OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

November 2010

How to curb currency wars

Reserve role makes America, not China, key player

Paola Subacchi, Advisory Board

As rhetoric on 'currency wars' heats up, tensions between the US and China are casting a baleful shadow over the world economy. However, China's decision to raise its benchmark interest rate by a quarter percentage point is a hopeful sign – since it seems partly designed to satisfy US policymakers who have called for China to increase the value of the renminbi.

In another relatively reassuring move, finance ministers and central bank governors meeting in South Korea have agreed a policy framework to reduce current account imbalances, part of a deal to give emerging nations more voting power in the IMF. However, an increasing number of countries is unilaterally intervening in the foreign exchange markets to curb their currencies' strength – as the verbal exchange between Japan and South Korea reminded us in the aftermath of the IMF/World Bank annual meeting. Naoto Kan, the Japanese prime minister, pointing out that efforts to depress currencies ran counter to G20 cooperation, called on South Korea and China to 'act responsibly' in foreign exchange policies – one more sign of the multilateral nature of the monetary tussles.

Yet we must be clear on one point. No matter whether or not China is free-riding on the exchange rate, the threat of a full-scale currency war will be defused only if the US takes the lead in promoting international exchange rate coordination and acts responsibly to prevent any rise of protectionism.

Since the dollar is the key reserve money, the US sets the pace on currency issues. South Korea, the host of this year's G20, is unlikely to put exchange rate coordination on the Seoul summit agenda in November unless the US is willing. This is both a risk and an opportunity. The US should seize the chance to set a positive role model and defuse undoubted protectionist threats.

This agenda clearly extends to the issue of quantitative easing, where it seems almost a foregone conclusion that the Federal Reserve will resort to a new round of Treasury securities purchases in early November. European as well as Asian governments and central banks will be watching closely for signs that America is moving over-aggressively in a deliberate ploy to force the dollar down further – a policy that the US of course denies it is following.

World economic uncertainty is irrefutably increasing as a result of countries' measures to use the exchange rate to rebalance their domestic economies. The grave threat is that this could have a general beggar-thy-neighbour impact.

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Road to the future

Ben Simpfendorfer, RBS China

The New Silk Road Nations linking China and the Middle East are emerging as a powerful and inspirational force on the world economic scene. This is a group of countries bound together by history, geography and culture – a region that ranges from India and Korea to Morocco and Turkey. It accounts for 61% of the world's population and 33% of the world's economy.

Centuries ago, China and the Middle East rose together as trade flourished along the Silk Road. They also subsequently fell together, as Europe took over as the world's dominant economic power. Now, the renaissance of the Silk Road has reinforced the impression that China and the Middle East may reclaim former glories as part of a historic rebalancing of the global economy. On United Nations estimates, the region's urban population will grow from 1.7tn to 2.6tn people by 2030, an increase equivalent to 10% of the world's population.

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Letter from the chairman

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A taste of Arabia

Midway between East and West

David Marsh, Co-chairman

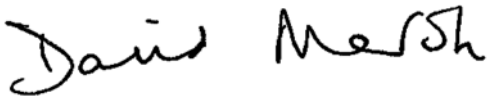
To mark the Inaugural Meeting of OMFIF in the Middle East, in association with the Central Bank of the United Arab Emirates and with the generous support and hospitality of Governor Sultan Bin Nasser Al Suwaidi, the November OMFIF Bulletin extends more widely than before into issues of East and West. The U.A.E. and the other lands of Arabia straddle the creditor and debtor nations of the world. The search for reliable cooperation rather than destabilising confrontation between these two groups is a principal theme of our gathering.

At a time when global policy-making is increasingly nationally-orientated and when the G20 process looks like lurching towards irrelevance, Paola Subbachi and John Nugée remind all players, particularly the US, of their responsibilities in the skirmishes over competitive currency depreciation. Ben Simpfendorfer takes a look at the historical position of the Middle East at the cross-roads of trade, capital and ideas.

The large countries of Africa should not be forgotten in this process; Sanusi Lamido, governor of the Central Bank of Nigeria, outlines his nation's efforts to rebuild stability after the financial crisis. On the brink of a possible new phase of quantitative easing by the Federal Reserve, Mary Miller of the US Treasury underlines the progress America has made in improving the structure of its debt position. Darrell Delamaide, in a new feature that we will extend to Asia too, introduces BankNotes – a guide to movements in central banking opinion over the last month, focused this time on the Federal Reserve.

Europe is a long way from recovering from its own debt crisis. Stefan Bielmeier says the whole of Europe would benefit if Ireland drew on the new stabilisation facility set up in May. Yves Mersch, governor of the Central Bank of Luxembourg, urges us to learn from Pierre Werner's plan of 40 years ago. He calls for an independent EU fiscal authority for monitoring and coordinating budgetary policy. European governments, unfortunately, do not appear so ambitious. The latest Franco-German compromise seems likely to accentuate calls in Germany for a monetary hardliner to take over at the ECB next year.

A fundamental issue for discussion in Abu Dhabi will be the gradual rise of a multiple reserve currency reserve system in which Asian currencies (including those from South East Asia as well as the yen and the renminbi) play an important role. Hon Cheung throws light on the meteoric rise of the Asian local currency bond markets and indicates how these instruments will become part of central banks' portfolios. As William Keegan tells us, the recent IMF/ World Bank meetings have underlined the comprehensive shift in the East-West power balance. This will have repercussions on reserve balance sheets – and in many other spheres too.



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Key role in Nigerian stability

Four-pillar structure for banking quality

Sanusi Lamido Sanusi, Governor, Central Bank of Nigeria

Nigeria has the chance of achieving sustainable economic growth and showing economic resilience if all stakeholders commit to the reforms under way, including the objectives of good governance and transparency. We will be a force to be reckoned with in the global economic arena if we consistently do the right things at the right time. But we have to end the past habits of seeking quick fixes and easy solutions. A resilient economy requires hard work, intelligence, consistency and time. No-one should be so rich or powerful as to jeopardise the system to feed personal greed.

Nigeria's insufficient industrial base and huge infrastructural deficit are binding constraints on development. The CBN is focusing attention to drive industrial activities and infrastructural developments.

The global financial crisis brought Nigeria considerable strains. The direct effects were limited because of Nigeria's limited integration with the global financial system. But the indirect results were significant in view of a variety of factors: declining oil revenue, reduced capital inflows and a significant fall in external reserves, a substantial decline in stock market capitalisation, and huge bank losses on margin loans and share-backed facilities as well as on loans to the downstream oil and gas sector.

A key part of the reforms centres on the Central Bank of Nigeria's four pillars of reform aimed at enhancing banks' quality, establishing financial stability, enabling healthy financial sector evolution and ensuring that the financial sector contributes to the real economy. Furthermore, the CBN had to act decisively when it became evident that some of the banks had more deep-rooted problems that were not discernible from the regular reports rendered to the regulatory authorities. Some of the actions we took included replacing the chief executives and executive directors of the banks identified as the source of instability and injecting Naira 620bn into the banks in the form of Tier II capital to prevent a systemic banking crisis.

Further arrangements were made to recover non-performing loans from the banks' debtors while guaranteeing all foreign credits and correspondent banking commitments. Linked to this, the CBN decided to set up an asset management company to deal with non-performing loans. The Asset Management Corporation of Nigeria (AMCON) is designed to take up the banks' toxic assets and provide liquidity while facilitating their recapitalisation.

Regarding the overall macroeconomic environment, we have identified Nigeria's insufficient industrial base and huge infrastructural deficit as binding constraints on development objectives. As a result the CBN is focusing attention on ensuring the availability of long-term funds at affordable interest rate to drive industrial activities and infrastructural developments.

The CBN has taken steps to integrate the banking system into the global best practices in financial reporting and disclosure through the partial adoption of the International Financial Reporting Standards (IFRS).

More generally, the universal banking model adopted in 2001 allowed banks to diversify into non-bank financial businesses. Following the consolidation programme in 2004, banks became awash with liquidity often deployed in high-risk areas. Banks engaged in non-banking practices to the detriment of core banking, for example through speculation on asset prices. The central bank is now steering the banks back to core banking businesses. Under the new model, banks will not be allowed to invest in non-bank subsidiaries, while banks currently with such investments will be required to divest or spin-off the businesses to holding companies licensed as other financial institutions. Depositors' funds can no longer be used for insurance, stock broking and other non-banking activities.

Intense competition among financial institutions calls for banks' management to examine where their true strengths lie and determine where they should most profitably invest. We may need to move towards strategic differentiation among financial institutions to serve

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ECB's concern on exchange rates

Blaming currencies for world imbalance is wrong

John Nugée, Deputy Chairman, Advisory Board

The increase in the debate over currency tensions – and even the recurring phraseology of 'currency wars' – shows every sign of being orchestrated. That certain countries manage their currencies and exchange rates is hardly news, and one might therefore ask why the subject has suddenly re-emerged.

In one sense it is perhaps a sign that economic and financial life is continuing its return to normal after the financial crisis. Economies are no longer all in deep recession. On the regulatory side, the initial optimism for global co-ordinated progress is evaporating and we are returning to the more usual position of limited progress against a headwind of national interests. Particularly in those countries where economic recovery is slower, the temptation to revert to blaming others is a natural one. Nevertheless, there is a danger that official comment, not least from Washington, may ignite a more general period of currency instability and manipulation. Moreover, the lack of comment from the Obama administration on successive bouts of Swiss and Japanese intervention earlier this year leaves the US open to the accusation of being fixated by China and the renminbi exchange rate.

If any central bank could be justified in being concerned about currency movements, it is probably the European Central Bank, which has seen the euro rise by around 15% from its mid-year low against the dollar. It is unlikely that the ECB will actively push for a weaker euro. The Frankfurt-based institution is neither likely to join in the probable Anglo-American move to further quantitative easing, nor to proceed towards zero interest rates as in Japan. ECB intervention on the foreign exchanges is improbable. But the ECB would probably wish for the euro to soften somewhat against the dollar.

There is no single set of exchange rates that can rebalance the world economy when domestic economies are internally so unbalanced. The US is heavily dependent on consumption and housing, and Japan and Germany, with their weak domestic demand, are equally reliant on exports. China's vast economy epitomises this lack of balance (above all between the coastal cities and the inland provinces). As for the euro area, the main thing that connects the northern and southern economies is the debt the latter owes to the former, with neither region's economic model sustainable long term on their own.

There is no euro-dollar rate that is simultaneously right for both Germany and Greece, any more than there is a renminbi-dollar rate that is simultaneously right for both Beijing and Urumqi. We expect too much if we ask currency markets to solve the global imbalances that dominate the world economy, or to ward off the deflation that China's, Japan's and Germany's export-driven economies tend to engender. Domestic economies continue to display their own, in many ways more fundamental, imbalances – and it is here, not on currency markets, where remedial action should be concentrated.

There is no euro-dollar rate that is simultaneously right for both Germany and Greece, any more than there is a renminbi-dollar rate that is simultaneously right for both Beijing and Urumqi.

Key role in Nigerian stability *(continued from page 3 ...)*

relevant market segment or niches in an optimal way. Market or functional specialisation may be the result, depending on institutions' decisions on the appropriate combination of risk management, customer service provision and product innovations – in line with the CBN's new blueprint for specialised banking authorisation which also allows banks to be international, national or regional players.

Existing rules and laws need to be reviewed in line with the new financial environment and international best practice. The challenge is to ensure the cooperation of the legislature and the judiciary to work closely in the enforcement of existing laws, and at the same time to reform other laws such as in the mortgage sector. Maintaining a safe and sound banking sector is essential to Nigeria's growth objectives, especially given banks' central part in financing infrastructure, agriculture and industry. Most emerging market economies use domestic financial institutions to execute large-scale projects of crucial importance for overall development. Financial institutions in Nigeria should be no exception. The reforms under way are geared to allowing the banks to live up to this vital task.

How to curb currency wars *(continued from page 1 ...)*

More specifically, it is the malaise of the dollar rather than that of any other currency that risks upsetting the slow move back to world economic balance and triggering fresh financial unrest.

Since January 2010 to mid October 2010 the dollar lost 10.0% against the yen, 7.1% against the Taiwanese dollar, 17.9% against the South Korean won, 28.7% against the Brazilian real and 15.2% against the Thai baht. And since June, when the euro touched $1.20 as a result of sovereign debt pressures, the greenback has lost almost 15% against Europe's single currency. [See article by John Nugée, p.4 for a discussion of Europe's dilemma.]

Emerging market economies and developed countries are equally concerned about being burdened with the costs of America's own economic adjustment. In view of serious concerns about flagging growth in Europe and Japan, these countries are deeply worried about competitiveness of their exports. For emerging market economies, the issue is the destabilising effect of a surge in capital inflows. And for all dollar-holders – above all, the world's two biggest owners of official reserves, China and Japan – the key concern is the possibility that the US may inflate itself out of current troubles.

But unilateral intervention on the foreign exchange market seem a sub-optimal way to deal with the dollar's problems. Such action rarely achieves the desired impact and even risks encouraging further speculative attacks. For instance, despite cumulative intervention totalling nearly $200bn, the Swiss franc has gained almost 20% against the dollar since March 2009 when these measures were unveiled (although the rise may have been even steeper if no intervention had taken place).

And despite Japan's finance ministry intervening to the tune of $25bn in September, the yen has further appreciated against the dollar. The intervention was clearly ineffective and yet may generate a further round of dollar purchases to curb market expectations that the yen will continue to rise.

There is a clear risk that currency intervention can undermine the multilateral dialogue on global economic and financial issues at the heart of the G20 process. Countries deciding active measures to weaken their own currencies are making absolutely evident their choice of protecting their national interests – a decision that undermines public good.

What is the alternative to unilateral action? The answer lies in the US recognising that dollar weakness is a matter for the international agenda – while the dollar-renminbi exchange rate is mainly an issue between the US and China. Expansionary American monetary policies putting downward pressures on the dollar are shifting the burden of adjustment on to other countries. As a result, the US should lead efforts to co-ordinate exchange rate policies. Achieving this is difficult. But at the Seoul summit in mid-November, the G20 members should aim at least to stop the race to the bottom. In current circumstances, achieving even this slender aim will be a commendable result.

Silken glories *(continued from page 1 ...)*

This is a rise that will require huge infrastructure spending, from sewers to subways. Additionally, the region's private consumption, based on purchasing power parity, has grown impressively from $3.9tn to $9.2tn between 1998 and 2008, nearing the US total of $10tn, emerging as an important source of global demand.

The modern economic relationship linking China and the Middle East has flourished especially since 2001 following China's entry into the World Trade Organisation. The small Chinese coastal town of Yiwu, a four-hour drive south of Shanghai, is illustrative of the changes taking place. The city receives 200,000 Arab visitors annually and is a virtual Arab market town.

China's WTO accession represented one important explanation for the rise in Arab arrivals. Another significant factor was the surge in oil prices after 2004 and the relaxation of China's visa policies even as the developed economies tightened their own.

The results are evident in trade flows, with China overtaking the US as the world's largest exporter to the Middle East in 2008. Most of China's exports match the clothing and electronics goods found in shopping malls across Europe or the US, but they also increasingly include capital goods, from automobiles to port cranes, as Chinese manufacturers grow in sophistication.

There is a risk that the surge in Chinese exports to the Middle East result in factory closures and jobs losses, troubling for a region in which 60% of the population is under the age of 30. However, there are tentative signs that Chinese firms are building factories in the region itself, from air-conditioner factories in Egypt to aluminium refineries in Saudi Arabia. The Chinese entrants hoping to sell to local consumers, while also profiting from the Middle East's strong trade ties to Africa and Europe. Chinese direct investment in the Middle East will not only create jobs, but also strengthen commercial relations between the two.

Yet the relationship is also about what China buys from the Middle East. China imports half its oil from the Middle East. By 2030, the Middle East is expected to provide every two out of three barrels of oil that China consumes. The upshot is that China is starting to take a new interest in the Middle East's security.

Islam is a more delicate topic. But it is also easily misunderstood. China's Muslim population is targeting the Middle East as a potential market for Halal food and Muslim clothing. Prime Minister Wen Jiabao, speaking at the Arab League Headquarters in Cairo last year, was keen to emphasise that China has 35,000 mosques and requires Halal food to be served in public offices.

On track for reduced borrowing

Broad investor base for US Treasury debt

Mary Miller, Assistant Secretary for Financial Markets, US Treasury

America continues to recover from the recession that began in December 2007 and lasted for 18 months, making it the longest since the Second World War. Since 2008, we have taken unprecedented steps toward regaining financial market stability and restoring growth. While necessary, these steps have had significant implications for debt management and financial market regulatory reform. In the longer term, the legacy of the financial crisis and ensuing recession will require significant fiscal discipline to restore budget balance.

We could finance our borrowing needs at record low cost and with strong interest from investors, both domestic and international.

Today, we are moving in the right direction as the US economy continues to heal and financial markets have strengthened. The recent passage of financial regulatory reform legislation in the US is a major step forward, but more work remains to be done both domestically and internationally. The US fiscal deficit reached nearly 10% of GDP in the 2009 fiscal year. We expect the 2010 deficit to be a similar or slightly lower percentage of GDP. However, after a year of positive growth in GDP, we are seeing improvements in revenues at the federal level and reduced borrowing needs. Corporate tax revenues are running over 40% above last year's levels and personal income taxes are 5% ahead.

We have also benefited from a steady stream of repayments of investments under the Troubled Asset Relief Program (TARP), which has proven remarkably successful in stabilising the financial sector and laying the foundation for recovery – at a fraction of the cost originally anticipated. While originally authorised to provide up to $700bn, the programme may end up costing $50bn or less – roughly 7% of the original appropriation. To date, TARP has recovered $225bn in revenue from its investments; repayments are expected to continue. The Administration's decision to freeze non-security discretionary spending, together with economic recovery, will reduce deficits. The forecast from the Office of Management and Budget shows the deficit falling to 4% of GDP by fiscal year 2015. At the end of this year, the National Commission on Fiscal Responsibility and Reform, a bipartisan commission established by President Obama, will offer ideas to further reduce our deficit.

Since the end of 2008, outstanding debt held by the public has grown from $5.2tn to $8.5tn. Yet we could finance our needs at record low cost and with strong interest from investors, both domestic and international. To meet the extraordinary financing needs of the government, we built a large framework of regular auctions, increasing not just the size of auctions, but the frequency and maturity. We moved from quarterly to monthly auctions of 10 and 30 year bonds. We also reintroduced the three and seven year maturities.

At the end of 2008, Treasury was forced to raise a significant amount of cash in a very short period of time, largely due to financial stability related capital injections. These needs were met through a significant increase in the issuance of Treasury bills. This increase in bill issuance was also to meet market demands for liquidity at the front-end of the yield curve. As the markets calmed and liquidity needs subsided, we have been able to moderate bill issuance. Today, T-bills represent about 20% of our outstanding issuance, down from nearly 35% at end-2008.

One consequence of providing this liquidity is a lower average maturity of government debt than many other countries. Still, this figure has increased dramatically over the past 18 months from 48 months at the end of 2008, to 59 months today, a significant change given the amount of debt outstanding. We have been conscious to maintain this balance while bringing down auction sizes. Beginning in May, we announced decreasing note and bond issuance to reflect improving fiscal outcomes and a lower borrowing need than was initially envisioned. Since May, we have cut around $300bn on an annualised basis.

This article is an excerpt from remarks to a meeting of the Atlantic Council and OMFIF in Washington, 8 October 2010

The ultimate level of borrowing will depend on the pace and extent of the economic recovery, but our current forecast is for net new borrowing to fall significantly in 2012. The record level of issuance has been accomplished at very low interest rates that will be in place over the life of these bonds. Interest expense is at less than 1.5% of GDP, the lowest level in more than 40 years. The low cost of borrowing has been driven by a number of economic factors, but largely by very strong demand. At the beginning of the past decade, the amount of bids in Treasury auctions averaged close to two times the amount offered for sale. Over the past two years, bids have risen to cover Treasury auctions on average by three times.

As the Federal Reserve keeps short term rates anchored close to zero, Treasury rates have also remained low. If rates begin to rise because of a growing economy, we would expect a beneficial impact to revenues, which would offset our need to borrow. Although the figures are imperfect and subject to annual revision, it appears that domestic ownership has risen over the past two years, with higher holdings by domestic banks, households and other private investors. This supports a higher savings dynamic in the US, along with a desire by financial institutions to carry more and higher quality capital reserves. The Treasury's statistics indicate that foreign and international investors accounted for 51% of total private holdings of US Treasury debt as of end-June 2010, down from 52% at end-2008.

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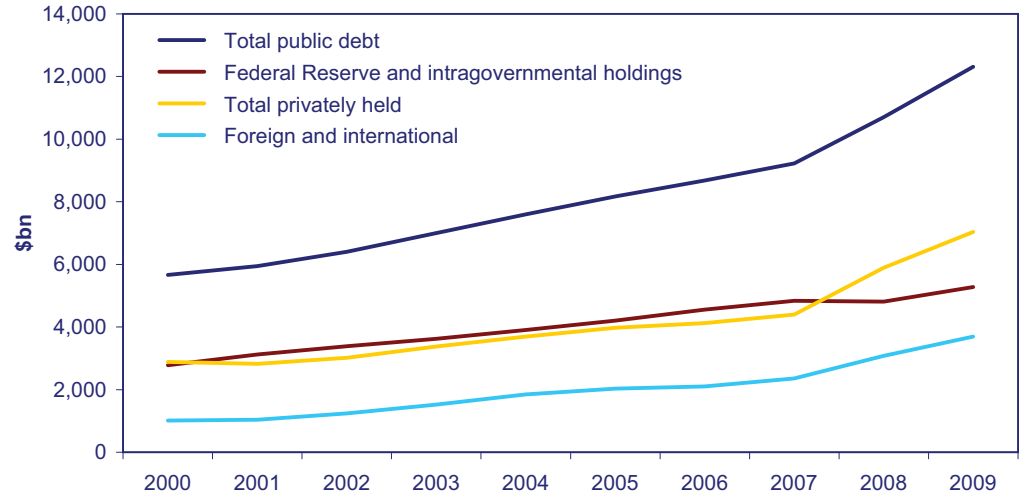
We welcome a broad international investor base for US Treasury debt and note the growing participation of emerging markets as investors with excess reserves put them to work, in a safe and prudent manner. The Federal Reserve remains a very large investor in our market. The Fed recently announced that it will reinvest principal repayments from its large mortgage-backed securities portfolio into Treasury securities in the secondary market. However, this decision does not, and will not, impact our debt management strategy. As debt managers, we are focused on the issuance of securities to the private market at the lowest cost over time. Fed monetary policy decisions are independent of that calculus.

The downside risks to the economy have led some to forecast a 'double dip' recession. That is not our forecast and seems unlikely. We are in an important transition period as government support for the economy subsides and private demand takes over. The economic data show that this transition is happening – private demand, including business investment and even consumer spending, has increased recently and will continue to increase in the second half of 2010.

While we have come quite a distance from the winter of 2009, when the economy was losing more than 700,000 jobs a month, more remains to be done for the millions of Americans who remain out of work. That is why the President recently announced a new plan for rebuilding and modernising America's roads, rails and runways. This will help the economy in the short term, while setting a foundation for continued growth and prosperity over the longer run.

How all components of US Treasury debt have grown as investment market widens



Source: US Treasury Bulletin, September 2010

FOMC shifts towards fresh easing

Inflation target debate picks up as economy drifts

Darrell Delamaide, Board of Contributing Editors

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

In a new monthly feature, the OMFIF Bulletin brings a round-up of the latest views of the men and women who make US monetary policy. On balance, the FOMC mood has swung behind more monetary easing ahead of the next FOMC meeting on 2-3 November.

Ben Bernanke

Bernanke and Evans back price targets

The consensus for a new round of quantitative easing is fairly well established. The debate within the Federal Reserve is now turning to the question of price targets to complement efforts to stimulate the economy and avoid a deflationary spiral. At a mid-October conference on monetary policy in a low-inflation environment sponsored by the Boston Federal Reserve Bank, Fed chairman Ben Bernanke (voter) made his strongest statement yet in favour of an explicit inflation target.

He suggested that the inflation projection contained in the Fed's quarterly Summary of Economic Projections (SEP) could be a de facto target for the Federal Open Market Committee in keeping with its dual mandate of stable prices and full employment. 'The longer-run inflation projections in the SEP indicate that FOMC participants generally judge the mandate-consistent inflation rate to be about 2% or a bit below,' Bernanke said. Since inflation has been running at 1% or below, Bernanke concluded, 'inflation is running at rates that are too low relative to the levels that the Committee judges to be most consistent with the Federal Reserve's dual mandate in the longer run.'

Chicago Fed president Charles Evans (non-voter) went a step further and said the FOMC should consider price-level targets – letting inflation run above the 2% level for a limited time in order to catch up on the inflation deficit and to return prices to the December 2007 level. In the current liquidity trap – low interest rates and excessive savings – anything less will be insufficient to reduce unemployment.

Dudley sees higher lending spreads from Basel III as a good thing

The tougher capital requirements of Basel III will indeed lead to higher lending spreads for banks, New York Federal Reserve Bank president William Dudley (voter) said, but this is a good thing. 'It would be prudent to assume that requiring banks to hold more capital and higher cost capital is likely to result in somewhat higher lending spreads,' Dudley said in a speech to the Institute of International Finance annual meeting in Washington.

The New York Fed chief cautioned against any rigid assumptions in evaluating the impact of these higher spreads on banks. Investors will settle for lower returns in better-capitalised banks. Funding costs will also be lower, and competitive pressures may force banks to reduce compensation. Most important, banks will gradually shift their business model to lower-risk activities. 'To understand what these new requirements mean for the amount of capital banks will ultimately have to hold, it is important to note that one of the intended consequences of these changes is for banks to adjust their business models in ways that reduce the risks their activities generate,' Dudley said.

Janet Yellen

Yellen strikes hawkish note in noting risks from low interest rates

Janet Yellen (voter) seemed eager to temper her dovish reputation in her first speech after becoming vice chairman of the Federal Reserve, acknowledging that prolonged low interest rates could feed new asset bubbles. 'It is conceivable that accommodative monetary policy could provide tinder for a buildup of leverage and excessive risk-taking in the financial system,' Yellen said at the annual meeting of the National Association for Business Economics in Denver.


Thomas Hoenig

Yellen's remarks were echoed later during the same conference by **Kansas City Fed chief Thomas Hoenig (voter)**, the most outspoken hawk among Fed policy-makers.

But Yellen maintained that expansive monetary policy alone was not the cause of asset bubbles and that it is the duty primarily of regulators, including the Fed, to watch out for excessive leverage and risk at financial institutions.

The pre-crisis view that financial markets are self-correcting 'lies in tatters today as we look at tens of millions of unemployed and the trillions of dollars of lost output and lost wealth around the world,' Yellen said.

Yellen, who served previously on the Fed board and as chairman of the Council of Economic Advisers before heading the San Francisco Fed, was named to the no. 2 spot at the Fed in April and took office on 4 October.

Speaking in Denver just a week after being sworn in, Yellen noted that the recently enacted Dodd-Frank Act assigned an important role to the Fed for supervising systemically important institutions and working with other regulators in the newly created Financial Stability Oversight Council. The dual role offers the Fed the opportunity to coordinate the impact of monetary policy and macro-prudential oversight, she said, even if they remain separate and distinct tasks.


Eric Rosengren

Employment is main Fed concern in proposed quantitative easing

Unemployment is what Fed policymakers have in their sights as they plan a new round of quantitative easing, Boston Federal Reserve Bank President Eric Rosengren (voter) says. In a recent speech to economic forecasters in New York, Rosengren said 'the recovery remains far too weak to restore what we consider full employment with the speed I would like to see.'

Because the Fed cannot lower its federal funds rate below zero, the unconventional measures of expanding the money supply through purchases first of mortgage-backed securities and now of Treasuries tends to lower long-term interest rates and counter deflationary pressures. 'My firm view is that it is important that policymakers be open to implementing policies consistent with achieving full employment, and an appropriate level of inflation, within a reasonable time frame,' Rosengren said. Meanwhile, another Boston area resident, MIT professor and new Nobel laureate **Peter Diamond**, gave an indication of the insight he could bring to the Fed if his pending nomination to the Board of Governors is confirmed by the Senate. 'The central focus of problems in the economy right now,' Diamond said in an interview with CNN, 'is not that the labour market is working badly, but demand for labour is way down.' In other words, says this economist whose work on labour market inefficiencies earned him the Nobel Prize, unemployment in the US is not structural but results from deficient demand that can be countered by fiscal and monetary stimulus.


Dennis Lockhart

QE2 could stimulate economy through various channels, Lockhart says

Quantitative easing could stimulate the economy not just by reducing long-term interest rates but my encouraging investors to move to higher-yielding securities and by boosting exports with a weaker dollar, Atlanta Federal Reserve Bank President Dennis Lockhart (non-voter) said. Speaking to the Savannah Rotary Club, Lockhart acknowledged that the banking system already had plenty of liquidity, which has led some Fed officials to the view that a second round of quantitative easing, usually referred to as QE2, will not have much effect on credit. But lower yields on long-dated Treasuries might encourage investors to migrate toward corporate bonds and equities that would be more productive economically.

'A third channel is the dollar exchange rate and stimulus to net exports,' Lockhart said. 'Speculation about QE2 has already caused a drop in the dollar's value on exchange markets and contributed to the rising concern over competitive efforts among nations to influence the relative position of currencies. Sellers of the dollar are responding to the prospect of lower yields.' On balance, Lockhart said, he is 'leaning' in favour of monetary stimulus. 'At this juncture, and given the circumstances of sluggish growth and measured inflation that is too low, I give greater weight to the risk of further disinflation leading to deflation,' he said. 'In my mind, QE2 is a form of risk management – an insurance policy that is prudent to put in place at this time.'

Lockhart said he would await further economic data and the FOMC debate before making up his mind. The release of the Fed's Beige Book, the periodic overview of economic activity across the nation, offered little comfort in that regard. The survey concluded that economic growth is continuing at a modest pace, but is likely to have little impact on employment. 'Hiring remained limited, with many firms reluctant to add to permanent payrolls given economic softness,' it said.

Fiscal authority at heart of EMU

What we should learn from Pierre Werner

Yves Mersch, Governor, Banque centrale du Luxembourg

There are strong lessons that we need to learn today from the report on economic and monetary union (EMU) issued 40 years ago by Pierre Werner, the Luxembourg prime minister and finance minister. In the wake of the economic and financial turbulence of the past three years, I strongly support the idea in the 1970 Werner report of an independent European institution for fiscal monitoring and coordination among EMU members. This is highly relevant to the needs of Europe today as we try to overcome recent uncertainties and build stronger European governance for the future.

An independent fiscal authority would advance the institutional deepening of the monetary area in a way that would follow on from Pierre Werner's thoughts. His guiding concept was that a single monetary policy would be supported by sound public finances – a view with which we must concur, given the straitened state of budgetary finances nearly everywhere.

The Werner report called for ever closer economic policy coordination with an agreed framework for national budgetary policies and, at the institutional level, it suggested a 'centre of decision for economic policy'. So, transposing his thoughts to the present day, I would propose a formal mechanism for monitoring member states' budgets with independent assessment to be provided by a Committee of 'wise persons'. Such a body would help in the general efforts to improve quality and reliability of statistics, and reduce the deadlines of assessment procedures and the time-frame for action to curb unwelcome developments. This would necessarily go hand in hand with a stronger Stability and Growth Pact, preventing and correcting macroeconomic imbalances at an early stage, and making enforcement more effective through gradual sanctions on non-compliant euro members.

EMU needs new structures to provide much greater policy coordination, and to my mind we need to be more ambitious than in the proposals set down by the task force of finance ministers under Herman Van Rompuy, president of the European Union. If the spirit of the Werner report had been better respected in the EMU blueprint decided in the 1990s, then the structure we have now would be more stable and resilient.

It is worthwhile dwelling on the circumstances of the Werner report, because they are in some way comparable to today's position. The proposals followed an outbreak of currency instability in 1968-69 which forced the revaluation of the D-Mark and the devaluation of the French franc. These developments demonstrated the weaknesses of the Bretton Woods System as well as the threats to the common market and specifically the common agricultural policy.

Werner was asked to preside over a committee to design the path to increased economic and monetary integration for the six founding members of the European Economic Community. That report, completed on 8 October 1970, proposed setting up EMU by 1980. In fact, the single currency took 20 years beyond this date to become reality, but it is worth revisiting the principles of the Werner report, for they are truly visionary.

Although many of the proposals of the original Werner plan were realised, some of the original thoughts were ignored or diluted, which with hindsight appears as a mistake. Of course, the Werner report came about in a different environment when the Union with its original six members was aiming for a final goal close to a federal Europe.

When the euro was eventually introduced in 1999, the number of member states had increased, and it had become clear that there would be no accompanying political union. National sovereignty in economic policymaking was preserved. Recent turbulence highlights the inherent tensions when sovereignty over monetary policy is pooled while economic policy remains a national prerogative.

EMU needs new structures to provide much greater policy coordination. We need to be more ambitious than in the proposals set down by the task force of finance ministers under Herman Van Rompuy.

During the intergovernmental conference that led to the 1991-92 Maastricht Treaty, there were parallel negotiations on monetary and political union. Political union made only limited progress, while the detailed draft for EMU was hailed as a breakthrough for European integration. The result was a compromise between the pooling of monetary powers at the European level – with opt-in and opt-out clauses for some countries – and the much less integrated development of economic union where ultimate responsibilities remained national.

Within the Werner committee, the German members – including former Bundesbank president Hans Tietmeyer, the only member of the Werner committee who is still alive today – argued that monetary union should follow political union. This was in line with the historical development of many countries including the US and Germany itself. Others such as France considered monetary policy union as a powerful catalyst for deeper integration in other policy fields. The overall approach represented a compromise between these two points of view.

Since, in the run-up to the Maastricht treaty, political union was off the agenda, politicians claimed that loose coordination of economic policies was deemed sufficient. The prevailing doctrine was that market discipline would bring about responsible behaviour regarding countries' fiscal and competitive position. Ironically, the land-grabbing attitude of the European Commission, with regard to its claims to be the economic and fiscal authority in the event of more integration, indirectly strengthened the case for the intergovernmental approach.

Looking back now at the events of the past decade, I find it surprising that governments were so confident that market discipline would impose constraints on national policies when one major factor of self-correction within a European currency union – labour mobility – was by design rather weak. To complement market discipline, in governments in 1997 invented the Stability and Growth Pact which mostly focused on the need to control fiscal deficits. Yet the result proved insufficiently coercive and was further weakened when Germany and France failed to abide by the rules in 2003.

The absence of meaningful macro-economic surveillance led to growing divergence which was strengthened in a self-feeding manner by the absence of market-induced corrections that otherwise would have been expected. Today we have to acknowledge that market reactions often come with delays and then tend to become a significant overreaction.

The absence of meaningful macro-economic surveillance led to growing divergence which was strengthened in a self-feeding manner by the absence of market-induced corrections.

Despite these caveats, I must underline that the single currency has been a success. It is widely accepted that the best a central bank can do in supporting economic growth is providing price stability, which is what the European Central Bank has done. During the past three years the ECB and the Eurosystem were forced to act very fast, boldly and innovatively to ensure their long term goal of price stability and the functioning of the transmission mechanism. The European economy is now recovering and the tensions in financial systems have eased somewhat, although it is still too early to claim victory.

When looking at recent experience, we have to examine carefully the role of excessive debt. With the eruption of the crisis in September 2008 the accumulation of private debt was suddenly stopped, but the problem of excessive indebtedness was not solved. Fiscal rescue packages, the impact of automatic stabilisers, and the necessary support of the financial system including guarantees to the banking sector led to a significant increase in public leverage to levels unprecedented in peacetime.

The European experience of private debt being transferred into public debt was similar to other industrialised countries. But the weak institutional framework for fiscal discipline at the national and euro area level, as well as the absence of control by financial markets, was underlined by some countries' rapidly deteriorating competitive position, reflected in divergences in unit labour costs and current account positions. Suddenly, at the beginning of 2010, markets woke up to reality and, as often happens, overreacted. Euro area governments meanwhile at first excelled in denial and then carried out some policy changes through a series of cloak and dagger movements that restored some semblance of order.

This slow reaction forced the ECB into action as a back-stop – exposing the unfinished work of the institutional set-up of EMU, in a similar way to how the financial crisis exposed failures in the macro-prudential area. In both cases, we have borne a very high welfare price as a result of overly relying on markets' vaunted ability to correct themselves.

Crisis prevention will be even more important than crisis management.

In the new EMU institutional set-up that looks likely to be installed, crisis prevention will be even more important than crisis management. Well before a fiscal deterioration occurs and requires corrective action, we need to registering and heeding early signals of nascent macro- economic imbalances. The fundamental point is that, despite the single currency and the ECB, national economic policies are insufficiently aligned. All this was foreseen by Pierre Werner in his report, for he wrote: 'Having regard to the marked differences between the member countries in the realisation of the objectives of growth and stability, there is a grave danger of disequilibria arising if economic policy cannot be harmonised effectively.' In building a strong new edifice that will guard against future risks, we need to take Werner's words seriously – and act on them, with courage and perseverance.

This article is an excerpt from the OMFIF Lecture on the Werner Plan given by Mr Mersch in London, 14 October 2010

Riddles persist over race to choose Jean-Claude Trichet's successor at ECB

OMFIF commentary

The latest agreement between Chancellor Angela Merkel and President Nicolas Sarkozy on reforming the EU's budget rules risks hardening the German government's position on the nomination of the next ECB president to succeed Jean-Claude Trichet when he retires at end-October 2011.

Sarkozy won concessions from Germany by forcing through a commitment that sanctions on errant countries will no longer be 'near automatic' as had been called for by the European Commission and also by the European Central Bank. [See article by Lorenzo Bini Smaghi, OMFIF Bulletin, September October 2010, p. 5.]

In return, Sarkozy has agreed to a German proposal to reopen the EU treaties to allow a permanent crisis mechanism, going beyond the European Financial Stability Facility agreed in May, for hard-hit states. New German-backed conditions would include the possibility of declaring that certain states are insolvent. This would open the way to debt restructuring on a consensual basis for heavily-indebted states, in a fashion that would require debt write-offs by both public and private sector creditors – a move for which Berlin has lobbied hard in recent months.

The problem with the Sarkozy-Merkel deal is that it is lopsided. As Merkel's Free Democrat partners in the German coalition government have pointed out, redrawing the European treaties will require complex bargaining with all 27 member states and could take years to push through. Britain, for one, is likely to set tough conditions for agreeing to such a treaty change. [See article by David Owen, OMFIF Bulletin, September 2010, p. 10.] So Merkel has bargained away a relative weakening of budgetary criteria for an indeterminate accord on a future stability mechanism that may never see the light of day.

All this is likely to increase Germany's resolve to see Axel Weber, the Bundesbank president, confirmed as the next ECB president in an arrangement that the EU would like to see formally certified by next June. Weber fulfils three of the main criteria for the post. He has the strong political support of the EU's most powerful state; he has well-regarded academic credentials; and he now has plentiful central banking experience, having held the Bundesbank post since 2004.

However, recent utterances, including his opposition to the ECB's purchases of weaker country bonds decided in May, have not endeared him either to other euro area governments or even to his own central banking fraternity. Weber said in New York on 12 October the ECB's Securities Market Programme, totaling slightly more than €60bn, had had no significant impact in cutting yields and should be 'phased out permanently' – drawing an unusual personal rebuke from Trichet in an interview with La Stampa on 17 October.

The Elysée Palace appears to have been behind rumours that it favours Dominique Strauss-Kahn, the IMF managing director, as the new ECB president – a completely untenable position, but one that shows the depth of opposition to Weber. Some French officials have called for Merkel to put forward another German such as Klaus Regling, the head of the EFSF, as the candidate for the job – a condition that the Germans would find unacceptable.

On 24 November Weber travels to Paris for a meeting with French economic leaders. A further complication is that EU governments are required to consult the ECB Governing Council (through a secret vote) on the presidency. Although this procedure is non-binding, it is unlikely that European governments could choose a candidate against the wishes of the council. Well-informed sources say Weber would be unlikely to command a majority in present circumstances.

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Asian currency bonds forge ahead

A new strategic asset class for world investment

Hon Cheung, Advisory Board

The rapid growth of the Asian local currency bond sector is one of the most remarkable features of world capital markets. Latest data from the Asian Development Bank show that the size of the East Asian bond markets (excluding Japan and the Pacific markets) stands at $4.6tn compared with $500bn in 1996; this market now accounts for 7.4% of the world total against 2.1% in 1996. [See table below.] A tripling of market share is an impressive achievement. A few years ago, Asian currency bonds barely registered on the international investment radar screen. Now, they are firmly established as a core category of strategic assets for institutional investors from the private and public sectors. There are a number of indications that this trend will continue. The progressive opening up of the Chinese renminbi bond market for both private and official investors is likely to be an immensely significant development in the next few years.

A few years ago, Asian currency bonds barely registered on the international investment radar screen. Now, they are firmly established as a core category of strategic assets for institutional investors from the private and public sectors.

Asian bonds have gained impetus from a number of quarters. One source of stimulus has come from the demand side, owing to a rethinking of investment criteria for reserve assets among many holders in the aftermath of the global financial crisis and worries over the stability of the euro. On the supply side, an extensive network of practical cooperation in Asia, both among governments and also between the public and private sectors, has sizeably improved the underlying infrastructure of the investment market. Furthermore, the asset class has benefited from widespread macro-economic factors from within and outside the region. Asian bonds have been attractive for investors seeking exposure to Asian currencies, while wishing to avoid the high volatility of Asia's equity markets. The strength of this trend has forced central banks to monitor capital inflows with great stringency and, in some cases, to take measures to manage these inflows.

Growth of Asian local currency bond markets ($bn)

	Mar 2010	Dec 1996
China	2,648	62
Korea	1,095	283
Other Asia	890	182
Total	4,633	527

Swiss National Bank shows the way in asset diversification

OMFIF commentary

Switzerland has emerged in the forefront of practical steps towards a multiple reserve asset system in which Asian currencies are playing a small but significant role, according to latest Swiss National Bank data. Total foreign exchange reserves rose to SF217bn at end-September compared with a SF82bn 12 months earlier and a mere SF47bn at end-2008. The reason for the sharp rise has been massive SNB intervention, especially in the second quarter, to hold down the Swiss franc against the euro. The currency purchases stopped after mid-year following domestic criticism of the SNB over losses caused by the euro's decline.

The SNB has made use of significant liberalisation of currency management statutes. It invests in a broad portfolio of bonds and equities. During the third quarter the SNB reduced its currency reserves (which had totaled SF227bn at end-June), sold some of its bloated euro portfolio and made important shifts into other currencies, including those from Asia. It held SF121bn worth of euro at end-September, down from SF160bn at end-June, making up 55.9% of its portfolio (previously 70.6% at end-June.) The dollar made up 24.6% of the total, against 21.5% in June, and the yen 9.7% against 3.9%, with holdings more than doubling to SF21bn. Sterling holdings rose to 3.1% from 2.4%, totalling SF6.7bn, Canadian dollars rose to 4.0% from 1.7%, totalling SF8.6bn. The SNB also held 2.7% of reserves (SF5.9bn) in newly-acquired, otherwise undefined 'other currencies', some of which seem likely to be from Asia.

The growth in the underlying economies of Asia, and the resultant expansion of government balance sheets, has also buttressed the growth trend. Another contributory factor has been Asia's managed currency policies and the resultant issuance of bonds as part of sterilisation of foreign exchange inflows. (The size of Asia's bond market issued under sterilisation programmes is estimated to be around $2.3tn.)

There is a strong case for including an allocation to Asian local currency bonds within a developed market fixed income portfolio.

Given the rapid expansion of Asian economies and the ensuing increase in affluence and savings, the appetite among local currency bond holders has risen sharply. The end-investors in Asian local currency bonds have greatly increased their activity; these include insurance companies, banks deploying their balance sheets, pension funds and other savers and also foreign portfolio investors. The growth in demand has tended to outpace supply. In general across Asia, a significant proportion of government bond issues are sold to buy-and-hold investors, resulting in reduced liquidity in the secondary markets.

The expansion of Asian local currency markets has global consequences. As Asian bonds have become significantly more investible, their reassessment as a core strategic asset class has gathered pace. The correlations of Asian bond relative to other developed markets, together with dollar bonds for comparison, are shown in the table below. The correlations demonstrate that Asian bonds provide significant diversification benefits versus dollar bonds; there is a strong case for including an allocation to Asian local currency bonds within a developed market fixed income portfolio. Increased investor concerns over the dollar and euro have sparked considerable capital flows into Asian local currency bonds. Reflecting this, foreign ownership in Asia's bond markets has grown rapidly in the past few years. According to AsianBondsOnline, the current percentage foreign ownership is 27% in Indonesia, 18% in Malaysia and 7% in Korea.

Increasing worldwide interest in Asian bonds coincides with significant strides in improving the openness of Asia's markets – a highly important factor, particularly for foreign investors. Gauging market openness is not easy; this is dependent on a number of factors that are difficult to quantify, such as legal and operational infrastructure, rules for inward and outward flow of investments and withholding taxes. One possible approach is provided by Markit in their iBoxx ABF Pan-Asia series of local currency bond indices (this is the index series used in the Asian Bond Fund, or ABF2, family of funds where State Street is a fund manager). The table on p. 15 shows how the 'Market Functionality' score, based on survey data from market participants, measuring the ease of access by foreign investors has changed in the last five years since the inception of the index.

The Market Functionality score varies from 0 to 100; the two most developed markets in Asia – Hong Kong and Singapore – have consistently scored 100 in the past five years. Across Asia, the score has consistently improved as Asia's bond markets have become more open and accessible. The pace of improvement has been impressive and this has been due, in large measure, to the pro-active measures of national governments as well as regional initiatives such as the Asian Bond Market Initiative and the Asian Bond Fund.

Another strong trend has been seen in China. Compared with the rest of Asia, it remains a challenging market to access for foreign investors (principally due to the Qualified Foreign Institutional Investor process). Yet – from a low starting base – it has shown the greatest degree of individual improvement within Asia. Recent developments in China's bond markets point towards further improvements in the future.

Correlations of dollar and Asian Bonds 2001-2010

	US	Pan Asia
US	1.00	0.34
Germany	0.79	0.21
UK	0.78	0.35
Japan	0.38	0.19
Australia	0.72	0.21

Source: SSgA, based on monthly returns of iBoxx Pan-Asia Index & Citigroup Government Bond Indices from January 2001 to September 2010.

In view of all these structural factors, it is likely that private sector investors will continue to increase exposure to this asset class. Similar reasoning applies to the public sector, too. Indeed, a set of specific factors driven by foreign reserve management considerations makes this asset class especially attractive for official sector investors such as central banks.

A leading consideration is, of course, the desire further to diversify reserves; the low correlations of Asian bonds make them naturally attractive diversification vehicles.

Furthermore, there is an equally natural tendency for Asian central banks to wish to hold Asian local currency bonds. This is because, unlike other institutions that normally seek to reduce and manage balance sheet exposures, central banks are mandated by their governments and by national statutes to maintain a highly exposed balance sheet as an act of deliberate policy. That is the result of an asset portfolio in foreign currencies juxtaposed with liabilities (principally money in circulation and government deposits) that are largely denominated in domestic currency. In addition, Asian central banks are charged with running an exchange rate policy that is sensitive to other local currencies in the region and also pays great attention to the growing importance of intra-regional trade. Bringing together all these considerations, inclusion of Asian local currency bonds in reserve portfolios provides an optimal strategy for moderating Asian central banks' intrinsic balance sheet exposures, and at the same time for diversifying foreign reserve holdings.

The global financial crisis and recent concerns over the euro have added further reasons for increased Asian central banks' interest in the bond markets of their fellow Asian economies. However there are significant practical challenges to applying this idea on an 'industrial' scale. The first hurdle is one of sheer size; total Asian foreign reserve holdings of $5.1tn outweigh – for all the market's growth in recent years – the entire volume outstanding of Asian local currency bonds totalling $4.6tn. Second, potentially the most important of these markets, China – both because of the absolute and relative size of its economy and because it is a principal trade partner for the rest of Asia – is difficult to access and will probably remain so for several years. For these reasons, I believe Asian central banks should inaugurate a network of sovereign bond cross holdings, under which they facilitate issuance of local currency bonds to be held in each others' portfolios as a means of overcoming these hurdles and achieving an optimal mix of reserve currencies on a large scale. [See OMFIF Bulletin, May 2010, p. 11-20 as one route to such a network.]

Recent developments demonstrate how another method is opening up to accelerate the holding of renminbi-denominated bonds by central banks. This could also act as a catalyst for broader growth of Asian central banks' holdings of Asian local currency bonds. The announcement by the People's Bank of China on 16 August 2010 [see OMFIF Bulletin, September 2010, p. 18-19] represents a significant new move towards foreign reserve diversification. This allows for a category of 'Eligible Offshore Institutions' that can invest in the onshore interbank bond market in China. Significantly, offshore central banks have been specifically designated as eligible. This underlines that much of the running in the next phase of development of Asian bonds will be made by Asian central banks themselves as they seek further to diversify their reserve holdings.

Another method is opening up to accelerate the holding of renminbi-denominated bonds by central banks. This could act as a catalyst for a broader growth of Asian central banks' holdings.

Market Functionality Score for iBoxx ABF Pan-Asia Index

	2006	2007	2008	2009	2010
China	30	30	40	40	45
Hong Kong, China	100	100	100	100	100
Indonesia	60	60	65	65	65
Korea	65	65	65	70	70
Malaysia	75	75	80	80	80
Philippines	60	55	60	60	60
Singapore	100	100	100	100	100
Thailand	70	55	60	65	65

Source: Markit, iBoxx ABF Pan-Asia Index, October 2010

Economic recovery slowing

Large differences in growth dynamics across regions

DZ Bank Economic Forecasts			
GDP growth			
	2009	2010	2011
US	-2.6	2.5	2.0
Japan	-5.2	3.0	1.7
China	9.1	10.2	8.5
Euro area	-4.0	1.5	1.0
Germany	-4.7	3.3	1.6
France	-2.5	1.7	1.4
Italy	-5.1	1.0	0.8
Spain	-3.7	-0.5	0.0
UK	-4.9	1.3	0.8
Addendum			
Asia excl. Japan	6.1	8.8	7.2
World	-0.7	4.4	3.7
Consumer prices (% y/y)			
USA	-0.3	1.6	1.5
Japan	-1.3	-1.1	-0.3
China	-0.7	3.0	3.7
Euro area	0.3	1.5	1.3
Germany	0.2	1.1	1.1
France	0.1	1.7	1.6
Italy	0.8	1.5	1.2
Spain	-0.2	1.6	1.1
UK	2.2	3.2	2.8
Current account balance (% of GDP)			
US	-2.7	-3.0	-3.1
Japan	2.8	3.7	3.5
China	6.5	5.7	5.3
Euro area	-0.6	0.1	-0.2
Germany	4.9	5.5	5.6
France	-2.2	-2.5	-2.5
Italy	-3.2	-3.0	-2.9
Spain	-5.1	-4.7	-4.6
UK	-1.1	-1.2	-1.0

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

The discussion about the deterioration in sovereign ratings of some euro area countries has pushed overall economic worries slightly into the background in the last few weeks. Nevertheless, the two issues are closely connected. Efforts to reach targeted budget cuts and satisfy the capital markets and the EU/IMF austerity monitors automatically weaken economic trends in peripheral euro members. And this in turn raises the risk that the countries in question will fail to fulfil their consolidation programmes – increasing the threat of a vicious circle.

The euro area accordingly presents a split economic picture. Core EMU countries consisting of Germany, France, the Netherlands and Austria demonstrate robust economies and face only moderate consolidation pressure in terms of public finances. Yet EMU peripheral states face far greater economic and fiscal problems. The hardest-hit are Greece, Ireland and Portugal, but Spain and Italy, too, face a number of serious challenges.

The latest economic data from the US have done nothing to improve confidence. It seems it is still too early completely to rule out either a double-dip recession or a slide into deflation, i.e. a lengthy period of falling consumer prices. We have downgraded our GDP forecast for 2011 to 2%, which means that we are still slightly more pessimistic than the consensus. Although our view is that the US can avoid a double-dip recession, we expect only a jobless recovery for the moment. In view of muted consumption, inflation is set to remain very low for some time.

Ample fiscal measures in China put in place to overcome the economic crisis are slowly coming to an end and even the generous lending of last year is being increasingly reined in again. This means that China's economy already lost noticeable momentum during the summer half-year. Although overall double-digit growth is expected for China 2010 following a strong start to the year, GDP growth in 2011 is likely to be only 8½%.

After an exceptionally lively recovery in the winter half year 2009/2010, the Japanese economy slowed down considerably in Q2 2010 with quarterly growth down to only 1.5% (annualised). Whereas private consumer spending has stagnated lately, exports have now also slowed as a result of weakening growth in China, now Japan's most important trading partner. Exporters' difficulties are compounded by the strong yen, which hit a 15-year high against the dollar in August and was only temporarily weaker after intervention by the central bank. Japan has not yet overcome its deflationary price climate, so the Bank of Japan is likely to stick to its generous liquidity provision for the time being. We expect a GDP rate of around 3% in full year 2010; growth in 2011 is likely to be significantly lower at around 1¾%.

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Why Ireland should tap EFSF

Outside funding would benefit other euro states

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

No other euro area country finds itself in more dramatic budgetary circumstances than Ireland. Injections of state capital into the banking system will bloat the Irish budget deficit this year to over 30% of gross domestic product. This puts Ireland in a lonely pole position within economic and monetary union (EMU). Its deficit to GDP ratio is more than three times as high as in Greece, Portugal and Spain and its debt is skyrocketing.

In particular, concern over the Irish banking sector has driven up the risk premium in the capital market during the last few weeks. The yield spreads versus German government bonds widened at times to around 450 basis points, the highest since the introduction of the euro. Yields on 10-year Irish government bonds are at 6.5%, roughly 420 basis points above Bunds with the same maturity.

The financial markets fear Ireland will not be able to rescue the banking sector by itself because of its large deficit and will have to fall back on financial assistance from the European Union as a result of the sluggishness of its economic recovery. There have been recurring rumours that Ireland could be the first country to make use of the European Financial Stability Facility (EFSF) set up with the backing of the European Union and the International Monetary Fund to help EMU countries in need. So far, however, the government in Dublin has contradicted all speculation in this direction. And for the time being at least Ireland looks unlikely to ask the EU or the IMF for financial assistance, as its liquidity resources are very comfortable. Irish officials say liquidity requirements are fulfilled up to mid-2011. The auctions that had been planned for later this year have been cancelled. But in the long term I doubt whether Ireland will be able to ride out the recession and bear the heavy costs of restructuring the banking industry without outside help.

Ireland will probably be able to reduce its net borrowing next year because it will no longer have to recapitalise the banks, or if so only to a far lesser extent. But even if no further assistance is needed for the financial sector, the national debt is likely to increase to around 120% of aggregate economic output by 2012. Sluggish economic growth will be a drag on state revenues for some years yet. Nevertheless, the situation in Ireland is hardly comparable to that in Greece. Nor do I expect Irish government bonds will be restructured or that Ireland will default even over the longer term. It is very unlikely that the outstanding bonds will not be repaid at all or will only be repaid late. The outlook for Ireland is incomparably better than for Greece since the Irish economy does at least have a 'business model.' Its competitive export sector will probably soon help make GDP growth rates of around 3% look feasible again.

If Ireland asks the EFSF for assistance, this could help break a vicious circle consisting of self-feeding doubts about Ireland's financial strength, economic weakness and ability to implement new savings. Rapidly rising yield mark-ups make recourse to the EFSF increasingly probable. In Ireland's case, such a step may be interpreted as a purely precautionary measure. Assistance from the supranational institutions can help the country win time to complete the recapitalisation of the banking sector without pressure and to impose a strict consolidation programme without having to rely on the capital market. In two to three years, when Ireland ceases to rely on official programmes and 'goes it alone' again in the capital markets, all doubts about its solvency will probably have been allayed.

In two to three years, when Ireland ceases to rely on official programmes and 'goes it alone' again in the capital markets, all doubts about its solvency will probably have been allayed.

If Ireland is the first country to apply to the EFSF for aid, this will also be advantageous for other euro-area member states. Since Ireland only needs the funds to bridge a critical phase, any widening of spreads triggered by activation of the assistance programme would probably be limited. The EFSF is likely to pass its first test more easily with a rather stable EMU member than with countries that are in more critical shape. If afterwards countries such as Portugal ask for help, then the financial markets' worries about the efficacy of the newly-established fund are likely to remain within bounds.

Sovereign funds and clean energy

State groups will get involved only if they can profit

Malan Rietveld, Chief Economist

What a difference a financial crisis makes. After concerted pre-crisis efforts by western governments to reign in sovereign funds that culminated in the Santiago Principles, calls for these funds to solve all the world's ills are now growing louder with each passing month. The 'to-do list' for sovereign funds suggested by western observers now includes buying the debt of recalcitrant governments and aiding Africa's escape from poverty, following the suggestion by Robert Zoellick, the World Bank president, that sovereign funds commit to investing 1% of their assets in the continent.

There are five basic arguments why sovereign funds and clean energy could – and indeed should – be an ideal match.

These ancillary objectives come on top of pressure from domestic stakeholders to generate consistent returns in fragile markets, prop up domestic economic sectors and financial institutions, strengthen regional trade links through infrastructure investments, promote national champions of industry and provide macroeconomic stability.

At a recent conference hosted by New York's Columbia University in early October one more item was added to the wish-list: financing clean energy. Five basic arguments were made as to why sovereign funds and clean energy could – and indeed should – be an ideal match. First, sovereign funds are members of a small class of investors capable of adopting the long-term horizon required to make successful and badly needed investments in alternative and renewable sources of energy, which suffers from an estimated $150bn per year shortfall. Second, sovereign funds are ultimately beholden to governments, which will be the primary agents for tackling issues of climate change. If governments tackled the corresponding investment needs, sovereign funds would be a logical vehicle.

Third, some argued that those sovereign funds whose assets are derived from the environmentally damaging extraction of finite natural resources had a moral obligation to provide funding solutions for an alternative energy future. Fourth, it was argued that markets had not yet adequately priced environmental risk to future energy prices and sources, with the example of carbon pricing frequently mentioned. Once this hypothesis is accepted, there is a clear rationale for long-term investors, including sovereign funds, to go overweight in 'investments that will benefit from emissions being priced, and away from investments that will be adversely affected when carbon is priced,' as Bob Litterman, the former MIT professor and Goldman Sachs risk-management guru put it.

Finally, given the anticipated future demand for energy in the emerging market economies that have sovereign funds – and the well-documented appetite of these funds for investing in strategic natural resource supplies – it seems logical that alternative energy sources should be part of their thinking. Believers in the so-called post-oil economy find it inconceivable that a fund geared to the long-term resource needs of a rapidly growing economy can ignore alternative energy sources.

These arguments – particularly the last two – should be seen as building blocks towards a constructive role for sovereign funds in the development of markets and broader solutions that deal with challenges of climate change and the depletion of scarce resources. But it is naïve, if not presumptuous, to suggest – as Joseph Stiglitz did at the Columbia gathering – that sovereign funds should forego returns in doing so. Sovereign funds are not going to subsidise solutions to a global problem where the West has failed to give a lead.

One of the consequences of the Santiago Principles is that sovereign funds' commitment to commercial objectives has been further strengthened. It is now well known that sovereign funds tend to drive a hard bargain – as well they should. They need to be presented with a compelling business case. There are many innovative ways of doing this. Promoting a better-functioning and more liquid market for investment in clean energy, encouraging partnerships and joint ventures with other long-term investors and governments, and driving forward more efficient pricing of carbon are all very useful routes towards this end.

Masters become supplicants – again

Echoes of the past in Washington meetings

William Keegan, Chairman, Board of Contributing Editors

'Nine-Eleven' changed many things, including the duration and form of the annual meetings of the World Bank and International Monetary Fund. For a start, the terrorist attacks of 2001 led to the cancellation of the usual end- September/early October gathering and a delayed 'Ways and Means' kind of meeting took place shortly before Christmas. A more lasting impact was the way it was finally recognised that the old days of Bank/Fund meetings lasting all week were gone. Gone, too, were those seemingly endless plenary sessions, with US presidents – or other leaders when the gatherings were outside the US (every third year) – putting in an appearance.

Those very formal affairs dated from the early post-war years when European delegations would cross the Atlantic on ocean liners and make a week of it. We saw the change in the latest Bank/Fund session that took place in Washington on 8-10 October. Britain's chancellor of the exchequer George Osborne flew in on the Thursday and out on the Saturday.

The annual meetings are hurried affairs these days. They are also worried affairs. The confidence with which the finance ministers and central bank governors of the Group of Seven used to dominate the proceedings has ebbed away. The views of the 'emerging economies' – once known as the 'less developed countries' (LDCs) or 'developing' nations – are much more influential. If there was one prevailing theme at this year's gathering, it was that power and the impetus for economic growth had shifted eastwards. The western, former masters of the IMF universe have now become supplicants.

One telling statistic quoted at a fringe meeting was that 20 years ago China and India accounted for 6% of world output; now it is 20%. But, as the Indians were quick to point out, India is only a third the size of China. China is the big story, the principal object of US administration and Congressional wrath, and whereas the economy may move fast in China, economic policy does not – so the much-sought after 'rebalancing' may take generations. Meanwhile 'currency wars' are not so much threatened as openly declared; a world that, thanks to enlightened 'Keynesian' policies, has, so far, fought off a recrudescence of the Great Depression may yet find that the aftermath of the financial crisis brings uncomfortable echoes of the 1930s.

Mind you, there is nothing new about the West being supplicants at these meetings. As I made my way round the halls I was reminded of the time when these meetings were much grander affairs, staged at the enormous Sheraton Park Hotel, and the West became supplicants to the oil producing countries (OPEC) after the two oil shocks of the 1970s.

Instead of being condescending towards the Middle Eastern and other oil producers, the western nations were desperate that those OPEC 'surpluses' be 'recycled' to keep the world economy moving. Indeed, in the early 1980s we experienced a precursor, on a much smaller scale, of the recent financial crisis when, as the late Anthony Sampson wrote in The Money Lenders – Bankers in a Dangerous World (1981) of the 1980 IMF meeting: 'There are too many lenders chasing too few borrowers ... and too large deposits compared to too little capital. Many of them are looking towards their central bank, or to the IMF as their safety net, or their debt collector. The word default is still in the back of their mind.'

I recall a banker friend of mine saying at that meeting something to the effect that 'We go through the motions of asking the LDCs all sorts of questions about their economies, but we hardly care. Our key questions is: "And what is your borrowing programme".' There was a huge celebration dinner in Washington this time in honour of Bill Rhodes, the New York banker who was a key man in all the subsequent Latin American debt renegotiations. The crisis we have recently been through leaves us with a policy and regulatory mess that seems to be beyond the ability a latter day Bill Rhodes, let alone the warring US-Chinese factions, to resolve. But OMFIF is working on it...

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Looking ahead – 2011 diary dates

OMFIF Meeting with
De Nederlandsche Bank
23-25 March 2011, Amsterdam
Europe's Place in the World Economy

OMFIF Meeting with
Banque centrale du Luxembourg
15 September 2011, Luxembourg
The New Forces in World Banking

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