was the one voting member who dissented, but there were grumblings in the wake of the announcement from other regional bank heads who are not in the voting rotation this year.

Fisher, Bullard line up as critics

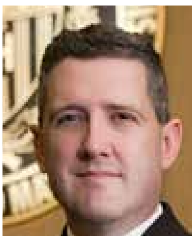

Richard Fisher

Über-hawk **Richard Fisher (non-voter)** of the Dallas Fed wasted no time in making known his displeasure with the decision. In a speech in New York at the Harvard Club, Fisher, drawing on his time at the Naval Academy before transferring to Harvard in college, launched into an extended nautical metaphor.

'I have repeatedly made it clear, in internal FOMC deliberations and in public speeches, that I believe that with each programme we undertake to venture further in that direction, we are sailing deeper into uncharted waters,' he said. 'And nobody – in fact, no central bank anywhere on the planet – has the experience of successfully navigating a return home from the place in which we now find ourselves.'

Fisher believes it is not lack of liquidity that is holding back business investment, but uncertainty about the fiscal situation and the crisis in Europe.

Fisher believes it is not lack of liquidity that is holding back business investment, but uncertainty about the fiscal situation and the crisis in Europe. He cites economists like Michael Woodford who believe that excessively easy monetary policy will have little positive effect in the short term and could lead to negative unintended consequences in the long term. Fisher said his own soundings gave him an urge at the FOMC meeting 'to tie the chairman to the mast, Odyssean-style, and to stuff wax in the ears of my fellow committee members, in order to resist the Siren call of further large-scale asset purchases.'


James Bullard

St. Louis Fed chief **James Bullard (non-voter)** also doesn't like the idea. 'Unemployment is a fickle variable,' he told reporters after a speech in Indiana. 'It can go up and down because of labor-force participation changes.' His solution: 'We would be better served by taking an overall approach to labour market conditions and assessing the situation that way.' Bullard told Reuters he thought the new round of asset purchases was premature. 'I would have voted against it based on the timing…. I didn't feel like we had a good enough case.'

Support from Atlanta, Minneapolis and Chicago

Dennis Lockhart

Other regional chiefs publicly defended the Fed action. 'All together, the rate guidance, asset purchase, and communications policy actions taken last week represented a forceful attempt to improve the outlook for the economy,' Atlanta Fed President **Dennis Lockhart (voter)** told an audience in Atlanta. 'The necessary natural healing from the large disruption of the financial crisis will certainly be supported, and likely accelerated, by the stance of policy with the new features introduced last week.

Narayana Kocherlakota

More surprisingly, Minneapolis Fed chief **Narayana Kocherlakota (non-voter)**, usually considered a hawk, contradicted some of his past statements about an early increase in interest rates and said the Fed should communicate it won't raise rates for another four or five years. In fact, Kocherlakota said in a speech in Michigan, the Fed should commit not to raise rates until unemployment has fallen below 5.5%. 'This specificity – about an event that may not take place for four or more years – will provide needed current stimulus to the economy,' he said.

Unlike his Dallas counterpart, Kocherlakota did not use a nautical metaphor but referred to his suggestion as a 'lift-off plan,' or a description of economic conditions that would lead the Fed to consider an initial increase in the fed funds rate. He did specify that the other parameter must be a stable inflation rate and that a medium-term forecast of inflation above 2-1/4% could also trigger a rate rise.

Kocherlakota's 5.5% target for unemployment was even more aggressive than the one proposed by the dovish head of the Chicago Fed, **Charles Evans (non-voter)**, who suggested, also in a Michigan speech, a commitment to lower rates and even further monetary accommodation if necessary until the jobless rate fell below 7%. However, Evans was willing to accept an inflation forecast of up to 3%.

Bankruptcy that changed world

The 12 lessons of Hellenic misfortune

Philip Wood, Head, Allen & Overy Global Law Intelligence Unit

The Greek debt reorganisation of 2012 changed the rules of sovereign insolvency, in a way that is likely to have a profound effect on future sovereign bankruptcies. There are at least 12 features that will change thinking in this field, representing either novel, unexpected directions or a dramatic confirmation of previous trends.

Greece did not actually default on its debt. But Greece was bankrupt in the generic non-technical sense of the word, since it reduced bondholder claims and needed a huge infusion of bail-out cash from the public sector. Many questions remain. Was Greece's reorganisation just an unfortunate accident, the result of a mistake which proves nothing more than that people, especially when in a herd, are prone to lapses with unfortunate consequences? Or was Greece a symbol of something much darker? Was Greece the first tolling of a great bell for the end of an era for many countries in the west, not just Greece?

Was Greece the first tolling of a great bell for the end of an era for many countries in the west, not just Greece?

In any event, it is worth looking at the mechanics of sovereign debt restructurings. These are vastly simpler than those of corporate groups. In the typical case, the sovereign offers to exchange existing bonds held by bondholders for new bonds which are worth less and have a longer maturity. A sovereign state may offer to exchange bonds of 100 for new bonds worth 60 and payable, not in five years, but in 30. It is up to bondholders whether they accept. Since the sovereign debtor often makes it clear that the sovereign debtor will not pay those who do not accept – hold-out creditors – the bondholders have little choice

In most of the major bond reschedulings since the late 1990s, usually more than 95% of bondholders accepted. These include the reschedulings of Pakistan, Ecuador, Uruguay, Ukraine, Dominican Republic and Belize. The only exception was Argentina where initially only about 76% accepted, increased in an amended offer.

The main official sector parties involved with Greece were known as the Troika, a moniker introduced by the Greeks for the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF). The euro area members were a collective fourth party deliberating matters in the Eurogroup of finance ministers from the 17 EMU member states and the Eurogroup Working Group. The principal bail-out vehicle was a company formed in Luxembourg, and owned by EMU members, called the European Financial Stability Facility – EFSF. In order to raise bail-out funds, the EFSF issues bonds guaranteed pro rata by member states. It is being replaced by a corporation created by treaty between euro area member states called the European Stability Mechanism.

In the prelude to the debt reorganisation, during early 2010, euro area countries and the IMF assembled a bail-out package of €110bn for Greece, nearly half of Greece's GDP. Greece's financial position subsequently deteriorated and a new public sector package was agreed in 2012. This amounted to about €170bn, although this figure included €34bn of undisbursed fund commitments under the first official sector programme of 2010.

On 24 February 2012, Greece invited bondholders to exchange existing bonds in return for new rescheduled bonds and other consideration.The total eligible amount of bonds was roughly €205.6bn in 135 series. This transaction was called the Private Sector Involvement (PSI), a euphemism introduced during one of the European summits. The bonds subject to the offer fell into five main classes: Greek law bonds, foreign law bonds, foreign law bonds of Greek companies guaranteed by Greece, other guaranteed special bonds, and a small series of Swiss law bonds. About €177bn were governed by Greek law and the remaining €28bn by foreign law.

The full report Allen & Overy Global Law Intelligence Unit 'How the Greek debt reorganisation of 2012 changed the rules of sovereign insolvency' is available from melissa.hunt@allenovery.com. Contributions from Yannis Manuelides, Katrina Buckley and Matthew Hartley of Allen & Overy LLP are gratefully acknowledged.

In most cases the bondholders were effectively offered 15% in cash plus accrued interest (in both cases represented by short-term EFSF notes), a new Greek government bond having a nominal amount of 46.5% of the original bonds and a detachable GDP warrant whereby Greece would pay a modest sum (capped at 1% per annum of the outstanding amount of the new bonds) if GDP growth exceeded certain official projections. The new bonds were payable over 30 years, starting in year 11. The initial coupon was 2% escalating over time with the average coupon at around 3.4% – very much below market rates.

The day before the offers, on 23 February 2012, Greece passed a statute whereby the government could insert collective action clauses (CACs) in existing Greek law bonds. Under these clauses, if the government decided to implement the clauses, then, if more than 66% accepted the exchange, all the bondholders would be deemed to have accepted the same deal. In other words, if a sufficient majority accepted, hold-out creditors would be bound by the same terms.

Before the implementation of the CACs, 85.8% and 69% respectively of the Greek and foreign law bondholders accepted, making an initial result of 83.5%, well below the figures in sovereign reschedulings since 1999, except for Argentina. However, with the application of the CACs on dissenting minorities, more than 97% of all bonds were exchanged.

The offer did not extend to bonds held by the European Central Bank and euro area national central banks, enabling them to be paid on the due dates of their existing bonds and so have priority. However the offer did apply to sovereign bondholders and central banks elsewhere.

The final amount of new bonds issued pursuant to the offer was about €70bn. Timing was extremely tight as a large payment of Greek law bonds fell due for payment on 20 March 2012 and the deal had to be done before that. The normal timetable for a transaction of this sort had to be sharply truncated.

Lesson1: Largest-ever sovereign bankruptcy

The bankruptcy of the Hellenic Republic in 2012 was by far the biggest sovereign insolvency in history. The amounts involved were about five times the amounts involved in the previous largest sovereign bankruptcy (Argentina in December 2003.)

The total Greek public debt was between €350bn and €400bn ($465bn and $532bn), whereas the amount involved in Argentina was about $81bn. Before Argentina, the previous record-holder was Russia, which declared a moratorium on $31.6bn of debt in 1998. Greece was about the same size as the bankruptcy of Lehman Brothers in 2008 (around $530bn).

The previous largest corporate bankruptcies were Enron and Worldcom in the early 2000s. The Enron case involved about $100bn. General Motors' total debt on a consolidated basis around the time of its bankruptcy in the late 2000s was about $172bn. The total liabilities of Chrysler at the end of 2008 just before its filing in April 2009 were just over $55bn.

Lesson 2: Developed country bankruptcy

Apart from the settlement of war debts after the Second World War, Greece was the first rich country since the 1930s to reorganise debt due to private creditors. Since 1980, almost half the sovereign states in the world have been bankrupt, but they were all emerging market countries or, as they were then called, less developed countries. South Korea was caught up in a financial crisis in 1998 by way of contagion from Thailand in 1997, but South Korea was swiftly rescued and did not default on loans from the private sector.

The bankruptcy was a surprise. The Greek public debt-to-GDP was extraordinarily high for a developed country historically – more than 160%. The IMF projected in 2011 that Greece's debt would peak at 186% in 2013. However, everybody at the time was looking the wrong way.

The financial crisis in 2007 did indeed threaten the finances of rich sovereign states by reason of the collapse of their banking systems, for example in Iceland, in Ireland, in Hungary and in Latvia. But Greece's bankruptcy was a consequence neither of the financial crisis nor of the collapse of Greece's banking system. The bankruptcy of Greece was brought about by itself, by its own overspending.

Greece earlier avoided direct scrutiny because creditors assumed that, as a member of the euro area, it had joined a group of countries which never defaulted. This belief, with no legal foundation or historical justification, was underscored by the way the euro area members' debt cost was measured: not in absolute terms but by reference to their 'spread' over the euro's core country and perceived pillar of stability and strength, Germany. In the years up to 2009, markets failed to provide adequate scrutiny of the euro area's constitution.

Lesson 3: Threat to monetary union

The bankruptcy of Greece threatened a monetary union involving the second largest currency in the world, the euro. Normally, the bankruptcy of a region forming part of a currency union is not fatal to that union. For example, when New York City became bankrupt in the 1970s, nobody suggested that New York should withdraw from the US. But a breakup of a currency union can be driven by the bankruptcy of member states if the bankruptcy is so large that it threatens the value of the currency itself in the eyes of the rest of the world. In that situation, the bankruptcy puts pressures on other members to bail out the bankrupt.

Bail-outs are routine features of currency unions, mainly involving a transfer of money from richer to poorer regions. Typical examples are common spending on defence, education, health, law and order, unemployment benefits and the like. For example, there are large transfers in the US from New York State to, say, Mississippi, in Britain from the London area to the north, in Canada from Ontario to the maritime provinces, in China from Zhejiang to Guizhou.

The transfers are particularly urgent in the case of the bankruptcy of a region. A striking recent example is provided by the transfers from Abu Dhabi to Dubai, both members of the United Arab Emirates with a common currency. Another example of this was the transfer of large sums in the 1990s by west to east Germany after reunification.

It is for this reason that central governments often restrict the powers of provinces and municipalities to borrow. However, the idea that tax and borrowing have to be the sole preserve of a central or federal government to sustain a currency union is not supported by logic or historical precedent. Nevertheless, many people felt that the currency was threatened by Greece's bankruptcy. This had a major impact on the bargaining power of the parties.

Central governments often restrict the powers of provinces and municipalities to borrow. However, the idea that tax and borrowing have to be the sole preserve of a central or federal government to sustain a currency union is not supported by logic or historical precedent

Lesson 4: Bankruptcy involving domestic currency debt

Greece was bankrupt in its own currency. This feature has not been all that common. The reason for this that central banks, which are the exclusive issuer of the national currency, can increase the supply of the currency so as to pay their debts. A central bank does not have to print money these days. It just sends an email to the creditor stating that the central bank owes the creditor any sum it cares to name.

A few states have, in fact, actually defaulted on their domestic public debt, including Argentina in 1982, 1989 and 2001. Other countries which have defaulted on domestic debt since 1975 include Turkey, Nigeria and Russia. (If we include countries which de facto defaulted by rapid inflation or other manipulations of their currency, then there will have been many defaults on domestic debt.) Although the euro was Greece's own domestic and national currency, Greece did not control it. The currency was exclusively under ECB control. So Greece's position was almost exactly as if it were indebted in a foreign currency.

Politically, it did have some influence. This reflected not so much Greece's tiny minority holding in the ECB, far more, widespread expectations that EMU members would be drawn to protect Greece in order to protect the common currency. This was new. While a number of sovereign states have used the dollar as legal tender, e.g. Ecuador, Panama and Zimbabwe, in none of these cases did the country's insolvency induce the US into thinking that the dollar was threatened.

There was another major factor. Domestic currency debt is usually subject to the law of the national issuer and this gave Greece power over the terms of its own debt. In addition, domestic currency debt typically has few creditor protections. Apart from the absence of an external governing law and jurisdiction, there is typically no waiver of sovereign immunity and it is rare to find events of default or other covenants such as a negative pledge prohibiting the grant of security or a pari passu clause requiring an equal legal ordering of priorities.

Lesson 5: Leadership of bondholders

One of the most important innovations was the constitution of a steering committee, effectively acting as the negotiating representatives for bondholders together with the Institute of International Finance (IIF). The negotiations were led by representatives from the IIF and from the largest bank members of the steering committee. The members of the committee were mainly banks and insurance companies, including Greek banks and hedge funds. They were chosen from a larger Private Creditor Investor Committee, which comprised the same types of institutions.

There has not been, it appears, a major steering committee for bondholders since the 19th century, although there have been steering committees for bank lenders. The steering committee of bondholders took its cue from the last great steering committees of bank creditors, established by international banks established in the 1980s to deal with the bankruptcy of Mexico in 1982 and many other emerging countries. These committees were composed of the largest bank creditors.

In the 1980s bank creditors could be organised in this way because only a couple of dozen of really major banks were involved. With the re-opening of the bond markets for emerging market economies in the 1990s, there was no mechanism whereby bondholders were sufficiently organised to form a representative group. There were too many bondholders and some were not subject to official pressures.

The steering committee was self-appointed. A steering committee does not necessarily hold a majority of the bonds. Its members are legally not the representatives of anybody and they do not owe any kind of fiduciary or advisory or management duties to bondholders or the sovereign debtor. They are just an independent conduit. Their position depends entirely upon their implicit acceptability to the sovereign debtor and to bondholders generally, and the fact that both the sovereign debtor and the official sector are willing to treat the steering committee as the main negotiating party on behalf of bondholders.

Lesson 6: Bankruptcy without a bankruptcy law

There is no international bankruptcy law for sovereign states. The outcomes are determined by the bargaining position of the parties and free agreement. This is an open regime. There are no stays or freezes on creditor actions, no petitions for bankruptcy before a court, no revocation of preferential transfers, no liability of managers for deepening the insolvency, no direct control through a creditor representative, no stays on set-off or collateral enforcement.

A key question is whether a legal regime is workable where there is no law, except free contract law. The Greek reorganisation showed a bankruptcy could be successfully handled without a bankruptcy law, but that may not always be the case. The outcomes of a sovereign bankruptcy are determined by the bargaining position of the parties. In practice, very few major sovereign bankruptcies are disorderly. The Greek transaction resembled a gigantic game of financial poker played between three parties – the Greek government, the financial markets and the official creditors. Each party had its own set of cards. Everybody knew what the cards were. All that was unknown was whether, and when, they would be played.

Debtors always hold the traditional card that creditors depend on the debtor to be able to get back to financial markets and to be in a position to reawaken borrowings. As the first player in the power game, Greece had another advantage that more than 85% of the Greek bonds were governed by Greek law. Greece could ultimately impose a unilateral rescheduling simply by passing a statute. In practice, Greece derived its bargaining position by piggy-backing on to the bargaining position of the other two players, and using their cards, such as the euro area's fears about contagion.

The second main player was the global capital markets in the form of bondholders. Bondholders have limited legal rights against bankrupt sovereign states. The domestic assets of a sovereign are almost always inviolable by local statute and cannot be attached by creditors. While the state may have external assets and while international bonds may contain waivers of immunity, most states do not own foreign assets in their own name.

The third player was the body of official or governmental creditors, comprising mainly the euro area countries and their various institutions, such as the ECB and the EFSF. The official creditors included the IMF. The main card for the euro area was that it was in practice the only source of bail-out cash. It could, as a last resort, arrange for the whole of Greek debt to be paid. The ECB could buy in all the bonds concerned and pay for them by sending the selling bondholders an email crediting the bondholders with the purchase price. Nowadays, the central bank does not even have to print money

Accord on the Greek bankruptcy was achieved largely because the main parties all wanted stability and order. Was the result in fact fair? Each of the three parties probably felt they had a raw deal. Euro members considered they had been forced to put in an excessive amount of rescue funds. Greece thought it had lost sovereignty and was being punished by austerity. The bondholders felt that they had been the victims, in that they were tossed a junior subordinated note payable in 30 years, worth a fraction of their original debt. A major factor will be the effect of the deal on the parties' future attitudes.

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Lesson 7: Impact on European political union

The bankruptcy of Greece was a major stimulus to calls for greater political union. Many politicians took the view that the only way to stop the threat to the currency was to ensure that there was greater fiscal discipline on EMU members, especially excessive borrowing to finance budget deficits. The possibility of the issue of bonds as the joint and several obligations of all the euro member states was raised. A third strand of thinking was that there should be a banking union: a single European bank regulator, a harmonised regime for bank insolvency, a central fund to finance failed banks and a common deposit protection scheme. All of these were focused on the bankruptcy of banks and the resulting adverse impact on state solvency.

Whether or not these grand schemes ever materialise remains to be seen. Apart from resistance in some members to any further erosion of national sovereignty by the EU, most of the proposals would involve the credit of strong states, such as Germany, being used to support financially weak states.

But there is no question that the experience of Greece, even though it represents only 2-3% of euro area GDP, enlivened the pulse of movement towards greater union. This shows that bankruptcy, as a spoliator and a destroyer, is a great driver of politics and law. It awakens passions which would otherwise remain dormant, and these passions generate change.

Lesson 8: Expeditious outcome compared with corporate work-outs

The Greek debt reorganisation, at least from the time of the involvement of the private sector, took nine months. Obsevers thought they witnessed fractured dysfunctions and disorderly disputes. However, compared with most corporate work-outs, the transaction was conducted at great speed and exhibited a high degree of cool financial diplomacy by the representatives of each of the three main players – the Eurogroup, the ECB and the EFSF, the bondholders and Greece.

Large work-outs can take many years and are often coloured by indignation, rants, stand-offs between competing creditors, rages between creditors and the debtor, and a general atmosphere of chaotic uncertainty.

The Greek transaction was not the quickest of recent bondholder reschedulings, but it was much quicker than others, despite enormous political complexity. For example, the Argentine reorganisation took several years.

Lesson 9: Avoiding a moratorium

Greece, though bankrupt in the non-technical sense, did not default on its debt. In most sovereign insolvencies over the past three decades, the sovereign debtor has declared a moratorium resulting in an actual non-payment, a default.

Typically a state will declare a moratorium for, say, 90 days accompanied by a statement that during that period the state intends to achieve an orderly resolution with its creditors. In the case of Greece, there was no moratorium and (so far) no actual non-payment;

Both Greece and the Troika consistently maintained that the exchange was voluntary. One reason was that there was initially a reluctance to trigger 'credit events' under credit default swaps. The euro area was very sensitive about a member's default because of the threat of contagion. A further reason was that the ECB would be barred from accepting a defaulting country's bonds as collateral, which would then inhibit its overall efforts to provide loans to Greece and other banks.

Yet financial markets were under no illusion that Greece was bankrupt. In the sovereign context, the technical legal definition of bankruptcy has minimal importance compared to corporate bankruptcies.

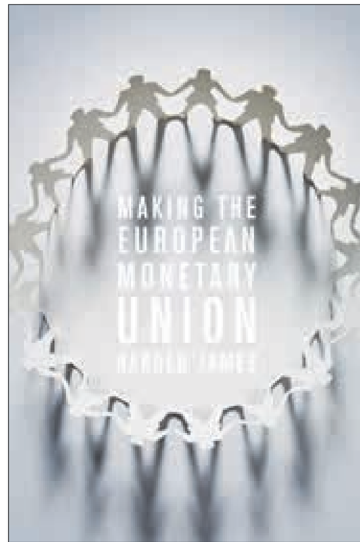
In corporate bankruptcies, the condition of insolvency is typically defined as either an inability to pay debts as they fall due or as an excess of liabilities over assets (balance sheet insolvency) or both. The most usual definition is inability to pay debts as they fall due.

In the case of sovereign states, where there is no statutory bankruptcy regime, the typical results of the condition of bankruptcy are, first, defaults in bond issues and loan agreements, hinging on failure to pay, and the possibility of sparking off cross-default clauses and, second, a downgrade in the sovereign's ratings by credit rating agencies.

Since the euro area insisted that the exchange offer must be voluntary, Greece in theory was not able to incentivise bondholders to accept its exchange offer by a declaration that it would refuse to pay creditors who did not accept the offer.

This technique had invariably been used in sovereign exchange offers in previous cases, leading to very high rates of acceptance – usually above 95% – in sovereign restructurings since 1999 (apart from Argentina.)

Harvard



MAKING THE EUROPEAN MONETARY UNION

HAROLD JAMES

FOREWORD BY MARIO DRAGHI & JAIME CARUANA

Belknap / 978-0-674-06683-0 / £25.00

Europe's financial crisis cannot be blamed on the Euro, Harold James contends in this probing exploration of the whys, whens, whos, and what-ifs of European monetary union. The current crisis goes deeper, to a series of problems that were debated but not resolved at the time of the Euro's invention.

Since the 1960s, Europeans had been looking for a way to address both the dollar's privileged position in the international monetary system, and Germany's persistent current account surpluses. While the monetary side of union was clearly conceived, other prerequisites of stability were beyond the reach central bankers. Issues such as fiscal rules and Europe-wide banking regulation were thoroughly discussed during planning, but remained in the hands of member states. That omission proved to be a cause of crisis decades later.

Here is an account that helps readers understand the European monetary crisis in depth, by tracing behind-the-scenes negotiations using an array of sources unavailable until now, notably from the European Community's Committee of Central Bank Governors and the Delors Committee of 1988–89, which set out the plan for how Europe could reach its goal of monetary union. As this foundational study makes clear, it was the constant friction between politicians and technocrats that shaped the Euro. And, Euro or no Euro, this clash will continue into the future.

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Lesson 10: Substantial debt reductions

An intriguing feature was the very large reduction in debt ('haircuts') owed to bondholders. Greece is nominally in the rich country club and therefore had been presumed to be capable of giving greater satisfaction to creditors. The actual value of such debt reductions is notoriously difficult to work out, but some estimates put the net present value of the package at about 25%, i.e. the bondholders took a loss of 75%. Apart from the desire to achieve an orderly solution quickly, the main bondholders were encouraged to agree by the fact that, at the time of the exchange, they received both accrued interest on existing bonds and also 15% in cash, both in the form of short-term notes issued by the EFSF and both financed by Greece through loans from the EFSF.

There are several objections to massive haircuts. They inevitably discourage investors from subscribing for the public debt of other euro area countries considered to be vulnerable. Additionally, the people actually being deprived are ultimately not just the bondholders. The real creditors of sovereign debtors are not the nominal banks and insurance companies. They are the depositors who put their money in the banks and the individuals who have insurance policies and pensions payable by the insurance companies. Ultimately it is the citizen who pays. Adding power to this objection, the average citizen does not know this is happening and thinks that somebody else is paying (a thought mostly not discouraged by politicians). It hardly seems right to run our societies on the basis of this kind of cloaking of reality.

In the end, the bondholders went straight to the end-game, without interim steps. On the other hand, although the terms of the euro area credits were concessionary, the official euro area lenders did not go to this end-game, because they wanted to preserve bargaining power over Greece so as to be able to enforce austerity policies. The result is that the euro area official creditors are likely to be the next in line for haircuts or an extension of maturities if the Greek debt continues to be unsustainable.

In mid-2012, the new Greek bonds were trading at less than 25%. In most recent sovereign bankruptcies, the new bonds held their market value and so the price collapse was remarkable, driven by Greece's bleak outlook and low credit rating, The perceived subordination of the new bonds was also not particularly encouraging.

Lesson 11: Contagion risk

The Greek bankruptcy involved a major risk of contagion prejudicing other developed countries in the euro area. All major insolvencies generate the risk that the insolvency will spread, not because other debtors are bankrupt, but because creditors suspect that similar debtors are likely to be in a similar situation to the bankrupt. This contagion risk may also be grounded in the reality of the domino or cascade or ripple insolvency, whereby the default of counterparties who do not pay results in the creditors concerned being, in turn, unable to pay. Contagion is therefore often a mix of the imagined and the real, illusion and actuality.

This menace of spreading sickness was distinctly observable in the crisis of the less developed countries in the 1980s and also, again, in the case of the Asian financial crisis in 1998 where the near-bankruptcy of Thailand spread quickly to other countries, such as Malaysia and South Korea. But the risk of contagion became a fundamentally important risk in the case of Greece, partly because of the fact that developed countries were involved, so that the amounts were extremely large, and because there seemed to be a threat to the second largest currency in the world.

At the time, there were frequent and increasingly unconvincing assertions that Greece was a special case and that Greece was 'ring-fenced'. The main form of ring-fencing was through an increase in the bail-out funds to the EFSF but the amounts were not sufficiently convincing to disarm fears about the spread of risk.

Lesson 12: Impact on banking sector

The Greek reorganisation has given impetus to the movement in favour of strong-arm bank resolution statutes. Under these statutes the conduct of the insolvency of banks is transferred to regulators from creditors and courts. Bankruptcy law is nationalised. The Greek banks were not recapitalised during the bailouts. The idea was that they would be recapitalised after the bond exchange out of EFSF money.

The insolvency of a sovereign state almost invariably leads to the insolvency of the country's banks. One reason is that, if a sovereign state is not able to pay its debts as they fall due, foreign creditors will not grant credit to domestic banks.

There are four major channels whereby the bankruptcy of a sovereign has an impact on banks. First, the banks often have large holdings of their own government's debt. Second, the higher sovereign risk reduces the value of collateral that can be used for funding. Third, if the sovereign credit rating is downgraded, the rating agencies will usually downgrade banks similarly. Fourth, the sovereign risk reduces the value of the implicit or explicit government guarantees given to banks.

No European federation in view

Europe must adapt to dominant but unsure Germany

Frits Bolkestein, Advisory Board

Germany's centre of gravity has shifted eastward. Germany is no longer a country at the edge of the European Union but at its centre. American domination has diminished, other actors such as Poland have become more important, and the German economy has changed. It has become more high-tech. Dutch industry must follow suit. Germany's awesome economic performance is a good thing for Holland. Germany will play a steadily more important part in the EU and in international economic affairs. The old question reappears: Is Germany too large for Europe?

The Polish foreign minister Radoslaw Sikorski has called upon Germany to lead. But how can it lead without appearing to do so? There is a considerable difference between what Germany's allies expect and what the Germans are willing or able to offer. Germany will have to get used to its dominant position just as France must accept that it should follow Germany. That will happen neither easily nor soon. A second, related, question is: Does Germany know what it wants? Since the fall of the Berlin Wall, Germany's external relations have changed fundamentally. It is unsure which role it should play. The two most important elements of German foreign policy were the US and NATO on one hand, and the European Union and the French-German axis on the other. The EU was for Germany an Ersatznation, a make-believe nation.

There is a difference between what Germany's allies expect from it and what the Germans are willing to offer. Germany must get used to its dominant position just as France must accept it should follow Germany. That will happen neither easily nor soon.

Is that still the case? Growing Euro- as well as euroscepticsm in Germany is understandable; the Germans are expected to pay but receive insults in return. This explains why the Germans are now less insistent on the 'community method' and seem to have discovered the benefits of intergovernmentalism. Angela Merkel's speech in Bruges in October 2010 clearly showed this. The chancellor attacked the limitations of the 'community method'. Instead, she said, there was a 'union method' that centred on the decisions of the member states represented in the European Council. Although Holland almost always follows German policies, this change of tack is not considered helpful in The Hague. On the other hand, compared with some of the immediate tensions after German unification, relations between Germany and the Netherlands have settled down. The nadir occurred in 1993. An opinion poll among Dutch youth showed they believed Germany was the most threatening country. Twenty years later these feelings have completely disappeared.

Germany's position in the EU has altered considerably since the chancellorship of Gerhard Schröder. Three changes are noticeable from a Dutch perspective. First, Germany has tried to sideline the European Commission as much as possible. Contrary to France, Germany has not endeavoured to get strong personalities appointed to key positions. But it has given much attention to the European Parliament, of which a German is now president. It is unclear whether Germany has lost confidence in the Commission as an institution or whether this reflects the lacklustre performance of its president José Manuel Barroso.

Second, Germany has based its approach to the euro crisis on a combination of orthodox economic thinking, domestic political motives and public emotions. It has insisted on a strict interpretation of the Treaty of Lisbon, in particular the no-bail-out clause. The German board member on the European Central Bank, Jürgen Stark, resigned last year in protest over the Bank's policies. Although his successor shows a more compliant attitude, Jens Weidmann, the president of the Bundesbank, has even more publicly opposed the prevailing policies.

Third, Angela Merkel up to now has had to fear Germany's Constitutional Court, which has applied a brake to the transfer of authority to Brussels. The court on 12 September approved the ESM permanent rescue fund, provided its actions and volume are controlled by the German parliament. Its reasoning is of interest. The court finds that the European Parliament is an insufficient guarantor of democratic control 'because it does not represent the European people' and is based too much on the equality of member states and not enough on the equality of citizens.

If we analyse Economic and Monetary Union (EMU), we must admit that this results from a French wish and a German concession. The French wish was to get a grip on the D-Mark through an ECB that would be amenable to political persuasion. But the ECB is independent since that was a sine qua non for Germany and also for the Netherlands. The German concession was to sacrifice the D-Mark on the altar of a European political union that was supposed to take the form of a federal EU. But this romantic notion failed to take root. There will never be a European Federation. There are certain federal characteristics in the European treaty, such as the European Commission, the European Parliament and the European Court of Justice. But that is as far as it goes and not only because the UK abhors a 'European superstate'. Only in Belgium does the idea of a federal Europe have any traction, because the Belgians believe that a European federation would provide a solution to their communal problems. So the conclusion must be that neither France and Germany got what it wanted.

If we analyse Economic and Monetary Union, we must admit that this results from a French wish and a German concession. The conclusion must be that neither France and Germany got what it wanted.

EMU suffers from two congenital defects. Firstly, there is no way to ensure that member states obey the criteria. This has now been altered by giving the European Commission more influence. It can now hand out a fine. But more it cannot do. Also, members must introduce rules – preferably at the level of their Constitution – to limit their deficit structurally to 0.5% of GDP. If they don't, the European Court of Justice may impose a fine of a maximum of 0.1% of GDP. But the Court is not concerned with the implementation of this rule. So not all that much has changed since the Maastricht treaty.

Second, EMU attempts to cover two groups with different economic cultures: north-west countries, led by Germany, which strive for rules and discipline, and the Mediterranean countries, led by France, which want political solutions to economic problems. The first group wants solidity, the second solidarity, i.e. other people's money. This is what you get when one size has to fit all. It could not go well and it has not gone well.

Herman van Rompuy, president of the European Council, has called the euro a sleeping pill. He is right. The Mediterranean countries could make use of an artificially low rate of interest. This they did in abundance. The euro isolated them from the market. We would have a similar outcome if we adopted the disastrous system of Eurobonds. EMU members should not have a budget deficit larger than 3% of GDP. We must stick to that rule. How quickly must they return to the straight and narrow, if their deficit is higher? Certainly the Spanish economy is not able to support any return to the 3% rule now. It's a different story for the Netherlands. The Dutch economy is very open, so budgetary looseness would quickly leak away. The less we save, the higher our national debt, so interest payments would crowd out other expenditure. All in all, best to keep the deficit as low as possible.

With regard to the 'peripheral countries', I see no future for Greece as a euro member. An inspection team from the Troika may visit Athens every three months but will return each time to say that the Greek government has again not done what it had undertaken.

The situation in Italy is different. Mario Monti, my former colleague from the European Commission, is attempting to redress the situation. I have full confidence in him. But, now he must propose specific measures, his popularity and political support are diminishing. As for France, it has a new President, François Hollande, who faces an economy in bad shape. The French state takes up 56% of GDP, sovereign debt is 85%, its budget deficit 5.5%. Unemployment is high owing to an inflexible labour market. Hollande's proposals come from an old model. Tax increases and an anti-business attitude will make more Frenchmen flee to London, already the fourth French city.

When in 1978 Chancellor Helmut Schmidt needed the cooperation of the Bundesbank to set up the European Monetary System, he referred to Germany's foreign policy which, he said, had to bear the burden of Germany's past. His successor Helmut Kohl was even clearer, 11 years later, when he admitted that the decision to relinquish the D-Mark was against Germany's interest. 'But,' he said, 'this decision is politically important since Germany needs friends. Europe should not feel suspicious of Germany.'

It thus becomes clear that EMU is a sequel of the Second World War and the role Germany played in it. We must bear this point in mind in all that lies ahead.

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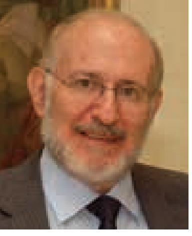
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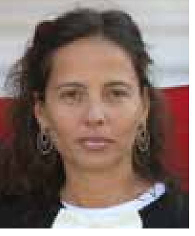
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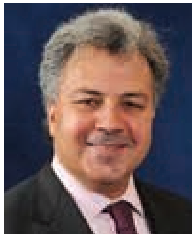
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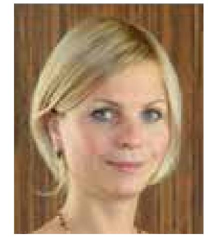
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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome Athanasios Orphanides, Professor at MIT Sloan School of Management. Until May 2012, he was Governor of the Central Bank of Cyprus and sat on the Governing Council of the European Central Bank. OMFIF also welcomes Dr. Stefano Carcascio, who was Chief Representative of the Banca d'Italia in London until September 2012. This takes the total number of Advisory Board members to 107. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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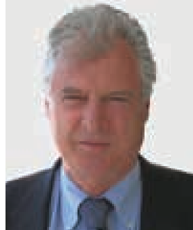
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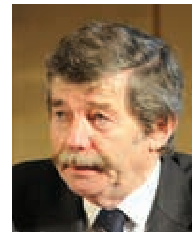
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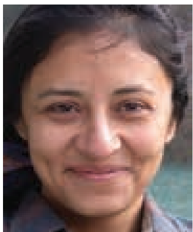
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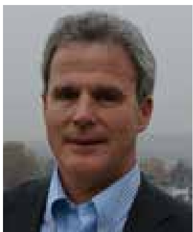
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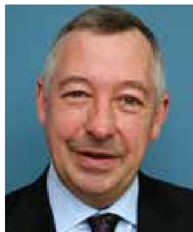
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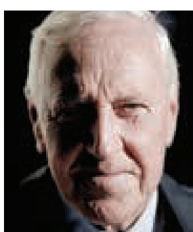
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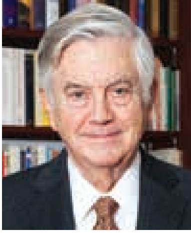
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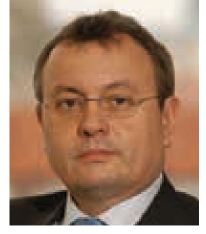
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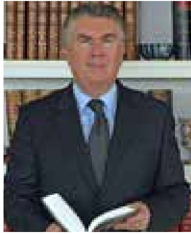
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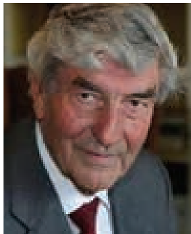
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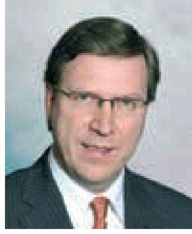
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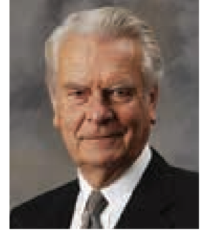
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Shoring up the structures

Van Rompuy gets on with the task

Ruud Lubbers and Paul van Seters, Advisory Board

Herman Van Rompuy, who became the first President of the European Council in January 2010, cannot claim to be the most powerful actor in the European Union, but over the last few months he has visibly grown in his role.

This is illustrated by the momentum behind Van Rompuy's 26 June report entitled 'Towards a Genuine Economic and Monetary Union', in which he presented far-reaching proposals to reform EU governance.

The European Council asked Van Rompuy to produce this report, which he wrote in close collaboration with the presidents of the European Commission (José Manuel Barroso), the Eurogroup (Jean-Claude Juncker), and the European Central Bank (Mario Draghi). The involvement of three other important European institutions indicates its broader backing.

The Plan Van Rompuy consists of four 'building blocks', proposing a Banking Union, a Budgetary (or Fiscal) Union, a Sustainable Growth Pact, and a system of decision-making within the EMU to ensure more democratic legitimacy and accountability.

These four building blocks, according to Van Rompuy, do not constitute a 'blueprint' but instead offer 'a coherent and complete architecture that will have to be put in place over the next decade.'

Van Rompuy's Plan was discussed by the European Council at its meeting of 28-29 June. According to the official conclusions of this meeting, there was 'an open exchange of views, where various opinions were expressed'. Van Rompuy was invited to elaborate all four of his building blocks, to present an interim report at the meeting of the Council on 18-19 October, and to submit a final report at the Council meeting on 13-14 December.

The plan is to take heed of the mistakes and miscalculations that have accompanied monetary union so far and carry out a considerable restructuring and reinforcement of this basic edifice of European integration. Clearly the European Council is taking the Plan Van Rompuy very seriously.

At its meeting in June, the European Council addressed the need 'to put Europe back on the path of smart, sustainable and inclusive growth.' It decided to launch a new 'Compact for Growth and Jobs.' In line with the third building block of the Plan Van Rompuy, the text of the Compact emphasised the importance of 'sustainable growth'.

The Compact further contained two significant financial items: the decision to reserve €120 bn for 'fast-acting growth measures' and the intention to increase the lending capacity of the European Investment Bank by €60bn. The Compact did not specify how this €180bn of additional investment is to be channeled into projects for green growth and jobs. Perhaps Van Rompuy's Interim Plan of October will bring more information on this.

We hope the Interim Plan Van Rompuy will especially support and strengthen a new role for the EIB. Both in Brussels and in the member states these days there is no lack of projects for green growth and jobs, all waiting to be financed and implemented. It is time to decide that selection of these projects will be carried out by a strong organisation with a solid reputation and the highest financial expertise. The same organisation could be given responsibility for the further elaboration of the Compact for Growth and Jobs.

The EIB has the right background, track record and skills for this role. Expanding its mission to take on these additional projects would be an exemplary way of showing that Europe is serious about reinforcing its structures to meet the challenges of today and tomorrow.

The EIB has the right background and track record to take responsibility for selecting and financing projects for green growth and jobs.

When action by ECB is not enough

As Germany is caught up in malaise, hopes of upturn fade

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013
US	1.8	2.0	2.0
Japan	-0.7	2.5	1.4
China	9.2	8.2	8.8
Euro area	1.5	-0.4	0.0
Germany	3.0	1.2	0.8
France	1.7	0.2	0.4
Italy	0.5	-2.5	-0.9
Spain	0.4	-1.6	-2.2
UK	0.8	-0.3	0.5
Addendum			
Asia excl. Japan	7.3	6.7	7.4
World	3.6	3.2	3.4
Consumer prices (% y/y)			
US	3.1	2.4	2.8
Japan	-0.3	0.2	0.2
China	5.4	2.8	3.6
Euro area	2.7	2.4	2.5
Germany	2.5	2.0	2.1
France	2.3	2.3	2.4
Italy	2.9	2.9	2.4
Spain	3.1	2.5	3.6
UK	4.5	2.5	2.3
Current account balance (% of GDP)			
US	-3.1	-3.3	-3.1
Japan	2.0	1.3	1.8
China	2.8	2.1	2.3
Euro area	0.0	0.0	-0.1
Germany	5.7	5.2	4.3
France	-2.0	-2.3	-2.2
Italy	-3.3	-2.2	-1.8
Spain	-3.5	-2.7	-2.0
UK	-1.9	-1.5	-1.2

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

The European Central Bank's 6 September decision to launch its so-called Outright Monetary Transactions programme brought some relief to financial markets. But signs of concern remain. In the real euro area economy, there is virtually no sign of any improvement.

The second quarter GDP numbers were sobering. Euro area economic output fell 0.2% quarter-on-quarter. Spain has been in recession for three quarters, and Italy and Portugal for four quarters in a row.

While France's GDP has stagnated since last winter, Germany, the Netherlands and Austria recorded positive growth in the second quarter.

However euro area business confidence deteriorated significantly again during August. So the optimistic idea that the cycle would turn for the better in the third quarter can now probably be ruled out.

In Germany, the reported Q2 growth rate of 0.3% was appreciably below the rate of 0.5% registered in Q1. Consumer spending and the continuing strength of foreign trade were the two main contributory factors to the latest quarter's positive GDP balance.

Despite the crisis afflicting some euro area countries, German companies increased exports in the quarter. For the second half of 2012, we expect growth to slow down but to remain positive, as the weaker international environment feeds through to the German economy too.

In previous months, signs of weakening were mainly confined to the leading indicators. However, the sharp fall of the Ifo business expectations index testifies to widespread caution over prospects.

On balance, we see the German economy's full year 2012 growth rate slightly higher than 1%. The strength of the domestic economy, especially construction and private consumption, will probably prevent a fall back into recession. Yet we see the gradual weakening continuing into next year, with growth likely to dip below 1% in 2013. Inflation will temporarily drop below 2% towards the end of 2012.

Growth has slowed, too, outside the euro area. The UK has recorded another GDP contraction, not least as a a result of forced savings by the public sector and private households.

Despite the upwards revision of second quarter numbers, the US economy has slowed markedly compared with the end of 2011. And China's spring wave of stimulus measures has still to show the desired effect. The result of all these factors is that we have lowered our global growth forecasts slightly (by 0.1 percentage point) to 3.2% for 2012 and 3.4% for 2013.

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Unconventional becomes standard

Enormous dilemma for central banks

Stefan Bielmeier, Advisory Board

A type of monetary policy that used to be called 'unconventional' just a few years ago now seems to have become the common standard for most central banks. The goal of price stability is taking a back seat. Although there is hardly any reason to be concerned about immediate inflationary effects, central banks have embarked on a tricky mission.

The US economy and many others with it have failed to recover fully from the 'Lehman shock'. The economic stimulus packages set up in the following recession have now mostly come to an end, without having brought about a self-sustaining upswing.

Another round of massive fiscal policy stimulus is not an option in the light of the desolate situation of the public finances in many countries. As a result, more or less as part of a process of elimination, monetary policy has become responsible for growth and jobs.

But with key rates near zero the major central banks have used up most of their ammunition. This is why traditional interest rate policy has been complemented by 'quantitative easing', with central banks' purchases of securities one of the crucial elements.

With the announcement of so-called QE3, the US Federal Reserve is now in the third round of quantitative easing. It has announced that it will continue purchases of mortgage-backed bonds until the outlook in the labour market has improved, and will also refrain from raising the key rate until 2015.

In Frankfurt, the European Central Bank announced purchases of sovereign debt of problem countries in the secondary market, with no upper limit. The programme will take place only under strict conditions regarding an official aid application that lays down budget and structural reforms in the countries concerned – and so far these countries, led by Spain, seem in no hurry to apply.

The Bank of Japan has been operating such a policy for many years – so far without any sweeping success. And so has the Bank of England, which by now holds large positions in British government bonds.

This means that, now that government balance sheets are all but exhausted, the big central banks are placing their balance sheets at the markets' disposal. One important goal of these measures is also to drive down (or keep down) yields in the longer maturity segment to facilitate consumption and investments and further stimulate the economy.

Although the downward pressure on yields looks impressive, real yields in Britain and the US (and also in Germany) are in bearish territory. In the two Anglo-Saxon economies, the stimulus measures are not really succeeding.

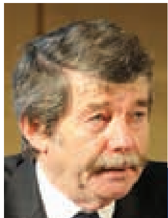
The main reasons lie in the fact that not only the public sector is heavily indebted; private households and the banking sector are also under pressure to 'reduce their leverage', in other words to cut their debts.

Although current monetary policy does not yet imply any direct danger of inflation, in the longer term imbalances are building up again. Without a doubt, the foundations for future inflation have been laid.

At a certain point this will oblige central banks to take determined counter-measures. The dilemma they face is enormous. If these measures are implemented at an inopportune time, they could throw the global economy out of kilter again. If they are not taken at all, then, looking back, one will wonder why imbalances were allowed to build up again and why nobody put a stop to it sooner. We face nerve-racking times ahead.

Although current monetary policy does not yet imply any direct danger of inflation, in the longer term imbalances are building up again. Without a doubt, the foundations for future inflation have been laid.

A regular round-up on international monetary affairs



Crockett's tale and Bank's search

Deficits, downturns and debate on King legacy

William Keegan, Chairman, Board of Contributing Editors

The first time I met my friend, the late Sir Andrew Crockett, to whom I must pay tribute, was in the late 1960s, whenhe seemed a kind of junior (working) partner to the economist Charles Goodhart at the Bank of England. In those days, instead of the vast open press conferences the Bank now holds, there would be private briefings for a handful of 'broadsheets' on the eve of publication of the Bank of England's quarterly bulletin. There was plenty of inflation, but no inflation report.

Andrew attended some of those, before going off to represent the Bank at the International Monetary Fund and British Embassy in Washington. As is well known, he deeply offended the Bank by deciding to stay on at the Fund, doing much good work, returning (only half-forgiven) to be Overseas Director of the Bank many years later. Then there was the Bank for International Settlements. And finally J P Morgan.

During those years the relationship of officialdom and the press changed enormously, so that there is a far more open exchange. The media are deluged with information these days, and, in turn, inundate the public. One of the great things about Andrew was that, when his colleagues thought they were being daring by telling you what time it was, he would always conduct a grown-up discussion and be as helpful as possible, without being indiscreet or bad-mouthing anyone. Indeed, I recall a pre-IMF meeting briefing he gave at the Bank, when Overseas Director, on Tuesday 15 September 1992. After his frank answers to our questions, Anatole Kaletsky and I emerged from the Bank agreeing that we might be on the verge of one hell of a crisis. The next day was Black Wednesday.

Andrew was considered a possible candidate for Governor both in 1993, when Eddie George was appointed, and 2003, when Mervyn King took over. In the run-up to the 2003 appointment, Andrew got into trouble with 'the selectors' for making remarks that were considered too 'pro euro'.

What is less widely known is that it might have been a case of 'third time lucky' five years later, if it had not been for the illness that he bore with such fortitude and good humour.

The situation in 2007 was that relations between the government and the Bank were so bad in the immediate aftermath of Northern Rock that, as Alistair Darling has revealed, the government did not wish to reappoint Mervyn King. At one stage the powers that be thought they had a suitable alternative, namely Andrew Crockett. But they then learnt about his illness.

So here we are in the autumn of 2012, with intense speculation about the succession to Mervyn King, and the Governor himself reportedly worrying about how he will go down in history.

There has been no shortage of criticism of the Governor: concentration on the inflation target rather than financial stability in the pre-crisis days; obsession with 'moral hazard' when the problem was the hazardous state of the entire system; and reaching beyond the monetary bounds into the fiscal province of an elected government.

In their book Banking on the Future two prominent former Bank men, Sir Howard Davies and David Green, observe: 'King's not, perhaps, a natural manager.' Treasury people seem to have this point in mind in their search for his successor. Davies and Green note that 'Critics accuse him of disregarding the capabilities of people whom he regards as not "good economists".'

Such assessments of 'good' and 'bad' economists tend to be subjective. King is an outstanding economist, but some pretty good ones fell by the way and left while he was Chief Economist. They say he does not take kindly to criticism and disagreement.

On the more substantive issue of King's putatively slow response to the banking crisis, one defence is that, in due course, the Governor adapted impressively. And he has certainly been forthcoming, indeed fearless, in his criticism of the banks. He has now conceded that the Bank should have 'shouted from the rooftops' to publicise the warning signs in the Bank's Financial Stability reports. And he has agreed that there should be adjustments to the fiscal targets, given world economic sluggishness.

Sir Mervyn is sensitive to claims that he privately frightened the UK coalition government into its deficit reduction strategy, arguing that his message to them was no different from what he had been saying publicly. My own view is that both Governor and the government made the wrong call about the strategy needed to emerge from the crisis.

Experienced economist though he is, and proud of his sense of history, the Governor did not, to my mind, take sufficient note from history that there are times when vast deficits have to be tolerated. One of his predecessors as Chief Economist was Christopher Dow. Dow drew the lesson from history that, to emerge from major recessions, long periods of fiscal expansion are required, not the opposite.

This is also the view of an economist King much admires, the Harvard professor Larry Summers. On this vital issue, I side with Dow and Summers, and not, on this occasion, with Sir Mervyn King.