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Bergsten was one of four expert witnesses to testify before the House Ways and Means Committee hearing on China’s foreign exchange policy. All four acknowledged that the stakes were high and all four urged the US to proceed on a multilateral basis to avoid a damaging confrontation with China [see article by Songzuo Xiang on p.5].

But even if the administration does pull the trigger – and the political pressure across the US to do so is intense – that would not signal the start of a new cowboy diplomacy. Rather, it would be an effort to get some traction on a multilateral solution to the issue.

‘US unwillingness to implement the plain language of the 1988 Trade Act has undermined its credibility in seeking multilateral action against China in the IMF, the WTO, the G-20 or anywhere else,’ Fred Bergsten, former Treasury undersecretary, said in congressional testimony in late March. ‘A sensible and effective strategy must begin by reversing that feckless position.’

But the vote in favor of the 15 April declaration was 3-1 among these experts. Both Harvard economic historian Niall Ferguson and former Reagan administration official Clyde Prestowitz agreed with Bergsten that a Treasury declaration was called for. ‘There is no point pretending that this is not “currency manipulation”;’ said Ferguson, ‘and in its 15 April report the US Treasury should call a spade a spade.’ Prestowitz said that failure to designate China would make the administration look ‘weak’.

Philip Levy, a trade advisor in the Bush administration, urged caution, however. He noted that the designation by itself, without any follow-up action, would have no policy impact but would make it politically more difficult for the Chinese to react. Levy argued that trying to force revaluation of the renminbi would provide no immediate boost to US employment but could cause significant long-term harm to US interests.

In the meantime, Chuck Schumer, the influential New York senator, stepped up the pressure on the administration by saying he would seek action this spring on his bill making it easier for the US to impose retaliatory tariffs against countries deemed to have misaligned currencies. The congressional skirmishing takes place against a backdrop of repeated Chinese assertions that it will not bow to outside pressure to change its policy.

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Renminbi ructions
Misreading the tealeaves

Jonathan Fenby, Advisory board

The debate on the renminbi has underlined western misreading of how policy is made in Beijing. The annual meeting of the National People’s Congress in early March was accompanied by numerous foreign forecasts that the currency would appreciate.

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Indeed, Premier Wen Jiabao could not have been more straightforward in his press conference closing the legislative meeting. Underlining the challenges that lie ahead despite last year’s economic recovery, the Prime Minister’s core message was that China’s best hope ‘lies in our own efforts’. That applies to the currency as much to other areas.

(continued on page 4 ...)
German-Chinese parallels

Surplus countries in the dock

David Marsh, Co-chairman

The parallels between Germany and China have been growing more evident during the past month. Whether you call the combination of the two economies ‘Chimany’ or ‘Chermany’ – or, slightly more fancifully, ‘Germina’ or simply ‘Gina’ – the evidence has been stacking up that generating current account surpluses is no guarantee of a quiet life.

In their respective currency zones – for Germany, the euro area, for China, the Asia-Pacific region – both the Germans and the Chinese have come under attack for allegedly not doing enough to stimulate their economies. In a variety of instances, ‘Chimany’ stands in the dock. The charge is that of underpricing exports – either because wages have not risen enough (in the case of Germany) or because the currency is being unfairly depressed (as in China). There is no shortage of examples of a war of words on various repercussions of the two countries’ surpluses – ranging from the increasingly acrimonious debate on the renminbi through to German finance minister Wolfgang Schäuble’s go-it-alone idea of a European Monetary Fund.

This month’s Bulletin bears ample testimony to the force of these arguments. Darrell Delamaide and Jonathan Fenby dissect the renminbi debate from different sides of the Pacific. Songzuo Xiang, one of our two Chinese advisory board members, says that the Americans are simply looking for a scapegoat – and the dispute risks impeding the search for real monetary reform. Stewart Fleming argues that the implications of the European decision to call in the International Monetary Fund extend well beyond Greece.

Michael Lafferty looks beyond the present perturbations over Greece and China to complain that moves by the US and Europe to produce two sets of partly contradictory accounting standards are a grave setback to the global market. And William Keegan harks back with a mixture of nostalgia and frustration to the time when Britain could have had its own sovereign wealth fund, bemoaning subsequent UK policy failures over selling gold at far too low a price.

Otmar Issing and Niels Thygesen, two veterans of the European monetary debate, subject Schäuble’s EMF plan to acerbic investigation. Makoto Ustumi, a former deputy Japanese finance minister and another member of the OMFIF advisory board, points out the contrasts with Japan’s plan for an Asian Monetary Fund in 1997. In a special two-page Archive Insight, economic historian Harold James reveals the shortcoming of past embryonic plans to develop versions of the European Monetary Fund model. Bundesbank opposition seems to have been a defining factor in previous cases – and may prefigure the outcome of the latest EMF plan.

It is perhaps reassuring that, in European monetary affairs, some things never change.

Quote of the month

‘If the IMF steps in, the image of the euro would be that of a currency that is able to survive only with the external support of an international organisation.’

Lorenzo Bini Smaghi, Executive Board Member, European Central Bank
Economic policymakers on both sides of the Atlantic still have a great deal to worry about. Even the pessimists are beginning to believe that the worst of the financial sector crisis which erupted in the summer of 2007 may be passing. Everyone can see, however, that economic and political tensions have been mounting internationally.

This partly reflects trade tensions linked to global imbalances and allegedly misaligned currencies, notably in the case of China. But it is also due to the oppressive debt burdens facing nations on both sides of the Atlantic at a time when growth is so feeble that unemployment is likely to remain high for years to come.

At the end of March, following a summit meeting of European Union leaders in Brussels, one of these clouds hanging over the world economy, the risk of an immediate economic catastrophe in the European Union because of the Greek financial crisis, began to lift. But economists have been left wondering whether relief will be more than temporary. On 29 March Athens was able to return to public markets and float €5bn of bonds, four days after the summit agreed a strategy involving the European Union, the Eurogroup of euro area member states and the International Monetary Fund for bailing Greece out should this be necessary.

The summit accord was positive news, but concealed a dual setback for the European Central Bank, which had argued against IMF involvement on the grounds that Europe should be able to look after its own affairs without recourse to Washington. In addition, in a highly significant move for the ECB’s independence, the central bank had to reverse its earlier strictures and accept that the current relaxation on conditions for accepting downgraded Greek bonds as collateral in its lending operations will be continued beyond the end of the year.

This piece of monetary Realpolitik may upset the purists. But it signals that the ECB agrees with the numerous capital market experts who believe that the debt crisis stalking the governments of the trans-Atlantic region still has a long way to run. Greece had to pay 6% for its money, double the yield on similar German government bonds. So the successful sale of the bonds could not be seen as a wholehearted vote of confidence in either the rescue plan for Greece or the Greek government’s new-found commitment to fiscal probity. ‘Why should anybody lend money to Greece at a spread of only 300 basis points over German bunds? It’s a serial problem debtor which has persistently lied about the state of its finances,’ says one financial consultant following the saga.

With nearly €50bn of Greek debt to be refinanced this year, experts are dubious about the adequacy of the €20bn total which, according to informed speculation, seems to be on the table for Greece. Professor Nouriel Roubini of New York University’s Stern School, suggests ‘a large IMF programme of €50bn to prevent a run on public debt and banks in the tough times ahead.’ Erik Nielsen, an economist at Goldman Sachs, believes that Greece’s debt sustainability problems ‘resemble a sovereign solvency crisis.’ Short- and longer-term interest rates are now at relatively low crisis-management levels. Assuming the trans-Atlantic economies evade a double-dip recession, they are going to have to rise.

With Greece already paying almost a third more for its money compared with three years ago, economists estimate that within a year debt service costs alone could rise to account for 6% of national output, more if the economy performs as badly as some pessimists are expecting. The singular focus on Greece is misplaced however. What concerns policy-makers in Europe and America is past experience. Their minds are focused on how Mexico’s 1982 debt crisis spread around Latin America, and the Asian debt crisis of 1997-98 was transmitted, virus-like, around the world, eventually forcing Russia into default.

(continued on page 4 ...)
Debt worries cloud trans-Atlantic policy (continued from page 3 ...)

If the Greek crisis were to spread to Portugal, Spain, Italy, the UK and vulnerable east European borrowers, the dreaded double-dip trans-Atlantic recession would probably follow – and a global downturn would not be far behind.

The EU summit’s ability to agree on a broad strategy on Greece, reflecting above all an accord between France and Germany, reflects the pressures to build a firewall against such sovereign debt contagion.

It needs to be remembered, too, that there are precedents for the sort of IMF-nation state coordination on bail-out loan conditionality which the summit envisages, not only in eastern Europe in the past two years, but also in the Mexican bailout of 1995, when America demanded tougher conditions for providing bail-out finance than the IMF.

The summit deal also sends an uncompromising message to other debt-ridden countries. If they fail to adjust to today’s brutal economic realities, they too will have to submit to harsh externally imposed discipline – there will be no soft option bail-outs.

But financial markets will almost certainly test not only governments’ capacity to put the EU support strategy into effect but also the Greek government’s ability to implement, in a weakening economy, the now-agreed austerity measures. Containing Europe’s debt crisis will be a protracted saga requiring unprecedented cooperation.

In the face of such a threat, it would be surprising if, behind the scenes, talks were not under way aimed at persuading heavily-committed European banks (particularly from France and Germany) to roll over their existing loans to Greece.

Efforts to secure a so-called private sector ‘bail-in’ of existing creditors to back up the official bail-out plans announced at the summit should surely be part of a comprehensive rescue strategy.

After all, this is the model already being employed in eastern Europe under the so-called ‘Vienna initiative,’ and it was the model which initially worked relatively successfully to contain the damage from the 1980s Latin American debt crisis.

Currency High Noon for US and China (continued from page 1 ...)

At the same time, there has been a worrying rise in the yield on US Treasuries. Yields surged 30 basis points to above 3.9% on the 10-year benchmark, their highest level in nine months. Weak demand at a Treasury auction in the week following passage of the healthcare reform bill prompted the sell-off and was attributed largely to its trillion-dollar price tag, but some commentators suggested that China was cutting back its bond purchases in advance of the 15 April date as a warning shot to Washington.

Who knows whether President Barack Obama, emboldened by healthcare and nuclear disarmament success, is ready to play the sheriff and challenge China to ‘draw’ on 15 April?

‘These are questions of the utmost historical significance,’ Ferguson said in his congressional testimony. He noted that the threat of tariffs have pressured the Chinese in the past to revalue their currency, but that they seem more pugnacious this time around. Ferguson summed it up with professorial understatement: ‘The stakes are high.’

Renminbi ructions (continued from page 1 ...)

The presumption that, because China should appreciate the renminbi in the interests of the global economy, it will do so shows a fundamental misunderstanding of its decision-making process.

As the issue becomes increasingly politicised on both sides of the Pacific, China is putting the best face on its disinclination to do as others would wish. It has sent a mission to the US to plead its case.

The next set of trade figures may, by chance, show the People’s Republic going into deficit. Beijing says that if only it was allowed to import America high-tech goods, the imbalance would be put right, and points to the US companies that do well by manufacturing on the mainland.

Wen hopes for harmony at a Sino-US meeting in May. Though US commentators stand shoulder-to-shoulder on the issue, economists in Beijing maintain that, whatever people such as Paul Krugman say, China is not guilty of undervaluing the currency [see article on p. 5]

As part of the political game there may be a gradual and minimal appreciation of, say, 3% during the course of this year, which will do nothing to change the trade position (and could attract hot money by encouraging belief of more appreciation). But rebalancing the Chinese economy away from exports towards domestic consumption is a medium-term process. Until Beijing is confident of sustained recovery in external demand, it will not take significant steps that could hit exporters.

This is a complex matter. Nothing exists in isolation. Take, for instance, the 15-25% increase in the minimum wage just announced in coastal provinces with big exporting industries. While that is a step towards raising consumption, it also puts pressure on exporting firms with tight margins which will complain that they cannot also absorb a currency appreciation. Like so much else, currency policy has to be seen as part of the whole, rather than a suitable subject for isolated forecasts.

This is part of a mosaic which stretches from maintaining employment to preserving the power of the Communist Party, and which must combine a desire to rebalance the economy with deep reluctance to be seen moving at the bidding of others – particularly Washington.
There is noise – but little illumination – in the debate on the renminbi exchange rate. The discussion would be more helpful if it was guided by a better understanding of the Chinese economy. Many arguments have been advanced since 2002 to press for a renminbi appreciation. Very few, however, have any solid theoretical rationale or empirical support. Imperfect or biased explanations have focused unwarranted blame on the renminbi exchange rate as the main cause of the shortcomings of the international monetary system. This diverts attention from the real failures and from the opportunity to reform the system.

The most popular argument for a renminbi revaluation is that it would help restore global economic equilibrium, which the US Treasury Department appears to define largely in terms of US trade deficits and balance of payments deficits. To my mind, that is a rather narrow definition. And it pays insufficient attention to the reality that, under the current dollar-dominated system, the core reserve-issuing country (that is, the US) must have balance of payments deficits in order to supply reserve money, just as South Africa under the Gold Standard had to have balance of payments deficits to allow gold exports.

We must remember that since the breakdown of Bretton Woods in 1971, world foreign reserve assets have increased roughly 160-fold, from $45bn to $7.5tn, more than 70% of which has been supplied by US balance of payments deficits. Levels of dollar exchange rates, whether in the 1970s against the D-Mark, in the 1980s against the yen, or now against the renminbi, have very little to do with US deficits and so-called global imbalances. If US officials wish to correct their deficits and rebalance the world economy, then the best way would be to take active steps away from the dollar-oriented reserve system.

With regard to the Chinese trade and current account surpluses, it is important to note that at least 50% of total Chinese exports are manufactured products with foreign intermediate products as inputs. At least 60% of total Chinese exports are supplied by joint ventures and foreign companies. The Chinese trade surplus is the result of the international division of labour. China’s huge foreign reserves (now almost $2.4tn) stem partly from the trade surplus, partly from capital inflows, triggered in part by expectations of a renminbi rise.

A more plausible argument for renminbi appreciation is that the People’s Bank ultimately needs a flexible exchange rate policy – and currency appreciation – as a means of carrying out an independent monetary policy and controlling inflation. This argument rests on the thesis of the ‘impossible trinity,’ under which a country cannot simultaneously run an independent monetary policy while maintaining exchange rate stability and unrestricted capital flows. However, empirical research since 2002 has found no persuasive evidence of a relationship between renminbi appreciation and monetary independence.

So we should learn the right lessons from the global financial crisis and mobilise forces to rethink the international monetary system. I believe the asymmetry of the dollar-dominated monetary standard, and the fallacies associated with floating exchange rates, are two fundamental reasons for recurrent financial crises and the phenomenon of global imbalances. There has been a sharp contrast between the relative financial stability of the Bretton Woods fixed exchange rates era and the extraordinary volatility of flexible exchange rates after the final breakdown of Bretton Woods in 1973.

The increasing politicisation of the renminbi exchange rate and a search for scapegoats point us in the wrong direction. No-one pretends that reconstructing the monetary architecture will be easy. The Chinese authorities as well as the Americans, Europeans and other regions all have a part to play in this. But we should make a start in a down-to-earth manner that is free from finger-pointing politicking and polemics. The Official Monetary and Financial Institutions Forum provides a useful platform to help develop this agenda.
The proposal for a European Monetary Fund from German Finance Minister Wolfgang Schäuble is a highly inadequate solution to the problems illustrated by the Greek crisis. The idea for such a fund seems to have been put together in a hurry. This is hardly the right way to yield sustainable answers to difficulties within economic and monetary union. It could become operational only far too late to help solve present problems.

Proceeding with this concept would risk opening a Pandora’s box. If, as is likely, such a fund required a change to the European Union’s constitutional treaty, winning a majority would be a great political hurdle. Financing such a fund would raise enormous problems. It might be attractive for governments to provide financing to shore up individual countries’ ability to raise further credits on financial markets. However, the transfer of taxpayers’ money from stronger to weaker countries would contravene the no-bail-out clause.

Some supporters may believe that an EMF could be more effective than the Maastricht treaty guidelines in backing reforms in debtor countries. These supporters argue for strict lending conditions through a politically neutral and independent body that could resist pressures for more generous lending at times of crisis. But all experience makes me doubt whether such a framework could be realised. And without such conditionality, there would be a significant risk that the prospect of financial aid would lower the debtor countries’ willingness to take tough action. Rather than negotiating emergency financial support, the EU should concentrate on securing stability for heavily-indebted countries through budgetary monitoring and timely sanctions. Such a mechanism already exists through the Stability and Growth Pact. Rather than thinking up new credit procedures, Europe should implement what it has already decided.

Germany’s EMF initiative is reminiscent of the Asian Monetary Fund proposed by the Japanese Government in September 1997 amid the Asian financial crisis – a concept that never saw the light of day. Although both plans share similar shortcomings in that neither is endowed with any great detail, we can see clear differences between them.

The first issue concerns conditionality. In the Japanese plan, the degree of conditionality was left unclear. This gave rise to the expectation that Asian countries confronting the crisis could borrow from the AMF with much softer conditionality that from the IMF, whose tough negotiation style was proving an irritant to several would-be borrowers in the region. The German initiative, on the other hand, would clearly intend to impose much severe conditionality than the IMF. Initial indications from Berlin reveal that sanctions for non-compliance would extend as far as potential exclusion from the single currency.

The second difference concerns the reaction from outside the regions. In the case of the AMF, in spite of enthusiastic support from many ASEAN countries and Korea, there was strong opposition from the US (and to an extent China too), which were concerned about the perceived growth in Japan hegemonic power in the region. The IMF, too, opposed the project on the grounds that it would significantly weaken its raison d’être. In sharp contrast with the AMF, in the case of the EMF the principal opposition does not come from outside the region. It is within Europe that we see the main stumbling blocks for this particular idea. Asian observers will be following with interest whether the latest proposal for important institutional renewal in Europe gets off the ground.
The idea that a member of the euro area could default on its public debt will strike many as outrageous, yet it may have to be faced. The aim of financial regulation is to curtail excessive risk-taking by laying individual institutions open to potential insolvency. Similarly, the possibility of sovereign default is the ultimate warning to governments and the markets against failure to correct unsustainable budgetary policy. Maintaining the possibility of defaults within economic and monetary union (EMU) is a better option than active consideration of bail-outs for states such as Greece that get into difficulties over excessive borrowing. Bail-outs would fatally upset the delicate balance at the heart of EMU, which in 1999 saw sovereign countries centralise monetary authority, while leaving budgetary and other economic policies (largely) in national hands.

Some commentators, central bankers and politicians have said that monetary union cannot survive without political union. The founders of EMU were indeed well aware of the special – one might say, lop-sided – nature of the project. They proceeded, because it was the best that could be done at the time. EMU dealt definitively with the long-standing disruptive problem of exchange rate instability. It combined the politically feasible with the economically adequate. There was no political backing 20 years ago for centralisation of authority over taxation and public expenditures, or for intergovernmental transfers. Nor is there any such backing today.

It is worthwhile recalling these essential facts as we ponder various ideas for financing for weaker states from euro governments, or from a new European Debt Agency or European Monetary Fund (EMF), as has been suggested by German finance minister Wolfgang Schäuble. An EMF of course could become operational only well after the current crisis. More importantly, if governments set up an EMF, the intrusion into the debtor’s budgetary policies would be far stronger than in the present framework that merely sets guidelines for consolidation. The risk of tensions and mutual recriminations would be severe, since the creditors would be individually identifiable and unlikely to agree on the severity of the conditionality for such financing. This would lead towards more political union, but it would be much more risky and confrontational than in the past.

In the context of an EMF, we need to remember that no international framework offers a guarantee against sovereign default. This is the case for conditional lending by the International Monetary Fund, as several examples testify, and as the IMF recognised in 2002. While a default could sour political relations, it would be consistent with continued participation in EMU; indeed, renewed access to borrowing will be easier with the euro than without it.

In Greece’s reaction to the commotion over its excessive debt, there are signs that the combination of monetary pooling combined with continued national fiscal responsibility may be starting to work. If the impressive Greek adjustment programme is seen as sufficient to obviate the need for other governments’ direct participation in Greek refinancing, then original model centred on national budgetary sovereignty – though more intensively monitored than in the past – will have survived for now.

Willingness to implement EMU fiscal rules set down in the 1990s under the Stability and Growth Pact has been gradually eroded. This was partly due to French and German reluctance to apply the rules themselves around 2003. But the rules remain useful. For a long time, markets may be excessively tolerant of sovereign credit risk, but they can change perspective brutally. EMU can continue to prosper if its members are subject to discipline from a combination of market forces and policy norms. Keeping open the possibility that individual members may default is not a sign of failure. Rather, it is a condition for the system to function properly.

Keeping open the possibility that individual members may default is not a sign of failure. Rather, it is a condition for the system to function properly.

Niels Thygesen, Advisory Board

Default must be an option for EMU
European Monetary Fund would bring confrontation
There are two reasons why adapting the procedures of the International Monetary Fund for dealing with European countries in profound crisis appears attractive. These were no doubt uppermost in the mind of German finance minister Wolfgang Schäuble when he proposed a European Monetary Fund to handle Greece. Unfortunately, there are several unfortunate precedents. The idea of an EMF has been put forward several times in past decades. It has never got off the ground. The lesson of history, as well as that of the past few weeks, is that the fate of Schäuble’s EMF may follow the same pattern.

A European IMF would have the benefit of following clearly established procedures. These are thus less likely to produce moral hazard and are more propitious in preventing a country from letting matters slip and triggering a costly international rescue. Second, the IMF takes the political sting out of support operations. In the mid-1970s, when Italy needed international support, it could have concocted a deal with Germany, but the Germans preferred to see the IMF negotiating with Rome.

What is the situation in Europe, 11 years after creation of economic and monetary union? The European Central Bank is not a substitute for an EMF, because the central bank is barred from giving credit to governments, and because a politically independent central bank is not the right institution to lay down policy conditionality. Only an institution which has a clear measure of political responsibility could take on such a task. An EMF would be an effective way of helping realise the old European objective of ‘economic governance.’

The EMF suggestion is in fact a very old one. The first concrete suggestion for a European Monetary Fund was made by the brilliant French economist Raymond Barre, then EEC Commissioner with responsibility for economic affairs. This was in a report presented to the EEC on 12 February 1969, which suggested concrete ways of increasing economic and financial policy coordination in the face of growing threats to the international financial order.

The best mechanism for dealing with EEC-wide problems, he argued, was to extend financial assistance within the Community, and to operate the same sort of credit cooperative that Keynes and his associates had envisaged at the international level in 1944 at Bretton Woods. As Barre put it: ‘The Treaty makes specific provision in Article 108 for “mutual assistance” between Member States.’ As specific remedial measures, Barre suggested not only improvements in coordinating short- and medium-term policies, but also mechanisms for short-term monetary support and for medium-term financial arrangements.

In the 1970s, there were some provisions for short- and medium-term support, but a European Monetary Cooperation Fund turned into a simple mechanism for dealing with central bank swap arrangements, and had no policy role. The EMCF was a logical part of the new exchange rate apparatus which tied the European currencies closer together in a ‘snake’ which moved with narrower margins than the fluctuations of the international monetary system. Its proponents thought mostly in terms of short term interventions, rather than sustained balance of payments support; though the boundary was always somewhat shady. But it was clear that a stable exchange rate regime would require interventions, and these might be financed by short-term borrowing. The EEC Committee of Central Bank Governors was anxious that the new mechanism should be controlled by the central banks (unlike the IMF, which was fundamentally owned by finance ministries and had been conceived in 1944 as a way of breaking the power of central banks).
A report on 1 August 1970 from a Commission chaired by the former President of the Belgian National Bank, Baron Ansiaux, on the consequences of a narrowing of fluctuation margins had also argued that the new institution’s role would be parallel to that of the US Federal Reserve System. The original draft of the EMCF statute was prepared in late 1972 by Barre along with Olivier Wormser from the Banque de France and Otmar Emminger of the Bundesbank. It more or less fully reflected the standpoint of the central banks. In particular the governors believed it was of paramount importance that they manage the EMCF’s operations.

The Commission contributed to the EMCF drafting process statute, and one addition (which provoked a fierce response in the Governors’ Committee from the Bundesbank and the Nederlandsche Bank) supplemented Article Two with a provision that the EMCF should report biannually and that it should act in conformity with the directives of the Council. Emminger, the Bundesbank’s intellectual éminence grise, commented that this would risk being interpreted as ‘precise instructions on particular problems’ and that it raised the issue of relations between governments and central banks, ‘which are different in the member countries and whose particularism should be preserved.’

But the text was supported in a discussion in the EEC Committee of Central Bank Governors as ‘reasonable’ by the Governor of the Bank of England, Sir Leslie O’Brien, who added that ‘he had the impression that the British Treasury had wanted more, and that further editing might produce an outcome even less favorable to the cause of the Governors.’ Wormser, as chairman of the Committee, immediately endorsed this British view and concluded that ‘the Committee might trust the diplomacy of the Commission.’ In fact, the central banks, in particular the Bundesbank, were not prepared to do this. This drafting alteration – accepted by the Governors’ Committee largely because of a powerfully-asserted British viewpoint – proved crippling to the effective functioning of the EMCF. Emminger had presented quite faithfully the position of the Bundesbank, which in view of its ferociously guarded independence would never accept a major role for a European central banking institution that had to obey directives from governments or from the Commission.

A few years later, the European Monetary Fund was a central part of the proposals that Chancellor Helmut Schmidt sprung on European leaders during a dinner in Marienborg castle during the Copenhagen summit on 7 April 1978. [February OMFIF Bulletin, p. 10.] Schmidt proposed a European Monetary Fund as a regional version of the IMF and as a revival of some of the 1940s idealism that had driven the Bretton Woods conference. There was also a revival of aspirations surrounding the EMCF. Countries should pool 15 to 20% of their reserves. They should increasingly use EC currencies rather than dollars in foreign exchange intervention, and there should be an enhanced use of the European Unit of Account (EUA).

In Schmidt’s view, these proposals would move the world away from reliance on the dollar; he even held out the prospect that OPEC members might invest a part of their surplus in the EUA, and that the EMF might issue EUA-denominated Special Drawing Rights. At a meeting between Schmidt and French President Valéry Giscard d’Estaing in Aachen on 14-15 September 1978, which laid the basis for agreement on the European Monetary System, the leaders agreed on a ‘presumption’ that the EMF should be modelled on the IMF. And in December 1978 a Brussels European summit, in agreeing to the European Monetary System, provided for an EMF to be created within two years. In the end, the EMF failed for exactly the same reasons that the EMCF had been sidelined into insignificance. Central banks, especially the Bundesbank, were worried that the EMF might be subject to ‘instructions’ from the Council. By December 1980, the idea of an EMF had been abandoned. This may not have been a problem for the operation of the European Monetary System. But – 30 years later – the absence of an institution for dealing with unanticipated shocks is a flaw in Europe’s present-day monetary union.

The EMF failed for exactly the same reasons that the EMCF had been sidelined into insignificance. Central banks were worried that the EMF might be subject to ‘instructions’ from the Council.
Risk of reversal for global accounting
Europe must not spoil its track record for investors

Michael Lafferty, Co-chairman

The world may be a global market – but there is no agreement on how to account for what goes on in it. Much as investors might like to see the world’s accounting rule-makers abiding by one set of international financial reporting standards, the chances are that this will not happen for the foreseeable future. Indeed, the world could even take a step backwards. The European Union is threatening to withdraw its commitment to international financial reporting standards (IFRS) – and to write its own accounting rules for Europe’s companies. This is because the International Accounting Standards Board (IASB) is not dancing to the tune of European politicians who want to use accounting to further their political objectives.

If enacted – and there is still time for the EU to draw back from the brink – this would be a seriously retrograde step. Rather than withdrawing support, European politicians and their global counterparts should agree a clear mandate for the IASB, in a similar way that they have given central banks an inflation mandate. And then the politicians should give the IASB operational freedom on how best to implement that mandate. It is critical that this mandate should be about transparency, and not about manipulating accounts in the supposed interests of financial stability.

The EU move would risk a grave setback to the progress made since 1973 when the accounting professions of the world came together to set up the International Accounting Standards Committee in London, the forerunner of the IASB. Such a step would cancel out the breakthrough five years ago when the EU agreed to implement IFRS by copying them out into EU law – in all 23 official languages of the Union.

The move towards international standards was extraordinarily ambitious, but success gradually came after 1973 as country after country agreed to apply international standards in the published accounts of quoted companies. The EU move was of great significance because accounting standards across the continent varied enormously and all too often resulted in leading corporations publishing financial statements that were obtuse, to say the least. As recently as the 1990s big German companies, for example, had a tradition of applying tax rules for depreciating fixed assets and were still getting used to the concept of consolidated accounts for groups of companies. Outdated laws and practices dating from the early 19th century were typical across the continent.

The problem was exacerbated by the wide disparity in development of the accounting profession across Europe. At one extreme was the UK, which gave birth to the modern accounting profession and the limited liability company back in the 1860s; at the other was Italy where, though justifiably proud of having invented double-entry bookkeeping in the 15th century, the accounting profession had yet to mature. In truth, the accounting professions of most European countries are still closer to Italy in their development than those of the UK, Ireland, Scandinavia and the Netherlands.

There has always been a fundamental tension between the desire of countries or regions to realise the benefits of international standards and their desire to retain sovereignty over reporting standards which apply in their jurisdictions. Until recently Europe has been better at serving the needs of international investors than the US.

The best that can be hoped for is a continuation of the present position – where accounts users are expected to be bi-lingual in accounting and capable of moving back and forth between financial statements presented under either international or US conventions.
During a session of the OMFIF Inaugural Meeting at the Bundesbank in March, the subject of Sovereign Wealth Funds came up. I could not help thinking of the contrast between the way the Norwegians had, with good husbandry, handled that great bonus of North Sea oil, and the attitude of successive British governments. I passed a scribbled note to a nearby Bundesbanker pointing out that, back in 1975, my colleague Adrian Hamilton and I had written an article for the Financial Times (where we both then worked) advocating the creation of a ‘North Sea Fund’, but that neither the Labour Government nor the Conservatives (after 1979) were interested. The Bundesbanker wrote back: ‘But they sold the gold.’

Yes, indeed. We British are past masters at such ill-timed decisions. It was none other than Gordon Brown, in the early days of the Blair government, who decided to sell a large part of the Britain’s gold reserves at $275 an ounce – about a quarter of the current value. One authoritative calculation is that the loss on these transactions amounted to $9bn.

The idea behind the 1975 proposal for a North Sea Fund was that this was a golden opportunity (the metaphor is intended) to invest in the UK’s infrastructure, which lagged well behind France, Germany and Switzerland, notably in transport. The Fund could have been used to provide for the investment that would be required when the oil and gas began to run out. But the Treasury was against ‘hypothecation’ of revenue, and the politicians had other uses for the funds. In the cynical words of one of Mrs Thatcher’s Cabinet Ministers: ‘We used the North Sea revenue to finance unemployment.’

Possession of North Sea oil was widely blamed in the early 1980s for the overvaluation of the pound that did so much harm to British industry – and with consequences even today. But there were other oil producers which did not suffer from an overvalued exchange rate. The contribution of Mrs Thatcher’s personal economic adviser Sir Alan Walters was to play a decisive role in arguing that the reason for the overvaluation was the excessively tight monetary policy then in operation.

Which brings us to the San Andreas Fault lying beneath most British economic disasters – chronic troubles arising directly from an overvaluation of the pound. The greatest example of this was the return to the gold standard in 1925 at an absurdly overvalued exchange rate. Keynes was a vigorous opponent of this strategy; even producing a book entitled The Economic Consequences of Mr Churchill – Churchill being the Chancellor of the Exchequer at the time. The British economy came off the gold standard in 1931, and had a relatively easier time during the 1930s than in the 1920s. The devaluation of 1949 was inevitable, as was the subsequent one in 1967. But that 1967 devaluation was fatally delayed.

The Conservatives loved referring to Labour as ‘the Party of devaluation’. Although devaluations are necessary when costs get out of line with other economies, and an adjustment of the real exchange rate is necessary, they are never popular. But the Conservatives were to have their comeuppance. After putting the pound into the European exchange rate mechanism in 1990, at what was subsequently recognised as ‘the wrong rate at the wrong time for the wrong reasons’, they suffered the humiliation of Black Wednesday on 16 September 1992, when the pound was withdrawn.

And now here we are in spring 2010 with the value of North Sea oil production diminishing rapidly, the earnings of the City of London suffering from the financial crisis, and a manufacturing industry that has not been assisted by the overvaluations of recent decades. The markets are becoming nervous, and there is much derogatory talk about the pound. But we have already experienced a huge devaluation of some 25% in the last couple of years. I do not get the impression that other European governments are as keen on ‘talking the pound down’ as the financial markets are. And the ratings agencies? After their pre-financial crisis performance, I am not sure I rate the ratings agencies.
Looking ahead – diary dates

OMFIF E-Money World Roundtable
15 May 2010
Bank Negara Malaysia, Kuala Lumpur, Malaysia
Symposium: From practice to policy

OMFIF Inaugural Meeting in Asia
16 & 17 May 2010
Bank Negara Malaysia, Kuala Lumpur, Malaysia
Symposium: Asia’s role in the world economy

OMFIF Advisory Board

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