OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

May 2010

G20 reform process runs into the buffers

European disarray spills over to wider grouping

Stewart Fleming, Board of Contributing Editors

The G20 reform process bringing together the world's powerful advanced and emerging market economies has run into the buffers. Although the leaders of the Group of 20 are scheduled to meet again in June in Toronto, the chances of significant breakthroughs in creating a more stable financial system and world economy have diminished dramatically.

Until a decision by euro area finance ministers on Monday 10 May, just as Asian markets were about to open, Europe's response to its emerging sovereign debt crisis triggered in Greece had been dilatory and incoherent. If even the culturally and economically relatively homogeneous region of Europe, with 50 years of economic cooperation behind it, is struggling to coordinate its decision-making, then why should we expect much from the G20?

Early on 10 May, members of the European Union and the 16 nation euro area, together with the International Monetary Fund, followed up their 2 May announcement of a €110bn loan plan to help Greece with a monster €750bn package of initiatives to support threatened euro members. This was coupled with a crucial decision from the European Central Bank that it would take the momentous step of intervening to support 'dysfunctional' euro area government and private sector bond markets.

The package bears the hallmarks of long-standing French efforts to create an 'economic government' for the euro, an ambition of Dominique Strauss-Kahn, the IMF managing director and former French finance minister. [See article on p.23.] However, the ECB move was clearly opposed by the Bundesbank, whose president, Axel Weber, said it involved 'considerable risks'.

Officials within the Group of 20 say many divisions are opening up, not only between richer and not-so-rich G20 members but also among the emerging economies. India and Brazil, for example, last month lined up with the US by signalling publicly their dissatisfaction with China's failure to allow the renminbi to appreciate. The G20 can now be seen as too diverse a body, with too many competing interests, to make a real difference to the workings of the globalised world economy.

Important emerging economies are excluded and there are too many participants, especially Europeans, at the table. Considerable differences, too, are emerging on financial market regulation, including over President Barack Obama's drive to separate commercial banking from investment banking activities.

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Renminbi road-map

US-China funding needed

Songzuo Xiang, Advisory Board

Many people are talking about internationalising the renminbi, but no-one has yet designed a clear-cut road-map. China needs to enshrine this goal within a much wider and more comprehensive financial strategy corresponding to the full potential of its economic and monetary ambitions.

One important component of this approach would be to enhance the use of the renminbi in international bond issues, including by foreign governments. The US Treasury could pave the way. This would be a positive and stability-orientated method of recycling China's current account surplus abroad in a way that – in contrast to the amassing of dollar reserves by the People's Bank of China – does not build up unnecessary foreign exchange risks for Chinese creditors. The issuing activity would be concentrated on Shanghai. There would an important side-effect in enhancing both the profitability of Chinese banks and Shanghai's status as an international financial centre.

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When troubles come...

We lift our eyes to Asia

David Marsh, Co-chairman

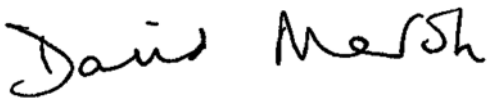
When troubles come, they come not in single spies, but in battalions. Georges Papandreou, the Greek prime minister, might be forgiven for quoting Shakespeare as he surveys his tide of problems. At OMFIF, we are lifting our eyes beyond the Greek ferment to take a wider look at the world, on the special occasion of the Inaugural Meeting in Asia at Bank Negara Malaysia.

Stewart Fleming surveys the challenges facing the Group of Twenty and concludes that the organisation and the reforms it is meant to espouse are running into the buffers. Songzuo Xiang sets down an unusually detailed and well thought out road-map for renminbi internationalisation, including the proposal that foreign governments such as the US should start borrowing in the Chinese currency.

Governor Zeti of Bank Negara Malaysia, our host for the OMFIF meeting, outlines the consequences for the West of a prospective ending of the Asian savings glut. In a magisterially wide-ranging essay, Meghnad Desai says that Asia's time has come to ascend to the top table of world economic governance: the West can no longer hide behind veto power. John Nugée gazes into the monetary crystal ball and finds the future looking distinctly Chinese. Jonathan Fenby, who has been consistently right in his assessment of renminbi policy, considers the Chinese mood now that the US Treasury has climbed down from sabre-rattling over a revaluation. Global Analysis takes an in-depth look at the perspectives for Asian currencies to become established in coming years as fully-fledged reserve units accompanying the dollar and the euro. A key issue will be borrowing in Asian currencies as governments and corporations seek to diversify fund-raising instruments and investors try to spread out their portfolio across different regions.

The euro's travails are highly relevant to asset choices in Asia, given that the 11 top Asian central banks hold around $1.5tn of euros in their reserves.

So, returning to the Athens prime minister's sea of troubles, we offer a clutch of articles on various aspects of the European upheavals. Darrell Delamaide believes IMF managing director Dominique Strauss-Kahn's pivotal position in the Greek rescue efforts makes him a more potent presidential candidate against Nicolas Sarkozy. Archive Insight investigates the limit to Franco-German monetary friendship as demonstrated by a revealing dispute over the French franc and D-Mark in 1992. David Green examines the transformation of central banks and their rapidly mounting challenges, not least for those in Europe beset by the Greek flare-up. Paul Boyle looks at threats to global accounting standards that have been worsened by euro strains. And William Keegan ponders parallels between Greece and Ireland. The Celtic tiger, though mauled by financial disruption, is certainly a lot less sick than the Aegean one. All this provides plenty of material for comparisons between healthier and less healthy components of the world monetary system.



Quote of the month

'Greece is on the brink of the abyss. We are all responsible to ensure it does not take the step into the void.'

Karolos Papoulias, President of Greece

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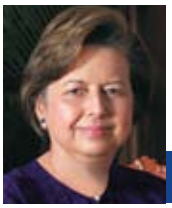

Asia savings flow into infrastructure

Capital shifts should rebalance world economy

Zeti Akhtar Aziz, Governor, Bank Negara Malaysia

Asian economies have for several decades benefited immensely from their high savings. Today, despite the growing significance of domestic demand in Asia, the average rate of gross national savings to gross domestic product in Asia remains high. This represents one of Asia's strengths. Recent global developments, particularly in Europe, have shown how countries with low savings have become highly vulnerable, having depended heavily on external sources to finance their fiscal deficits and their overall growth. This is in marked contrast to Asia where the average rate of saving to GDP is 35% and where most of the growth is financed from domestic sources.

The next step for Asia is to achieve greater financial integration but by taking a different route from that of Europe.

Two important developments in this recent decade have reinforced the implications of this fundamental strength in Asia. The first relates to the financial reforms and the increased resilience of the banking system in Asia in the current environment. The second relates to the development of the capital markets in Asia, in particular, the bond markets. Both these trends have intensified in the post-Asian financial crisis period. The tremendous payoffs from the financial reforms and the initiatives taken to develop the domestic financial markets are highly evident in the current more challenging global environment.

The more developed and resilient banking sector in Asia has been important in supporting the financialisation of savings and the intermediation of these savings to borrowers for investment. While this process was briefly interrupted during the Asian financial crisis in 1997-98, the aggressive financial restructuring and reforms that followed the crisis have not only restored the efficient functioning of the banking systems in Asia, but have also strengthened their resilience. The banks are for the most part well capitalised with better risk management and governance practices and have continued to remain profitable. There has, therefore, been no disruption in the intermediation process as savings continue to be channelled to borrowers for productive investment.

The second trend relates to the development of domestic bond markets in Asia so as to avoid the risks of over-reliance on the banking sector as was the case prior to the Asian financial crisis. Between 2000 and 2009, the Asian bond markets expanded by more than 2.5 times in size to a cumulative value of $14tn, with a greater range of instruments and more diverse participation from both the public and corporate sectors. In most of the major ASEAN economies, the bond market now accounts for between 40% and 95% of GDP. With this significant transformation, supported by robust regulatory infrastructure, the bond markets are now better positioned to meet the changing financing requirements of the region in its transition to the next stage of development.

Corporations now have access to more innovative and sophisticated financing solutions through the bond markets to meet their diverse funding requirements. In Malaysia, the bond market is the fourth largest in Asia after Japan, China and Korea. The Malaysian bond market is unique with more than 55% of outstanding bonds being Shariah compliant, drawing participation from multilateral agencies and corporations from different parts of the world.

Another important factor supporting the positive growth prospects of Asia is regional economic integration. This trend is expected to continue despite the sovereign debt problems in Europe and its potential contagion to other parts of the world. In the current environment, more than 50% of total trade taking place in Asia is with the Asian economies. The rising incomes in Asia, the relatively low levels of unemployment and a young population have supported the rising significance of domestic demand. This in turn has created a massive cumulative consumer market in Asia which will contribute to a mutual reinforcement of regional growth prospects.

Asia savings flow into infrastructure *(continued from page 3 ...)*

The next step for Asia is to achieve greater financial integration but by taking a different route from that of Europe. An important objective of this financial integration is to achieve greater intermediation of the funds in Asia for investment opportunities in the Asian economies. This has already started with Asian financial sector and capital account liberalisation. As a result, there is now an increased presence of Asian financial institutions across the region. There is also greater regional participation in Asia's domestic financial markets. This will facilitate some part of the high savings to be channelled to the different parts of the region that offer investment opportunities.

An area that will become more important in Asia is infrastructure development given its role in promoting economic growth, reducing poverty and connecting economies within Asia and with the rest of the world. In future, demand for extensive, efficient and reliable infrastructure is expected to rise significantly. The Asian Development Bank estimates that Asia will require about $8tn of infrastructure investment in the next decade. Meeting this infrastructure investment is vital to Asia's continued economic competitiveness.

Being the highest savings surplus region in the world, Asia has a considerable internal capacity to meet these infrastructure requirements. Based on rough estimates, the cumulative gross national savings of the region for this decade is estimated to be $80tn-100tn. The infrastructure financing requirement thus represents less than 10% of this amount. In fact, this large infrastructure financing requirement will act as a catalyst for further development of Asian capital markets, deepening bond markets and extending maturities. There is thus significant potential to tap Asia's abundant savings for infrastructure investment. The development of a vibrant and integrated Asian capital market would facilitate this process to enable a more effective and efficient allocation of savings towards the diverse investment needs across the region.

'Increased re-channelling of Asia's savings into the region as investment, coupled with Asia's overall positive growth potential, is likely to contribute towards more balanced global economic growth and to overall stability in the global environment.'

These developments have important implications for the global economy. The increased re-channelling of Asia's savings into the region as investment, coupled with the overall positive growth potential of the region, would contribute towards more balanced global economic growth and thus to overall stability in the global environment.

G20 reform process runs into the buffers *(continued from page 1 ...)*

The G20 process has its origins at a meeting of finance ministers in the Willard Hotel in Washington in the midst of the Asian debt crisis in 1998. A more formal summit of G20 leaders took place in Washington in November 2008, hosted by President George W Bush, in what was a well-timed boost to confidence at the height of fears about a global economic slump.

Since then, as the world embarks on a cautious recovery marked by big disparities between Europe, the US and the emerging world, there has been a stalling of efforts to improve international economic governance and financial regulation. Commitments to resist protectionist pressures have been largely ignored

The history of cooperation by the most prominent trans-Atlantic grouping, the Group of Five (which later became the G7 and then G8), also displayed great shortcomings. For example, the Bonn economic summit of 1978, which decided that West Germany should become a 'locomotive' for world growth, was ill-timed and, ironically, helped drive the Germans into recession in the early 1980s. The G5 Plaza accord on currencies in 1985 was more successful in politicians' memoirs than in reality.

That these limited economic policy coordination exercises had any effect at all was due in large measure to the hegemonic role in trans-Atlantic relations played by America in past years.

Today, however, within the G20, two leading peers, the US and China, are probably destined to become 'great nation' rivals with antipathetic societal philosophies. China remains locked into its history as an autocratic, centralised, non-democratic power. Within the G20, India harbours not only memories of an unhappy bilateral history with China, but also deep suspicions of its growing economic and military strength, both on its northern border and in the Indian Ocean.

With regard to the pivotal currency and trade relationship between China and the US, the omens are not positive, in view of the weight of Chinese currency reserves still heavily invested in the dollar and the troubling bilateral US trade deficit. Participants at the last G20 summit, in Pittsburgh in September 2009, pledged progress to reduce global imbalances between deficit and surplus economies. The European Central Bank warned however in its latest April monthly bulletin: 'The narrowing of imbalances during the crisis has been only partial and is likely to be largely temporary.... It remains to be seen whether significant progress will be made in the main deficit and surplus economies in terms of living up to G20 commitments.'

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West should prepare for China debate

Beijing pressure is one more reason to reduce debt

John Nugée, Advisory Board

In March 2009 Zhou Xiaochuan, governor of the People's Bank of China, raised the question of whether the global financial system was best served by continuing use of the dollar as the dominant reserve currency. Neither the precise capacity in which he expressed his comments, nor whether the Chinese authorities have any strong pre-formed views on the question, is entirely clear. Nor is the subject is new: this is a question that has been a matter of international monetary debate since the 1960s. Yet once Zhou lent new impetus, it acquired a momentum of its own, and experts from around the world have been adding their thoughts.

On one level, the long-term prognosis for the dollar seems fairly clear. Very nearly all commentators expect the dollar's standing to decline. Almost as many expect the renminbi to assume a much larger role in the international currency system of the future. But that is largely where the consensus ends. Whether the renminbi will simply replace the dollar, whether there will be a multi-currency reserve system in which the dollar has a continuing but reduced role, or whether the future global financial system will be based on a supranational currency such as the Special Drawing Right, are all issues on which experts disagree.

However, what western experts think may not be of ultimate significance. Historically, whenever there is a significant redesign of the international monetary system, the voice of the creditor nations carries most weight. This was certainly the case in 1944, when the US as the world's main creditor shaped Bretton Woods to its own preferences, and it is likely that it will be again when the dollar era draws to its close. China is likely to have the major say in deciding the contours of the world financial system of the 21st century.

What, indeed, might this new global financial order look like? It is probable that China itself has yet to decide what it wants. After all, the Chinese authorities have not yet announced when or even how they will make the renminbi convertible, or what its role will be when it is. One might expect a resolution to this issue to precede any debate on the international financial system. But when China has decided what it wants, the rest of the world can expect Beijing to push increasingly hard to get it. Many commentators expect China to seek not just a new reserve currency system, but also new voting rights at the International Monetary Fund, new powers for creditor countries and perhaps new rules on cross-border finance. The IMF's procedures certainly need strengthening: it is for many people an unfortunate lacuna that the IMF's Article IV consultations – centred on assessing whether countries' individual economic policies correspond to global economic requirements – are voluntary, and that the US and UK, two large debtor countries, have been able to avoid them.

Proposals for institutional change may well go alongside the growth of Chinese financial power. But first the Chinese will have to reach their own consensus. A substantial part of Chinese international policy-making at present seems to be framed more in terms of what the Chinese do not want, rather than through policies that they promote and may even have modelled themselves. But this seems likely to change. In future, for example, Chinese proposals could conceivably include the creation of a Global Financial Regulator based in Shanghai with a remit that includes the oversight of US financial institutions.

There is no doubt that at present the US would resist the creation of such a body, and much else besides out of a possible Chinese policy agenda. But future pressure from the world's leading creditor nation will not be easy to ignore. It would be wise for the West to prepare for what will be intense policy encounters. And certainly the looming Great Debate with China represents one more reason why the West should do everything it can to reduce the debt burden with which it is emerging from the financial crisis. The greater the Chinese creditor advantage when it eventually reaches the negotiating table, the more gruelling the West's experience will turn out to be.

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Renminbi road-map *(continued from page 1 ...)*

There are some interesting parallels here with the expansion of borrowing in D-Marks through bond issues by foreign governments and corporations in Germany during the 1970s. Particularly after the 1973 oil crisis, issuance increased markedly as the West German authorities liberalised the market to allow the Federal Republic's current account surplus to be siphoned off abroad, culminating in the landmark issuance of 'Carter bonds' in D-Marks by the US Treasury under the administration of President Jimmy Carter.

With these parallels in mind, I recommend that the US government should issue renminbi-denominated bonds in Shanghai and then convert the proceeds into dollars. Such high-grade renminbi bonds would be attractive assets both for private Chinese investors and for official bond-holders (including those outside China). Encouraging the US to borrow in renminbi rather than in dollars would lower the Chinese authorities' potential currency risks inherent in China's large foreign exchange reserves. The corollary is that the US would be exposed to vulnerability, as the Treasury would build up liabilities in renminbi. But surely, in any international capital markets system, over time, the debtors and not the creditors will have to bear the brunt of foreign exchange risks – especially if the asset- liability gap continues to grow.

Among all these considerations, China needs to bear mind that international reserve money status requires formidable preconditions. The GDP of a new reserve currency area would need to be comparable to that of the dollar and euro. Financial markets must be liquid and transparent. Supervision and regulation must be strengthened. Banks, along with the rest of the financial industry, must be commercialised and opened up to domestic private as well as international investors. Monetary and fiscal policies must be sound, stable and responsible. The currency must be fully convertible. Domestic and foreign investors must have full freedom to trade assets across national boundaries. Foreign exchange markets must be well developed for investors to hedge exchange risks, yet currency rates must be stable enough to prevent speculative capital flows from becoming uncontrollable.

So the Chinese people will have to overcome many hurdles for the renminbi to become a fully-fledged international reserve money. By the end of 2009, China's GDP accounted for only about 8% of the world's GDP, against 25% for the US and 22% for the euro area. The renminbi is only partly convertible, reflecting restrictions on capital flows. China's financial markets are extremely under-developed.

'There is a now a large task for the Chinese authorities to bring together all the elements of a renminbi internationalisation strategy into a cohesive and realisable strategic road-map.'

At the root of the challenge is the aim of modifying China's growth model and development strategy which relies strongly on the state-controlled financial sector and on fiscal measures to maintain an extremely high ratio of investment to GDP. This model is unsustainable and inconsistent with the aim of renminbi internationalisation. Chinese leaders have accordingly decided to speed up transformation by shifting the emphasis of growth strategy away from exports towards domestic demand; away from labour, energy and resources towards technological innovation and human capital; and away from secondary industry towards the tertiary sector led by services.

The key to achieving these objectives is financial deregulation to promote competition and innovation. Without consumer financing, it will be impossible to build up a long-term mechanism to stimulate domestic demand. Without venture capital, private equity and many other financing measures, the road toward independent technology innovation and entrepreneurship will remain sealed. Without a liquid securities market, particularly for bonds, local governments will continue to rely on tax revenue and land-selling to finance their infrastructure investment and other expenditures.

Financial deregulation will above all require measures to open up the financial sector to domestic private investors. Domestic entrepreneurs must be allowed to operate banking, securities business, insurance, trust and other financial services. Domestic companies and local governments must have freedom to issue bonds which domestic and foreign investors can trade freely. Interest rates must be liberalised to create an equal playing field for all banks. A legal framework must be set to encourage innovative financial services such as venture capital and private equity.

Additionally, the overriding aim of internationalising the renminbi will require opening China's financial markets to foreign investors and borrowers. With regard to possible issuance of renminbi bonds by foreign borrowers such as the US government, some people worry that permitting foreigners to issue renminbi-denominated bonds would put at risk the Chinese development model by diverting investment abroad. That's a misguided concern because Chinese people have huge bank deposits and they are eager to find much more attractive alternatives. Even more important, in its own interest, China needs ways of dispersing its huge stock of foreign exchange reserves among a much larger and more diversified variety of private sector savers. All this entails that China's financial corporations should aggressively expand their services into foreign markets.

There is a now a large task for the Chinese authorities to bring together all the elements of a renminbi internationalisation strategy into a cohesive and realisable strategic road-map. This will then of course need to be implemented. But the first step is to assemble the package. Until a comprehensive strategy is designed and announced, all talk of the renminbi eventually coming of age will remain a pipe dream.

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Caution remains watchword on China

Beijing still in driving seat after Obama deadline

Jonathan Fenby, Board of Contributing Editors

China's policy on renminbi appreciation remains highly cautious after the passing of the much-hyped 15 April deadline by which the US Treasury was going to decide whether or not to label the Chinese authorities 'manipulators' of the currency.

The Obama administration's sensible decision to postpone – and perhaps shelve altogether – the day of Sino-American monetary judgment has not stilled debate in Washington, where commentators remain anxious for a swift and substantial renminbi appreciation. However, China's currency policy is only one part of its much broader economic management. The prime concern of the leadership this year is to slow down the explosive credit expansion of 2009 and to assert central control over local authorities, without badly undermining the significant economic growth the regime needs to maintain its legitimacy and popular appeal.

Communist Party leader Hu Jintao and Prime Minister Wen Jiabao require steady sustainable expansion in the 8-9% range as they enter the last stretch of their 10 years in power, culminating in the handover to the next generation of Politburo chiefs in 2012. Another step in the measures to cool economic expansion and damp inflation pressures came on 2 May with the third increase this year in banks' reserve requirements – part of a pre-determined series of steps to take the heat off the Chinese credit boom.

Economic growth surged to 11.9% on an annual basis in the first quarter of the year and the government is trying to lower a surge in house prices fuelled by massive bank lending. The politically sensitive housing price index rose 11.7% in March over a year earlier, although this significantly understated price rises in key urban areas of the country. It was followed by a series of measures to damp down prices which had an immediate effect in the biggest cities. Increased supply from housing starts undertaken in the second half of 2009 should help, too, while an interest rate increase is widely expected in July. A 25% drop in prices from the peak seems quite possible as the central authorities are considering a property tax on real estate assets.

I have argued in recent months that expectations of a big currency move which periodically sweep markets and investment bank analysts are not founded in the reality of Chinese decision-making. There may be a small move later this year after renewed talks between Washington and Beijing. Holders of renminbi bank accounts in Hong Kong certainly expect this.

Appreciation would serve China's political purpose by presenting it as a reasonable global player, but the extent would be limited – probably to around 3%. The trade figures for the last 18 months, showing China's share of US imports rising, probably serves to convince the Politburo that it can afford a small rise in the renminbi rate. But China remains loathe appearing to be railroaded by Washington. And the regime wishes to ensure that small exporters in coastal regions, which are already being hit by monetary tightening, do not suffer a double blow.

Nor does China want to incur the risk of attracting a wave of hot money betting on further appreciation. The credit figures are starting to go the right way. The leadership has no desire to see foreign money adding to monetary pressure. So caution remains the watchword in Beijing. On a range of issues including Iran and climate change as well as the renminbi, the Hu-Wen leadership is ready to make small concessions without incurring the risk of putting its basic interests at stake. The gradual internationalisation of the renminbi will fall into this pattern, too.

On the currency and on other issues, Beijing has every reason to think that its policy is working, that is it conserving its basic position and interests, and that the Obama administration lacks the means to force the pace. Meanwhile, it has to focus on the gradual deflation of the 2009 bubble, the cooling of the property market, the creation of jobs, the encouragement of domestic consumption and the balance between labour-intensive industries and high margin production on the property market. Change will come on the currency front but the pace will be slow. Beijing is doing all it can to ensure it is in the driving seat – and remains there.

Change will come on the currency front but the pace will be slow. Beijing is doing all it can to ensure it is in the driving seat – and remains there.

This is Asia's millennium

West can no longer hide behind veto power

Meghnad Desai, Chairman, Advisory Board

The 1930s Great Depression changed the nature of capitalism by bringing in New Deal-type policies and establishing US hegemony in global finance. We have now had the sequel, the Great Recession of 2008-09. A fresh set of new players has emerged more or less unscathed, this time concentrated on Asia, apparently ready to provide leadership. The West should get used to the consequences. This is epoch-changing stuff. The world's future financial and economic architecture will carry the hallmark of the international creditor nations.

Asia's rise is not just an upheaval. It is a renaissance. It marks Asia's return to the top table after an absence of half a millennium.

These circumstances may cause disturbance and soul-searching, yet we should see them as an opportunity. Before we resume the bad old ways of highly leveraged banks and highly indebted consumers, it is time for fundamental reflection and fundamental action. The entire system of global economic governance needs refashioning. This will require renewing the institutions of world financial and economic power, and remodelling them in line with Asia's own approach to fiscal and financial responsibility.

Asia must be fully co-opted into efforts to create and supervise the new structures – a condition that the G20 process, though welcome, only partly fulfils. Global governance has been one of the major culprits of the crisis. Imbalances need repairing, not just in finance but also in the political sphere. The leadership of the Bretton Woods institutions can no longer be left as a US-EU duopoly. The field must be thrown wide open. The West can no longer hide behind veto power.

Asian countries will be the powerhouse of the global economy for the next 50 years. China and India are now the engines of growth, as Germany and Japan were in the late 1970s. China has earned its place as a member of the G2 tandem with the US. Asia has responded well to a recession it did not cause, preventing the feared 'double-dip'. China led the way with one of the largest reflationary packages. India's package was inclusive of its rural hinterland as well as its urban industries.

Asia's rise is not just an upheaval. It is a renaissance. It marks Asia's return to the top table after an absence of half a millennium. The Classical Age saw the Empires of Rome, Persia and China. India never had a single imperial authority for any length of time, but it was a thriving society. Trade flourished between these areas in silk, textiles, spices, horses and gold. Europe ran a balance of trade deficit vis-à-vis Asia. From the decline of Rome until around the 15th century, Islamic armies rode high. Across North Africa and Southern Europe there was a thriving Muslim Empire.

In the late 15th century the world turned on its axis and tilted towards the West. The Iberian powers were first off the block, as the advance guard of maritime Empires. China gave up on its Imperial Navy for reasons which are a mystery. The crucial innovation of manoeuvrerable ships carrying light artillery gave the West its decisive advantage. The maritime link with Asia around the Cape of Good Hope spurred expansion of trade. The hoards of gold and silver taken by Spain and Portugal from South America went to Asia to pay for the spices and textiles and silks. In the 100 years between 1750 and 1850, the West secured its military domination over Asia. Its armies were smaller but better trained and organised – and were often manned by the Asians themselves. Even before the Industrial Revolution gave further advantage, the West had secured an Empire. Asia lost. Europe won.

The balance began to change in the late 20th century. After 25 years of growth and mass consumerism, the West began to lose its competitive advantage as full employment and inflation eroded industry's profitability. Asian Tigers were waiting in the wings. They used western technology to win markets abroad. By the 1980s China had joined the Tigers – Taiwan, Hong Kong, Singapore and South Korea. Soon Malaysia, Indonesia, Thailand and the Philippines took their place among high-growth Asian economies. In the 1990s India entered the club too.

The fall of the Berlin Wall and the death of the Soviet Union stemmed from, and accelerated, globalisation. Many emerging economies embraced fully-fledged financial markets and free trade under the auspices of the World Trade Organisation. Asian manufacturing exports from Asia poured into Europe and the US. Everyone benefited: Asian economies had surplus labour while western capital was looking for higher returns. Low tech and medium tech left western shores and settled in Asia. And, in the West, financial services and IT companies grew up in the gap left by industry.

Asia can help remodel the IMF and World Bank to maintain the global system in expansionary mode without restrictions on trade and capital flows.

Asia learns its lessons

Asia had its harsh lesson in globalisation during the 1997-98 financial crisis. Asian countries realised the fragility of their banking structures and regulatory systems. These lessons led Asia to accumulate large foreign exchange reserves in the next 10 years. Asia under-consumed and over-saved, mainly via exports. The West over-consumed – especially the US and UK. The West borrowed from Asia but did not invest the money productively. The real estate boom did not last long enough to valorise all the debt incurred. The Great Recession of 2008-2009 brought the coup de grace.

Now we face many challenges. The fragile international payments system needs repair so that financial imbalances can be managed without causing another recession. The damaged parts are in the West, not in resurgent Asia. Yet the structures of global governance – the G20, the G8, the IMF and so on – do not give Asia its due place. Voting power in the Bretton Woods institutions does not pay sufficient regard to the new creditor countries. The old post-Second World War structures – the gold/dollar exchange standard, the formation of Special Drawing Rights, today's IMF voting system – have all failed to serve their original purpose. We need a multilateral exchange rate and reserve asset regime to replace a de facto dollar standard that gives little incentive to Washington to be fiscally responsible. The crisis showed that US seigniorage gains are as unhealthy for the US as for the rest of the world. Unfortunately, the current euro upheaval may perpetuate the dollar system that many believed had its day.

Over-representation of OECD countries is a scandal

There is a similar situation with regulatory reform. Much of Basel II had problems in its design. As reform discussions proliferate – with various suggestions such as returning to the Glass-Steagall system, improving host country/home country co-ordination, higher capital adequacy, living wills – it is beneficial to study how Asia got it right. The western regulatory authorities failed to see the crisis building up. They did not only fail to prick the asset bubbles; they positively fed them. These authorities cannot be the best agents for designing the new system. The over-representation of OECD countries at all levels of reform discussions is a scandal.

Asia as a region did not have a deep recession, only a growth correction. Its banks remained solvent. Asia learned its lessons from 1997. Asian countries reformed their structures and did not fall for the siren voices lulling them in the West's direction. Asia has large pools of saving and it has invested in productive assets. It has taken advantage of international market access, showing that, in quality and price, it can compete on equal terms. Asia can outline the route to a balanced multilateral set-up in which the burden of adjustment will be shared by the deficit countries as well as the surplus nations, but where there can be no single currency dominance.

Asia can help remodel the IMF and World Bank to maintain the global system in expansionary mode without restrictions on trade and capital flows. Asia can help fashion structures that encourage savings more than indebtedness as the path to growth. Asia can point to its own example of harnessing market forces without being overwhelmed by them. It can remind the West about its own old habits of thrift and sensible banking that many forgot. Asia has a voice. In the highest echelons of world governance, on reforming, regulating and remodelling the global economy, it should make this voice heard. Asia has arrived. It is here. This is Asia's millennium.

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Asian currencies advance as reserve assets

Global shift promotes search for monetary alternatives

The composition of world's currency reserves has become a major political issue affecting international relations at the highest level, as last month's exchanges on the renminbi between US and Chinese Presidents Barack Obama and Hu Jintao showed. Focus on China alone however diverts attention from wider questions concerning enormous accruals of reserve assets across the major Asian economies.

The 11 largest Asian reserve holders owned $5.1tn of reserves at end-2009 – 63% of total official holdings of $8.1tn, according to the International Monetary Fund. The Asian countries accounted for the lion's share of unprecedented increases in overall currency reserves in the last 10 years, which have quadrupled from a mere $1.9tn in 2000.

Even if reserve growth slows after this heady expansion, the big Asian holders will be in the vanguard of future efforts to build up reserves outside the two main assets, the dollar and the euro. Gold will play a role in these endeavours, as recent purchases by China and India demonstrate, but the main running will be made by currencies. Reserve diversification has been a constant feature of the world monetary scene since the 1960s. What is new about the latest endeavours is that the new reserve units are likely to be the Asian currencies themselves. This is likely to be synonomous with growth in Asian currency bond markets as development of instruments, maturities and liquidity make these investments increasingly attractive for central banks.

The key Asian foreign exchange reserve holders are China with $2.4tn at end-2009, Hong Kong ($256bn), India ($259bn), Indonesia ($66bn), Japan ($997bn), Korea ($270bn), Malaysia ($97bn), Philippines ($44bn), Singapore ($188bn), Taiwan ($349bn) and Thailand ($139bn). The reserves are the product of large current account surpluses, currency inflows and managed currency policies that have been geared to lowering exchange rate volitility, as well as offsetting the perceived threat of destabilising currency appreciation.

Much-enhanced reserves give Asian countries very real financial power. But they also represent a source of great vulnerability. Much of the total seems to be managed far too conservatively, in a way that is ill-matched to countries' liabilities and therefore represents a grave source of potential risk. Asian countries seem in some ways to have swapped one form of risk – the feared negative effects of currency appreciation on export industries and social cohesion – for another.

Finding a way out of this impasse will not be easy, but Asian countries should start considering whether the best escape route lies in constructing a far more systemic approach to allowing their own currencies to take on the mantle of fully-fledged reserve assets. A pre-condition for reserve currency status in Asia is a fully-developed market in Asian currency bonds. [See box below].

The result could be a seismic shift in world reserve currencies. The last decade has seen, with the start of European economic and monetary union (EMU), the birth of the euro which – whatever its current problems – has become a genuine alternative to the dollar. During the last 10 to 15 years, one formally important Asian reserve currency – the yen – has become much less so, and now makes up only around 3% of world reserves (against 7% in 1995) – less than the 4.2% share taken by sterling. The next 10 years will probably see fresh shifts as the world develops a genuine multilateral reserve system.

Precondition for Asian currency reserve status: increasing volumes on Asian bond markets

Since the 1997-98 Asian crisis, governments and central banks have made significant efforts to develop and expand Asia's bond markets, partly as a means of lowering the risk of future upheavals. The lack of local currency bond markets was widely held to be a major contributory factor to the crisis, since countries built up short-term debts in foreign currencies which led to a vicious circle of falling confidence and increased redemptions in appreciating currencies.

The efforts by government to increase the size of local currency bond markets have had a significant impact. Since 1997 to 2010, Asian local currency bond issues, excluding Japan, have grown from $174bn to $4.4tn, reported by the Asian Development Bank's ADB's AsianBondsOnline. This represents an annualised growth rate of 31%. In contrast, the Asian foreign currency bond market size has been relatively stable. In 2008, estimated issuance was $500bn, an annualised growth rate of around 5% since 1997.

Local currency bonds were smaller than the foreign currency bond markets during the Asian crisis of 1997, but have now grown to be the major component of Asia's bond markets. Asian local currency bond markets now represents around 5% of global bond markets and is rapidly becoming a core asset class. An additional factor behind increased issuance has been the necessity for governments to launch large quantities of local bonds as part of foreign exchange sterilisation policy. But in many cases governments have issued bonds beyond that required for sterilisation purposes in recognition of the need to establish liquid government yield curves as a fundamental component to efficient-functioning capital markets.

Along with the yen, other Asian currencies will emerge as small but significant components of world reserves – and will account for disproportionately large parts of Asian central banks' official bond portfolios. The Chinese renminbi looks likely to lead the way, perhaps followed by the Singaporean dollar, the Korean won, the Thai baht and the Malaysian ringgit.

The possible emergence of Asian currencies as reserve assets in their own right requires a series of institutional moves, not least with regard to convertibility and other legal issues. Some Asian central banks have begun to accelerate moves in this direction, and others may join in.

Twists and turns in the long-running vicissitudes of the dollar as the world's prime reserve asset have sparked frequent controversy over the past 50 years. This was the basis of the criticism in the 1960s by President Charles de Gaulle's Finance Minister Valéry Giscard d'Estaing of America's 'exorbitant privilege' in being able to issue unlimited amounts of dollars to fund its payments deficits. These question were at the heart of the ill-fated 'substitution account' initiated by President Jimmy Carter in 1979 as a means of lowering the importance of the dollar and increasing that of the Special Drawing Right.

Establishing a European currency to rival the dollar was one of the motivations behind the euro's creation in 1999. And the desire to lower excessive reliance on the US currency drove People's Bank of China governor Zhou Xiaochuan in March 2009 to call for a new form of international currency.

The renaissance of Asian currencies would mark an astonishing transformation from their woes in 1997-98 when many countries in the area suffered substantial devaluations caused by unsustainable current account deficits and the failure to maintain a system of fixed exchange rates against the dollar. In reaction to the 1997-98 crisis caused by the collapse of untenable currency 'pegs', Asian countries have on the whole maintained undervalued currencies, run large current account surpluses and built up unparalleled levels of reserves as a form of insurance policy to guard against a repeat of the drama.

European countries have proceeded down an opposite road. In supreme contrast to the lessons of the Asian experience, a number of peripheral countries in EMU have run unsustainable current account deficits, lost massive amounts of competitiveness and suffered a substantial deterioration of their international financial positions. They have gambled on membership of the single currency protecting them from the fall-out – a judgment that, on the present view of many financial market practitioners, may not pay off. The current account deficits of the

Annual economic performances: emerging vs. developed economies

Industrial/emerging economies in Asia

	China			Hong Kong			India			Indonesia			Japan		
	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A
1990	3.8	3.1	3.1	3.9	10.3	6.2	5.6	9.0	-2.5	7.2	7.8	-2.5	5.2	3.1	1.5
1991	9.2	3.4	3.2	5.7	11.3	4.3	2.1	13.9	-1.6	7.0	9.4	-3.1	3.4	3.4	2.0
1992	14.2	6.4	1.3	6.1	9.5	3.0	4.4	11.8	-1.2	6.5	7.5	-2.0	1.0	1.6	3.0
1993	14.0	14.7	-1.9	6.0	8.8	4.8	4.9	6.4	-0.6	6.8	9.7	-1.3	0.2	1.3	3.0
1994	13.1	24.1	1.4	6.0	8.8	-0.8	6.2	10.2	-0.5	7.5	8.5	-1.5	1.1	0.6	2.7
1995	10.9	17.1	0.2	2.3	9.0	-6.3	7.4	10.2	-1.6	8.2	9.4	-3.0	1.9	-0.1	2.1
1996	10.0	8.3	0.8	4.2	6.3	-2.5	7.6	9.0	-1.7	7.8	7.0	-2.9	2.6	0.1	1.4
1997	9.3	2.8	3.9	5.1	5.8	-4.4	4.6	7.2	-0.7	4.7	6.2	-1.6	1.6	1.9	2.3
1998	7.8	-0.8	3.1	-6.0	2.8	1.5	6.0	13.2	-1.7	-13.1	58.0	3.8	-2.0	0.6	3.1
1999	7.6	-1.4	1.4	2.6	-3.9	6.3	6.9	4.7	-0.7	0.8	20.8	3.7	-0.1	-0.3	2.6
2000	8.4	0.4	1.7	8.0	-3.7	4.1	5.7	4.0	-1.0	5.4	3.8	4.8	2.9	-0.8	2.6
2001	8.3	0.7	1.3	0.5	-1.6	5.9	3.9	3.8	0.3	3.6	11.5	4.3	0.2	-0.7	2.1
2002	9.1	-0.8	2.4	1.8	-3.0	7.6	4.6	4.3	1.4	4.5	11.8	4.0	0.3	-0.9	2.9
2003	10.0	1.2	2.8	3.0	-2.6	10.4	6.9	3.8	1.5	4.8	6.8	3.5	1.4	-0.3	3.2
2004	10.1	3.9	3.6	8.5	-0.4	9.5	7.9	3.8	0.1	5.0	6.1	0.6	2.7	0.0	3.7
2005	10.4	1.8	7.2	7.1	0.9	11.4	9.2	4.2	-1.3	5.7	10.5	0.1	1.9	-0.3	3.6
2006	11.6	1.5	9.5	7.0	2.0	12.1	9.8	6.2	-1.1	5.5	13.1	3.0	2.0	0.3	3.9
2007	13.0	4.8	11.0	6.4	2.0	12.3	9.4	6.4	-1.0	6.3	6.0	2.4	2.4	0.0	4.8
2008	9.6	5.9	9.4	2.1	4.3	13.6	7.3	8.3	-2.2	6.0	9.8	0.0	-1.2	1.4	3.2
2009	8.7	-0.7	5.8	-2.7	0.5	11.1	5.7	10.9	-2.1	4.5	4.8	2.0	-5.2	-1.4	2.8
2010	10.0	3.1	6.2	5.0	2.0	12.1	8.8	13.2	-2.2	6.0	4.7	1.4	1.9	-1.4	2.8

Notes: GDP = Annual change in GDP in constant dollars. Infl. = annual change in consumer price index. C/A = current account surplus or deficit in % of GDP

Source: IMF

three weakest EMU members, Greece, Portugal and Spain, have been larger, and more persistent, than the deficits that destroyed the Asian currency 'pegs' in the late 1990s. Iceland's current account deficits (outside EMU) were particularly large – showing that these are an inevitable precursor of monetary upheaval. [See boxes on annual performances of industrialised and emerging economies, p.12, 15 and 19. The shaded areas in the tables highlight the years of maximum current account deficits in Europe and Asia. The warning signals in Europe over the past decade have been much more pronounced than those for Asia in 1990-97.]

The current account deficits of Greece and Portugal, for instance, were close to 10% of GDP on average dutring the past decade The result has gravely undermined the European single currency – and bolstered the international position of the dollar that many euro protagonists sought to displace.

The demise of the dollar as the world's pivotal reserve unit, like Mark Twain's death, has been much rumoured – and has failed to materialise. Indeed, the share of the dollar in world reserves (at 62%, according to the end-2009 IMF figures for both developed and emerging economies) is now above the level in 1995 when according to IMF figures, it was 58%. (This may have been an anomaly caused by the build-up of D-Mark reserves used by European countries for financing operations in the pre-euro European Monetary System. As soon as EMU started, these reserves were converted not onto the euro, since this was a domestic and not a foreign currency, but into the dollar and other units).

Heavy investment in US government bonds by Asian and other reserve-holders underlines the advantages of the American Treasury bond and bill market in terms of liquidity, transparency and depth. These are not always adequate compensation for the underlying volatility of the dollar. Yet the bulk of Asia's reserve accruals has been channelled into the greenback because, as the world's leading transaction and vehicle currency, it remains the near-inevitable unit of choice.

There are no precise figures, but it can be assumed that the dollar makes up around 60% of Asian currency reserves. This is the IMF's figure for the US currency's share in collated foreign exchange reserves for 107 emerging and developing economies. (The statistics do not include the holdings of the world's largest reserve owner, China, which means that there is a large and growing grey zone of 'unallocated' reserves – amounting to $3.5tn as of end-2009 – for which the IMF has no reserve component breakdown.)

However, partly because of the strong showing of Asian economies after the 2007-09 upheavals, accelerated shifts into multiple currencies now

Demand from private sector is key for Asian bond market growth

Demand for local currency investments from the private sector has played a pivotal role in the growth of local currency bond markets. Asia's increased affluence has boosted growth of the financial services industry and resulted in increased demand for bonds from sectors such as insurance companies. The pension industry is another important part of the increasing pool of bond-holders. Asia's defined contributions platforms have seen enormous growth and the use of industry approaches such as target retirement date (or life-cycle) products has resulted in significant bond allocations. The banking industry has also benefited from fast economic growth in Asia. One side-effect of the financial crisis is likely to be an increased allocation to government bonds as part of regulatory bank capital.

Regional measures to develop local bond markets have been highly important. The two main steps were the Asian Bond Market Initiative (ABMI) under the governments of the ASEAN+3 countries and the ADB, and the Asian Bond Fund (ABF) under the 11 Asia-Pacific central banks represented in EMEAP (the Executives' Meeting of East Asia-Pacific Central Banks).

The ABMI under ASEAN+3/ADB has created Asian Bonds Online to provide greater transparency for Asian bonds; facilitated its Asian bond issuance programs by creating a single unified framework with a common set of documents governed by English law; proposed a new Credit Guarantee & Investment Mechanism; initiated a dialogue to enhance Asia's bond dealing, settlement and depositary infrastructure.

EMEAP, through the Asian Bond Fund initiative, has approached bond market development in a more practical way by creating a series of bond funds designed to be open to the public. This approach has spurred efforts in financial innovation such as exchange traded funds and has also increased product portability across Asia. One of the funds created under the Asian Bond Fund programme is domiciled in Singapore and listed in Hong Kong and Tokyo. The initiative has created an environment for accelerating the removal of withholding taxes and has also promoted a set of market indices, contributing to greater transparency.

In future governments will need to go beyond action to reduce market impediments and promote sovereign issuance, by taking steps in other fields too. An important area for development is in the corporate sphere. Rapid growth in size and liquidity of the Asian local currency sovereign bond market has not been replicated in the Asian local currency corporate bonds. Ultimately, corporate decision-making will hold the key to significant steps forward to increase the size of this market.

appear likely as Asian countries seek added financial weight to add to their undoubted economic clout. Asian countries exhibit growing self-confidence in trade and investment policies. They are becoming an increasingly integrated economic bloc – although it seems highly unlikely that they will wish to emulate Europe's project for a fully-fledged single currency. In addition, most of them believe that huge US government debts and other financing pressures will reduce the value of the dollar over the next decade.

All these factors have spurred a desire to diversify reserves out of the dollar in and into the euro in recent years, which for many countries has appeared a timely solution to the problem of over-dependence on the dollar. On a conservative estimate, based on the IMF figures for reserve asset composition for its sample of 107 emerging and developing economies, the 11 main Asian reserve holders own $1.5tn in euros.

Further sizeable shifts into the European single currency may be put on hold as the euro area seeks to resolve the grave problems caused by the indebtedness of peripheral countries. This is another reason why Asians' diversification efforts are likely to take them increasingly down the Asian monetary road.

At present, reserve preferences in Asia appear to be conservative in the extreme, in a way that is inimical to the reserve-holders' own longer-term interests. Changes in the level of foreign reserves can be analysed by reference to the balance of payments, as illustrated in the box on p.20 using China's example.

At the end of 2009, China's foreign reserves of $2.3tn were attributable to a cumulative capital account surplus over the last 13 years of $559bn and a cumulative current account surplus of $1.8tn. (Within this current account surplus, roughly $260bn can be calculated as representing interest income received over this period). It is important to distinguish between 'transitory' capital that may enter the country through flows of 'hot money' (and can equally well flow out again) and semi-permanent inflows that take the form, for example, of capital investment in plant and equipment.

Another significant factor in the analysis concerns central banks' interventions to purchase foreign exchange sold in the exchange markets, for example by domestic exporters.

When this happens, the central banks normally issue domestic bonds to absorb or 'sterilise' the liquidity that would otherwise be released by the foreign exchange sales – and thus avoid inflationary threats. Using this analysis, foreign exchange reserves can be separated into three components:

- Transitory Capital Reserves are held to ensure that the repatriation of foreign transitory capital can be met

Annual economic performances: emerging vs. developed economies

Industrial/emerging economies in Asia

	Korea			Malaysia			Philippines			Singapore			Taiwan			Thailand		
	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A
1990	9.3	8.6	-0.7	9.0	3.0	-2.1	3.0	13.5	-6.1	9.2	3.5	8.5	6.9	4.1	6.6	11.6	5.9	-8.3
1991	9.7	9.3	-2.7	9.5	4.4	-8.5	-0.6	18.5	-2.1	6.6	3.4	11.3	7.9	3.6	6.7	8.1	5.7	-7.5
1992	5.8	6.2	-1.2	8.9	4.8	-3.7	0.3	8.9	-1.9	6.3	2.3	11.9	7.6	4.5	3.9	8.1	4.2	-5.5
1993	6.3	4.8	0.2	9.9	3.5	-4.5	2.1	7.6	-5.5	11.7	2.3	7.2	6.7	2.9	3.0	8.3	3.3	-5.0
1994	8.8	6.3	-0.9	9.2	3.7	-7.4	4.4	9.0	-4.4	11.6	3.1	16.1	7.6	4.1	2.6	9.0	5.1	-5.4
1995	8.9	4.5	-1.6	9.8	3.5	-9.6	4.7	8.1	-2.6	8.2	1.7	17.1	6.4	3.7	2.0	9.2	5.8	-7.9
1996	7.2	4.9	-4.0	10.0	3.5	-4.4	5.8	9.1	-4.6	7.8	1.4	15.0	5.5	3.1	3.8	5.9	5.9	-7.9
1997	5.8	4.4	-1.6	7.3	2.7	-5.8	5.2	5.8	-5.2	8.3	2.0	15.5	5.5	0.9	2.4	-1.4	5.6	-2.1
1998	-5.7	7.5	11.3	-7.4	5.3	13.0	-0.6	9.7	2.3	-1.4	-0.3	22.2	3.5	1.7	1.2	-10.5	8.1	12.8
1999	10.7	0.8	5.3	6.1	2.7	15.7	3.4	6.4	-3.8	7.2	0.0	17.4	6.0	0.2	2.7	4.4	0.3	10.2
2000	8.8	2.3	2.3	8.7	1.6	9.0	6.0	4.0	-2.9	10.1	1.3	11.6	5.8	1.3	2.7	4.8	1.5	7.6
2001	4.0	4.1	1.6	0.5	1.4	7.9	1.8	6.8	-2.4	-2.4	1.0	13.0	-1.7	0.0	6.4	2.2	1.6	4.4
2002	7.2	2.8	0.9	5.4	1.8	8.0	4.4	3.0	-0.4	4.2	-0.4	13.2	5.3	-0.2	8.8	5.3	0.7	3.7
2003	2.8	3.5	1.9	5.8	1.1	12.0	4.9	3.5	0.4	3.8	0.5	23.4	3.7	-0.3	9.8	7.1	1.8	3.4
2004	4.6	3.6	3.9	6.8	1.4	12.1	6.4	6.0	1.9	9.2	1.7	17.5	6.2	1.6	5.8	6.3	2.8	1.7
2005	4.0	2.8	1.8	5.3	3.0	15.0	5.0	7.6	2.0	7.6	0.5	22.0	4.7	2.3	4.8	4.6	4.5	-4.3
2006	5.2	2.2	0.6	5.8	3.6	16.4	5.3	6.2	4.5	8.7	1.0	24.9	5.4	0.6	7.0	5.1	4.6	1.1
2007	5.1	2.5	0.6	6.2	2.0	15.7	7.1	2.8	4.9	8.2	2.1	27.6	6.0	1.8	8.4	4.9	2.2	6.3
2008	2.3	4.7	-0.6	4.6	5.4	17.5	3.8	9.3	2.2	1.4	6.5	19.2	0.7	3.5	6.2	2.5	5.5	0.6
2009	0.2	2.8	5.1	-1.7	0.6	16.7	0.9	3.2	5.3	-2.0	0.2	19.1	-1.9	-0.9	11.2	-2.3	-0.8	7.7
2010	4.5	2.9	1.6	4.7	2.0	15.4	3.6	5.0	3.5	5.7	2.1	22.0	6.5	1.5	8.5	5.5	3.2	2.5

Notes: GDP = Annual change in GDP in constant dollars. Infl. = annual change in consumer price index. C/A = current account surplus or deficit in % of GDP

Source: IMF

in full. These reserves are managed on the basis of liquidity and capital preservation, with assets held in the major bond markets, particularly in the US.

- Sterilisation Reserves are held to offset the liabilities of the sterilisations, and can therefore be invested in a much broader range of bonds aside from those dictated by liquidity requirements.

- Surplus Reserves are free of underlying claims and therefore can be invested in all asset classes.

Applying this analysis to the 11 major reserve owners in Asia, their $5.1tn of foreign exchange reserves can be subdivided into $381bn in Transitory Capital Reserves, $2.3tn in Sterilisation Reserves and a further $2.3tn Surplus Reserves. The different asset preferences suitable for each category of reserves are illustrated in the box on p.20.

It is clear that Asian countries' demonstrate an overwhelming leaning towards the classic reserve asset characteristics of liquidity and capital preservation, yet this bias seems to be misplaced. The substantial allocation of reserves in dollars to amortise sterilisation bonds seems inappropriate as these instruments should be matched by investment in Asian currencies. Such reserves can be invested in any market, especially as secondary trading in Asian markets has improved.

One appropriate route to meet this goal would come via central bank purchases of greater volumes of Asia currency-denominated bonds' This would continue and enhance the various initiatives launched by governments and central banks since the Asian currency crisis of 1997-98. [See boxes on p.11, 13 and 17.]

For example, Asian central banks could themselves promote the popularity of such bonds by joining in a programme of capital-raising through issuance of domestic currency bonds. In a series of transactions that would result in expansion of both the asset and liabilities side of Asian central banks' balance sheets, the proceeds would be invested in equivalent amounts of

Asian Development Bank – Bond issuance in Asian currencies

The Asian Development Bank has a long history of innovation in Asian currency bonds. In 1970, it was the debut foreign issuer in the Japanese yen (or Samurai) market. Since then, ADB has been a regular issuer in Asian capital markets. ADB was also the first supranational issuer in the domestic capital markets of Australia, People's Republic of China, India, Korea, Malaysia, Philippines, Taipei, China, and Thailand.

As part of its developmental mandate, ADB contributes to the development of regional bond markets through local currency bond issuances. To promote capital market development in the Asia and Pacific region, ADB established in April 2006 a 15-year Malaysian ringgit (MYR) 3.8bn Medium-Term Note Programme (MYRMTN) Progra in Malaysia.

In September 2006, ADB established its 30-year $10bn equivalent Asian Currency Note Programme (ACNP), and launched the inaugural offering of notes under the ACNP in the domestic capital markets of Singapore and Hong Kong Total issuance under ACNP is SGD550 m and HKD2.5 bn. Up to now five local currencies have joined the ACNP: Singapore dollar, Hong Kong dollar, Malaysian ringgit, Philippine peso and New Taiwan dollar.

ADB Local Currency Borrowings 2004-2009

Currency	Issue date	Maturity date	Principal amount		Coupon %	Reference
Renminbi	08-Dec-09	08-Dec-19	RMB	1,000,000,000	4.200	0756-000
Philippine peso	24-May-07	25-May-12	PHP	5,000,000,000	5.230	0557-000
Hong Kong dollar	18-Jan-07	18-Jan-12	HK$	1,500,000,000	4.000	0514-000
Singapore dollar	8-Feb-07	8-Feb-12	SGD	250,000,000	3.270	0519-000
Malaysian ringgit	8-Feb-07	8-Feb-17	MYR	500,000,000	4.000	0517-000
Hong Kong dollar	21-Sep-06	21-Sep-09	HK$	1,000,000,000	4.280	0495-000
Singapore dollar	18-Sep-06	18-Sep-11	SGD	300,000,000	3.335	0494-000
Thai baht	18-Sep-06	18-Sep-11	THB	5,500,000,000	5.340	0493-000
Thai baht	18-Sep-06	18-Sep-16	THB	1,000,000,000	5.540	0493-001
Malaysian ringgit	25-Apr-06	24-Apr-11	MYR	500,000,000	4.265	0473-000
Philippine peso	09-Nov-05	10-Nov-10	PHP	2,500,000,000	0.000	0453-000
Renminbi	14-Oct-05	14-Oct-15	RMB	1,000,000,000	3.340	0445-000
Thai baht	24-May-05	24-May-10	THB	4,000,000,000	3.870	0414-000
Malaysian ringgit	10-Nov-04	10-Nov-09	MYR	400,000,000	3.940	0399-000
Indian rupee	27-Feb-04	27-Feb-14	INR	5,000,000,000	5.400	0385-000

Source: ADB

Annual economic performances: emerging vs. developed economies

Industrial/emerging economies in Europe/US

	France			Germany			Greece			Iceland			Italy		
	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A
1990	2.6	3.4	-0.8	5.7	2.7	2.9	0.0	26.5	-3.8	1.2	14.8	-2.1	2.1	6.1	-1.9
1991	1.0	3.2	-0.5	5.0	3.5	-1.3	3.1	19.5	-1.6	-0.2	6.8	-4.0	1.5	6.2	-2.5
1992	1.2	2.4	0.3	2.3	5.0	-1.1	0.7	15.9	-2.0	-3.4	3.7	-2.4	0.8	5.0	-2.7
1993	-0.8	2.1	0.7	-0.8	4.5	-0.9	-1.6	14.4	-0.7	1.3	4.1	0.7	-0.9	4.5	1.2
1994	2.2	1.7	0.5	2.6	2.7	-1.4	2.0	10.9	-0.1	3.6	1.5	1.9	2.2	4.2	1.3
1995	2.2	1.8	0.5	1.8	1.7	-1.2	2.1	8.9	-2.2	0.1	1.7	0.7	2.8	5.4	2.1
1996	1.0	2.1	1.2	1.0	1.2	-0.6	2.4	7.9	-3.3	4.8	2.3	-1.8	1.1	4.0	3.2
1997	2.2	1.3	2.7	1.7	1.5	-0.5	3.6	5.4	-3.7	4.9	1.8	-1.8	1.9	1.9	2.8
1998	3.5	0.7	2.6	2.0	0.6	-0.7	3.4	4.5	-2.8	6.3	1.7	-6.8	1.4	2.0	1.6
1999	3.2	0.6	3.1	1.9	0.6	-1.3	3.4	2.2	-5.3	4.1	3.4	-6.8	1.5	1.7	0.7
2000	4.1	1.8	1.6	3.2	1.4	-1.7	4.5	2.9	-7.8	4.3	5.0	-10.2	3.7	2.6	-0.5
2001	1.8	1.8	1.9	1.2	1.9	0.0	4.2	3.7	-7.2	3.9	6.7	-4.3	1.8	2.3	-0.1
2002	1.1	1.9	1.4	0.0	1.4	2.0	3.4	3.9	-6.5	0.1	4.8	1.6	0.5	2.6	-0.8
2003	1.1	2.2	0.8	-0.2	1.0	1.9	5.9	3.4	-6.5	2.4	2.1	-4.8	0.0	2.8	-1.3
2004	2.3	2.3	0.6	1.2	1.8	4.7	4.6	3.0	-5.8	7.7	3.2	-9.8	1.5	2.3	-0.9
2005	1.9	1.9	-0.4	0.7	1.9	5.1	2.2	3.5	-7.5	7.5	4.0	-16.1	0.7	2.2	-1.7
2006	2.4	1.9	-0.5	3.2	1.8	6.5	4.5	3.3	-11.3	4.6	6.8	-25.6	2.0	2.2	-2.6
2007	2.3	1.6	-1.0	2.5	2.3	7.6	4.5	3.0	-14.4	6.0	5.0	-16.3	1.5	2.0	-2.4
2008	0.3	3.2	-2.3	1.2	2.8	6.7	2.0	4.2	-14.6	1.0	12.4	-15.8	-1.3	3.5	-3.4
2009	-2.2	0.1	-1.5	-5.0	0.1	4.8	-2.0	1.4	-11.2	-6.5	12.0	3.8	-5.0	0.8	-3.4
2010	1.5	1.2	-1.9	1.2	0.9	5.5	-2.0	1.9	-9.7	-3.0	6.2	5.4	0.8	1.4	-2.8

Notes: GDP = Annual change in GDP in constant dollars. Infl. = annual change in consumer price index. C/A = current account surplus or deficit in % of GDP

Source: IMF

Annual economic performances: emerging vs. developed economies

Industrial/emerging economies in Europe/US

	Poland			Portugal			Spain			UK			US		
	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A	GDP	Infl.	C/A
1990	-7.2	585.8	1.9	7.9	13.4	-0.2	3.8	6.7	-3.5	0.8	7.0	-3.8	1.9	5.4	-1.4
1991	-7.0	70.3	-0.4	3.4	11.4	-0.8	2.5	5.9	-3.6	-1.4	7.4	-1.8	-0.2	4.2	0.0
1992	2.0	43.0	1.0	3.1	8.9	-0.2	0.9	7.1	-3.5	0.1	4.3	-2.1	3.4	3.0	-0.8
1993	4.3	35.3	-1.3	-0.7	5.9	0.3	-1.3	4.6	-1.1	2.2	2.5	-1.9	2.9	3.0	-1.3
1994	5.2	32.2	5.3	1.5	5.0	-2.3	2.3	4.7	-1.2	4.3	2.1	-1.0	4.1	2.6	-1.7
1995	6.7	27.9	0.6	2.3	4.0	-0.1	4.1	4.7	-0.3	3.1	2.6	-1.2	2.5	2.8	-1.5
1996	6.2	19.9	-2.1	3.6	2.9	-3.5	2.4	3.6	-0.2	2.9	2.4	-0.8	3.7	2.9	-1.6
1997	7.1	14.9	-3.7	4.2	1.9	-5.8	3.9	1.9	-0.1	3.3	1.8	-0.1	4.5	2.3	-1.7
1998	5.0	11.8	-4.0	4.9	2.2	-7.1	4.5	1.8	-1.2	3.6	1.6	-0.4	4.4	1.5	-2.4
1999	4.5	7.3	-7.4	3.8	2.2	-8.5	4.7	2.2	-2.9	3.5	1.3	-2.4	4.8	2.2	-3.2
2000	4.3	10.1	-5.8	3.9	2.8	-10.2	5.1	3.5	-4.0	3.9	0.9	-2.6	4.1	3.4	-4.2
2001	1.2	5.5	-2.8	2.0	4.4	-9.9	3.6	2.8	-3.9	2.5	1.2	-2.1	1.1	2.8	-3.9
2002	1.4	1.9	-2.5	0.8	3.7	-8.1	2.7	3.6	-3.3	2.1	1.3	-1.7	1.8	1.6	-4.3
2003	3.9	0.8	-2.1	-0.8	3.3	-6.1	3.1	3.1	-3.5	2.8	1.4	-1.6	2.5	2.3	-4.7
2004	5.3	3.5	-4.0	1.5	2.5	-7.6	3.3	3.1	-5.3	3.0	1.3	-2.1	3.6	2.7	-5.3
2005	3.6	2.1	-1.2	0.9	2.1	-9.5	3.6	3.4	-7.4	2.2	2.0	-2.6	3.1	3.4	-5.9
2006	6.2	1.0	-2.7	1.4	3.0	-10.0	4.0	3.6	-9.0	2.9	2.3	-3.3	2.7	3.2	-6.0
2007	6.8	2.5	-4.8	1.9	2.4	-9.4	3.6	2.8	-10.0	2.6	2.3	-2.7	2.1	2.9	-5.2
2008	5.0	4.2	-5.1	0.0	2.7	-12.1	0.9	4.1	-9.6	0.5	3.6	-1.5	0.4	3.8	-4.9
2009	1.7	3.5	-1.6	-2.7	-0.9	-10.1	-3.6	-0.3	-5.1	-4.9	2.2	-1.3	-2.4	-0.3	-2.9
2010	2.7	2.3	-2.8	0.3	0.8	-9.0	-0.4	1.2	-5.3	1.3	2.7	-1.7	3.1	2.1	-3.3

Notes: GDP = Annual change in GDP in constant dollars. Infl. = annual change in consumer price index. C/A = current account surplus or deficit in % of GDP

Source: IMF

bonds issued in other Asian currencies by other regional central banks.

Such schemes might fall foul of Asian countries' reluctance to take on extra debt, but a whole-hearted effort to promote greater use of Asian bonds as reserve currency vehicles will require a some 'kick-starting' if it is to get off the ground.

Asian currencies may turn out to be the vehicle of choice – or at least vie in popularity with the dollar, the euro and the yen – for capital-raising throughout the region for Asia's huge infrastructure spending in coming years. The programme of issuance by the Asian Development Bank [see box on p.17.] has set a pattern that others will undoubtedly follow.

Soverign issuers in Asia are already raising finance to fund productive investments and infrastructure. As Asian financial markets grow in scope and variety, such instruments will be increasingly regarded as attractive investment outlets by central banks. There seems little doubt that, eventually, Asian currency borrowing will represent a significant fund-raising route for western governments' debt management offices. Sizeable quantities of the bonds issued in this way may end up in central bank portfolios, in similar fashion to official preferences today for dollar-denominated US Treasury bonds and bills.

Asian reserve management principles

	Transitory capital reserves	Sterilisation reserves	Surplus reserves
Nature of claim	Speculative/transitory capital flows	Deferral of economic consumption through a bond sterilisation program	No underlying claims
Estimated value for Asia	$381.4bn	$2,335.3bn	$2,344.9bn
Reserve management objective	**Liquidity**: ensure future capital outflows can be repaid from future foreign reserves	**Liability match**: ensure future sterilization bond value is matched by future foreign reserves	**Risk adjusted returns**: maximize returns for a given risk tolerance
Investment horizon	Short-term	Medium-term	Long-term
Principal investments	Bonds	Bonds	Any asset class
Appropriate asset classes	Major government bonds markets: USD and other highly liquid government bonds	Wider choice of bonds: government bonds including Asia and high credit corporate bonds; potentially commodities	Any asset class consistent with diversified risk/return objective: bonds, equities, direct investments; hedge funds

Source: State Street Global Advisors

China's balance of payments and foreign reserves ($ bn)

	Capital & finance Account	Current account	Total balance of payments	Increase in reserves	Closing reserves	Interest income (US five-year yields) [2]
1996					105.0	
1997	21.0	37.0	58.0	34.8	139.9	6.5
1998	(6.3)	31.5	25.1	5.1	145.0	8.0
1999	5.2	21.1	26.3	9.7	154.7	6.6
2000	1.9	20.5	22.4	10.9	165.6	9.8
2001	34.8	17.4	52.2	46.6	212.2	8.2
2002	32.3	35.4	67.7	74.2	286.4	9.1
2003	52.7	45.9	98.6	116.8	403.3	7.8
2004	110.7	68.7	179.3	206.7	609.9	13.1
2005	63.0	160.8	223.8	208.9	818.9	22.0
2006	10.0	249.9	259.9	247.5	1,066.3	35.6
2007	73.5	371.8	445.3	461.9	1,528.3	50.0
2008	19.0	426.1	445.1	417.8	1,946.0	52.6
2009	141.4	311.6	453.0 [1]	453.0	2,399.0	30.1
Total	559.0	1,797.7	2,356.7			259.6

Notes: [1] SSgA estimated value for 2nd half 2009 [2] US 5-year government bond yields are used to compute estimated interest income

Source: National Bureau of Statistics of China and State Administration of Foreign Exchange; Bloomberg

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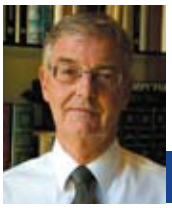

Central banks can still be surprised

Landscape changes almost beyond recognition

David Green

The recent volcanic eruption in Iceland and the spate of major earthquakes across the globe reminds us how easily the landscape can be transformed by events we are perfectly aware can and almost certainly will take place, but whose timing is unknowable. It is the same in the world of central banking.

When Howard Davies and I set out almost two and a half years ago to write a book about the future of central banking we were pretty confident that changes were in the making. We had a very strong sense that the world of pure inflation-targeting pursued by independent central banks could not last much longer.

Growth had remained strong and prices remarkably stable during the period known as the Great Moderation. Yet very substantial borrowings had been accumulated by individuals likely to be unable to service their debts. And these were held by banks and other firms unlikely to be able to withstand the losses that would eventually occur from non-servicing of the debt. Imbalances of this kind were known almost invariably to end in grief. Until only very recently the flow of credit within the financial system had been a perennial preoccupation of central bankers and a focus of policy. Yet despite this knowledge and this history a number of central banks persuaded themselves that this time it would be different.

As we were attempting to finalise our manuscript in summer 2008 we knew from the tremors in the US subprime market and the demise of Northern Rock that future shocks were likely. What we did not anticipate were the events of a few weeks later, when the world's most important central bank first allowed the collapse of Lehman Bros, but then procured the rescue of AIG on systemic grounds, even though insurance companies had usually fallen outside the reach of last resort rescue. The name of the game suddenly became securing the functioning of the means of payment and the preservation of core financial intermediaries and markets. This was all far removed from the fine tuning of the Fed Funds rate to shift inflation a few degrees.

We went back to the drawing board with our manuscript and late last year were ready with our final version. By then it contained much about the unique central banking structure that is the Eurosystem. We noted that the euro was a political venture, that some of those most responsible for deciding to create it did not understand how it worked, that it certainly lacked the kind of fiscal counterparty on which all other central banks rely, and that Germany and France has subverted the attempts to address this defect through a Stability and Growth Pact. As a consequence of all of this, notwithstanding the calm environment of the euro's first decade, we believed tensions were bound to emerge sooner or later.

What we did not foresee was that the fact that a national government could so soon run out of cash without a central bank to print some for it, or without the ability to devalue. In the face of these events, the world of central banking has been transformed. The economic theories on which monetary policy had been based have become widely discredited without new ones yet being put in their place. Inflation is no longer necessarily the primary goal of policy. Central banks have become major intermediaries in the private markets. In the US the independence of the Federal Reserve has come under threat. In the euro area the president of the ECB has had to appeal to national parliaments with whom he had hitherto had no relationship – and has now announced a controversial programme of buying government bonds. In the UK the Labour party which gave the Bank of England independence has told the electorate what the course of interest rates needs to be. The Conservatives have said that, if in power, they would look to the Bank for decisive advice on fiscal policy – previously off limits.

Central bankers are thus faced with extraordinary challenges in a landscape transformed almost beyond recognition in a matter of a few months.

The economic theories on which monetary policy had been based have become widely discredited without new ones yet being put in their place.

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Strauss-Kahn in vanguard in Europe

Greece gives statesman's shine to Sarkozy rival

Darrell Delamaide, Board of Contributing Editors

Dominique Strauss-Kahn's move to take control of the Greek debt imbroglio has put him further ahead in the political stakes in France, should the managing director of the International Monetary Fund choose to run against Nicolas Sarkozy in the 2012 presidential election. The unprecedented package for the euro area announced on 10 May bore his imprint, along with that of President Barack Obama, who telephoned the hapless German Chancellor Angela Merkel shortly before the weekend European summit to tell her to put Europe's house in order.

Strauss-Kahn's Superman-like arrival in Berlin on 28 April to cajole the German parliament on Greece already put him in the ascendancy against the Germans – which can only strengthen his hand further in the presidential polling stakes. Even if Greece is forced to restructure its debts – which seems likely – it will be the IMF that is in charge. The German government – far from seeking to run Europe, the criticism levied against it by many politicians and commentators in France who are wary of German power – has been exposed as exceptionally dilatory over aid to Greece. But while Merkel and her finance minister Wolfgang Schäuble have dithered, Strauss-Kahn has laid on an impressive show of strength, supplying the right mix of challenge and reassurance to tell German parliamentarians and the public that decisions are needed quickly to protect not just Greece but the whole of economic and monetary union (EMU).

EMU members could never have righted Greece on their own, even if they had acted with more decisiveness. The situation now has gone well beyond clumsy, ad hoc mechanisms. And the costs have risen dramatically, too.

It is not likely that EMU members could ever have righted Greece on their own, even if they had acted with more decisiveness some months ago. The situation now has gone well beyond whatever clumsy, ad hoc mechanisms the euro area could cobble together. And of course the costs have risen dramatically, too. So Strauss-Kahn's polished performance is giving the French an opportunity to show up the Germans in financial crisis management. Former economics professor DSK, as he is known in France, served as French finance minister in Lionel Jospin's cabinet in 1997 to 1999. Already then he stirred up German politics by calling for overall governmental economic control of EMU.

DSK lost out to Ségolène Royal as the Socialist Party candidate in the 2007 presidential election. After Sarkozy defeated Royal, Sarkozy came up with what seemed like a brilliant practical solution of sending his political rival to the traditionally French-held IMF post after Spanish incumbent Rodrigo Rato considerately vacated the position. DSK quietly went to work with his deputy, John Lipsky, to take care of some of the agency's long-running problems, starting with overstaffing and governance. He pragmatically devised a scheme to sell off some of the IMF's gold to allay his budget problems and worked to rejuvenate some of the more sclerotic lending practices, streamlining and diversifying credit facilities to make the agency more flexible. So when the financial crisis of 2008-2009 struck, Strauss-Kahn had positioned the IMF to respond quickly to contain some of the peripheral damage to the global economy in places like Iceland, Pakistan and Eastern Europe.

Strauss-Kahn's IMF was also poised to answer the calls for 'multilateral surveillance' and 'early warning systems' in the wake of the crisis. The managing director began to take on a higher profile as crisis meetings proliferated. The IMF has supplied powerful guidance to the Group of 20, as the G20 took the mantle of global economic coordination from the G8.

As Sarkozy's popularity has taken a dive, rumours of a DSK candidacy have increased. Strauss-Kahn has pledged to serve out his current term as IMF managing director, which expires six months after the French election. There is always the risk that deterioration in Greece and other European countries could outstrip the IMF's ability to solve it. What is likelier, though, is that the well-oiled IMF machinery will put Greece through its maw and achieve a semblance of order, leaving Merkel, Sarkozy and other European leaders sheepishly sifting through the tattered remnants of EMU. Under that scenario, DSK could well be the last European standing – a presidential candidate with true statesmanlike stature.

A monthly foray into monetary secrets hidden in archives

How Trichet told Köhler the facts of life

In ECB chief's 'close and friendly co-operation' with the Germans, he acts with 'brutality' and speaks to future Berlin president with 'rare violence'

Jean-Claude Trichet, president of the European Central Bank, is a man of many parts – and a veteran of many battles. At the eye of the storm over Greek debt, Trichet travelled to Munich on 29 April 2010 to make a keynote speech in the Hotel Bayerischer Hof to an annual economic and business conference.

At the beginning of his speech, Trichet directly addressed German President Horst Köhler, who was in the audience and made a speech fulminating against bankers' excesses. Trichet spoke fondly of the two men's encounters – 'It has always been an enormous pleasure to talk with him and to work with him' – during negotiations on the Maastricht treaty 20 years ago. 'We were also heavily involved with the handling of the European Monetary System crisis in 1992-93,' he added. 'I remember that episode very well. It was a defining moment not only for the monetary integration of Europe. It remains in our memories as a vivid example of what close and friendly cooperation can do in very exceptional and demanding circumstances.'

Trichet's definition of 'close and friendly cooperation' is rather flexible. This is demonstrated by a contemporaneous record of a heated exchange with a German delegation in September 1992.

Trichet's definition of 'close and friendly cooperation' is rather flexible. This is demonstrated by a contemporaneous record – drawn up by Trichet himself – of a heated exchange with a German delegation, including Köhler, on 22 September 1992 in Washington. At the height of a crisis surrounding the French franc and the D-Mark, shortly after 'Black Wednesday' on 16 September 1992 when sterling and the lira left the European exchange rate mechanism (ERM), Trichet was director of the French Treasury.

Trichet led a small French team in what appeared a highly unequal contest in the German delegation's offices at the Sheraton Hotel on the fringes of the annual meeting of the World Bank and International Monetary Fund. Michel Sapin, the French finance minister, and de Jacques de Larosière, Governor of the Banque de France, had left central Washington and were on their way back to Paris, preparing for what they thought would be a devaluation of the franc the next day.

Trichet sat down accompanied solely by Banque de France official Francis Cappanera. On the other side were Theo Waigel, German finance minister, and Köhler, then Finance Ministry state secretary, together with Bundesbank president Helmut Schlesinger, deputy president Tietmeyer and head of the international department Wolfgang Rieke. Gert Haller, head of the monetary department at the German Finance Ministry, and Otmar Isssing, the Bundesbank's directorate member for economics, joined in.

After two highly pressurised days in Washington coping with the franc's travails, Trichet's showdown at the Sheraton was the supreme test of his nerves and negotiating skills. He surmounted the trial with aplomb. Passions rose to great heights. Waigel – who had considerable sympathy for Trichet's predicament – believed that the independent Bundesbank was overplaying its hand. At one stage Waigel intervened angrily to force Schlesinger to restrain the devoted amateur photographer Rieke from taking candid souvenir photographs of Trichet squirming under German pressure.

Schlesinger argued that France had either to raise interest rates or devalue. The Bundesbank president initially refused to sign a declaration that the Franc's parity was inviolable. According to Trichet's own account, the exchange went as follows:

Main source: Trichet note. 'Compte rendu des entretiens franco-allemands. Mardi après-midi 22 septembre – Washington.' The note – marked Secret – was sent by Trichet to Mitterrand with a covering letter on 31 December 1993. Mitterrand wrote on the note: 'Essential document – to photocopy and keep here.'

Schlesinger: 'I will not sign any joint declaration by the French and German Central banks on maintaining the parity. Don't count on me for that. I am only the President of the Bundesbank, nothing more. I do not wish to face the ridicule of being contradicted by the facts 12 hours, 24 hours or 48 hours later. That is not the attitude of a responsible central bank! If you are in the situation of the French franc, you devalue. France has done nothing to defend the Franc! Nothing serious! It has not even made use of our offer to buy francs in Frankfurt for your account ....!'
Trichet: 'The German finance minister will understand that I am stupefied and indignant. The remarks that we have just heard do not correspond to the orientations of the heads of state and government of the two countries. This language is the language of break-down..... '
Waigel: (*visibly moved, makes conciliatory gestures*)
Trichet: (*turning to Schlesinger*): 'The alliance of France and Germany has been the pivot of the European system since the reconciliation. Your speech and your tone indicate the system is going to burst apart.'

Trichet gave a long exposition of why a franc devaluation was unjustified. He said the Banque de France would be willing to accept that the Bundesbank intervened for France's account in Frankfurt, on condition that the markets were not told that this was the case.

There followed a meeting break in which German Chancellor Helmut Kohl – in a Parisian restaurant after talks with French president François Mitterrand – telephoned Waigel and Schlesinger in Washington. During the pause, Trichet, by his own account, took the future German President Horst Köhler aside, and imparted a message 'of rare violence' regarding Germany's European priorities.

'I told him with brutality,' Trichet wrote in his account, 'that the Bundesbank (and Germany) were making a mistake if they thought they could treat us in the same way that England and Italy had been treated quantitatively and qualitatively. We were not comparable, neither economically nor politically nor strategically.'

After the phone calls with Kohl, the Germans took a more conciliatory stance. Waigel asked Köhler to speak. Köhler said Germany would accept a common declaration on the franc's parity along with agreement to use all financing mechanisms available within the exchange rate mechanism 'We are doing more for France than for any other nation,' Waigel noted. Schlesinger said he would sign a declaration only if the two other Bundesbank directorate members at the meeting, Tietmeyer and Issing, went along with the idea – which they did.

The Bundesbank agreed to raise total credits to the Banque de France to DM39bn – DM4bn more than granted to the Bank of England during the Black Wednesday turmoil. Schlesinger declared that support by the Bundesbank could not be unlimited, in view of the danger to Germany of a liquidity build-up from massive intervention. The Bundesbank president insisted that if automatic intervention to support the franc on its ERM floor exceeded DM10bn Germany would convene the European Monetary Committee as a prelude to a franc devaluation.

Trichet's tactics worked. After all-night preparations in Paris, the French and German central banks and finance ministries published a joint communiqué early on 23 September, declaring the sanctity of the D-Mark-franc parity. 'Germany had its own interest in signing this statement,' Sapin said later. 'Schlesinger saw the economic situation getting worse. Preventing a large franc devaluation against the D-Mark was important to help not just the French but also the German economy.'

Trichet wrote 15 months later to Mitterrand declaring his pride at having surmounted the test, declaring 'I felt I was "on the front"' and enclosing his own 12-page note of the meeting for the French president's personal perusal.

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Stronger global accounting governance

Transatlantic tug-of-war will set back progress

Paul Boyle, Advisory Board

Accounting is regarded as a technical subject – but it operates in a political context that can on occasion be significant. The recent financial crisis could be one of these occasions. Questions have been raised about whether accounting standards have exacerbated the crisis (for example, is fair-value accounting pro-cyclical?) and about whether differences in accounting standards are impeding reform of global banking regulation.

A choice will have to be made between pooling accounting sovereignty or accepting a less ambitious goal.

How, for instance, can a global leverage rule be introduced when US GAAP and IFRS have different rules for netting-off derivatives? Some commentators regret the political dimension of accounting standards but this ignores the current realities. Although accounting standards were once the private concern of the accountancy profession – and the institutional standard-setting arrangements reflect these origins – they have now become matters of public interest. Accounting standards have, directly or indirectly, been given the force of law in many jurisdictions and as a result they have acquired a political dimension, which the questions about the role of accounting in the banking crisis has highlighted.

Politicians face a tension between two laudable objectives: the benefits to their jurisdictions of having a single set of accounting standards to underpin the increasingly-international financial system and capital markets, and the retention of sovereignty over the laws applying in their jurisdictions. EU member states faced a similar tension in relation to the euro: how to reconcile the benefits of a single currency while retaining national sovereignty over monetary policy. These two objectives are not compatible and a choice had to be made. Most EU members decided the loss of monetary sovereignty was a price worth paying.

In effect, the euro states pooled their sovereignty over monetary policy but they paid considerable attention to the governance arrangements for the European Central Bank. An international treaty established the ECB as a public body, clearly specified its primary objective, its powers, its financing arrangements and the methods for appointing its leaders. A key feature of the ECB is its independence from national political considerations. The logical goal of the international accounting standards project is a global accounting union. The International Accounting Standards Board (IASB) is a private sector organisation, with modest resources compared with the ECB and with no legally binding funding arrangements. It has made substantial progress on the technical issues but it is now facing increasing difficulties in securing political acceptance for its standards, especially those which are most relevant to regulated financial institutions.

One reason for these difficulties is a global political failure to face the incompatibility of having global accounting standards and retaining jurisdictional accounting sovereignty. If the world's leading jurisdictions are seriously committed to global accounting standards then they need to pool accounting sovereignty. The necessary arrangements would need to include re-constituting the IASB as a public authority, with clearly specified objectives, powers, financing arrangements and methods for appointing its leaders.

It is not clear that the politicians in the EU, US, or indeed in any of the jurisdictions adopting IFRS are sufficiently convinced of the benefits of global accounting standards that they are prepared to pool sovereignty. It has been reported recently that the new EU Commissioner for the Internal Market, Michel Barnier, has asked for further strengthening of the governance links between the IASB and the EU, whilst the Chair of the US SEC has said that 'she would not be prepared to delegate standard-setting … to the IASB.' The rest of the world is understandably not happy to see the IASB in a transatlantic tug-of-war.

In the absence of pooled sovereignty it is likely that the IASB will be torn between different political masters. It can probably muddle through for a few more years but the costs of the IASB attempting to square the political circle could be considerable. And a choice will have to be made between pooling accounting sovereignty or accepting a less ambitious goal.

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Ireland quicker than Greece

Dublin takes the pain, may reap reward

William Keegan, Chairman, Board of Contributing Editors

It was Greek mythology that bequeathed the legend of Heracles cleaning out the Augean Stables; but it was modern Ireland that was quicker off the mark than Greece when it came to the financial crisis and the necessary mopping-up operation.

As an almost completely unreconstructed Keynesian, who favours expansion in general and full employment in particular, I was horrified when I first heard of the scale of the Irish budgetary retrenchment. It was no less horrifying to hear it from the horse's mouth, when I saw Brian Lenihan, the finance minister, on a visit to Dublin towards the end of April.

Brian Lenihan took office in May 2008, having previously had ministerial responsibilities in non-economic departments. Ideally he would not have started from there. There had been an Irish economic miracle, and the Celtic Tiger had enjoyed a good diet in the late 1990s and early years of the new millennium. But, as every European school person knows, things got completely out of hand after that. Ireland ended up with the biggest property boom and the worst banking crisis in the European Union. The fiscal cost of the bursting of the bubble and the collapse of tax revenue also brought Ireland to 'the top of the poll', as Patrick Honohan, governor of the Central Bank of Ireland, pointed out to me on that same visit, with a borrowing requirement of 14% of GDP.

Honohan's was an inspired appointment. An economist, he already had a distinguished career as an academic. He has worked for the World Bank and in the 1980s he was economic advisor to Dr Garret Fitzgerald, when the latter was prime minister (Taoiseach). Rumour has it that it was Fitzgerald who suggested Honohan's name to Lenihan.

Lenihan arrived at the finance ministry after the peak of the boom, variously dated at fourth quarter 2007 or first quarter 2008. Honohan was appointed in September 2009 and the experienced regulator Matthew Elderfield shortly afterwards. Coincidentally an outsider from California called Strike the Tiger was a big winner at Ascot that year: the key strategic decision of this formidable trio was, indeed, to strike the prowling tiger. They did not try to minimise the scale of the problem. In addition to the dramatic moves to nationalise Anglo-Irish, and recapitalise AIB and the Bank of Ireland, the Central Bank and Financial Services Authority have proposed a very strict corporate governance regime for the banks.

The pain in Irish society is tangible; and the anger is audible: even while I was visiting the Governor, truck drivers were making noises off, down in the streets. But, unlike the Greeks, the sweepers with new brooms in Dublin have gone out of their way to be completely open about the problem.

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This refreshing approach adds to their confidence that they are on top of the financing problem. Most of the money needed to fund the budget deficit is already in the bag for this year.

The wage and benefits cuts are huge, and far from popular. But the impact on competitiveness – on unit wage costs – also promises to be dramatic and necessary in a monetary union where devaluation in the face of the fiercely competitive German economy is by definition ruled out. Irish policymakers hope that the cohesion of society in their small economy will hold despite the widespread feelings of injustice. Patrick Honohan's patron, Dr Garret Fitzgerald, now a sprightly 84, is hopeful of a return to annual average GDP growth of 5% between 2011 and 2015.

And the figures for budgetary contraction spelled out by Brian Lenihan? No less than the equivalent of 4%, 2.5% and 1.5% of GDP in the budgets for 2009, 2010 and 2011 respectively – with unemployment currently around 13%. As a believer in full employment, your correspondent flinches that it has come to this in the Old Country…

Welcome to all delegates

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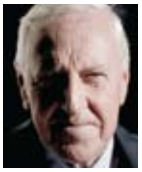
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