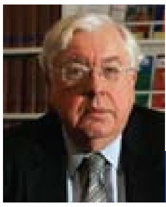
OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

February 2011



EMU changes will be global

Germany leads path to new European governance

John C. Kornblum, Advisory Board

The European debt crisis will be resolved one way or another. While we cannot predict the outcome, we can be sure that, when it is over, the European Union as we have known it during the past half a century will have ceased to exist. This will lead to a fundamental change in the way European and North American partners deal with each other across the Atlantic and globally.

Myriad questions abound. They are as much about politics and national culture as about economics. Are austerity and budget cutting the right solutions for underperforming economies? Can the relatively new democratic systems of countries such as Greece, Portugal and Spain bear the political and social burden of months, if not years, of declining standards of living? On the other hand, will the richer, more successful euro members be willing to subsidise the poorer-performing countries?

All of this has the makings of a major restructuring in Europe's political and social systems, in a delayed result of the 1989 fall of the Berlin Wall. Pre-1989 Europe was a protected island of relative prosperity shielded from global pressures by American protection and the self-censorship engendered by the fear of thermonuclear war. European leaders had lost the habit of thinking and planning strategically. 'Building Europe' was virtually their only goal. Only after 1990 were European societies slowly but steadily exposed to the full force of global change. Germany has done better than most, because it is more developed, but also because it had the discipline and the incentive to make important changes. The challenges of reunification ultimately proved positive by pushing Germany towards modernisation rather than simply imposing a financial burden as most Germans still seem to believe.

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Schröder indicates central banking shake-up by calling for Luxembourger to run ECB

Gerhard Schröder, the former German Chancellor, has paved the way for a possible shake-up in European central banking by calling for a Luxembourger to head the European Central Bank. His statement may strengthen the likelihood that Yves Mersch, governor of the Luxembourg central bank, will be favoured. Schröder says Germany should support common 'Euro bonds' to pool European debt and increase guarantees to improve availability of the EFSF bail-out fund for hard-up European states. 'This would be a signal to the markets.' **FOR INTERVIEW WITH GERHARD SCHRÖDER SEE P. 8-15.**

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Dollar shifts

US role in decline

Ousmène Mandeng

The unrest in Egypt has provided a reminder of the role of the dollar in the international economy. On the one hand, mounting political uncertainty in Northern Africa and the Middle East is likely to underpin its 'haven' status. On the other hand, markets have shown an appropriate amount of differentiation and contagion has been limited.

There appears a general consensus – shared even by some thinkers in the US – that the dollar's share in the world monetary system will necessarily diminish in coming years. Certainly this is the view of the Chinese leadership.

One way to institutionalise and control this trend would be for G20 central banks to undertake to make allocations of a certain portion of their foreign exchange reserves, say 10% of the total, to emerging market currencies over the next five years. This would be a major step to world monetary reform.

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Official Monetary and Financial Institutions Forum

One Lyric Square
London W6 0NB
United Kingdom
t: +44 (0)20 3008 8415
f: +44 (0)20 3008 8426

David Marsh
Co-chairman
david.marsh@omfif.org
+44 (0)20 3008 5207

Michael Lafferty
Co-chairman
michael.lafferty@omfif.org
+44 (0)20 3008 8415

Evelyn Hunter-Jordan
Managing Director
evelyn.hunter-jordan@omfif.org
+44 (0)20 3008 5283

Edward Longhurst-Pierce
Kevin Molloy
Freddie Leclercq
OMFIF Secretariat
edward.longhurst-pierce@omfif.org
kevin.molloy@omfif.org
freddie.leclercq@omfif.org
+44 (0)20 3008 5262

Neil Courtis
Development Director
neil.courtis@omfif.org
+44 (0)79 4747 5044

Malan Rietveld
Head of OMFIF Education
Chief Economist
malan.rietveld@omfif.org
T: +27 (0)21 422 0681
M: +27 (0)73 776 7810

Sanjay Ujoodia
Chief Financial Officer
sanjay.ujoodia@omfif.org
+44 (0)20 3008 8421

Darrell Delamaide
US Editor
darrell.delamaide@omfif.org
+1 (0)202 248 1561

Christopher Goodwin
Sales
christopher.goodwin@omfif.org
+44 (0)203 008 5262

Emerging problems

Reversal of fortunes

David Marsh, Co-chairman

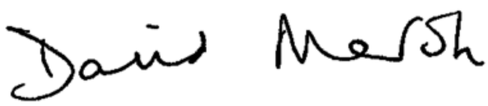
The New Year has demonstrated that what goes up frequently comes down. Emerging markets – more sensibly known as 'high growth economies' – have become a victim of their own previous success, with investment perceptions damaged by a mixture of growing inflationary pressures, export-damping currency appreciation and fears of political and social unrest.

The February Bulletin takes a global view both on the effects of the sovereign debt crisis in Europe, evinced by John Kornblum's magisterial front-page essay, and on the growing strains in the emerging markets. Ousmène Mandeng makes a powerful plea for central banks to accept the logic of a declining world role for the dollar by adopting targets for investing in emerging market currencies.

Both Michael Kaimakliotis and Andy Seaman look at the dangers of growing debts in developed and developing countries, with the risks of higher inflation especially in the debtor nations of the industrialised world not yet priced into financial markets. Mariela Méndez Prado asks what Latin American countries can learn from the experiences of the euro. Malan Rietveld, now relocated to his native South Africa, focuses on the Reserve Bank's probable tilt to tighten credit – symptomatic of a new set of challenges now sweeping across the high-growth regions.

Previous miscalculations by the Federal Reserve overshadow the articles on US monetary policy by Darrell Delamaide and Steve Hanke, the former dwelling on misjudgments over the burgeoning credit boom in 2005, the latter calling on the Fed to raise interest rates now to ward of the threat of world-wide contamination from loose US monetary policies.

Gerhard Schröder sets out his recipes for euro stability, Stewart Fleming says the euro will be saved but asks whether it will be weak, Michael Lafferty assesses the likelihood of banking splits in the UK and William Keegan portrays the Labour party's latest Keynesian hope. Stefan Bielmeier spots a euro revival. Just to maintain a spirit of healthy competition as well as sense of déjà-vu, Freddie Hopson opines 2011 will be, despite everything, the Year of the Dollar.



Note on contributors to February Bulletin

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore

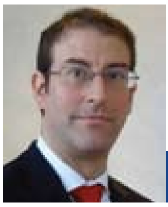
Michael Kaimakliotis is Head of Investments, Quantum Global Wealth Management

John C. Kornblum, US ambassador to Germany (1997-2001), is Senior Counselor at Noerr

Ousmène Mandeng is Head of Public Sector Investment Advisory at Ashmore Investment Management

Mariela Méndez Prado is Professor in the Faculty of Economics, FEN-ESPOL, Ecuador

Andy Seaman is Fund Manager and Partner at Stratton Street Capital



Debt fault-lines split the world

Inflation worries could hit emerging market creditors

Michael Kaimakliotis, Quantum Global Wealth Management

A principal concern for global investors is high indebtedness throughout much of the world economy. Fault-lines are opening up between the old and the young, between core and peripheral Europe and between tax-payers and bond-holders. But the most critical fault-line is between the developed world and the emerging markets.

As debt levels rise, debtors and creditors have increasingly opposing objectives and incentives which can lead to destabilising outcomes.

Overall debt is focused on the developed nations, with the emerging economies representing some of the most important creditors. Tensions will get bigger if, as expected, the developed countries turn to inflation to erode the value of their debts. Whatever the protestations of the US and other leading industrial countries, it is difficult to avoid the conclusion that this will be the outcome.

At the helm of the debtors' list, the US can be expected to resort to its most powerful tool: not military might but the power to print dollars. For financial markets, the outcome of such a scenario will be an extended period of low real interest rates, followed by high inflation and bubbles throughout the emerging markets. There is likely to be a sharp adjustment in the nominal exchange rate of China, the principal banker to the US. Investors would do well to favour real assets, avoid long-term bonds, and expect a steeper US Treasury curve from five to 10 years.

While question marks remain over European sovereign credit exposure, in general, emerging market investments can be expected to do well. The short-term outlook for emerging markets is clouded by inflation risks. Emerging economies are operating at or above their potential but currently inflation is being driven primarily by higher food prices, which represents a much large proportion of the consumption basket than in the developed world. The result is upward pressure on emerging market interest rates which risks attracting large and potentially destabilising capital flows. Of even greater concern is the link between higher inflation and social unrest. We can see this most dramatically in Egypt but the threat is significant in a number of emerging economies. Despite these risks, fundamental factors continue to favour emerging economy investments, especially on a longer-term perspective.

Financial markets seem unprepared for a prospective increase in developed country inflation. Five-year forward inflation break-even rates measured by US inflation-indexed bonds have risen from 2.2% in August to near 3% now, but they are only marginally above the average rate of 2.75% over the past 10 years.

On the overall debt problem, it is important to take a comprehensive view. In the US federal debt is around 70% of GDP, which is worrying enough. But the picture worsens dramatically if other sectors of the economy such as state and local municipalities, households and corporate are taken into account, when economy-wide debt surges to 300% of GDP. Perhaps surprisingly, countries like Germany and France face similar average debt ratios, while those in Japan (around 500%) and the peripheral European countries are far higher.

The emerging economies stand in sharp contrast. For example, comparable measures of economy-wide debt to GDP are only 150% for China, India and Brazil. These extreme levels of debt are balanced by correspondingly high levels of credit. It is important to understand that as debt levels rise, debtors and creditors have increasingly opposing objectives and incentives which can lead to destabilising outcomes. At low levels of overall debt, debtors and creditors have fairly consistent objectives. The tools and factors that can reduce the debt burden (default, inflation, changes in law and policy) tend to introduce high costs which outweigh the potential benefit of debt reduction. We seem to be nearing a point where the benefits may begin to outweigh such costs. In such situations, outcomes are not necessarily determined by free markets but rather by the power that each 'player' can muster.

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So while free markets may provide a certain discipline and limit the set of possible outcomes, the way forward may increasingly be better characterised by competitive game theory than by traditional macroeconomics. How will this affect the struggle between emerging market creditors and developed world debtors? Much attention is focused on the Chinese exchange rate. Economists argue over whether a revaluation would be a panacea, a placebo or something in between. The Chinese, on the other hand, deny they have manipulated their currency.

China's currency has appreciated in real terms by an average annual rate of 2.6% since 1994. This makes it the ninth strongest currency out of the 58 for which the Bank for International Settlements calculates real and nominal effective exchange rates. [See chart below.] However, the real appreciation was 5.5% at an annual rate from 1994 until 2000 but fell to 1.7% thereafter.

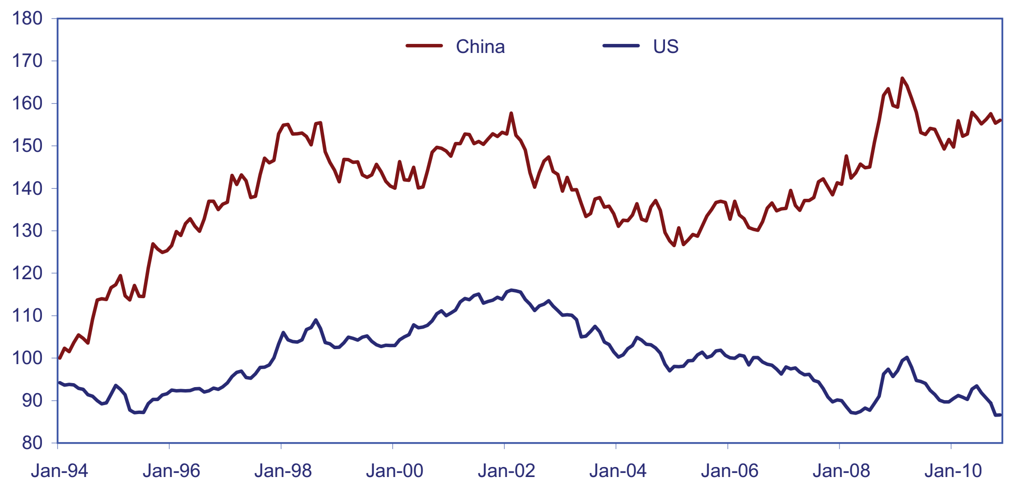
In 2000 China entered the World Trade Organisation, and this deeper integration could have been expected to increase convergence with the rest of the world and therefore the rate of currency appreciation. Yet, instead of this, pressure for a more rapid appreciation was channelled into massive accumulation of reserves. Indeed, China accumulated reserves at a 30.8% annual rate since 2000 while its trade balance expanded at a 25.6% rate over the same period.

China's efforts in damping pressure on the exchange rate have had a significant effect not only on the US but also on its neighbours in Asia, which have lost market share in America over the past decade. A report in January from the Congressional Research Service notes that between 1996 and 2009 the share of US imports coming from China rose from 6.5% to 19% while those from Asia declined modestly from 38.8% to 37.6%. As an earlier CRS report notes: 'China's exports to the United States are taking market share from other Pacific Rim countries, particularly the East Asian newly industrialised countries (NICS), which have moved most of their low-end production facilities to China.'

It could be that we are now entering a new phase of Chinese exchange rate policy. As US Treasury Secretary Timothy Geithner said in January, the renminbi is now appreciating against the dollar at an inflation-adjusted rate of 10% a year, in view of the accelerated nominal appreciation since June 2010 and the substantial difference between Chinese and US inflation – 5% versus about 1% respectively. This pattern, noted explicitly in the US Treasury's formal assessment of Chinese exchange rate policy on 4 February, describes a trend that is almost certain to continue in 2011. olution of the quandaries over the Chinese exchange rate will have implications not just for the US and Asia but also for the entire relationship between developed economies and emerging markets.

China's efforts in damping pressure on the exchange rate have had a significant effect not only on the US but also on its neighbours in Asia, which have lost market share in America.

Real effective exchange rates – renminbi v. dollar



Source: Bank for International Settlements

Euro lessons for the sucre

Currency for Latin America will be long haul

Mariela Méndez Prado, Advisory Board

The sucre could blaze a trail in Latin America similar to the effect of the euro in the Old Continent – or it could run into similar difficulties based on insufficient economic convergence. Linking the eight-strong ALBA group – Antigua and Barbuda, Bolivia, Cuba, Dominica, Ecuador, Nicaragua, St. Vincent and the Grenadines and Venezuela – the sucre is a virtual currency, a composite unit of account valued at 1.25 to the dollar that was introduced in January 2010 as the centrepiece of an embryonic clearing union.

Establishing a regional currency in Latin America as an alternative to the dollar will be a long haul.

Named Sistema Único de Compensación Regional, or Unified System for Regional Compensation, the sucre is intended eventually to replace the dollar as a medium of exchange and improve integration of trade and investment in Latin American economies. So far however it is a small-scale experiment which is a long way from establishing itself as a alternative to a dollar-based system.

The left-leaning ALBA group (Bolivarian Alliance for the Americas) was created as a counterweight to the US-orientated Free Trade Agreement of the Americas (FTAA). Just as it in the case of the euro, a strong reason behind the sucre was to build regional economic self-sufficiency and cohesion. This is indicated by the eponymous link with Antonio José de Sucre, the so-called Grand Marshal of Ayacucho who was a leading figure in Venezuelan and Latin American independence, and who gave his name to the Ecuadorian currency in existence between 1884 and 2000, when it was replaced as legal tender by the dollar.

The aspiration toward a Latin American financial architecture through the sucre adds to previous integration projects including the establishment of a customs union, where achievements have been hamstrung by tariff discrepancies and lack of political will to promote further harmonisation.

Whether larger countries such as Argentina, Brazil, Chile, Colombia and Peru will eventually join the sucre scheme is a highly important question. Such adhesion would further the sucre as a regional unit in the same way that the European unit of account was developed as a forerunner to the euro during the 1970s and 1980s. The lesson from Europe is that such composite units only become functional when the private sector adopts them for pricing and carrying out transactions.

Opinions on future development vary widely. Ecuador has ruled out the possibility that the sucre could become a regional currency in circulation like the euro, but President Hugo Chavez of Venezuela ambitiously suggests it may emerge as a reserve currency.

European experience tends to suggest caution is necessary. After the economic and financial crises that affected the European Union and as a result of the broad differences in economic performance of its members, Europeans are seriously questioning the permanence of monetary union. Clearly, considerable coordination of economic policy is required to guarantee durability.

Both Ecuador, with the dollar as local currency for the last 10 years, and Bolivia, with the dollar-linked boliviano, have relatively stable currencies. Trade with countries such as Nicaragua, Venezuela and Cuba could be facilitated by the sucre clearing union, although Cuba's non-use of the dollar in international transactions creates complexities.

Latin Americans are watching Europe's troubles with great attention. History shows that monetary integration on the whole results from a previous process of economic integration. It is not so much the starting point, rather the destination. That experience suggests that establishing a regional currency in Latin America as a genuine alternative to the dollar will be a long haul.

New South Africa challenges loom

Marcus may move to tighten credit

Malan Rietveld, Chief Economist

Gill Marcus has steered the South African Reserve Bank through an exceptionally tricky period with aplomb. Now she and her team must prepare for a new challenge.

Since taking the reigns as governor in Pretoria in November 2009, Marcus has continued a policy of gradual monetary easing started one year earlier by her predecessor Tito Mboweni. The Reserve Bank's policy rate has been cut from 12% in December 2008 to the current 5.5% reached in November 2010, with Marcus taking over with rates at 7%. Despite the fall in interest rates, the rand strengthened in 2010.

This resulted in predictable calls from South Africa's political Left and exporters (often awkward bedfellows in their attacks on the Reserve Bank's monetary orthodoxy) for the central bank to do more to weaken the currency. Last month, the exchange rate activists were joined by no lesser authority than Nobel Prize winner in economics Joseph Stiglitz, the former World Bank chief economist. Stiglitz argued that South Africa needed a more competitive exchange rate to accelerate growth and create jobs.

Marcus, a former deputy governor of the Reserve Bank under Mboweni who subsequently chaired the Western Areas mining company and then Absa Bank, deserves great credit for standing her ground. Recently, she pointed out that intervention in the currency markets to stem the rand's ascent had been an expensive failure. She also pointed to the benefits of a stronger currency, most notably the pass-through effect to lower inflation.

Now, the tide seems to be turning. A number of factors suggest that Marcus needs to prepare markets and stakeholders for a second phase of her tenure in which credit tightening is the order of the day. First, while inflation is hovering around the lower end of the bank's 3% to 6% target, private sector forecasts suggest it could be pushing towards the upper end of that range by the end of year.

Second, South Africa is unlikely to escape the global phenomenon of commodity and food price-generated inflation. Although monetary policy can do little to counteract resource-driven price increases, tighter credit can mitigate second order effects through a potential wage-price spiral. Third, the rand's rise may be over. Although this is the most difficult variable to predict, the flight out of the rand during the political turmoil in North Africa and the Middle East has wiped out a large portion of the 2010 appreciation, underlining how quickly the exchange rate picture can change.

Markets are now pricing in at least a 50 basis point hike this year (with a roughly 50% chance of a full percentage point rise by the year end). This presents Marcus and her team with fresh challenges. The difference between South Africa's current and potential growth rate (the output gap) remains large. Additionally, the rand's decline may be temporary and that rate rises will simply promote a new round of currency appreciation this year.

The political picture will presents major obstacles. The South African government has ushered in the New Year with a single-minded focus on job creation. As part of an effort to boost employment, the organised labour wing of the ruling ANC appears to have been persuaded (or forced) to make concessions towards employers on various labour market policies. Given these compromises in the name of job growth, the Left is certain to demand that the Reserve Bank plays its part by not raising rates too sharply.

Governor Marcus faces a struggle. But she enjoys the advantage of personal credibility. By sticking to consistent policies in 2010, Marcus contributed to the anchoring of inflation expectations and generally inspired confidence, despite a volatile environment. Should she delay future rate rises to see if some of the inflationary pressures prove temporary, she will probably retain the benefit of the doubt among most financial market participants.

Should Governor Marcus delay future rate rises to see if some of the inflationary pressures prove temporary, she will probably retain the benefit of the doubt.

Dollar shifts *(continued from page 1 ...)*

A formal target on emerging market currencies would help assuage worries about a disorderly exit from the dollar. It would allow for an appreciation of emerging markets currencies, thus meeting calls for a weak dollar and euro while addressing individual country concerns of bilateral exchange rate appreciation.

Such a move would not require a treaty or complex multilateral agreements.

The allocations could be managed by individual central banks or by central banks investing in a pooled fund to be managed by a third party. Naturally, it will be some time before emerging market currencies replace the main units of world money. However, they could assume important secondary roles. In terms of liquidity and size, many key emerging economy fixed-income markets already exhibit properties in line with or superior to other secondary currencies such as the Australian and Canadian dollars or the Danish and Swedish crowns.

Upheavals in world savings rates underline value of NFA analysis

By Andy Seaman, Partner, Stratton Street Capital

The world economy faces a perilous period where enormous adjustments in countries' savings rates will need to take place. Indebted countries will need to save more and consume less and to avoid a devastating slowdown in global growth, the world's creditor nations will need to consume more and save less.

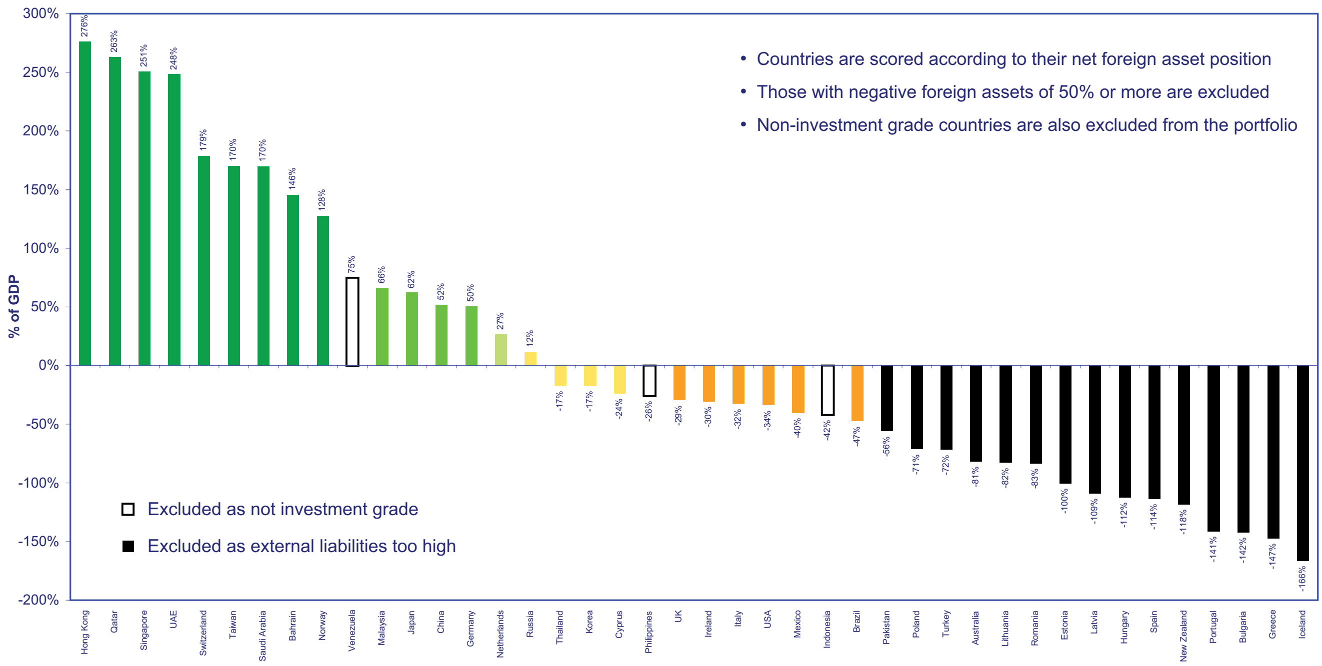
The wealth of a country depends on the wealth of its citizens. In our database of 128 countries, only 34 countries have a positive net wealth. The other 94 countries are indebted and therefore owe the money to a relatively small group of countries. This mismatch between borrowers and lenders is unhealthy for the world economy as it means that any decline in credit availability will impact a large number of countries simultaneously.

The best-known example of an overly indebted economy is Iceland, which accumulated debt to foreigners of over 180% of GDP. This is the highest debt to GDP ratio in the world, aside from Nicaragua. Despite this the country's debt was rated Aaa as recently as May 2008.

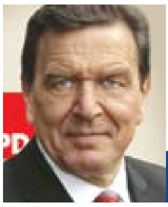
Investors would be well advised to adopt a fundamental assessment of country risks through Net Foreign Asset (NFA) analysis. NFA measures the value of assets a country owns abroad minus debts owed to foreigners. The NFA position describes the degree to which a country's level of indebtedness to foreigners and/or its exposure to currency risk implies instability in the future. In bull markets, money flows from creditors (seeking higher returns) to debtors. In bear markets, the opposite is true as creditors worry about 'getting their money back.' NFA analysis gives investors a better chance of working out who will bear the burdens.

A major cause of debt accumulation is the perverse construction of bond indices whereby the greatest weight is given to the biggest debtors. As a country becomes more indebted, their weight in the index increases, whereas smaller, well-run economies which have little debt have very low representation. As most fund managers benchmark themselves against these indices, this means that the more indebted a country becomes, the greater the weight in the index and the more fund managers need to acquire that debt to match their index. This creates a misallocation of capital across the world on a colossal scale.

Net foreign asset positions for selected countries in % of GDP – criteria for Wealthy Nations Bond Fund portfolio



Source: Stratton Street Capital and extended version of External Wealth of Nations Mark II data base developed by Lane and Milesi-Ferretti (2007)



Wanted: political union for euro

Ex-German Chancellor favours Luxembourger for ECB

Gerhard Schröder, former German Chancellor

Gerhard Schröder, the former German Chancellor who presided over the introduction of the euro in 1999, calls for more German funds and guarantees to bail out the troubled members of monetary union, coupled with tougher action on economic governance and moves to political union for the euro 'core'.

A man well known for his hard-headed and unsentimental stance on the euro, Schröder – who now plays no role in day-to-day politics – neatly encapsulates the various dilemmas facing his successor Angela Merkel. Interviewed in his Hanover law office, Schröder lays down a marker for the future leadership of the European Central Bank by stating baldly that it should pass not to a German but to a representative of the smallest and wealthiest EU state, Luxembourg.

Marsh: What could Germany have done better in handling the euro crisis?

Schröder: Greece should have been helped earlier. It was clear for quite some time that Greece would need funding. In substance the Government was right to involve the International Monetary Fund. I know the processes in the European Council. You get a decision only if these are linked to firm conditions and there is pressure from outside. However, Chancellor Merkel should have acted earlier, which would have saved a lot of money. Six weeks were wasted.

Marsh: Do you see positive signs from the crisis?

Schröder: The crisis offers a chance to analyse from the start of economic and monetary union (EMU) what things were done right, and which were wrong. I was initially sceptical about the single currency, partly for factual reasons; I was a supporter of the 'coronation theory', according to which a monetary union should come only at the end of a long process of convergence. Naturally, another reason for my stance reflected electoral factors.

Chancellor Merkel should have acted earlier, which would have saved a lot of money. Six weeks were wasted.

A Chancellor whose reforms set a model for neighbours that are now struggling

OMFIF commentary

Schröder is one of only three former German Chancellors still alive. (The others are Helmut Schmidt, still intellectually active although wheelchair-bound at the age of 92, and Helmut Kohl, 80, who is incapacitated and seldom appears in public.) Aged a sprightly 66, Schröder concentrates on a business career and his young family partly inherited from his fourth marriage.

After seven years of heading a coalition between his Social Democratic Party (SPD) and the ecologist Green party between 1998 and 2005, Schröder has sparked controversy by his closeness to Russia and particularly with president-turned-prime minister Vladimir Putin. But he is still accorded a good deal of respect, above all because of the economic reforms he brought in under 'Agenda 2010' in 2003. Schröder and many others see these successful efforts to restructure the German economy – in which he was powerfully aided by larger and smaller businesses across the country – as paving the way for the eventual German upswing. These reforms also set a model for other countries in Europe now struggling with huge problems of lagging competitiveness against a redynamised Germany.

Schröder's closeness to business marked his time as Chancellor. After leaving office, he became chairman of the board of the Russian-German pipeline company Nordstream which has raised hackles particularly among the Poles as setting up a privileged energy partnership between the two powerful states flanking Poland. He is an independent director of TNK-BP, the Russian oil company in which BP has a stake, and he advises Swiss publishing house Ringier on international political issues.

He predicted before he became chancellor in November 1998 that the euro would increase Germany's dominance in Europe – a forecast that has proven remarkably accurate. During his chancellorship, he was involved in several bruising clashes with the European Central Bank over the Stability and Growth Pact, which Jean-Claude Trichet, the ECB president, regularly accuses him of undermining – a charge he briskly, but not entirely convincingly, denies.

Marsh: In the meantime, you changed your mind?

Schröder: I became convinced that one could start monetary union without political union even though it looked like putting the cart before the horse. For politics is not the same as theory. I thought the introduction of the euro would force us towards political union.

Marsh: Why did this not happen?

Schröder: There were two reasons. First, the conservative parties of Europe were against a European economic government: close coordination of budget, fiscal and social policies. They wanted to prevent this at all costs. The second reason reflected the attitude of countries like Britain, as well as Sweden and Denmark. They were not in monetary union, but they wanted to have their say in European affairs and intervene politically. The answer would have been to create a system with an economic government linking only those countries that were members of EMU. Otherwise, the system always risked being exposed to the slowest members of the European Union, such as the Czech Republic under [former prime minister and now president] Václav Klaus, who would have been content with the mere functioning of the common market and had no desire for further intensification of cooperation.

Marsh: Even before your time as Chancellor, you clearly analysed the outcome of monetary union, saying it would enlarge Germany's industrial dominance in Europe. This is exactly the opposite of what was intended, but it happened.

Schröder: Take a country like Italy, for example. In the past, Italy resorted to devaluation whenever it faced pressure on competitiveness. Italy cannot do this any more. Therefore, it is clear that Germany, as the No. 1 economy in the EU, has further secured its position. In addition, Germany strengthened its competitiveness through the Agenda 2010 reform policy launched in 2003. Germany did things that were urgently needed, at a time when other countries in Europe considered such policies were not necessary.

In the past, Italy resorted to devaluation whenever it faced pressure on competitiveness. Italy cannot do this any more. Therefore, it is clear that Germany, as the No. 1 economy in the EU, has further secured its position.

Marsh: Were the main factors behind Agenda 2010 European or domestic in nature?

Schröder: The background was German demography, much more than the situation in Europe. While the birth rate was in decline, life expectancy was increasing. The social security system is entirely financed through current employment. Individuals no longer enter a job aged 14, work for 50 years and then retire. To meet these challenges and to preserve the welfare state, Germany needed reforms. We carried these out, but we paid the price by being voted out of office in 2005.

Marsh: What does this tell us about Social Democracy in Germany?

Schröder: I do not criticise my own party, but if the SPD had held to the principles of Agenda 2010 and continued to fight for them, then they would now be by far the most advanced Social Democratic party in Europe – and would, I am convinced, still be in power. But that's the problem of the democratic Left in Germany that we always swing between dreams and reality. This gives Social Democracy a human face, but it is not always helpful for governing...

Marsh: Does the Agenda 2010 make Germany a model for the rest of Europe?

Schröder: You cannot ignore what we in Germany have done. When we introduced the Agenda 2010, we were the black sheep in the family of the European Socialists. We faced criticism, even defamation. Now, countries like Portugal, Greece, Spain, all with Social Democratic governments, have to implement what they failed to do earlier. These countries all enjoyed low interest rates after the introduction of the euro. They thought: 'That's all I need to do.' But these countries are now facing the same difficulties as we did in Germany in 2003, with falling birth rates and increasing financing problems for the welfare state. We implemented the reforms during an economic slowdown. Now, under still more difficult circumstances, other countries have to do the same.

Marsh: Was it a mistake to bring weaker countries like Italy into monetary union?

Schröder: Politically, it was not possible to leave out Italy – a founding member of the European Community. The same was true for Belgium, even though, as with Italy, the public debt was above 100% of GDP. These were political decisions. Theo Waigel [then German finance minister] repeatedly expressed scepticism about the inclusion of Italy, and he was constantly criticised for this. Although this was not the most important question, it would not have been in the interests of the German export industry if a country like Italy had remained outside.

Marsh: But the numbers were partly covered up. And Greece joined during your chancellorship.

Schröder: We could hardly say that the data did not correspond to reality. Probably the Greeks tricked us, but we were all dependent on the data from the European Commission. I could not say to the Greek prime minister: 'You are cheating us.'

Marsh: The European Central Bank accuses the German government, during your Chancellorship, has having undermined the Stability and Growth Pact and set other members a bad example.

Schröder: We didn't do this. We did not water down the criteria, we politicised them… One must understand the political sensitivity. If, in monetary policy, countries transfer power to a European Central Bank, it is impossible that they will give away decision-making authority in other issues such as budget policy. That's the compensation for giving up sovereignty in monetary policy.

Marsh: But, through this politicisation, do we not open ourselves to the risk that budgetary sinners will sit in judgment over misconduct by other sinners?

Schröder: It is illusory to expect that all such decisions could be taken by independent bodies of experts… National policy-makers would not accept such a thing. Additionally, you must have a range of acceptable criteria, such as for the debt, so that you are not bound by rigid figures. These decisions must be political decisions. Otherwise you weaken democracy.

We did not water down the criteria, we politicised them… If, in monetary policy, countries transfer power to a European Central Bank, it is impossible that they will give away decision-making authority in other issues such as budget policy.

Paradox at the heart of the euro – debt crisis raises chances of survival

Stewart Fleming, Board of Contributing Editors

The worse Europe's sovereign debt crisis has become, the more likely has been the euro's chances of survival. This is the paradox at the heart of the euro. Were Europe's sovereign debt crisis to lurch out of control and threaten to land already vulnerable banks with further heavy losses, then, like the Latin American debt crisis of 1982 which came close to bankrupting America's major banks, it would cause the European financial system to implode.

So closely are global, and especially trans-Atlantic financial markets integrated, this would trigger the devastating, and much feared, double-dip recession. This time Asia would not escape so lightly. An uncontained sovereign debt explosion in Europe could trigger the break-up of the European Union.

No wonder then that, behind the scenes, intensive official efforts are underway to prevent Europe's debt crisis escalating. No wonder the top officials of the Group of Seven industrial countries conferred before the announcement of the official bail-outs of Greece and Ireland. No wonder China is offering to buy Portuguese and Spanish debt.

Even judicious commentators like Sir Samuel Brittan, for decades the Financial Times's erudite and highly respected columnist, wrote towards the end of last year (FT, 4 November 2010), that the euro's days were numbered. But in recent weeks commentators and professional economists have begun to argue that the single currency will survive. At the end of January, President Nicolas Sarkozy and Chancellor Angela Merkel redoubled their affirmations of confidence. For a number of reasons I have never doubted the single currency's capacity to weather the storm which erupted in autumn 2009 with revelations that Greece's public finances were in a mess.

But forget the brave words about a strengthening global economy. The worst economic crisis since the Great Depression is far from over. Recovery

(continued on page 11 …)

Marsh: What consequences do you draw now from the aid programme for countries such as Greece and Ireland?

Schröder: The No Bail-Out clause could never represent the final answer. This clause was a kind of tranquiliser for the introduction of the euro. During the relatively relaxed time in the initial years of EMU, it was not necessary to put the clause into question, but now that we have difficulties, it is impossible to maintain it.

Now, after interest rates have risen sharply in the bond markets for some EMU members, we have no choice but to offer refinancing on better terms. This is the logical consequence of monetary union. The stronger countries have to help the weaker ones.

Marsh: What practical measures do you have in mind?

Schröder: I favour the proposal of [Jean-Claude] Juncker to introduce common Euro bonds. If you want to keep the European Union and EMU within it as a central element – and the end of monetary union would be a disaster – then common bond issues represent a form of compensation for member states' abandonment of exchange rate flexibility.

Rather than denying this, the German government should simply accept that this is the logic of the single currency. In the various aid packages, the federal government acts under pressure every time, and during these processes it always finds things it doesn't want to do. It would be better to follow a coherent policy from the outset.

That's the advantage of the crisis: that we can and must now finally talk about things that matter in EMU. You can't avoid the conclusion: we have to organise a federal Europe for members of EMU... even if this is a terrible idea for the UK.

Marsh: But it's all very well for you to give this advice, now that you're no longer in day-to-day politics. The I government has to live with difficulties within the coalition. It has incurred the displeasure of the people regarding further solidarity for the Greeks or the Irish. The Government faces seven state and regional elections this year. Many German think they have already made enough sacrifices for Europe.

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Many banks remain in intensive care and are vulnerable

(... continued from page 10)

will at best be slow, not least in the US where the housing market is teetering again and both the state and private individuals are over-burdened with long-standing debts which need radical surgery.

In the euro area, as in America, many banks remain in intensive care and are hugely vulnerable to sovereign debt. French banks' exposure to the six European problem countries – Portugal, Ireland, Italy, Greece, Spain and Belgium – is officially estimated at one third of French gross domestic product and almost three times the banks' total capital.

While many predict that a peripheral country like Greece or Portugal might choose to quit the club, few have examined the dynamics. An exception is financial consultant Graham Bishop, who points out that at the first hint of such a defection bank depositors in the country in question would move their euros quite easily to say, a safer German bank or invest in German government euro-denominated bonds. But, just like a run on a bank, this 'run' on a sovereign euro member would simply trigger the broader collapse officials are seeking to avoid.

To avoid such a disaster, the central issue is how much money rescuers will provide and how much reform (adjustment) will be required of the malefactors.

Germany, with firm support from other, mainly northern European countries and the European Central Bank, is determined to install a rigorous economic governance regime to ensure the crisis is not repeated.

Just as importantly, it wants economic reforms to allow euro members to compete internationally. Inevitably, weak borrowers do not want a tough governance regime.

In the next few weeks it will become clear that the euro will survive. But doubts remain about the combination of stricter rules and market discipline needed to ensure its long term stability. There is still a risk that financial markets will see the euro as a soft currency, not the successor to the D-Mark its founders wanted.

Schröder: We had the courage to follow through the reformist Agenda 2010 in the midst of a difficult period of sluggish growth. This was anything but popular. I would also expect the current government to muster the courage to make unpopular decisions that are consistent and necessary to preserve EMU. As for the willingness to help countries in trouble, this seems no longer to be disputed in principle in the [Christian Democratic] Union.

The Union has thrown overboard many of its basic points on EMU. As in other areas such as immigration policy, the CDU has shown unlimited flexibility. But the government should not always carry out this adjustment in small steps; instead, this policy should be accompanied by a vision to win public acceptance.

My impression is that the latest proposals in the direction of economic government in Europe go in the right direction. The question is whether – in view of quarrelling in its own ranks – the Government has the strength to implement these proposals.

Marsh: Is not it dangerous for Europe if the Germans seem politically to be running the show. One recalls the old slogan: 'The German character will edify the world'. That was not the goal of monetary union, just the opposite, in fact.

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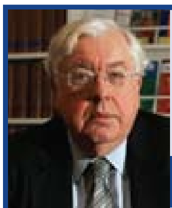

Global EMU changes

John C. Kornblum, Advisory Board

(continued from page 1 ...)

But until last year Germany had not begun the important psychological changes needed to accompany a global economic role. In particular, the country had not understood that post-Cold War Europe will become more rather than less diverse. Europe's new diversity requires a new sort of governance, which more resembles an ever-changing political matrix rather than the strict treaty relationships of today's EU. Angela Merkel seemed to be abandoning Germany's long attachment to European federalism by stating recently that Europe would move from a Commission-oriented structure to a community-based approach in which the member states would have the major say. Her proposals for a new concept of governance for competitiveness – even though they are hotly contested by some member states and also by her Free Democrat coalition partners – appear another step in this direction.

The complex cultural background of the euro crisis underlines the importance of an historical perspective to help put the full drama of what is happening into the correct perspective. The US is not free from subjective judgments about the very existence of the euro. Among the most exciting of my jobs as a young American vice consul in Hamburg in the mid-1960s was, for example, the counting of the gold coins. Every embassy and consulate in Europe had a stash of such coins, which had to be counted regularly. They were to be used in case of war or catastrophe to hire a car, bribe invading Soviet soldiers etc. As late as the early 1970s, the US State Department believed in gold as the common European currency. Gold had the same value for everyone. You could feel and even taste it. A perfect currency for Europe.

The American faith in gold tells us a lot about some basic differences between the US and Europe. The Americans certainly did not consider that, in Cold War Europe, the D-Mark was sound enough to take over a European role. Had the euro existed then, American doubts would have been even stronger. This distrust of 'artificial' money has permeated American public opinion for most of the history of the Republic. Symptomatically, last year the Tea Party movement was calling for abolition of the Federal Reserve on the grounds that it violated the Constitutional Provision against assigning the right to coin money away from direct control of Congress.

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Schröder: This has nothing to do with exercise of power. But since German reunification the situation has changed. Europe was rebuilt after the Second World War on the premise that France was politically dominant, and the Germans gained access to the markets. France's leadership status was expressed in the words of Helmut Kohl that one should always bow twice to the tricolore. After reunification the Germans established themselves as the No. 1 economic power in Europe. Since then France's political dominance has had to be replaced by a real partnership of equals. This is sometimes difficult for the French. President Chirac accepted it only in the last two to three years of his presidency.

Marsh: The French have never made a secret of their distaste for the independence of the central bank. They always wanted the ECB to be subordinate to political control.

Schröder: The French must now realise that ECB independence is irrevocable. But there are other areas where their policies are gaining ground. It is a question of balance. If the Germans accept an economic government, with close coordination of economic, social and fiscal policy, and bands offering some flexibility for the observance of certain criteria such as public debt, then this represents an equilibrium vis-à-vis the independence of the central bank. This corresponds to positions which were long fought for by France. The German Government seems to be moving in that direction.

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Global EMU changes

(... continued from page 12)

For similar reasons, after an initial burst of enthusiasm, by the mid-1970s the US Government and even most well-informed Americans had lost interest in the European unification movement. Once it became clear that Europe was not going to form a 'United States of Europe', patience for the complex steps towards reconciliation began to wane.

When the idea of economic and monetary union (EMU) rolled around, American scepticism was already entrenched. The case was settled by the joint declaration from Chancellor Helmut Kohl and President François Mitterrand that the euro was necessary so that war would never return to Europe. Not having shared the scars of two world wars, America could never understand how such an important project could be founded on this kind of emotional certainty.

In addition, most academic economists recalled America's own difficult experience with a common currency, and wondered loudly how such a process could succeed. Doubts focused on the difficulties in harmonising the economies of such different countries; on the complexity of managing the European Central Bank and the organs which supervise it; and the sheer difficulty of replacing national currencies with a single unit. One highly respected economist, Martin Feldstein, even predicted that the euro, far from preventing war among Europeans, could even cause one.

By the time the EMU was nearing completion in 1997, there was considerable danger that leading American monetary authorities would come out against the project. As Assistant Secretary for European Affairs, I played a small but important role in preventing this from happening. I adopted the classic diplomatic stance that such criticism would not be helpful: it would not succeed in derailing the project, but could harm relations with Europe. I suggested to Deputy Treasury Secretary Larry Summers and Federal Reserve chairman Alan Greenspan that they should reserve comment. They told me to discuss the issue with Europeans and then to make a proposal.

So, without fanfare, I embarked on a mission to Europe in early 1997 and met monetary officials from several countries. These included people from the French Foreign Ministry and Treasury, Dutch parliamentarians and senior German officials such as Jürgen Stark, then state secretary in the Bonn Finance Ministry, now a member of the executive board of the ECB. I asked for an explanation of their goals and asked also how US reactions would be received. Without exception, all these

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Marsh: How would you deal specifically now with implementing the EFSF rescue fund?

Schröder: I anticipate that the EFSF will have to be increased, to raise the threat and hence the credibility vis-à-vis financial markets. But the issue is less the overall volume of this facility, more about the availability. The amount available is far less than €440bn, as collateral has to be installed to maintain the Triple A rating.

If countries such as Portugal and Spain came under attack, the EFSF would no longer suffice. To increase availability, Germany and the other five countries with individual triple-A ratings should expand their guarantees so they vouch for the full amount of the bailout fund, and not just a part.

This would be a signal to the markets that they should not dare to attack individual countries, because the attacker would put itself in danger. It is ironic that we have now introduced a European rescue fund, but its operation is heavily dependent on US credit rating agencies. This is the price we pay for Europe's failure so far to set its own credit rating agency.

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Global EMU changes

(... continued from page 13)

people warned against expressing doubts or criticism. Such an approach would be a disaster not only for trans-Atlantic relations, but also for joint management of the global financial system.

I also wanted to hear their point of view on how a monetary union could function without political unity and in particular how the Stability and Growth Pact would keep things in balance. Before my trip, I had not considered myself well enough informed to have a view on the project. When I returned, I was a sceptic. But whatever my personal views, I worked hard to convince US officials not to oppose the project.

Larry Summers reflected my 'guidance' in testimony before Congress on 22 October 1997 when he said, 'Today an ambitious European project seems close to becoming a reality and is attracting serious attention in the US. The administration has never thought it fitting to enter the debate over whether economic or monetary union is right for Europe, nor over the details of how it should be structured.... Yet no one doubts that Europe still faces serious economic challenges that will have to be overcome if the EMU is to succeed.'

Alan Greenspan was less ready to stick to the agreed points. In an interview with the International Herald Tribune on 2 May 1997, he said: 'The euro will come, but it will not be sustainable.'

Until recently, this scepticism had seemed ill-founded. Now the old doubts are resurfacing. Writing in late 2009, Adam Posen, an American who joined the Bank of England's Monetary Policy Committee in September that year, noted: 'It is revealing that even in the midst of the worst financial crisis in 70 years, one widely…believed to have begun in the US economy and resulting from US policy mistakes, the flight to safety of world savings was to the US Treasuries, and not noticeably to the euro.'

Since the full force of Greece's debt problems burst upon us in March 2010, even strong supporters of EMU have had to admit that the system is in crisis. Rather than adjusting their economies to meet the stability criteria of EMU's strongest members, weaker countries used the high credit ratings induced by euro membership to borrow money from commercial banks to covering deficits generated by their lower productivity. In a globalised financial system, where traders measure their advantage in milliseconds, there is no hiding place for underperformers. The pressures have become virtually impossible to resist. It is these pressures that are driving the Europeans to select a new form of political and economic governance. The world is waiting to see which direction they choose.

Marsh: Do you believe it's the turn of a German to take over as president of the European Central Bank?

Schröder: I doubt whether that would serve the cause of German stability policy. It has nothing to do with professional qualifications; Mr. [Axel] Weber [the Bundesbank president] is a good man. For maintaining and enforcing the German culture of stability, it is possibly better if this is not promoted by a German at the head of the ECB. I would favour a representative of a smaller stability-minded country such as Luxembourg carrying out the job.

Marsh: Do you know Mr. [Yves] Mersch [Governor of the Banque centrale du Luxembourg]?

Schröder: I have not met Mr Mersch, but I know Mr Juncker.

Marsh: Will we see in coming years the accession of major countries to EMU? In the last few years only smaller countries have joined.

Schröder: Poland's membership would be very important. The Polish National Bank is guided by an excellent man [Marek Belka]. Poland is in better shape than many other European countries. I expect that Poland will join within the next five years. If you ask me in general about EU expansion, then I would say Russia needs a formal contract of association, and we would have to bring in Turkey as a full member – of course, with transitional periods in difficult areas such as social and immigration policy

Marsh: Do you speak with Mrs Merkel and Mr Schäuble on European issues from time to time? Do they seek your advice?

Schröder: No. The party system in Germany is too rigid for this.

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Looking ahead – 2011 diary dates

OMFIF Meeting with
Dr Joachim Nagel
Deutsche Bundesbank
Emmanuelle Assouan
Banque de France
17 Feb 2011, London
The Outlook for Financial Markets

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

OMFIF Lecture with
Dr Hans Tietmeyer
Bank for International Settlements
20 April, London
The Future of EMU

OMFIF Lecture with
Dr Jürgen Stark
European Central Bank
11 May 2011, London
Lessons from the ECB

OMFIF Seminar with
Dr Lorenzo Bini Smaghi
European Central Bank
26 May 2011, London
The Outlook for the ECB

OMFIF/Lafferty Conference
The World Banking Summit
29-30 June, London
New Models for Growth

OMFIF Seminar with
Philipp Hildebrand
Swiss National Bank
4 July 2011, Edinburgh
Swiss Franc's Role in World Money

OMFIF Meeting
Asian Central Bank Watchers' Conference
19 July 2011, Kuala Lumpur
Asian Perspectives on World Money

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

Stand-alone future beckons

In UK, retail-only banking may be on way

Michael Lafferty, Co-chairman

Britain's banks could soon turn into financial holding companies with stand-alone subsidiaries for separate activities like retail banking and investment banking. Before long, assuming full transparency, arm's length transfer pricing and a separate treasury for the retail bank, investors might demand that these new financial conglomerates exit activities that are not producing adequate returns. The result could be the creation of retail-only banks – the dream of many critics of today's universal banks.

This is the prospect being considered by the UK government's Commission on Banking, chaired by Sir John Vickers, which is due to report in September. The status quo, where all the activities are conducted within one centrally-managed business – typically under the overall management of an investment banker or corporate banker – is no longer an option, Sir John seemed to hint in a speech in January. The impression he left was that the universal bank is simply rigged to subsidise the investment banking business and the bonuses that go with it.

Discussing one of the arguments made in favour of universal banking, namely that it allows diversification of risks with the result that the probability of bank failure is lower than if retail and investment banking are in some way separated, Sir John rationalises: 'It does not follow that retail bank failure is less likely with universal banking. In this respect universal banking has the advantage that a sufficiently profitable or well-capitalised investment banking operation may be able to cover losses in retail banking. But it has the disadvantage that unsuccessful investment banking may bring down the universal bank including the retail bank. In shorthand, in this simple setting, retail banking is safer with universal banking than with separated banking if and only if the probability that *I* saves *R* exceeds the probability that *I* sinks *R*.'

Britain's banking leadership is not at all happy with a scenario of stand-alone subsidiaries for different forms of banking and is already fighting it tooth and nail, claiming that it will cost major banks billions in extra costs.

Britain's banking leadership is not at all happy with a scenario of stand-alone subsidiaries for different forms of banking and is already fighting it tooth and nail, claiming that it will cost major banks billions in extra costs. Having faced down David Cameron's coalition government on the highly contentious issue of bank bonuses – and threatened to move headquarters outside the UK if the government does not do their bidding – the banks seem to think that this is another battle they can win.

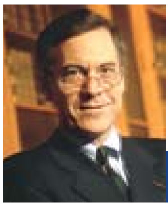
In one respect at least the UK banks have already scored a victory with the Commission, which is not convinced by the arguments for so-called narrow banking where only the entity taking retail deposits would be covered by a state guarantee. 'What sort of institutions would have loans on their books under narrow banking? Maybe mutual funds – a kind of mass securitisation. But to ban the funding of ordinary credit by deposits could have considerable economic cost,' says Sir John Vickers dismissively.

Meanwhile, Britain's senior retail bankers are not saying anything in public, nor have they at any time during the current crisis. The official line at all senior management levels is that the only sensible way to run a bank is the universal banking way.

Out in the branch networks the attitude of Britain's' bank managers is typically different. They know that, in living memory, customers have never been more furious with banks and they appreciate that banks cannot be equally good at serving people, small businesses, large corporates, multinationals and governments. They are also very uncomfortable with the sales-driven culture mandated by head office as well as the vast price increases they have been ordered to impose on retail customers since the crisis began.

Most bank managers dream of the day when they will be able to provide customers with what they really need.

OMFIF
Official Monetary and Financial Institutions Forum



Zero sum game for US policy

Low US interest rates fuel emerging market troubles

Steve H. Hanke, Advisory Board

With the onset of the financial crisis and the collapse of aggregate demand in the US, the Federal Reserve reached for the standard textbook solution to stimulate demand. It pushed short-term interest rates toward zero – a zone in which they have been trapped ever since. The Fed's zero interest-rate strategy has created a credit crunch – yes, a credit crunch – at home and generated dangerous policy responses abroad. This has gone on for too long. It's time for the Fed to raise the Fed funds rate to, say, 2%.

The Fed's zero interest rate strategy has created a credit crunch at home and generated dangerous policy responses abroad. It's time for the Fed to raise the Fed funds rate to, say, 2%.

The distortions don't stop – contrary to Chairman Ben Bernanke's assertions – at the US borders. The Fed-created excess liquidity does not simply stay in the US. It chases yield. This hot money floods into emerging market countries and international commodity markets via so-called carry trades in which dollars are borrowed at 'low' rates and invested in asset markets with higher prospective yields. The hot money carry trades weaken the dollar which reduces the cost of repayment of dollar loans and creates inflationary pressures outside America – most notably in emerging market countries. The hot money flows also fuel commodity price surges.

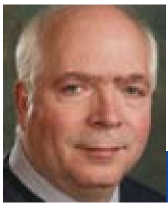
In an attempt to tame the appreciation of their currencies against the greenback, foreign central banks intervene in the foreign exchange markets and accumulate dollar reserves. But, absent huge amounts of sterilisation – selling domestic bonds and bills to mop up the liquidity created by foreign exchange intervention – domestic inflation and asset bubbles in the countries that are hot money destinations spiral upward. In the end, capital controls – which are permitted under the International Money Fund's rules (Article VIII) and represent a residual influence of John Maynard Keynes who was obsessed with hot money flows and carry trades – become increasingly inviting.

In terms of the impact on the domestic economy, the textbooks tell us that these 'low' interest rates should have stimulated investment and given aggregate demand a big boost. The economy should be in a boom phase. But it is barely holding its head above water. Why is this? In the monetary sphere, the Fed has, in a standard Keynesian manner, flooded the economy with high-powered base money since the onset of the crisis. But the money multiplier collapsed and has remained depressed. In consequence, broad money measures, such as M2, have barely budged during the post-crisis period and the economy has continued to disappoint.

For all the pumping of liquidity into the economy, the US is facing a credit crunch. Banks have used their liquidity to pile up cash and accumulate government bonds and securities. In contrast, bank loans have actually decreased, And since credit is a source of working capital for businesses, a credit crunch acts like a supply constraint on the economy.

To understand why, in the Fed's sea of liquidity, the economy is being held back by a credit crunch, we have to focus on the workings of the loan markets. Retail bank lending involves making risky forward commitments. A line of credit to a corporate client, for example, represents such a commitment. The willingness of a bank to make such forward commitments depends, to a large extent, on a well-functioning interbank market – a market operating without counterparty risks and with positive interest rates. With the availability of such a market, even illiquid (but solvent) banks can make forward commitments (loans) to their clients because they can cover their commitments by bidding for funds in the wholesale interbank market.

At present, the major problem facing the interbank market is the zero interest-rate trap. In a world in which the risk-free Fed funds rate is close to zero, banks with excess reserves are reluctant to part with them for virtually no yield in the interbank market. Accordingly, the interbank market has dried up – thanks to the Fed's zero interest-rate policy – and, with that, banks have been unwilling to scale up their forward loan commitments.



Dangers of policy 'groupthink'

Why we need earlier FOMC disclosure

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 (San Francisco currently has no president) 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 rotation at the beginning of 2011 brought in regional bank presidents Charles Evans of Chicago, Richard W. Fisher of Dallas, Narayana Kocherlakota of Minneapolis, and Charles Plosser of Philadelphia.

Plosser is considered hawkish on inflation and interest rates, while Fisher and Kocherlakota lean hawkish. Evans is considered middle of the road. In the first FOMC meeting of the year on 25-26 January, the committee voted unanimously to keep monetary policy unchanged. It was the first meeting without a dissent in a year after Kansas City Fed chief Thomas Hoenig systematically dissented during his year as a voting member.

The Obama administration re-nominated MIT professor emeritus Peter Diamond to the open board position for confirmation in the new Congress, but the Senate has yet to act on it. Some senators had blocked his nomination last year, saying that Diamond, who won last year's Nobel Prize in economics, did not have sufficient macroeconomic experience.

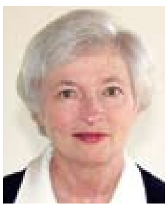
Alan Greenspan

Belated Fed disclosures indicate need for more transparency

The release of transcripts from the 2005 meetings of the Federal Open Market Committee showed that Federal Reserve officials were well aware that a housing bubble was forming. The June meeting from that year included a presentation from Fed economists indicating that housing prices had decoupled from traditional measures of value.

The economists and the FOMC members were also alert to the dangers posed by an increase in nonconventional mortgages, such as interest only, adjustable rate and Alt-A mortgages, which, they suggested, were not fully capturing the risk in these loans. Fed Governor Susan Bies noted that the securitisation of mortgages could lead to laxer lending standards because banks did not keep the loans on their books. However, the discussion – which appears somewhat desultory in the dry transcript – meandered down some seemingly irrelevant paths as chairman **Alan Greenspan** focused on the relationship of land values to home values and the assembled experts concluded that a slump in housing prices would not significantly impact banks and could be handled by monetary policy.

The belated disclosure suggests that five years might be too long a period to hold these deliberations secret. It is clear from the transcript that, following Greenspan's lead, a kind of 'groupthink' settled on the committee and legitimate concerns fell by the wayside. Public exposure and debate might well have led to some much-needed correction in the policymakers' thinking. Whatever monetary policy reasons there are for keeping these discussions hidden for so long seem less compelling in hindsight than the benefits of transparency. The minutes published three weeks after that June meeting offered few clues to the actual content of the discussion. And there is the question of accountability. Only one of the 11 voting members at that meeting, Dallas Fed president Richard Fisher, is still in office five and a half years later. Greenspan, of course, yielded the chairmanship after 18 years and the then vice chairman of the FOMC, Tim Geithner, has since become the chief economic policy-maker of the administration. Surely a year's grace would be sufficient time to shield participants from undue political pressure and yet provide the public with the opportunity to weigh in on some of these momentous economic deliberations.



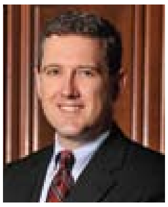
Janet Yellen

Yellen suggests eight year timeline for quantitative easing

Newly installed Fed vice chairman **Janet Yellen** (**voter**) offered a scenario for the US central bank's quantitative easing that suggests an eight-year timeline for restoring its balance sheet to pre-crisis levels. Speaking in Denver, Yellen described the results of a simulation of the monetary accommodation by Fed economists in the wake of November's decision to purchase a further $600bn of US government debt. 'The simulation imposes the assumption that the purchases of $600bn in longer-term Treasury securities are completed within about a year, that the elevated level of securities holdings is then maintained for about two years, and that the asset position is then unwound linearly over the following five years.'

The timing is predicated on the success of the monetary policy measure in actually reducing unemployment, which Fed economists project will fall to 8% by the end of 2012 from above 9% now.

In other remarks, Yellen said the Fed's quantitative easing had aided economic recovery in general. She rejected the notion that it could lead to excessive inflation because resource utilisation remains low and the Fed has many tools to drain bank reserves when necessary. And she said that the foreign exchange impact has been minimal and potential growth in the US would offset any disadvantages to foreign economies resulting from the policy.


James Bullard

Bullard hails success of emergency liquidity measures

In all of the hullaballoo over QE2, some of the Fed's emergency actions to provide liquidity during the financial crisis have been forgotten – a testimony to their success, suggests St. Louis Fed president **James Bullard** (**non-voter**).

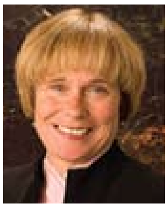
'Most of the programmes were closed naturally as the financial crisis subsided because the borrowers found better terms in the private sector,' Bullard, who was a voting member of the FOMC last year, wrote in the January issue of the bank's Regional Economist. 'Their size and variety demonstrate how flexible and powerful the lender-of-last-resort function can be during a crisis.'

Beginning in August 2007, the Fed eased conditions for borrowing from the discount window, then established the Term Auction Facility to provide funds to banks without the stigma of going to the discount window.

The Fed expanded currency swap agreements with foreign central banks to relieve tightness in short-term dollar funding, first in 2008 and then again in May 2010 to address renewed problems in European markets. Other programmes were set up in 2008 to provide liquidity to primary security dealers, to commercial paper markets and money market funds, and to asset-backed security markets.

The Fed also provided liquidity to institutions deemed too big to fail – notably to JP Morgan Chase to assist its takeover of Bear Stearns and to AIG to prevent a disorderly bankruptcy. 'These were some of the most controversial decisions made during the entire financial crisis,' Bullard said of this aid.

Because the Fed applied standard risk-management practices on soundness of borrowers and collateral, the system has sustained no losses from any of these operations – at least on the programmes closed so far.

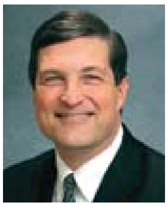

Elizabeth Duke

Fed officials see 'happier new year'

Fed officials greeted the New Year with a somewhat more optimistic view of the economy.

'Although the recovery continues to be uneven across sectors, recent economic and financial developments are broadly consistent with my forecast that the economic recovery will gain even more momentum and that the expansion will become sufficiently strong to gradually bring down the unemployment rate,' Fed governor **Elizabeth Duke** (**voter**) said in Baltimore in early January.

She forecast further strengthening in consumer spending and business investment in equipment and software, which both benefited from the compromise tax package enacted at the end of 2010.


Jeffrey Lacker

Richmond Fed president **Jeffrey Lacker** (**non-voter**) also saw hope in stronger consumer spending. "Against that backdrop of a disappointingly sluggish recovery, many of our readings for the last quarter of 2010 point to a distinctly sunnier outlook," he told risk managers in Richmond in mid-January. "Most importantly, consumer spending is starting to show some real signs of life. Retail sales rose at a blistering 12% annual rate over the five months ending in December.'

At a mid-January mortgage conference in Connecticut, Boston Fed president **Eric Rosengren** (**non-voter**) said that 'over the past several weeks we have been getting economic data consistent with a somewhat happier new year.'

The Fed's quarterly update of the economic outlook is due in mid-February.

Germany leads Europe out of downturn

Different economic challenges outside euro area

DZ Bank Economic Forecasts

GDP growth	2009	2010	2011	2012
US	-2.6	2.8	2.7	2.8
Japan	-6.3	4.4	1.6	1.8
China	9.2	10.3	9.2	8.7
Euro area	-4.0	1.7	1.2	1.5
Germany	-4.7	3.6	2.5	1.8
France	-2.5	1.4	1.2	1.7
Italy	-5.1	1.0	0.8	1.2
Spain	-3.7	-0.2	0.0	0.7
UK	-5.0	1.7	1.0	1.5
Addendum				
Asia excl. Japan	6.1	9.1	7.7	7.6
World	-0.7	4.7	4.0	4.1

Consumer prices (% y/y)	2009	2010	2011	2012
US	-0.3	1.6	2.0	2.0
Japan	-1.4	-1.0	-0.1	0.2
China	-0.7	3.3	5.0	3.0
Euro area	0.3	1.6	1.8	1.8
Germany	0.2	1.2	1.7	1.9
France	0.1	1.7	1.9	2.0
Italy	0.8	1.6	1.7	1.7
Spain	-0.2	1.8	2.2	1.4
UK	2.2	3.3	3.3	1.7

Current account balance (% of GDP)	2009	2010	2011	2012
US	-2.7	-3.3	-3.2	-3.2
Japan	2.8	3.4	3.4	3.5
China	6.0	4.7	4.3	3.8
Euro area	-0.6	-0.6	-0.3	-0.2
Germany	4.9	5.5	5.6	5.0
France	-2.0	-2.2	-2.4	-2.0
Italy	-3.2	-3.0	-2.9	-2.5
Spain	-5.1	-4.7	-4.6	-4.0
UK	-1.3	-1.8	-1.0	-1.0

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

In the wake of the massive economic crunch of 2008-2009, the German economy grew strongly again in 2010. With an upturn of 3.6%, gross domestic product grew faster than at any point since reunification in 1990. Growth in Germany was, without doubt, crucially driven by the swift recovery of the global economy and global trade, but also has been increasingly stimulated by domestic demand.

Last year, hardly any other major industrialised nation achieved stronger growth than that seen in Germany. German GDP actually grew at three times the average for the EMU member states. Even if no official data is yet available for 2010 as a whole for most of the EMU member states, we can assume that the 'EMU ex Germany' only posted economic growth of about 1%.

We expect that Germany will report growth of 2.5% in 2011, with in particular the trend for domestic demand to improve continuing. Thanks to the favourable labour-market performance and climbing income levels, we expect that private consumer spending should rise just short of two% in 2011, which is notably the most robust growth in the last decade. In EMU, countless consolidation measures such as reductions in expenditure, cuts in public-sector jobs and in part tax increases will spell only weak economic growth of 1.2% in 2011. Owing to intensive budget consolidation, the economic recovery is now very restrained in most EMU member states.

The Chinese economy closed the year with real verve: according to official figures, in the final quarter of the year gross domestic product rose 9.8% on the year, meaning that most recently the gradual economic slowdown in China did not persist. Measured in terms of growth rates in the prior quarter, which we have estimated on the basis of available data, the pace of growth has most recently actually picked up appreciably again. We have therefore raised our growth forecast for the first half of this year and we predict growth for 2011 not of 8.5% but of 9.2%.

For the US in 2011, the picture is now more upbeat thanks to US Congress having passed a tax bill that entails retaining the tax reductions from the Bush era. In the wake of this latest tax package, we have revised our US growth forecast upwards and it now comes to 2.7% for 2011 and 2.8% for 2012, markedly up on our previous predictions. The downside of the new fiscal stimulation are higher budget deficits. In the near future the administration will have to come up with a fiscal exit strategy that will include politically unpopular cuts in public-sector spending. In recent weeks, inflation has risen noticeably in almost all countries, owing to higher food and energy prices. In particular in the emerging markets rising inflation has already forced a more restrictive monetary policy, which will continue.

Lesser of two evils

Why dollar problems will command attention

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

Based on the general gloomy picture painted by much of the media, one might assume that the euro was hovering near parity against the dollar, rather than in the comfortable ranges around $1.30-1.35. As far as the euro area is concerned, the news remains negative pretty much across the board. EU finance ministers are bickering rather than looking for long-term solutions, while measures already put into place are coming under renewed scrutiny.

The euro will undoubtedly survive its tests. The threat of instability no longer appears to have the potential to push the currency aggressively lower.

The European Central Bank has successfully fended off pressure to increase its bond purchases. But now it suddenly finds itself confronted with the challenging task of managing rising inflation expectations in Germany while simultaneously providing adequate monetary stimulus to ailing economies in the southern periphery. It is not surprising that, in light of all this, experts around the globe continue to forecast various shades of doom.

Objectively, I have to admit that most of this pessimism is entirely justified. Rather than moving closer together to come up with workable solutions, the EU is struggling to show a united front. As the economic aftermath of the financial market crisis continue to linger (and have indeed been amplified in some countries by the euro upheaval), governments are, understandably, more concerned with national rather than EU-wide solutions. While some progress has been made in recent months, the overall tone of discord remains.

With all this going on, it seems surprising to see the euro is holding up relatively well. We may have seen a sizable decline from lofty levels above $1.40, but at around $1.35 the euro remains reasonably strong, certainly by historical comparison. As far as the ECB is concerned, the resilience of the euro will be more than welcome. A stronger euro, if it lasts, will slow down export growth in booming Germany.

This redresses some of the imbalances created by the ECB's still ultra-loose monetary policy, which may be appropriate for the southern periphery, but is no longer appropriate for the German economy. But can the stronger euro last? This, we believe, will depend very much on the fortunes of the US.

The euro's resilience has less to do with hope that the euro crisis is about to end, but more with the simple fact that the euro – dollar exchange rate remains very much a choice in favour of the better of two evils. It may be true that growth in the US will remain nominally higher than growth in the euro area, but on what basis? While euro member governments are already well along the path towards more fiscal restraint, the same cannot be said about the US.

The issue can be simply stated: growth in the euro area happens despite the fact that governments are saving, while US growth takes place because the government keeps supporting it as best as it can.

In addition, US portfolio flow data provide ample evidence that foreign investors remain reluctant to invest in risky US assets, making the US extremely dependent on the Treasury market. In addition, we can also observe that Chinese demand for US assets has declined dramatically – in fact, official demand for US assets in general has waned. Hardly a comfortable equilibrium!

The euro will undoubtedly survive its tests. Already the threat of euro instability no longer appears to have the potential to push the currency aggressively lower. As the year progresses, we therefore expect the multitude of problems faced by the US to shift more fully into focus. On a longer-term view, this makes the dollar decidedly a less attractive prospect.

Ruminations of a foreign exchange trader

The Year of the Dollar beckons

Whenever a market trend seems clear, it changes

Frederick Hopson, Advisory Board

FREDERICK HOPSON, WHO RETIRED FROM A GERMAN LANDESBANK BOARD IN 2000, DESCRIBES HIS IDIOSYNCRATIC VIEW OF FINANCIAL MARKETS

One feature of the New Year has been the turn-round of bets against the euro placed on the Chicago Mercantile Exchange. Traders abruptly covered their short positions or even went long of the previously so derided euro because Europe suddenly appeared to be solving its debt problems. How amazing! Greek or Irish bonds may well be restructured in some novel form, perhaps a swap similar to 'old lamps for new', based on an exchange of parity of the new Euro junk bond for 60 of the old Hellenic obligation. When this finally happens, might we perchance find out this doesn't solve the currency problem?

It's time for a reality check. The euro has merely retraced a small portion of its recent decline against the dollar, a decline that has been the subject of daily doom-mongering. Similarly another trend has surfaced on emerging market currencies. This is a theme that's easy to sell and easy to justify. 'They keep going up so it must be right….look how those guys are growing!'

Illustrious analysts and managers of gigantic bond funds tell us simultaneously that the US will soon be bust, Europe is going bust and Japan should already be bust. So shouldn't their currencies all be worthless? Japan is the biggest relative debtor of speculative interest to currency traders, yet its currency stands at ¥82.70 to the dollar! That's the level it traded at in 1995 after moving down from ¥260 in 1985. During the 'lost' decades it has gone from strength to strength, so something is wrong with the connection between foreign exchange rates and debt valuation. Cynical observers might conclude there may not be a connection!

What is sentiment really telling us about the dollar's long- term trend? The last few years have been characterised by fundamental mistrust of the US currency owing to burgeoning American debt. But the view that is interrupted from time to time by terror attacks and coups in small and not-so-small countries, when the dollar suddenly becomes a safe haven. We're seeing a little of this now over Egypt.

This safe haven feeling also exists for the hallowed Swiss franc, even though Switzerland is playfully described by one of my American friends as a toy country.

So the market continues to generate its own illusions and as we all know they change daily as thousands of clever people in the boiler rooms are paid large sums of money to keep the machine pounding away at maximum speed.

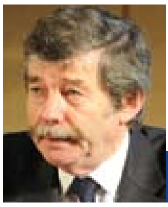
The current lack of fundamental regard for the dollar reminds me of a previous period when gold was high and everyone believed the dollar was washed up for good – at the end of 1979 when gold was on its way to a high of $850. This ushered in a five year dollar bull market and gold went out of fortune for 20 years.

Gold is now being rediscovered by central banks, who play their own game of 'watch the press' but unfortunately not 'watch the markets'. Partly nostalgically, they are finally looking to buy gold again. The counter-cyclical investor would consider that unsettling, to say the least!

The Swiss franc is at absolute highs, the yen at multi-year highs, gold close to its high. Surely all this gives us cause to worry. Whenever anything seems that clear in the markets, we can generally expect to face a change. Hindsight tends to be painful. Think of Gordon Brown and the Treasury decision to sell British gold a decade ago.

A simple example of market blindness was the US property market. Once it had finally been repackaged so that it could never fail, we experienced the biggest decline in wealth of all time. Even the casino owners suffered for a while,

So let's all take a deep breath and think. If the US economy really is recovering, perhaps the next argument will be that the US dollar is set to recover too! At least for a while, maybe a few years even. It is foolhardy to try and predict long term movements. But as long as gold is being pushed as the new currency of choice, it feels a lot safer to be long of the dollar.



Keynesian returns to the fray

Balls' rebound poses problems for Osborne

William Keegan, Chairman, Board of Contributing Editors

The British political scene has been considerably enlivened by the resignation of Shadow Chancellor of the Exchequer Alan Johnson and the return to the economic fold of Ed Balls. Before moving to ministerial responsibilities Balls, 43, had been Gordon Brown's right hand man for many years, both in Opposition and at the Treasury after Labour's victory in 1997.

Johnson, 60, had been Home Secretary in the Brown government which ended last year, and was once considered a possible successor when Brown resigned from the Labour leadership after last May's election defeat. But Johnson declined to stand, giving the impression that he did not think he was up to the job. When Labour moved back into Opposition under its new leader Ed Miliband, 41, Balls was the obvious person to shadow Chancellor George Osborne in the Conservative/Liberal Democrat coalition. But the general view was that Miliband regarded Balls (who has also stood for the Labour leadership) as too much of a rival – and that he could be a threat if given the shadow chancellorship.

Both from the Labour Party's point of view and that of the country, this was an unfortunate decision, because, at such a crucial time in the economic debate, someone of Balls' stature was sorely needed. It was no secret in Westminster that Osborne was relieved when Balls was not appointed.

However, with Johnson's resignation for personal reasons, everything changed. Johnson is a very decent man, with plenty of experience. But economics is not his bailiwick. Balls eat and breathes the subject. Despite fearing him, the Conservatives have some ammunition against Balls, which they have not been slow to use. His close association with Gordon Brown has enabled them to tarnish him with partial responsibility for Britain's current economic problems. And they continually label him as a 'deficit denier'.

But Balls relished the fight. It might have been helpful to spend longer away from the economic debate, so that memories of his association with previous policies could fade. But now he is out there fighting. To the criticism that he was associated with Brown's excessive reliance on the financial sector – the tax revenue which collapsed after the financial crash – Balls can reasonably claim that the Conservatives were even more enthusiastic about boosting the City of London. Indeed, the main criticism of the Blair and Brown governments in this regard is that they were persistently trying to please the right-wing press and natural Conservative voters who were more supportive of the financial sector than traditional Labour voters.

Nor is it fair to say that Balls is a 'deficit denier'. The deficit is there. It is manifest. The debate is about how to handle it. Balls is pretty impressive at attacking the Conservatives when they try to blame the entire budgetary position on Labour. There is no doubt that Brown's claims to have abolished 'boom and bust' were always foolhardy – demonstrating an ignorance of history, which is strange coming from Brown, who is a historian.

Balls loses no chance to point that that this has been a world economic crisis, for which Labour's responsibility is limited. Indeed, he goes further, and chides the Conservatives with the change that at every stage they opposed the measures – bank rescues, the fiscal stimulus – which prevented the Great Recession from turning into another Great Depression.

Balls' position is essentially Keynesian: this is not the time for savage cuts in public spending on the lines already being introduced by the. He does not deny that the deficit must be reduced eventually, but argues that the coalition is, at worst, sowing the seeds for a double dip recession and, at best, needlessly slowing down the recovery. And with the news that UK GDP fell by 0.5% in the final quarter last year, Balls' anti-cuts campaign is now fully in the centre of public debate.

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