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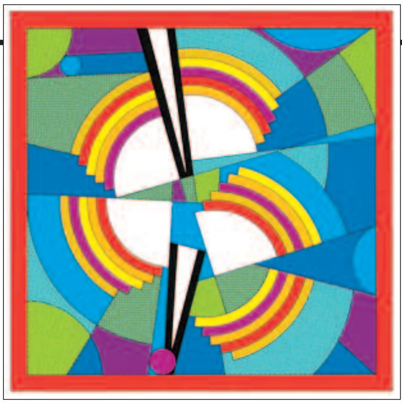

OFF THE NEWS

"Better Than the Bundesbank"

Jean-Claude Trichet

Outgoing ECB President Jean-Claude Trichet argues that the central bank's delivery of price stability under his presidency has been superior even to the Bundesbank's over the past fifty years.

"We have delivered price stability over the first twelve, thirteen years of the euro! Impeccably! I would like very much to hear some congratulations … This figure is better than any ever obtained in [Germany] over a period of thirteen years in the past fifty years."

Trichet adds that the ECB's "independence is inflexible…May I remind you that in 2004 and 2005, [even Germany] asked for a weakening of the Stability and Growth Pact?"

Draghi's "Constâncio Problem"

When eurozone heads of government were debating who should be the successor to Jean-Claude Trichet, many in the German press ridiculed the notion of Italian Central Bank head Mario Draghi as president of the European Central Bank, suggesting he would be an agent for Italian political interests. Those in the policy world who know Draghi well believe such criticism to be ridiculous. The Bank of Italy under Draghi, they say, has become Italy's one institution of credibility. Draghi is anything but a political tool of Italian interests.

Mario Draghi, *the ECB's new chief.*

None of this is to suggest that Draghi's job as incoming president of the European Central Bank will be easy. For starters, he will be confronted with the question of whether to continue the policy of unlimited ECB purchases of Italian sovereign debt. Draghi probably has no choice but to continue those purchases, but the exercise no doubt will entail a significant degree of personal discomfort. According to several of his colleagues, however, Draghi's most difficult challenge will be to maintain order on the Executive Board of the ECB Council. Specifically, as one of his colleagues put it, "Mario is going to have a difficult time handling [Portuguese ECB Vice President] Vítor Constâncio." The ECB's number-two policy official is said to have "enormous ambition and energy" and is not one to sit back silently waiting for others to lead. One of Draghi's colleagues summed up the situation as follows: "Mario is taking over at a difficult time for the eurozone economy when being a creditor is scary because the rule of law may be on the way down."

—D. Smick

Will the Eurozone Become Japan?

A number of German financial policy strategists suggest that the world may be misreading the true nature of the European sovereign debt crisis. Increasingly, the view is that the eurozone no longer has a liquidity problem given the European Central Bank's promise to extend seemingly unlimited supplies of liquidity to the banking system, while promising continued purchases of weak country sovereign debt for as far as the eye can see. With the European governments providing financing for the new EFSF rescue facility, with guarantees for any leveraging of the funds of that facility, the eurozone may not even have a solvency problem.

Instead, in the end, many German policy strategists suspect the eurozone may be in the process of creating a confidence problem—that is, confidence in the financial credibility of monetary union itself. Here's their argument: If Germany becomes the ultimate backstop for EFSF funding and guarantees, and if the EFSF is forced to bail out not only Greece and the other "weak sister" countries but also Italy, Germany's debt/GDP ratio could easily reach 240 percent (compared to just 80 percent today). That's higher than Japan's debt/GDP ratio. Remember, in Germany, government guarantees are part of government debt for accounting purposes. (This stands in contrast to the U.S. budget where, for example, guarantees for Fannie Mae and Freddie Mac are not part of the budget liabilities.)

Some non-German analysts counter that this 240 percent figure is far too high and suggest the number will likely be closer to 130 percent. Assuming the number comes in somewhere between these two extremes, Germany will nevertheless soon become one of the world's great debtor nations.

And here's the question: Where does this all leave France, which has an economy less competitive than the German economy, with a more vulnerable banking system, and with higher current debt and deficits? "It means that France will be the first to be downgraded," a worried German policy strategist said, "which could have a nasty contagion effect on the strong countries of the eurozone, including Germany."

—D. Smick

What, Me Worry?

In Greece, the number of suicides has increased by 50 percent over the 2009 figures and now averages two per day. Organized crime has taken control of large swathes of downtown Athens, with drug and prostitution rings controlling the streets. This phenomena has now spread to small towns and to the countryside in the provinces. There is mass emigration abroad of the young and educated, and migration from the cities to the countryside of the young and not-so-educated in search of agricultural labor. Official unemployment is over 16 percent (concentrated among the young) and unofficially over 25 percent. Retail trade has fallen by about 20 percent and will fall further as increasing numbers of people, resorting to barter, exit the cash economy. A mass emigration of the most productive cohorts of labor, the return of the rest to subsistence agriculture, and exit from the money economy are not conditions that will ever allow the already-collapsed Greek state repay any of its $465 billion in debt.

—Criton Zoakos

"I'd love to, Barbara, but I'll have to check with the Bundesbank."

A G-20 Conversation Stopper

At this fall's IMF/World Bank gathering in Washington, D.C., of finance ministers and central bankers, an unexpected conversation took place in a hotel lobby not far from the White House. A group of bankers and former central bankers were in conversation over whether the eurozone and U.S. economies were both at risk of experiencing their own "lost decades" of weak economic performance *à la* Japan since the 1990s.

An American banker was in the midst of offering a counter-argument that the U.S. economy is more flexible than the Japanese economy and that the Federal Reserve has been quicker and more creative in responding to crises.

Just as the banker was concluding, a former Japanese vice minister of finance walked by, joined the discussion and, completely unaware of the previous conversation, unwittingly offered this comment: "I just came from an unusual meeting. For 2012, the Japanese economy is expected to grow at a faster rate than the eurozone and U.S. economies." Very quickly, the group broke off the discussion.

Why America Is Not Creating Jobs I

"Economist Robert Litan of the Kauffman Foundation likes to recall that half of today's Fortune 500 companies began as start-ups in a recession or a bear stock market. And why not? During a recession, it's cheaper to hire new workers, rent office space, buy supplies. But Litan suspects the same process may not be working now. In contrast to earlier slumps, when the number of start-ups barely fell, there's been a steep decline. From 2006 to 2009, start-ups dropped 27 percent."

"Confidence surveys show the longest streak of low ratings on record. The Conference Board's index, based on people's outlook and buying plans, sets 1985's attitudes at 100 and, in good times, usually registers between 120 and 140. The latest reading (September) was 45.4; the low was 25.3 in February 2009. "We've never seen it drop so low and stay so low," says the Conference Board's Ken Goldstein."

"Stock values reflect low expectations of future profits. One measure of mood is the P/E ratio: a stock's price (P) compared to each dollar of per share earnings (E). High P/Es signal optimism. Today's P/E is 13.8 for the Standard & Poor's 500-stock index, well below the average of 18 from 1950 to 2011, says S&P's Howard Silverblatt."

—ROBERT SAMUELSON
Washington Post

Why America Is Not Creating Jobs II

"According to research funded by the charitable Kauffman Foundation, in 1980–2005 firms less than five years old created 40 million net new jobs—equivalent to 100 percent of the net new jobs created in the entire American private sector. Alas, this magnificent hiring machine is sputtering."

"In 2008 and 2009 there were fewer initial public offerings of firms backed by venture capitalists than in any year since 1985. Medium-sized firms find the regulatory barriers daunting: the proportion of IPOs worth less than $50 million has plunged to 20 percent in the past decade from 80 percent in the 1990s. This matters, because according to the National Venture Capital Association over 90 percent of job creation by venture-backed firms occurs after they go public."

—*The Economist*

Beware What You Ask For

The world economy has a lot of global capital with the potential for mobility. For example, of Japan's $2 trillion current account surplus, $1.5 trillion has gone abroad in what has become known as the so-called "carry trade." In a global meltdown scenario, a lot of that capital is sure to return to Japan for safety and familiarity. This would send the yen even higher, threatening to further hollow out Japan's manufacturing sector. At least half of China's $3.2 billion in reserves is said to be highly mobile.

Recently during times of global uncertainty, a favorite destination of mobile global capital has been the U.S. Treasury long bond. In the past year in particular, with the eurozone crisis and the uncertainties of the Arab Spring, capital inflows have helped lower Treasury yields significantly. Financial traders call this a flattening of the yield curve as the industrialized world central banks, led by the Federal Reserve, have kept short-term rates extraordinarily low.

So what's wrong with a decline in long-term interest rates? After all, the Bernanke Federal Reserve recently instituted "Operation Twist," which in effect has the Fed artificially driving down long-term rates, flattening the yield curve.

Even the most seemingly sensible policy moves can often entail unintended consequences. The more the yield curve is suddenly flattened as a result of unexpected capital inflows or moves by the central bank, the more America's large banks could suddenly see their profitability decline with the potential for a drop in lending. The big Wall Street banks can survive this situation, but many small and regional U.S. banks, the financiers of small business job creation, are at risk.

This situation is similar to that of Japan during the last two decades when its short-term interest rates were reduced to near zero percent. Over a ten-year period, the yield on the Japanese ten-year bond steadily dropped to below 1 percent, contributing to a brutal decline in Japanese bank lending.

Over the last year, the U.S. ten-year Treasury bond has continued to flirt with the 2 percent level. True, there are differences between the U.S. and Japanese systems. But it would, nevertheless, be foolhardy for U.S. officials simply to ignore completely the fact that the severe flattening of the Japanese yield curve contributed to a collapse in bank profitability and lending, which helped fuel a self-reinforcing deflationary spiral and two decades of economic misery.

—D. Smick

Reboot the IMF

When computers malfunction there is often a simple recourse: Rebooting.

The International Monetary Fund has been through an undeservedly rough patch. As the fiscal policeman to the developing world, it lost relevance, as policemen do, when the going was good: Emerging markets were booming, liquidity was abundant, trade was growing, and, by and large, appropriate monetary and fiscal policy management was the rule, not the exception.

In fact, five years ago, all was moving along so smoothly that the IMF was experiencing operating deficits because so few countries were borrowing from it. It was a bank going out of business from lack of clients. Indeed, to remain as a functioning entity, the IMF was obliged to sell a portion of its gold reserves and create, effectively, an endowment to fund its research and other operational activities. Then, of course, the world economic ship foundered, and the Strauss-Kahn affair in New York robbed the IMF of a particularly able leader. In Christine Lagarde, a competent alternative has emerged, but the IMF remains troubled. Rebooting is in order.

This rebooting is relatively simple as global policy actions go. It should go this way. Take the initiative to encourage the financial help tentatively offered by the BRICs to refinance, re-liquefy, and restructure failing European debtors and creditors, and act as a forceful and disciplined work-out manager of the debt restructuring process. This is exactly what the IMF was created for and it can do it well, particularly working with its counterparties in the European Union. It can then be a formidable, constructive, and deflective partner, offering technical assistance, guarantees, and any base capital needed to recapitalize core banking institutions, and allow risk and equity holders to take hits for well-deserved losses. Most important of all, it can and must help Europe achieve fiscal policy coherence, which is the unfinished and critically missing link in the European Union.

This would also be the time to seize the opportunity to restructure the voting power within the IMF. BRICs want and deserve more power at the IMF. This would be the time to give it to them, and re-energize the world economy along the way. Rebooting the IMF will ease the political stalemate between moralists and realists, and build confidence and character among borrowers and lenders. Most important of all, it could do wonders for the world economy.

—Hilda Ochoa-Brillembourg