

# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Tuesday, March 9, 2010

## CHART OF THE DAY

### Dow Jones Industrial Average and S&P 500



When U.S. stock markets plunged to 12 1/2-year lows last March, many people were expecting more pain. The market crumbled through the autumn of 2008, defying pundits' expectations that a bottom had been reached, and 2009 got off on the same foot. But March 9 has not been breached, with the broad S&P 500 surging as much as 70 percent off that low.

## TODAY'S TOP NEWS

- W.House's Romer: Too soon for spending clamp-down
- China says committed to U.S. debt, wary on gold
- Jobless aid, tax breaks clear Senate hurdle
- Greece calls for ban on speculative trading
- Treasuries, sovereign debt 'dangerous' -Fuss
- Fed's Evans says labor market weakness pervasive
- **For more stories please click here**

## ECON WATCH

FOR WEDNESDAY MARCH 10

ET	Indicators	Unit	Reuters	Prior
02:00	DE HICP final mm	%	0.2	-0.6
02:00	DE HICP final yy	%	0.3	0.8
02:00	DE Trade balance, EUR	bln	16.0	16.7
02:45	FR Industrial output mm	%	0.2	-0.1
04:00	IT Industrial output mm	%	0.6	-0.7
04:30	GB Industrial output mm	%	0.3	0.5
04:30	GB Manuf output mm	%	0.3	0.9
04:30	GB Manuf output yy	%	1.4	-1.9
05:00	IT GDP final qq Q4	%	-0.2	0.6
07:00	US Mortgage mkt index	ind	-	629.9
07:00	US Mortgage refi index	ind	-	3054.3
10:00	US Wholesale inventories	%	0.2	-0.8
10:00	US Wholesale sales	%	0.7	0.8
14:00	US Federal budget	bln	-222.0	-193.86
18:50	JP GDP revised qq	%	1.0	1.1

## MARKETS TODAY

**TODAY'S TOP STORY:** Clamping down on spending now to cut the gaping U.S. budget deficit would be "pound-foolish" and derail the economic recovery, a top White House economic adviser said.

**For more please click here**

**TREASURIES:** U.S. Treasury debt prices rose modestly, aided by hedging before a heavy schedule of corporate bond issuance and encouraged by a well-bid three-year Treasury auction.

- 10-yr notes rose 7/32, yielding 3.7 pct. Two-yr notes were up 2/32 to yield 0.87 pct.
- Treasury investors had been worried that the Fed would actively try to sell assets into the market, thereby depressing prices.
- 3-yr notes were flat yielding 1.38 pct, down from 1.42 pct. 5-yr notes rose 6/32, with yields slipping to 2.33 pct from 2.37 pct.
- 30-yr bonds rose 8/32, yielding 4.67 pct down from 4.69 pct on Monday.

**FOREX:** The safe-haven yen gained broadly amid Japanese repatriation flows, while the euro declined on concerns peripheral euro zone economies could face debt problems similar to those of Greece.

- The dollar fell 0.35 pct to 89.96 yen while the euro shed 0.6 pct to 122.32 yen.
- Euro was down 0.25 pct to \$1.3597.
- Yen rose 0.2 pct against the Canadian dollar, 0.57 pct against the Swiss franc and 0.87 pct against the sterling.

**CORPORATES:** U.S. corporate bond yield spreads were steady to slightly wider as investors absorbed about \$12 billion of new debt.

- The CDX.IG-13 index widened by 1 bps to 84 bps.
- Amgen Inc launched a \$1 bln two-part sale.
- American Honda Finance launched \$1.0 bln of notes in a two-part sale.

**STOCKS:** U.S. stocks ended slightly higher, helped by gains in the telecom and industrial sectors, though the advance was limited by falling commodity prices that pressured materials shares. The market's mild finish came on the first anniversary of its drop to 12-year closing lows on March 9, 2009.

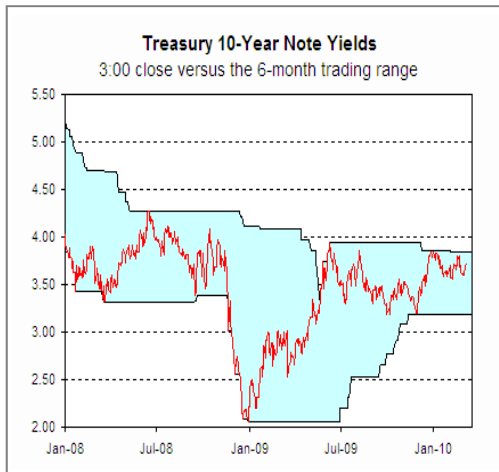
- Dow rose 0.11 pct to 10,564.38, S&P was up 0.17 pct to 1,140.45 and Nasdaq rose 0.36 pct to 2,340.68.
- AMR Corp rose 9.28 pct to \$9.77. The Arca Airline index jumped 2.91 pct to its highest in more than two years.
- Cisco was up 0.2 pct to \$26.19, while the S&P telecommunications index gained 1.23 pct. S&P materials index dropped 0.52 pct.
- Union Pacific rose 1.94 pct to \$70.84 and CSX added 1 pct to \$49.52, while the Dow Jones Transportation Average gained 1.31 pct, after earlier reaching a 17-month high.

- **C & E:** Oil prices slipped back from eight-week highs, pressured by a stronger dollar and uncertainty about an economic recovery.
- U.S. crude prices fell 0.65 pct to \$81.34 per barrel, after reaching a low of \$80.16 a barrel earlier.
- Gold was down 0.25 pct to \$1,120.05 an ounce.
- Reuters-Jefferies index shed 0.69 pct to 274.79.

- **For MARKET SNAPSHOT click here**
- **For NEXT UP click here**
- **For DEEP DIVE click here**



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.110	0.075	0.112	-0.006
3-Mo Bill	0.155	0.145	0.157	-0.008
6-Mo Bill	0.205	0.200	0.208	0.001
1-Year	0.340	0.330	0.346	-0.003
2-Year	99.984	100.016	0.884	0.039
3-Year	99.953	99.992	1.392	0.078
5-Year	100.133	100.180	2.347	0.137
7-Year	99.313	99.359	3.110	0.188
10-Year	99.313	99.375	3.708	0.141
30-Year	99.047	99.109	4.684	0.102

EQUITIES

	INDEX	CHANGE
DJIA	10553.58	1.06
NASDAQ	2336.53	4.32
S&P 500	1138.69	0.19

OIL

	PRICE	CHANGE
NYMEX	81.3	-0.5
BRENT	79.5	-1.0

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.740	0.003
Jun-10	99.640	0.005
Sep-10	99.460	0.005
Dec-10	99.170	0.005

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.190	O/N	0.210
2-Week	0.220	2-Week	0.240
1-Month	0.220	1-Month	0.250
3-Month	0.240	3-Month	0.280
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.200	10:00 AM	0.130
2-Week	0.230	3:00 PM	0.128
1-Month	0.250		
3-Month	0.250		

IR SWAPS <19901>

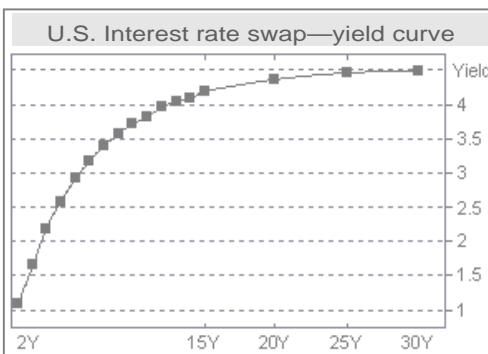
	SPREAD		RATE	
2-Year	20.00	24.00	1.08	1.10
3-Year	28.50	32.50	1.67	1.69
5-Year	25.25	29.25	2.59	2.60
7-Year	9.00	13.00	3.20	3.19
10-Year	2.00	6.00	3.72	3.71
30-Year	-18.50	-14.50	4.50	4.47

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.79	0.07
CBOT 10 yr	118.55	0.17
CBOT 30 yr	118.16	0.25

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.150	0.170	-	-
1-Month	0.200	0.280	0.154	0.164
3-Month	0.220	0.400	0.168	0.178
6-Month	0.250	0.400	0.202	0.212
12-Month	0.600	1.000	0.344	0.354



CURRENCIES

	BID	ASK
Euro	1.3591	1.3594
Sterling	1.4986	1.4992
JP Yen	89.94	89.96
Swiss Franc	1.0756	1.0758
Can Dollar	1.0258	1.0264
Mexico	12.6368	12.6424

FED FUNDS NYFR<sup>SM</sup> - 10AM

Open	0.1500	1m	0.2175
High	0.1600	3m	0.2575
Low	0.1000		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1	04/04/2012	19	18	1.07
3-Year	1.75	22/02/2013	21	20.5	1.62
5-Year	2.875	09/02/2015	29.5	28.5	2.64
7-Year	5.125	18/10/2016	22	16	3.32
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	37.75	37	5.06

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	-2.75	-3.5	0.86
3-Year	1.625	15/04/2013	30	29	1.71
5-Year	2.625	20/11/2014	18	17	2.54
7-Year	5.25	15/09/2016	18	17.25	3.29
10-Year	3.75	27/03/2019	23	21	3.94
30-Year	6.25	15/07/2032	38	37	5.06

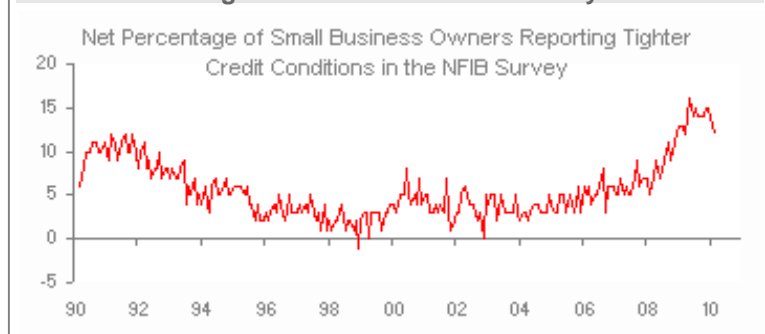
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2420	105.2620	2.476
FHLMC	5.0	105.2420	105.2620	2.476

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.2120	105.2320	2.890
FHLMC	5.5	106.0120	106.0320	2.683
GNMA	5.5	106.0550	106.0750	3.381

Wrightson ICAP<sup>SM</sup> Chart of the Day



## TODAY'S TOP NEWS

**W.House's Romer: Too soon for spending clamp-down**

Clamping down on spending now to cut the gaping U.S. budget deficit would be "pound-foolish" and derail the economic recovery, a top White House economic adviser said.

"Immediate fiscal contraction would inevitably nip the nascent economic recovery in the bud -- just as fiscal and monetary contraction in 1936 and 1937 led to a second severe recession before the recovery from the Great Depression was complete," said Christina Romer, who heads the Council of Economic Advisers. Romer, in a speech to the National Association for Business Economics, also said President Barack Obama's \$787 billion stimulus package had been successful in pulling the economy out of a deep recession.

However, she said additional measures were necessary to bring the jobless rate down from the current level of 9.7 percent, which she called "a terrible number by any metric."

Romer said Obama's job creation proposals -- a hiring tax credit, additional aid for cash-strapped states, and providing capital to small banks -- would help to bring down the jobless rate although she acknowledged that the economy probably would not grow fast enough to quickly close the labor gap.

**Jobless aid, tax breaks clear Senate hurdle**

Democratic efforts to spur job creation advanced in Congress as a \$149 billion package of tax breaks and unemployment aid cleared a procedural hurdle in the Senate.

The 66 to 34 vote allows the Senate to move toward a final vote for the bill, part of what Democrats call a "jobs agenda" to bring down the country's 9.7 percent unemployment rate before November congressional elections.

The Senate is expected to pass the bill within the next few days and send it to the House, where many Democratic lawmakers have pushed for more aggressive job-creation measures.

The bill largely continues existing government policies. Jobless workers would see unemployment aid and healthcare subsidies extended to the end of the year, while businesses would once again benefit from \$25 billion worth of tax breaks that expired at the end of 2009.

Cash-strapped states would get \$25 billion to help cover their portion of the Medicaid healthcare program for the poor.

**Treasuries, sovereign debt 'dangerous' -Fuss**

Investors should avoid government securities, including U.S. Treasuries and the debt of other nations, because of the risks associated with excessive borrowing, Dan Fuss, vice chairman of investment manager Loomis Sayles, said.

"The most dangerous market there is is national government debt because the borrowing doesn't seem to be ending soon -- and it's not just a U.S. phenomenon," Fuss, who helps oversee more than \$142 billion in assets at Boston-based Loomis, told Reuters.

Fuss does not expect the U.S. Federal Reserve to raise short-term interest rates at any time in 2010, noting that the economy still has not turned the corner on recovery.

Moreover, job creation will not develop for some time, he said.

A separate report showed, Japanese government bond futures rose to their highest in more than two months, as a 30-year debt sale earlier in the day drew strong investor demand and sparked buying in longer-dated notes.

The Ministry of Finance's 600 billion yen (\$6.6 billion) 30-year JGB auction attracted bids 3.85 times the offer, above the average of 3.48 from the past 12 sales in the same maturity.

**China says committed to U.S. debt, wary on gold**

China, the world's biggest holder of foreign exchange reserves, renewed its commitment to the U.S. Treasury market but said it would be wary of substantially boosting its gold holdings.

The country's chief currency regulator said China would attract more capital inflows this year, partly reflecting expectations of a stronger yuan, but he left the market none the wiser as to when Beijing might let the currency resume its rise.

The exact composition of China's \$2.4 trillion of reserves is a state secret and the subject of intense scrutiny by global investors aware that, with such large sums at stake, even marginal portfolio shifts have the potential to move markets. Global investors are equally attuned to any clues about the yuan, given its role in China's trade with the rest of the world and the potential spill-over effect a stronger yuan would have on other currencies in Asia.

Speaking during the annual session of parliament, Yi expressed the hope that China's presence in the U.S. Treasury market would not become a political football. China, he stressed, was not in the game of short-term currency speculation.

Yi dampened hopes of gold bulls that China might be itching to add to the 1,054 tonnes of the metal in its reserves.

**Greece calls for ban on speculative trading**

Greek Finance Minister George Papaconstantinou proposed a ban on derivative trading techniques that increase debt costs for countries like Greece which struggle to cut their deficits.

In an interview on CNBC television, Papaconstantinou recounted how the Greek government that came to power last fall discovered budget deficits were twice what had been made public and instituted austerity measures to try to regain control.

He repeated a call made yesterday by Greek Prime Minister George Papandreou for stricter controls to curb speculators that target debt-strapped countries and make it difficult and costly for them to borrow to finance their deficits.

Meanwhile, an Obama administration official said, Greece's main priority right now should be to move forward on its plans to revive economic growth and bring its debt problems under control. The official, speaking ahead of a meeting between Greek Prime Minister George Papandreou and President Barack Obama, also highlighted steps the administration has taken to rein in financial market speculation.

Separately, Fitch Ratings said it still has a negative outlook on Portugal's double-A ratings and was studying the details of the country's new austerity measures announced a day earlier.

**Fed's Evans says labor market weakness pervasive**

Weak U.S. labor markets are likely to justify easy money policies for quite a while longer, a top Federal Reserve official said.

With a sluggish economic recovery, the Fed's promise to hold rates very low for a long time should be seen as a signal it will do so for "the next three or four meetings," said Evans, who is not a voter on the central bank's rate-setting panel this year.

"Beyond that ... I think six months is a good time period to say I think we'll have accommodative policy like we have today," he said. If circumstances were to change, the Fed could change course sooner without surprising markets, he said.

Analysts noted that Evans' "some time" formulation seemed to stray from the Fed's language pledging "exceptionally low levels of the federal funds rate for an extended period."

Asked about the apparent shift, Evans said he had not intended to signal any move to lift the promise.



## TODAY'S TOP NEWS

**Strong demand for U.S. \$40 bln, 3-yr debt sale**

The U.S. government sold \$40 billion worth of three-year debt in an auction that met robust demand and bode well for offerings later this week.

The three-year auction, part of this week's \$74 billion in bond offerings, attracted bids worth 3.13 times the amount on offer, which was above the average of 2.98 at the last six sales.

Yields at the auction came in slightly below expectations, based on trade in the when-issued market at the deadline for bids. This indicates investors were willing to pay a small premium to get their hands on the bonds.

This was marginally below the average of 53.58 percent in the auctions since June, which has become a benchmark for comparisons due to changes in calculations that have boosted this category. The recently growing direct bid accounted for 10.3 percent of the sale, beating its 9.27 percent average since June.

**U.S., Jan job openings rate highest in nearly a year**

U.S. jobs opened up in January at the fastest pace in nearly a year, the government said. The rate of job openings rose to 2.1 percent in January after holding steady at 1.9 percent for three straight months, the Labor Department said.

The rise was the fastest pace since February 2009, according to the department's monthly Job Openings and Labor Turnover Survey.

The job openings rate has ranged from 1.8 percent to 3.1 percent since December 2007 when the recession began.

The labor market has started to inch toward stability. But the rate of hires by businesses was unchanged at 3.1 percent in January from the previous month and has fluctuated between 3.0 percent and 3.2 percent since November 2008.

The quits rate has held steady at 1.4 percent for three consecutive months, suggesting a lack of confidence in the economy jump-starting job growth. The figures in the January report were revised from December 2000 forward to incorporate annual updates to the Current Employment Statistics employment estimates and the Job Openings and Labor Turnover Survey seasonal adjustment factors, the department said.

**FDIC offers second deal for failed banks' assets**

The FDIC is offering \$1.37 billion of structured guaranteed notes tied to the assets of failed U.S. banks in the second sale of its kind this month, market sources said.

The latest securitization is backed by performing and non-conforming construction loans and real estate-owned assets originated from Corus Bank. TriMont Real Estate Advisors is the servicer, while Starwood is a 40 percent equity holder, market sources said. The deal includes \$150 million of 1.62-year notes, \$850 million of 2.62-year notes and \$377.35 million of 3.62-year notes, which will be underwritten by sole manager Barclays Capital, the sources said.

The upcoming sale follows a \$1.81 billion FDIC guaranteed securitization backed by option ARM mortgages that priced last week and was met with strong oversubscription from investors.

The two deals are part of the total \$3.85 billion of securitizations that the FDIC is selling to investors that are guaranteed by the government. A third \$668 million FDIC guaranteed securitization is also in the works and is backed by performing and nonperforming residential mortgage loans on real estate-owned properties seized from Franklin Bank, market sources said.

**UAE govt backs Dubai; Abu Dhabi help may lag**

The United Arab Emirates pledged its support for Dubai but said the emirate had yet to ask for federal help, which analysts said would come reluctantly and with strings attached.

The UAE finance minister said the federal government would support the emirate as it negotiates a plan to restructure \$26 billion in debt and said he expected a deal to be finalized soon.

State-owned conglomerate Dubai World is holding informal talks with major creditors, which include HSBC and Standard Chartered, in London this week. Asked whether the federal government would support Dubai, Sheikh Hamdan bin Rashid al Maktoum said: "Of course. Dubai is part of the federation."

Separately, ratings agency S&P has cut its ratings on cooling firm Tabreed, bailed out on Monday by Abu Dhabi, saying a debt restructuring looked likely and the prospect of further help was low.

## NEXT UP

**Supply calendar heats up; data remains dull**

The U.S. government approaches the business end of this week's \$74 billion bond issuances late on Wednesday, with a \$21 billion offering of 10-year debt.

There are reasons to expect a solid 10-year sale, despite ongoing worries about the burgeoning budget deficit, because a recent bond market sell-off has cheapened up prices enough to spur demand from bargain-hunting investors.

This was the case today, when investors paid a slight premium to get ahold of three-year debt in the government's \$40 billion offering. A 10-basis-point rise in yields over the last week helped fuel investor enthusiasm. While analysts caution that longer dated debt can be trickier to sell, they figure a little more cheapening could bring reasonably solid demand for Wednesday's 10-year auction. Continuing this week's slow pace of data releases, there is little if anything that could alter traders' push for a further price concession ahead of Wednesday's 1 p.m. bond auction, which is a reopening of previously issued 10-year notes.

Feigenwinter said a slight rise to the "mid-3.70s" might be enough to draw good demand.

Longer dated debt can be trickier to sell than shorter maturities.

**POLL-Greeks oppose cuts but accept need for pain**

Most Greeks oppose the government's latest austerity drive but accept that painful measures are necessary to contain a swollen budget deficit that has rocked the euro, an opinion poll showed.

The survey carried out by polling agency GPO on behalf of MEGA TV between March 4 and 8 showed 60 percent of 1,400 people surveyed disapproved of the new measures worth 4.8 billion euros (\$6.6 billion), while 39 percent backed them.

Today's survey 65 percent of previously polled said the 4.8 billion euros worth of spending cuts and tax hikes announced last week were unfair while 33 percent described them as fair.

People were evenly split, however, on the likely effectiveness of the measures with 35.8 percent saying they were likely to be enough to tackle the problem while 38.6 percent said they expected the government would have to do more.

Meanwhile in another sign of resignation, 52.5 percent said they accepted painful measures were necessary to address the scale of the fiscal crisis and Greece's 300 billion-euro debt mountain while 44.8 percent rejected the idea.

More than 60 percent of those polled opposed cuts in public sector holiday bonuses, a VAT rise and higher fuel taxes.



## DEEP DIVE Commentary and Analysis

**COLUMN-Looking for Messrs Supply and Demand**

By James Saft

The global economy faces a massive reallocation of capital, resources and employment -- a process that will take years and arguably is being harmfully delayed by current policy.

As it has in every period of economic or financial stress in the past 20 odd years, monetary and government policy has concentrated on easing conditions in order to stoke demand, while with few exceptions, policy towards the shape of the economy has tried to keep obviously overgrown industries like housing, automobile manufacturing and finance from shrinking.

But shrinking is exactly what huge swaths of the global economy almost certainly need to do.

So massive have been the interventions - think about the U.S. support for housing and China's cap on its currency - that we really have very little idea what the "real" economy, if such a thing can be said to exist, actually looks like.

"What do we know about aggregate demand?" William White, chair of the OECD Economic and Development Review Committee asked at a conference in February organized by the Reserve Bank of India.

"The answer at the moment is virtually nothing because of the effects of all the balance sheet (programs) we've never seen before," he said.

"What do we know about aggregate supply? The answer is virtually nothing.

"Cash-for-clunkers in the U.S. where the consumption household spending ratio (at its peak) is 80 percent. This is madness.

"Short time working in the auto industry in Germany when those jobs will never come back? Holding down the exchange rates in China to keep export jobs still functioning when we all know that longer term this is not going to be sustainable?"

White, a former chief economist at the Bank for International Settlements, has argued convincingly that successive interventions by central bankers, led by the U.S. Federal Reserve, seeking to cushion fallout from one bubble or another has simply led to further distortions in the economy and, as Austrian economists would put it, "malinvestment."

This poor investment and consumption in the U.S. and in export-oriented industry almost everywhere else, now needs to wither.

The great debate now is whether this asymmetric policy - cushioning on the way down but not blocking on the way up - can be succeeded by a policy where central banks exert pressure on asset prices as they inflate.

Its not a matter of central bankers knowing the "right" price for an asset, but, as they should, controlling the amount of credit being created.

Central banks and banking regulators seemed to be blissfully unaware during the bubble exactly how much credit was being created by the shadow banking system of derivative-enabled securitization. Asset prices were at the time some of the best sources of evidence that something was amiss and the idea that this should be outside their remit is risible.

**LIVING WITH THE POLICY WE HAVE**

Outsiders can, of course, talk until they are blue in the face about the policy we ought to have, but perhaps more interesting is what will happen because of the policy we actually are going to have to live with.

There seem to be three alternatives as to how this will work out. Those responsible for the current policy argue that it's the right path, that it will ease a transition to a differently shaped global economy, with less consumption in the west and more in Asia, and that the alternative to keeping alive a failed model was too

dire. Let's call that the right policy, right outcome possibility. The second alternative is that its the wrong policy precisely because it will work. The current mix of fiscal and monetary stimulus will reignite some bubble or other which will distract us from our current problems, lead to re-employment and strong economic growth and only bite us when the new bubble explodes some five years or so down the line. That explosion would be worse because the build up of debt to keep the circus afloat will be greater. Let's call this the "Bubble Next Time" argument.

The final alternative is that it is the wrong policy and it won't work. We may have reached the limits of effectiveness for a set of policies that depend on falling interest rates and rising levels of debt to artificially drive demand. We may finally have arrived at the place Japan reached long ago. Low interest rates and quantitative easing may simply not be all that effective when both borrowers and lenders realize its in their interests to trim sails.

Or, a sovereign debt crisis may show that we've reached the point where the creditors will no longer play their assigned role. That, rather than euro zone pantomime, is the most interesting angle on the Greek debt crisis.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

**COLUMN-ECB's Greek blunders show need for reform**

By Brendan Brown

Corrupt and spendthrift ways of Greek governments and the hubris of European leaders in launching a currency without fiscal union have taken much of the blame for the Greece debt drama. In fact, the wrong lies elsewhere. The European Central Bank in its conduct of monetary policy has failed to protect the euro zone from the ills of U.S. monetary policy. The ECB now faces a unique opportunity to redress the damage.

"A Greek Tragedy" is surely the worst title for the EMU drama in recent weeks. Next worst is "Athens again the cradle of European civilization". Under that title the happy Europhile dramatist tells how the threat of Greek insolvency could prove to be the catalyst to EMU member countries at last building a fiscal union to complement their monetary union.

Perhaps the drama most insulting to European citizens' common sense is the morality play. In this, as indeed narrated recently by a powerful ex-Bundesbanker, ex-ECB official, the culprits are the governments which over-spent and the EU regulators who did not enforce the fiscal stability pact. The narrator warns that a bail-out in any shape or form would doom the present historical experiment of monetary union without political union as it would mean overwhelming moral hazard for evermore.

The taxi driver in Vienna or Brussels, who moans that the financial crisis and recession of the last few years is in considerable degree the fault of European Monetary Union, would not attend any of these three dramas. Why would he or she be interested in make-believe about grim reality?

The authentic drama is entitled "monetary failure". It was the force of global monetary disequilibrium which drove so many investors (including banks) in the last decade into the debts of the weak euro-zone economies despite the only paltry returns related to the large underlying risks.

Yes, there is tragedy, but not essentially Greek. A decade (1999-2009) of potential economic progress in Europe and the U.S. has been lost due to J.S. Mill's feared monetary monkey wrench getting into the machinery of the global economy. In

## DEEP DIVE Commentary and Analysis

consequence, there has been no gain in aggregate economic welfare across the advanced economies in an age of IT revolution.

The European plot in the drama of monetary failure takes place in Frankfurt's Eurotower. In a prologue, the narrator recounts how the strongest economic argument made by the advocates of EMU back in the 1980s and 1990s is its strengthening of Europe's defences against repeated destabilizing monetary shocks from the U.S.. These can be traced as far back as the 1920s, then to the Great Inflation of the 1970s, and then to the Volcker bubble and accompanying mega dollar devaluation in the mid/late 1980s.

The self-congratulating officials in the Eurotower had no qualms in the immediate wake of the credit quakes starting in summer 2007 about proclaiming that EMU had saved Europe from a much worse fate. In fact the ECB not only failed to protect Europe from U.S. monetary instability - this time the Greenspan/Bernanke inflation-targeting regime which ignored the many symptoms of growing monetary disorder - but magnified the knock-on effects by following precisely the same mistaken policies as the Federal Reserve!

Back in the early 1970s, when the Arthur Burns Fed was pursuing aggressive monetary reflation and President Nixon was trumpeting that "we are all Keynesians now", the Bundesbank had quietly forged practical monetarism. This was built on strict targets for the growth in central bank money stock fortified by a high level of non-interest bearing reserve requirements on bank deposits.

In spring 2003, by contrast, when Chairman Greenspan, taking his intellectual cue from newly arrived (in the FOMC) Professor Bernanke, announced the policy of "breathing inflation back into the economy", out of concern that an actual 1 percent p.a. inflation rate in the aftermath of the Nasdaq bubble bursting was the precursor to "Japan-style" deflation, leading euro-officials joined the Washington club. The ECB responded to IMF warnings about "deflation in Germany" by declaring that 2 percent p.a. was now both the virtual lower limit and the ceiling to its quasi-target for inflation over the medium term.

That is all past history. But the danger of U.S. monetary shock is still for real. The inflation time-bomb thrown by the Bernanke Fed into the tracks of the U.S. economy last spring (2009) has the clear potential to destabilise the global economy including

Europe if not defused in time.

So what is the most positive scenario for European monetary evolution?

\* In this the ECB would commission a new design of its policy-making framework. Medium-term targeting of inflation would be discarded and replaced by the aim of price level stability over the very long run. A main feature of the design would be a monetary pillar in the form of strict targets for monetary base growth. And the monetary construction would include the restoration of non-interest bearing high reserve requirements (as in the old Bundesbank regime) and freely floating money market rates (no strict rate-pegging even in overnight markets).

\* A comprehensive well-policed fiscal union would be no part of the positive scenario. Market forces, not EU regulators, are potentially (within the right overall policy framework) the strongest disciplinarians. What re-design of EMU could strengthen those forces which in the last decade so hopelessly failed to prevent a delinquent and fraudulent government running up massive debts or banks in the bubble economies accumulating huge indebtedness to financial institutions in the North?

\* The most radical step to accompany the monetary re-design involves contemplating what ECB President Trichet as recently as March 4 says is "unthinkable" - the potential exit from EMU of a present member. There would be a contingency plan so that exit could occur in an orderly fashion without promoting panic. The possibility of an exit would enforce fiscal discipline much more effectively than the community of credit-rating agencies, credit default swap traders, and bond investors.

As soon as large fiscal deficits or rapid credit expansions made their appearance in a given member economy, funds would begin to pull out of banks there under the influence of a feared eventual devaluation. As borrowers there started to face a growing interest rate premium, the credit and asset market temperature in that country would start to fall.

In that sense, a Greek exit from EMU as a consequence of the present crisis might well be salutary for the whole system, rather than a dangerous first stage in a contagious process of divorce.

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