OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

February 2010

Avenger Volcker sharpens Atlantic split

Europe-US divisions hamper recovery strategy

Stewart Fleming, Board of Contributing Editors

European political and monetary decision-makers do not know whether to applaud the bravery or deplore the audacity of President Barack Obama's proposals effectively to split US banks again into commercial and investment banking activities.

By apparently cutting directly across Europe's universal banking model, Obama's plan widens further the monetary gulf between Europe and the US. This casts a blight over trans-Atlantic cooperation as economies haltingly prepare for what policy-makers earnestly hope will be a post-recession return to semi-normality.

The Obama recommendations sprung on European policy-makers take up wholesale the long-held views of Paul Volcker, the 82-year-old former Federal Reserve chairman, lately donning the mantle of an Old Testament avenger [January OMFIF Bulletin, p.3].

The President's plan would move towards reversing the November 1999 blunder by President Bill Clinton. Then, encouraged by his Treasury Secretary Larry Summers, now a top White House economic adviser, and Fed chairman Alan Greenspan, a rabid de-regulator, Clinton succumbed to banking lobby pressure and agreed to repeal the 1933 Glass-Steagall Act.

This legislation, following revelations of scandalous banking behaviour before and after the 1929 Great Crash, forced a split between retail deposit-taking commercial banks that could participate in a newly-established deposit insurance scheme, and securities-underwriting investment banks that would not benefit from deposit insurance.

The Obama proposals followed an extraordinarily combative speech on 3 January by Greenspan successor Ben Bernanke. The current Fed chairman bluntly denied that US interest rate policies bore any responsibility for the financial crisis. This view conflicts directly with the judgment not only of many Europeans, but also with that of a former senior colleague in President George W Bush's administration (and a fellow monetary policy expert), Prof. John Taylor.

European officials believe the Volcker-Obama plan, if propounded internationally, could threaten international efforts to build a standardised globalised regulatory architecture. Many details have yet to be worked out, let alone agreed by Congress. But the plan is in direct conflict with Europe's universal banking model written into the Second Banking Directive of 1989.

The trans-Atlantic divide seems likely to be emphasised anew by differences

(continued on page 4 ...)

Contents

Gulf power play

Saudis flex muscles over GCC

A special correspondent

A key reason for the fresh momentum behind Gulf monetary union [January OMFIF bulletin, p.9] has emerged in the shape of Saudi Arabia's desire to reassert regional leadership and limit damage from growing international irritation over a default by two of the kingdom's leading conglomerates.

A long-simmering power struggle between the two largest regional economies, Saudi Arabia and the United Arab Emirates (UAE), has come to a head as a result of a preferential deal for Saudi creditors in the tangled affair over alleged fraudulent activity at Saad Group and Ahmad Hamad Algosaibi and Brothers (Ahab). The two groups are together estimated to owe dozens of regional and international banks $20bn, after debt-fuelled misdemeanours last year that are causing considerable ructions within and beyond the Arab world. UAE banks have been hard hit by a freeze on Saad assets by the Saudi Arabian Monetary Agency, part of an apparent bid to feather-bed Saudi creditors.

(continued on page 4 ...)

Letter from the chairman

Official Monetary and Financial Institutions Forum

One Lyric Square
London W6 0NB
United Kingdom
t: +44 (0)20 3008 8415
f: +44 (0)20 3008 8426

David Marsh
Co-chairman
e: david.marsh@omfif.org
t: +44 (0)20 3008 5207

Michael Lafferty
Co-chairman
e: michael.lafferty@omfif.org
t: +44 (0)20 3008 8415

Vasi Papadopoulos
Wiebke Räber
OMFIF Secretariat
e: vasi.papadopoulos@omfif.org
e: wiebke.raeber@omfif.org
t: +44 (0)20 3008 5207

Evelyn Hunter-Jordan
Managing Director
e: evelyn.hunter-jordan@omfif.org
t: +44 (0)20 3008 5283

Gert van Deventer
Chief Financial Officer
e: gert.van.deventer@omfif.org
t: +44 (0)20 3008 8421

Darrell Delamaide
Newswire Editor
e: ddelamaide@aol.com
t: +1 (0)202 248 1561

Olann Kerrison
Senior Editor
e: olann.kerrison@omfif.org
t: +44 (0)20 3008 8417

Tom Brown
Production Editor
e: tom.brown@omfif.org
t: +44 (0)20 3008 5269

Changing the world, again

Wind of change blows through banks

David Marsh, Co-chairman

A 6 foot 7 inch octogenarian ex-central banker with a defective hearing aid and a deceptive mumble is walking unusually tall and riding unusually high. What is more, this is the second time that Paul Volcker is changing the world.

In those bygone days of August 1979 when Leonid Brezhnev was ensconced in the Kremlin, Margaret Thatcher had just entered Downing Street and China had foreign exchange reserves of just $2bn, President Jimmy Carter appointed Volcker chairman of the Federal Reserve Board.

Just two months later he revolutionised the US system for steering monetary policy, raising interest rates to nerve-crunching levels to squeeze inflation out of the economy.

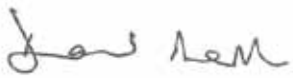
More than 30 years later, Volcker is again turning the world upside down, prompted by another hard-pressed Democrat president who – like Carter – faces the danger of being relegated to history as a one-term incumbent.

Hardly surprisingly, the February OMFIF Bulletin has a Volckerian tilt. It's an occasion in particular for my co-chairman Michael Lafferty – a man who has fought through thick and thin over the years to encourage retail banks to stand up against the powerful forces of investment banking – to welcome the wind of change in global banking. In similar vein, William Keegan summons the spirit of J.K. Galbraith to salute the latest towering devil-cum-hero in Washington.

But it's not all Volcker. We have Jonathan Fenby examining the domestic political influences behind China's renminbi policy. A special correspondent dissects the power play in the Gulf states. And Brendan Brown looks at the real causes of the dollar's weakness, which he says is home-grown, not made in Asia.

On the European scene, Darrell Delamaide baptises the new-old French president Charles de Sarkozy. Niels Thygesen makes an unfashionable plea in favour of the euro – and, in particular, urges his native Denmark to abandon its 'halfway house' policy on the single currency and join in fully. David Green says Europe's 'one size fits all' interest rate policy will not work unless backed up by fiscal solidarity between richer and poorer states.

As sovereign borrowers jostle for competitive advantage on capital markets across the world, that is a theory that is being truly tested in practice in the case of Greece. There is certainly plenty to keep an eye on.



Quote of the month

'Having fallen off a cliff, the bounce in financial markets has been more startled bunny than dead cat.'

Andy Haldane, Executive Director for Financial Stability at Bank of England

OMFIF
Official Monetary and Financial Institutions Forum

Spinning the wheel of Chinese fortune

People's Bank lacks political clout on renminbi

Jonathan Fenby, Board of Contributing Editors

Zhou Xiaochuan, Governor of the People's Bank of China, is highly respected among his international peers. His technocrats are first rate. If it had been left to them, China might some time ago have decided to let the renminbi float upwards to curb inflationary pressures and meet international demands for a more market-oriented currency policy to help lower international imbalances.

But it is not up to them. The Chinese leadership believes monetary policy is too important to be left to technocrats. Zhou and his expert advisers do not enjoy political clout. He is near the bottom of the State Council rankings and does not belong to the Politburo, let alone its Standing Committee. For all its trappings of modernity and economic reform, China is still a nation ruled by Communist Party veterans. The state commands the towering heights. Land, labour and capital markets have not been liberalised. Everybody wants China to raise the value of its currency in 2010. But Beijing is highly unlikely to fall in with the consensus wish in any big way.

There is a mood afoot in China similar to that of high Victorian Britain or 1950s America. Getting growth up to 10.7% in the last quarter of 2009 (8.7% for 2009 as a whole), on top of 30 years of expansion since Deng Xiaoping launched market-led reforms, has greatly boosted Chinese self-confidence. As it showed at the Copenhagen climate change summit, China is not going to give way or cut deals.

There is a mood afoot in China similar to that of high Victorian Britain or 1950s America. Getting growth up to 10.7% in the last quarter of 2009 has greatly boosted Chinese self-confidence. China is not going to give way or cut deals.

As long as the Chinese economic story remains fundamentally successful, the men in charge will do what they want to do. And they will do so with popular backing. The regime needs short-term growth to maintain its legitimacy, minimise the risks of social discord and keep the middle class happy. So it will not allow an appreciation until it is convinced that external demand has picked up in a meaningful manner. That may sound simplistic. The calculations of the beneficial medium-tern effects of a dearer renminbi on the domestic economy, including the need to move away from exports towards consumption, are much more complex. But the nine top decision-makers on the Standing Committee of the Politburo are politicians intent on staying in power. Simple arguments are what counts.

No doubt, the weakish renminbi (although it has followed the dollar upwards recently against the euro) attracts speculative flows because of appreciation expectations. But if the currency crawled upwards in the way it did until the end of July 2008, those flows would probably multiply as expectations built up of further steady rises. To have a real effect, a one-off appreciation would have to be around 20%. This would hit exporters in way that Beijing wishes at all costs to avoid.

Similar political reasoning applies on the domestic monetary front. Headlines focused on the $580 bn fiscal programme launched in November 2008. But the easing of credit was far more important. Last year, new loans were above $1.3 trillion, double the rate in 2008. Some tightening was clearly going to take place this year. I believe the volume will come down to around $1 trillion. That will be achieved through window guidance, raising of reserve requirements and other technical measures. Interest rates have little effect on China's credit markets.

In expectation of tougher times, borrowers scrambled for loans in the first half of January, and the banks poured out more than $160bn in two weeks. That led to a temporary official ban on some banks extending new loans. But the target for the year is still 50% higher than in 2008. Beijing knows that the cheap money is inflating bubbles, particularly in property. But local authorities need access to cash to meet their obligations under the infrastructure programme. This represents an economic carousel that the Chinese leadership wishes to keep turning. Beijing will need a lot of persuasion to stop the wheel of Chinese fortune from spinning further.

Avenger Volcker sharpens Atlantic split *(continued from page 1 ...)*

on the 'exit strategy' from monetary easing, with the European Central Bank probably set to start tightening ahead of the US.

All this coincides with discreet Schadenfreude in Washington and New York over the Greek fiscal crisis. This has knocked the euro in recent weeks and underlined the drawbacks of Europe's 'one size fits all' interest rate policies. In part because of the threat to their banks from the Greek funding crisis, it is also forcing France and Germany, the most influential euro members, to work on contingency plans for a Greek support package.

Bernanke, previously an economics professor at Princeton, chose the appropriately cerebral annual meeting of the American Economic Association to argue that super-low interest rates, between December 2001 and June 2004, did not create the US housing bubble that triggered the economic slump.

The Fed chairman appeared determined to establish that blame for the 'Great Recession' - unlike the Great Depression of the 1930s - cannot be laid at the US central bank's door. Lax regulation was at fault, he maintained, claiming it needs to be 'better and smarter' in future – although it is uncertain whether he agrees with the radical line espoused by Obama and Volcker.

Bernanke's speech followed the classic Fed statement on asset bubbles, laid down by deputy chairman Donald Kohn at a Frankfurt conference in 2006 to mark the retirement of Otmar Issing, founding father of the ECB's monetary policy strategy. Kohn said a central bank should not use monetary policy to try to contain speculative bubbles, but should aim to clear up the mess when the bubble has burst.

Issing has stuck firmly to his very different view that this policy is perverse and has now been 'destroyed' by the crisis. In an approach that still forms the centrepiece of the ECB's philosophy, Issing attacks the Fed view (the so called 'Jackson Hole consensus') that central banks should follow a 'mop-up' strategy after the burst of a bubble. Such an approach is 'totally asymmetric', he says, and 'over a long period of time necessarily leads to a sequence of ever bigger bubbles.'

With its 'twin pillar', explicitly medium term-focused monetary policy strategy, designed to keep an eye on the money supply and so on credit growth as a lead indicator for asset bubbles, the ECB takes a wholly different line.

It believes it has a monetary strategy which can 'lean against the wind' blowing behind both asset price and goods inflation. It also supports the European Union's plan to introduce anti-cyclical financial market regulations to support the thrust of monetary policy.

But the ECB cannot look back on its performance in the past decade with too much pride either. It too cut rates in the early years of the last decade (although not as dramatically as the Fed), and did not move firmly to contain emerging asset bubbles.

Recent evidence that close to zero level short term interest rates were again showing signs of sparking asset bubbles in financial markets will not have been welcomed in Frankfurt. But now conditions are changing ominously, underlined by erratic equity markets since the start of 2010.

Gulf power play *(continued from page 1 ...)*

Bankers are contrasting the high-handedness of the Saudi authorities to the Saad/Ahab default with the UAE's forced action to protect international creditors threatened by Dubai's quasi-sovereign debt problems that erupted in December 2009. Abu Dhabi stepped in by offering a $10bn loan to stave off a threatened debt standstill at the troubled Dubai World conglomerate – although it has since emerged that the $10bn included two loans that had already been announced by two banks, Al Hilal Bank and National Bank of Abu Dhabi.

One reason why Saudi Arabia, together with Kuwait, Bahrain and perhaps Qatar, now wants to go ahead with a single currency appears to be Riyadh's desire to flex its economic muscles towards the UAE over the Saad/Ahab episode. The UAE has rejected participation in monetary union, following earlier withdrawal by Oman, the other member of the six-member Gulf Cooperation Council. The UAE has stressed its disagreement with the Saudi Arabians over the site of the putative Gulf Central Bank, but the real reasons are more complex.

The Saudi Arabian authorities have facilitated a preferential settlement for Saudi banks over the Saad/Ahab afffair, but have neglected to investigate and act, in public at least, on massive documentation fraud allegations surrounding guarantees granted to support borrowings by the Saudi conglomerates. Foreign creditors owed billions of dollars have been angered by consignment to a slow-moving queue to have petitions heard by Saudi Arabian Grievance Boards.

The UAE has been forced on to the defensive over the Saad/Ahab affair, in contrast to its high profile stance a few months ago when UAE Central Bank officials publicised their participation in bilateral debt recovery meetings with Ahab. Abu Dhabi sources pursued a whispering campaign against both conglomerates, inferring, largely on the basis of court testimony, that the full story had not yet emerged, with hints of aspects that could be of interest to the US authorities seeking to help American creditors and to enforce their money transfer laws.

As a result, the traditional alliance of the northern GCC States of Kuwait and Bahrain appears to be lining up with Saudi Arabia against the 'nouveau riche' UAE, with Qatar and Oman carefully placed in a neutral corner. With the UAE weakened by the Dubai debt problems, the northern triumvirate is moving into pole position on the common currency plan.

OMFIF
Official Monetary and Financial Institutions Forum

Welcome shake-up in global banking

Wresting control back from the investment bankers

Michael Lafferty, Co-chairman

Ever since barriers in London's securities markets were dismantled in the 'Big Bang' in the mid-1980s, I have been growing increasingly worried about the rise of the sprawling Anglo-Saxon universal banking model. I have voiced concern on many occasions about a spreading culture which saw investment bankers, often motivated by short-term personal profit goals, come to dominate many institutions.

The abolition of Glass-Steagall barriers under the Clinton administration in 1999 heightened my disquiet. For this reason I wholeheartedly welcome the proposals to split American banks' commercial and investment banking activities. The US plans can form the basis for worldwide banking reforms that will I hope create more stable and healthier financial systems.

It has become apparent over the past 20 years that, amid the creation of the mega-banks, some with assets of $1 trillion or more, their top managements were being wrested away from traditional commercial bankers. It was particularly vexing that, in the new banking order, the investment bankers always seemed to come out on top.

In just two decades, investment bankers achieved the extraordinary feat of taking control of many of the world's largest retail deposit-taking institutions. The most spectacular example came in 1998, with the merger of Citibank and Sandy Weill's Travelers. Retail bankers around the world began to complain about what was happening. They voiced much of their criticism in private, because they were afraid to challenge their new bosses.

The most telling point retail bankers make about universal banking has been that investment banking is a totally different business, with behaviour and practices that are totally alien and, at worse, even corrupting to retail or commercial banking. All too often, say retail bankers, their investment banking counterparts take enormous risks, and pay themselves, rather than shareholders, most of the profits that result.

Alongside this have been the endless complaints of retail and private banking clients being saddled with inappropriate products manufactured by the investment bank. The 'One Bank' concept, where private banking simply became part of the investment bank, was one way of dealing with this.

Another frequent complaint of retail bankers is that the investment bankers have no respect for the customer-centric traditions and history of retail banking, and regard this whole service area as at best second-class and boring. This attitude rapidly manifested itself in splendid new head offices, executive jets, and most worryingly in dramatic changes in management culture. All of a sudden, the more notorious Wall Street practices, including the bonus culture, came to London, Paris and Frankfurt and other centres worldwide.

Manipulation of transfer pricing and management accounts was and remains another major complaint of retail bankers working in universal banks. As recently as December 2009, I listened as a senior retail banker in a major continental European bank described how the retail bank had been short-changed for several years because of alleged transfer-pricing manipulation.

Of course, investment banking has a valid role to play in global finance. But to allow it to dominate the action so fully has proved a tragic mistake, emphasised by the ruthless repackaging of US subprime mortgage debt which helped trigger the financial meltdown.

Retail banking and investment banking are like oil and water. They will never really mix. We have at last the opportunity to return banking to real bankers, concerned about customers and with a proper appreciation of risk. This may be one way of helping markets break out of their extreme tendency for booms and busts over the past three decades.

Retail banking and investment banking are like oil and water. They will never really mix. We have at last the opportunity to return banking to real bankers, concerned about customers and with a proper appreciation of risk.

America is culprit for dollar weakness

Asia only the scapegoat for monetary imbalances

Brendan Brown, Mitsubishi UFJ Securities International

A blame game is under way in both Europe and America to attempt to pin responsibility for a weak dollar on to global imbalances - in particular East Asian (especially Chinese) trade surpluses. But this hunt for scapegoats diverts attention from the main culprit: America itself.

Pressure on the East Asian nations, especially China, to float their currencies and break with quasi-pegs against the dollar has been building up from monetary populists and trade protectionists in America. The same pleas have been made by French governmental lobbyists, ranging from President Nicolas Sarkozy through to proxy voices at the European Central Bank and the International Monetary Fund.

For French government elites, an upward shift in East Asian currencies and a de-pegging from the dollar would be part of a general international move towards multi-polarity in currency matters and away from US hegemony.

In fact, the finger-pointing at alleged Asian monetary miscreants lays down a false trail leading us away from the real issues. The truth lies in a different direction. The dollar's underlying weakness – though masked over the past fortnight by a flare-up of European Angst over runaway Greek fiscal deficits – is a deliberate (but non-stated) result of aggressive 'stimulatory' policies by the US authorities.

Ben Bernanke, chairman of the Federal Reserve, argues in his writings about the Great Depression that currency devaluation is the most powerful tool for promoting recovery. Together with fellow-travelling monetarists he prescribes the medicine of quantitative easing for inducing devaluation. And together they propagate the myth that they are not responsible for the dollar's fall. Rather, that is termed an inevitable consequence of global imbalances.

We have been here before. Nearly 40 years ago President Richard Nixon and Fed chairman Arthur Burns said the Japanese trade surplus was to blame for knocking the dollar out of the fixed parities of the Bretton Woods system. In fact the fall was an intended result of the then super-easy monetary policy pursued by the Federal Reserve.

The trade protectionists were also around in Nixon's day. Then as now, their clamouring about global imbalances provides a veneer of academic respectability for currency and trade policies which are old-fashioned mercantilism. The protectionists are deaf to neo-classical economics teaching which demonstrates that the invisible hands of markets, if given a chance, are well able to transfer vast quantities of capital out of countries in large savings surplus into those in savings deficit. There is no imbalance here!

Amid all the confusion caused by these dishonest mantras about global imbalances, investors can be led astray from the path of rationality. Instead of diagnosing a rise in temperatures across a wide swathe of financial markets as due to monetary disequilibrium, they may convince themselves that structural changes have occurred with long-run consequences for valuations of different asset classes.

Those in the state of such delusion may be fortunate enough to prosper if they buy just as some asset markets are hotting up. There have been examples in recent moths in emerging market equities and in the Indian summer-heated residential real estate markets of London, Paris, or Manhattan. But they should not complain about the arrival of a Black Swan when the next crash occurs, precipitated as it is almost certain to be by the reversal of rampant monetary populism - whether in Beijing, Washington, or London.

We have been here before. Nearly 40 years ago President Richard Nixon and Fed chairman Arthur Burns said the Japanese trade surplus was to blame for knocking the dollar out of the fixed parities of the Bretton Woods system.

OMFIF
Official Monetary and Financial Institutions Forum

France returns to Gaullism

Charles de Sarkozy makes waves on dollar reform

Darrell Delamaide, Board of Contributing Editors

Nicolas Sarkozy swept into office in 2007 as a 'new look' French president for the 21st century. But in his recent pronouncements on currencies and the global economy, he is sounding Gaullist themes all too familiar from the previous century.

We will probably see a lot more of this in the future. It looks as though Sarkozy will make exchange rate policy a major theme of France's presidency of the Group of Eight and Group of 20 forums of leading economies in 2011 – a year ahead of his bid to win a second term in the 2012 presidential election.

Although Sarkozy says he's a friend of America, his recent dollar-bashing plays to the residual anti-Americanism of his countrymen. In a widely reported speech last month, Sarkozy complained that the dollar had lost 50% of its value against the euro.

'How can you manufacture in the euro zone and sell in the dollar zone – unless you give up selling at all,' he asked rhetorically. 'You know how much I consider myself close to the United States of America. But this isn't possible.' The world of the 21st century is multi-polar, he went on to say, and so it must become 'multi-monetary' and consign Bretton Woods definitively to the past.

Heard it before? We need to recall that Charles de Gaulle spoke equally strongly against the dominance of the dollar when Bretton Woods was in full force. As Time magazine reported in February 1965: 'There was Charles de Gaulle last week proclaiming that the primacy of the dollar in international dealings was finished, calling for an eventual return to the gold standard.'

The time has long since passed, De Gaulle, said 45 years ago, when any single nation should enjoy the 'signal privilege' of holding the foremost world trade and reserve currency. The founder of the Fifth Republic did what he could to bring down Bretton Woods by demanding the US deliver gold for his dollars and urging other nations to do the same.

Sarkozy has continued along a similar path. The global financial crisis, he said, showed that the 'nation' was the ultimate protector of the common good. Banks that bragged they no longer had any nationality suddenly rediscovered their national roots when they needed bailout funds.

Europe, for all its integration, remains a Europe of nations, Sarkozy said. That's another strong Gaullist throwback. As syndicated columnists Rowland Evans and Robert Novak wrote in 1967, 'President Charles de Gaulle's nationalistic foreign policy, far from reflecting the eccentricities of an old man as some US officials claim, is likely to be the most permanent legacy of his long rule.'

Since Sarkozy made his speech, the euro has in fact declined against the dollar, as a result of foreign exchange operators' concern about the errant behaviour of Greece. It would be ironic if Sarkozy's fretting over the strong euro were to be replaced by something else: worries about its sustainability.

It would be ironic if Sarkozy's fretting over the strong euro were to be replaced by something else: worries about its sustainability.

When Charles de Gaulle launched his strictures about national strength, France retained – and often used – the levers of national monetary power. Now, however, Sarkozy has to live with the legacy of having subsumed France's national money into the euro, run by the super-independent European Central Bank. There will be plenty of opportunity, in due course, for the ECB to have its say about Charles de Sarkozy's reform proposals – and no-one will be surprised if there is not a perfect measure of agreement.

The need for euro area fiscal policy

Single currency reality requires new machinery

David Green, Financial Reporting Council

A Canadian finance minister, visiting the Governor of the Bank of England when the euro was in the course of creation, expressed puzzlement, based on bitter Canadian experience, that Europe should willingly choose a single currency. Over a diverse economic area, he said, the stance of monetary policy tended to be wrong for most regions most of the time. The common interest rate could not restrain a boom in Ontario while simultaneously staving off recession in British Columbia. Fortunately, he went on to say, the effects were mitigated by regional economic stabilisation thorough the Canadian federal budget.

During its first decade the euro area managed to skirt round the absence of a fiscal counterpart to the European Central Bank, as much through luck as through the ECB's undoubted skill. However, the reality of the challenge is now plain. It has finally been uncovered by the sudden revelation of the true horror of Greece's unsustainable fiscal position. The European authorities have to respond with more solidarity on the fiscal front. How they will do this is not clear, yet they have no choice but, sooner or later, to act.

If and when the social disruption becomes serious enough, with or without public or private defaults, then intra-euro area fiscal transfer mechanisms will have to be mobilised.

The other area where the authorities need to respond is in financial supervision. The euro creates a need for more regionally differentiated approaches, seen in sharp focus in Spain and Ireland. A first challenge for the new European Systemic Risk Board will be to reconcile the decision to adopt a more unified rule book with the requirement for very different supervisory responses to the regional consequences of the single interest rate. This is where we will find out how macro-prudential policies can be made to work in practice

Such adjustments are inevitable because the time-honoured safety valve of devaluation is not available, either for Greece or any other member state facing comparable difficulties. For Greece to leave the euro would be hugely unpalatable for the Greeks, for economic reasons that have often been advanced. However the real reasons why the Greeks (or any other country contemplating departure) are locked in go much further.

Let us assume that a country in difficulties wished to restore its former currency at a new rate against the euro. It is simply not possible to know which euros should be converted into new drachma, new Irish pounds or whatever. It might seem simple to decide that the assets and liabilities of the Greek authorities should be redenominated as new drachma, but what about the euro liabilities of a Greek bank in Frankfurt or New York or Sydney, or a US bank in Athens or a Greek shipping company in Singapore?

Would it be the law covering a specific transaction that counted, if that could be agreed? Or would it be the nationality - or the residence - of a debtor? Or would these questions apply to the creditor? For cash, would the new rate apply to the euro coins originally minted in Greece, wherever they were now located? Or to the euro coins circulating in Greece, irrespective of the place where they were struck?

The list of imponderable questions is very long. They would all be contested in courts across the globe. Splitting the currency so as to devalue arbitrarily a certain proportion of the world's euro-denominated assets and liabilities is so difficult that it would be impossible.

Inescapably, disparities caused by 'one size fits all' interest rates have to be handled at a fiscal, not a monetary level. No other significant monetary area is without substantial and powerful fiscal coordination machinery to stand alongside the monetary authority. If and when the social disruption becomes serious enough, with or without public or private defaults, then intra-euro area fiscal transfer mechanisms will have to be mobilised through something far more far-reaching and robust than the dysfunctional Stability and Growth Pact.

The euro has delivered very many far-reaching benefits. But the machinery to respond to its reality is not yet in place.

OMFIF
Official Monetary and Financial Institutions Forum

Danes should embrace single currency

Moment of danger is time of opportunity

Niels Thygesen, Advisory Board

Denmark should join European economic and monetary union (EMU) rather than continue with the present euro peg – an awkward halfway house, through membership of the ERM-II mechanism, that started when the single currency was launched in 1999. To many outsiders, EMU seems to be under attack, not least as a result of Greece's current difficulties. Somewhat counter-intuitively, this presents Denmark with an ideal moment to join.

Denmark's present course appears like a safe policy, in view of the turbulence affecting less well-performing euro members. The Danes seem to profit from the 'option value' of retaining the freedom of a national currency in case EMU becomes dysfunctional as a result of tensions and, ultimately, defections affecting some participants. But this is an illusion. Over the longer term, the present Danish policy risks losing precious gains from trade in closely integrated markets – likely to be available only if Denmark makes the decision to join up formally.

Undoubtedly, political willpower is needed to overcome the sceptics. A cool, level-headed analysis is necessary. The 'option value' of Denmark remaining formally outside the euro depends on a rational assessment of the likelihood of EMU indeed becoming dysfunctional. From the point of view of the foreign exchange markets, the euro may look somewhat less robust in the light of rapidly deteriorating public finances in nearly all countries (especially Greece) and the EU's limited ability to facilitate, let alone enforce, consolidation.

But - reflecting the sheer chaos into which Europe would be plunged were it to break up - the single currency looks very likely to survive. It provides a more secure framework than any participant could find individually. Paradoxically, the point of maximum perceived threat may turn out to be the point of maximum stability.

Denmark's position on EMU is perhaps the most complex of any of the EU's 27 EU members. Of these, 16 have joined EMU, eight are committed to do so – and expected to meet the requirements within a few years – while Denmark is among the three (along with the UK and Sweden) to reject participation. Already at Maastricht in 1991, the Danes obtained the right to decide later whether to opt into the final stage. After Danish voters rejected the treaty in 1992, Denmark exercised its option not to join, a position confirmed in the 2000 referendum. After reelection in 2007, the current centre-right government said it wanted to hold a referendum to remove the euro derogation (and two other opt-outs). But these plans now appear to have been shelved for the next couple of years.

Denmark's position is more piquant than those of the UK and Sweden, which had brief, tumultuous experiences of monetary integration leading to forced abandonment of exchange rate pegs in 1992. They subsequently developed inflation-targeting monetary policies and individual fiscal rules somewhat different from the rest of the EU. In contrast, Denmark – which kept the krone's parity unchanged for the final 12 years of the D-Mark up to 1999 – has maintained a euro peg for 11 years sibce then. The logical conclusion is to turn this nearly quarter-century of euro linkage into formal membership.

Full participation in the euro would give the Danes full security against being blown off course, as happened briefly in autumn 2008. Despite solid macroeconomic policies, Denmark was hit by a sizeable net outflow of capital, inducing a highly unwelcome increase in interest rates. The threat that this could one day be repeated cannot be overlooked.

Denmark can gain economically from membership of the single currency – and the political benefits are still higher, given the advantages of being part of decision-making, including within the strengthened Eurogroup of finance ministers.

Courage and cool thinking must lead the Danes in one sole direction – into the euro.

Full participation in the euro would give the Danes full security against being blown off course, as happened briefly in autumn 2008.

A monthly foray into monetary secrets hidden in archives

Metamorphosis in Marienborg

German chancellor expounds to European leaders a scheme to hold down the D-Mark and 'change the balance of the world'

The 18th century summer residence at Marienborg north of Copenhagen of Danish prime minister Anker Jorgensen was the scene of an extraordinary monetary exchange after dinner among European government leaders on 7 April 1978. The conversation, in which West German Chancellor Helmut Schmidt self-importantly expounded his views on a new monetary system to forge greater European currency stability, led to the fixed-but-adjustable European Monetary System in 1979 and eventually to the euro in 1999.

Schmidt, who dominated the conversation with other leaders including British prime minister Jim Callaghan and French president Valéry Giscard d'Estaing, wanted to forestall a threatened appreciation of the D-Mark that placed at risk hundreds of thousands of jobs in export-dependent Germany. The session took place only four months before the nomination in August 1979 of Paul Volcker as chairman of the US Federal Reserve – an appointment that led to a sharp increase in US interest rates and a forced tightening of Bundesbank credit policy.

Callaghan: 'The net effect would be to hold the pound too high and the D-Mark too low.'

Schmidt: 'Yes.'

Callaghan: 'When I said at the start of the evening that Chancellor Schmidt's statement may be the most important, I did not think it would be as important as it proved to be…. The hesitations I have expressed do not mean that I dismiss what I have heard …. I think we should be very cautious. I think that German industry is more dynamic than the British. How should we, for instance, enter into such a scheme? The rates of entry must be calculated very carefully.'
Giscard and Schmidt: 'There would of course be a start period of easy adjustments.'
Callaghan: 'The net effect would be to hold the pound too high and the D-Mark too low.'
Schmidt: 'Yes.'
Callaghan: 'This could mean that the D-Mark will spill over into the British economy.'
Schmidt: 'Yes, but right now, you are exporting billions to the US. So you see, very much would depend yon the entry rates.'
Callaghan: 'It would be a poor approach if I assume that Britain would have arthritis for the next 20 years. So I say: yes to examine the proposal. It should be examined quietly among the experts. There must be no public declarations.'
Schmidt: 'I said before dinner that the community had achieved quite a lot. We are still not enemies, we have not started competitive devaluations, nor real protectionism. But we can still fail. Britain has two million unemployed, Germany has 1.5 million. We can within 24 to 36 months be forced to have a Community that exists only on paper.'
Giscard: 'I don't believe it. If our country introduces protectionist measures, it would certainly not be against the other Community countries, but possibly against Japan.'
Schmidt:'Oh, but your Japanese steel comes via Rotterdam, so your measures would be through Holland.'
Callaghan: 'I can see [the system] would lead to much greater stability.'
Schmidt: 'The speculators would not single out the D-Mark, the pound or the lira any more.'
Callaghan: 'Would you dismiss an attempt to do this through the SDR? I would rather we converted our reserves into SDR. Why should anyone take on the role of a reserve currency?'
Schmidt: 'We are forced to, because already 10% of the world reserves are in D-Mark. We cannot avoid it and I really do not care too much about it...'
Callaghan: 'But will that always be the case? Germany will not always have a Helmut Schmidt. And furthermore no one country can carry that burden. Germany cannot do it. Neither can the US do it any more….'
Giscard: 'I think, Jim, that no one wants his currency to become a reserve currency, it just becomes one. But when the monetary system works well, there are always several reserve currencies side by side. Most recently, we had gold and dollars as reserve currencies. And if in the future we have yen, dollars and Europeans units of account to be parallel reserve currencies then the world would be more stable. The new adjustment we have been talking about would change the balance of the world.'

OMFIF
Official Monetary and Financial Institutions Forum

Volcker draws on the spirit of Galbraith

In a complex world, simple solutions are the answer

William Keegan, Chairman, Board of Contributing Editors

One of the periods of his long and distinguished career of which J. K. Galbraith was most proud was the time he administered price controls in the US during the Second World War. Time and again during the many interviews I had with the great man he would reminisce warmly about those days.

In his memoirs Galbraith drew a lesson from his experience which I believe has relevance to the current debate about the future administration of the world's financial sector. And I use the word 'administration' advisedly for, the more that financial practitioners and politicians protest about moves to constrain their casino-like proclivities, the faster we should be counting the spoons or controlling the issue of chips to the casino.

Galbraith found that the administration of price controls in Washington, that bastion of free enterprise, became devilishly more complicated. In the end, Galbraith decided to make a break from the labyrinth, opt for simplicity, and declare a general price-freeze.

There is a moral for decision-makers in the Group of Seven (and Group of 20) as they struggle to try to minimise or eliminate the chances of a repetition of the financial crisis. Policy-makers are trying to balance the need to constrain the financial sector while not constraining the financing of economic recovery and what seasoned assemblers of G7 communiqués call 'sustainable growth'.

They are doing so against a background where the forces of resistance from the financial sector are formidable: despite what they have put us through, most of the offenders have given the strong impression that, government bail-outs or no, they would be perfectly happy to return to the status quo ante. And governments, not least the soi-disant Labour government of Gordon Brown in the UK, have been nervous of radical regulatory action for fear of driving financial sector sources of revenue to other jurisdictions (I use the word 'jurisdiction' advisedly. What bankers want is plenty of 'diction' but an absence of 'juries').

Meanwhile, there are stentorian voices warning that the fact of the bail-out exacerbates the danger that 'moral hazard' will produce another crisis in due course, with some believing that that 'course' will be due in no time at all.

Given the strength of the financial lobby in general and Wall Street in particular, it was not surprising that the announcement of President Obama's proposal to curb the activities of casino chip-holders should have been so fierce. Perhaps more surprising, given its columnists' outstanding coverage of the crisis, was the nitpicking reaction of the Financial Times' initial judgment of the proposal – or perhaps one should say 'intention', because full details had yet to be worked out, let alone approved by a febrile Congress.

Which brings us back to Washington DC, the scene of Second World War price controls, under the aegis of Galbraith. The Obama proposals are very much the brainchild of the one and only Paul Volcker. There was instant criticism that, aged 82, Volcker was out of touch, and a lot of commentary that the world had moved on, anything like Glass-Steagall was no longer practical, and so on.

For those of us who never lost sight of Volcker's career after he left the Federal Reserve in 1987, it is abundantly clear that he has been more 'in touch' than most of the more 'involved' practitioners. Apart from anything else, he saw storm clouds on the horizon when the international debt-set were believing their own 'clear blue sky' weather forecasts.

The opponents of Obama and Volcker will no doubt continue to argue that their approach is too simple for a complex world. But Volcker, like Galbraith in the 1940s, can see that complexity sometimes demands simple solutions.

There was instant criticism that, aged 82, Volcker was out of touch. but he has been more 'in touch' than most of the more 'involved' practitioners.

OMFIF Advisory Board


Meghnad Desai


Paul Boyle


Mario Blejer


YY Chin


Darrell Delamaide


Jonathan Fenby


Stewart Fleming


Dick Harryvan


Carl Holsters


Harold James


William Keegan


Joel Kibazo


Lord Lamont


Oscar Lewisohn


John Nugée


John Plender


Poul Nyrup Rasmussen


Frank Scheidig


Songzuo Xiang


Paola Subacchi


Niels Thygesen


Makoto Utsumi


Lord Walker


Ernst Welteke


Zhong Wei

Note on contributors to February 2010 Bulletin

Brendan Brown, Director and Head of Economic Research at Mitsubishi UFJ Securities International, is the author of *EURO CRASH: the implications of monetary failure in Europe*, (Palgrave, March 2010).

Jonathan Fenby is China Director of Trusted Sources, the research service, and author of the *Penguin History of Modern China*. His new book *The General: Charles De Gaulle and the France He Saved* (Simon & Schuster) appears in June.

David Green advises the Financial Reporting Council on international issues. He is a former Bank of England and FSA official and co-author with Howard Davies of *Banking on the Future: The Fall and Rise of Central Banking* (Princeton University Press; forthcoming in spring 2010) and *Global Financial Regulation: The Essential Guide* (Polity Press).

Message of the month

'Congratulations for your January OMFIF Bulletin - almost all the pieces are worth reading, but it won't be easy to continue to comply with your high standards!'

Alexandre Lamfalussy, former President, European Monetary Institute, former general manager, Bank for International Settlements