OFF THE NEWS

Why the Euro Remains a Relatively Strong Currency

In June 2012, the balance sheet of the European Central Bank peaked at over €3 trillion. Since then it has fallen every month, so that by the end of 2013 it stood at €2.2 trillion. Over this same period, the Federal Reserve's balance sheet rose from less than $3 trillion to more than $4 trillion. That is, as the ECB's balance sheet was falling by a quarter, the Fed's rose by a third!

One of the biggest reasons for this difference is that the two largest central banks have very different operating procedures. The result is that the balance sheets have a very different structure. At its peak, of the €3 trillion-plus worth of assets on its balance sheet, the "Consolidated financial statement of the Eurosystem" showed more than €1.2 trillion related to refinancing operations. These are repurchase agreements with the commercial banks of the euro area. By comparison, over 90 percent of the Fed's balance sheet is in the category labeled "Securities held outright."

Since European commercial banks decide whether to tender securities in a refinancing operation, they collectively determine the size of the ECB's balance sheet. And the fact that these banks want to shed reserves is what's behind the shrinkage over the past eighteen months. By contrast, the Fed can purchase securities and force U.S. banks to hold reserves. This balance sheet expansion, what is commonly known as "quantitative easing," has been the foundation of the Fed's expansionary monetary policy since 2008.

The lesson is that, because of the way it interacts with the financial system, the ECB cannot engage in quantitative easing as it is commonly understood. Unless it were massive, an increase in outright purchases of bonds would simply change the size of the refinancing operation, leaving the level of reserves in the banking system unchanged. And by massive, I mean big enough to replace virtually all of the reserves currently provided through the refinancing operation, which at the end of 2013 was nearly €700 billion.

What can the ECB do to further monetary accommodation when the nominal interest rates hit zero? The answer is that they have a variety of tools available. These include altering the mix of assets on their balance sheet in an effort to change relative interest rates, forward guidance intent on influencing the term structure of interest rates, and even charging rather than paying commercial banks for their reserve deposits at the ECB (setting a negative rate on the deposit facility).

—Stephen G. Cecchetti
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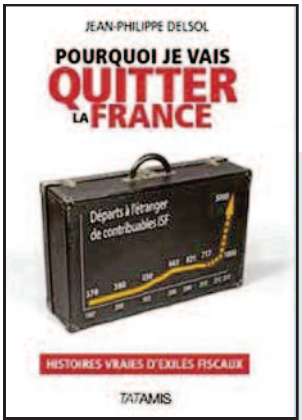


French Fried

"More than half of the active French population is living off the state, according to figures in a new book by a tax lawyer seeking to explain why so many of his clients in private enterprise are leaving France.

"With the country on the brink of nationwide tax revolt, *Why I'm Going to Leave France,* published this week, has thrown more fuel on the fire by suggesting that 14.5 million people out of the country's 28 million-strong workforce are—one way or another—making a living off taxpayers' money. To reach the figure, the author begins with France's civil servants, of which there are 5.2 million and whose number has increased by 36 percent since 1983. These represent 22 percent of the workforce compared with a European average of 15 percent, leading him to conclude that France has 1.5 million too many 'fonctionnaires.'

"He then adds the 3.2 million unemployed people in France relying on state benefits, another 1.3 million taking low-income handouts, a further two million in the 'parapublic' sector—majority state-owned companies—and more than a million people in state-funded associations such as charities. Under the current Socialist government, there are 750,000 state-subsidized jobs and the author includes a million people in the agricultural sector who rely largely on contributions from European Common Agricultural Policy subsidies.

"Although not a direct comparison, figures released by Britain's Office for National Statistics in August found that 80.9 percent of jobs were in private industry and commerce—a record high of 24.1 million people—and 19.1 percent, or 5.7 million, were in the public sector.

"He said that the figures in his book were only logical. 'When you consider that public spending in France now accounts for 57 percent of gross domestic product, it's only natural that more than half of the active workforce are paid with public money,' said Mr Delsol."

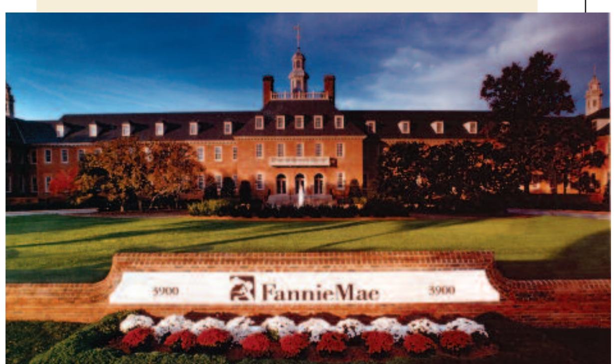
—HENRY SAMUEL
Daily Telegraph

Policy by Cliché

"As recently as 1980, government-sponsored Fannie Mae and Freddie Mac held, guaranteed, or securitized fewer than 10 percent of U.S. mortgages or less than $100 billion. Today, it's $4.7 trillion. Add Ginnie Mae's mortgage guarantees, and the number exceeds $6 trillion. Since 2008, these agencies have been involved in more than 95 percent of all new mortgages. This massive exposure has been justified by clichés: Housing should be affordable; ownership creates financial independence; government programs sustain the economy by increasing ownership. But did ownership increase?

"According to the Census Bureau, 65.6 percent of households owned a home in 1980. More than three decades and trillions of dollars later, the needle hasn't budged—it's still about 65 percent."

—MICHAEL MILKEN



Fannie Mae headquarters in Washington, D.C.