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THE INTERNATIONAL ECONOMY

The Magazine of International Economic Policy FALL 2011 • $18
www.international-economy.com

Jens Weidmann: The ECB's Last Hawk

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