OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

December 2011

Why Europe must stand united

Preserving single market is main priority

Marek Belka, President, National Bank of Poland

European leaders' efforts at resolving the euro crisis will be futile if, at its hour of need, Europe becomes divided between those inside and outside the single currency. As an EU member not part of economic and monetary union (EMU), Poland remains strongly committed to joining the single currency in coming years. But we will do so only after the euro area has shown it has learned its lessons and restored a sense of shared purpose.

Europe must do more than take steps to ensure that such calamitous circumstances never re-occur. It must find ways of rekindling growth, without which much of what Europe has achieved will be lost. Allowing divisions between EMU members and non-members, separating countries such as Poland from Europe's mainstream and sub-dividing the single market would harm euro members themselves.

Entering the euro was supposed to bring its members sustainable growth by lowering credit costs and facilitating access to a common market. These assumptions have been unveiled as illusions, but the goals remain valid.

Poland's experience in doing its homework without undue reliance on others contains precepts for other countries undergoing economic transition. First, European countries must recognise the importance of self-help. Poland profits greatly from European trade as well as counter-cyclical receipts from EU structural funds and the Cohesion Fund. But it also has to rely on its own efforts. Poland is a relatively small open economy, yet we are large enough to absorb negative external shocks, at least partially. Inflation and the public deficit are still too high, but in recent years Poland had a sustainable external position.

Second, in combating tough policy issues, there is nothing wrong with sustained, sensible gradualism. For example, Polish experience in lifting capital controls step by step avoided excessive outflows or inflows and cushioned social acceptance. In another field, some states now in EMU reversed their fiscal deficits in the mid-1990s in a rush to meet the Maastricht deadlines. Fiscal consolidation was anything but durable. Steadiness over time would have been better.

Third, fiscal soundness is a priority. It is paramount to set a ceiling for public debt, as Poland did in 1997, along with pre-emptive thresholds, the breaching of which automatically triggers sanctions. Such measures alone do not guarantee fiscal stability, but they are higly important in underpinning domestic discipline.

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Vatican views

Dragooning Draghi

Darrell Delamaide

The head of the Vatican Bank, Ettore Gotti Tedeschi, has added his voice to calls for the European Central Bank to become lender of last resort in the European sovereign debt crisis, and specifically backing joint euro area bonds.

While German chancellor Angela Merkel, daughter of a Lutheran pastor, may be able to resist the admonitions of the Holy See, the Vatican may expect that new Italian ECB president Mario Draghi could pay them more heed. The latest calls by Tedeschi (whose name means 'German' in Italian) come on the heels of a Vatican document in October that stirred up controversy because it calls for a reform of the international financial system in the interests of the common good of humanity. Intriguingly, Tedeschi is a declared follower of Friedrich Hayek and liberal economics, who had a long career in Italian and international banking before coming to the helm of the Institute for Public Works, the official name of the Vatican Bank, in 2009.

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Letter from the chairman

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Euro dominates

Many questions, fewer solutions

David Marsh, Co-chairman

Is Europe is experiencing an economic and monetary crisis? Former German Chancellor Helmut Schmidt, the grand and grumpy old man of world finance, earned rapturous applause when he told an audience in Frankfurt in late October that it was all 'got up' by mischievous politicians and journalists.

He has not always said that. Intriguingly, Schmidt told the Bulletin in December 2010 that the EU made 'great mistakes' by deciding to start monetary union with a wider rather than a narrower group. As Meghnad Desai writes, some people have been in denial, at least part of the time. Our approach is to look at both pitfalls and opportunities. Marek Belka, president of the National Bank of Poland, says – whatever happens – the single market must be preserved. Two doughty euro campaigners on our advisory board, former Dutch prime minister Ruud Lubbers, and Niels Thygesen, the Danish economist who was on the Delors committee, expound answers to Europe's conundrums. Lubbers believes Europe now has a second chance.

Attacking UK complacency, Paddy Ashdown explores the dilemmas facing Britain (or England) as euro core states embark on more integration. The ECB, now under Mario Draghi, believes it's done its bit, as outlined in Roel Janssen's exposé of the ECB's financial stability warning to euro ministers a year ago. There are many questions, fewer solutions. Stefan Bielmeier, though doubtful about compromising German principles, believes the time may have come for ECB intervention. Stewart Fleming underlines the daunting task awaiting Greek's shy technocrat leader Lucas Papademos. Pawel Kowalewski throws light on Spain's new identity. Michael Kaimakliotis and Marina Shargorodska believe a euro break-up and banking failure are on the cards. William Keegan says David Cameron has erred over the euro crisis, and Mervyn King has got it right. Scant solace, at this time of wan seasonal cheer, if at least one person has made the correct call.

David Marsh

Looking ahead – 2011-12 diary dates

OMFIF Lecture with
Yves Mersch
Governor, Banque centrale du Luxembourg
13 December 2011, London
EMU's future – 20 years after Maastricht

OMFIF Dinner with
Gerhard Schröder
Former Chancellor of Germany
7 February 2012, London
OMFIF International Statesman Dinner

OMFIF Lecture with
Klaas Knot
Governor, De Nederlandsche Bank
17 February 2012, London
The Future of EMU

OMFIF Meeting with
Deutsche Bundesbank
14-15 March 2012, Frankfurt
The World Economy at a Turning Point

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

OMFIF Lecture with
Patrick Honohan
Governor, Central Bank of Ireland
8 May 2012, London
Ireland's experience with EMU

OMFIF Lecture with
Ewald Nowotny
Governor, Oesterreichische Nationalbank
12 June 2012, London
Austria, Europe and the euro

OMFIF Conference
World Banking & Finance Summit
26-27 June 2012, London
Managing Economic Transformation in a World of Creditors and Debtors

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Wellink reveals ECB wrangling

Ministers warned over stability a year ago

Roel Janssen, Board of Contributing editors

A mounting battle for responsibility between the European Central Bank and European politicians has gained fresh momentum with revelations of an ECB warning on financial stability passed to ministers a year ago.

The ECB told European finance ministers it could not guarantee European financial stability unless governments at least doubled the €440bn EFSF rescue fund. The message late in 2010 was revealed by Nout Wellink, the former president of the Dutch central bank.

The ECB communication was placed on the agenda of a meeting of euro finance ministers under Jean-Claude Juncker, the Luxembourg prime minister, attended by Jean-Claude Trichet, the then ECB president. Trichet later angrily reported to the ECB's decision-making council that the communication made no impression. Its content was not even discussed since the finance ministers apparently did not want to live up to their responsibilities.

Underling the issues still dividing governments and central bankers over ECB purchases of weaker country bonds, Wellink revealed in a book published in the Netherlands similar wrangles over ECB attempts to persuade government formally to indemnify it against possible losses on bond purchases.

At the end of last year, the European Financial Stability Facility contained €440bn, only about half of which was available because of the need to maintain a technical buffer. Earlier this year, Wellink publicly suggested raising the EFSF at least to €1.5tn. Wellink stepped down from his post on1 July and was replaced by Klaas Knot from the Dutch finance ministry.

Showing continuity with the role played by Wellink, Knot has publicly sided with Bundesbank president Jens Weidmann in opposing large-scale ECB purchases of Italian and Spanish bonds since the further deterioration of European financial market conditions in August.

In past months the ECB along with many financial market players has been critical of European governments' sluggish response to the growing debt problems of heavily-borrowed European states. In July 2011 European leaders decided to increase the EFSF to its originally-conceived size of €440bn, and this was further enhanced in October.

In the book, Wellink proposes establishing a commission of experts to propose urgent changes in the European Treaty. He proposes that this should be headed by Jacques de Larosière or Jean-Claude Trichet. The task of this commission should be similar to the 'Delors Committee' that paved the way with its report in 1989 for the monetary union. Wellink sees federalisation of euro budgetary and fiscal policies as inevitable.

Wellink reserves some vitriol for the Dutch government's suggestions that countries could be expelled from the euro area, suggesting that this amounts to provoking a run on Greek banks. However Wellink says Greece is not the biggest threat to the euro. 'The real problem is: how do we keep the eurosystem afloat. Without sufficient measures, this can turn into a crisis of the entire system. That's where we have to focus.'

Among other things, Wellink urges an overhaul of the articles in the Treaty on the ECB. The ECB's mandate, he says, should be broadened, allowing it more freedom of action to strengthen financial stability in crisis situations. This would allow the ECB to operate more effectively through a change in the ECB's current, limited mandate.

'The real problem is: how do we keep the eurosystem afloat. Without sufficient measures, this can turn into a crisis of the entire system. That's where we have to focus.'

* *The book, Wellink aan het woord ('Wellink speaking'), is published by De Bezige Bij in Amsterdam.*

Why Europe must stand united (...continued from page 1)

Backed by our experience, Poland unequivocally supports Germany's efforts to introduce debt ceilings throughout EMU, a path now adopted by Spain.

Fourth, on financial markets, macro-prudential measures aimed at avoiding bubbles must be adopted Europe-wide, but they need to be ingrained in national consciousness. Poor co-ordination of fiscal and structural policies, weak and fragmented banking supervision, and lack of cross-border bank resolution exacerbated financial weaknesses, which spilled over to the real economy.

In the last five years, the rather low degree of development of Polish financial markets has been a blessing. This is partly a question of culture rather than rules, but other nations would do well to follow the cautious Polish attitude on systemic risk.

Fifth, the people will put up with the hardships of economic transition if they know where they are going. This has not always been the case for countries that entered monetary union on a false prospectus that was neither properly explained nor enforced by politicians. In the Polish case, the switch in foreign trade dependence from the old Comecon towards western Europe brought countless bankruptcies and job losses. But, instead of provoking riots and social unrest, this led to an unprecedented eruption of entrepreneurship.

Led by Germany, the euro area is now moving toward a model where nations must fend for themselves. Since Europe's financial markets are highly integrated, rising expectations of default have led to capital flight into 'safe countries' – creating further instability and divergence, with a damaging split between the faster-growing, more solvent north and the indebted south. Countries outside the euro must help bridge that split. The answer lies in greater, not lesser, integration of trade and investment in the European single market.

Improving competitiveness may prove extremely difficult with rigid employment procedures, high production costs and onerous taxation. Europe must boost export product quality compared with Asia. Non-euro countries have shown exemplary policies in these fields. In the interests of EU cohesion, but also with regard to their own economic objectives, euro members would be foolish to allow new barriers to grow up between the euro and those outside. EMU strategies for higher growth and stability are welcome. They are far more likely to succeed if they embrace the whole EU.

Vatican views (...continued from page 1)

It remains to be seen whether the Vatican's moral authority will sway Draghi or other members of the executive board, where five of the six members come from predominantly Catholic countries.

The 'note' from the Pontifical Council for Justice and Peace, with its suspicious overtones of world government and a world monetary authority, was dismissed by some as coming from the 'socialist' side of the Church.

The pontifical council is headed by Cardinal Peter Turkson of Ghana, a rising star in the church who could become the first African pope. Turkson and the other churchmen on the council are not trained economists.

But two of the lay members have impeccable credentials in international finance: Michel Camdessus, former IMF managing director and former governor of the Banque de France, and Onno Ruding, former Dutch finance minister. Camdessus' presence lends special piquancy to the document's contention that 'the International Monetary Fund has lost an essential element for stabilising world finance, that of regulating the overall money supply and vigilance over the amount of credit risk taken on by the system.'

Leonardo Becchetti, a firebrand Rome economics professor, was reportedly involved in the drafting, though the Vatican says he was pulled in only to explain the document to the press.

The document complained about the neo-liberal approach to economics that largely dominates policymaking. It specifically criticised a'technocratic' approach just as Greece and Italy were appointing 'technocratic' governments to sort out the crisis.

'The primacy of the spiritual and of ethics needs to be restored and, with them, the primacy of politics – which is responsible for the common good – over the economy and finance,' the pontifical council said. 'These latter need to be brought back within the boundaries of their real vocation and function, including their social function, in consideration of their obvious responsibilities to society….'

Notes on contributors

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Jón Sigurgeirsson is a director of the Central Bank of Iceland and former alternate executive director at the IMF.

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Firewall becomes wall of fire

Litany of errors by European leaders

Michael Kaimakliotis and Marina Shargorodska

Developed economies' debts have shift from the financial to the public sector in recent years. This, combined with massive fiscal expenditures, has shielded the global economy from the worst potential outcomes of the financial crisis. Yet policymakers have made poor use of this manoeuvring room. We face the most difficult period of financial deleveraging in 80 years. Don't be surprised if this results in deflation, the collapse of at least one global financial institution and the break-up of the euro.

We face the most difficult financial deleveraging in 80 years. This could lead to deflation, the collapse of at least one global financial institution and the break-up of the euro.

Recent economic data from the US and China have been better than expected. That, together with a technically deeply oversold equity market, led to a sizeable rally in October when equities had one of their best months ever. Alas, much of the rally was due to positioning by investors who were short equities when the EU summit was announced in late October. An upward spiral ensued, based on misplaced optimism about a euro debt deal. This will be seen as one of the great 'dead cat bounces' ever.

Bond markets reflect a much more accurate picture. Inflation expectations have fallen sharply, while credit spreads among euro periphery sovereigns have risen. Italian five year inflation expectations have turned negative, matching those of Japan, while France's five year expectations fell from 2% to below 1%. The much-needed firewall has turned out to be a wall of fire. And the flames are approaching Paris.

The Europeans have got things dreadfully wrong. Snatching defeat from the jaws of victory might appear entertaining but when repeated it becomes excruciating. Europe now faces disaster as investors shun sovereign bonds in Italy and Spain. With yields around 7% the situation is unsustainable. And the outlook is dismal. Europe is already most likely in recession. Increasing austerity will weigh further on growth next year. EU leaders have committed a litany of errors. By talking about a Greek euro exit they have opened Pandora's Box. If Greece, then why not Portugal? If Portugal, why not Spain? By insisting that banks maintain a Tier 1 ratio of 9%, they have started a firesale of assets, including sovereign bonds, rather than promoting accumulation of equity capital. The likely outcome is a credit crunch driving Europe into a deeper-than-necessary recession.

By allowing the ECB to avoid write-downs, governments have indicated that senior debt-holders may face significant subordination in future bailouts. By stopping hedging of sovereigns by CDS, they further cut demand for banking debt. By telling banks they should raise capital by converting subordinated debt to equity before tapping local government support and the EFSF they have made things even worse for banks trying to find funds.

But this is not just about Europe. America's budget agreement in August ensures a massive cut in fiscal expenditure is coming in 2013 – on top of cuts of up to 2.5% of GDP in 2012 if no compromise agreements can be reached by the misnamed Super Committee. The Republicans are making it ever more difficult for the Fed to use stimulative policies as the election approaches. And the Frank Dodd law ensures that many measures the Fed and the Treasury employed in 2008 would now no longer be permitted. Among the important elements of the law is the no-bail-out clause which only allows support at an industry level. This makes the failure of a major US institution much more likely than in 2008. The FDIC can no longer guarantee financial firms' bonds without Congressional approval. The Treasury is not permitted to use its foreign accounts to support money market funds.

And all of this comes at a time when deleveraging will start to regain pace. There is a small glimmer of light. If Europe starts to experience deflation, then the ECB will feel justified in employing quantitative easing. As Jürgen Stark, the departing ECB board member, has put it: 'Monetary policy in advanced economies needs to take into account longer-term risks to price stability emanating from destabilising financial and monetary trends.' We agree. But the risk now is not inflation, but deflation.

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It's the politics, stupid!

Snow White and the 17 dwarfs

Meghnad Desai, Chairman, Advisory Board

The long-running euro crisis has reached a crunch. The bond markets have seemingly started to become disenchanted even with the German state signature, and were not inclined to give Italy a break despite Mario Monti. We are starting to run out of alternatives. Each rescue plan has rapidly been been superseded by events.

The euro crisis is not an exchange rate crisis. The euro area overall is a net creditor to the world. Trade is in balance if not in slight surplus. So how did we get into this mess?

The answer lies in bad political leadership. OMFIF was set up almost at the birth of the turmoil. At its several meetings in various locations, the issue has been discussed and solutions debated. But one thing stands out in my memory. Euro leaders have been in denial from the beginning that a crisis exists. By the time a solution becomes urgent, the crisis is recognised but any proposed solution is spurned. Three months later we have a half-hearted solution, but it is no longer sufficient. In March 2010, in Frankfurt, we British eurosceptics (about the euro not the EU) were worried about Greece. We were told there was no problem.

Then in May 2010 we met at Kuala Lampur and I said the IMF would have to be brought in. The IMF was not necessary, we were told. By the time of the IMF meetings in autumn of 2010, the ECB had begun buying sovereign debt in secondary markets and we were saying that may be there should be Eurobonds. When EU Commissioner Olli Rehn spoke to meetings in Washington I asked whether 'haircuts' were not the answer. Rehn forcefully denied this. No haircuts now or ever. Other issues were exit from euro for weaker countries ('not possible constitutionally'), two speed euro area (' no') and so on.

We are starting to run out of alternatives. Each rescue plan has rapidly been superseded by events.

There are too many decision-makers. There are no formal structures for decision-making and no transparency. What has emerged is the duumvirate of Angela Merkel and Nicolas Sarkozy. For those who would recall Antony and Cleopatra, Merkel is Augustus and Sarkozy the indolent Antony. Each of the two Ceasars is weak on home turf. Merkel faces an angry citizenry unwilling to do the right thing and pay the price for the benefits of an undervalued currency. Sarkozy is scared that if he stakes any French money he will lose his triple A rating.

Merkel 's preferred solution is to drive towards a full fiscal union. But the time frame is years not in months let alone weeks. And what credibility will such a union have when the first breach of the Stability and Growth Pact was by Germany and France ?

The European experiment has thrived on the fallacy that before completing one project one must start another. The analogy is that of a bicyclist who falls off if he stops. The stupidity of the analogy is obvious to any cyclist. The single market was launched. And before it was finished, the single currency. And before that happened, enlargement. At each stage, complications were brushed aside. Henry Kissinger's question retains its potency. Whom do you call in Europe? Now there is talk of the Groupe de Francfort, another ad hoc group of seven people. Within this we don't know who is inserting the mountain climber and who are the sherpas.

While the governance deficit lasts, plans will be made without any proper testing. The EFSF has lost credibility because the plan to leverage it was released without a proper pre-test. It sounded like a CDO of dubious parentage. Now its time has passed. The ECB can help but only if it can break its mandate and becomes lender of last resort. Three months from now, Merkel will be ready to allow the ECB to buy bonds across all sovereign euro states. But by then it will be too late. Perhaps the IMF will come to the rescue and pour in aid several times the quota entitlements of Greece, Italy, Spain and Portugal. Snow White may yet come to the aid of the 17 dwarfs.

Europe's second chance

Bretton Woods renewal can help euro governance

Ruud Lubbers, former Netherlands Prime Minister, Advisory Board

Moves towards a genuine European economic government should be accelerated as part of a series of measures to heal the euro crisis. I welcome progress in this regard by France and Germany. Measures now on the European agenda confirm the validity of efforts made 20 years ago when as Dutch prime minister I attempted to bring in 'communitisation' of economic policy as an essential accompaniment to the unification of money under the European Central Bank.

These plans fell foul of a Franco-German veto in September 1991, reflecting Chancellor Helmut Kohl's desire to appease French worries about losing sovereignty. This was shortly before the Maastricht summit that I chaired - the meeting that launched the path to monetary union. We now know that the lack of an economic union to accompany monetary union has been a major reason for the setbacks that have befallen the euro. Europe now has a second chance to repair the euro's birth defects.

Lack of an economic union to accompany monetary union has been a major reason for the setbacks. Europe now has a second chance to repair the euro's birth defects.

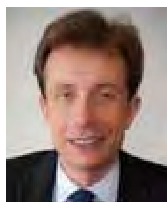
In a new governance regime – with two monetary authorities: a euro minister of finance in Brussels and a fully mandated president of the ECB – we need more stringent monitoring of countries' budgetary and economic policies. Building on its securities market programme, the ECB should enlarge its role in policing European bond markets. Euro countries would be allowed common bond issuance, subject to stringent budgetary requirements.

The setting up of the European Financial Stability Facility (EFSF) last year as an emergency fund for troubled euro states is a step in the right direction. But, as recent setbacks have showed, this needs far greater underpinning by governments if it is to gain full credibility. The solidarity initiative is in two phases: first the emergency fund, then, from June 2013, the European Stability Mechanism (ESM), the permanent fund. Furthermore, the troika of the International Monetary Fund, the ECB and the European Commission itself amounts to a powerful governance tool to define necessary financial policies for states facing problems and to monitor compliance with loan conditionality.

After the initial programmes for Greece, Ireland and Portugal, Italy and Spain may be the next countries to require such action – underlining how last year's emergency measures need to become institutionalised. It is helpful that Chancellor Angela Merkel and President Nicolas Sarkozy are backing an enhanced role for Herman van Rompuy, the president of the European Council, at the helm of the Eurogroup. In addition, the present Netherlands government has proposed a separate 'Super-Commissioner' for budgetary surveillance.

Changes to Europe's monetary constitution represent just part of efforts to bring Europe back to growth. The lack of fiscal discipline in the euro area's Stability and Growth Pact find an echo in a much wider set of problems. We need finally to check the disastrous financial innovations and the build-up of 'casino capitalism' in the Anglo-Saxon world that have contributed to the disruptive spiral of risk, greed and bankruptcy in world banking. Even highly-educated economists supported a destabilising short-term culture of exaggerated bonuses and 'get rich quick' transactions, using instruments few could understand and still fewer could control. Dubious innovations effectively severed the links between borrowers and lenders, leading to wholesale misuse and massive losses.

The IMF requires thoroughgoing renovation and modernisation, regarding both balance of power and voting rights for China and other BRICS countries, as well as an enhanced role for the Special Drawing Right as a global reserve currency. We also need an international move towards a 'Green Growth' strategy, as recently advocated by the Organisation for Economic Cooperation and Development. The Cannes G20 summit in early November was regrettably overshadowed by European debt turmoil. But repairing the European crisis and achieving a renewal of the Bretton Woods institutions can be pursued in parallel in coming years - for the good not just of Europe but of the world economy as a whole.



Spain rediscovers its identity

New dawn beckons amid economic challenge

Pawel Kowalewski, Advisory Board

Far-reaching changes lie ahead in Spain following the 20 November poll that saw the election of Mariano Rajoy at the helm of the Partido Popular. The new centre-right government is embarking on a programme focused on curing the distressed economy burdened by above-20% unemployment and soaring borrowing costs. One outcome is likely to be a redefined relationship between central government and the autonomous regions as Spain tries to rein in excessive decentralisation that contributed to economic imbalance under Jose Luis Zapatero, the previous Socialist prime minister

The poll marked a watershed. By a neat piece of historical symmetry, it took place on the 36th anniversary of the death of General Francisco Franco, after a reign lasting 36 years following the end of the civil war in 1939. After Spain moved too far towards regional autonomy to counter Franco era central planning, the pendulum is now swinging back towards government from the centre. Amid massive economic challenge, Spanish politics is entering a new, potentially positive phase. The separatist ETA movement has declared it will end military activity, and the key political parties say they will work together to heal the economy. Zapatero deserved some credit for bringing in unpopular reforms that cost him his job. The ability of his now Opposition Socialist party to cooperate with the centre-right government on necessary austerity poses a new test for the maturity of Spanish democracy.

After Spain moved too far towards regional autonomy to counter Franco era central planning, the pendulum is now swinging back towards government from the centre.

After excellent first few years of euro membership, the fast-growing economy has come to a grinding halt. A prudent fiscal policy in the boom years was unable to prevent economic disaster. Largely construction sector-fuelled expansion has turned to bust, exposing many previously hidden weaknesses.

In spite of Zapatero's reform efforts, Spain continues to suffer from a two-tier labour market, separated by great differences in privileges and protection. The two-tier system extends further too. Prudent fiscal policies by the central authorities stood in sharp contrast to profligacy and mismanagement by the autonomous regions. Infrastructure provides the most painful illustration. Of Spain's bloated number of 49 airports, in 21 cases the number of passengers using them in October 2011 was less than 1,500 a day – a sign of how unprofitable these airports have become. El despilfarro (the Spanish equivalent for squandering) could be observed not only in relatively backward Castilla-La Mancha, but also in the wealthy region of Catalonia previously renowned for economic management.

Another example of the souring of the economy concerns las Cajas (Spanish saving banks), where many have ended in dire straits owing to lack of transparency and abusive links with regional politicians. In some cases the Banco de Espana has had to step in to restore order, again indicating how centralised power is starting to come back into fashion.

One way to measure the redefinition of statehood and nation lies in perceptions on the country's football team. Only four years ago, Spaniards were seriously considering a contest to select lyrics for their national anthem. A beautiful melody, the national hymn lacked words, on account of efforts to avoid hurting the pride of the autonomous provinces and exposing the fragile construction of the Spanish state. Soccer fans suspected that their team's inability to sing their anthem was a motivational handicap that led to on-field losses.

After a string of footballing victories, including the European Cup in 2008 and last year's World Cup triumph, the Spanish team is no longer regarded as lacking in motivation. The members of the national side, La Roja, remain silent and contemplative ahead of key matches, and their example seems to inspire the rest of the country. During my last trip in early November, no-one said the Spanish anthem needed words to accompany the music. Despite or perhaps because of the economic crisis, in the last four years Spain has regained its identity and pride. The task now is to put these attributes to good use in the struggles that lie ahead.

Shy technocrat with thankless task

Papademos must glean advantage from economic talents

Stewart Fleming, Board of Contributing Editors

It is hard not to feel a tinge of sympathy for Lucas Papademos, Greece's newly-anointed interim prime minister. He is surrounded by political enemies, lacks his own democratic mandate and, on the evidence so far, is burdened by a personality better suited to his previous job as European Central Bank vice president than the role of national saviour.

On 10 November this shy and privately charming, public servant was catapulted from his post as a professor of international finance at Harvard's Kennedy School to take on this thankless task after having repeatedly refused to join the government at all. Just 10 days earlier, George Papandreou, the centre-left prime minister elected in October 2009, had recklessly torpedoed a second International Monetary Fund/ EU-led bailout plan for Greece, whose government and banks are no longer able to meet their obligations without massive foreign aid.

Papandreou, typically for Greece the son of a previous prime minister, had announced on 31 October that his government would put the bail-out plan to a national referendum, the timing and outcome of which were uncertain. With Italy, too, on the edge of its own potentially catastrophic debt crisis, Papandreou's move was a potentially lethal blow to the euro area's already faltering strategy for healing its sovereign debt disaster. Within days, under pressure from Germany and France, Papandreou had been forced to make way for what is, unconvincingly, described as a government of national unity. New elections are planned as soon as 19 February.

Papademos has all the technical qualifications required for assessing the economic and social policy choices for reviving the Greek economy and controlling the government debt mountain.

Papademos, 64, is a former governor of the Greek central bank. He has all the technical qualifications required for assessing the economic and social policy choices for reviving the Greek economy and controlling a government debt mountain expected to soar swiftly to 180% of GDP.

Papademos almost certainly lacks many of the personal and political characteristics (qualities would be the wrong word) relied upon by his democratically-elected predecessors to attain high office in the vicious, tribal and corrupt cesspit of Greek politics. That represents a compliment to his integrity – and a concern about how effective he can be in the short period he is expected to serve before elections expected in February.

Papademos comes from a privileged, public service background. His father was a senior Greek civil servant. He attended the elite, private, Greek-American school in Athens. When he left in 1966, he headed straight for America's Massachusetts Institute of Technology to study physics and theoretical electrical engineering. A superb mathematician, he switched to economics, completed a PhD under Franco Modigliani, a Keynesian Nobel Prize winner, and swiftly became a youthful associate professor at Columbia University in New York.

Eighteen years after moving to America, he returned to Greece. In 1985 he became, first, chief economist then, in 1994, Governor of the central bank, the Bank of Greece. During the countdown to economic and monetary union (EMU), he was charged with helping to stabilise a volatile economy at a time when Greece was setting its sights on economic convergence with 'core Europe' to join the single currency. In 2002 he left the Greek central bank to become one of the ECB's six executive board members in Frankfurt.

When it emerged in 2004 that, in the run-up to joining the single currency, Greece's budget deficit figures had been wilfully misrepresented, Papademos, to his chagrin, came under fire for not raising a red flag. In an interview in 2005 he fiercely denied knowing the budget figures were fraudulent. In a sentence redolent of his unashamedly boffin-like style, he said: 'The Bank of Greece was fully transparent in providing information about the magnitude of the deficits as estimated on the basis of cash data available to the bank.'

According to a former Greek finance ministry official, 'Papademos is the best hope Greece has. If he fails, Greece will be forced out of the euro.'

Papademos has long argued that deficient economic growth in Europe cannot be addressed effectively and on a permanent basis by monetary policy. 'We have to use other policy instruments and implement reforms which can increase the economy's long-term potential growth rate. We primarily need supply-side measures,' he said in his 2005 interview.

As prime minister, he has to put such reforms into effect – with time and money fast running out. His predecessor, Papandreou, tried and failed, in the face of fierce opposition from within his own government, from lobbyists outside it and from angry mobs on the streets of Athens.

Papademos is well aware of the single currency's vulnerabilities. In another interview, in 2007, he bemoaned the lack of political underpinnings for the single currency. 'EMU has been established in a way that has been irreversible in a very fixed manner – through institutional underpinning, the independence of central bank, introduction of a single currency that is both physically present and widely traded internationally. On the other hand, there is a lack of political union and also a lack of will to promote and enhance political integration.

But, at that time, he doubted that full political integration was needed to assure the smooth functioning of monetary union. 'This can function smoothly and effectively if we have adequate political cooperation and better coordination of national economic policies.' It is a view which must surely be changing now for him, as it is for most of the euro area's political leaders. He was clear, however, that leaving EMU was not a soft option for weaker members like Greece, arguing that such countries would find 'their longer term performance would be worse outside than inside the currency area.'

People who know him well praise his intellect, demonstrated once again by the speed with which he mastered the financial stability brief at the ECB. In his 2007 interview, he summed up with masterful clarity the problems that have since befallen the single currency. 'There has not been a wider realisation that certain key issues have changed – that you cannot devalue any more, that wage and price increases above norm have to be addressed in a different way compared with the pre EMU period. There has been slippage in fiscal discipline, sometimes because of a relaxation of policies, sometimes because of a move to downright expansionary policies, sometimes because of economic weakness. And wage moderation has not always been apparent. I would not have been surprised if such a phase had lasted for two, three or four years but in fact it has gone on for longer than that.'

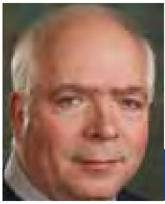
The reason for that, he rationalised, was because 'the very act of creating EMU has detracted from the[(currency] market pressures which in the past would have forced the authorities to take action. The overall result has been a reduction of market discipline on fiscal policy and labour market developments.'

Papademos has a reputation for being indecisive and for lacking the communication skills of the natural politician. Revealingly, he said in 2007 that, during his time at the ECB, he never went to Greece to tell his compatriots about the country's festering difficulties. This taciturn individual found nothing troubling about sitting silently through the monthly ECB press conferences next to Jean-Claude Trichet as the loquacious president held forth.

All this deepens potential pitfalls stemming from the poisonous political culture in which he now finds himself. Papademos has not been able to appoint a loyal cadre of ministers or officials. Here he stands in contrast to Mario Monti, the new Italian prime minister, widely alleged to be a fellow 'technocrat', but in reality a natural politician. Monti has assembled his own team in Rome. But Papademos has inherited almost all his predecessor's Pasok party ministers and officials, leavened by a handful of arch rivals from the centre-right New Democracy party.

Indicative of the jostling for advantage ahead of February's election, New Democracy's leader Antonis Samara has refused to sign a letter demanded by the EU and the IMF as a condition for release of €8bn of bail-out funds. 'Papademos cuts a lonely figure surrounded by party bigwigs,' says a senior official close to the government. 'He faces a Herculean task, and one he did not seek.'

Papademos' strengths are his weaknesses. Voters admire him precisely because of his uprightness and because he is not a member of a party machine. For many years he has lived outside Greece, far from political corruption. The critical question is whether such respect can translate into widespread support for the painful reforms Papademos will have to sponsor, and whether it will be sufficient to neuter Greece's powerful interest groups. According to a former Greek finance ministry official, 'Papademos is the best hope Greece has. If he fails, Greece will be forced out of the euro.'



Walking the US-European tightrope

Torn between competing distractions

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. The gathering turmoil over the single European currency has become a major cloud on the US horizon, providing the American monetary leadership with a further worry in addition to purely domestic developments. Effectively, the Fed is walking a tightrope between the euro crisis and the separate uncertainties overhanging the US economy

Fed officials express confidence in euro…sort of

William Dudley

Top Federal Reserve officials have been at pains in recent weeks to express confidence in Europe's ability to handle the euro crisis, while maintaining that the risks to the US financial system were manageable. **William Dudley (voter)**, president of the New York Fed and vice chairman of the FOMC, said in a television interview in mid-November that the commitment of European leaders makes it likely the common currency will survive.

'I absolutely think the euro survives,' Dudley said on PBS. 'I think the important thing to recognise here is the European leadership is fully committed to the euro. They're fully committed to the European Union.'

Regarding US banks, Dudley went on to say: 'Their direct exposures are quite modest. And they're much better equipped to manage any type of crisis today than they were in 2008. They bolstered their capital significantly. They built their loan loss reserves. They have very large liquidity buffer. So I think that our banks are in very, very good shape.'

Janet Yellen

Earlier in the month, **Janet Yellen (voter)**, vice chairman of the Board of Governors, also expressed confidence, though in a somewhat more nuanced fashion. 'US banking institutions have manageable levels of direct exposure to the peripheral European countries but more substantial links to financial institutions in the larger European economies,' she noted at an international banking conference in Chicago. She also pointed out that some major European banks that rely on dollar funding from US money market funds appear to be facing funding pressures. 'In light of such international linkages, further intensification of financial disruptions in Europe could lead to a deterioration of financial conditions in the United States,' she cautioned.

Yellen said the rescue package announced in late October indicated a 'strong commitment' by European leaders to address the issues stemming from sovereign debt. 'But many details of the plan were unclear,' she said, 'and the measures would require rigorous implementation.' The rise in sovereign debt spreads in Europe and market volatility in general indicated the need 'for forceful action to stabilise the situation,' she said.

Along with closely monitoring US bank risks, the Fed has put in place dollar liquidity swap lines with a number of foreign central banks, Yellen said. 'We will continue to do all that we can to mitigate the consequence of any adverse developments abroad on the US financial system,' she said.

NY Fed's Dudley sees possible expansion of asset purchases

New York Fed chief **William Dudley (voter)** also expressed some optimism about the Fed's ability to apply further stimulus to the US economy, if needed, hinting at a possible expansion of its asset purchases. 'We are not out of ammunition,' he said in a speech at the US Military Academy at West Point. FOMC policies to expand the balance sheet and to communicate interest rate intentions have been effective in lowering longer term rates and making financial conditions more supportive of growth, he said. 'We could do more in both directions,' he added.

On the communication front, he suggested, the committee could provide additional guidance regarding the economic conditions they would expect to see before raising interest rates. 'And we could purchase more longer term financial assets,' Dudley said. 'If additional asset purchases were deemed appropriate, it might make sense to do much of this in the mortgage-backed securities market.' Dudley acknowledged that such actions would be the subject of debate within the committee. 'Some may view balance sheet expansion as sowing the seeds of future inflation—an incorrect view in my opinion,' he said.

But markets should not take the 'vigorous debate' among FOMC members as a sign the Fed would be paralyzed. 'I am convinced that all FOMC members are committed to taking whatever steps they deem would help advance the dual mandate of price stability and full employment,' Dudley said.

'What would be especially helpful at this juncture are fiscal policy actions that work in tandem with monetary policy to stimulate the economy.'

Chicago Fed's Evans urges economic targets for rate action

Charles Evans

Chicago Fed president **Charles Evans (voter)** was even more explicit in calling for specific economic targets for Fed action on interest rates. In a television interview, Evans, a dove, suggested the Fed should clarify there would be no move to raise rates unless unemployment, currently at 9%, would drop below 7% and core inflation rose above 3%, topping the Fed's informal target of 2%.

He said he also favoured the Fed making further asset purchases, instead of just shifting its short-term holdings to longer term securities. 'I just think that this is the time to stretch the boundaries a little bit more and take a few chances,' he said.

The Fed official chided congressional Republicans for sending a letter to FOMC members on the eve of their last policy meeting, warning against further monetary stimulus, as having 'especially bad' timing.

Fed ready to be lender of last resort, again, Minneapolis' Kocherlakota says

Narayana Kocherlakota

Minneapolis Fed chief **Narayana Kocherlakota (voter)**, meanwhile, extolled the virtues of a central bank as lender of last resort. The market interventions of the Fed starting in 2007 and ultimately swelling its balance sheet by $1tn were a classic example of a central bank stepping in when financial panic blurred the lines between liquidity and solvency, he said in a speech in Winnipeg, Manitoba.

Legislation in the wake of that financial crisis now bars the Fed from proving loans to specific institutions, as it did to the AIG insurance group, but the US central bank can still provide emergency market support during a panic.

Although he didn't mention Europe specifically, Kocherlakota clearly had the crisis there in mind in this late November speech, when he concluded, 'This ability of the Fed could be useful in the event that financial market turmoil in other parts of the world ever threatens to spread to US credit and capital markets.'

San Francisco's Williams calls for fiscal stimulus

John Williams

The newest regional Fed chief, **John Williams (non-voter)**, who took office as head of the San Francisco Fed in March, bewailed the lack of fiscal policy to stimulate the US economy. 'Fiscal policy actions that reduce uncertainty and stimulate recovery are badly needed,' Williams said at a central bank conference in Santiago, Chile. 'What would be especially helpful at this juncture are fiscal policy actions that work in tandem with monetary policy to stimulate the economy.'

Monetary policy alone will take a very long time to bring about maximum employment, given the 'strong countercurrents' impeding economic recovery, said Williams, who was chief economist at the San Francisco Fed when Janet Yellen was president. He cited a recent measure allowing homeowners underwater on their mortgages to take advantage of a government programme providing very low rates for refinancing as an example of a supportive fiscal measure.

'This will trim monthly payments for some households and could reduce foreclosure rates,' he said. 'Other actions that address the continuing problems in the housing market could help spur recovery and enhance the effectiveness of monetary policy as well.'

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Why Iceland is not Greece

How Reykjavik kept state signature intact

Jón Sigurgeirsson, Central Bank of Iceland

As debt problems in euro members intensify, an erroneous perception of events in Iceland towards the end of 2008 makes frequent cameo appearances in the international media. There is often confusion between the collapsed Icelandic banks and the Republic of Iceland, which did not default and never has defaulted on its sovereign obligations. The sovereign has maintained an investment grade rating with Moody's and Standard & Poor's since it was first rated over two decades ago.

When the lid on the failed banks was lifted, this revealed unappetising contents. But the signature of the Icelandic state remains intact.

Iceland was hit by both a currency and banking crisis. The first signs appeared with the reversal of global financial flows in 2007. Icelandic banks, with a global reach amounting to up to ten times the size of the economy, were intensely vulnerable – with hugely deleterious consequences for the whole country. The upheavals unleashed by the receivership of Landsbanki, Glitnir and Kaupthing in September/October 2008 prompted the imposition of capital controls under an International Monetary Fund programme agreed in November 2008. Cooperation with the IMF proved successful and the programme was completed in August 2011. While a lot still remains to be done, Iceland is firmly on a path to recovery. This is indicated both by a turnround in the external accounts and by a resumption of economic growth, expected to be 3% this year.

In similar fashion to Ireland, Iceland's crisis has demonstrated how a private banking problem can have fiscal consequences. Among the troubled euro members, Greece has faced a fiscal problem with consequences for the banks. Thus it is not easy to find lessons for Greece in Iceland's experience.

There has been occasional comment about similarities between Iceland's referendum in March 2010 and the subsequently-rescinded call by then Greek prime minister George Papandreou for a referendum on the austerity programme in Greece. In fact the two issues are very different. The referendum was about a solution to the so-called Icesave dispute between Iceland, the UK, and the Netherlands. That dispute hinged on the legal question whether Iceland had an obligation to backstop the guarantee by the deposit insurance fund (TIF) of certain deposits in offshore branches of Icelandic banks (Icesave deposits).

The Icelandic government reached an agreement with the British and Dutch to backstop the TIF. This was made with the proviso that the sovereign did not have a legal obligation to assume responsibility for the failed banks' liabilities. Parliament approved the agreement but the president of Iceland decided to put the legislation to referendum, where it was overwhelmingly rejected. The question of Iceland's legal obligation may now go before the EFTA court. Meanwhile strong collection by the estate of the failed Icelandic bank means that most Icesave liabilities will be covered. With orderly payouts and a legal process underway, this state of affairs is far removed from debt repudiation.

The banking crisis in Iceland was a long time coming, but its symptoms were blurred by the abundance of global liquidity and debatable behaviour within the banks. After Lehman Brothers collapsed in September 2008 and international liquidity dried up, the first Icelandic bank approached the Central Bank of Iceland for emergency liquidity assistance. Within a week, over 80% of the Icelandic banking system had collapsed.

The banks' difficulties and the failed attempts to garner international support made it obvious that the banking system was too big and too heavily foreign-denominated to save. All efforts were placed on protecting the signature of the sovereign. Cross-border banking resolution proved chaotic and confusing, prompting some unpleasant reactions. By the time the IMF arrived in Reykjavík in October 2008, Iceland's three large banks had already collapsed. No further attempt was made to save them. The contents revealed when the lid on the banks was lifted were unappetising and await judicial attention. But the signature of the Icelandic state remains intact – mirroring expectations of eventual recovery.

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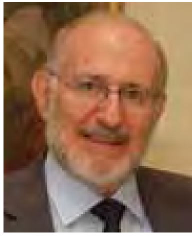
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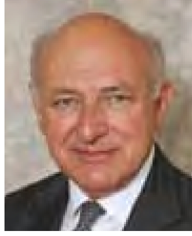
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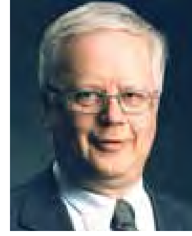
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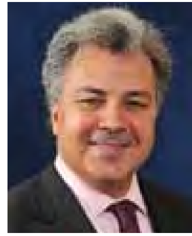
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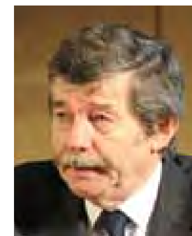
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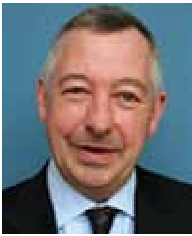
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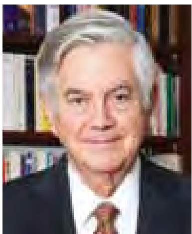
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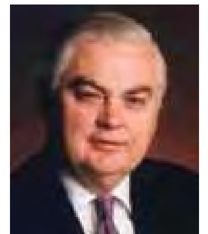
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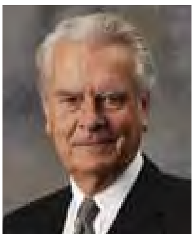
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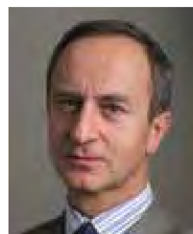
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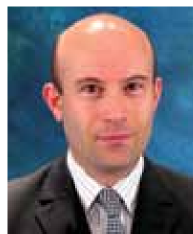
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Italy and Spain in crucial position

Financial crises weigh on economic outlook

DZ BANK Economic Forecast Table			
GDP growth			
	2011	2012	2013
US	1.7	1.7	2.0
Japan	-0.3	2.0	1.4
China	9.0	8.2	8.8
Euro Area	1.6	0.8	1.1
Germany	3.1	1.4	1.5
France	1.7	0.8	1.1
Italy	0.8	0.0	0.5
Spain	0.6	0.3	0.7
UK	0.8	1.3	0.8
Addendum			
Asia excl. Japan	7.5	7.0	7.7
World	3.7	3.5	3.8
Consumer prices (% y/y)			
US	3.2	2.3	2.6
Japan	-0.3	0.0	0.1
China	5.5	3.3	3.5
Euro Area	2.7	2.0	2.2
Germany	2.5	1.9	2.3
France	2.2	2.1	2.2
Italy	2.9	2.2	2.2
Spain	3.0	1.5	2.1
UK	4.5	2.5	2.4
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.0	2.5	2.8
China	3.6	3.0	3.3
Euro Area	-0.7	-0.6	-0.5
Germany	5.1	4.7	4.3
France	-2.2	-2.3	-2.0
Italy	-3.6	-3.6	-3.7
Spain	-4.7	-4.7	-4.8
UK	-2.5	-3.0	-2.0

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

The European financial markets' crisis of confidence is dragging on, in recent weeks apparently getting worse on a daily basis. Italy and Spain have moved into an especially critical situation with regard to their bond markets. They need to refinance large volumes of debt in coming months. But with investor confidence evaporating, their ability to do so is ever more questionable.

New governments are taking office in Athens and Rome in an attempt to regain lost trust through new, beefed-up consolidation packages and economic policy reform. But both countries are on the brink of recession. Contracting economic output will make it even harder to hit austerity targets.

The signs of an economic slowdown are multiplying in Germany as well. The most recent rise in the Ifo business expectations sub-index – after eight falls in a row – does provide a glimmer of hope that business confidence will not continue its steady deterioration. In general however, the sentiment indicators have deteriorated faster in recent months than equivalent 'hard' data such as production or sales statistics.

Should coming weeks see the politicians groping their way to solutions aimed at restoring financial market confidence, then sentiment in Germany could rapidly turn positive again. This would permit solid economic growth next year. In the worst case scenario, which in our view would be a break-up of the currency union, a severe recession would however be inevitable.

In the US, after a generally somewhat weak first half, the economy has gained impetus since the middle of the year. GDP growth should however remain fairly moderate in 2012 and 2013 since unemployment is unlikely to fall much below 9% and the federal government will need to switch gradually to consolidating the budget.

Many structural obstacles to growth remain unresolved, such as housing market problems and excessive personal debt. At least inflation has peaked at 4% for the time being. Oil prices should continue to fall at the beginning of next year, which will boost real purchasing power and stabilise the economy.

The Chinese economy has continued to grow at a rather moderate pace (by Chinese standards) through the summer months. According to official figures, year-on-year GDP expansion slowed slightly again in third quarter to 9.1% from 9.5%.

We continue to see significantly slower GDP growth in coming quarters. Our GDP growth forecast for the full 2012 year remains at just over 8%.

Yet growth dynamics should gradually regain momentum in 2012. This above all reflects a maintained rather neutral monetary policy stance, helped in turn by fading price pressures

Inflation, declared by the Chinese authorities as the No.1 economic problem in recent months, should drop clearly below the 4% target next year.

Why ECB will have to intervene

How to make up for government errors

Stefan Bielmeier, Advisory Board

On several occasions in past months, European heads of government have presented strategies for solving the euro debt crisis that were financially and politically viable and adequately structured, most recently the proposal to expand the EFSF rescue fund's firepower to around €1tn. However, these resolution strategies have been massively undermined and robbed of their potential effect by coordination and communication errors as well as by wrong decisions by individual euro area governments.

All this has prevented the necessary vigorous response and both extended and intensified the crisis. However, the unrest has also exposed crucial differences in the fundamental economic-policy convictions held by various governments and other decision-makers. Recent weeks s have seen Germany and the Bundesbank increasingly pilloried as obstructing a rapid solution out of devotion to so-called 'sacred principles'. The long-drawn out nature of the crisis has so strengthened its momentum that it is now virtually impossible to halt its progress through solutions that are readily compatible with acceptable political principles. I believe that the available options have narrowed to two basic approaches. Either the European Central Bank acts as a 'lender of last resort' and makes unlimited funding available, or the euro countries pool their sovereign debt into common bond issues.

Of the two possible ways forward, the central bank-based approach is less in conflict with the political principles underpinning the euro than the use of joint Eurobonds.

A third option would be to let market forces hold sway with only occasional intervention from the European institutions. This would load significantly more burdens onto the already harassed European banking sector, and there is a risk that many banks would not withstand the resulting stress – with very severe negative consequences for the real economy. Weighing up the risks rules this out as a viable option. In truth I consider the first two options as false choices, since I am convinced that the foundations for a genuine solution have to be built stone by stone in the individual countries. Out of the two possible ways forward, however, I believe that the central bank-based approach is less in conflict with the political principles underpinning the euro than the method using joint Eurobonds.

This is because the central bank – assuming it remains independent – is likely to have the longer-term option to reduce the expansion of credit and to reassert its principles once the acute crisis has been overcome. By comparison, the introduction of joint liability for sovereign debt, e.g. via common Eurobonds, appears to be a irreversible option that therefore runs the risk of gradually undermining the positive incentives for stable money acting on individual countries.

We have to consider, too, that an institutional framework for Eurobonds would need to be put in place in haste and that the process could be correspondingly error-prone. Having said that, I believe that the concept of Eurobonds – a facility that countries could opt into, subject to strict stability criteria – will be needed in the longer-term, once the crisis is behind us, to provide the euro area with an extra pillar of stability.

Mario Draghi spells out ECB's principles on price stability

'These three principles – continuity, consistency and credibility – are at the root of the Governing Council's outstanding record during the past 13 years in terms of price stability and anchoring inflation expectations.

National economic policies are equally responsible for restoring and maintaining financial stability. Solid public finances and structural reforms – which lay the basis for competitiveness, sustainable growth and job creation – are two of the essential elements.

But in the euro area there is a third essential element for financial stability and that must be rooted in a much more robust economic governance. It implies the urgent implementation of the European Council and Summit decisions. …..Where is the implementation of these long-standing decisions?'

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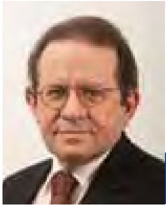


Towards multi-polar currencies

Why the dollar won't easily be toppled

Vítor Constâncio, Vice President, European Central Bank

There are many predictions about the gradual addition of other currencies to the dollar as truly international currencies. Factors behind this apparent unavoidability include the emergence of the euro, the increasing strength of China and the growing vulnerabilities of the US. The growth in importance of emerging countries, with their share in the world GDP up by 15 percentage points in the last 20 years, creates a structural increase in demand for reserves that cannot be met by developed countries, including the US.

This question is linked to the provision of official international liquidity, and also has a fiscal dimension. No single country could indefinitely offer its currency as the reserve asset that could satisfy all the needs of a growing world. In the present circumstances where deficit and debt ratios need to be reduced, the US could not offer its bonds and T-bills as the almost exclusive reserve asset. In this context, euro assets are necessary. Even if they are clearly seen as an unrealistic prospect, Eurobonds, from the pure perspective of the international monetary system, would be useful as a reserve asset.

A move to a multi-polar international monetary system could produce credible alternatives to dollar-denominated investments, enhancing policy discipline in the core reserve issuer. A multi-currency world would imply greater monetary policy autonomy in emerging economies such as China, which would be in a better position to tackle its own imbalances.

There are five key conditions for a major international currency. The first one is having a very large economy, engendering network externalities and lowering transaction costs. The second is given by deep, efficient and open financial markets. Third, good political and macroeconomic governance is of the essence. Fourth, full enforcement of the rule of law is crucial. Fifth, one should not overlook the importance of geopolitical influence and political stability. It is not easy to fill all the conditions. Consequently, a major change in the role of the dollar over the next 10-15 years is unlikely – though the conclusion may be different over a longer horizon. The appearance of the euro has not produced a shift to a genuine duopoly in international currencies, and had little impact on the dollar's centrality.

The euro has established itself as the second most important international currency after the dollar. This role is predominantly regional in nature, since the euro is mainly used by economic agents resident in euro area neighbouring countries. More recently, it is known that Asian investors and foreign central banks accounted for a sizable share of the demand for bonds issued by the European Financial Stability Facility (EFSF). The share of the euro in international markets has the potential to rise further once financial stability is restored in the euro area. The efforts to improve the governance of the euro area and provide it with a credible crisis resolution mechanism will indirectly affect the international use of the euro.

The use of the renminbi as an international currency has remained limited despite the increase in the size and importance of the Chinese economny and Chinese trade. The Chinese authorities have launched several initiatives since March 2009 to promote a wider international use of the renminbi, e.g. in trade invoicing, in deepening the role of the offshore centre played by Hong Kong, or in agreeing local currency swap agreements with several central banks. Nevertheless, the renminbi's full potential can be achieved only with the liberalisation of the capital account, accompanied by the reform of domestic financial markets. Once these will be in place, a major internationalisation of the renminbi will happen as a by-product. The Chinese authorities are prudently promotling financial liberalization, for example through market-driven renminbi securities in Hong Kong. But this increases exposure to capital flows which poses macro-prudential challenges, especially given the renminbi's undervaluation. Should tensions for domestic policy-makers mount, the Chinese authorities may slow down the renminbi's use abroad.

The renminbi's full potential can be achieved only with the liberalisation of the capital account, accompanied by the reform of domestic financial markets.

This text is based on a speech to OMFIF in London on 23 November 2011.

Britain's open euro question

Core single currency may test Cameron

Paddy Ashdown, former leader, UK Liberal Democrats

The argument that Britain would have experienced disaster had we joined the euro rests on the presumption that we would now be like Spain, Italy, Portugal and Greece. But Britain is not small, southern, cavalier about the rules, and largely without a manufacturing base. It is large, northern, rich, serious about the rules and with a strong manufacturing tradition, as are those who faced the challenges of the euro by liberalising markets and improving competitiveness. Why should we have acted like the countries most unlike us rather than those most like us?

Euro to the north of us, euro to the south, euro to the east of us, euro to the west. Splendid little England. Splendidly isolated. Splendidly alone. And of course, as ever, splendidly right.

Take Germany. Only a few years ago commentators warned about German stagnation. Could Germany ever again be the engine of Europe? Now we know. Not just the engine: the fire engine, too. From sick man of Europe to its saviour. Germany achieved this result by facing its problems and improving competitiveness. As it couldn't devalue its currency and refused to borrow excessively, there was no other way.

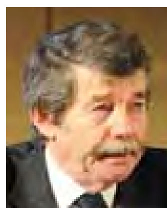
Thanks to Margaret Thatcher's reforms in the 1980s, Britain was well placed to do the same. But, being out of the euro, we could devalue. So we did, by a whopping 20%. As so often, Britain ducked the problem by devaluing ourselves out of it. Unrestrained by the euro's rules (which the Italians broke, but we would have followed), we followed them in borrowing to maintain living standards. But 15 years later, we are back to exactly the problem that the euro would have made us face: how to improve competitiveness and produce goods the world will buy. And we must cut a huge deficit at the same time.

Would it really have been worse if, like our northern partners, we had been subject to the euro's disciplines, rather than free to repeat our old indisciplines? We might, too, have added weight to those who argued (as I did) that you could not create an economic giant, controlled by a political pygmy; that there had to be stricter rules, stronger sanctions, more muscular central institutions.

I am not arguing that Britain should join the euro now. But we should not exclude the possibility. If it becomes in Britain's interest to join, we should join. Sooner than we think, this could become an acute issue. Leaving aside the possibility that the whole thing will unravel, two options remain. Either, the current 17-member euro is made to work. This appears unlikely. Even if the people don't reject it, the markets cannot yet be made to believe in it. Or, if the 17 fail, a core euro follows, with Germany, Benelux, Austria, Finland and (for political reasons) France and probably Sweden. Strong, free-market, in surplus and working together.

In either case, deeper integration, treaty change and very probably, a referendum. In either case Britain would be almost alone in the outer ring and trying to get further out, while almost all the others, even David Cameron's best friends, the Poles, try to get further in. Britain has now lost almost all influence over the dynamics of Europe, and over the timing and context of a UK referendum. Euro members will caucus to advantage those who are in and disadvantage those who are out. A discontented England becomes an angry one. A UK referendum on EU membership becomes unstoppable, with the No outcome a foregone conclusion.

I say England, because there will be another referendum about the same time, in Scotland, held on Scottish Nationalist leader Alex Salmond's terms and timing. There is every chance that he will win and then seek to join the euro. This is the tiger we are riding. The outcome would be unappealing. Spurning the best in the single currency, we reformed our economy 15 years too late. Following its worst, we ran up debts we shouldn't have. Cutting ourselves off from influence in the EU, we finally leave in disgust. And end up with the euro to the north of us, euro to the south, euro to the east of us, euro to the west. Splendid little England. Splendidly isolated. Splendidly alone. And of course, as ever, splendidly right.



Cameron meets his Waterloo

UK prime minister no match for King

William Keegan, Chairman, Board of Contributing Editors

Rather as, in the song Chicago, Frank Sinatra croons 'I knew a man, who danced with his WIFE, in CHICAGO', I once had a weekday lunch with my wife, a leading barrister, who seldom has time for such frivolity. We were in a fashionable restaurant in London's Clerkenwell, and at the next table there was an English economist we knew, who was becoming more and more agitated as his guest failed to show up.

The guest was French, and was coming from Paris that morning, in the days when the Eurostar terminal was still at Waterloo. He eventually made it. 'I am sorry I am late' he said, with the most engaging of Gallic charm. 'There was trouble coming into Waterloo'. He added: 'Always difficult for us French, Waterloo...'

Somehow I was reminded of this when the British prime minister made his day trip to Berlin in mid-November, to see Chancellor Angela Merkel and discuss the future of Europe. Europe! Always difficult for the British, and especially for a Conservative prime minister whose party politicking over the issue has caused nothing but trouble for a string of his predecessors. In recent decades the subject of Europe has also been difficult for those of us British who think of ourselves as strongly pro-European, but who regarded economic and monetary union (EMU) as a mistake, worthy and well-intentioned, but, from an economic point of view, inadvisable.

One would find some of one's closest friends saying that, while they agreed with various other stands one was taking, surely it was important to support the single currency – and therefore Britain's participation in it. Conversely, there would be those right-wing 'anti-Europeans' (in many cases owners of fine second homes in France and Spain) who would assume that one was as anti-European as they were.

There were some awkward moments, but your intrepid correspondent somehow managed to cope. But now, as Chancellor Merkel and David Cameron struggle to confront their challenges, we find that Mrs Merkel and the European Central Bank have a well-placed ally in London as they resist calls for the ECB to become 'lender of last resort' to bail out a string of troubled peripheral countries. That ally is none other than Sir Mervyn King, Governor of the Bank of England, and a man whose name does not always spring to mind when it comes to defenders of the single currency and the ECB.

There is a wonderful irony to the following tale, an irony that, to the Bank of England's relief, was hardly noticed by often mischievous British political correspondents. Two days before Cameron's day trip to Berlin, Sir Mervyn gave his customary press conference on the launch of the Bank's quarterly Inflation Report. With Cameron about to press the case with Mrs Merkel for the ECB to act as 'lender of last resort', King was asked his view.

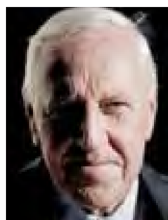
He began his reply thus: 'This phrase, 'lender of last resort' has been bandied around by people who it seems to me have no idea what lender of last resort actually means, to be perfectly honest'.

The Governor proceeded to give a textbook definition: 'It is very clear, from the origin, that lender of last resort by a central bank is intended to be lending to individual banking institutions, and to institutions which are clearly regarded as solvent. And it's done against good collateral and at a penalty rate...that is a million miles away from the ECB buying sovereign debt of national countries which is used and seen as a mechanism for financing the current account deficit of those countries'.

This goes to the heart of the debate: in a fiscal union the appropriate transfers can be made – but between governments, not central banks. Memo from King to Cameron! When it comes to 'last resort lending', Cameron has met his Waterloo in the Governor.

In a fiscal union the appropriate transfers are made between governments, not central banks. When it comes to 'last resort lending', Cameron has met his Waterloo in Mervyn King.

A regular round-up on international monetary affairs



Breaking the vicious circle

Better monitoring could spur ECB action

Niels Thygesen, Advisory Board

The next European summit on 9 December needs to break the vicious circle of a lack of investor confidence in most European sovereign bonds and financial institutions. The potential outcome is unpalatable in the extreme: ever higher interest rates for public borrowers, a credit crunch for private debtors, and a possible recession in 2012 and beyond.

What can be done? The earlier euro summit in late October launched what appeared to be a promising package for the short and the longer term: orderly Greek debt restructuring, bank recapitalisation, more resources for the EFSF, and euro governance reforms. But over the past month market impatience has overwhelmed the impact of these initiatives and additional good news from the political front : the emergence of (at least temporary) governments committed to reforms in Greece and Italy and an electoral victory in Spain which sent similar signals.

Much extended mechanisms for euro surveillance come in to effect on 1 January. These have the somewhat chilling advantage that governments are acutely aware of the market discipline they face if they fail to carry out the right policies. There are two essential questions.

First, with regard to the European Central Bank, one could hope that positive initial actions of the governments facing market attacks, combined with more intense and wider surveillance, would provide sufficient political 'cover' to allow an extension of ECB bond purchases under its securities market programme (SMP), in the context of an expansionary monetary policy.

Second, looking towards the longer end of the time scale, if appropriately enchanced surveillance is on the horizon, and as countries draw on joint support facilities, is it really necessary to set in motion the onerous and risky process of European treaty changes? Politicians who seek to 'sell' the need for treaty change purely on the need for a more disciplinarian framework will need to find wider-ranging and more positive arguments.

The ECB's duty is to conduct monetary policy for the euro area as a whole, not to sit in judgment on the relative performance of individual participating economies.

There has been no shortage of more radical proposed solutions in recent days. The European Commission has outlined various options for Eurobonds, now renamed 'stability bonds'. Fiscal monitoring is to be tightened further, and steps towards fiscal union are no longer excluded. All of these steps take time to implement. Some may imply treaty changes. This explains the calls for short-term action through greatly-increased ECB bond purchases.

All this needs to be put in context. The SMP's launch in May 2010 accompanied the first package for Greece and the founding of the EFSF to prevent financial contagion across the euro area. It was a traumatic decision for all on the ECB's governing board, not just the German members. This was not so much because of fear of inflation – which might seem remote – but because it broke with the traditional division of labour between the monetary and the political authorities.

The ECB's duty is to conduct monetary policy for the area as a whole, not to sit in judgment on the relative performance of individual participating economies.

It is an essentially political task to take a stand on whether a particular spread of interest rates between sovereign issuers is excessive or not. Market participants apparently want the ECB to put a cap on rates or on a spread with the German government bonds.But this can be done only if there is a political arrangement with economic conditions between a euro member and the area as a whole. An extension to a wider group of countries now seems likely.

Possibly the most innovative decisions at the October euro summit were the recommendations to Italy and Spain, with unprecedented specificity, extending beyond budgetary consolidation to structural reforms in labour markets and pensions Time is very short, but the next summit on 9 December should be able to take account of the tighter monitoring of fiscal and economic imbalances, which sets a new benchmark in January. So one could say that Europe is addressing not only prevention of future crises, but also an exit from the present one.

From January, country imbalances and performances will be under the scrutiny of the new mechanisms. Some countries have borrowed thorough joint facilities (Greece, Ireland, Portugal). Others are under the excessive deficit procedures, as in the past, but with firmer controls. Some are likely to apply for EU and/or IMF liquidty assistance. The latter group will be subject to conditionality as soon as they have drawn on the facilities, as yet to be brought up to size. One question is how many euro countries will be left only under normal, though still intensified, surveillance. The new monitoring mechanisms could open the way to greater ECB activism; but this is a decision that only the central bank itself can take.