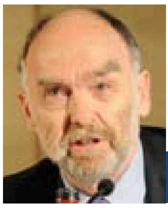
OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

January 2010



Congress hits at post-Greenspan Fed

US should copy Europe by limiting chairman's term

Stewart Fleming, Board of Contributing Editors

As the US Congress seeks revenge on those behind the worst financial crisis since the Great Depression, one of the politicians' highest-profile victims could be the Federal Reserve Board, America's central bank. Yet, in its battle with the Fed, Congress is deploying the wrong weaponry.

Incomprehensibly, the proposals before Congress do not include one obvious, overdue reform: limiting the Fed chairman's term to eight years, as is the case for European Central Bank board members. This could help avoid repeating the disastrous errors of Alan Greenspan's 18-year reign.

Differing regulatory reform bills before the House and the Senate could, if passed as they stand, subject the Fed to what its friends fear would be a political audit of its monetary policy decisions – undermining its freedom to conduct a (relatively) independent monetary policy. The proposed legislation could also eviscerate the Fed's banking regulatory and supervisory roles, with uncertain consequences.

By contrast, the European Central Bank is on the way to seeing its financial market oversight and influence increase, not diminish – although the ECB, too, faces some tricky challenges to avoid diluted monetary independence. [See stories pp 4 and 16].

Greenspan's exceptional longevity gave him undue dominance through subtle manipulation of his colleagues and a personality cult on a scale never before seen for a central banker. Greenspan superimposed on the Fed an obstinate adherence to outdated neo-conservative, free market ideology – leading to policy paralysis that severely constrained the Fed's response to sweeping structural changes in the global economy and financial markets.

The Greenspan legacy is certainly high in US legislators' minds. In the past, there has been lots of wild-eyed anti-central bank rhetoric on Capitol Hill, but politicians knew that wresting too much independence from the Fed would saddle them, in voters' view, with responsibility for unpopular increases in interest rates. So, over the years, Congress has produced mainly hot air plus some legislative tinkering.

This time could be different says Ted Truman, a former top Fed official, now at the Peterson Institute for International Economics, who believes a bill could be passed which will weaken the central bank's ability both to conduct independent monetary policy and to combat the sort of banking crises we have just witnessed.

The ECB, although not entirely free from attacks on its independence, faces

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Changing fortunes

Retail banks hold the key

Olann Kerrison, Senior Editor

Retail banking was a significantly greater source of profitability than investment banking during the last four years – exploding the myth that investment banking was a better and more efficient destination for capital.

Chasing better returns on equity was one of the driving forces behind the risk build-up that led to the great collapse of 2008. It was perceived wisdom that investment banking was the primary driver of profitability. However, examination of profits at 10 of the world's largest banks engaged in both retail and investment banking activity tells a different story. Between 2006 and Q3 2009, these banks earned a profit of $192 bn from retail banking, against $119 bn from investment banking. Even during the boom years of 2006 and 2007, retail accounted for $162 bn in profit, well above the $93 bn in investment banking.

Performance in 2009 showed a different pattern – something that places regulators in a rather precarious position. Among the 10

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The search for dialogue

A specialised yet creative eye

David Marsh, Co-chairman

The aim of the Official Monetary and Financial Institutions Forum is to promote a dialogue on issues of particular interest for central banks and sovereign funds, and the community that follows them within the financial markets and beyond. We highlight the questions of asset management, financial supervision and regulation, and the structure of the financial industry worldwide. Additional topics are individual countries' and regions' exchange rate regimes; changing patterns of international payments imbalances; and the semi-permanent tension between retail and investment banking.

We bring a specialised but also a creative eye to scanning these matters. We hope we can impart knowledge in a way that will provoke thought, but will also show adequate awareness of underlying nuances and complexities. In a world where financial and capitalistic power is moving, in fits and starts, from west to east, we aspire (albeit from an Anglo-Saxon base) to be global.

We would seek the support of our readers, friends and helpers as we try to live up to that objective We seek brevity and conciseness. And we maintain a sense of history. Those wishing to surmount the challenges of the present must be conscious of experience in tackling the struggles of the past.

This first issue bears witness to these preoccupations. Paul Volcker adds weight to the debate on 'narrow' banking. Meghnad Desai calls for a limited restoration of the primacy of gold in international financial dealings. Ousmène Mandeng laments the G20's paltry ambition on monetary reform. Darrell Delamaide says renminbi revaluation is a mirage. Our Global Analysis takes a uniquely detailed look at Gulf Monetary Union, pointing out the implications for central banks and sovereign funds if the plan went ahead – and how it might spark a re-appraisal of gold's role.

John Nugée ponders how times are getting tougher for independent central banks. Archive Insight resurrects a forgotten exchange between Margaret Thatcher and Hans-Dietrich Genscher. We are mildly respectful of the European Central Bank's speedily-won prowess; Stewart Fleming even advises the Americans to copy the ECB's statutes on the Fed chairman's term. But Harold James points out how the EU's fissiparous structure impedes solutions for troubled banks.

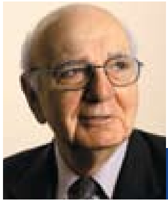
John Plender casts a sceptical glance at macro-prudential supervision and Michael Laffery berates the accounting profession (in Europe and elsewhere) for rehabilitating hidden reserves. Closer to home in London, William Keegan assesses the problems facing Mervyn King. Against that poignant background, let me wish you a Happy New Year.

Quote of the month

'Whoever believes that the European Union state members will put their hands in their pockets to save Greece, will end up deluded.'

Jürgen Stark, Member of the European Central Bank Executive Board

OMFIF welcomes readers' comments and we will print a selection in next month's Bulletin. Please send to david.marsh@omfif.org



Way forward for commercial banks

Why I favour separation from the capital markets

Paul Volcker, former Chairman, Federal Reserve Board

We simply cannot afford further financial market breakdowns. As well as an improved international approach toward capital and liquidity, we need better surveillance of the grossly swollen shadow world of derivatives, including credit default swaps. These are financial innovations that stretched beyond a certain point will do more harm than good.

But, beyond all else, we must deal with a fundamental issue. I favour a separation of commercial banking activities that are essential to the functioning of our financial system from more speculative trading-oriented capital markets activities that are not.

To tackle the financial crisis, governments and central banks have not only rescued particular financial firms but have also flooded markets with liquidity. However necessary in the circumstances, these interventions bring adverse consequences, most damagingly by generating expectations of future rescues, thus encouraging further risk-taking – the essence of moral hazard.

The challenge now is not only to reduce highly aggressive, excessively risk-prone banking but also to make the financial system safe against failure.

We must recognise that commercial banks – running payments, taking deposits, furnishing credit for individuals and businesses, underwriting corporate debt – lie at the heart of any financial system. That is why these activities have always been regulated and protected That will continue to be the case.

In recent years non-bank financial institutions have proliferated – hedge funds, equity funds, investment banks heavily engaged in trading activity.

These capital market institutions, despite some overlap, serve different functions than commercial banks. They trade and speculate in open markets on the basis of price and spread rather than primarily for customers. They provide liquidity and may raise capital, but they do so without implied responsibility for meeting customers' needs.

The distinction between commercial banking and capital market institutions provides a clear rationale for more effective regulation and supervision.

To lower the risk and vulnerability of commercial banks, I favour prohibiting their ownership or sponsorship of hedge funds, private equity funds, and large-scale purely proprietary trading activities in securities, derivatives or commodity markets. Furthermore, I would strictly enforce a functional separation of banking organizations from commercial and industrial activities.

These measures would directly eliminate potential areas of risk, reduce conflicts of interest and focus management attention on the core functions of banking. They would also limit the size of the largest mega-banking organizations.

Commercial banking is core and needs to be protected. There is nothing wrong with non-banking activities like hedge funds, equity funds and so on, but they are not core. If they fail, they fail; their shareholders and creditors will suffer and there'll be no public money for bail-outs. That is a logical way forward. To protect us from further calamities, we need an international consensus on this issue – as fast as possible.

Commercial banking is core and needs to be protected. Non-banking activities like hedge funds, equity funds and so on are not core. If they fail, they fail.

Threatening tide for central banks

Emerging pattern looks like repeat of 1930s

John Nugée, Advisory Board

What a difference a crisis makes. In 2010, central banking independence around the world will be under threat from many quarters. In contrast to the relative serenity of only three years ago, central banks are now no longer beyond the reach of politics. Governments around the world are running high-profile interventionist policies to restore growth – policies that bring incursions into no-longer-sacrosanct fields of central banking.

Pre-crisis, central bankers could enjoy the status of highly-regarded technocrats protected by political consensus on their operational independence, allowing them to use their technical skills and market presence to pursue the statutory objective of price stability. Despite residual concerns over what some might term a democratic deficit of public servants operating under only lightest political oversight, politicians and central bankers alike did their utmost to depoliticise the institutional framework and the operational independence of central banking.

This is no longer the case. As a result of the crisis, many governments have taken a much more direct and interventionist role in their economy and financial system. Inevitably some of this is politically controversial. As the main agent of governments in the markets, central banks cannot avoid this controversy. There are many possible flashpoints, including possible increases in interest rates after the drastic easing action of 2008-09, to unloading of government bonds amassed through various forms of liquidity support in the last 18 months.

Déjà-vu? The recent independence of today's central bankers is slight indeed compared to that of their 1920s predecessors. Leaders such as Governor of the Bank of England Montagu Norman, the Banque de France's Emile Moreau, Benjamin Strong at the New York Federal Reserve and the Reichsbank's Hjalmar Schacht negotiated directly with each other without consulting their finance ministries, or even sometimes informing them of their agreements.

Such independence and power, unthinkable today, became unacceptable after the financial world collapsed in 1929-33. Governments stepped in to restore order and solvency, and having done so, systematically trimmed the bankers' wings: the New York Fed was placed more firmly under the Board of Governors, and both the Bank of England and the Banque de France were nationalised within 15 years. The Reichsbank, meanwhile, became a tool of the Nazi state.

History shows central bank independence is not a monotonic progression but a swinging pendulum, as central bankers oscillate between close political oversight and relative operational freedom. Right now the pendulum is swinging back to the politicians. But, sooner or later, a new cry will go up: once again, to free the central bankers from political meddling.

History shows central bank independence is not a monotonic progression but a swinging pendulum, as central bankers oscillate between close political oversight and relative operational freedom.

A Bundesbank view on central banking independence

'The Bundesbank is a form of a state within a state – an economic policy counterweight to the government.'

Karl Otto Pöhl, Bundesbank president 1980-91, in 1989

A super SDR needs a gold lining

India's bullion purchase points to new reserve balance

Meghnad Desai, Chairman, Advisory Board

It is time to look again at the Gold Standard as a means of backing a new global monetary unit and restoring effectiveness to the international financial architecture. Surplus countries, led by the Chinese, have been calling for a super Special Drawing Right as a new reserve currency that can properly bear the burden of being a global asset. But a super SDR will need a golden lining if it is to become acceptable to a wide range of monetary holders and emerge as the pivot of a reformed system.

A new role for gold would be the right way of implementing important lessons learned from the near-breakdown of the financial system in 2007-09. There have been a number of indications of the rising importance of gold: the sharp increase in the price, the desire of leading emerging economies to add to their bullion stocks, and the recent reluctance of many old-established monetary gold holders to reduce their reserves of the metal. The Reserve Bank of India's purchase of 200 tonnes of gold in October, graphically underlining how central banks may prefer gold to the dollar, was a particularly important pointer.

It may be useful to resurrect in modified form Keynes' radical proposal of the bancor – a global currency that would deny monetary sovereignty to individual nations and avoid payments imbalances by punishing the hoarders of excess reserves. To continue Keynes' line of thinking, a reserve currency should be a combination of national currencies and also try to stabilise commodity prices, the volatility of which (such as in the 2007-08 oil price fluctuations) augmented the financial boom in its last stages and hastened the real output recession. The International Monetary Fund should be the central intermediary at the heart of this system, recycling surplus savings to deserving borrowers in ways which can reduce excess volatility.

It may be useful to resurrect in modified form Keynes' radical proposal of the bancor – a global currency that would deny monetary sovereignty to individual nations.

However, the IMF needs to preside over a global monetary unit that would be not only a stable standard of value, but also a means of payment and a store of wealth. That is why a reformed super-SDR will have to be backed by gold if countries are to trust their surpluses to the IMF's care. The IMF can then behave like a global bank, from which countries can borrow resources for investing at home and also for settling international debts. A basket of currencies modelled on the existing SDR might provide a stable standard of value if there was suitable diversification in its portfolio of currencies. But a modified SDR based on currencies alone would not be a means of payment, even for settling balance of trade debts, let along a store of wealth. To fulfil this criterion, gold would need to be added to the asset portfolio backing the SDR.

The 1990s and the first three-quarters of the first decade of the 21st century were a period of near-unprecedented growth, along with a high degree of integration in flows of capital, commodities and labour. This enabled Asian countries to emerge as vibrant economic powerhouses. But these years also generated massive payments imbalances which, by helping fuel the over-leverage of financial institutions, ended up bringing the edifice to the brink of collapse.

The Gold Standard accompanying a previous wave of globalisation in the 19th century was an exogenous, self-imposed constraint on monetary sovereignty. It provided a fully reliable monetary system in which the purchasing power of money was not in doubt, nationally or globally. Since the breakdown of the Bretton Woods gold-dollar exchange standard in 1971 we have been grappling intermittently with the task of finding a successor. We have been left with a system where all nations except the reserve currency country – the US – had an exogenous constraint on their monetary sovereignty. The supply of international liquidity became intertwined with US fiscal discipline. All too frequently, the world has been vulnerable to American fiscal misbehaviour.

In recent years, under-saving in the US and other industrialised economies was financed, broadly speaking, by global flows of excess savings of Asian and other economies. This

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flow from savers to consumers happens all the time in national economies and the banking system facilitates it. In the global context, in the absence of a truly global central bank or a global currency, the flows were intermediated through US Treasury bills or generally through the US financial system. This gave the US unearned seigniorage gains and generated unsustainable credit booms which central banks, far from countering, actually provoked.

One key conclusion from this episode is manifest. We need an international currency system that would insulate all national economies, especially the US, from seigniorage gains that impede the pursuit of sound financial policies. To restore discipline and pave the way for stability, gold can play a crucial role. To determine how to accomplish this aim, it is time for a serious international debate. We at OMFIF will do our best to try to lead it.

Congress hits at post-Greenspan Fed *(continued from page 1 ...)*

nothing like the legislative barrage confronting the Fed – a sign, perhaps, that it has had a relatively good crisis. The ECB's performance, not just over the past 2-1/2 years but from its birth in 1998, has on the whole been pretty sure-footed. Moreover, from the days in late July and early August 2007 when (prompted, it must be said, by the Bundesbank), it reacted swiftly and courageously to inject billions of euros into the collapsing money markets, it has held its nerve.

However, in the decade of financial market transformation up to Greenspan's January 2006 departure, the Fed's conduct of monetary policy, both practically and intellectually, was at best haphazard, at worst an unmitigated disaster.

Crucially, in 2001-03, partially overlapping with current chairman Ben Bernanke's period as board member, the Fed ignored a massive easing of fiscal policy and slashed interest rates recklessly during the dot.com crash – fighting a deflation which was present only in officials' imaginations. The Fed then held rates at crisis levels of 1% for a year, before telegraphing to the markets the ensuing monetary tightening, so diminishing its impact and laying the foundations for the sub-prime crisis.

Prisoners of outdated economic theories, Greenspan and his acolytes contrived to ignore the asset bubbles around them, concocting weird theories to justify their irresponsibility. Inevitably, as he aged, he became both complacent and lazy, failing to grapple mentally with the dramatic changes and new challenges confronting economic policy makers. Only after Greenspan's retirement at age 79 did he publicly confess to this error.

Changing fortunes *(continued from page 1 ...)*

banks, retail profits in the first nine months of the year totalled $7.6 bn, while profits through investment banking activities reached $59.8 bn.

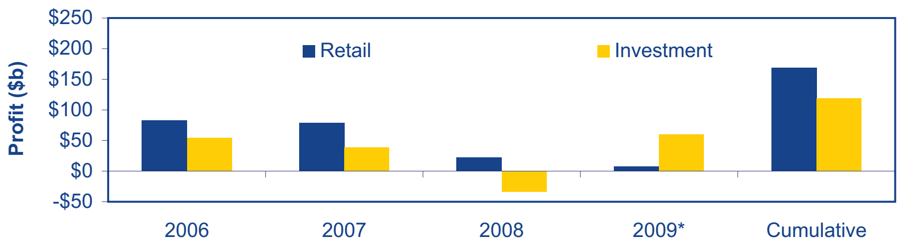
This reversal is explained by the different effects of the economic downturn. Investment banking write-downs were ploughed through the system in 2008, while 2009 was a year for recession-induced cheap funding, less competition and plenty of fees for capital raising. For the retail sector, 2009 was characterised by collapsing demand and rising unemployment, which boosted credit losses to record levels. Retail will suffer due to the downturn for some time yet, at least in developed markets. Unemployment will remain high, lagging economic recovery, and this will hold down customer acquisition and new lending.

The relative success of investment banking activities creates a headache for regulators. Investment banking profits now appear to be propping up the banking industry, after a period in which governments and central banks around the world have given the industry hundreds of billions of dollars of support. Many regulators and politicians would like nothing better than to bring in swingeing new curbs on investment banking activities. But this might lead authorities to shoot themselves in the foot by crippling the very industry they have worked so hard to save.

The hard facts of the relative underlying profitability of retail and investment banking are well-nigh undeniable. But it will probably take a lot to correct the misplaced view that investment banking is the better bet for capital allocators. One reason why investment bankers could attract capital for their activities is because, in this sector, results happen quickly, based on transactions; the quicker the deal, the greater the profits.

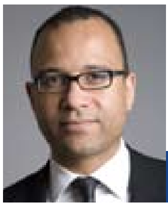
Given the importance of quarterly reporting, bank management has often preferred to feed the capital allocation appetites of deal-hungry investment bankers to the detriment of retail banking activities that are more relationship-based and take much longer to build up. By appearing to be both more profitable and less time-intensive, investment bankers have laid claim to producing golden eggs. Now that the geese laying them have had to be supported with massive state help, maintaining that pretence may be more difficult.

Selected global banks: profit by business type



Notes: includes Bank of America, JPMorgan Chase, Citi, RBS, HSBC, Barclays, BNP Paribas, Deutsche Bank, Santander, Standard Chartered; currencies converted at reporting date; * 2009 figures are YTD Q3 2009, excluding HSBC and Standard Chartered, which relate to H1 2009

Source: Company reports, Lafferty Group research



G20 challenge on reserve currencies

Three-pronged action to renew Bretton Woods

Ousmène Jacques Mandeng, Ashmore Investment Management

Now that the worst of the global financial and economic crisis appears behind us, the G20 process promoted with great fanfare over the last two years looks like running out of steam. The two summits planned in 2010 – in Canada in June and in Korea in November – should put reform of the world monetary system firmly on the agenda, as a prerequisite for securing the path to durable recovery.

Replicating Bretton Woods cannot be accomplished overnight, but we should make a start. Unless the G20 evolves in this direction, we will not see conditions for a durable recovery.

At the Pittsburgh gathering in September, G20 leaders agreed to launch a framework for 'strong, sustainable and balanced global growth' but failed to spell out concrete measures. The statement at the close of the meeting resounded with vacuous-sounding phrases such as 'mutual assessment', 'regular consultations" and 'strengthened cooperation' but was singularly non-committal regarding adjustment mechanisms or penalties for non-compliance.

While the statement mentioned 'balanced growth' and related expressions 29 times, it referred to 'exchange rates' only once. Leaders made no reference whatsoever to the international monetary system. Yet, as part of a lasting crisis resolution, the world urgently needs to overhaul its basic monetary machinery. This is the G20's greatest reform challenge.

At the heart of the matter is the dollar, which has remained the dominant currency since the Second World War even though over time the US has lost a large amount of economic competence and authority compared with the rest of the world.

Reliance on the dollar has caused significant global imbalances that have contributed to the global crisis in the first place. Furthermore, use of national currencies to manage international liquidity, risks being inherently unstable as issuing countries are unlikely to subordinate their domestic policy objectives to the needs of the international economy.

A three-pronged package of currency measures would help alleviate the problem.

- Currency diversification: To restore greater payments discipline, provide incentives for payments adjustment and dilute reliance on individual currencies, the international economy should not rely on few but many currencies as reserve assets. To foster inter-currency competition, many leading emerging market economies should be prepared to allow their currencies to be used as reserve assets.

- Capital account liberalisation: To allow currency diversification, emerging economies should bring forward measures to liberalise their capital accounts to foster portfolio allocations to new currencies.

- New currencies reserve pool: To facilitate adoption of trading and foster liquidity in underlying securities of new currencies, a pool for new currencies should be established where central banks exchange current assets against new international reserve claims.

Policies along these lines would help revive the spirit of the 1944 international monetary conference at Bretton Woods, which agreed fixed exchange rates based on the dollar and gold and established the International Monetary Fund to enforce adjustment. Replicating Bretton Woods in today's complex multi-polar world cannot be accomplished overnight, but we should at least make a start. Unless the G20 evolves in this direction, the large group of leaders who convene these days for world summits are unlikely to establish conditions necessary for a durable recovery.

Rolling out the welcome mat

But US views on funds may not have durably changed

David Marsh, Co-chairman, & Darrell Delamaide , Board of Contributing Editors

Sovereign wealth funds, once forecast to inherit the earth, are now expected merely to finance it. Less than three years ago, the state funds run by oil-, commodity- and foreign exchange-rich countries were widely forecast to quadruple their assets under management by 2015, comfortably outstripping central banks as the world's main holders of official wealth.

The credit crunch, stock market attrition, recession and a series of sometimes stunningly unsuccessful individual investment setbacks, especially in financial stocks, have put a stop to that type of heady speculation. The end of the love affair between state funds and western banks has been aptly symbolised by the lawsuit brought over Abu Dhabi Investment Authority's 2007 purchase of a $7.5bn stake in Citibank.

Frequent miscalculations have reversed the current of suspicion between eastern investors and western targets. Sovereign funds now find the welcome mat rolled out in places that previously shunned them. Conversely, as estimates of their wealth fluctuate like a weight-watcher's waistline, the funds are sensibly eschewing 'me-too' deals brokered by Wall Street's finest – and turning to investments they actually understand, such as domestic projects, raw materials or back-to-basics industry.

Germany illustrates the new mood. Unaccountably for a country which itself is one of the world's largest capital exporters, as a result of its endemic current account surplus, the German parliament in 2008 brought in a registration system to deter foreign purchases of domestic companies. One financial crisis later, international buyers are seen as knights chasing away the stock market bears. Investments by Abu Dhabi's Aabar in Daimler, or the Qatar Investment Authority in Volkswagen, met Germanic acclaim.

Latest figures from Germany indicate that foreigners now own 52% of the largest 30 companies on the German stock market – up from only around 33% eight years ago, according to the Handelsblatt newspaper. A significant proportion of this is in holdings by state-linked investment vehicles. Unlike some of the Gulf funds' well-publicised excursions into financial stocks, Middle East and Asian money entering German industry appears to be there for the longer haul. Echoing the view of Kuwait, which took a stake in Daimler as long ago as in 1974, Aabar has spoken of its new holding in the Stuttgart-based motor company as lasting for '50 to 100 years.'

Unlike some of the Gulf funds' well-publicised excursions into financial stocks, Middle East and Asian money entering German industry appears to be there for the longer haul.

In the US, controversy about sovereign funds' activities has wound down as they redirect spending to domestic targets to help stabilise home economies. Efforts at de-mystification, including the end-2008 adoption of the Santiago principles to promote transparency, have defused some US government concern. Some funds have actually taken concrete measures to improve transparency.

But Washington insiders say that does not mean any efforts by a sovereign fund to acquire a controlling interest in a US company would meet with less resistance than before. The Committee on Foreign Investment in the US (CFIUS, an inter-agency government committee) is alive and well, and may make even more difficulties than before for potential foreign government investors.

Governments around the world are now playing a greater role in national and global economies. But that doesn't mean everyone has to like it. American political and public opinion is likely to be more averse than ever to government interference in the economy. In the US, at least, views on state funds have changed less than meets the eye.

Arab monetary union plan inches closer

Big implications for reserve assets and sovereign funds

A single currency across the heartlands of Arabia is inching closer. The six countries of the Gulf Cooperation Council (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Oman and Bahrain) that have been intermittently discussing a single currency for more than 30 years have more economic homogeneity than the 16 members of the euro – and much more than the highly diverse countries of South-East Asia that have also been considering closer monetary cooperation.

Moreover, the Arab states can look back on a much longer historical record of monetary unity than either the euro area or the highly disparate states of South East Asia linked by the 14-member Chiang Mai currency initiative.

Advancing the long Gulf monetary legacy to the modern age has hitherto proven a mirage. Now, however, the shapes in the sand are now starting to take on slightly more distinct contours. Shortly before Christmas, Kuwaiti Finance minister Mustafa al-Shamali, speaking at a GCC summit in Kuwait, proclaimed, 'The Gulf monetary union pact has come into effect.' Grand phrases are nothing new. Reminiscent of the crab-like progress towards EMU in Europe over 50 years, the target date of 2010 for a Gulf single currency was set nearly a decade ago but has been subject to repeated postponements. More important than broadcasting fine phrases, Gulf technocrats are now at last starting to grapple with laying down the considerable statistical and institutional infrastructure required for a new system to function. [See panel 'Pointers from the European Central Bank', pp 11 and 13].

One significant hurdle centres on the degree of independence from government that not only a mooted new supranational GCC central bank but also all constituent national central banks would be required to attain to give a new Gulf currency credibility on world financial markets. For EMU, Europe had no choice in the matter: on offer was the successful model of the super-independent Bundesbank, which Germany made non-negotiable condition for the single currency. In view of the intricate interweaving of public and private affairs in the Gulf, any hybrid culture for a semi-autonomous GCC monetary institution will be a great deal more complex.

Another highly important issue in Gulf monetary union, hitherto given only the scantiest attention, is the need for harmonisation of foreign exchange and investment practices between national central banks and the sovereign funds that hold most of the region's foreign assets. At the very least, this would presuppose much greater accountability and transparency of these funds' operations.

A third factor is the role of gold. The GCC countries are at present mainly pegged to the dollar (although Kuwait linked the dinar to a currency basket in 2007). On the assumption that a GCC currency would have a diminished link with the dollar, countries in the region might favour a greater weight of gold in their monetary reserves to buttress the new currency's standing. They might seek to emulate the main EMU members which include (after the US) the world's main monetary gold holders. [See table on pp 12].

The six largest EMU economies (Germany, France, Italy, Spain, the Netherlands and Belgium) hold a collective 9,400 tonnes of gold – largely a residue of official transactions during the 1960s. The giant European total compares with a paltry official tally of just 230 tonnes for the GCC. In the top three euro economies, bullion reserves valued at $1,000 per ounce outweigh foreign exchange holdings by four, three and two to one (in the case of France, Germany and Italy respectively). The position is reversed for the GCC, where the main gold holders, Saudi Arabia and Kuwait have (on the basis of official figures supplied to the IMF) seven times as much foreign exchange by value compared with

Importance of a potential GCC currency

The global importance of the putative Gulf currency lies in:

- the region's hydrocarbons concentration – the GCC accounts for over 40% of global oil reserves and 23% of natural gas;
- its $1- $1.5 trillion stocks of official currency reserves and other marketable assets husbanded in a myriad array of sovereign funds;
- its potential to unhinge the pivotal role of the dollar by moving its monetary arrangements away from a peg to the US currency.

A Gulf currency grouping would be insignificant in terms of economic size or population. The GCC's combined nominal GDP is less than Australia's; Vietnam has twice as many people. However the Gulf states, whatever the tribal and historical differences, share a common language, religion and traditions and have not been riven by the fratricidal wars that tore across Europe for much of the past 500 years. All these factors should reduce complexity.

The region's security reliance on the US is arguably much greater – and will continue to be so – than that of Europe in the post-Cold War era. None the less, it is almost inconceivable that a single GCC currency area would stick to the present fixed dollar link upheld by most members (the exception is Kuwait, which switched its currency peg to a currency basket including the euro in 2007). This would extend the move towards a multi-currency reserve system that will be one of the main features of the next 20 years.

gold. (The ratios for Bahrain, Qatar and Oman are, respectively, 12, 41 and 11,400 to 1.)

The imbalances are even larger in the Chiang Mai group, where foreign exchange outweighs gold 68 to 1 in China, 41 to1 in Japan, 50 to 1 in Thailand, 25 to 1 in Indonesia, 77 to 1 in Malaysia and 7 to 1 in the Philippines and Cambodia. If there was a global desire to even out these imbalances, an intriguing proposition would be for the main EMU states to organise in the next 10 years a massive asset swap for currencies against gold with the leading Gulf and Asian economies.

For the moment, though, the minds of Gulf central bankers and finance ministers are on more prosaic matters. One factor aiding the GCC monetary drive has been the relatively robust functioning of EMU in Europe during the financial crisis, at a time when oscillations in the world economy led to falling GCC current account surpluses (and even small deficits into two states last year) and exposed vulnerability in places like Dubai.

Yet frequent hold-ups over the past decade underline the tortuousness of the journey. The GCC was formed in 1981. Two members, Oman and the UAE, have withdrawn from the monetary union project, for a mixture of political and technical reasons – setbacks accompanied by bickering similar to that which dogged the decades-long trek to EMU. Oman, the second smallest GCC economy, said in 2006 its economic structures would not be ready to meet the exigencies of a single currency, while the UAE pulled out last year to protest at the plan to site the regional Central Bank in Riyadh, the capital of Saudi Arabia (which has five times the UAE's population but has an economy that is only two-thirds bigger).

Even optimists say it will take at least 10 years for the Arab states to bring in a physical single currency. But this time, they may at last be starting to show the necessary political will to fulfil the target. A Common Market has now been functioning (for all its shortcomings) since 2008. There are signs that the low level of intra-GCC trade (stuck at 5 to 6 % of total trade for decades) is starting to pick up. The December GCC summit formulated a long-mooted plan for a monetary council as the forerunner of a Gulf central bank to coordinate interest rates and money supply policies. This is in line with the European experience of setting up the European Monetary Institute in 1994 to prefigure the European Central Bank that started in 1998.

The importance of technical issues has been underlined by UAE Central Bank Governor Sultan bin Nasser al-Suweidi, who said his country's withdrawal from the monetary project was based on reservations over currency technicalities and the role of

What's in a name?

European states reached agreement on the name for the new European currency only in December 1995, more than two years after the decision to place the European Central Bank in Frankfurt. The neutral name 'euro' was seen as vital to obviate suspicions about dominance by particular states. Even on the most optimistic assumptions, the GCC will need several years before it can select an appropriate name from a list of possible options:

Khaleeji – Arabic for 'of the Gulf'. *Drawback*: already associated with banks and other institutions in the region.

Karam – Arabic for 'generosity'. *Drawback*: might imply monetary laxity.

Gulfo – analogous to euro. *Drawback*: sounds like a VW car.

Araby – romantised version of Arabia, would appeal to Anglo-Saxon traders. *Drawback*: reminiscent of James Joyce's 1914 story.

Dinar – currency in Kuwait and Bahrain, derived from Roman denarius. *Drawback*: not neutral.

Dirham – currency in UAE, and 1/100 of Qatari riyal, derived from Greek drachma. *Drawback*: not neutral.

Ri(y)al – currency in Saudi Arabia, Qatar, Oman. *Drawback*: not neutral.

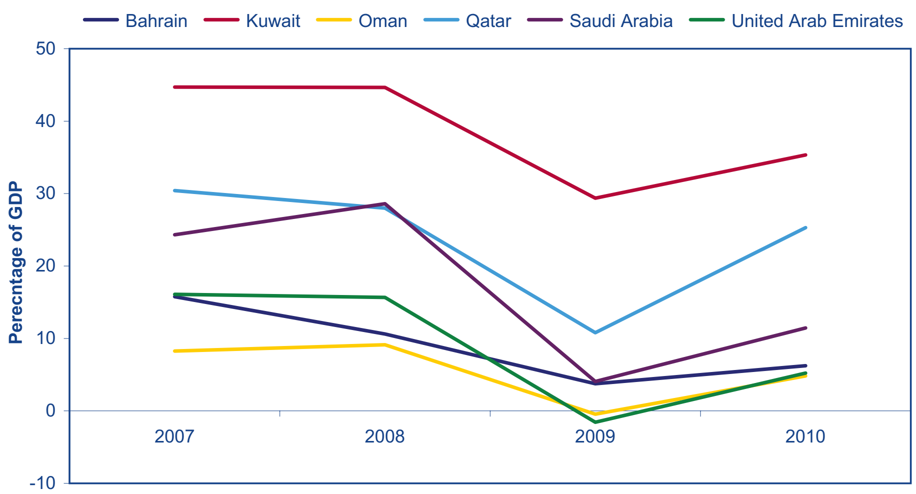
Darad / Dirhal – merges Dinar, Riyal and Dirham. *Drawback*: inelegant.

Pound – harks back to currency in Palestine in 1927, later turned into dinar. *Drawback*: colonial memories.

Rupee – pre-1960s tradition. *Drawback*: dependence on India.

Piaster – Ottoman currency. *Drawback*: ultimately devalued.

Fluctuating current account balances



Source: IMF

the monetary council, not simply the issue of where to house the Gulf central bank. The UAE Governor has argued for the GCC gradually to adopt a unit of account to test monetary policy ahead of introduction of a single currency. He has also emphasised the need for other preparatory steps such as a unified inflation index. These proposals seem thoroughly sensible, and parallel European practice before EMU took effect. If such questions can be resolved, Arab leaders should be open to some form of compromise that would allow the UAE to re-enter the project, perhaps by splitting the putative Gulf central bank's functions between Riyadh and the Emirates.

The European Central Bank, playing a behind-the-scenes role in the process, can point to the long time lags in the European experience. The 1970 Werner plan calling for monetary union by 1980 led to nothing more revolutionary than the fixed but adjustable European Monetary System. The December 1991 Maastricht summit laid down the path to EMU, but another seven years elapsed before exchange rates were fixed, and only in 2002 did euro coins and notes start to circulate.

Certainly, Gulf states can draw inspiration from a rich monetary history. Over more than two millennia, rulers ranging from Roman emperors and Islamic caliphs to Ottoman sultans and British generals have all provided unifying monetary influences in the region and, in many cases, a common currency. The Kuwaiti and Bahraini dinar are daily reminders of the silver Roman denarius first minted 2,200 years ago.

Shortly after the Bretton Woods monetary conference in 1944 – at which the only modern Arab state to be represented was Egypt – 22 Arab countries pledged exchange rate cooperation and devised a united currency called the Arab dinar. Up to the 1960s the Indian rupee was still the most widely-used currency in the Gulf.

Conditions for Gulf monetary union – pointers from the European Central Bank

A research document from the European Central Bank in June 2005* laid down some key pointers for success of Gulf monetary union. Although not meant to express the precise institutional views of the ECB, the paper sets down the orthodox European consensus on the principal conditions needed to make Gulf monetary union a success. The following extracts provide a flavour of the institutional hurdles to be mounted.

POLITICAL CONSENSUS – 'A broad consensus [is needed] on i) the basic orientation of monetary and exchange rate policy and other key areas of economic policy, in particular fiscal policy; and ii) political commitment to the economic integration process in general, and the monetary union project in particular. ... The political commitment has to be strong and unambiguous at the highest political level ... . an informed commitment that takes fully into account the inevitable implications of monetary union [which] ultimately results in the transfer of sovereignty from the national to the supranational level in monetary affairs and, to some extent, needs to be accompanied by constraints for budget deficits , which are widely regarded as being at the core of national sovereignty.'

MONETARY DECISION-MAKING – 'As monetary union requires a single monetary and exchange rate policy, the GCC has to establish a supranational monetary institution to formulate and conduct such a policy. While different models could be envisaged for the division of labour between such a supranational central bank and the national central banks and monetary agencies, decision-making on monetary and exchange rate policy has to be centralised in the new institution. The single monetary policy has to be geared to economic, monetary and financial conditions in the monetary union as a whole.'

EXCHANGE RATE RULES – 'The main question ... is likely to be the exchange rate regime of a single currency. Up to now, all GCC member states have chosen to peg their currencies to an external anchor and, in so doing, have achieved a remarkable degree of macroeconomic stability. However, there might be considerations to modify the external anchor or to move to a more flexible exchange rate regime, thus allowing more autonomy for a domestically-oriented monetary policy. Whichever path is chosen, many of the other institutional and policy decisions ahead of the launch of the GCC single currency may depend to some extent on the choice of exchange rate regime. Therefore, reaching a broad consensus in the GCC on this fundamental orientation of monetary and exchange rate policy before a monetary union is established would help to avoid possible conflicts later on.'

CENTRAL BANKING INDEPENDENCE – 'Both central bank practice and academic research provide ample evidence that central banking independence is essential for monetary stability …. The decision on the degree of independence is ultimately a political one to be taken by the relevant authorities in the GCC, against the background of their historical experience and their political systems. A broad consensus on the status of a GCC monetary institution and its relations with political authorities at the GCC level and the national level prior to the establishment of a monetary union would reduce the risk of conflicts later on. Furthermore, the agreed level of independence is to be granted to all central banks in order to provide monetary stability, and to avoid institutional incompatibilities between a supranational institution and national monetary agencies and central banks.'

** Regional monetary integration in the member states of the Gulf Cooperation council, by Michael Sturm and Nikolaus Siegfried, ECB occasional paper No. 31.*

Monetary unions, actual and envisaged, in Europe, Middle East and Asia

How the nations compare – Key statistics at a glance

	GDP			Population	Consumer prices	Current account		Official reserves		
	$bn	Per capita $	% change	million	% change	$bn	% of GDP	Foreign exchange $bn	Gold (m troy oz.& $bn)	Ratio foreign exchange: gold
Gulf Cooperation Council (GCC) – potential members of Gulf Monetary Union										
Saudi Arabia	380	14,870	-0.9	25.5	+4.5	+15.4	+4.1	30.2	4.6	7:1
UAE	229	46,580	-0.2	4.9	+2.5	-.3.6	-1.6	35.9	N/A	N/A
Kuwait	115	32,490	-1.5	3.5	+4.7	+33.7	+29.4	18.5	2.5	7:1
Qatar	93	75,960	+11.5	1.2	0	+10.0	+10.8	16.4	0.4	41:1
Oman	52	18,720	+4.1	2.8	+3.3	-0.2	-0.5	11.4	0.001	11,400:1
Bahrain	19	24,350	+3.0	0.8	+3.0	+0.7	+3.7	1.8	0.15	12:1
European economic and monetary union (EMU) members – top six economies										
Germany	3,235	39,440	-5.3	82.0	+0.1	+94.2	+2.9	38.0	109.5	1:3
France	2,634	42,090	-2.4	62.3	+0.4	-30.4	-1.2	27.6	78.3	1:4
Italy	2,089	34,950	-5.1	59.8	+0.8	-52.4	-2.5	35.8	78.8	1:2
Spain	1,438	31,140	-3.4	46.2	-0.3	-86.7	-6.1	12.9	9.1	1.4:1
Netherlands	790	47,040	-4.1	16.8	+0.9	+55.6	+7.0	9.8	19.7	1:2
Belgium	462	42,960	-3.1	10.7	+0.2	-4.5	-1.0	8.0	7.3	1:1
Chiang Mai states – top six economies										
Japan	5,049	39,570	-5.4	127.6	-1.1	+96.9	+1.9	1,005	24.6	41:1
China	4,758	3,570	+8.5	1,334.3	0	+371.5	+7.8	2,328.3	33.9	68:1
Korea	800	16,450	-1.0	48.7	+2.6	+27.0	+3.4	259.3	0.5	518:1
Indonesia	515	2,220	+4.0	231.5	+5.0	+4.5	+0.9	59.1	2.4	25:1
Thailand	266	3,970	-3.5	67.1	-1.2	+12.9	+4.9	134.7	2.7	50:1
Hong Kong	209	29,560	-3.6	7.1	-1.0	+22.3	+10.7	240.0	0.07	3,430:1
EMU members – next 10 economies										
Austria	374	45,090	-3.8	8.3	+0.5	+7.9	+2.1	5.1	9.0	1:1.8
Finland	242	45,880	-6.4	5.3	+1.0	+1.3	+0.5	7.1	1.6	4:1
Greece	338	30,300	-0.8	11.2	+1.1	-33.8	-10.0	0.2	3.6	1:18
Ireland	227	51,130	-7.5	4.4	-1.6	-3.9	1.7	0.5	0.2	2.5:1
Portugal	220	20,650	-3.0	10.6	-0.6	-21.7	-9.9	0.8	12.3	1:15
Slovak Republic	88	16,310	-4.7	5.4	+1.5	-7.1	-8.0	0.05	1.0	1:20
Slovenia	50	24,580	-4.7	2.0	+0.5	-1.5	-3.0	0.6	0.1	6:1
Luxembourg	47	94,420	-4.8	0.5	+0.2	+3.5	+7.6	0.3	0.07	4:1
Cyprus	23	30,240	-0.5	0.8	+0.5	-2.3	-10.0	0.5	0.5	1:1
Malta	8	18,530	-2.1	0.4	+2.1	-0.5	-6.1	0.4	0.01	40:1
Chiang Mai states – next eight economies										
Malaysia	207	7,470	-3.6	27.8	-0.1	+27.8	+13.4	92.4	1.2	77:1
Singapore	163	34,350	-3.3	4.8	-0.2	+20.5	+12.6	182.5	N/A	N/A
Philippines	158	1,720	+1.0	92.2	+2.8	+5.1	+3.2	36.6	5.0	7:1
Vietnam	92	1,050	+4.6	87.2	+7.0	-8.9	-9.7	18.4	0.3	61:1
Myanmar	27	442	+4.3	60.0	+6.7	+0.4	+1.5	N/A	N/A	N/A
Brunei	15	36,680	+0.2	0.4	+1.2	+5.2	+35.2	0.9	N/A	N/A
Cambodia	11	780	-2.7	13.9	-0.6	-0.6	-5.5	2.7	0.40	7:1
Laos	6	900	+4.6	6.4	+0.2	-0.9	-15.4	N/A	N/A	N/A

Notes: All figures are for 2009.

Source: IMF Global Database (as of November 2009). Official foreign exchange and gold reserve figures are from International Financial Statistics (latest month.- mainly October-November 2009)

In 2001 the Gulf states agreed on the plan for a single currency by 2010 as a means of enhancing general economic and financial integration.

The dollar currency peg has facilitated economic convergence – although the same factor has been blamed for the region's above-average inflation rate. An IMF staff paper in 2007 concluded that ratios on liquidity to GDP, budget deficits, government consumption, and degree of openness were highly correlated over 1991-2005, although it called for further increases in macroeconomic policy harmonisation.

In terms of economic structure, there is much divergence – but some broad similarity, too, with Europen patterns. Saudi Arabia makes up 43% of GCC GDP and has 20 times the economic weight of the smallest economy, Bahrain. But such disparateness is also a feature of the euro, where Germany makes up 30% of the GDP of the top six EMU states (and 26% of the 16-member region). Germany's economy is 400 times larger than the smallest, Malta, and is 25 times larger than the combined total of the bottom four EMU economies (Slovenia, Luxembourg, Cyprus and Malta). The richest GCC state measured by GDP per capita, Qatar, is five times wealthier than the poorest, Saudi Arabia, while the wealthiest euro state, Luxembourg, has six times the GDP per capita of the Slovak republic.

Economic discrepancies are still larger among the Chiang Mai states. Japan, the largest economy in terms of nominal GDP, accounts for 41% of the GDP of the 14-nation area, while China makes up 39%. The Japanese economy is 840 times larger than that of the smallest, Laos, and 85 times bigger than that of the four smallest combined (Myanmar, Brunei, Cambodia and Laos).

In terms of population density, however, the GCC shows convergence with the Chiang Mai area: China and Saudi Arabia account for 63% and 65% of the population of their respective 14- and six-nation areas, against only 25% for the German share of population of the 16-member EMU.

Conditions for Gulf monetary union – pointers from the European Central Bank

CENTRAL BANK OPERATIONS – 'A supranational GCC monetary institution will have to be fully operational as from the day on which the single currency is introduced. Therefore it is crucial to take into account the lead times require to set up the institution, including, for instnace, the analytical agenda that has to be addressed, and testing the operational framework. The European experience suggests that preparation for monetary union and he ultimate set-up of a supranational central bank are greatly facilitated if a predecessor institution, such as the European Monetary Institute in the case of the EU, is set up early on in the process of monetary integration.'

FOREIGN EXCHANGE RESERVES – 'An agreement has to be reached about control over and management of foreign exchange reserves. Reserves can be transferred either totally or partially to the supranational institution, or left in the hands of the national central banks... . If , for instance, the supranational monetary institution is assigned the task of executing interventions on the foreign exchange market, it might be preferable for it to command part of the reserves directly... . It is of great importance that the GCC monetary institution and its decision-making body have effective control over the use of foreign exchange reserves if they remain with the national central banks, and that the supranational institution is in a position to influence large foreign exchange transactions undertaken by other public bodies in the member states, which might impact the single exchange rate policy.'

PAYMENTS MECHANISMS – 'Monetary union requires the provision of safe and reliable monetary area-wide mechanism for the settlement of payments and securities transactions. The existence of such mechanisms is a crucial precondition for a smooth execution of a single monetary policy... . Area-wide infrastructure for he handling of large-value and retail payments and securities transactions are vital not only for the overall efficiency of the economic system, but also because they facilitate economic and financial integration in a more general sense. A first step could be to define the requirements and to conduct a thorough review of the payment and securities settlement systems currently in place for the handling of transactions within and between GCC member states.'

CONVERGENCE CRITERIA – 'Prior to monetary union the GCC faces the challenge of designing an appropriate set of convergence criteria, taking into account the specific situation of the region and the inevitable policy choices involved in establishing such criteria. Monetary criteria could be used to monitor whether the high degree of monetary convergence already achieved by GCC member states is maintained up to the introduction of a single currency. Fiscal criteria would be crucial in fostering fiscal convergence on the the basic of sound public finances…. Fiscal convergence has to be ensured via a permanent framework for fiscal policy even after the single currency has been introduced.'

FISCAL FRAMEWORK – 'A fiscal framework for the GCC could be based on more than one indicator, in particular given the intricacy of fiscal policy in oil economies. For instance, developments in an oil-price-related overall balance-to-GDP ratio could be combined with and cross-checked by the primary non-oil balance. ... A further element could be a close monitoring of and target for debt (asset)-to-GDP ratios. Identifying a target for this indicator and a path to achieve the target could be beneficial, given the importance of debt (asset)-to-GDP ratios for the long-term fiscal policy.'

Focus on system-wide risk may disappoint

No new dawn for a safer economic cycle

John Plender, Board of Contributing Editors

Such is the global consensus on the merits of macro-prudential supervision that a high degree of scepticism is in order. Granted, the theoretical case is sound enough: the idea that if financial institutions are rigorously supervised individually, systemic risk will look after itself has been wholly discredited by the events of the past 2-1/2 years. That alone makes the case for a renewed focus on system-wide risk.

Macro-prudential supervision is the fashionable nostrum of the day. Yet the key methodology is largely untried and implementation will be fraught with difficulty.

But where is the novelty in the macro-prudential approach, what is it intended to achieve and what does its toolkit look like? Bodies such as the Financial Stability Forum were long ago asked to assess the vulnerabilities of the international financial system, which is essentially a macro-prudential task. These spectacularly failed to deliver. Yet now we are to have more bodies, including the cumbersome European Systemic Risk Board, where the outcome may be all too similar.

If there is a novelty in the current debate, it is the proposal for counter-cyclical provisioning to create capital buffers. Some argue that this could be used to smooth the economic cycle and pre-empt bubbles. Others see it as a more limited tool to secure financial stability.

Then there is the question of how far the capital regime should be mechanistic and how far subject to discretion, which would require difficult judgments to be made about where we are in the economic cycle. How such judgments would meld with wider monetary policy decisions remains unclear – as indeed does the state of play on monetary policy itself.

In the post-Greenspan world, many acknowledge that exclusive reliance on inflation targeting is one of the more egregious examples of one-club golfing in economic history. Yet there is no clarity on how far policy should lean against the wind of booming asset prices, nor on what support such policies should receive from macro-prudential tools.

There does, at least, appear to be growing agreement on the need for an element of discretion in the operation of capital buffers. In which case there are two potentially huge difficulties in the proposed macro-prudential approach. One is that this implies a return to the old central banking art, famously described by William McChesney Martin at the Federal Reserve in the 1950s and 1960s, of taking away the punchbowl when the party is getting going. It is a lost art and it remains a moot point whether watchdogs can be found to do the job well.

The second snag is that the existence of discretion creates an opportunity for private bankers to exercise their formidable lobbying power. The recent Spanish experiment with capital buffers ran into powerful criticism from the banks for being too restrictive at precisely the point where the party was getting going. The rules were promptly relaxed and while the Spanish banks have been less badly hit than some, the economy has suffered a more extreme cycle than most.

Macro-prudential supervision is, then, the fashionable nostrum of the day. Yet the key methodology is largely untried and the implementation will be fraught with difficulty, especially in terms of the cross-border dimension. At the very least, it will herald a new era in the battle between the guardians of monetary and financial stability and the partygoers of the business and political systems. But a new dawn for a less accident-prone economic cycle? Surely not.

Back to past on hidden reserves

Why we must resist the Spanish model

Michael Lafferty, Co-chairman

The field of bank accounting is in a chaotic state, mainly because banking regulators around the world are seeking to dictate how banks should account for bad debts and other financial instruments. They are talking their own regulatory book, and are not required to consider the interests of shareholders and other stakeholders.

Fortunately, securities regulators like the Securities and Exchange Commission (SEC) in the US are fighting back to protect the interests of investors. Though bank regulators probably do not realise it, if they have their way banks will rapidly sink back to the bad old days of secret reserves and profit-smoothing – a regime that persisted in the UK and many other countries until the 1980s. As a result banking will become less efficient. The system may appear to be more stable. But we will be reinforcing it on foundations built on sand.

Under existing accounting standards banks are treated like all companies and are required to publish financial statements that show a true and fair view of their position. This means that they should not maintain secret or inner reserves. Nor should they smooth their results. Specifically, banks like other companies are only permitted to maintain provisions for losses and liabilities that are known at the balance sheet date. Any provision above and beyond that is a reserve, or part of shareholders' funds.

The method of provisioning applied by most banks around the world, called the incurred loss model, is now under threat. Regulators represented by the Financial Stability Board want banks to adopt a totally different model called dynamic provisioning, where banks provide for all the losses on loans that they expect to make, regardless of when these are incurred. This has the effect of reducing profits in good times and reducing losses in bad times – by a smoothing process that brings losses forward for accounting purposes. The regulators point to the example of Spain, where the regulator has imposed dynamic provisioning on banks for years.

The global accounting rule-maker, the International Accounting Standards Board, has proposed a third approach – the so-called expected loss model, which is a half-way house between the incurred loss approach and dynamic provisioning.

In reality there is now a gentlemanly stand-off between the banking regulators and the accounting standard-setters. The accountants want to be helpful, but know that they will destroy their credibility with investors if they authorise dynamic provisioning.

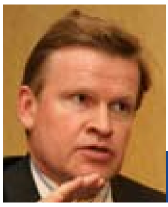
Meanwhile leading accountants remain bemused about the Spanish case study so often touted by the banking regulators. It is an unpalatable truth, but it needs to be said: in any serious ranking of countries for their accounting prowess, Spain would be close to the bottom of the league table.

There is a stand-off between the banking regulators and the accounting standard-setters. The accountants know that they will destroy their credibility with investors if they authorise dynamic provisioning.

Another view on Spanish provisioning

'I think Spanish provisioning is a good system that is now much more widely accepted, but it is not a panacea. Still, I am glad things are moving into this camp as it makes the system less pro-cyclical.'

Jaime Caruana, general manager, Bank for International Settlements, former Governor, Bank of Spain, August 2009



Balkanisation threat to the euro

Why nation-states are insufficient to tackle bail-outs

Harold James, Advisory Board

Of the world's central banks, the European Central Bank has probably emerged from the financial crisis with its reputation most enhanced. That is in part because of sensible policy responses; but it is also in large measure because the immediately urgent policy excitements and controversies seem to be occurring among the larger players.

Smaller countries – including the UK – are struggling with the aftermath of the bank disasters and bailouts. Large countries are at the focus of the discussion of global imbalances. Critics are already suggesting that 'Chimerica' is back to blowing bubbles. There is less to criticise in Europe, and much to commend in terms of the prompt provision of unprecedented amounts of liquidity.

But two long-term problems confront Europe. Both had been the subject of intense debate 20 years ago, before the euro was born. Neither was adequately resolved. The first, and best known of these intractable issues, is the question of fiscal rules, and the attempt to impose limits on debts and deficits through a Stability and Growth Pact. But that 'Pact' was substantially watered down in the first years of the 21st century. As fiscal deficits explode in the aftermath of the financial crisis, the chances of some sort of sovereign default are rising.

A default by a member state would not necessarily mean the end of the euro, any more than the problems of California pose an insuperable challenge to the position of the dollar. But there need to be clearer guidelines on how such a default would be handled. Otherwise, rising spreads will mean that the EU becomes a framework in which two groups of countries move in different directions, as high reputation countries can borrow cheaply, and as a result may grow faster. In the end, such a two-speed economy, especially when the higher speed countries are also the richer ones, would destroy the core of the European project.

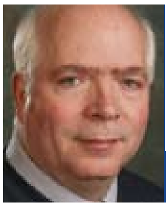
The second intractable problem concerns the desirability of a Europe-wide mechanism for banking supervision and regulation. Such a possibility was also debated in the early 1990s, and the ECB Statute provides for the possibility of such supervision. But the potential for Europe-wide supervision and regulation was not explored before the crisis, and efforts to move in this direction are still tentative and half-hearted. Instead there is a substantial 'renationalisation' (it might also be termed Balkanisation) of finance and banking.

There are three sources of this dynamic. Banks that have received bailouts not unsurprisingly are under pressure to concentrate their lending more on domestic borrowers, and to sell off foreign engagements. Efforts to increase capital ratios are pushing down bank lending. Finally the EU competition authorities are demanding down-sizing and smaller banking.

Because bank bailouts are essentially fiscal operations, they can only be managed by nation-states, and cannot at present be tackled at the EU level. The result is a constant suspicion that European banks do not have the same kind of safety net behind them as the large US institutions.

Although both the US and China are more obviously the guilty parties in 'causing' the financial crisis (through sub-prime mortgages and big current account surpluses), their financial institutions are less badly affected. On the contrary, American and Chinese financial institutions will emerge out of the crisis as stronger in global competition. Unless Europe can find a way of responding to that challenge, it will lack some of the infrastructure needed to respond effectively to globalisation.

Banks that have received bailouts not unsurprisingly are under pressure to concentrate their lending more on domestic borrowers, and to sell off foreign engagements.



The mirage of renminbi revaluation

Americans and the world should get used to reality

Darrell Delamaide , Board of Contributing Editors

The reality is slowly dawning in Washington. There's going to be no significant change in the uncomfortably skewed balance of forces between the dollar and the renminbi.

For the world economy, the awkward creditor-debtor relationship between China and the US is a central economic fault-line. We've had 12 months of high-flying Sino-American monetary diplomacy aimed at alleviating the disequilibrium.

But no amount of huffing and puffing by Beijing will bring down the gigantic US budget deficit. And no amount of windy rhetoric by the Obama administration is going to persuade the Chinese government to propel the renminbi towards sustained appreciation. The defiant declaration by Prime Minister Wen Jiabao last month that China will not yield to foreign pressure on revaluation could not have been clearer.

In Washington, there's now a certain acceptance that an undervalued currency is China's passport to fast export-led growth – and to accomplishing its long march to the head of the economic league. With an estimated two-thirds of its $2.3 trillion currency reserves invested in the dollar, China has no interest in seeing the greenback depreciate further. The US is rich, China is still poor, yet the Americans are the debtors. What we see now is a snapshot of the economic ranking in the years to come: only a cataclysm will prevent China becoming the world's biggest economy.

China's ascendancy does not imply that the US must grow poor, no more than Europe did with the rise of the US in the last century. America will continue as a rich, powerful nation – more powerful than Europe ever was in relation to the US.

As for the dollar, don't bet on its imminent demise. Pundits may preach the emergence of a tri-polar currency regime encompassing the dollar, the renminbi and the euro – much as a generation ago we sometimes envisaged a dollar, yen and ECU world. For the moment, though, China clearly is not ready for convertibility. And the debt woes of southern Europe underline the euro's fundamental weaknesses.

Numerous exhortations to explore the use of Special Drawing Rights as a reserve currency – notably from China's ever-quizzical Governor Zhou – have failed to strike a chord. We've seen it all before, 30 years ago, when those calling for a diminution of the dollar's reserve role invented the ill-fated SDR substitution account under President Jimmy Carter – with precious little effect.

Numerous exhortations to explore the use of Special Drawing Rights as a reserve currency – notably from China's ever-quizzical Governor Zhou – have failed to strike a chord.

So we're left with a paradox. China's on the way to world economic leadership. But a key condition for this to happen is that the renminbi never reaches its true value, and the dollar stays at the top of the currency pole. One thing is sure. In the next 12 months we will see far fewer hand-wringing international declarations favouring a renminbi revaluation. It ain't going to happen. The world should wake up to that fact.

Uncompromising view from Beijing

'We will not yield to any pressure of any form forcing us to appreciate. As I have told my foreign friends: on the one hand, you are asking for the renminbi to appreciate; and on the other hand, you are taking all kinds of protectionist measures.'

Wen Jiabao, Chinese Prime Minister, December 2009

A monthly foray into monetary secrets hidden in archives

High hopes from joining 'Gold Standard' D-Mark

How a German minister Thatcher disdained helped persuade her of the merits of a European monetary scheme she later condemned

Hans-Dietrich Genscher, the veteran German foreign minister who was one of the architects of German unification 20 years ago, has emerged in a new and unlikely role. He is the man, British government archives reveal, who became an incongruous Continental sounding board during the stormy period in which then Prime Minister Margaret Thatcher was eventually persuaded to join the European exchange rate mechanism (ERM) in 1990.

Genscher's meeting with Thatcher took place at 10 Downing Street on 30 July 1990. It was a bitter-sweet occasion. Only a few hours earlier, one of Thatcher's foremost political allies, Ian Gow MP, had been murdered by an IRA car bomb. Genscher was held in no great esteem by the British prime minister, who thought him 'soft' on military spending and on standing up to the Russians. But the visiting Foreign Minister, who had been entertained to the opera at Glyndebourne in the Sussex countryside by Foreign Secretary Douglas Hurd the previous evening, was in emollient mood. Genscher started off by comiserating with the prime minister over the Gow killing. Thatcher was on her best behaviour. Only a fortnight earlier, another key confidant, Industry Secretary Nicholas Ridley, had been forced to resign after making anti-German remarks in an interview with The Spectator magazine.

Thatcher told Genscher the UK would join the ERM 'to use the D-Mark as a sort of Gold Standard which would help bear down on inflation.' She had told John Major, the Chancellor of the Exchequer, the previous month, that she would no longer resist joining the ERM in principle, but opposed joining straight away. The Genscher meeting was part of a tortuous political journey under which she eventually agreed on an October entry date.

The Genscher meeting was part of a tortuous political journey under which Thatcher eventually agreed on an October 1990 entry date for sterling joining the ERM.

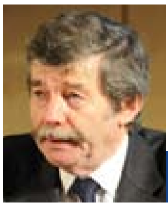
Thatcher told Genscher there was no case for going further than the ERM. A single currency 'did not make sense and would no be accepted by the British parliament.' When Genscher – finding it hard (according to the official document) to get a word in – said the best way to discipline European countries was through an independent European Central Bank, Thatcher demurred; she would have 'much more confidence in the discipline of the D-Mark, based on the historic aversion of the German people to inflation, than in a Central Bank where Germany might find itself out-voted.'

After she left office, Thatcher condemned the ERM as a straitjacket, saying Britain should have realigned sterling earlier rather than stay on to the bitter end with the pound's forced departure on Black Wednesday in September 1992.

Ironically, if Thatcher had had her way, Britain might have devalued sterling unilaterally, in, say, January 1992. It would thus have ridden out the currency storm far better in the course of the year. Maybe Black Wednesday would have never happened. Sustained membership of the ERM – but at a lower value for sterling against the D-Mark – would have put the British debate on EMU on to an entirely new footing.

Britain's ERM episode left epochal scars. It demolished the claims of the Conservative government (under Major as Thatcher's successor) that its economic policies were superior to the Labour Opposition's. It condemned Major to a premiership of drawn-out attrition and eventual defeat by Labour in 1997. And it confirmed UK suspicions about the drawbacks of fixed rate European currency schemes. Still today, this remains a substantial psychological hurdle to UK membership of the EMU.

Sources: Documents on British Policy Overseas: German Unification 1989-1990 (Routledge/Foreign and Commonwealth Office, 2009); Hans-Dietrich Genscher, Erinnerungen, 1999; Margaret Thatcher, The Downing Street Years, 1993.



The problems confronting Mervyn King

Sobering New Year message from Bank of England

William Keegan, Chairman, Board of Contributing Editors

In the ante-rooms to the Bank of England's magnificent Court Room there are portraits of previous governors and deputy governors. The visitor is reminded of how in recent years the governorship has been a 10-year cycle – Gordon Richardson, 1973-83, Robin Leigh Pemberton, 1983-93, and Eddie George, 1993-2003.

When, after a seven-year spell (1991-98) as Chief Economist and five years (1998-2003) as Deputy Governor, Mervyn Allister King was appointed Governor in succession to Eddie George, a number of his friends thought that the lure of academia would be too strong, and that King would want to step down at some stage during his second term that started in 2008.

However, King, who is a well-read man with interests far outside economics, must be all too aware of the reply given many years ago by the British Prime Minister Harold Macmillan to an interlocutor who asked what worried him most. It was not what the Labour opposition might do: it was 'the opposition of events, dear boy.'

One of King's best known remarks after he became Governor was that his ambition was 'to make monetary policy boring.' It has not quite worked out like that. In common with many of his central banking counterparts, King's main interest in the early years was inflation-targeting. He never harboured any illusions that true love of inflation-targeting would run smooth: indeed, he warned that what he in 2003 dubbed the Nice Decade – non-inflationary consistent expansion – would be succeeded by tougher times. But I do not think that he, or anybody else in the business, quite foresaw the form that those tougher times would take.

As King contemplates the year ahead – and the years after that – he must feel that he has become a prisoner of events, and that he may well now have to see the crisis through to the end of his second term. The pressures on the Governor have been, and remain, heavy; but, unlike the days of his predecessor Montagu Norman, so vividly captured in Liaquat Ahamed's book Lords of Finance, the present Governor cannot just go off on a three month cruise.

Most commentators are speculating about the Governor's plans for the 'exit strategy' – about when quantitative easing will come to an end and how differences between the Governor and the Government will be resolved over the UK's budget deficit and the form of future banking regulation. This is against the background where King has been remarkably courageous – his critics would say mistaken, or even foolhardy – in attacking the very banking system of which the central bank is usually regarded as the custodian.

Thus the Governor has described last year's emergency measures as being 'designed to protect the economy from the banks'; and, with regard to the thousand billion pounds of official support to the British banking system, he has echoed Churchill with the words 'never in the field of financial endeavour has so much money been owed by so few to so many.'

But friends of Mervyn King say his public pronouncements are but a shadow of the anger and pessimism he feels in private about the slow progress of financial and international monetary reform, and the 'moral hazard' problem of banks that are still seen as 'too important to fail.'

There are plenty of obvious worries for the Governor in 2010. One of the biggest must be that, although he wants a greater commitment from government with regard to deficit reduction, he is very pessimistic, given the state of the banks and the contraction of money and credit (for all that quantitative easing!), about the scope for the kind of economic recovery that would assist deficit reduction.

Overhanging everything is the Governor's concern that, to reverse that cliché beloved of politicians, with regard to the banking system, 'Lessons have not been learned.' It all adds up to a sobering New Year message.

Looking ahead – diary dates

Inaugural OMFIF meeting

2 & 3 March 2010
Deutsche Bundesbank, Frankfurt, Germany
Symposium: Official Asset Managers and the New World Regulatory Architecture

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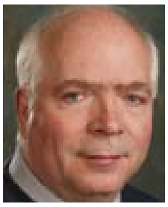
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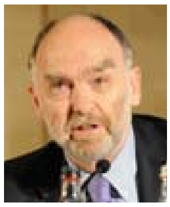
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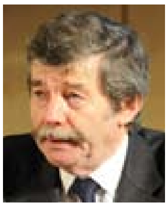
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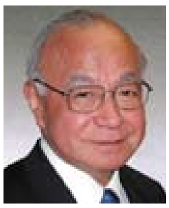
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OMFIF welcomes readers' comments and we will print a selection in next month's Bulletin. Please send to david.marsh@omfif.org