MONETARY PANEL
Amsterdam - 20 October 2006
Minutes of the meeting

Present

Wim BOONSTRA, President of the Monetary Panel

Austria	Marianne KAGER
Belgium	Jean-Jacques REY
Czech Rep.	Kamil JANACEK
France	André ICARD Philippe JURGENSEN Paul MENTRĖ Robert RAYMOND
Germany	Werner BECKER Rainer BODEN
Italy	Giovanna PALADINO
Netherlands	Han de JONG Cees ULLERSMA
Switzerland	Jean ZWAHLEN
Un. Kingdom	Graham BISHOP

Speakers

Francesco MAZZAFERRO, Head of Division - Dir.Gen. International & European Relations - ECB
Norbert WALTER - Group Chief Economist - DEUTSCHE BANK

ELEC Secretariat

Jean-Claude KOEUNE, Secretary General

- - - - - - - - - -

Introduction

The *President* took the chair at 9:05am and welcomed participants from nine countries. He expressed the Panel's gratitude to ABN AMRO and to his chief economist Han de Jong for hosting the meeting, which had also included the night before a working dinner with a fascinating speech by Maurice Oostendorp, head of ABN AMRO's Group Finance.

Further he paid homage to his predecessor Jean-Jacques Rey, who after a very distinguished career in central banking had chaired the Monetary Panel for three and a half years: this was a period of great activity and intellectual achievements for the Panel which gave rise, *inter alias*, to the publication of two *Cahiers Comte Boël*, on European economic governance and Financial supervision respectively. The Panel joined in this homage.

1. Adoption of the agenda

The agenda was unanimously adopted.

2. Approval of the minutes of the last meting

The minutes of the meeting held in Paris on 24mar06 were approved.

3. Future role of the euro in the international financial architecture

a) Presentation by Francesco Mazzaferro

Dr *Mazzaferro* prefaced his presentation entitled "International Role of the Euro" with a few introductory remarks, stressing first that for the ECB the international role of the euro was an analytical problem and not a policy concern, though this was an issue that the financial industry worldwide very much liked to discuss as it had become accustomed to work with different currencies. He observed next that the notion of a "boxing match" between the euro and the US dollar, whereby one could only gain at the expense of the other, was not an interesting one, noting first that over the last decade Europe's influence in the world had waned and that the emergence of the euro could not change this, and, second, that a dollar crisis could only result from events such that Europe would suffer at least as much as the United States. Finally he underlined that the euro's international role was only a part of the eurosystem's international relations, which also included regular meetings with central banks at the periphery of the EU (for instance in Russia, or Southern Mediterranean countries) and extensive consultancy work with countries trying to build monetary unions in their region (for instance the Gulf States).

The speaker's presentation highlighted the following trends in the euro's international use:

- gradual increase in euro-denominated international debt securities and deposits in third countries and as an anchor currency
- high degree of stability as a vehicle currency in forex markets and for international loans and deposits
- mixed evidence concerning trade invoicing in euro and euro banknotes circulation outside the euro area
- regional pattern of the euro's international use in most market segments.

b) Speech by Norbert Walter

Dr *Walter* dealt first with prospects for the enlargement of the eurozone, likely to be delayed in his view as the ECB was not pushing for it, academic research was rather negative toward it, and some of the new member states were politically moving away from joining. As to the "non-ins" (UK, Denmark, Sweden), he saw no scenario whereby they would join in the foreseeable future, since the political opposition to such a move remained solid in those three countries although - at least for Denmark and Sweden - there was no economic gain in staying out. The "deepening" of the eurozone appeared to be even more in limbo to the speaker, as " reform fatigue" had set in and "sovereigny delusion" was on the rise once again: as a result the completion of the single market and the abandonment of the unanimity rule were, for the time being, very doubtful.

He found Europe's economic momentum difficult to assess owing to the variety of situations it contained: small countries making good progress and Central European economies catching up in spite of political turmoil, but Italy, Germany and France showing little dynamism and suffering besides - like the rest of Europe - from a stagnant demography and a lack of qualified young labour, with the risk, increasingly, of losing out to North America and Asia. But Europe's role (Germany's in particular) in foreign trade remained impressive, and moreover it was now in a position to challenge the US

financial sector in many fields, though this by no means implied that the euro would soon overtake the dollar.

For Asia Dr Walter saw no chance of a monetary union before 2050, implying that the euro would remain for long the n°2 world currency. Any move by Asian central banks away from the dollar would likely be gradual but necessarily toward the euro, and not, for the foreseeable future, toward the rouble, renminbi or yen. Talk about monetary union was more advanced in the Gulf countries, but the question of what anchor they would eventually choose (USD, euro, or a basket) remained open. The huge US current account deficit, he argued, would eventually be corrected by a substantial weakening of the dollar -accompanied by rising US interest rates - which neither the ECB nor the BOJ would be able to prevent and which would obviously be detrimental to a number of European companies. But at the same time, given the weight of Europe in trade and finance, it would allow the euro to become a more important reserve currency, and this, concluded Dr Walter, provided good reasons to continue to improve Europe's financial architecture and the liquidity of the euro.

c) <u>Debate</u>

The *President* thanked both speakers and opened the floor for discussions. Mr *Icard* commented on recent trends in the composition of official reserves, with some Asian central banks having built significant positions in euro from its start, the yen having fallen below 5%, the share of the Swiss frank now minimal, but sterling becoming once again a significant reserve currency. Further he asked who would have an interest in converting dollars into euros and hastening the dollar depreciation: Asian central banks, he argued, were perhaps "locked in" their huge dollar holdings but would likely start buying real assets with part of their reserves.

Mr *Bishop* argued that, politically, the USA had lost its moral authority and asked how long the rest of the world would keep accumulating dollars when the US international role was increasingly questioned. Mr *Raymond* commented on the trade balance adjustments and on changes in balance-of-payments structures that would result from the dollar depreciation, which would therefore not be catastrophic, though painful. He also wondered whether, with national economies and companies being more and more open to globalization, there was still room for specific rules and systems for Europe: in the new member states especially, he said, businessmen's minds were increasingly open to the rest of the world, and big companies in France were profitable because they did most of their business outside the eurozone. Mr *de Jong* asked about the international role of the ECB in comparison with the Federal Reserve, and about the use of large (€500) euro notes in illegal activities.

Dr *Mazzaferro* agreed with Dr Walter that ending the enlargement process would not necessarily make room for further deepening, whether of the EU or the eurozone. He thought it unlikely that Gulf countries would change their dollar peg, arguing that for the time being they had no capacity to run independent monetary policies and acted in fact as in a currency board. He indicated that the ECB was, on a much larger scale than the IMF or the FED, a provider of technical assistance to foreign central banks (f.i. Egypt, Bosnia, and above all Russia).

Dr *Walter*, answering Mr Icard's suggestion that Asian central banks might start converting part of their dollar reserves into real assets in the United States, wondered how the US Congress would react to such a move, and argued that the "locked-in" effect would not forever prevent the necessary adjustment from occurring or even turning into an avalanche. To Mr Raymond he answered that more than trade adjustments would take place to the extent that people would not react rationally and would adjust their portfolios in favour of alternatives to the dollar; he also argued that many companies, in a globalized economy, were still oriented toward Europe because this was supported by political and institutional structures, while US governance and accounting standards were not necessarily optimal, and that in terms of political economy regional champions still made sense.

Mr *Boonstra* remarked that, in spite of its deficits, the US still had strong asset positions abroad; he also asked whether the US might not eventually be forced to finance its deficit by borrowing in foreign currencies. Mr *Ullersma* observed that oil-exporting countries now used hedge funds to manage part of their (mostly) dollar reserves, and that such funds being less conservative than central banks, the

risk of dramatic changes occurring in the currency composition of those reserves could not be ignored. Mr *Zwahlen* indicated that the composition of official reserves in Switzerland mostly took into account the geographical composition of its trade; the decline in the reserve status of the Swiss frank had to do, in his view, with the insufficient depth of its capital markets, to which central banks paid much greater attention nowadays, whereas sterling's position could be explained by the importance of British trade both with other European countries and with the USA. Concerning China's policy vis-à-vis the dollar, he asked whether at some point political considerations might not prevail for the communist regime. He also wondered about the true extent of "euroisation" outside the eurozone, considering the importance of outward shipments of euro notes (authentic or forged).

Mr *Jurgensen* observed that Slovenia would shortly become the 13th member of the eurozone and wondered who the 14th might be. He also wondered why Asian central banks did not start diversifying their reserves now to prevent dramatic moves later on. Mr *Mentré* remarked that while the US fiscal deficit had sharply declined over the past year, the current account deficit remained as high as before. Mr *Rey* wished to temper the gloom expressed by Dr Walter on Europe's political future, arguing that the decisive point was how to get rid of the unanimity rule for most decisions and that the pressure to do something to improve EU decision making would start rising soon, should the situation of *blocage* continue. Mr *de Jong* asked Dr Walter whether he agreed with the negative sentiment generally expressed by academic research vis-à-vis the enlargement of the eurozone.

Dr *Mazzaferro* indicated that the ECB did not encourage euroisation outside the eurozone to the extent that it wanted to ensure equality of treatment - including observance of the Maastricht treaty criteria - in getting access to the euro, although it was not obvious how to deal with euroisation in Montenegro and Kossovo (the latter suffering from severe deflation for having unwisely adopted the euro as its currency) once they became sovereign states applying for EU membership. In reference to Lithuania, he said that the ECB's tendency was to interpret Maastricht criteria very strictly, but that room for a political interpretation of the criteria existed at the Council's level. To Mr Rey he replied that rejection of the constitutional treaty by France made EU's political crisis deeper, in his opinion, than a question of decision-making procedures.

Dr *Walter* stressed for Mr Boonstra that, though the US still got a better return on its foreign assets than foreigners obtained on US liabilities, a situation where $700bn were added each year to those liabilities needed sooner or later to be corrected, but he doubted that US authorities would soon start denominating part of their debt in foreign currencies. Answering Mr Zwahlen on China, he said that if the Chinese were not treated well by the USA, they might indeed respond by dumping US Treasuries, which explained why the new Treasury Secretary had stopped China-bashing. To Mr de Jong he replied that on the question of the eurozone's enlargement he disagreed with academic research, most academic economists being in his view much too functional and not enough institution-minded. To Mr Rey he answered that with regard to the European project and to monetary unification he had long been not only a analyst but a missionary, which probably explained his current disappointment and his insistence on giving "lazy Europeans" a forward push. Similarly, he was concerned lest the world became too complacent about imbalances that had built up.

The *President* thanked both speakers for their stimulating presentations and active participation in a lively debate.

4. Economic and monetary conditions in European countries

The *President* opened the floor for the traditional *tour d'horizon*.

Mr *Janacek* commented on the situation in the <u>Czech Republic, Hungary, Poland and Slovakia</u>, observing that real growth was on the high side (5-6%), fueled a.o. by continued strong FDI inflows (except for Hungary), and that unemployment was decreasing (except in Hungary). Current account deficits were sustainable, except again in Hungary where it was officially estimated at 7% of GDP. Admission into the eurozone would probably come in 2009 for Slovakia and 2014 at the earliest for Hungary. For Poland and the Czech Republic he noted that important structural reforms had taken

place in the 1990's but that the appetite for new reforms was now rather low, and that they would probably not join the eurozone before 2012.

Mrs *Paladino* underlined Italy's macro-economic weaknesses -slow growth (1.5%), high budget deficit (4.8% this year), debt/GDP ratio rising again, and core inflation above the eurozone average- and mentioned the downgrading of its sovereign rating just announced by Standard & Poor's (from AA- to A+) and by Fitch Ratings(from AA to AA-). Questions were asked about Italy's competitiveness and the evolution of its unit labour costs by Messrs *Icard* and *de Jong*.

Mrs *Kager* quoted good numbers for Austria, but deplored the lack of structural reforms and the difficult situation on the political front following the recent general election.

Mr *Icard* saw clear signs of improvement in France's economic outlook (unemployment down, better budget prospects, business and household confidence rising), but expressed concern over competitiveness, as ULC was rising in France while falling in Germany. Mr *Jurgensen* noted that the political situation had changed since the rejection of the constitutional treaty, and that both Mr Sarkozy on the right and the three would-be candidates in the socialist party were in favour of restarting the process of EU's institutional reform.

Mr *Zwahlen* was optimistic for Switzerland (3% growth, 3.4% unemployment, productivity rising), claiming success in particular for its monetary policy, and only expressing slight concern for a certain weakness of the Swiss frank.

Mr *Becker* said that Germany no longer was the sick man of Europe, with 2.5% broad-based growth this year, budget deficit likely to fall below 3%, and investments rising in both machinery and construction. Slower growth was due next year however owing to the planned VAT-increase that would depress consumer spending. To a question by Mr *Koeune* on the quality of decisions taken by the grand coalition, Mr Becker responded that a number of bad compromises had been struck, but that the EU presidency would probably close the ranks of the coalition for six months. Mr *de Jong* argued that the inflationary impact of the VAT-rise might be limited next year to the extent that companies had started raising prices beforehand. Mr *Becker* agreed, and pointed out that the announced VAT-increase had also given a temporary boost to demand, allowing firms to raise prices. Mr *Raymond* stressed that the VAT-increase was equivalent to a devaluation for the German economy, since it would raise import prices but would not apply to exports. Mr *Becker* agreed that this would indeed change competitiveness.

Mr *Rey* expressed satisfaction on the economic situation in Belgium and commented on the political consequences of the recent local elections, with all political parties (with the exception of Flemish liberals) being able to claim victory, to the extent that the main party (socialist) in Wallonia had lost less than it had expected.

Mr *de Jong* commented on the situation in the Netherlands, where the economy was doing well (3% growth, 1.5% inflation, balanced budget, strong corporate profits) although some slowdown was expected for next year in the wake of Germany, where in addition structural reforms had been adopted, but where the political debate was more and more dominated by immigration problems, indicating concern by a growing number of Dutch people over their identity.

Mr *Bishop* outlined possible scenarios for the United Kingdom, where anti-European sentiment was still running high, to such an extent that a majority of SMEs now thought that the single market had failed. The economy was running its longest period of uninterrupted growth on record, but this, he claimed, was due to the large influx of migrants workers which had prevented wage inflation from developing but was now beginning to have a social impact. Government expenditures, as well as private debt, were rising sharply. Should this lead to a worsening of the situation, it might possibly induce a change in public opinion towards EMU membership and the benefits it provides of external constraints on public finance. On the political front, Mr Bishop said, financial scandals were threatening the Labour Party and, should one erupt, Gordon Brown might not escape its consequences entirely. Whether this possibility might provoke him into calling an early election (normally due in 2009) was an open question. Answering a question by Mr *Mazzaferro*, Mr Bishop

specified that there were now two major categories of immigrants into the UK: skilled and unskilled workers workers on the one hand, and criminals on the other, the latter creating the possibility of a very serious social backlash.

5. Future work of the Panel

The *President* asked the Panel for its preferences concerning topics to be discussed in 2007. The following subjects were proposed:

- financial market integration (by Mr *Mentré*)
- remaining obstacles to a European retail banking market (by MM *Boden* and *Rey*)
- internal clearings between big financial groups (by Mr *Raymond)*
- asset price inflation (by Mr *Jurgensen*)
- changes in relative competitiveness of European countries (by Mr *Becker*).

The *President* suggested that the Spring 2007 meeting should focus on the retail banking market and what could be done to remove the obstacles to its European consolidation. Mr *Bishop* agreed that this was an excellent topic and suggested that the outcome of the Spring meeting should be a paper containing ELEC's recommendations which would then be put on the table of the following ELEC-EFC dinner (see below). Messrs Becker and Boden and Mrs Kager volunteered to draft such a paper prior to the Panel's next meeting.

6. A.O.B.

At the President's request, the *Secretary general* reported on a meeting he had had on October 3 in Brussels with Graham Bishop, Wim Boonstra, Jean-Jacques Rey, Ansgar Tietmeyer and Anton van Rossum in order to take stock of a project (which the Panel had previously been briefly appraised of) initiated by Graham Bishop a year before and, of progresses toward its realization. The project was to have ELEC organize twice a year in Brussels ELEC-EFC working dinners with the support of financial institutions willing to host such dinners. They would bring face to face members of the EU's Economic and Financial Committee and ELEC participants (not necessarily members of ELEC but invited by ELEC).

As explained by Mr Bishop in a letter to Xavier Musca, EFC's chairman, *"ELEC participants would be senior representatives of their financial institution: board members or direct advisers. They would be specialists in economics, investment management, regulation, legal affairs, risk management etc. Thus the expertise would correspond to the areas that the EFC has to grapple with – but at a level of seniority so that the discussion would be about the principles and policies rather than technical details. (..) Perhaps the critical ingredient that would make this unlike any other session with national experts would be the wide geographical cross-section of expertise. So this event could give officials (rather than just the Commission – via its various advisory groups) a valuable direct exposure to the viewpoints of senior market players from outside their own state."* ELEC's stature and its past history, according to Mr Bishop, would give EFC participants sufficient guarantee that such encounters would not be a refined form of lobbying aimed at official players by private financial institutions.

The Secretary general added that Mr Bishop, with the approval of ELEC's President, had done over the past 12 months an extensive amount of footwork in approaching officials at the European Commission and the EFC, and had brought to the October 3 meeting the good news that EFC's chairman appeared to be convinced and willing to put the proposal to his colleagues. The rest of that meeting had focused on practical matters and had agreed that:

- prior to the first ELEC-EFC dinner (which might take place early in 2007), ELEC would submit to EFC a range of possible subjects for discussion (two subjects per dinner), with the provision that EFC should be free to select other topics
- the number of participants should not exceed 30 persons at most, viz. 10-20 from EFC and 10 from ELEC
- the dinner should be chaired by President van Rossum

- ELEC would introduce each subject in 5' and this would be followed by a 60' discussion.

Mr *Bishop* underlined that he had received strong support from the European Commission and said that ELEC should now develop a concrete proposal with a list of possible topics and a range of names of ELEC members (or to be invited by ELEC) with enough expertise on such topics. The remaining difficulty would be to find suitable dates for those dinners, given the EFC members' tight agendas and the fact that the eurogroup generally organized working dinners on the eve of EFC meetings. He added that, in his view, such ELEC-EFC dinners, if successful, would be a strong point for attracting to ELEC new members from financial institutions.

The *President* thanked Mr Bishop and the Secretary general and underlined that although this project was not *per se* a Panel activity, the Panel should have a strong interest in it to the extent that (a) some of its members would be participants on ELEC side in such dinners, (b) the project might bring interesting new members to the Panel, and (c) it should increase the impact of ELEC's work and of the Panel's positions in particular. Mr *Zwahlen* said that it was important to bring financial markets practicians, from ELEC's side, to such meetings. Mr *Raymond* stressed the need for careful preparation and suggested that the selection of persons to be invited by ELEC should be a function of the topics to be discussed. He also wondered about the risk of having EFC members sending their deputies at the last minute.

Mr *Ullersma* praised the idea but saw possible tensions between the fact that ELEC might have firm positions on some of the topics to be discussed at such dinners and the informal character of the discussion. He suggested therefore that ELEC participants speak in their personal capacity. Mr *Jurgensen* said that the topics should not be selected in the monetary and financial field only, given the broader mandate of the <u>Economic</u> and Financial Committee. He also wondered whether a formula less demanding for participants' agendas might not be acceptable, such as a one-hour meeting before the eurogroup's dinner. Mrs *Kager* suggested working breakfasts.

Mr *Bishop* agreed with Mr Ullersma that ELEC participants should be free to air their personal views, but stressed that if ELEC had a paper published on one of the selected topics, it should be briefly presented at such dinners. As to the formula (dinner or else), he said that the secretariat of EFC would have to inform ELEC about what was feasible, and that one had to stay flexible.

The *President* concluded that the project had the Panel's full support and needed very careful preparation. He suggested that a small group should continue to work out the details and examine in addition the implications of the project for the Panel's work.

Mr *Boden* informed the Panel that the forthcoming <u>meeting of the Monetary Commission in Kronberg</u> on November 24-25 could well be the last one, depending upon Deutsche Bank's willingness to continue to organize and fund such meetings. Mr *Bishop* stressed that, given the prestigious history of Kronberg, it was important that ELEC should keep the format and continue the tradition by organizing the meetings in Kronberg, with the help of other sponsors if they could be found. Mr *Jurgensen* agreed and wondered if the ECB could be a possible sponsor. Mr *Rey* agreed with the need to find other sponsors but expressed the view that the venue of the meeting should not necessarily be Kronberg.

7. Date, time and place of the next meeting

In Prague or Rome, in March 2007 (date to be arranged with the hosting institution).

- - - - - - - - - -