OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

May 2011

The message of the gold price rise

Hainan summit marks move from US standard

Meghnad Desai, Chairman, Advisory Board

The rising price of gold is sending us a message of monumental significance – that world money urgently needs reorganisation. The April spring meeting of the International Monetary Fund as usual did not come to any dramatic conclusions.

It was overshadowed by the summit of the BRICS countries – Brazil, Russia, India, China and South Africa – in Hainan, southern China, which made a significant move to fashion an alternative to the dollar-dominated monetary standard. One outcome could be a greater role for gold in a restructured system.

The five R currency nations – renminbi, rupee, rouble, real and rand – resolved to facilitate cross-border payments among their central banks in their national currencies. This is reminiscent of the 1950s European Payments Union designed by West European economies recovering from the Second World War as a means of sharing their meagre dollar resources and settling their trade deficits in local (then inconvertible) currencies.

This time the motivation is not a shortage of dollars but rather that the countries concerned have too many of them in their reserves. By proposing a new scheme at Hainan, China has given notice that it wishes to challenge the dollar, but without as yet going for full capital convertibility. To add momentum, the Hainan summit invited other like-minded countries to join the club.

Standard & Poor's underlined the key issues by issuing a negative warning on US debt. While some would question the rating agency's judgment, given its poor performance during the financial crisis, its statement has struck a chord well beyond Washington, as a result of the stalemate over debt reduction ahead of the 2012 elections.

It is difficult to see how US can tackle its deficit and debt problems in either the shorter or the longer term. The two schemes unveiled by Congressman Tim Ryan and President Barack Obama do not even start to take the problem seriously. The US budget has not been in balance in the last 30 years except for two years at the tail end of the Clinton administration.

Many have sought to make a virtue of this saying that the US is acting as consumer of last resort. But the people who have lent money to the profligate consumer are getting jittery since the consumer is claiming a sovereign right to carry on borrowing and appears in denial about debt.

Because of the Byzantine budget process, no-one knows when real budget reduction will begin – compounding the likelihood that the world will go on dumping the dollar.

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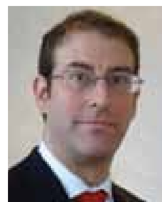

Out of dollar

Diverse trends

Michael Kaimakliotis, Quantum Global

Currency diversification among reserve asset holders is on the rise. The background is provided by Standard & Poor's negative statement on US debt, outlining a probability of at least one-third of a rating downgrade within two years. S&P's rationale appears to be that, to repay massive debts, governments that can print their own currency may adopt policies that risk hyperinflation and possible default – and that they may even choose default rather than monetise debt.

Even though I believe inflation, not default, is the chief risk, the outlook for owners of US Treasury securities is not particularly bright, especially where dollar holdings represent a currency mismatch. It's not surprising therefore that the IMF's latest data on reserve holdings, giving the position at end-March, showed that the proportion of new reserve currencies in 'allocated reserves' (for which the currency is revealed by the holder) once again rose sharply.

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Systemic reorganisation

Foreboding tempered by hope

David Marsh, Co-chairman

There is an unmistakable cloud of foreboding overhanging the world economy – but the positive aspects, too, cannot be ignored altogether. The OMFIF Bulletin for May tries to take note of these apparently contradictory developments. The rise in the price of gold and other commodities – although tempered by a sell-off earlier in May – offers the chance, according to our advisory board chairman Meghnad Desai, of a reorganisation of the world money system in which the yellow metal would play an important de facto and even de jure role.

This has implications for Europe, too. Stephane Deo, a new advisory board member, chief European economist for UBS, outlines how the large increase in the value of the Eurosystem's gold acts as an important buffer against potential losses on the European Central Bank's purchases of peripheral county bonds. A gold lining, indeed. Mind you, that may not appeal to the Germans who (followed by Italy and France) are the main owners of gold in Europe – and may not be keen to share revaluation profits.

The slow, steady transition towards a multi-currency reserve system – likely to be promoted by the negative S&P view on US debt – is analysed by Michael Kaimakliotis of Quantum Asset Management, who points out that the fall in the dollar's share of world reserves as itemised by the IMF has been accompanied not by a shift into the euro but by a move into non-standard reserve currencies. The Swiss National Bank, for example, has become the first mainstream European central bank to reveal its purchase of such non-standard currencies. It now holds a small number of Singaporean dollars – as well as a lot of euros.

Andy Seaman of Stratton Street points out how analysis of net foreign assets as applied to euro area countries would have helped fund managers make better returns on their European fixed income portfolio. Greece is uppermost in the mind of Stefan Bielmeier who outlines why bond restructuring should come sooner rather than later to prevent too much debt ending up in the hands of the public sector.

In the US, Darrell Delamaide explores how Bernd Bernanke has used the new, apparently open Fed tone to burnish his scholarly image. China-watcher Jonathan Fenby believes Beijing has now become inured to higher inflation – a crucial factor determining the future direction of the renminbi. In Africa, Malan Rietveld looks at some seminal personnel changes at the South African Reserve Bank and ponders on lessons for other countries.

In issues of regulation and banking structures, we have in-depth coverage from Michael Lafferty and John Plender of the implications of the interim report of the UK Independent Commission on Banking. Neil Courtis looks at the wider repercussions of Basle III, while Peter Norman investigates how some of the unsung heroes of the financial crisis – central counterparty clearing houses, or CCPs – could themselves become systemic risks unless they heed the lessons of experience.

Overshadowing the path of the IMF is the vexed question of if and when managing director Dominique Strauss-Kahn will resign to fight an election in France, and who will replace him – offering an opportunity for bitter-sweet reflections from William Keegan. Harold James closes with a look back at monetary history through the eyes of 19th century English essayist Walter Bagehot, perhaps pointing us towards the past and future in the direction of a two-speed euro.

David Marsh

Ad

The message of the gold price rise *(continued from page 1 ...)*

The gold market reflects these trends. The 93 tonnes of bullion purchases worth $4.5bn by the Mexican central bank in February and March – following earlier large accruals by Russia, China and India – sends the same message. Gold rose on in a single day on 29 April by $32 to $1,563 having risen 7.5% in 30 days and around 30% since the start of the year, although it slid to below $1,500 in early May.

Of course, the rise is smaller in terms of sterling and the euro. But the signal is clear: we need reform of the international monetary system to lower dependence on the dollar since yet again, 40 years after the collapse of the Bretton Woods system, the Americans cannot be trusted to implement fiscal discipline.

There have been many proposals to let the IMF devise a multilateral currency and/or act much more actively as a bank (not a central bank) that can be used as a parking place for surplus reserves of countries which have to resort to purchasing dollar Treasury bills at present.

The IMF needs to be able to issue liquid safe assets which central banks can keep in their reserves. Now it can offer solely the SDR – a drawing right, not a real currency which can be a means of payment and a store of value.

The SDR needs to be expanded both in terms of the supply available and its usefulness as a multilateral currency. In view of its composition comprising the dollar, euro, yen and sterling, the SDR is more stable than a single currency, but the question remains whether any of the four can be trusted by investors in maintaining purchasing power. Gold has the enviable reputation of having engendered stable prices in the UK under the Gold Standard between 1660 and 1931. (There were ups and downs, but mostly when the Bank of England had gone off gold – 1797-1815 for instance and 1918-1925.)

The world cannot go back to gold as a base for a global currency. Annual production is too small in absolute terms and in relation to the stock. Supply fluctuations will depend on individuals dishoarding their gold stocks as they take profit from price rises. Its guarantee of price stability is vitiated by income and employment instability. But gold can play a supporting role.

One way to do this would be add gold as a fifth 'currency' in SDR. There is a problem that if an owner were to present SDR to the IMF, it cannot be repaid in gold. But a scheme could be devised whereby the holder country will be paid in whichever currency it demands plus the value of gold in that currency depending on the fractional part of gold in the SDR. For example, if gold is weighted at 25%, the SDR could be cashed for currencies up to 75% with an additional 25% made up of the value of gold in that currency.

A 'gold lining' to the SDR would make it much more attractive as a store of value, prompting countries to exchange their surplus reserves for SDRs from the IMF, which could then become a proper bank by lending the deposits to needy countries at commercial rates. The world needs better global economic governance. The costs of the dollar standard are becoming too large.

Out of dollar *(continued from page 1 ...)*

What the IMF describes as 'other currencies' – which are largely emerging market and commodity currencies – now make up 4.3% of these allocated reserves up from 1.4% in as short a time ago as end-2007. Perhaps surprisingly, the rise in these currencies' reserve share fully accounts for the fall in the dollar proportion from 64.3% to 61.4% over the same period. Indeed, the share of reserves held in euro has remained steady at 26.2%.

Four trends will probably support continuing accumulation of reserves in emerging market currencies.

First, emerging markets are becoming larger and more liquid, making it worthwhile for reserve managers to pay attention to them. Second, the opportunity cost of holding reserves in the main currencies has been rising as interest rate differentials have grown. Central banks have great incentives to minimise losses associated with their reserve policies as their profits and losses are normally regularly reviewed by politicians and media.

Third, countries are getting smarter and thinking about asset-liability management rather than using a single reference currency for their portfolio. It makes little sense for countries to hold all of their reserves in dollars together with other established currencies such as the euro when the US and European share of global GDP will be eclipsed by those of the emerging economies within a decade. (What matters is less the currency of trade, rather than the risk of shortfalls caused by adverse currency movements. Even though oil is priced in dollars, holding reserves in dollars to purchase oil is not logical. Oil prices rise when the dollar falls).

Fourth, and most importantly, reserve managers are speculating on major changes in currency values. They believe that they can pick winners and losers. And the consensus clearly dislikes the major currencies.

With overall reserves accumulation showing no signs of ending, this trend is likely to become increasingly important. The 196% growth in 'other currency' reserves holdings between end-2007 and March 2011 amounted to a reallocation of a mere 3 percentage points. If these growth rates are repeated over the coming three years, the effect would be much larger, although the change depends on aggregate reserve accumulation.

In this environment, emerging market currencies will remain well supported, and credit spreads are likely to shrink. But investors must be careful. On the date that S&P announced its new outlook, emerging market currencies sagged and credit spreads widened as risk aversion rose – a development that represented a buying opportunity for strategic investors.

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Problem of investment concentration

Constructing a portfolio to overcome debt risks

Andy Seaman, Fund manager, Stratton Street

A major cause of debt accumulation is the perverse construction of bond indices whereby the greatest weight is given to the biggest debtors. As a country becomes more indebted, their weight in the index increases, whereas smaller, well-run economies with little debt have very low representation. As most fund managers benchmark themselves against these indices, this means that the more indebted a country becomes, the greater the weight in the fixed income index and the more fund managers need to acquire that debt to match their index.

A measure of net foreign assets (NFA) should be used to work out which countries are wealthy and which countries are indebted. On this basis Qatar, for example, is one of the wealthiest countries in the world with a net foreign asset surplus of 263% of GDP. At the other end of the spectrum countries such as Greece, Portugal and Spain have net foreign liabilities of more than 100% of GDP – a figure indicating the need for considerable caution.

To overcome the problem of indebted countries becoming ever larger proportions of an investor's portfolio, I would recommend a mechanism along the lines of the WONDA model, which stands for Wealthy of Nations Debt Adjustment. By scaling a country's index weight by 1 + the NFA number we give a greater weighting to the wealthiest countries and a zero weighting to countries with net foreign liabilities of more than 100% of GDP. The Bloomberg / EFFAS (European Federation of Financial Analyst Societies) weights for countries in the euro area and the WONDA adjusted numbers for 2011 are shown in Table 1.

The WONDA weights change each year and, by using historical performance data for each country with the Bloomberg/ EFFAS indices, performance of the two indices can be calculated. We would hope that the WONDA-adjusted model provides better returns for investors.

The performance of each index as applied to investment in euro area countries is shown in Table 2. (Please note that the Bloomberg / EFFAS indices for Greece start in December 1999).

In the early period of monetary union the two index models showed negligible difference in performance. First, the level of indebtedness of each country was similar, with the Netherlands having a net foreign liability of 17% of GDP and Spain 24% of GDP in 2000. Secondly, the returns for each country differed only marginally in the early period. For instance, in 2000 Spain returned 7.23%, France 7.21%, Belgium 7.20% and Germany 7.43%. Small weighting changes combined with small performance differences makes very little difference to the total return for each index for the first few years.

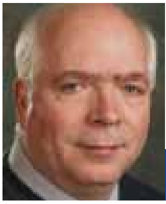
However, Spain, Portugal and Greece saw their indebtedness rise steadily in the lter years of euro membership, which meant that their relative weights declined each year. In the case of Greece and Portugal their weights had dropped to zero by 2007 and this happened to Spain in 2008. Consequently the WONDA-adjusted performance is vastly superior to the unadjusted index. In 2010, the WONDA-adjusted index outperformed by 3.6%, which is a substantial difference.

Table 1 - Applying NFA adjustment to portfolio weights

Country	Bloomberg/EFFAS euro area weights	WONDA-adjusted weights	Change
Austria	4.11%	4.19%	0.07%
Belgium	6.03%	8.73%	2.69%
Finland	1.32%	1.18%	-0.14%
France	21.41%	24.88%	3.48%
Germany	21.00%	34.69%	13.69%
Greece	3.53%	0.00%	-3.53%
Ireland	1.69%	1.29%	-0.40%
Italy	23.62%	17.56%	-6.05%
Netherlands	5.37%	7.47%	2.10%
Portugal	2.08%	0.00%	-2.08%
Spain	9.83%	0.00%	-9.83%

Table 2 – How the debt adjustment portfolio model has worked for euro area

Year	Bloomberg/EFFAS	WONDA-adjusted	Diff
2000	7.51%	7.48%	-0.03%
2001	5.51%	5.49%	-0.02%
2002	10.26%	10.19%	-0.06%
2003	4.14%	4.11%	-0.03%
2004	7.79%	7.73%	-0.02%
2005	5.41%	5.41%	0.00%
2006	-0.35%	-0.34%	0.00%
2007	1.79%	1.78%	0.00%
2008	9.39%	10.40%	1.01%
2009	3.51%	3.18%	-0.33%
2010	-1.87%	1.73%	3.60%
2011	-2.49%	-2.59%	-0.10%

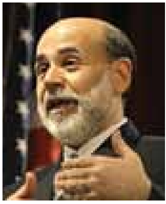


Prof. Bernanke holds class

Fed chairman strives for dull - and succeeds

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation.



Ben Bernanke

Fed chairman's message: Steady as she goes

Federal Reserve chairman **Ben Bernanke (voter)** clearly was striving for dull in the central bank's first-ever scheduled press conference, and he succeeded. The former university professor set the stage as a one-room schoolhouse with himself as teacher seated at a small desk and mini-podium, fielding questions in an unruffled and largely academic manner. It helped that the docile Washington press corps was appropriately deferential and served as a role model for well-behaved schoolchildren – in contrast to, say, the congressional committees that Bernanke regularly testifies before, which are somewhat more unruly.

On the whole, Bernanke reinforced the 'steady as she goes' message of the formulaic statements from the Federal Open Market Committee. The end of QE2 – the Fed's second round of 'quantitative easing' – would have little impact on markets, Bernanke said, because they've known about it for eight months. Besides, the overall size of the Fed's balance sheet will remain the same, as it reinvests the principal in new securities purchases, Bernanke said, quietly affirming what everyone had presumed. At some point, the FOMC in its wisdom, will 'exit' from this easing stance and reduce the size of the balance sheet when it stops reinvesting all or part of the securities that are maturing. 'But take note,' the schoolmaster said, 'that that step, although a relatively modest step, does constitute a policy tightening.' This will be on the test.

The professor chairman gently deflected questions about the dollar by pointing out to his wayward students that the US Treasury Department is responsible for exchange rate policy. In the medium term, the Fed supports a strong dollar by maintaining stable prices and fueling a strong economy, he lectured. When a recalcitrant student noted that the dollar rate has been somewhat volatile in a downward trend, the professor acknowledged that yes, indeed, it does fluctuate in the short term. 'One factor, for example, that has caused fluctuation has been the safe haven effect.' Money flowed into Treasuries during the financial crisis and drove up the value of the dollar. The recent decline is just the unwinding of that, as uncertainty has been reduced. 'That's indicative, I think, of the high standing the dollar still retains in the world,' the professor concluded.

Class dismissed.

Janet Yellen

Fed still sees commodity, food inflation as 'transitory,' Yellen says

At his press conference, Chairman Bernanke reiterated the Fed's view that the rise in commodity prices is transitory and not the harbinger of a more generalised inflation. This view, at odds with that of the European Central Bank, which raised interest rates in April in a preemptive strike against inflation, were expounded at length by Fed vice chairman **Janet Yellen (voter)** in a speech in New York. She expects the recent increases in commodity prices to have only fleeting effects on headline inflation. 'The current configuration of quotes on futures contracts – which can serve as a reasonable benchmark in gauging the outlook for commodity prices – suggests that these prices will roughly stabilise near current levels or even decline in some cases,' she said in mid-April.

Yellen acknowledged there would be some pass-through effects as firms reflect at least part of these increased raw materials costs in prices they charge their customers. But these, too, are likely to be 'modest and transitory,' she said. Labour costs, the single largest component of producing goods and services, are essentially unchanged since 2007, she noted, and likely to remain so. 'It would be difficult to get a sustained increase in inflation as long as growth in nominal wages remains as low as we have seen recently,' she said, repeating the recent mantra of Fed economists.

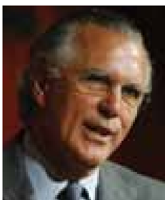
Nonetheless, the Fed vice chairman insisted, the central bank remains vigilant. 'The FOMC is determined to ensure that we never again repeat the experience of the late 1960s and 1970s,' Yellen said, 'when the Federal Reserve did not respond forcefully enough to rising inflation and allowed longer-term inflation expectations to drift upward.'

James Bullard

Bullard downplays focus on 'core inflation'

One Fed policy maker generally considered to be dovish-leaning, St. Louis Fed president **James Bullard (non-voter)**, has been sounding more hawkish of late. In as recent presentation in Louisville, Kentucky, he cautioned against the central bank's reliance on its concept of 'core inflation.'

'From 2003-2006, core inflation was consistently below headline inflation,' he said in a power-point presentation. 'Core was not a good indicator of headline during this period,' he added, noting that four years is a 'substantial' period. While the Fed tends to use core inflation, which eliminates volatile food and energy prices, as a predictor of headline inflation, Bullard said, it should not be the focus of monetary policy.


Richard Fisher

Fisher warns against prolonging quantitative easing

While most observers don't expect any immediate tightening by the Fed, one FOMC member, Dallas Fed chief **Richard Fisher (voter)**, is eager to exit from quantitative easing very quickly. He opposed QE2 at the time, and now, he thinks, even those who thought more liquidity was necessary must see that the central bank has done enough. 'Having done our job, I see many risks to the Fed overstaying its welcome,' Fisher told a conference of business journalists in Dallas.

The Fed must avoid even the perception that it is in any way acting to monetise federal government debt with its purchases of Treasury securities, Fisher said. 'Throughout the history of nations, monetising the budgetary excesses of governments has proven to be a direct path to economic perdition,' said Fisher, who has a broad background in banking and government. 'Having already peeked inside that door, I feel strongly that we must now shut it, lock it and throw away the key.'

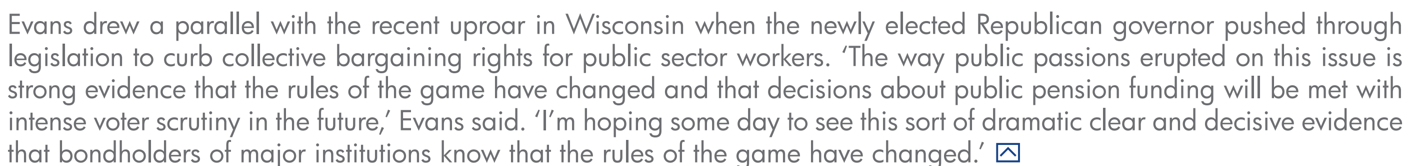
Charles Evans

Evans worries that 'too-big-to-fail' problem persists

Wearing the Fed's bank regulator hat, Chicago Fed president **Charles Evans (voter)** is worried that US financial reform legislation has failed to solve the problem of banks deemed too big to fail. 'What I'm looking for is evidence that there's been a sea change in investor expectations,' Evans said at the annual Hyman Minsky Conference sponsored by the Levy Economics Institute at Bard College in New York. 'To date, though, I haven't seen very strong evidence that these investors get the message.'

Evans is not convinced that the so-called resolution authority in the Dodd-Frank Act, which leaves actual terms to the discretion of regulators, goes far enough in removing the semblance of a government guarantee from the large banks. 'Will creditors today believe that this discretionary process will force them to take losses in some future crisis?' Evans asked rhetorically. 'I'm not sure.'

Evans drew a parallel with the recent uproar in Wisconsin when the newly elected Republican governor pushed through legislation to curb collective bargaining rights for public sector workers. 'The way public passions erupted on this issue is strong evidence that the rules of the game have changed and that decisions about public pension funding will be met with intense voter scrutiny in the future,' Evans said. 'I'm hoping some day to see this sort of dramatic clear and decisive evidence that bondholders of major institutions know that the rules of the game have changed.'



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Learning to live with inflation

Credit, food and wages behind Chinese price rises

Jonathan Fenby, Advisory Board

The Chinese authorities appear to have accepted that a higher inflation rate is an inevitable outcome of their broader economic strategy. The days when consumer prices in the People's Republic were increasing in the 2-3% range are past. Instead, the target is 4%, but this spring has seen year-on-year increases of more than 5%.

Higher inflation is now part of the Chinese landscape – and the consumer price index captures only part of the boom in real estate prices.

Higher inflation is now part of the Chinese landscape – and the consumer price index captures only part of the boom in real estate prices. Three main factors lie behind this shift – credit, food and wages. The 2009 credit surge in which banks advanced $1.3tn in new loans has led to high liquidity, pushing up asset prices across the board – from property to fine French wines. The government is now trying to bring this under control, but – as Prime Minister Wen Jiabao said recently – it's tough getting the tiger back in the cage.

Bad weather and other temporary factors produce recurrent food price spikes. Last winter it was vegetables and fruit, then pork, with Chinese medicine prices jumping in the spring. But there are also deeper structural factors. Middle class food demand has become much more varied, with sharp increases for meat and dairy products. And rising wages for blue collar workers are spurring demand for more basic foodstuffs.

The supply side is deficient. Arable land shortages are growing under the impact of urbanisation, infrastructure development and desertification. Pollution is affecting farms. Water is short in northern China, especially around Beijing. Food distribution logistics are inefficient. Lack of ownership rights for farmers who hold their fields on a leasehold basis – while all farmland belongs to the state – creates distortions and prevents large-scale more efficient farming.

Alongside the food problem, the government's policy of raising blue collar workers' wages from last summer is starting to feed through into price rises. The official line is that this will be absorbed by increased productivity and the move of manufacturing from high-wage southern provinces to cheaper central and western China. Population growth is slowing, but the country still must create at least 10m jobs a year to maintain employment required for social stability. The move to central China brings lower wages but, if substantial increases in minimum pay continue, the effect will be diminishing.

Since growth is likely to outstrip the 7% target for the Five Year Plan launched this year, 4-6% inflation may not look dangerous. But what happens if it spikes up further and spreads from food to manufactured goods? Already there are anecdotal reports of substantial wage pressure on the big city service sector.

Higher inflation gives the authorities a strong argument against appreciation. The 4% inflation gap with the US, on top of a nominal 3-4% annual increase in the renminbi against the dollar, produces a real rise of 7-8%, doubling the Chinese currency's value over 10 years. A bigger appreciation would bring anti-inflationary benefits, but keeping the export sector healthy after the first quarter trade deficit remains an important objective. If food problems lead to considerably higher buying on world markets, especially of animal feed, the argument for faster appreciation would gain strength. Financial markets repeatedly gear up for a big one-off renminbi revaluation, yet there's no sign that policy has changed.

China has lived before with an undervalued currency and inflation averaging 4-5%. In the background lurks the memory of the huge mid-1990s rises in the consumer price index. So the government is working case-by-case, using methods ranging from constraints on cabbage prices to offers of fuel subsidies for road haulage firms and loan-monitoring at the big banks to rein in credit. Beijing wants to smooth the economic path to the leadership transition starting in October 2012. As always in China, this is a long-term game with much to play for.

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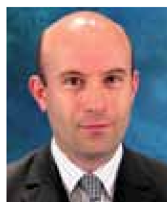

Gold offset for ECB losses

Bond purchase write-downs look manageable

Stephane Deo, Chief European Economist, UBS

The end-2010 recapitalisation of the European Central Bank via a doubling of its capital to €10bn has raised the debate on the risks to its balance sheet from the present uncertainties surrounding economic and monetary union (EMU). An analysis of the potential losses – estimated at around €10bn in the case of the sovereign debt purchases started in May 2010 – shows these are manageable.

The €5bn capital increase announced in December is essentially pre-emptive. The ECB can probably avoid further recapitalisation even if it was found to hold toxic assets on its balance sheet. The Eurosystem stock of gold increased in value by €100bn last year, which could more than offset potential losses.

The ECB can probably avoid further recapitalisation even if it was found to hold toxic assets. The Eurosystem stock of gold increased in value by €100bn last year, which could more than offset potential losses.

Analysis of the issue is complicated by the fact that we need to look at the balance sheet of the ECB and the member central banks (17 with Estonia which joined in January). The overall Eurosystem capital is €78bn, considerably more than that of the ECB itself. None the less, concerns have arisen about possible default by euro member states. The asset side of the ECB balance sheet could be affected in at least three ways.

First, through the securities markets programme launched in May 2010, the ECB bought €73.5bn of sovereign paper until the end of 2010, accounting for 3.7% of its balance sheet. It purchased sovereign paper in the market, probably at an average price of 75-80 cents per euro. This means that if a country defaulted and assuming a 35% write-down, the ECB would lose 'only' 10-15 cents per euro, not 35 cents, making a loss of €9.7bn. This assumes that all the bonds in the ECB portfolio would suffer the same write-down. Probably about 65% of the bonds bought by the ECB were Greek bonds, 20% Irish and 15% Portuguese. So the losses would be made up by €6.4bn from Greece, €2.0bn Ireland and €1.5bn Portugal.

Second, via the €60bn purchase programme for covered bonds decided in June 2009 (3% of the ECB balance sheet), the ECB has built up risk exposure that is independent from sovereign debt problems and is almost certainly much smaller. The bond purchases have been spread on all European countries. Their design makes losses on these instruments rather unlikely and anyway limited. Indeed, this programme may have been a good investment for the ECB.

Third, another source of risk comes from the ECB's repurchase operations. If a bank was to default, the ECB would keep the collateral but would probably incur a loss in realising these assets. In 2008, five banks (Lehman Brothers Bankhaus AG, three subsidiaries of Icelandic banks, and Indover NL) defaulted on the repo operations. The amount involved was €10.3bn, and the ECB passed €5.7bn of provisions against impaired assets. As of the end of 2010, repo operations amounted to €546bn, 27% of the ECB balance sheet. Repos are inflated at the end of the year and the total amount will probably fall to around €450bn in the near future, below 25% of the ECB balance sheet.

In the case of default, the ECB is protected twice. The collateral is pledged at market price, so at a discount in the case of government paper from peripheral countries. In addition, the ECB applies a its own discount which varies from 0.5% to a massive 69.5% – much more severe than at the time Lehman defaulted. So the ECB balance sheet is probably much better protected now.

It is worth pointing out that, in extremis, the ECB can turn to revaluation of assets in its balance sheet. The Eurosystem has a lot of gold: 345m fine troy ounces at the end of 2010, which at the spot price of €1055/ounce was worth €367bn. Gold is marked to market in the Eurosystem. Since its bullion was booked at €267bn at the end of 2009, an increase of around €100bn could be booked in the 'revaluation accounts' for 2010 alone.

Risks rise for global upswing

Commodity prices and fiscal policy in the spotlight

DZ Bank Economic Forecasts

GDP growth	2010	2011	2012
US	2.9	2.6	2.7
Japan	4.0	-1.7	2.5
China	10.3	9.2	8.7
Euro area	1.7	1.5	1.5
Germany	3.6	2.8	1.8
France	1.5	1.4	1.7
Italy	1.2	0.8	1.1
Spain	-0.1	0.5	0.7
UK	1.3	0.9	1.6
Addendum			
Asia excl. Japan	9.3	7.9	7.6
World	4.7	3.8	4.1
Consumer prices (% y/y)			
US	1.6	2.9	2.3
Japan	-0.7	0.0	0.3
China	3.3	5.2	3.4
Euro area	1.6	2.6	2.0
Germany	1.2	2.4	2.1
France	1.7	2.4	2.2
Italy	1.6	2.5	1.8
Spain	2.0	2.9	1.7
UK	3.3	4.0	2.1
Current account balance (% of GDP)			
US	-3.2	-3.1	-3.2
Japan	3.6	2.1	3.3
China	5.2	4.8	4.5
Euro area	-0.6	-0.2	0.0
Germany	5.7	4.9	4.7
France	-2.2	-2.4	-2.0
Italy	-3.0	-2.9	-2.5
Spain	-4.7	-4.6	-4.0
UK	-2.3	-1.8	-2.0

This table and commentary appear by courtesy of DZ Bank, a partner and supporter of OMFIF

Soaring oil prices are causing accelerated inflation around the world. Euro area consumer prices were 2.7% higher in March than a year earlier. The European Central Bank responded by making its first rate hike of the new cycle at the start of April. However, this more restrictive monetary policy comes at an unfortunate time for euro members suffering a severe consolidation crisis.

Some of the peripheral countries are still in recession, and necessary fiscal constraints are already weighing on their economic prospects. Finding an appropriate monetary course is a hire-wire act for the ECB. Members states' economic positions are just too far apart.

Other central banks are under growing pressure to tighten policies to counter strengthening inflation. The economies of many newly-industrialising countries are now heading towards overheating.

By contrast, in the US and UK, the still-uncertain economic recovery is making central banks cautious about tightening policy. Both countries' budgets are still massively in deficit, and public debt is rising rapidly.

While the UK has already put its fiscal policy into reverse, and is implementing a severe consolidation regime, there is no sign of the US deciding similar action. The recent furore over the negative outlook for US debt stated by Standard & Poor's has made clear that international investors will not show infinite patience. So pressure for the US government to take action is likely to grow.

The Chinese economy has made an energetic start to the year. According to official data, economic output in the first three months was up 9.7% compared with the same period of 2010.

The growth rate was only slightly weaker than the closing quarter of 2010. We estimate that on the rolling quarterly basis, China's growth has even accelerated slightly. This means that, despite significant monetary policy intervention, we are still waiting for the Chinese economy to cool perceptibly.

By comparison, fathoming the consequences for the world economy of the catastrophic earthquake and nuclear mishap in Japan remains pretty much guesswork. On the other hand, the impact on the Japanese economy is likely to be immense.

Very little hard economic data for the period after the earthquake has reached the public domain in Japan so far. The March foreign trade data suggest a major slump is on the cards. We remain convinced, however, that the start of reconstruction will inject positive stimulus into the economy as early as the second half of 2011.

Greek restructuring on the cards

Debt shake-up should come sooner than later

Stefan Bielmeier, Head of Research and Chief Economist, DZ Bank

The latest bout of rumours and speculation on the possibility of a restructuring of Greece's sovereign debt has raised risk premia on government bonds in economic and monetary union (EMU). The unscheduled European finance ministers meeting in Luxembourg on 6 May concentrated minds further. When will restructuring happen? What form will it take? A sovereign debt restructuring has to be meticulously planned. And the so-called contagion effects on other EMU member states need to be minimised.

To moderate the impact on other euro countries, Greece's debt restructuring should be delayed until other EMU countries' consolidation efforts are starting to show signs of paying off. Reducing the nominal value of Hellas bonds can only work if the financial market regains confidence in the financial strength of the euro area as a whole.

In addition, reducing aggregate debt makes sense only if the country concerned is within striking distance of reporting a primary surplus. Only on this condition can a restructuring of liabilities sustainably reduce the crippling interest burden that Greece would otherwise have to pay in the years to come. As long as the Athens government remains in primary deficit, the country will remain dependent for funding on the European Union and/or the IMF.

Despite this, there are a lot of reasons for early restructuring of Greece's debt. It looks probable that Greece will not be able to cover its full funding requirement next year but will have to seek additional funding then. There is little chance that investors will be willing to lend the Hellenes more money in 2012. Additional support will have to be discussed next year if not before, or debt write-downs will be on the agenda even before the present aid package runs out.

There are a lot of reasons for early restructuring of Greece's debt. The longer everyone waits, the greater the probability that the bonds will end up in the hands of a central institution in the euro area.

One reason for not delaying a Greek debt restructuring would be to involve as many private creditors as possible. The longer everyone waits, the greater the probability that the bonds will end up in the hands of a central institution in the euro area – either the European Central Bank or some other agency such as the EFSF/ESM rescue funds. In this case, the cost will be spread ultimately among taxpayers, rather being concentrated on private creditors which subsequently suffer losses from what turned out to be a risky investment.

How can a Greek debt restructuring be handled to prevent an incendiary blaze? The first stage of the process must be to clarify whether a default as legally defined has to be prevented or whether it is 'acceptable'. If it is decided that a default must be prevented because of the incalculable effects of a possible chain reaction on the euro, other EMU sovereign bonds and bank bonds, then a Greek debt restructuring could be undertaken on an essentially bilateral basis through a central organisation, such as the EFSF/ESM.

To persuade creditors voluntarily to accept a debt restructuring looks like a very big challenge. Politicians would probably need to threaten everybody with mandatory write-downs. If the decision is to go for a default, then creditors could be forced to waive a proportion of their entitlements. The advantage of this approach would be that Greece's liabilities could fall rapidly and significantly. An alternative would be to reduce the coupons of the outstanding bonds or to give Greece more time to repay the liabilities. The decision makers would need to weigh up the actual size of the debt reduction to ensure that Greece is able to stand on its own two feet again. A write-down of 50% or more is possible.

Decisions on whether to undertake a Greek restructuring, and on the timing and manner of its execution, are the responsibility of politicians. They cannot focus purely on the economic arguments, but need to address the fears and concerns of society as a whole. It appears evident that Greece will have to restructure its debt. This will probably affect all creditors. Financial markets should prepare for this to happen before the present emergency facility runs out.

Route map for separation

UK retail banks face ring-fencing

Michael Lafferty, Co-chairman

The interim report of the Vickers Commission on the future of British banking, published in April, outlines a blueprint for a new type of banking system that will have a powerful impact far beyond the UK. In essence, the Independent Commission on Banking says that banks that wish to offer retail banking services to the public will have to do so through ring-fenced, separately-capitalised subsidiaries. The Commission seems to be setting the stage for a possible full break-up of UK banks, although it will be up to shareholders to decide exactly what happens.

Investors may demand that banks get out of investment banking. Some investment banks could face the kind of funding problems seen by UK merchant banks after the mid-1990s collapse of Barings.

Some say that the experts under Sir John Vickers, former chief economist at the Bank of England, should have recommended full, immediate separation of retail from wholesale banking and that he has given in to the fierce lobbying of the UK's big universal banks. Yet repeatedly throughout the interim report the commission shows sophisticated understanding of the practical realities of universal banking as well as determination to end abuses such as excessive subsidisation of investment banking through retail activities. Individual subsidiaries could face 'additional restrictions…. including limitations on financial links to the rest of the group,' the report states.

The new world envisaged by Vickers may not take effect in Britain for five to 10 years. But UK banks could begin to move in the direction envisaged by the report within a couple of years – not least because the authorities want to curb incentives for excessive risk-taking by universal banks before the next crisis hits global financial markets. Some might even opt for new brands – and separate headquarters , as Citibank did back in the glory days of its individual bank.

So what will be the shape of UK banking, assuming the report's recommendations are maintained in the final report in September? The main structural changes are likely to be:

- Universal banks become holding companies. Logically, they might be expected to opt for a series of separate subsidiaries – for investment banking, corporate banking, insurance, etc.

- Retail banks become separately-capitalised subsidiaries. There will be much scrutiny of intra-group activities, with most being banned. The report focuses on key issues by, for example, asking for comments on whether the retail bank should have its own treasury department. UK banks operating in retail markets abroad will be bound by local laws and will not be obliged to operate through extensions of the UK retail banks. Nevertheless, the chances are they will.

- Investment banking subsidiaries will face higher funding costs. The issue is whether they will continue to be subsidised by the retail banks or instead have to pay market rates for funding – which may well be much higher than normal interbank interest rates. In some cases investors will demand that banks get out of investment banking. Some investment banks could face the kind of funding problems that UK merchant banks encountered after the collapse of Barings in the mid-1990s.

It is not clear yet how foreign banks operating in the UK retail banking market will be affected, but for all practical purposes they are likely to operate as separate retail banking businesses. ING Direct is an example.

Will other countries follow Britain by going for separation? America's new Consumer Financial Protection Bureau, most of whose powers come into effect in July, is carefully studying Vickers and may well use its powers to push the US in a similar direction. However, other countries such as Switzerland, France and Germany where universal banks are a significant force are likely to adopt a wait and see attitude.

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Commission eschews 'Swiss finish'

Defusing the too big to fail problem

John Plender, Advisory Board

The most delicate task facing Britain's Independent Commission on Banking is how to defuse the problem of banks that are too systemically important to fail and too expensive to rescue. In its interim report, the commission chose to differentiate itself from the Swiss National Bank, which is tackling the problem primarily through imposing tough capital ratios on oversize universal banks such as UBS and Credit Suisse. Instead, the British approach will involve ring-fencing retail banking operations while increasing banks' loss-absorbing capacity and improving resolution mechanisms.

The commission was careful to leave open the possibility of stiffer ratios, arguing that its proposal that capital need not exceed international standards was dependent on credible resolution plans and adequate loss-absorbing debt.

The commission's recommendations on capital are less draconian than the so-called 'Swiss finish' and were not regarded as life-threatening by Barclays, HSBC and RBS, the UK based banks with the biggest investment banking operations. The report was also welcomed by George Osborne, the chancellor of the exchequer.

On capital, the commission argues that a 10% equity baseline should become the international standard for systemically important banks and should apply to large UK retail banking operations in any event. This was less than some academics and central bankers had been advocating. And there was relief among bankers at the commission's proposal that capital should be able to be transmitted from retail operations to other parts of a universal bank provided the retail bank maintained minimum capital ratios and loss-absorbing debt.

Yet the commission was careful to leave open the possibility of stiffer ratios, arguing that its proposal that capital need not exceed international standards was dependent on the existence of credible resolution plans and adequate loss-absorbing debt to ensure that the UK taxpayer was not on the hook in the event of failure. That is a substantial caveat.

The most obvious doubts about the Vickers report's approach concern whether it will be enough to protect the taxpayer from the collapse of non-retail banking institutions. Lehman Brothers and Long Term Capital Management were not, after all, retail outfits, yet they raised systemic concerns. While ring-fencing has obvious attractions, the practicalities of defining boundaries within banks that manage legally separate subsidiaries on a group basis will be formidable and potentially subject to arbitrage. Then there is the question raised by Martin Hellwig, director of the Max Planck Institute: which retail subsidiary chief executive will stand up to the chief executive of the holding company if the latter asks for something he should not ask?

The report has relatively little to say about behavioural issues, most notably the fact that bank executives and shareholders are obsessed with return on equity, a metric that can readily be boosted by leverage. Pay and incentive structures in banks remain heavily biased towards performance yardsticks related to profits and equity returns, so people running systemically important institutions still have a strong motive to take on more risk and press hard against regulatory boundaries.

Loss-absorbing debt remains experimental territory. Despite the recent success of Credit Suisse's issue of contingent capital, many investors continue to ask how such debt will perform in stormy weather and question how much demand exists for the paper.

The Vickers commission does not have an answer to the problem of the flawed risk-weighting methodology at the heart of the Basel capital regime and nor does anyone else. The other over-riding concern, which applies to all efforts to re-regulate the system since the financial crisis, is that we are light years from international agreement on many of the most sensitive regulatory issues on the agenda, so the scope for regulatory arbitrage is all too obvious. The fear must be that taxpayers everywhere may still be on the hook, despite the efforts of Sir John Vickers and all the others working to make the system crisis-proof.

OMFIF Advisory Board

Bolkestein and Deo join Advisory Board

Frits Bolkestein, the leading Dutch Liberal politician and former European Commissioner for internal market affairs, and Stephane Deo, chief European economist at UBS, have joined the OMFIF Advisory Board. They join other new members of the now 64-strong body, including John Hughes, Robin Humphries Fellow for the Study of the Americas at London University; Isabel Miranda, Latin America adviser at BP; and Sabrina Wong, a former asset manager at Bank Negara Malaysia.

Meghnad Desai*

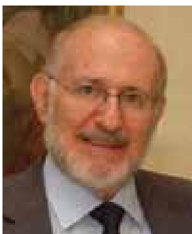
Songzuo Xiang**

John Nugée**

Frank Scheidig**

Katinka Barysch

Paul Boyle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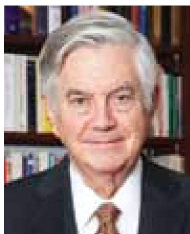
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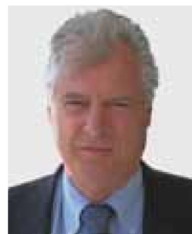
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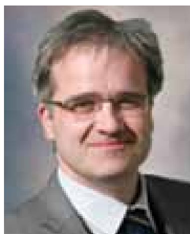
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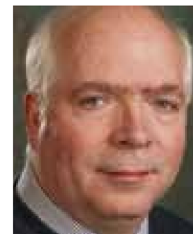
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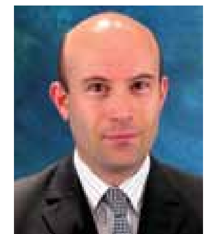
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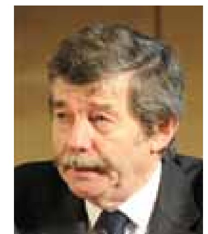
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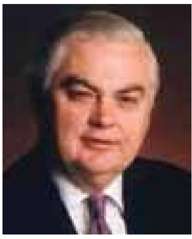
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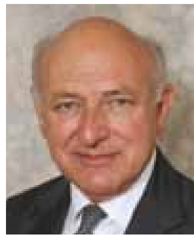
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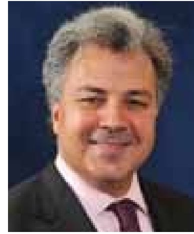
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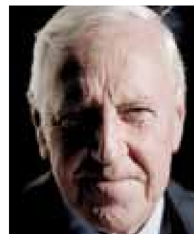
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John West

Ernst Welteke

Derek Wong

Sabrina Wong

Advisory Board members perform a variety of tasks including participation in seminars and speaking engagements for OMFIF's clients and members. For details contact omfif.secretariat@omfif.org

** Chairman* *** Deputy Chairman*

Looking ahead – 2011 diary dates

OMFIF Lecture with
Dr Jürgen Stark
European Central Bank
11 May 2011, London

OMFIF Seminar with
Dr Lorenzo Bini Smaghi
European Central Bank
26 May 2011, London

OMFIF Lecture with
Miroslav Singer
Czech National Bank
28 June 2011, London

OMFIF/Lafferty Conference
The World Banking Summit
29-30 June, London
New Models for Growth

OMFIF Seminar with
Philipp Hildebrand
Swiss National Bank
4 July 2011, Edinburgh
Swiss Franc's Role in World Money

OMFIF Meeting with
South African Reserve Bank
22-23 August 2011, Pretoria

OMFIF Meeting
Luxembourg Monetary & Finance Week
12-16 September 2011, Luxembourg

OMFIF Lecture with
András Simor
Hungarian National Bank
6 October 2011, London

OMFIF Meeting
Asian Central Bank Watchers' Conference
1 November 2011, Kuala Lumpur

Not eliminating risk, but controlling it

New expanded role for clearing houses

Peter Norman, Author

There were few obvious heroes following the collapse of Lehman Brothers in September 2008. Central counterparty clearing houses, or CCPs, were among the very few organisations to emerge from the resulting global financial crisis with their standing enhanced. In the chaotic aftermath, they helped avert financial Armageddon by completing trades worth many trillions of dollars in a multitude of financial instruments around the globe. However, doubts have started to surface whether the new front-line attention given to CCPs – which mitigate the effects of defaults in markets by interposing themselves between counterparties as the buyer to every seller and the seller to every buyer – might itself be inflating rather than diminishing risks in the financial system.

CCPs have an important role in contributing to a safer financial system, so long as the big systematically important CCPs are kept free of the risks of moral hazard that have infected other comparable institutions.

As the financial crisis unfolded, regulators and politicians fastened onto these hitherto little-known financial market utilities as a way of averting future financial disasters. Previously a back-office issue of interest only to technical specialists, CCPs became the stuff of high politics. Clearing was propelled on to the agenda of G20 summits, and became a central feature of the new wave of legislation and regulation for taming financial markets.

Clearing houses were seen as a way of mitigating risk in the $600tn global market for over-the-counter derivatives. These financial instruments, mainly traded among a few big systemically important banks, were blamed for exacerbating the crisis and necessitating a $180bn US tax-payer bail-out of US insurance group AIG. Central clearing of OTC derivatives formed a large part of the July 2010 Dodd-Frank Act for reforming US financial markets and of the proposal for a European Markets Infrastructure Regulation (EMIR).

And now second thoughts have started to surface. In March, Manmohan Singh, a senior IMF economist, warned in a Fund working paper that 'forcing' OTC derivatives into clearing houses was a 'huge transition' that would turn CCPs into 'derivatives warehouses or concentrated "risk nodes" of global financial markets.' In early April, Fed chairman Ben Bernanke observed that clearing houses had generally performed well in the crisis only to add: 'However, we should not take for granted that we will be as lucky in the future.'

These words of caution are welcome. A recurring theme in '*The Risk Controllers*', my newly published book on clearing*, is that CCPs concentrate risk. Rather than eliminating risk, clearing controls risk, which is concentrated in the CCP and mutualised among its clearing member firms. CCPs' generally good performance after the Lehman bankruptcy involved some luck and improvisation. Even more luck was needed following the Wall Street crash of October 1987. Although rare, there were clearing house failures before then. Added to this, many risks now destined for clearing are complex, underlined by credit default swaps.

On the other hand, the authorities have become steadily more aware of the risks embedded in CCPs and borne by clearing house member firms since they began to grapple with moving OTC derivatives onto clearing houses. These risks were recognised in the Dodd-Frank act, the EU's draft EMIR regulation and the Basel III bank rules. In March, the BIS Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of International Organisation of Securities Commissions (IOSCO) put out for consultation 24 principles for Financial Market Infrastructures to serve as global standards aimed at making the world's financial plumbing (including CCPs) better able to withstand financial shocks.

These multifarious initiatives now need to be properly completed and implemented and topped off with a regime for regulating systemically important financial institutions that includes systemically important CCPs. Clearing is a not a panacea. But CCPs have an important role in contributing to a safer financial system, just so long as the big systematically important CCPs are kept free of the risks of moral hazard that have infected other comparable institutions now brought down to earth.

* *The Risk Controllers: Central Counterparty Clearing in Globalised Financial Markets*, April 2011, John Wiley

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Mega-crisis, micro-reaction

Basel III response masks serious weaknesses

Neil Courtis, Advisory Board

Financial crises, like natural disasters, don't have a script, but do follow patterns. Once the initial threat passes, those tasked with defending the system typically try and work out what went wrong and then labour to stop it recurring. If you look around the developed world, there is little evidence of a massive crack-down on banks. Banks are too important, and the economies of developed countries still too weak, for policy-makers to bring them to heel with draconian action. The mega-crisis has produced a micro-reaction.

The challenge of financial sector reform is not in the end bureaucratic, but political. Dumping every radioactive issue in international finance into the lap of the Basel Committee clears political 'to do' lists but invites failure.

In this context the Basel Committee on Banking Supervision's success in devising and approving a new international agreement on minimum bank capital in just two years (rather than the decade the previous attempt took) is an impressive achievement. The committee now joins 27 member countries all committed to implement the new Basel III rules.

Basel III will require significant increases in capital in the world's banking system, and will for the first time regulate banks' liquidity. More risks will be included, the definition of capital tightened and a leverage ratio added to act as a backstop. The problem of how to discipline banks without causing the economy to crash has been solved elegantly by a stepped phase-in of the accord over more than a decade. Banks which need more capital will be able to retain earnings over the period. Large interest rate spreads created by super-cheap central bank money will boost profits.

So is the job done? Sadly, no. Some issues are just too big for the Basel Committee to finesse. Here are two:

Too big to fail. Huge taxpayer-funded bailouts have concentrated the minds of policy-makers on fixing banks that are 'too big to fail'. The obvious solution, a size tax, has been judged too difficult to implement. So the hot potato has passed, via the Financial Stability Board, to the Basel Committee, which has come up with a 'methodology' to identify TBTF banks. This looks likely to be a scorecard system which imposes a small capital add-on for around 30 of the world's megabanks. The Committee's reference to 'differentiated' treatment suggests a sliding scale with only a handful of banks facing the full charge.

There are two problems with this approach. First, measured against the most serious financial crisis for generations, it is timid stuff. Second, and much more important, it may actually prove counter-productive. Although the TBTF list will not be published it won't stay secret. Many banks will judge that it is actually advantageous from a funding perspective to be definitively in the TBTF camp. It is not impossible that banks could merge to achieve TBTF status. Hardly what the committee had in mind.

Policing implementation. Ensuring that international agreements are implemented is hard enough when these are backed by treaties with sanctions. The Basel Committee is essentially a gentleman's club and members don't find it easy to police each other. In the past those who have experienced regulatory catastrophes are more likely to receive tea and sympathy than censure from their peers. The IMF has been trying to police members' financial regulation for years through its Financial Sector Assessment Programme launched in 1999. The US refused to participate and there was, and remains, nothing anyone could do.

Given that the Basel Committee's work represents the cornerstone of the international response to the financial crisis these are serious weaknesses. More lurk in the detail. The fault is not with the Basel Committee, whose members display the archetypal qualities of the 'busy man' loaded with jobs only because their counterparts are ineffective. The challenge of financial sector reform is not in the end bureaucratic, but political. Dumping every radioactive issue in international finance into the lap of the Basel Committee clears political 'to do' lists but in the end invites failure. With clear public mandates to fix financial sector weakness, treasury departments and governments should have done much better.

Africa watches personnel changes

Reserve Bank shake-up a landmark

Malan Rietveld, Chief economist

The South African Reserve Bank (SARB) has experienced a quiet internal shake-up with a string of new appointments to important senior positions. Central bank watchers and the financial markets have reacted to the change in personnel with a collective shrug of the shoulders. The Reserve Bank's policies appear to have gained predictability. In short, rules and principles trump personalities.

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Achieving what all hope will be a problem-free transition is an important challenge. How the bank handles the change-overs will be watched beyond the country's borders, given South Africa's landmark status in African central banking and its recent elevation to the informal bloc of pioneering transition economies, the so-called BRICs. The main changes are:

- Lesetja Kganyago, the influential director-general at the National Treasury, has been named deputy governor. Kgangayo, who takes up his new position on 16 May, is seen as one of the architects of South Africa's prudent fiscal policies and the public face of its international debt issuance.

- Errol Kruger, the highly-regarded registrar of banks, steps down at the end of July after almost eight years in charge of South Africa's banking supervision and 34 years at the central bank. Kruger is widely credited for his role in preserving the stability of the country's banking system. His departure is somewhat unexpected and filling his shoes could prove problematic (his replacement is yet to be named). Kruger was intricately involved in helping South Africa's banks prepare for implementing the Basel accords.

- Dr. Rashad Cassim, the former deputy director-general of economic statistics at South Africa's independent stastics agency, joined the SARB as its new head of research on 1 March. Some observers have questioned his credentials in monetary economics, but he is widely regarded as a hard worker and keen learner, and his appointment is certainly a positive for the central bank.

- At the start of the year, Zanele Mavuso Mbatha took over from Roelf du Plooy as head of the SARB's financial markets department. Du Plooy, a central bank veteran, retired on 1 April.

- Sheenagh Reynolds will serve as the central bank's permanent secretary. Reynolds joined the central bank from the private sector and took up her position on 1 April.

These personnel changes are important. Some are critical functions for policy development and organisational efficiency. Others are vital to the central bank's regular interactions with the financial markets and financial institutions, notably the head of financial markets and the registrar of banks (effectively, the head of bank supervision).

There is a belief that the central bank's success at finding good people to fill key positions has come at the expense other South African economic policy and civil service organisations. Some South African political pundits have questioned whether the National Treasury in particular can afford the brain drain. One of the worst-kept secrets in Pretoria is that the SARB's pay-scale far exceeds those of government ministries in the economic policy cluster, the statistics agency and even other financial regulatory agencies. This, some critics argue, means that the central bank will always end up with the most talented people.

The Reserve Bank faces an important task in ensuring its new recruits adapt to developments in central banking – ranging from technical aspects of monetary economics to the problems of macro-prudential supervision. Notably, Kgangayo, a fiscal policy expert, and Cassim, who has specialised in trade and statistics, will both serve on the Monetary Policy Committee. Learning on the job may be the best way of building up their value for the committee.

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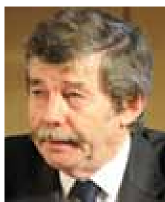

Manners, please, Prime Minister

Cameron was wrong to veto Brown on the radio

William Keegan, Chairman, Board of Contributing Editors

Back in the autumn of 1989 I had dinner with the late John Smith, then Shadow Chancellor, and not yet Leader of the Labour Party, which he became after Labour lost the 1992 British general election. Smith had been a rather successful opponent in the House of Commons of Nigel Lawson, who was Chancellor of the Exchequer from 1983 until he spectacularly resigned in October 1989. When Smith arrived that evening at the bar of London's Garrick Club, the first thing he said to me was: 'I have just had a drink with Nigel. He says he hopes his resignation has ruined the sales of your book.'

I recall this story because it is a reminder of relatively sound relations between the main British political parties two decades ago. Since then, there has been a distinct souring – and this has a deleterious effect on the way international appointments are made.

The episode of autumn 1989 interested me at two levels. First, despite Smith's success in exploiting divisions in the Thatcher government, which helped goad Lawson into resigning, Smith and Lawson remained on friendly terms.

Secondly, the book Lawson referred to was Mr Lawson's Gamble. Lawson and I were also on friendly terms, even though I was often critical of his Chancellorship. As far as I was concerned, his remark about my book, to which he later gave a generous acknowledgement in his memoirs, was a good joke.

The scene shifts to today. The British Prime Minister, David Cameron, was asked on the influential BBC Today Programme whether he would support the candidacy of his Labour predecessor Gordon Brown if the latter wanted to succeed Dominque Strauss-Kahn as Managing Director of the International Monetary Fund.

In response, Cameron made it as plain as a pikestaff that he would not dream of backing Brown, thereby ruining his predecessor's chances.

Behind this latest episode lay a viciousness in British public life which does nobody any credit. There has never been a British managing director of the IMF, although that institution owes its origins in considerable part to the work of the great English economist John Maynard Keynes.

For a serving British prime minister to scotch the chances of one of his fellow countryman and politicians is bad enough. But the manner in which it was done reflects poorly on Mr Cameron. He could easily have brushed the question aside and said – which was certainly true – 'There is no vacancy'. For, although last month's World Bank/ IMF spring meetings resounded with speculation about whether (or when) Mr Strauss-Kahn would declare his candidacy for the French presidential election, he has not up to now done so.

I am not suggesting that all the blame for the breakdown lies with Cameron. One suspects that the personal animosity between Cameron and Brown is mutual. But the substantive reason for Cameron's effective veto is blatantly political. The Cameron government blames Brown for the economic crisis, as if what Strauss-Kahn terms 'The Great Recession' had made no contribution.

This is a gross misrepresentation, although it suits Cameron and his Chancellor George Osborne to blame the entire UK fiscal problem on their predecessors – even though they supported Brown's public spending levels at the time. Gordon Brown is recognised around the world for having made a vital contribution to the G7 rescue effort which staved off a much feared recurrence of the Great Depression. But, like the proverbial prophet, he does not seem to be sufficiently honoured in his own country. I am not saying that Brown should be the next IMF managing director of the IMF. But his hat ought certainly to be in the ring.

Cameron made it as plain as a pikestaff that he would not dream of backing Brown, thereby ruining his predecessor's chances. Behind this lay a viciousness in British public life which does nobody any credit.

A monthly foray into monetary secrets hidden in archives

Bagehot points to euro separation

Britain's 19th century thinker reflects on Europe's cultural split: 'No doubt the Teutonic money would be most frequently preferred'

Harold James, Advisory Board

An economic thinker who has made a major comeback in the aftermath of the financial crisis is Walter Bagehot, the 19th century British economist and essayist.

Fed Chairman Ben Bernanke has repeatedly referred to the relevance of Bagehot's rules for the lender of last resort functions of central banks; and the Columbia University economist Perry Mehrling has presented an elegant and convincing updating of Bagehot's rules for central bank operations that depend on securities transactions rather than on the commercial bills of Bagehot's own Victorian age.

It is intriguing to reflect on Bagehot's account of another feature that seems to link the mid-nineteenth century with today's world: the search for supranational money, and its difficulties.

In the 1860s, questions of European monetary unification and a simplification of the world's money were intimately linked. Emperor Napoleon III thought that he provided a solution. He and his advisers had already pushed through the Latin Monetary Union, by which the coinage systems of France, Belgium, Switzerland and Italy were homogenised, with a standard franc or lira coin of a standard weight and purity of silver that would circulate freely in the member countries of the currency union.

The 1867 World Monetary Conference, held in Paris, went substantially further in its ambitions. Only a very slight alteration of parities would be required to bring into line France, Britain and the US, which was just recovering from the massively costly and destructive Civil War.

Bagehot wrote enthusiastically about the new proposals in a tract of 1869: *A Practical Plan for Assimilating the English and American Money as a Step Towards a Universal Money*. In his view, monetary unification would require France to give up a theoretically unsustainable bimetallic base, while Britain would have to give up the odd coinage of twenty shillings to a pound and twelve pence to the shilling. Decimalisation would have provided a rational answer to Britain's monetary arithmetic.

Walter Bagehot

Bagehot gave a fascinatingly modern perspective on monetary simplification. Money, he argued, should not be seen as the creation of the state. 'We commonly think, I believe, that the coining of money is an economic function of government; that the Government verifies the quality and quantity of metal in the coin out of regard to the good of its subjects, and that Government is admirably suited to this task that it is a very reliable verifier.

But in truth, if we look at the real motives of governments, and the real action of governments, we may come to think otherwise. The prevalent notion about coinage is not an economic but a mystic notion. It is thought to be an inalienable part of sovereignty; people fancy that no one but a government can coin that it is nearly a contradiction that anyone else should coin. A superstition follows the act. Coining is called a natural function of government, as if nature would not permit a government without it.'

Bagehot thought it much better to conceive of money as serving the needs of commerce (and of the people more generally) rather than the interests of the state and its rulers.

But he did not simply endorse the scheme for a world monetary union. On the contrary: he wanted to propose a northern, stability-oriented currency, that would leave the periphery with more flexibility. He thought of using American currency instability in the wake of the Civil War in order to give the world the chance of having a currency based on a British-German vision of stability.

Britain could take the opportunity to harness a newly powerful Germany into its monetary orbit, and then associate the US with the new project of a strong currency. As Bagehot put it: 'In that case, there would be one Teutonic money and one Latin money; the latter mostly confined to the West of Europe, and the former circulating through the world.

Such a monetary state would be an immense improvement on the present. Yearly one nation after another would drop into the union which best suited it; and looking to the commercial activity of the Teutonic races, and the comparative torpor of the Latin races, no doubt the Teutonic money would be most frequently preferred.'

Was Bagehot thinking of a reformed, north European euro?