OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

March 2010

IMF staff paper gets it wrong

Blanchard ideas add to government bond uncertainty

Stewart Fleming, Board of Contributing Editors

With government debt levels soaring to oppressive levels on both sides of the Atlantic, the International Monetary Fund's chief economist has made a radical, yet wrong-headed, suggestion. Central banks should consider raising their inflation targets to 4% from 2% – tantamount to inviting politicians to ratchet up inflation as a way of reducing the burden of public (and private) debts.

The recommendation – in a paper by Professor Olivier Blanchard, the Fund's chief economist – comes at an acutely sensitive time. The document, '*Rethinking Macroeconomic Policy*', is not IMF policy. But its publication with Prof. Blanchard's imprimatur is designed to underpin controversial arguments about the lessons of the financial crisis. One of these arguments, described as 'crazy' by one former top IMF official, is that it's better to have more inflation than to run the risk of deflation.

Many will regard this as playing with fire. Some policy-makers, as well as many market participants, are already wondering how long it will be before a combination of zero interest rates, massive liquidity injections and huge budget deficits will either directly trigger inflation or lead to intense political pressure for the same outcome.

Indeed, the just-published Barclays Bank Equity Gilt Study 2010 concludes bleakly: 'According to our demographic bond models, long term government yields in both the US and the UK are set to more than double from current levels over the next decade, moving up to around 10% by 2020. Under such circumstances, total returns from government bonds are likely to be negligible over the next decade.'

As debate sharpens about the sort of economic medicine errant nations like Greece will have to swallow, Blanchard's paper seems likely to add to European divisions about the correct 'exit strategy' from the financial crisis.

There is a wider dimension, too. The IMF is charged with promoting global stability through its surveillance of the major economies. Some official asset managers are tiring of buying floods of sovereign debt at current interest rates. There may be 'technical' reasons why China dumped a record $34bn of US government paper in December, according to official US figures. But Blanchard's paper seems calulated to add to caution among central banks and sovereign wealth funds about adding to holdings of western debt.

Revived French suggestions for a 'gouvernement économique' in Europe, put forward last week by former French prime minister Edouard Balladur, point to a fresh French effort to ensure that

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'Oh my God' on euro

US: Europe 'muddling through'

Darrell Delamaide, Board of Editors

However sceptical American policy makers might have been about the European single currency, there's little joy in Washington over the unfolding euro crisis. The prevailing sentiment is more 'Oh my God' than 'I told you so.'

Policy-makers such as Alan Greenspan, the former Federal Reserve chairman, were mostly critical when the euro was launched in 1999. Greenspan told a Goldman Sachs conference four years ago: 'I didn't think it was going to happen. I'm surprised that it worked. And I didn't think it would last.'

Ted Truman, a former Treasury and Federal Reserve official now at the Peterson Institute, tells the Bulletin that, while there were doubts about setting up a common currency without a government to back it, 'No one fully anticipated this particular set of circumstances.' He sees the crisis as not so much for the euro, but for the 'European project' of moving forward on greater integration. The new crisis underlines the fragile

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Air thick with upheaval

The flavour of the Bundesbank

David Marsh, Co-chairman

The monetary air has been thick with alarum and upheaval, whether from fiscal disturbances centred on Greece or fears of economic overheating in China. And this heady brew has been stirred up further by the International Monetary Fund. Its chief economist, the estimable Prof. Blanchard, has chosen a moment of deep sobriety on world bond markets to raise the spectre of higher inflation – something that may happen anyway, with or without IMF encouragement. As Stewart Fleming indicates in his front page story: A brave man indeed.

This month's Bulletin has an unmistakable Bundesbank flavour, in keeping with the Inaugural Meeting of OMFIF at the headquarters of that august institution in Frankfurt. Helmut Schlesinger, the former Bundesbank president, finds some features to applaud in Paul Volcker's proposals to separate commercial and investment banking activities. This is despite the universal appeal (in Germany and other continental countries) of the universal banking model, which the present Berlin government seems highly unlikely to want to dismantle, whatever happens in America. Schlesinger takes a sideswipe at the 'Great Moderation' of the Federal Reserve and the European Central Bank – and, in passing, at the latest suggestions of the IMF's Blanchard, which he says are 'the last thing we need.'

Hans-Helmut Kotz, a current Bundesbank board member, outlines the essential characteristics of the Financial Stability Board set up as a world policeman to guard against further regulatory failure. Global Analysis focuses on the parallels between West Germany in the 1950s and China today. Both countries took over leading positions as holders of monetary reserves, as the result of massive inflows of foreign exchange caused by intervention to hold down strengthening currencies. A minority faction in the Bundesbank (spearheaded by the then widely unknown Otmar Emminger, but not including, it must be noted, the president of the central bank) led a rearguard action to promote a D-Mark revaluation as a means of countering the inflationary effect of these inflows. This intriguing episode may form a precursor to what could happen in China.

Archive Insight examines how the Bundesbank scuppered Helmut Schmidt's plan to bail out Britain in 1976. This has some relevance to today's goings-on in Europe. We look at wider matters too. John Nugée calls for sovereign wealth funds to take a more active line on shareholder governance, although he admits it's difficult. Jonathan Fenby delves into the real reasons behind China's increase in reserve requirements. Michael Lafferty analyses the risks of a global accounting crisis to add to the global financial crisis. Stephen Fay asks what lessons can be learned from the good performance of banks in South Africa, Canada and Australia. William Keegan pays tribute to the late Gordon Richardson, a man whose behind-the-scenes trouble-shooting instincts certainly would be sorely tested by the present combination of extenuating circumstances.

David Marsh

Quote of the month

'It would be a disgrace if it turned out to be true that banks that had already pushed us to the edge of the abyss were also party to falsifying Greek statistics.'

Angela Merkel, German Chancellor

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How to curb bankers' risk-taking

Why some things may need to change

Helmut Schlesinger, former President, Deutsche Bundesbank

President Barack Obama's espousal of former Fed chairman Paul Volcker's proposal for separating investment banking and commercial banking activities has set in train a world-wide discussion. It appears to me that Volcker's recommendations contain useful pointers that are highly relevant for the discussion of possible institutional and monetary policy changes, in Germany and beyond.

The Volcker proposals contain useful pointers. We have to ask ourselves in Germany whether, after the shock of the financial crisis, everything should really remain the same as before.

This issue was handled in a broadly-based text book published before the Second World War by Professor Adolf Weber, the well-known German economist. In his book, *Depositen- und Spekulationsbanken*, published in four editions between 1902 and 1938, Weber analysed the British banking system separating capital market activities from deposit banks and compared it with the German 'universal' banking system.

The term 'speculation banks', denoting institutions involved in securities issuance, broking and so on, was not meant pejoratively. Rather than describing casino-like activity, Weber saw it as simply summing up a economic function that was a key part of everyday business behaviour. Furthermore, his conclusion was not that one should separate deposit banks from issuing houses and other capital market institutions, according to the model practised in the UK and also (before the repeal of the Glass-Steagall Act) in the US. On the contrary, his analysis led him to the opinion that the German-style universal bank model was better.

Weber did however outline the views of the German economic writer Hans Gestrich, who in the pre-war period expressed some sympathy with the British system of banking separation. Here we see some similarity to the 'Volcker Rule'. Gestrich was one of the few German monetary theorists who focused on money creation through the banking system. Gestrich would certainly sympathise with Volcker's principle that money-creating banks – banks that can create bank deposits through advancing credits – should be composed exclusively of a separate category of 'deposit-taking' banks. According to this argument, solely these banks should be permitted access to central banking refinancing and to deposit insurance cover paid for ultimately by the taxpayer. This conditions would make 'speculation banks' more risk-conscious, forcing them to provide sufficient equity capital to cover their risks.

The essence of the universal banking system is that all 'banks' that are permitted to take deposits have access to central bank finance and to deposit insurance. This applies to all categories: the German subsidiary of Lehman Brothers or a German retail bank or a large privately- or public sector-owned bank where deposit-taking certainly does not play a dominant role.

Partly for historical reasons, Germany generally takes a negative view of banking separation. This is a result of the constructive role of German universal banks after the 1923 hyper-inflation and also after the 1948 currency reform. It also reflects the generally positive experience of banks combining lending operations with other activities such as trade finance, advisory work and capital market issuance. Additionally, large-scale state-backed changes in economic structures, such as splitting up banking corporations into smaller units, are often reversed over time, shown by the break-up of the large (and subsequently recreated) German banks into regional entities after the Second World War.

However, even when we bear all these points in mind, we have to ask ourselves in Germany – just as in the US and the UK – whether, after the shock of the financial crisis, everything should really remain the same as before. I believe two large questions have to be answered. First, in a many-layered universal banking system such as Germany's, is it right that all participants should have unconstrained access to central bank money and to deposit insurance? Second, should central banks themselves draw fundamental conclusions from the experience of the past few years?

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Straight thinking on banking reform

People who profit from risk-taking must pay for its costs

Meghnad Desai, Chairman, Advisory Board

The battle lines are now drawn. In contrast to the much-broadcast peace and harmony at the Group of 20 summit last April, we do not have a globally co-ordinated approach to reform of banking. The Europeans want to strengthen regulation – to make it macro-prudential as well as micro-prudential, to look at capital requirements for specific risk-prone activities, to curb the bonuses but leave the universal banks as they are. The British want living wills and reliable pathways to insolvency when the next crisis hits us.

The Americans seem to have broken ranks and want to return to the era of Glass-Steagall. The Europeans are furious since their banks operating in the US will be asked to shed their non-deposit taking business. Some hope that the proposals by former Federal Reserve chairman Paul Volcker are not really drastic as they seem. The Volcker proposals have still to be acted upon by Congress.

What conclusions can we draw from all this? The world may be globalised. But even in banking and finance, national structures still matter. On regulation, Europe has struggled with the host country/home country issue. The Americans do not believe in anything but host country regulation if banks want to do business on their soil.

The argument as to whether banks should be simple retail deposit-taking institutions and avoid all investment banking-type activities has been proceeding apace in the UK as well as the US. It is not likely that this outcome will happen. Governments have been too slow in coming forward with proposals. Banks have recovered in the meantime. It is better to adopt a different perspective. The financial crisis was caused by several interacting factors. Continuous cheap credit caused by Asian surpluses being recycled via US Treasury bills allowed banks and financial institutions to take unsustainable risks – thanks to financial innovations such as securitisation, credit default swaps (CDS) and collateralised debt obligations (CDOs) which helped conserve cash and built up a huge leverage mountain.

Is the root of the problem (a) cheap credit caused by lazy central bankers; (b) an inadequate international architecture for recycling financial surpluses, for example, because the International Monetary Fund is too slow with reform of the Special Drawing Rights; (c) banks associated with excessive risk-taking, bad policies on compensation, too much leverage (casino banks not simple banks) or financial innovations sparked off by economists teaching free market doctrines? All these may be good questions. But my answer is: Who cares ?

Crises have occurred before in financial systems. Each generation of innovations has led to excessive risk taking and a meltdown. Whatever we do by way of regulation, we know that another crisis will take place. The real issue then is how to minimise the costs of mopping up the next time around. That will assure that taxpayers are not fooled a second time.

We must concentrate on insurance schemes. Let us see if we can get them financed by the banks themselves. If Basle I /II can calibrate capital requirements according to the portfolio of bank activities, why can we not calculate what insurance premiums would be required to insure banks against failure? It has been argued by John Kay that such insurance is too expensive. Maybe so, but surely if there is a market for such insurance there will be new firms who will provide innovative schemes to reduce costs. If simple banks are easier to insure than complex ones, market competition may tilt the balance towards simple banks.

Customers have to know which banks are insured and for what activities. Retail depositors may wish to stick with simple banks, but corporates may take a more risk-taking attitude and bank with under-insured banks. As long as it is clear that under no circumstances will banks be rescued again, the costs of risk-taking misbehaviour can be borne by those who profit from them. What sort of banking we adopt can be then left to the banks themselves.

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The swing to conservatism

Judgment needed in setting international rules

Hans-Helmut Kotz , Member of the Board, Deutsche Bundesbank

The financial dislocations that shook the world economy emanated from what initially appeared a rather unimportant sector – low-quality, high-risk mortgages, backing apparently safe securities. Up to summer 2007, the world believed in the doctrines of 'no contagion' and 'decoupling'. Financial disruptions in one segment of the market would not, it was believed, spill over elsewhere. This, of course, was not consistent with the law of one price, ruling that identical cash-flows, however they are re-packaged, will bear the same price tag.

Disregarding the gap between private and social costs has been a basic flaw of rules on capital requirements.

We can draw a host of lessons from this dismal experience. Some of these should have been (indeed, were) known before. After all, some fundamental reasons for instability are immutable. One lesson is, indeed, the global character of the crisis. Although it originated in the US 'financial space,' it spread rapidly as an inevitable result of financial inter-linkages. Any regulatory solution has to acknowledge this basic characteristic of our financial environment. We are in this together.

And who is 'We'? In our case, it is the Financial Stability Board, the international group of financial authorities and regulators created in 2009 by the Group of 20, stemming from the Financial Stability Forum – which, in turn, was a response to the Asian financial crisis. The FSB is charged by its mandate to take a systemic view: to promote the work of international rule-writers. In particular, standard-setters and regulators are called upon to cooperate, albeit partly through arm-twisting and jawboning. Bank regulators and accounting standards bodies now, at last, talk to each other on the definition of capital. By extending its geographical or jurisdictional reach, and being more inclusive, the new FSB enhances the legitimacy of policy proposals. Policy-building has become less clubby, and more effective – making use of all available 'outreach' organisations such as the IMF, the OECD and the BIS.

Essentially, the FSB is about controlling the new rules of the game – while the game is going on, and while the players are in many ways starting to adopt their old habits again. At its rule-creating core are the two basic reasons why financial markets, by nature imperfect, need a regulatory back-up: unevenly distributed information (generating all sorts of distortions before and after transactions), and externalities, i.e. effects which rational individuals do not acknowledge when taking decisions.

Disregarding the gap between private and social costs has been a basic flaw of rules on capital requirements. Competitive forces in the past led market operators neither to acknowledge nor to self-insure against low-probability, high-impact events. As a consequence, there is an obvious difference between economic and regulatory capital – which inevitably leads to over-leveraging. This is the point behind the FSB's argument for more, and higher quality, regulatory capital. Regulators in the past lost sight of the endogenous nature of liquidity crunches. This led, too, to a tendency to ignore the systemic or macro-prudential dimension. In view of the degree of interdependence of different sections of financial markets, keeping individual institutions apparently safe and sound is neither necessary nor sufficient.

Unfortunately, there are no ready-made, off-the-shelf concepts. We have to rely heavily on judgment. One point is clear. In view of the large opportunity costs of this crisis, rule-makers definitely have become more conservative. These concepts add up to *Ordnungspolitik* in its international variety, combining, too, some of the propositions of the late, great Paul Samuelson. The FSB's job is to design a set of consistent, robust and, if possible, simple rules. These should help financial markets reliably to discharge their central purpose: serving customers – ultimately, savers and investors – in a cost-efficient way.

How to curb bankers' risk-taking *(continued from page 3 ...)*

The first point deals with whether institutions dealing primarily with capital market activities should enjoy the possibility of turning to the central bank as a last-resort source of finance. In Germany since 2007, the weakest institutions that had to be rescued with state support were not primarily deposit-taking banks. Rather, they were privately- and public sector-owned banks with diverse business models dependent to a large degree on capital market activities and innovations.

If one wanted to cut off the access of such business areas to central bank finance, then these activities would have to be carried out in institutionally separate units. Another route would be for central banks to introduce refinancing quotas where the volume of available finance depended on borrowing institutions' deposits.

The second point deals with central banks' own policies and behaviour. If we left fundamental banking structures as they are, central banks could react with a tougher monetary policy to the perception that the banking system over time has developed a continuously growing appetite for taking risks. In a recent study, the BIS in Basle has concluded that there is a 'significant link between low interest rates and high risk-taking.' Such a return to monetary stringency, which I must say I lean towards, would run diametrically opposite to the view that we should repeat the lax monetary policy of the 'Great Moderation' of recent years. This recommendation of course also completely counters the latest conclusion from an International Monetary Fund study, according to which we should consider raising inflation targets to 4%. In the present rather uncertain situation, that is the last thing that we need.

IMF staff paper gets it wrong *(continued from page 1 ...)*

economic policy is not concentrated too much in the hands of the increasingly Bundesbank-like ECB. Euro members like Greece, Spain, Portugal and Ireland, facing years of deflation in order to regain lost competitiveness, would naturally welcome a much higher average level of euro area inflation to make adjustments less painful.

One factor strengthening the monetary orthodoxists in the Bundesbank and elsewhere is that it's not just theorists who are concerned about the inflation outlook. Thomas Hoenig, President of the Federal Reserve Bank of Kansas City, is already worrying about the inflation outlook. 'It seems inevitable that a government turns to its central bank to bridge budget shortfalls, with the result being too-rapid money creation and eventually, not immediately, high inflation,' he said just after Blanchard's paper was published on 12 February.

Blanchard's fundamental idea, which sounds perfectly respectable from a theoretical point of view, is to give monetary policy more room to manoeuvre. So a higher inflation target means a higher policy interest rate and therefore more room to cut it in a crisis before central banks reach a rate of near-zero, where normal monetary policy tools become ineffective because rates can be cut no further.

There are many problems with the paper's approach. One is that it distorts history to arrive at its conclusions. The other is that it underestimates the costs to large sections of the population of getting from the present position of excess liquidity, super-low interest rates and low inflationary pressures to the 4% inflation target.

After reflecting somewhat dismissively on a few of the arguments against a higher inflation target – higher inflation, for example, distorts economies and leads to higher inflation volatility- Blanchard states, 'The question remains whether these costs are outweighed by the potential benefits in terms of avoiding the zero interest rate bound.' Blanchard asks, 'Are the net costs of inflation much higher at, say 4% than at 2% , the current target range?'

Blanchard's lofty suggestion that 'if higher inflation is associated with higher inflation volatility, indexed bonds can protect investors from inflation risk,' is completely unworldly. As former ECB chief economist Otmar Issing has regularly pointed out, it is the poor who suffer most from the 'inflation tax' Blanchard makes light of. These are people who generally have next to no savings to invest and would not recognise an indexed bond if it mugged them in the street.

'Oh my God' on euro *(continued from page 1 ...)*

equilibrium that has obtained since the introduction of the euro in 1999, Truman says. 'They are where the US was in 1785, when the Articles of Confederation were too weak,' he says. As for the euro itself, though, Truman thinks Europe will muddle through and preserve the currency.

Economist Paul Krugman says he always saw the chance of a euro crisis because of the lack of fiscal and labour market integration. 'I just never dreamed how bad it would get.' He blames Europe's elite for launching a common currency when the continent was not ready.

Some American economists fear that the draconian terms envisaged for a Greek bailout could lead to a political backlash. Draconian is a throwback to Draco, severe archon of Athens. If Germany and other hardliners are too tough, it could result in, well, a Pyrrhic victory – the term to describe the high cost of winning in the Greek King Pyrrhus's victory at Heraclea.

Simon Johnson, a former chief economist for the International Monetary Fund, suggests not too surprisingly that the European Union should draw on IMF expertise and find at least a consultative role for the international lending agency. He urges Europe not to postpone the Greek reckoning. That would lead to similar turbulence spreading to other southern states affected by declining competitiveness and high current account deficits. Greece must be forced to adjust in return for a bailout, or international investors in other peripheral countries will head for the exits, he says. But Johnson remains relatively optimistic. 'The eurozone will be fine,' he tells the Bulletin. 'In the end, bailing out Greece is cheap and easy. It's annoying, but all the alternatives are much worse.'

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Shareholder governance questions

State funds should exert more influence – but how?

John Nugée, Advisory Board

As the financial crisis of 2007-09 begins to recede and the world comes out of fire-fighting mode, so the emphasis is switching from handling the immediate consequences of the crash to understanding the causes. And there is no shortage of candidates. Weak management of financial companies, inadequate risk control, misguided regulation and global imbalances have all been highlighted as contributing to the conflagration.

Many commentators have pinpointed shortcomings in shareholder governance as a key issue. Among the rights and obligations conferred by the western (Anglo-Saxon) system of company ownership, shareholders are required to exercise control over executive management and to hold them to account. All too often in the run-up to the crisis, shareholders failed in this duty. Executive management was allowed too free a hand, and in many cases abused this freedom to drive their companies to destruction, to the detriment of not only their shareholder-owners but also society at large.

There is widespread agreement with the general principle that shareholders should in future exercise greater control over their companies. For sovereign wealth funds (SWFs), however, this poses a particular challenge. While many institutional shareholders have merely been lax about exercising their role as owners, many sovereign funds have taken a conscious decision not to play any part in the management of investee companies. They have pointedly abstained from taking up the directorships to which they would be entitled, and have in general abstained from exercising rights to vote.

This decision by SWFs to play an entirely passive role has some longer-term antecedents, but arises above all from their experiences in 2007. A succession of high-profile SWF purchases of stakes in the developed world's financial companies engendered considerable comment, much of it hostile, in the western media on how control of companies was being ceded to overseas holders. Most SWFs hastened to reassure their western partners that this was not their intention, and backed up these words by declaring that they would waive shareholder rights. However, while this was undoubtedly meant as a conciliatory gesture, it weakened shareholder governance and allowed headstrong and poor management too much freedom.

It is widely agreed that, in general, such complete passivity by major shareholders is neither in the company's nor in society's interest. Most companies benefit from active involvement by their owners, and there is no reason why this should not also be the case when those shareholders are leading sovereign funds. The time has come, therefore, to ask whether SWFs' current passive stance is optimal.

Many commentators are of the opinion that SWFs should be more ready to accept that they have not only rights but also obligations as a result of entry on to the shareholding registers of important western companies. A more active role in shareholder governance by leading SWFs would be in the general interest, they claim; by confirming that they support the principles of solid management and good governance for the companies they invest in, SWFs would be making a powerful contribution to the underlying macro-economic stability on which the health of the financial system ultimately rests.

But for would-be active SWFs, there is a fine line separating involvement and interference. Too little involvement, and they stand accused of failing in their obligations. Too much, and they risk renewed criticism from populist western commentators that they are seeking undue control.

This remains one of the central issues that sovereign funds need to resolve. With their large stakes, their global viewpoint and their very long investment horizons, they have the potential to make a major contribution towards the better governance of western companies. The leading SWFs are well aware of this. The task is to find a way for them to do so in a manner that is acceptable to all.

With their large stakes, their global viewpoint and their very long investment horizons, sovereign wealth funds have the potential to make a major contribution towards the better governance of western companies.

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Not the time to please Obama

Interest rates irrelevant to Chinese economic control

Jonathan Fenby, Board of Contributing Editors

The rabid response on international financial markets to the latest increase in Chinese reserve requirements shows one thing: most market participants do not understand how China's monetary policy works. On 12 February the People's Bank (PBC) announced a 50 basis points increase in ratios for banks. This led to widespread fears about an impending Chinese slow-down with negative effects on world growth.

In fact, the move will simply mop up additional liquidity injected into the market before Chinese New Year and resulting from maturing bills. It is a neutral measure that does not point to additional tightening.

Manufactured goods liberalisation over the last three decades and the image of China as the home of go-go competition have made many people think the economy operates on western lines. Far from it. The state accounts for 80% of the economy. The core sectors of land, labour and capital markets remain under its control.

In monetary policy, reserve requirements and interest rates count for little, except when they are hiked to astronomic levels. At its quarterly meeting in December, the PBC's Monetary Policy Committee [See box p.17] reiterated the line taken at the broader Economic Work Conference in early December to continue a 'relatively easy monetary policy' but added that 'Proper money and credit growth and smooth credit extension will also be important to avoid dramatic fluctuations in lending.'

These two meetings laid down an administrative plan for monetary tightening from last year's runaway loan growth. The loan ceiling for 2010 was set at Rmb7.5trn ($1.1tn), down from Rmb9.5trn ($1.4tn) in 2009. The key point is the destination of the new loans. It seems likely that they will go predominantly to state-owned enterprises (SOEs) and big central government infrastructure projects. Local authorities which got all the cash they wanted in 2009 will find the going harder.

The Monetary Committee reinforced the policy of favouring sectors that would guarantee employment, help 'emerging industries of strategic importance and industrial relocation' and support agricultural financing and small enterprises. Lending to energy-consuming and polluting industries and to newly-started projects will be restricted. With an implicit reference to local government financing, a 'macro-prudential management system' will be set up 'to prevent and resolve potential financial risks'.

Monetary policy is set by the political leadership, as at the Economic Work Conference, and applied administratively by the PBC. The Chinese authorities dole out the money as they see fit. They do not use interest rate rationing. Equally misguided are market rumours that China will significantly raise interest rates and revalue the renminbi to fight inflation. There will probably be interest rate increases later this year, but their main purpose will be to ensure the big state banks preserve large lending margins to strengthen their balance sheets against the prospect of increasing non-performing loans.

On the currency front, Beijing's tough line towards the US makes a renminbi revaluation even less likely than before. [February OMFIF Bulletin, p.3]. China does not want to favour President Barack Obama amid a row over US-Taiwan arms sales and the Dalai Lama.

The major cause of consumer price inflation, which will probably rise to 5% this year after being negative in 2009, is food, accounting for three-quarters of the expected increase. This is primarily a supply issue as farmers and the distribution chain cannot keep up with what people want to eat. The way of dealing with that lies in land reform, irrigation improvements, better fertilisers, GM crops and modernised logistics chains – together, perhaps, with increased imports. Raising interest rates is not the answer.

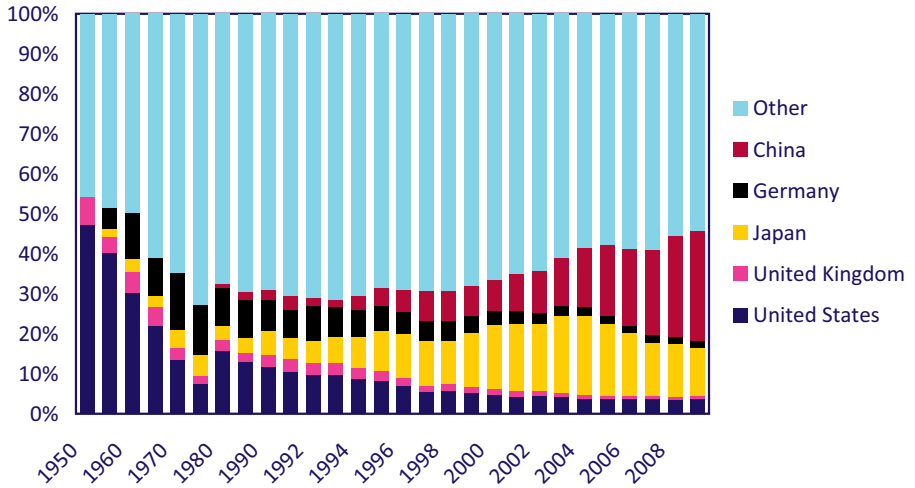
Monetary policy is set by the political leadership, as at the Economic Work Conference, and applied administratively by the PBC. The Chinese authorities dole out the money as they see fit.

How China took German reserve lead

Who will emerge as Beijing's Otmar Emminger?

The mid-February decision by the People's Bank of China (PBC) to raise reserve requirements sparked financial market worries that the Chinese authorities are starting to fret about rising inflationary pressures. A behind-the-scenes debate may be building up within the top echelons of China's economic policy-making between central bank technocrats leaning towards an appreciation of the renminbi to damp inflation, and the politicians who want to keep growth going at all costs.

HOW CHINA HAS TAKEN OVER GERMANY'S FORMER RESERVE SUPREMACY
Gold and foreign exchange reserves (percentages of world total)



Source: IMF International Financial Statistics

China's recession-defying growth and massively expanding foreign exchange reserves force financial markets to keep the vagaries of Beijing monetary policy under close surveillance.

History provides some important indicators as to what may happen next. And the principal clues are to be found not in Asia, but in Europe half a century ago. An intriguingly parallel set of circumstances, combining the influences of war, revolution and state collapse with the complex international geopolitics of under-valued currencies, links the position of China today and that of West Germany in the 1950s and 1960s. Central to the German development was the rise to intellectual pre-eminence within the late 1950s Bundesbank of a hard currency hawk, the psychologically peppery and intellectually lethal economist Otmar Emminger (who became the central bank's president in the late 1970s). [See box below.] The link between 1950s Germany and China today is that both countries presided over heavy increases in reserves, which made them the world's largest holders of foreign exchange. The Federal Republic in 1960 held 20% of international currency reserves – although the figures were tiny compared with today's.

In 2010 China, the pro-growth politicians, for the time being, are in the ascendancy, as Jonathan Fenby makes clear on p.11. But how long will this last? If the threat of an inflationary surge in China becomes more acute, the world may see a Beijing faction rising in power that is dedicated to lowering inflation through a higher external value of the currency.

We have been here before. In the move towards eventual break-up in 1971-73 of the Bretton Woods fixed exchange rate system based on the dollar and gold, a pivotal episode was the landmark revaluation of the D-Mark in 1961. This was part of a series of events that led to the primacy of Germany in European economic policy-making, only a generation after the country's destruction in the Second World War – a sequence that bears some resemblance to China's economic rebirth after the strife of the Cultural Revolution. The D-Mark was undervalued in the 1950s, leading to large-scale currency intervention and heavy inflows under the Bretton Woods rules as the West German

Otmar Emminger: a key international figure

Otmar Emminger joined the precursor of the Bundesbank, the Bank deutscher Länder, as an economist in 1950, becoming board member for international affairs in 1953. This was a pivotal position at a time when West Germany – although still an occupied country – was rapidly regaining international significance as a result of its fast-growing economy and the Cold War. He became deputy president of the Bundesbank in 1970 and president in 1977 to 1979. Chancellor Helmut Schmidt did not want him to stay on and he was replaced by Karl Otto Pöhl in January 1980.

Emminger, who had a pedantic leaning to correcting the written questions of visiting journalists before he would go about answering them, was a supreme monetary pragmatist. Paul Volcker – who greatly admired him – once discussed with him the consequences of Germany's 1923 hyper-inflation on accentuating the need for Bundesbank independence.' Volcker told him: 'After this experience, I'm sure Germany wanted to gear its monetary policy to preventing such a disaster from happening ever again.' Emminger replied drily: 'Well actually it wasn't quite like that. We simply thought that putting forward the inflation experience was a good way of getting our independence.'

authorities, at first abbetted by the US, tried to keep down the value of the D-Mark.

The D-Mark revaluation in 1961, fuelled by Emminger's worries about inflation, was preceded by bitter argument between the Bundesbank and the West German government led by legendary post-war leader Konrad Adenauer. Forging an alliance with Ludwig Erhard, the economics minister, Emminger marshalled a hard money faction in the Bundesbank that pushed through a revaluation that was initially opposed both by Adenauer and by Bundesbank president Karl Blessing – but was strongly backed by the US government under President John F. Kennedy who came to power in January 1961.

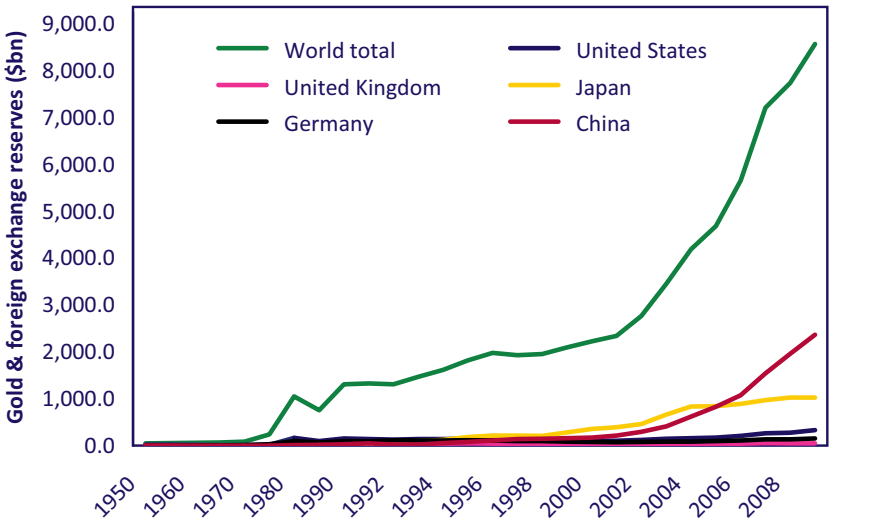
If history repeats itself, then – based on the Emminger saga – the following events are likely to occur within the Chinese monetary leadership in the reasonably near future:

- An Emminger-like figure preaching a semi-heretical policy of renminbi revaluation will rise to prominence either within the staff of the People's Bank or, more likely, from the PBC's shadowy Monetary Policy Committee (MPC) [See box p.17] containing both central banking technocrats and government officials.

- The Chinese Emminger may already have circulated secretly within the MPC a landmark pro-revaluation memorandum similar to one released at the West German central bank in 1959. [See box below]. The Emminger-like figure will find allies within the elite bastions of Chinese economic power, including a leading economic minister (the modern-day Chinese version of Ludwig Erhard) – but will encounter strong opposition from leaders of both the government and the central bank.

- Hefty amounts of vitriol will be exchanged between the different groupings. The anti-devaluation

WORLD RESERVES QUADRUPLE IN 2000s THANKS TO CHINA
Foreign exchange and gold reserves 1950-2009 (value)



Source: IMF International Financial Statistics

The six-point Emminger plan from 1959-1960 – potential precursor for China?

Otmar Emminger's 1959-1960 currency plan combined six main elements – all of which have parallels in today's Chinese position:

1. Monetary policy held the key to curbing the overheating of the West German economy, since corrections to budgetary policy by the Bonn government were unlikely to be forthcoming.

2. Cooling the domestic economy by restrictive interest rate action would turn out to be self-defeating since it would further divert economic resources into exports and increase still further the country's trade surplus.

3. Once of the main reasons for the overall distortions in the foreign exchange markets was the persistent US balance of payments deficit. Since this was unlikely to be corrected by American action, it was up to West Germany to take appropriate measures to end the distortion.

4. If opponents of a revaluation won the day, the alternative would be a gradual increase in domestic prices and ending of the competitive imbalances between Germany and the US through higher inflation – which would seriously undermine monetary stability.

5. A D-Mark revaluation would be ideally brought about through a multilateral currency realignment, but since this was highly unlikely to take place, the best option was unilateral action.

6. Emminger proposed a 7.7% D-Mark revaluation. The actual revaluation in March 1961 was 5%. This was not enough to stem a series of further German current account surpluses, and the D-Mark was revalued again – after a series of high-profile arguments with the US, the UK and France – by a further 9.3% in October 1969.

faction in Beijing will accuse its opponents of damaging export industries, undermining the interests of the state, and devaluing the country's foreign exchange reserves, most of which are held in dollars.

- The pro-revaluation faction in Beijing will eventually triumph. Realisation will dawn that massive intervention to hold down the renminbi – similar to the large purchases of dollars by the Bundesbank in the late 1950s to prevent the D-Mark from rising – results in destabilising inflows of currency that can not be sterilised, or 'mopped up', sufficiently quickly by the central bank to stop inflation from rising.

- A limited revaluation of the renmbinbi of around 5% – the figure by which the D-Mark was revalued in March 1961 – will have little effect in precipitating the internationally-desired rebalancing of the Chinese economy towards domestic consumption and away from exports. Instead, by fulfilling the Chinese authorities' wish to restrain inflation, the revaluation will eventually increase rather than reduce the competitiveness of Chinese exports compared with the US and other countries – similar to the pattern of the German economy in the 1960s. So pressure for a further revaluation will build up again later in the 2010s – just as it did in the 1960s with the D-Mark, which was eventually revalued again (after a furious row with the US, France and Britain, which all wanted the Germans to revalue in 1968).

Of course, similarities between West Germany and China should not be

The international gold – foreign exchange reserve balance 1950-2009: World, US, UK

FOR COUNTRY COMMENTARIES SEE P.15, 17, 19 AND 20

How the nations compare – key reserve asset statistics. Percentages refer to proportion of world totals

Year	World				United States							United Kingdom						
	Gold		Forex	Total	Gold			Forex		Total		Gold			Forex		Total	
	m oz.	$bn	$bn	$bn	m oz	$bn	%	$bn	%	$bn	%	m oz	$bn	%	$bn	%	$bn	%
1950	999.8	35.0	13.3	48.3	652.0	22.8	65.2	0.0	0.0	22.8	47.3	81.7	2.9	8.2	0.6	4.4	3.4	7.1
1955	1,066.6	37.3	16.7	54.0	622.0	21.8	58.3	0.0	0.0	21.8	40.3	57.6	2.0	5.4	0.1	0.8	2.2	4.0
1960	1,154.0	40.4	18.7	59.1	509.0	17.8	44.1	0.0	0.0	17.8	30.1	80.0	2.8	6.9	0.4	2.3	3.2	5.5
1965	1,232.9	43.2	23.9	67.1	402.0	14.1	32.6	0.8	3.3	14.9	22.2	64.7	2.3	5.2	0.7	3.1	3.0	4.5
1970	1,167.8	40.9	45.1	86.0	316.0	11.1	27.1	0.6	1.3	11.7	13.6	38.5	1.3	3.3	1.2	2.7	2.6	3.0
1975	1,188.0	77.1	160.5	237.6	275.0	17.8	23.1	0.1	0.1	17.9	7.6	21.0	1.4	1.8	3.4	2.1	4.8	2.0
1980	1,152.2	679.2	374.5	1,053.7	264.0	155.6	22.9	10.1	2.7	165.7	15.7	18.8	11.1	1.6	18.7	5.0	29.8	2.8
1985	1,147.4	375.2	382.8	758.0	263.0	86.0	22.9	12.9	3.4	98.9	13.0	19.0	6.2	1.7	9.7	2.5	15.9	2.1
1990	1,144.2	441.7	868.6	1,310.3	262.0	101.1	22.9	52.2	6.0	153.3	11.7	18.9	7.3	1.7	32.9	3.8	40.2	3.1
1991	1,143.0	403.5	925.6	1,329.1	262.0	92.5	22.9	45.9	5.0	138.4	10.4	18.9	6.7	1.7	38.7	4.2	45.4	3.4
1992	1,131.3	376.7	930.9	1,307.6	262.0	87.2	23.2	40.0	4.3	127.2	9.7	18.6	6.2	1.6	34.1	3.7	40.3	3.1
1993	1,125.0	439.9	1,030.8	1,470.7	262.0	102.4	23.3	41.6	4.0	144.0	9.8	18.4	7.2	1.6	34.6	3.4	41.8	2.8
1994	1,119.6	428.8	1,186.8	1,615.6	262.0	100.3	23.4	41.2	3.5	141.5	8.8	18.4	7.0	1.6	38.5	3.2	45.5	2.8
1995	1,115.3	431.3	1,389.8	1,821.1	262.0	101.3	23.5	49.1	3.5	150.4	8.3	18.4	7.1	1.6	39.2	2.8	46.3	2.5
1996	1,111.1	411.1	1,566.3	1,977.4	262.0	96.9	23.6	38.3	2.4	135.2	6.8	18.4	6.8	1.7	37.1	2.4	43.9	2.2
1997	1,091.4	315.6	1,616.2	1,931.8	262.0	75.8	24.0	30.8	1.9	106.6	5.5	18.4	5.3	1.7	24.9	1.5	30.2	1.6
1998	1,078.2	309.9	1,643.8	1,953.7	262.0	75.3	24.3	36.0	2.2	111.3	5.7	23.0	6.6	2.1	27.4	1.7	34.0	1.7
1999	1,077.8	312.8	1,781.9	2,094.7	262.0	76.0	24.3	32.2	1.8	108.2	5.2	20.5	6.0	1.9	27.5	1.5	33.5	1.6
2000	1,062.9	289.8	1,936.3	2,226.1	262.0	71.4	24.6	31.2	1.6	102.6	4.6	15.7	4.3	1.5	34.2	1.8	38.5	1.7
2001	1,053.9	291.4	2,049.6	2,341.0	262.0	72.4	24.9	29.0	1.4	101.4	4.3	11.4	3.2	1.1	28.8	1.4	32.0	1.4
2002	1,042.1	357.2	2,408.1	2,765.3	262.0	89.8	25.1	33.8	1.4	123.6	4.5	10.1	3.5	1.0	31.0	1.3	34.5	1.2
2003	1,024.3	427.4	3,025.1	3,452.5	262.0	109.3	25.6	39.7	1.3	149.0	4.3	10.1	4.2	1.0	28.6	0.9	32.8	1.0
2004	1,007.7	441.4	3,748.4	4,189.8	261.5	114.5	26.0	42.7	1.1	157.2	3.8	10.1	4.4	1.0	34.1	0.9	38.5	0.9
2005	988.4	507.0	4,174.6	4,681.6	261.5	134.1	26.5	37.8	0.9	171.9	3.7	10.0	5.1	1.0	35.8	0.9	40.9	0.9
2006	976.7	620.9	5,036.9	5,657.8	261.5	166.2	26.8	40.9	0.8	207.1	3.7	10.0	6.4	1.0	38.9	0.8	45.3	0.8
2007	960.5	800.8	6,411.1	7,211.9	261.5	218.0	27.2	45.8	0.7	263.8	3.7	10.0	8.3	1.0	47.5	0.7	55.8	0.8
2008	954.6	830.3	6,909.3	7,739.6	261.5	227.4	27.4	49.6	0.7	277.0	3.6	10.0	8.7	1.0	41.6	0.6	50.3	0.6
2009	968.5	1,053.2	7,516.0	8,569.2	261.5	284.4	27.0	50.5	0.7	334.9	3.9	10.0	10.9	1.0	38.0	0.5	48.9	0.6

Notes: 2009 figures are latest month: September-December

Source: IMF International Financial Statistics

taken too far. West Germany in the 1950s was a democracy – albeit one that had been ruled since the birth of the Federal Republic in 1949 by governments led by Adenauer's Christian Democrats. China is a one-party state ruled by a Communist party equipped with dictatorial powers.

Additionally, the People's Bank is an arm of government, whereas the Bundesbank, in the form of its predecessor, the Bank deutscher Länder, had been given statutory independence in 1948, reaffirmed in the Bundesbank Law of 1957. There is, however, one fundamental parallel between the two institutions. Both the People's Bank and the Bundesbank derive particular status from being set up (in 1948) before the birth of their respective states. The People's Bank was established in December 1948 through the fusion of three separate banks, the Huabei Bank, the Beihai Bank and the Xibei Farmers Bank, while the civil war still raged that led to the promulgation of the People's Republic in October 1949. The Bank deutscher Länder was established by Germany's western occupying powers in March1948 ahead of the birth of the Federal Republic in May 1949.

In present-day China, there are several other echoes of monetary developments in West Germany in the 1950s. In both cases, the

THE STORY BEHIND THE INTERNATIONAL RESERVES STATISTICS

Big shift in world currency distribution as China leads massive increase

The volume of world gold reserves has remained largely constant at around 1,000m troy oz over the past 60 years, descending below this figure only over the last decade as a result of moderate gold sales by some leading central banks. The volume has declined by just 3% since 1950, although the value has risen 30-fold as a result of the increase in the gold price from the Bretton Woods level of $35 per oz, following large-scale but futile official attempts to hold down the gold price in the 1950s and 1960s.

The distribution of gold reserves has shifted from the US and towards Europe as a result of large American gold sales during bouts of dollar weakness in the 1950s, 1960s and, to a certain extent, 1970s. However the relative distribution of gold reserves between the US and Europe has barely changed since 1980 as a result of the stabilisation of overall volumes of gold reserves since then. The three biggest gold holders, the US, Germany and Italy, have maintained their gold reserves more or less intact over the past 30 years, while France, traditionally the No.3 holder, has somewhat surprisingly sold nearly one-quarter of its gold reserves through gradual annual sales since the introduction of the euro in 1999.

A medium-sized gold holder, Britain, having moderately increased its gold reserves during the 1990s, made the even more costly mistake of selling half of its reserves in 1999-2002 ahead of a period of sharply rising prices.

World foreign exchange reserves have shown much more dynamism than gold reserves, rising nearly 580-fold over the past 60 years. Currency reserves were less than half the size of gold reserves in 1950. They outweighed gold by 1970, but were once again roughly half the level of gold reserves in 1980, when the bullion price reached $850 per oz on the Soviet invasion of Afghanistan.

As a result of massive reserve accumulation by countries outside the US and Europe, principally China, world foreign exchange reserves roughly doubled during the 1990s to $1.9tn by 2000 and then rose nearly four-fold during the first decade of the 21st century to reach $7.5trn by the end of 2009 – dwarfing gold reserves (even at the substantially higher price) by 7.5 to one.

US holds steady on gold as foreign exchange reserves show relative decline

The US share of world gold reserves declined from 65% in the immediate aftermath of the Second Wold War to only 27% in 1970 but has remained steady since then. There have been only negligible sales from US official gold holdings since 1980.

Having proceeded throughout the Bretton Woods system without official holdings of foreign exchange, the US built up stocks of foreign exchange reserves during the period of floating exchange rates that started in 1973 – above all in connection with currency intervention These reserves have been fluctuating in the $30bn to $50bn range in the past two decades, although their usefulness can be called into question as a result of the lack of foreign exchange intervention by the US authorities in recent years.

Foreign exchange reserves, having been 6% of the world total in 1990, declined by end-2009 to just 0.7% of the total. Overall, American reserves of gold and foreign exchange made up just 4% of the total as of end-2009 against 12% in 1990, 30% in 1960 and 47% in 1950.

authorities were at pains to maintain an undervalued currency to promote exports and assist in large-scale domestic economic restructuring. Both West Germany and China had overriding social reasons for favouring exports. In Germany's case, the under-valuation of the D-Mark helped promote the integration into the German economy of millions of refugees displaced from central and eastern Europe by post-war turmoil. In China, the renminbi's under-valuation has been part of an effort to prevent possible unrest from unemployment among the huge influx of rural peasants attracted into urban factories by rapid Chinese industrialisation.

The rest of the world, and in particular the American authorities, were content to turn a blind eye to the distortions building up as a result of massive German and Chinese trade surpluses. In the 1950s, the Americans were loath to see disturbance to the Bretton Woods system of fixed parities that would have caused a rise in the sacrosanct dollar price of gold and thus a devaluation of the US currency. In the 2000s, the US – in common with the rest of the world – was content to see the outpouring of cheap Chinese exports prompted by the low renminbi as contributing to a worldwide lowering of inflationary pressures. This was a false illusion, as it turned out, since the fall in the inflation rate masked a dangerous build-up of asset bubbles that burst with the onset of the financial crisis in 2007.

American compliance with the West German and Chinese under-valuations reached its limits on both occasions with the taking office of charismatic, untried Democratic presidents in the

The international gold – foreign exchange reserve balance 1950-2009: Japan, Germany, China

FOR COUNTRY COMMENTARIES SEE P.15, 17, 19 AND 20

How the nations compare – key reserve asset statistics. Percentages refer to proportion of world totals

Year	Japan							Germany							China						
	Gold			Forex		Total		Gold			Forex		Total		Gold			Forex		Total	
	m oz	$bn	%	$bn	%	$bn	%	m oz	$bn	%	$bn	%	$bn	%	m oz	$bn	%	$bn	%	$bn	%
1950		0.0	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-	-	-	-	-	-	-
1955	0.6	0.0	0.1	1.0	6.0	1.0	1.9	26.3	0.9	2.5	2.0	12.0	2.9	5.4	-	-	-	-	-	-	-
1960	7.1	0.2	0.6	1.6	8.6	1.8	3.1	84.9	3.0	7.4	3.8	20.3	6.8	11.5	-	-	-	-	-	-	-
1965	9.4	0.3	0.8	1.6	6.7	1.9	2.9	126.0	4.4	10.2	1.9	7.9	6.3	9.4	-	-	-	-	-	-	-
1970	15.2	0.5	1.3	3.2	7.1	3.7	4.3	113.7	4.0	9.7	8.5	18.8	12.5	14.5	-	-	-	-	-	-	-
1975	21.1	1.4	1.8	10.6	6.6	12.0	5.0	117.6	7.6	9.9	22.7	14.1	30.3	12.8	-	-	-	-	-	-	-
1980	24.2	14.3	2.1	21.6	5.8	35.9	3.4	95.2	56.1	8.3	44.5	11.9	100.6	9.5	12.8	7.5	1.1	2.3	0.6	9.8	0.9
1985	24.2	7.9	2.1	22.3	5.8	30.2	4.0	95.2	31.1	8.3	39.0	10.2	70.1	9.3	12.7	4.2	1.1	11.9	3.1	16.1	2.1
1990	24.2	9.3	2.1	69.5	8.0	78.8	6.0	95.2	36.7	8.3	63.0	7.3	99.7	7.6	12.7	4.9	1.1	28.6	3.3	33.5	2.6
1991	24.2	8.5	2.1	61.8	6.7	70.3	5.3	95.2	33.6	8.3	57.5	6.2	91.1	6.9	12.7	4.5	1.1	42.7	4.6	47.2	3.6
1992	24.2	8.1	2.1	61.9	6.6	70.0	5.4	95.2	31.7	8.4	85.9	9.2	117.6	9.0	12.7	4.2	1.1	19.4	2.1	23.6	1.8
1993	24.2	9.5	2.2	88.7	8.6	98.2	6.7	95.2	37.2	8.5	72.7	7.1	109.9	7.5	12.7	5.0	1.1	21.2	2.1	26.2	1.8
1994	24.2	9.3	2.2	115.1	9.7	124.4	7.7	95.2	36.5	8.5	72.2	6.1	108.7	6.7	12.7	4.9	1.1	51.6	4.3	56.5	3.5
1995	24.2	9.4	2.2	172.4	12.4	181.8	10.0	95.2	36.8	8.5	77.8	5.6	114.6	6.3	12.7	4.9	1.1	73.6	5.3	78.5	4.3
1996	24.2	9.0	2.2	207.3	13.2	216.3	10.9	95.2	35.2	8.6	75.8	4.8	111.0	5.6	12.7	4.7	1.1	105.0	6.7	109.7	5.5
1997	24.2	7.0	2.2	207.9	12.9	214.9	11.1	95.2	27.5	8.7	69.9	4.3	97.4	5.0	12.7	3.7	1.2	139.9	8.7	143.6	7.4
1998	24.2	7.0	2.2	203.2	12.4	210.2	10.8	119.0	34.2	11.0	64.1	3.9	98.3	5.0	12.7	3.7	1.2	145.0	8.8	148.7	7.6
1999	24.2	7.0	2.2	277.7	15.6	284.7	13.6	111.5	32.4	10.3	52.7	3.0	85.1	4.1	12.7	3.7	1.2	154.7	8.7	158.4	7.6
2000	24.5	6.7	2.3	347.2	17.9	353.9	15.9	111.5	30.4	10.5	49.7	2.6	80.1	3.6	12.7	3.5	1.2	165.6	8.6	169.1	7.6
2001	24.6	6.8	2.3	387.7	18.9	394.5	16.9	111.1	30.7	10.5	43.7	2.1	74.4	3.2	16.1	4.5	1.5	212.2	10.4	216.7	9.3
2002	24.6	8.4	2.4	451.5	18.7	459.9	16.6	110.8	38.0	10.6	42.5	1.8	80.5	2.9	19.3	6.6	1.9	286.4	11.9	293.0	10.6
2003	24.6	10.3	2.4	652.8	21.6	663.1	19.2	110.6	46.1	10.8	41.1	1.4	87.2	2.5	19.3	8.1	1.9	403.6	13.3	411.7	11.9
2004	24.6	10.8	2.4	824.3	22.0	835.1	19.9	110.4	48.4	11.0	39.9	1.1	88.3	2.1	19.3	8.5	1.9	609.9	16.3	618.4	14.8
2005	24.6	12.6	2.5	828.9	19.9	841.5	18.0	110.2	56.5	11.1	39.8	1.0	96.3	2.1	19.3	9.9	2.0	818.9	19.6	828.8	17.7
2006	24.6	15.6	2.5	874.9	17.4	890.5	15.7	110.0	69.9	11.3	37.7	0.7	107.6	1.9	19.3	12.3	2.0	1,066.3	21.2	1,078.6	19.1
2007	24.6	20.5	2.6	948.4	14.8	968.9	13.4	109.9	91.6	11.4	40.8	0.6	132.4	1.8	19.3	16.1	2.0	1,528.3	23.8	1,544.4	21.4
2008	24.6	21.4	2.6	1,003.7	14.5	1,025.1	13.2	109.7	95.4	11.5	38.6	0.6	134.0	1.7	19.3	16.8	2.0	1,946.0	28.2	1,962.8	25.4
2009	24.6	26.8	2.5	997.0	13.3	1,023.8	11.9	109.5	119.1	11.3	37.4	0.5	156.5	1.8	33.9	36.9	3.5	2,328.0	31.0	2,364.9	27.6

Notes: 2009 figures are latest month: September-December; China did not report reserves pre-1980

Source: IMF International Financial Statistics

China takes over Germany's currency leadership

In 1980 China disclosed $2.3bn in foreign exchange reserves and 12.8m oz of gold – making a total of $10bn or 1% of overall world foreign exchange and gold reserves. China's foreign exchange holdings rose 12-fold in the 1980s, six-fold in the 1990s and 14-fold in the first decade of the 21st century. (The Bundesbank's currency holdings also rose 12-fold in the decade 1965-75 when the Bretton Woods system collapsed.)

China's foreign exchange reserves – $2.3tn as of end-2009, against $166bn in 2000 and $29bn in 1990 – now make up 31% of the world total, against 9% in 2000. Germany and China have switched positions. China made up 0.6% of world foreign exchange reserves in 1980, around the same as Germany had at end-2009. In its holdings as a proportion of the world total, China has now clearly surpassed Germany's peak levels of 20% in 1960 and 19% in 1990; this figure was however China's average level of holding in the last 10 years. There is little to suggest that the enormous increase in reserve holdings has been planned. In September 2006, as foreign exchange reserves were about to cross the $1tn mark, Zeng Quinghong, a Chinese vice president, said China 'would take comprehensive measures too avoid further significant growth' in the reserves. People's Bank governor Zhou Xiaochuan, asked about the reserves, said: 'We have enough.' However, in their policies on foreign exchange intervention, Chinese officials have been heavily influenced by Japan's lengthy recession in the 1990s, which they are convinced was partly due to the large revaluation of the yen forced by the US in the mid-1980s. This is an experience China wishes to avoid at all costs.

China announced in April 2009 that it had increased its gold reserves to more than 1,000 tonnes as a result of gradual purchases over the past six years. In view of the need to diversify monetary holdings away from preponderance on the dollar – thought to account for about 70% of Beijing's foreign exchange reserves – the move surprised no-one. China has reported to the IMF gold holdings of 33.9m oz, or 3.5% of world bullion reserves. Many international monetary officials believe this significantly understates the true level of Chinese gold reserves, given that China is now the world's largest gold producer.

Monetary Policy Committee of People's Bank of China – March 2010

Mr Zhou Xiochuan, Chairman, Governor, People's Bank of China
Mr You Quan, Deputy Secretary General, State Council
Mr Su Ning, Deputy Governor, People's Bank of China
Ms Hu Xiaolian, Deputy Governor, People's Bank of China
Mr Yi Gang, Deputy Governor, People's Bank of China, and Administrator, State Administration of Foreign Exchange (SAFE)
Mr Li Yong, Vice Minister, Finance Ministry
Mr Liu Mingkang, Chairman, China Banking Regulatory Commission
Mr Shang Fulin, President, China Securities Regulatory Commission
Mr Wu Dingfu, Chairman, China Insurance Regulatory Commission
Mr Jiang Chaoliang, Chairman, China Banking Commission
Mr Zhu Zhixin, Deputy Director, China State Development and Reform Commission
Mr Ma Jiantang, Director, China National Bureau of Statistics
Mr Fan Gang, China Academy of Social Sciences

Germany slims currency holdings

The Bank deutscher Länder, the Bundesbank's forerunner, was entrusted with holding monetary reserves when it was set up in March 1948. Initially, the holdings were nil. During the booming 1950s and 1960s, gold and foreign exchange stocks rose rapidly. By 1970, the Bundesbank had 114m oz of gold, 10% of world gold reserves and $8.5bn worth of foreign exchange, 19% of the world total. Together, the reserves made up 15% of world stocks of gold and currency. German's foreign exchange holdings, bigger than the combined total of Japan, the UK and France, were easily the largest in the world. Total reserves moved slightly ahead of the US (which, counting gold and foreign exchange, made up 14% of world reserves).

When Chancellor Helmut Schmidt took office in 1974, he was so impressed by the foreign exchange reserves that he proposed using them to place deposits and loans with Poland, the Soviet Union and Britain, which all needed balance of payments help. These plans largely fell foul of Bundesbank opposition. [See Archive Insight, p.24]. After reunification in 1990, Germany's stocks of foreign exchange reserves peaked in absolute terms at $86bn in 1992 – when the Bundesbank was buying massive quantities of foreign exchange to defend weak European currencies. Since then the Bundesbank has run down foreign exchange reserves to reduce the risk of holding dollars. Currency holdings at end-2009 totalled just $37bn – 0.5% of world foreign exchange reserves.

US – John F. Kennedy in January 1961 and Barack Obama in January 2009. On both occasions, the newcomer in the White House called for change in the country behind the undervaluation. Kennedy tried to promote higher inflation in West Germany; Obama prompted a policy accusing the Chinese of 'manipulating' their currency, which developed into a campaign for renminbi revaluation when he visited Beijing in November 2009.

The most striking parallel between the German and Chinese experience has been in the field of monetary reserves. In both cases, massive intervention on financial markets by West Germany and China to prevent their currencies rising against the dollar led to a huge rise of monetary reserves in the form of foreign exchange and gold at the central bank. West Germany's reserves held by the Bundesbank showed a similar rise during the 1950s and 1960s to the upsurge in Chinese reserves over the past 10 years, as the statistical breakdown on pages 14, 16 and 18 shows. Although the absolute amounts for present-day China are much larger than in 1950s Germany, the relative positions are very similar. West Germany went from a collapsed pariah in 1945 to the world's largest reserve-holder by the 1970s. It then bequeathed to Japan the position as most important owner of foreign exchange – before China supplanted Japan in the last decade.

In view of Germany's and Japan's war-time defeat, these two nations were far more compliant challengers to US economic leadership than China is likely to be over the next decade.

The international gold – foreign exchange reserve balance 1950-2009: France, Russia, India

FOR COUNTRY COMMENTARIES SEE P.15, 17, 19 AND 20

How the nations compare – key reserve asset statistics. Percentages refer to proportion of world totals

Year	France							Russia (Soviet Union)							India						
	Gold			Forex		Total		Gold			Forex		Total		Gold			Forex		Total	
	m oz	$bn	%	$bn	%	$bn	%	m oz	$bn	%	$bn	%	$bn	%	m oz	$bn	%	$bn	%	$bn	%
1950	15.6	0.5	1.6	0.1	0.8	0.6	1.3	-	-	-	-	-	-	-	7.1	0.2	0.7	1.8	13.5	2.0	4.2
1955	26.9	0.9	2.5	1.0	6.0	1.9	3.6	-	-	-	-	-	-	-	7.1	0.2	0.7	1.6	9.6	1.8	3.4
1960	46.9	1.6	4.1	0.5	2.7	2.1	3.6	-	-	-	-	-	-	-	7.1	0.2	0.6	0.4	2.1	0.6	1.1
1965	134.5	4.7	10.9	0.8	3.3	5.5	8.2	-	-	-	-	-	-	-	8.0	0.3	0.6	0.3	1.3	0.6	0.9
1970	100.9	3.5	8.6	1.3	2.9	4.8	5.6	-	-	-	-	-	-	-	7.0	0.2	0.6	0.7	1.6	0.9	1.1
1975	100.9	6.5	8.5	7.4	4.6	13.9	5.9	-	-	-	-	-	-	-	6.9	0.4	0.6	0.8	0.5	1.2	0.5
1980	81.9	48.3	7.1	25.3	6.8	73.6	7.0	-	-	-	-	-	-	-	8.6	5.1	0.7	6.0	1.6	11.1	1.1
1985	81.9	26.8	7.1	24.3	6.3	51.1	6.7	-	-	-	-	-	-	-	9.4	3.1	0.8	5.5	1.4	8.6	1.1
1990	81.9	31.6	7.2	34.1	3.9	65.7	5.0	-	-	-	-	-	-	-	10.7	4.1	0.9	1.2	0.1	5.3	0.4
1991	81.9	28.9	7.2	28.3	3.1	57.2	4.3	-	-	-	-	-	-	-	11.3	4.0	1.0	3.6	0.4	7.6	0.6
1992	81.9	27.3	7.2	24.4	2.6	51.7	4.0	-	-	-	-	-	-	-	11.3	3.8	1.0	5.5	0.6	9.3	0.7
1993	81.9	32.0	7.3	20.0	1.9	52.0	3.5	10.2	4.0	0.9	5.8	0.6	9.8	0.7	11.5	4.5	1.0	9.9	1.0	14.4	1.0
1994	81.9	31.4	7.3	23.5	2.0	54.9	3.4	8.4	3.2	0.8	4.0	0.3	7.2	0.4	11.8	4.5	1.1	19.4	1.6	23.9	1.5
1995	81.9	31.7	7.3	23.1	1.7	54.8	3.0	9.4	3.6	0.8	14.3	1.0	17.9	1.0	12.8	4.9	1.1	17.5	1.3	22.4	1.2
1996	81.9	30.3	7.4	23.1	1.5	53.4	2.7	13.5	5.0	1.2	11.3	0.7	16.3	0.8	12.8	4.7	1.2	19.7	1.3	24.4	1.2
1997	81.9	23.7	7.5	27.1	1.7	50.8	2.6	16.3	4.7	1.5	12.8	0.8	17.5	0.9	12.7	3.7	1.2	24.3	1.5	28.0	1.4
1998	102.4	29.4	9.5	38.8	2.4	68.2	3.5	14.7	4.2	1.4	7.8	0.5	12.0	0.6	11.5	3.3	1.1	27.0	1.6	30.3	1.6
1999	97.2	28.2	9.0	33.9	1.9	62.1	3.0	13.3	3.9	1.2	8.5	0.5	12.4	0.6	11.5	3.3	1.1	32.0	1.8	35.3	1.7
2000	97.2	26.5	9.1	32.1	1.7	58.6	2.6	12.4	3.4	1.2	24.3	1.3	27.7	1.2	11.5	3.1	1.1	37.3	1.9	40.4	1.8
2001	97.2	26.9	9.2	26.4	1.3	53.3	2.3	13.6	3.8	1.3	32.5	1.6	36.3	1.5	11.5	3.2	1.1	45.3	2.2	48.5	2.1
2002	97.2	33.3	9.3	22.0	0.9	55.3	2.0	12.5	4.3	1.2	44.1	1.8	48.4	1.7	11.5	3.9	1.1	67.0	2.8	70.9	2.6
2003	97.2	40.6	9.5	23.1	0.8	63.7	1.8	12.5	5.2	1.2	73.2	2.4	78.4	2.3	11.5	4.8	1.1	97.6	3.2	102.4	3.0
2004	95.9	42.0	9.5	29.1	0.8	71.1	1.7	12.4	5.4	1.2	120.8	3.2	126.2	3.0	11.5	5.0	1.1	125.2	3.3	130.2	3.1
2005	90.6	46.5	9.2	24.0	0.6	70.5	1.5	12.4	6.4	1.3	175.7	4.2	182.1	3.9	11.5	5.9	1.2	131.0	3.1	136.9	2.9
2006	87.4	55.6	8.9	40.3	0.8	95.9	1.7	12.9	8.2	1.3	295.3	5.9	303.5	5.4	11.5	7.3	1.2	170.2	3.4	177.5	3.1
2007	83.7	69.8	8.7	43.6	0.7	113.4	1.6	14.5	12.1	1.5	466.4	7.3	478.5	6.6	11.5	9.6	1.2	266.6	4.2	276.2	3.8
2008	80.1	69.7	8.4	30.4	0.4	100.1	1.3	16.7	14.5	1.7	411.5	6.0	426.0	5.5	11.5	10.0	1.2	246.6	3.6	256.6	3.3
2009	78.3	85.2	8.1	27.7	0.4	112.9	1.3	19.7	21.4	2.0	413.7	5.5	435.1	5.1	17.9	19.5	1.8	258.6	3.4	278.1	3.2

Notes: 2009 figures are latest month: September-December; Russia did not report reserves pre-1993

Source: IMF International Financial Statistics

Japan still world's second-biggest currency holder

Japan had no published reserves of gold and foreign exchange in 1950. The dollar's Bretton Woods travails allowed it quickly to build up stocks of gold and foreign exchange during the 1950s and 1960s. Japan accounted for 1% of world gold reserves and 7% of foreign exchange by 1970. Since then, although gold volume has remained stable (reaching 21m oz by 1980 and hardly changing afterwards), foreign exchange reserves have soared as a result of large export surpluses and intervention to hold down the yen.

By 1975, Japan was ensconced as the world's No.2 foreign exchange holder after Germany. It supplanted Germany in the 1990s and remained the No.1 owner of foreign exchange reserves until 2006 when Chinese reserves passed $1trn. Japanese currency reserves, having risen four-fold during the 1990s, increased threefold in the last decade, breaking through $1trn in 2008. Japan's foreign exchange reserves now make up 13% of the world total – having peaked at 22% in 2004. The relative decline has been caused by sharply rising reserves in China and other emerging economies. However, Japan is still by a very large margin the world's No.2 reserve holder – ahead of other important Asian holders such as Korea ($265bn), Hong Kong ($256bn), Singapore ($187bn), Thailand (134bn), Malaysia ($93bn) and Indonesia ($60bn).

UK decline from one-time strength

The UK, together with the US the pivotal country in the Bretton Woods system, held 8% of world gold reserves in the years after the end of the Second World War. Foreign exchange reserves at $600m made up 4% of world foreign exchange reserves in 1950. Overall, Britain had 7% of world's reserves of gold and foreign exchange in 1950; between them, the two Bretton Woods states had 54% of world reserves of gold and foreign exchange that year.

Since then, although foreign exchange reserves have increased substantially in absolute terms (partly because of the ill-judged decision to exchange gold for foreign exchange in 1999-2002), Britain's share of reserves, as of end-2009, has shrunk considerably – to 1% of the world total for gold, 0.5% for foreign exchange, and 0.6% of gold and foreign exchange combined

France's 1960s gold heyday

France kept its gold holdings out of German hands during the Second World War but entered the 1950s with reserves badly depleted by economic and political strife. The reserve-building heyday came in the mid-1960s when President Charles de Gaulle ordered the French authorities to switch excess dollars into gold. France briefly upstaged West Germany in 1965-67 as the world's second largest gold holder after the US, owning 134m oz in 1965 or 11% of world gold reserves – dwarfing currency reserves of a mere $800m.

Subsequent foreign exchange trials saw the gold reserves run down but currency holdings rise sharply to protect the French franc. Foreign exchange holdings fell to around $20bn in the early 1990s, rose before France entered EMU but have since declined again to below $30bn, reflecting France's economising on dollar reserves in EMU. Unlike Germany, France has gradually sold gold since EMU started, resulting in a nearly one-quarter fall in the volume of bullion holdings since 1998. France now owns just 8% of world gold reserves against 9.5% in 1998.

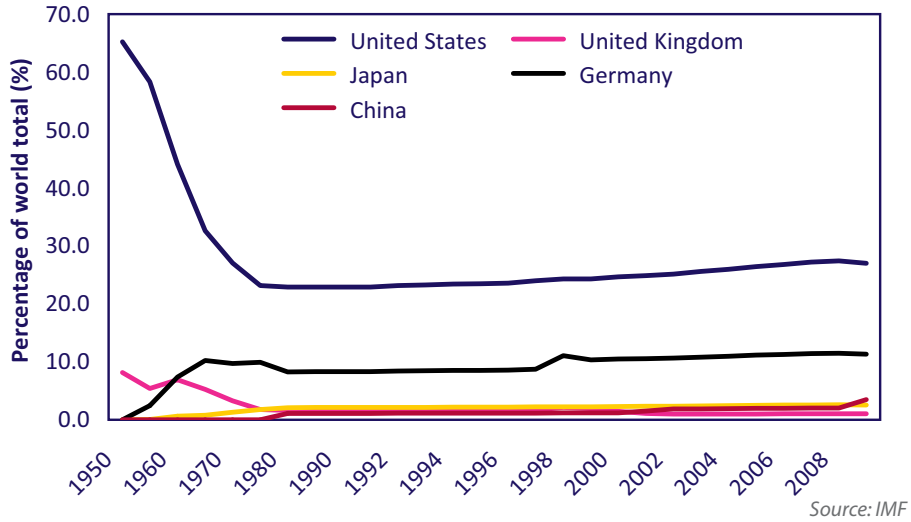
Key policy differences in reserve holdings between EMU members and non-members

Germany now has lower foreign exchange reserves than Denmark ($73bn), Poland ($73bn), the Czech Republic ($39bn), Sweden ($39bn) and Britain ($38bn). These non-EMU members have a greater need than for reserves for cushioning potentially adverse foreign exchange movements. Germany's foreign exchange reserves are also dwarfed by those in two other non-EMU members: Switzerland ($91bn) and Norway ($46bn) which are well-known as surplus countries attracting capital inflows.

EMU countries in balance of payments difficulties have massively run down reserve since joining the single currency. According to latest IMF data, Ireland had official foreign exchange reserves of $8.6bn before EMU in 1998 but only $500m at end-2009. Spain's currency reserves declined from $53bn in 1998 to $13bn at end-2009, Portugal's from $15bn to $800m. Greek reserves fell from $13bn in 2000, before Athens joined EMU, to just $200m at end-2009. These figures do not tell the whole story: in some EMU countries governments now hold considerable strategic reserves of currencies that were previously owned by central banks.

Global analysis

STABILITY IN BULLION AMONG MAJOR HOLDERS
Gold reserves 1950-2009 (% of world total)



Source: IMF

Main gold holders have kept volume roughly intact since 1980 – but China is increasing gold reserves and UK made ill-judged sales in 1999 to 2002.

Russia's reserve fluctuations

Since it started reporting monetary reserves after the break-up of the Soviet Union, Russia has shown regular fluctuations in foreign exchange reserves, reflecting vicissitudes in the domestic economy. But there has been one underlying trend: upwards. Russian foreign exchange reserves, 0.6% of the world total, had a bumpy ride during the 1990s, especially during the Russian debt crisis in 1998. They dipped in 2008 as a result of the world credit turbulence, but currency holdings rallied to $414bn as of end-2009, 5% of world currency reserves. Russia has increased its gold holdings by 50% over the past five years, according to the IMF, and these now make up 2% of world gold reserves.

India launches China gold catch-up with landmark purchase from IMF

India's landmark purchase of 200 tonnes of gold from the IMF last October [January 2010 OMFIF Bulletin, p. 5] signalled an apparent attempt to catch up with China over bullion holdings. The Reserve Bank of India's declared holdings of 18m oz are now 50% above earlier levels yet make up less than 2% of world gold holdings.

Almost certainly, more gold purchases are on the way, although the Reserve Bank is no doubt sensitive about public buying at a time when prices sees to have reached a plateau. India's foreign exchange reserves of $260bn at end-2009 were seven times larger than in 2000, following 30-fold growth, from a very low base, during the 1990s. India thus accounts for 3.4% of world currency reserves against 1.9% in 2000.

Brazil currency holdings leap – but not yet on gold trail

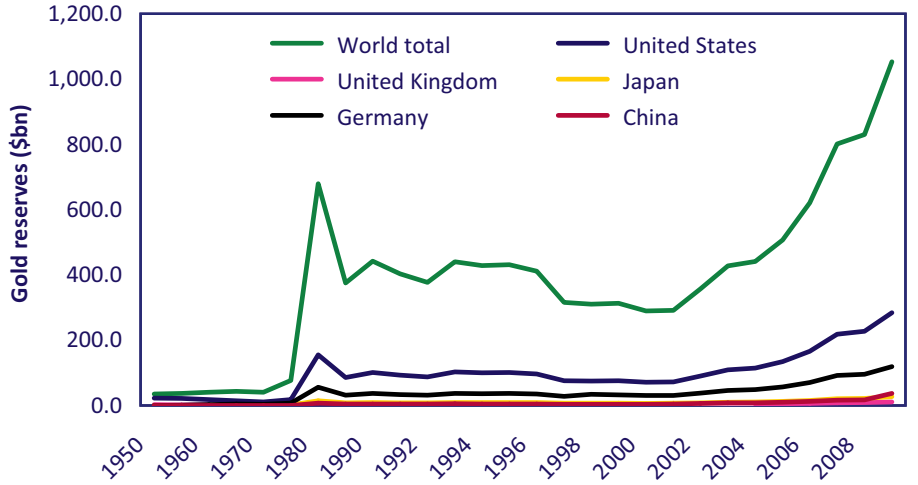
Brazil is one emerging economy which, publicly at least, has not yet embarked on the gold trail. Its gold holdings, according to the IMF, have been stable at 1.1m oz since 2001, having been run down from a figure four times that level during the 1990s as a result of balance of payments crises. Foreign exchange reserves rose seven-fold during last decade to $230bn, making up 3% of world foreign exchange reserves against 1.7% in 2000.

Saudi Arabian conservatism a constant feature

The Saudi Arabian official reserve balance sheet has been one of consistant conservatism. Gold reserves have remained unchanged since 1980 at 4.6m oz. Foreign exchange reserves, having peaked at $21bn in the late 1970s – compared with a mere $500m in 1970, before the first oil shock – declined to a low of $5bn in the early 1990s, before picking up to $18bn in 2000 and $38bn in 2009.

The full extent of Saudi Arabian monetary holdings is unclear as a result of the interlocking nature of Riyadh's public and quasi-public institutions. What is evident is that the Saudi Arabian Monetary Agency (SAMA) has no great appetite for direct lending to western governments in the manner of notorious German borrowings in the 1970s.

TREBLING OF GOLD RESERVE VALUE SINCE 2000
Gold reserves by value 1950-2009

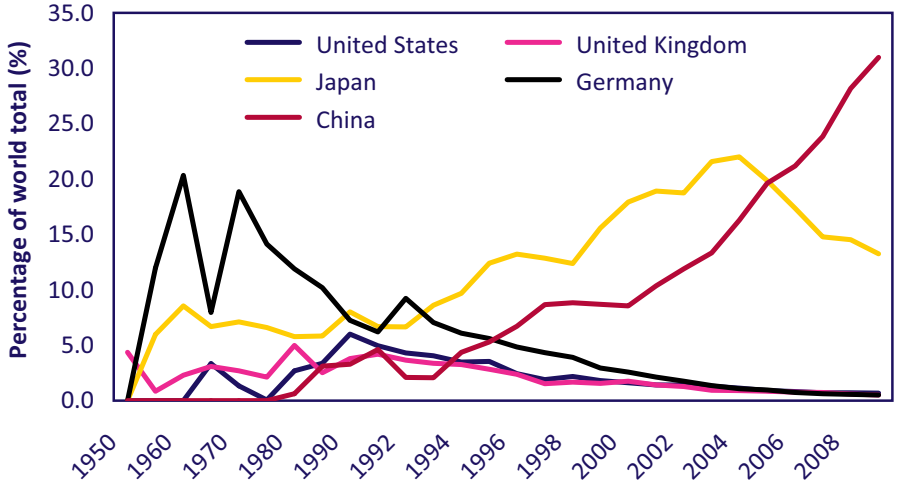


Source: IMF

US and Germany are main beneficiaries of gold price rise since 2000, as – for a variety of reasons – they have not sold bullion.

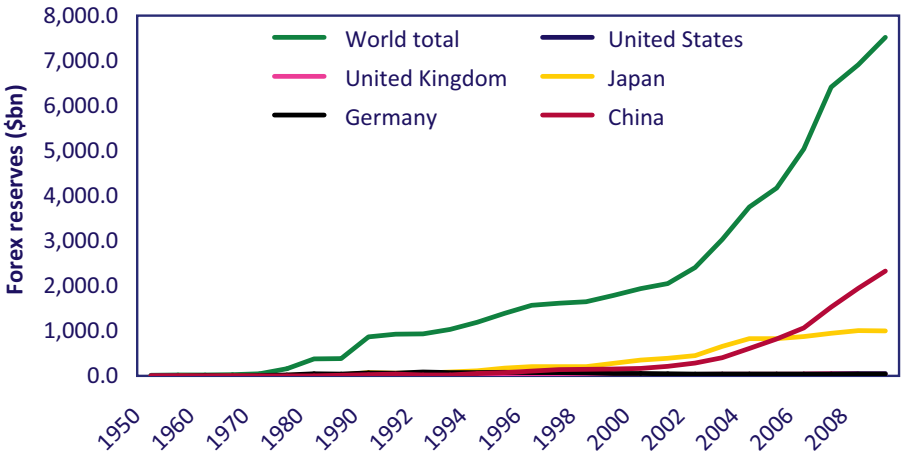
After leading the world in 1960, Germany gave up foreign exchange reserve lead to Japan in early 1990s – paving the way for China to take over as top reserve holder in 2006.

CHINA LEAPS FORWARD AND GERMANY DECLINES IN CURRENCY HOLDINGS
Foreign exchange reserves 1950-2009 (% of world total)



Source: IMF

CHINA TAKES INCREASING SHARE OF WORLD CURRENCY RESERVES
Foreign exchange reserves 1950-2009



Source: IMF

China's vast increase in currency holdings since 2000 has been unprecedented, but the relative rise has been similar to Germany's progress in the 1950s.

Risks from accounting concentration

What happens if one of 'Big Four' fails?

Michael Lafferty, Co-chairman

After the global financial crisis, can the world run the risk of a global accounting crisis? Just imagine what could happen if the Big Four world accounting firms were to become the Big Three, as another one of the big accounting firms failed in the same way as Arthur Andersen did in 2002.

In this dire state of affairs, there would not be enough capacity in the world to audit all of the world's quoted companies. Stock markets would go into shock. And the financial sector more generally would be affected as many banking and insurance regulators rely on independently-audited financial statements as a core part of their regulatory approach. Business as we know it would be seriously disrupted.

Imagine what that would do to global economic growth. The Big Four are a clear case of 'too big to fail' and possibly 'too big (or inter-connected) to save'.

It seems hard to believe that the world's financial regulators, finance ministries and central banks are unaware of this potential catastrophe but there is no evidence that they are taking the risk seriously or taking any actions to address it.

If they were they would be planning for the day when the world would go back to having twice as many major global accounting firms as it has now. They would also be constructing a global governance and contingency planning structure for the profession, for there is no such thing at present.

Although routinely described as the Big Four international accounting firms, the reality is that these 'firms' are not integrated global organisations, but networks of independent professional services businesses operating under one of four global brands – PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte. Amazingly, the world got to this point when the largest local accounting firms in the major economies worldwide decided not to compete across borders and instead organised themselves into what eventually became four global partnerships of partnerships.

The fees of the Big Four have ballooned ever since but gone is the dynamism that characterised the profession of the 1970s and 1980s.

Today, despite booming fees, all is far from well within the Big Four. The greatest risk comes from another Enron-style corporate collapse, where a firm is successfully hit with a multi-billion audit negligence claim. The likelihood of this happening must be far greater than before as a result of the global financial crisis.

In far too many respects, the Big Four are like the emperor with no clothes. Though they are supposedly networks of independent firms, they trade under global brands which mean that audit firms round the world are exposed to risks arising in other countries – as the Andersen case dramatically illustrated. All in all, this seems like a disaster waiting to happen.

The global financial community needs to grasp this problem before it is too late. Here are some examples for possible pre-emptive action. How could the concept of 'living wills' be applied to the Big Four? How could barriers to entry to the market be reduced so as to make it more feasible for serious competitors to the Big Four to emerge? In short, how can we reduce the dependence of the world economy on these individual firms? These are questions that prudential and competition regulators, as well as the wider bodies of public policy, need to focus on with great urgency. It is high time for a debate on this crucial issue.

The Big Four are like the emperor with no clothes. Though they are supposedly networks of independent firms, they trade under global brands which mean that audit firms round the world are exposed to risks arising in other countries.

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Official Monetary and Financial Institutions Forum

Prudent dominions show the way

Banking survivors can afford to be smug

Stephen Fay

Amid the chaos and confusion in global banking it is the victims who have received most attention, but the most fruitful lessons are to be learned from the survivors. For confirmation that prudent banking still exists, consider the enviable record of Australia, South Africa and Canada. None have used taxpayers money to bail out their banks – for the good reason that none of them has failed or faltered.

All three former dominions of the UK were originally schooled in British institutional and administrative traditions. But that shared cultural history seems to have had no discernible influence on their performance. Their central banks and regulatory regimes owe nothing to the Bank of England or to the Financial Services Authority. Since all are resources-based economies, they have recovered more quickly than the industrial nations.

Their domestic banking business is profitable; none needed to resort to ideas of splendid finance or to boost profits through takeovers. One more factor in common is that their mortgages are soundly financed, allowing for no permissive attitudes to income, employment and assets.

Each of the three systems had experienced banking crises, however, and had learned from them: Australia in 1992 when Westpac almost went bankrupt and 2001 when an insurance company called HIH did so. South Africa had a banking crisis in 2000-01, and Canada survived crises in 1993 and 2007.

In each case, the response was toughened regulation and tighter disciplines. The Australian regulator, for example, the Prudential Regulation Authority (APRA), boasted that it became 'sceptical, proactive, and when necessary intrusive and aggressive.'

The Canadian regulator from the Office of the Superintendent of Financial Institutions routinely attends bank board meetings, and in South Africa, the banks were summoned to the Reserve Bank in 2005 to be told by the regulator that a crisis was coming and a handbrake would be applied to expansion or acquisitions. In 2004 and 2008 all securitisation schemes at South African banks were reviewed and virtually no hybrid structures were permitted.

Despite some huffing and puffing from domestic bankers in the middle of the last decade, who looked enviously at the profits being announced in New York and London, none of the regulators was tempted to adopt a light-touch style of regulation, but the bankers themselves had also learned hard lessons during their crises. In Australia, the 'near-death experiences' of 1992 had seared themselves into the culture of banking. Risk management systems and techniques were taken seriously.

When American banks came calling in Sydney in 2006 and 2007 with the latest sleek securitisation packages, they were, for the most part, shown the door. In all three countries, restrictions were imposed on leverage and strict limits set for reserves of Tier 1 capital. South Africa's capital adequacy ratio was increased to 10.1%. Australian and Canadian banks were well capitalised.

Perhaps the greatest danger confronting commentators on all three systems is smugness, but the record suggests that they have something to feel smug about. As Errol Kruger, the South African banking supervisor, told the Johannesburg Financial Mail recently: 'I see my colleagues in other countries and they have got old very quickly.' True, they have been lucky, but isn't it the case that people and institutions make their own luck?

In Australia, South Africa and Canada, domestic banking business is profitable; none needed to resort to ideas of splendid finance or to boost profits through takeovers.

A monthly foray into monetary secrets hidden in archives

Bundesbank defies Schmidt plan for sterling

Leaders' proposals to draw on $38bn German reserves to aid UK turned down as Emminger and Pöhl cite need for IMF discipline

An important milestone in Britain's search for financial solvency came in June 1976 when the UK raised a $5.3bn three month credit from the US, Germany, seven other industrial countries and the Bank for International Settlements. To repay the loan, a drawing from the International Monetary Fund would be needed by the end of the year.

The pound's travails worsened as the British economy slowed and the US maintained Britain needed to cut public borrowing. Sterling's fall forced Chancellor of the Exchequer Denis Healey into a much-publicised abandonment of his journey to the IMF's annual autumn meeting in Manila. On 4 October, as sterling continued to decline, Prime Minister Jim Callaghan telephoned West German chancellor Helmut Schmidt to congratulate him on his victory in the German general elections that day. The pound's fall was sending 'frenetic people into a paroxysm', the prime minister said. Callaghan asked Germany for help in side-stepping the IMF's demand for tough economic conditions.

Callaghan: 'I think the immediate help we can have Helmut, if I may say so, is if the IMF can give us this loan on the basis of our existing policies which we intend to stick to, and that would be the short-term affair.'
Schmidt: 'Yes. Could that be decided in Manila?'
Callaghan: 'They [the IMF] have to send a team over here. But what is important in Manila is that your people should indicate, if you are free to do so and feel able to do so, that Germany feels that the existing policies are of sufficient character to enable the loan to be granted. And then the examination takes place. And it's when discouraging noises come out from the big countries in Manila that the markets start to tremble again. So anything your people can say in Manila is bound to be of help.'
Schmidt: 'A matter of hours, Jim, or of days?'
Callaghan: 'Oh, of days, really. We don't need the money quickly – what we need to know is that it's going to be available on the basis of our existing policies. That's really it. Because if I were to be forced into different policies now, the whole thing would start to – well it would look very different from what it does.'
Schmidt: 'I talked about this subject with [Bundesbank president] Karl Klasen yesterday and he very much applauds your policies and also the trade unions and says they were marvellous – he had never expected it and one should do anything one could to help, so I think the general attitude on our side is going to be helpful.'

Schmidt said: 'One should do anything one could to help, so I think the general attitude on our side is going to be helpful.'

Schmidt agreed to fly to London immediately to discuss the pound. When they met at Chequers on 10 October, Schmidt suggested drawing on Germany's reserves of $38bn to provide roughly half of a $10bn loan to the UK to prop up the pound. Sir John Hunt, the Cabinet Secretary, met Pöhl in Bonn on 18 October. Pöhl warned about the need for IMF conditionality and said that the US Treasury would 'fight to the last against weak conditions'. During the conversation Pöhl telephoned Bundesbank president Otmar Emminger, who relayed the central bank's uncompromising stance that Britain had to agree the IMF loan before any accord on the sterling balances.

Pöhl stressed the importance of IMF conditionality when he met the Treasury's Derek Mitchell in Brussels at the beginning of November. Pöhl said this would set a precedent for other countries that would be borrowing from the Fund. He was cautious about using the German reserves, explaining the 'helplessness' of the German government when faced with resistance by the Bundesbank. Schmidt delivered the coup de grace a few days later. He sent Callaghan a letter spelling out the orthodoxy of the Bundesbank: 'Decisions will be possible in my view only when the negotiations with the IMF have been concluded.'

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Getting used to the life outside

EMU expansion may slow as a result of crisis

David Marsh, Co-chairman

Unrest over Greek borrowing has increased Germany's financial clout at the centre of economic and monetary union (EMU). This may eventually solidify the edifice of the single currency. But it changes the balance of power vis-à-vis aspirant members. This will have an important effect in determining the overall shape of EMU in its second decade.

The Greek crisis has reinforced Germany's position in four ways. First, policy-makers at the Bundesbank in Frankfurt and in Berlin Ministries feel strengthened in their insistence that EMU member states must abide by low-inflation, low-deficit criteria both before and after joining the euro. German rage at Greek trickery in falsifying economic statistics has given the traditional forces of orthodoxy much more sway.

Second, the fall in the euro as a result of international worries about EMU's cohesiveness has given a welcome fillip to Germany's already highly competitive export industry. Combined with continued low wage increases across the German industrial heartlands, this will increase German export success in faster-growth countries outside the euro area.

Third, the focus on Greece and other southern European states has provided Germany with a welcome diversion from previous attention on its own shortcomings. From time to time in recent years, policy-makers outside Germany raised concerns about low growth in German consumption and wages in the 2000s. The 2007-09 financial turbulence has put paid, for the time being at least, to these criticisms of German stringency.

Fourth, a combination of episodes has enhanced the credentials of Axel Weber, the president of the Bundesbank, to become the next president of the European Central Bank at end-October 2011. Up to a few months ago, Mario Draghi, the well-respected governor of the Banca d'Italia, was the favourite to take over. However, law-makers in Germany and other countries seem to be moving towards the view that promoting the president of the Bundesbank would be one way of ensuring that EMU remains unbesmirched by fiscal profligacy.

What influence do these questions have EMU enlargement?

When Goldman Sachs wrote a review of "The Euro at Ten" – to mark the 10th anniversary of the founding of the ECB – in June 2008, the general view on financial markets was that the crisis made EMU expansion more likely. By the time of the euro's 20th anniversary in 2019, the bank wrote, most of the 12 states that joined the EU since 2004, as well as some of the older EU members, were likely to have joined the euro. The bank saw the earliest date at which Estonia, would join as 2011, for Denmark and Lithuania 2012, for Poland and the Czech Republic 2013 and for Sweden, Croatia and Latvia 2014. Although Estonia may well join on 1 January 2011, the overall judgment of relatively rapid new members now looks over-optimistic. The new mood will subject would-be more members to more discipline than before.

The Polish finance ministry in April 2009 spoke about entering the ERM-II exchange rate mechanism in the second half of 2009, as a prerequisite for joining EMU in 2012. Only nine months later, that projection is wholly unrealistic. EMU no longer looks so credible as a safe haven. The Polish government now says the earliest date for EMU accession is 2015.

However, there are some positive aspects. Poland's economic size, measured by GDP in current dollars, is now above Sweden's. Growth of close to 2% last year will continue this year. International demand for Polish debt has benefited from the country's relatively good reaction to the financial crisis. The Greek crisis has shown that euro accession needs long, sound and serious preparations. Poland can show exemplary character here. If countries like Poland end up sticking to their national currencies for longer than earlier anticipated, that may be no bad thing.

The Greek crisis has shown that euro accession needs long, sound and serious preparations. If countries like Poland end up sticking to their national currencies for longer than earlier anticipated, that may be no bad thing.

A man who worked behind the scenes

Richardson's pragmatism amid the turbulence

William Keegan, Chairman, Board of Contributing Editors

Gordon Richardson, who died at the grand old age of 94 in January, was every inch a central banker's banker – not least because of the time and effort he put in at meetings at the Bank for International Settlements in Basle, both during and after his spell as Governor of the Bank of England (1973-83).

In his early days as a central bank governor, he cultivated a 'softly softly' approach, so much so that the Bank of England building in Threadneedle Street was christened 'The Tomb of the Unknown Governor' by a mischievous financial journalist (not this one).

He was Governor during what his colleague Anthony Loehnis has described as a 'turbulent decade; There were no Bank of England Inflation Reports in those days, but there was plenty of inflation. It was not easy to be a guardian of sound finance when the British economy was experiencing not only the oil shock – a quintupling of the price of oil in 1973-74 – but also the impact of the highly inappropriate decision by Edward Heath's Conservative government to link wage increases to the cost of living.

The Bank of England was not yet independent in monetary policy. It was Richardson's duty to warn a Labour government that inflation, public spending and public sector borrowing were getting out of control, and that their ambitious programmes had to be reined in. It says a lot for Richardson that he had an outstandingly good relationship with Denis Healey (Chancellor of the Exchequer 1974-79) and James Callaghan (Prime Minister 1976-79) despite the inevitable tensions that arose when Britain was forced to seek assistance from the International Monetary Fund in 1976.

Richardson had come to central banking via the law and the City of London, where he was an outstandingly successful chairman of the merchant bank J Henry Schroder Wagg. He was tall, athletic-looking and handsome with a natural air of authority. Richardson liked to weigh all the evidence before coming to a decision or making a public pronouncement. Foreigners often think of Britain as the home of pragmatism. But during the 1970s it lurched, under Labour and Conservative governments, from one doctrine, extreme Keynesianism, to another, doctrinal monetarism. It helped that during this strange period Richardson's approach, after a few flirtations with monetarism, was essentially pragmatic.

He was probably the only person in public life of whom Chancellor Healey was in awe. And he stood up to Mrs Thatcher in a way few would dare. Indeed, in the early 1980s, Richardson was acutely aware of the damage being done to the British economy by Thatcher's excessive devotion to Milton Friedman and monetarism. (Richardson sanctioned a covert operation to prevent damage to British industry and the banks, an operation conducted by Sir David Walker, then a senior Bank official.) Paul Volcker and Jacques de Larosière credited him with greatly aiding their successful efforts, when respectively Chairman of the Federal Reserve and Managing Director of the IMF, in preventing the 1982 Mexican debt crisis from becoming a generalised banking crisis.

Gordon Richardson preferred to work behind the scenes. He was probably less well known to the British public than successors such as Eddie George and Mervyn King. The media held him in such high regard that he was often called 'Sir Gordon Richardson', In fact, he remained plain 'Mister' until his retirement from the Bank in 1983 – when he went on to a successful third career at Morgan Stanley International and the Group of 30.

He chose the title Lord Richardson of Duntisbourne, after the village in Gloucestershire where he lived with his devoted wife Peggy. Like many a public figure, he was also a private man. Conscious of security, he did not wish the press or public to know where he lived. But, as one of his staff commented: 'Here his attention to detail let him down. By choosing to be Baron of Duntisbourne, he announced to the world where he lived.'

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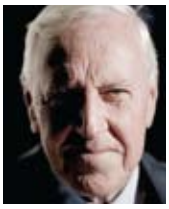
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Note on contributors to March 2010 Bulletin

Helmut Schlesinger was deputy president, Deutsche Bundesbank, 1980-1991, and president, 1991-1993.

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