OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

June 2010

Germany confronts monetary coalition

Continent's new disease is euro-schism

David Marsh, Co-chairman

Europe faces a new disease: euro-schism. As the sovereign debt crisis in Europe enters a further round of intensity, Germany is gearing up for confrontation with a strong, perturbed coalition of European governments and central banks over the stability of the euro. The threat is far broader than the important yet essentially technical issues of whether the European Central Bank should purchase European government bonds or relax its criteria for lending to commercial banks – issues that have hogged the headlines for weeks.

Axel Weber, the Bundesbank president, has risked isolation on the 22-member ECB Council by publicly criticising the 10 May government bond decision, a day after it was made in a scrambled early morning telephone conference as an adjunct to the €750bn IMF/European bail-out for weaker states.

Jürgen Stark, the ECB board member who looks likely to inherit Weber's present job if the latter takes over as ECB chief from Jean-Claude Trichet as expected in autumn 2011, has taken a slightly more compliant stance. But Karl Otto Pöhl, the former Bundesbank president, still an authoritative figure on the German financial scene, has rubbed salt into the wounds by saying that European governments and the ECB have fundamentally changed the basis for monetary union.

He foresees further euro weakness, 'because we [the Germans] are effectively giving guarantees for a range of weaker currencies that should never have been allowed to enter the euro.' Pöhl charged that Europe should have announced a Greek debt restructuring six months ago. The bail-out had now been decided, he added witheringly, to protect French and German banks to and to rescue 'rich Greeks'.

In the old days when the Bundesbank held sway over Europe, even the most rebellious Bundesbank Council member would have hesitated before publicly disavowing a monetary policy decision taken by majority vote. Yet, perhaps goaded by Trichet's desire to railroad through the bond decision without sufficient discussion, Weber did not shrink from broadcasting his judgment of 'considerable risks to stability'.

This was the first real split on the ECB council since the euro started. Other leading European central bankers have privately censured Weber for undermining a spirit of consensus built up since Trichet took over in 2003. One reason for Weber's self-confidence must be that his line is backed by German Chancellor Angela Merkel, who last year set down her hostility to monetisation of government debt by the Federal Reserve and the Bank of England.

(continued on page 4 ...)

Contents

Riyal rivalry

Challenge to dollar issuance

A special correspondent

The euro's woes are giving a temporary fillip to dollar borrowing by the US Treasury, which is covering its funding auctions with increasing ease despite investors' longer-term worries about the American budget deficit. Yet the move towards multiple currencies in international borrowing has been accelerating, illustrated by a landmark Qatari riyal-denominated bond issue worth $2.8bn that may herald a new Middle Eastern trend to lower reliance on the dollar.

Qatar's largest ever local currency bond, launched on 1 June, was issued in conventional and Islamic tranches to local banks, and is not intended to be transferable outside the country. But it is likely to be interpreted as a signal that official holders in the Middle East and elsewhere may start to build up Qatari riyals in their reserves – a process that would run parallel to increased official holdings of Asian currencies in recent years [OMFIF May Bulletin, p. 11-20].

(continued on page 4 ...)

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Capping credibility losses

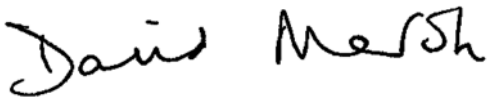
Greek bills and oil spills

David Marsh, Co-chairman

Having grappled for a long period with the dilemma of heaping up dollar reserves when the US currency has often been under pressure on the foreign exchanges, the Chinese monetary authorities are suddenly facing another challenge presented by the weakness of the euro. Perennial reports of the counter-productive effect on the value of Chinese currency holdings of a possible move out of the dollar have now been replaced by equal and opposite conjecture about the repercussions if the People's Republic were to reverse the trend of the past 10 years and diversify again – back into the greenback.

The episode is one further example of the inter-connectedness of the world economy. Greek difficulties are seen by President Barack Obama as a potential cause of a Lehman-style banking collapse, one of the reasons why he intervened last month to ask the European to take action. The euro's weakness is being blamed for a drop in Asian exports to the Old World. But, as we have pointed out before, the single currency's decline has been quite timely as it has helped defuse the simmering China-US discord over the renminbi. The OMFIF Bulletin has always been sceptical about whether large-scale Chinese currency changes have been in the offing; so far, we have been right. Reflecting the travails of European sovereign debt, on a trade-weighted basis, the Chinese currency has been on an uphill path. The complaint that Beijing is 'manipulating' its currency downwards has been looking increasingly hollow. So Washington's campaign to arraign the Chinese for monetary unfairness has melted away like snowflakes in summer. At the time of writing, the Number 1 target on the US authorities' charge sheet is no longer the People's Bank of China, rather a large British oil company whose reserves are disastrously and uncontrollably gushing out into the Gulf of Mexico.

Blow-outs occur in the world of money and central banking, too. The European authorities' efforts to put a cap on the credibility seeping out of the euro project occupies considerable space in the June Bulletin. Asia is taking a self-composed but by no means complacent view of the European problems, as evidenced by the report on the Inaugural OMFIF Meeting in Asia. Meghnad Desai thinks it's time for shifts in world financial power to be translated into an Asian managing director at the International Monetary Fund if and when Dominique Strauss-Kahn, the present incumbent, returns early to France to challenge Nicolas Sarkozy in the 2012 French president election. Strauss-Kahn is a politician. He will be the best judge of whether such such a move makes sense. The traumatic fate of his predecessor-but-one, Horst Köhler, the German financial technocrat catapulted into the symbolically hugely important post of German president, who resigned on 31 May because he felt a failure in his job, may give Strauss-Kahn pause. Sometimes it's better to stay where you are and get on with the task in hand.



Quote of the month

'China is a responsible and long-term investor in the investment of foreign exchange reserves and we will always follow the principle of diversification. Europe was, is and will remain one of the major investment markets for China's foreign exchange reserves.'

China State Administration of Foreign Exchange

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Time for Asian to head IMF

Finding the governance for a multi-polar world

Meghnad Desai, Chairman, Advisory Board

The European debt crisis is throwing up some unexpected opportunities. Not the least is the possibility that it could pave the way for a senior Asian official to become managing director of the International Monetary Fund, breaking the stranglehold Europe has had on the organisation since it opened its doors in 1946. This is the moment for Asia to make use of its impressive economic performance and to challenge the premise that the best person to head the IMF should always be a European.

There is no way that Asia can strike out on its own. An Asian at the helm of the IMF would show that we have all learned our lessons from the past 50 years.

Dominique Strauss-Kahn, managing director since 2007, is well known to harbour presidential ambitions in France. His active stance to promote aid for struggling euro members [May 2010 Bulletin, p. 23] gives him a high-profile platform for a spring 2012 battle with President Nicolas Sarkozy, who is struggling in the opinion polls. There is, of course, the small matter of winning the presidential nomination in France from the warring Socialist party, where Strauss-Kahn is not particularly popular and where party leader Martine Aubry would prove difficult to dislodge.

Despite these hurdles, there is a strong likelihood that Strauss-Kahn, buttressed by a display of financial mastery in Washington, will be heading back towards France next year – leaving a vacancy that Asian heads of government should now be thinking about filling. It may be difficult for China or India to claim the top job and Korea already has the post of the UN secretary-general, so the chances are that the other Asian G20 member – Indonesia – or one of the smaller countries may make the running. Certainly, any thought that a failed European politician – the recently-deposed British prime minister comes to mind – should be discarded. Gordon Brown had his chance in 2006 when Rodrigo Rato stepped down. That was his decision and he should not be given a second bite of the cherry.

Of course, there are good candidates available from Latin America and Africa, but there are three good reasons why world governments should favour Asia. First, Asia has the best claim to enshrine the principle of multi-polarity into the highest echelons of world economic governance. Asia owns two-thirds of world foreign exchange reserves and an increased amount of financial power is now heading Asia's way. Asian countries have to show they can deal with this power sensibly and with responsibility. Ensuring that the top IMF job goes to an Asian would be the best way of ensuring that will happen.

Second, the way of the world is that today's creditor nations set tomorrow's financial architecture. That was certainly the lesson of the foundation of the Bretton Woods institutions, when America, the former upstart, US emerged in the 1940s as the world's richest and dominant power with the highest gold reserves and the most valuable resources. The renaissance of Asia is hardly on a par with that, but America and the West must recognise that Asia's rise needs to be rewarded with a senior seat at the top table.

Third, many senior people in Asia still harbour resentment about the 1997-98 Asian crisis when the IMF handed down extremely tough conditions to the Asian states in return for loans. A lot of this medicine has been far too bitter for the West to swallow itself. There has been understandable head-shaking that latest aid for Greece has been on far less onerous terms. Additionally, the IMF's recent change of heart on capital controls – excoriated in 1998, but now permitted under exceptional circumstances – has also increased the belief that the IMF has learned its lessons from Asia. What better way of confirming this than to propel an Asian to the No. 1 spot in Fund decision-making?

Asia's renaissance in the world growth league tables since the 1960s is a return to past form, a throwback to the pre-globalisation centuries of the Middle Ages. Asia has moved back to centre stage, but in a relentlessly interdependent world, East and West have to learn from each other. There is no way that Asia can strike out on its own. An Asian at the helm of the IMF would show that we have all learned our lessons from the past 50 years.

Germany confronts monetary coalition *(continued from page 1 ...)*

In other areas, too, Germany appears to be taking a steadily more hectoring line. In her latest statement to the Bundestag on 19 May, Merkel said Germany faced an 'existential challenge' over the euro and spelled out with unmistakable candour her plans for the new 'stability culture' in Europe: 'The rules will be geared not to weakest states but to the strongest states.'

When the euro was born in 1999, German leaders warned weaker states that they would have to change their behaviour dramatically. The root cause of the pressures on the euro, indeed, has been the internal disequilibrium caused by individual euro states carrying out policies in line with past stereotypical behaviour. The Germans took refuge in the early 2000s by holding back wages and boosting exports and current account surpluses. Most of the others used the temporary respite of low interest rates and a relatively high exchange rate to step up consumption, employment and imports.

Yet the Germans did not predict that economic stress in peripheral states would feed through directly into financial problems in Germany itself. The financial claims on errant southern nations have inevitably ended up with the surplus countries whose banks are financing the southerners' deficits. Governments' fear of substantial write-downs at these banks has effectively turned the vaunted 'no bail out clause' into a 'no default clause'.

The ECB has largely declined to discuss the impact of internal payments imbalances, hiding behind the comfortable but irrelevant statistical truth that the euro area has a small overall current account surplus. However, in a speech in Rabat on 28 May, Lorenzo Bini Smaghi, a member of the ECB's six-person board, made a rare admission that one reason behind recent unrest was that 'during its first 11 years, the euro area economy experienced a strong convergence in real economic activity together with a significant divergence in nominal cost and price developments, which gave rise to large payments imbalances within the Union.'

Bini Smaghi impetuously took a sideswipe at Germany by criticising how 'in one large euro area country it was thought that public support for swift action [on a liquidity package] could be achieved only by dramatising the situation, for instance, by telling the public that "the euro is in danger" or by considering the possibility of expelling a country from the euro area.'

In remarks clearly aimed at Merkel's recent emotional parliamentary speeches, Bini Smaghi said, 'Such words are like fanning the flames ….the cost of the support package could only increase following such dramatic declarations.' He added: 'The media, of course, have a field day reporting on such apparently inconsistent activities.' The irony was perhaps unconscious. The remarks were immediately seized upon by the Wall Street Journal as one more sign of euro-schism.

Bini Smaghi is not the only senior official to rail against German actions. Jean-Claude Juncker, the Luxembourg prime minister and chairman of the Eurogroup of finance ministers, formerly (but no longer) a close confidant of the Germans, has criticised leading Germans such as Weber, Stark and Deutsche Bank chief Josef Ackermann (who told German TV he doubted whether Greece would repay its debts), recommending them to hold their tongues. Meanwhile uncertainties persist on the disbursement of the €500bn European component of the multinational aid. Anxious to dispel German opposition to subsidising miscreant states, Stark says the money will be disbursed only as a last resort, stressing that the interest rate on each national component of the package will be as high as possible.

Depending on whether or not the bond markets calm down, this could confront the ECB with an intractable dilemma. Either it foments German hostility by continuing to buy bonds of weaker euro states to prevent their yields from rising to crippling levels. Or it will be forced to acquiesce in these states turning to governmental debt because the private markets effectively dry up.

The divergences will continue. The danger is that, over the next few months, Germany and its euro partners will be locked in a disagreeable and undignified monetary St Vitus Dance in which interest rates and exchange rates appear to be ever more skewed against the interests of individual countries – and with debts between them becoming increasingly onerous and ultimately unpayable.

Riyal rivalry *(continued from page 1 ...)*

Local currency Asian bond issues have increased markedly in recent years, and the Middle east may be about to follow suit, possibly stimulated by revived plans for Gulf monetary union. The main reason for the Qatar bond launch represents an effort to diversify Qatar's funding away from the dollar, foster a domestic bond market and widen its range of monetary policy tools, above all to mop up excess liquidity in the banking system generated by government cash injections after the financial crisis.

The government's plan to develop deeper capital markets in Doha, preparing for possible larger recourse to borrowing for development projects both in Qatar and elsewhere throughout the Gulf, mirrors action in other Middle Eastern states.

Qatar, the world's largest gas exporter, issued a $7bn bond last November, the largest-ever emerging market bond, and several state-owned companies have been borrowing on international capital markets in recent years.

The gradual build-up of a multiple reserve currency system was one of the features of the OMFIF Inaugural Meeting in Asia in Kuala Lumpur on 15-17 May [see article on p. 6-9]. Among the recommendations from the meeting, delegates asked whether the International Monetary Fund might be able to broaden the range if currencies covered by its foreign exchange reserve composition series, in order to improve statistical coverage of the greater range of holdings in official reserves.

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How euro malaise helps dollar

On past patterns, Trichet faces toughest test

Darrell Delamaide, Board of Contributing Editors

Jean-Claude Trichet, the European Central Bank's embattled president, has carried out a spate of interviews with leading German and French newspapers in the past fortnight to dispel fears that the euro has become a weak currency. Along with public opinion in the two leading European economies, it is clear that Trichet is actively targeting an equally sensitive but much more elusive section of public opinion well beyond the euro's boundaries. These are the investment managers in central banks and sovereign funds who have made large investments in the euro, but whose faith in the single currency has been badly jolted by recent European upsets.

The dollar has now chalked up six successive months of gains against the euro. The move looks likely to be extended a while longer yet.

Official institutions in Asia and the Middle East have made a considerable commitment to the euro over the past 10 years, owning an estimated $1.5tn to $2tn worth of euros. These institutions face a familiar dilemma on commenting on their currency holdings and investments. Just as statements in recent years casting doubt on the dollar would tend to be counter-productive by undermining the currency's value, negative publicity in the euro would have a similarly destabilising effect. So it's hardly surprising that China's normally tight-lipped State Administration of Foreign Exchange (SAFE) made a rare public statement last week to try to dispel a Financial Times report that it was reviewing its euro holdings.

Like the German people, China was 'sold' the euro on the basis that the rules governing it would be as disciplinarian as the Bundesbank's. Recent visitors to SAFE have left with the strong message that China has been deeply worried by the outbreak of un-Germanic ill-discipline in the euro area. It would not be surprising if it took action, over time, to safeguard its investments. Similarly, when the Kuwait Investment Authority also disclaimed reports last week that it was contemplating divestment of some euro assets, that is likely to be taken with a pinch of salt.

One short-term beneficiary of the euro crisis has been the US Treasury. Global demand for Treasury paper has surged in the months since euro governments began grappling with the Greek fiscal imbroglio. Coverage at auctions of US government securities has steadily risen while yields have been hammered down to the 3% level. Interest cost on US debt is running at only 1.5% of gross domestic product, its lowest point in 35 years. In a recent swing through Asia, US Treasury officials seemed quite upbeat about borrowing. According to the most recent quarterly report of the US Treasury's Office of Debt Management, weighted coverage of all auctions has risen steadily toward 3 in the past few months, even as gross issuance has mushroomed. This compares with a coverage ratio below 2 in fiscal 2003.

Asian central banks are using some of their dollar reserves in foreign exchange intervention to keep the US currency from appreciating too strongly against their own units. The euro crisis and tension on the Korean peninsula are prompting many foreign investors to liquidate holdings of Asian equities, according to Brown Brothers Harriman foreign exchange strategist Marc Chandler. This has exacerbated the dollar's rise against the Korean won, the Philippine peso, and others.

Foreign exchange strategists know that seminal shifts in currency values often work in long cycles. The dollar has now chalked up six successive months of gains against the euro. The move looks likely to be extended a while longer yet. Trichet's earlier good fortune was to take over at the ECB in November 2003 at a time when a strong dollar that had plagued his predecessor, Wim Duisenberg, had started to give way to what turned out to be a long period of relative dollar weakness. This allowed Trichet to take control of monetary policy in an atmosphere of Bundesbank-like rigour. The long secular period of euro strength however came to an end in summer 2008. Trichet's final 18 months in office now look likely to be overshadowed by a bout of euro weakness that will make monetary policy a great deal more difficult than he has experienced before.

West faces long haul from crisis

'Asia has learned its lessons – West must do the same'

The West faces a long haul to emerge from the financial and economic crisis, on the basis of Asian experience after the region's financial upheavals of 1997-98. That was one of the main conclusions of the Inaugural OMFIF Meeting in Asia held as a symposium on 'Asia's role in the world economy' at Bank Negara Malaysia in Kuala Lumpur on 15-17 May 2010. Asian officials looking at continued financial unrest in trans-Atlantic economies insisted they had learnt their lessons from the 1997-98 Asian crisis. Asia had undertaken fundamental reforms since then, which had helped to insulate the region from the worst of the fall-out from America and Europe.

Four separate working groups, each linking 15 to 20 participants held individual discussions and produced separate reports to back up the content of the plenary meeting. [See boxes below and p. 7-9.]

The seminar, under Chatham House rules (i.e. no person can be quoted), brought together 39 institutions from 22 countries. Two institutions came from Africa, three from the Middle East, three from North America, 12 from Europe and 19 from the Asia-Pacific region. These included 19 central banks, two governments, three sovereign funds, one regulatory agency and seven private sector financial institutions. By comparison, at the Inaugural Meeting at the Deutsche Bundesbank in Frankfurt on 2-3 March 2010 there were 35 institutions from 28 countries.

Prime Minister Najib, Governor Zeti (right) and OMFIF co-chairman David Marsh during the question-and-answer session after the Prime Minister's lunch speech on 17 May.

There was a general view that Asia had focused on the real economy, the West on the financial economy. 'Asia learnt the lessons of 1997-98. We focused on macro stability, reform of the banking system and strengthening domestic capital markets and these actions have helped us in the last three years,' according to one senior Asian government official. But the Asian official recognised that, in an interdependent, globalised world economy, decoupling was illusory and Asian countries would

Optimising Asia's relationship with the West

Arrogance being replaced by understanding – but both sides need to learn

Delegates pointed out that the nature of the relationship was changing fundamentally. Previous western dominance and a mindset leaning to arrogance and neglect had shifted to a relationship geared far more towards engagement, cooperation and partnership based on mutual respect and understanding. The West was far more likely now to listen to the voice of Asia – a product of the changing power structure of the world economy and Asia's recently-demonstrated flexibility and resilience.

The West could learn from Asian countries' unique advantages and experience, just as Asian countries could continue to learn from the West. Asian and western economies had many complementary features and cooperation would enhance welfare in both.

Asia's relative success in weathering the financial crisis underlined the region's resilience in areas such as labour mobility, savings and cost efficiency. However Asian countries still lagged far behind in basic scientific research, high technology, entrepreneurship, financial market innovation and human resources development and mobility. There was a specific need for concrete measures in all of these areas, often involving cross-fertilisation with western initiatives and institutions.

The view was expressed that developed countries were over-represented in G20, IMF, World Bank and other international organisations, the structures of which had not reflected sharply changed realities. There was general belief that the status quo should be changed, but less accord on how to do it. Some participants suggested that the EU should have just one representative in G20 and in other arrangements, in contrast to the present set-up where the EU and individual countries each enjoy representation.

suffer spillovers from the western crisis if it continued.

He pointed out that implementing reforms in his country had been a protracted process, lasting almost 10 years. He expected a similarly lengthy time scale for reform in the western economies. This was one of the sobering lessons for Europe from the Asian debt crisis. 'Anticipate that the worst is yet to come,' this top Asian official said.

The issue of the renminbi exchange rate played only a negligible role in the meeting. It was recognised that the US and China had defused the issue surrounding previous American allegations of Chinese 'manipulation' and that the euro's fall anyway was pushing up the overall renminbi exchange rate. The renminbi was foreseen in future as being pegged to a basket of currencies and not simply to the dollar.

Asian countries recognised the need for efforts to improve the quality of their capital markets. 'Market infrastructure is inadequate, the markets are too small and financial intermediation is often inefficient,' according to one participant.

The inaugural OMFIF meeting in Asia focused on three key themes

1. Sovereign debt and currency relationships. Delegates expressed serious concerns about the European single currency's stability despite the €750bn European/IMF rescue package. "Safe haven" flows of funds into the dollar were temporarily easing the US Treasury's task of financing the US budget deficit, but there was still considerable scepticism over America's long-term debt challenges unless appropriate fiscal action was taken.

2. Asia's economic development and prospects. Asian officials suggested the West would need similar lengthy adjustment. Participants agreed prospective increases in Asian investment and consumption would help rebalance world growth. In view of international interdependence, there was doubt whether Asia's "growth model" could decouple from the West.

3. International reforms of banking and financial regulation and the effect on recovery. The one-size-fits-all regulatory reform model which seems to be emerging from the G20 and the Financial Stability Board was widely rejected as unduly rigid. There were worries that the broad reform agenda could damage banks' ability to support economic recovery

Bank Negara Malaysia Governor Dr. Zeti Akhtar Aziz, in a generally upbeat speech opening the meeting, said an estimated $8tn infrastructure investment for the region in the next decade would catalyse the deepening of Asian bond markets. The requirement, based on Asian Development Bank forecasts, could be managed without disruption as it compared with an estimated cumulative gross national savings for the region of around $80tn.

Dr Zeti took an optimistic view of the region's economic prospects. Asia produces around 30% of global GDP and this was forecast to rise to 40% in coming years. With annual growth in the region foreseen as averaging 7% over the next 10 years, efforts were underway to put in place much-needed comprehensive social safety nets. She highlighted the growth of intra-regional trade and suggested that, with domestic demand already

Finding solutions for banking and financial market regulation

'One size fits all' approach rejected

Financial markets anticipate that the G20 agenda for toughening up capital and liquidity regulations, and possibly the introduction of some form of leverage ratio, will be implemented by the governments of the trans-Atlantic economies. Indeed some moves in this direction had already been taken, notably by Switzerland.

But the big question facing both regulators and financial sector operators is whether the G20 leaders' one-size-fits-all approach makes sense. Experts in the group, particularly but not exclusively Asian participants, were virtually unanimous that the answer to this question is a resounding 'No.'

It was pointed out that Asian banks had not been hit by the sub-prime disaster, and that their leverage ratios were dramatically lower on average than those at US or European banks in 2007. Many states had introduced extensive regulatory reforms in the wake of the 1997-98 Asian debt crisis and felt no desire to take further comprehensive steps.

Some might find parts of the G20/Financial Stability Board agenda attractive and, on a 'pick and mix; basis, might adopt some elements of the proposals. But there was wide support for the judgment of one senior central banking participant that the emerging Basle approach was 'too rigid' and 'too formulaic'.

The 'Volcker rule,' named after the former US Federal Reserve Board chairman, calling for separating investment banking from traditional corporate and retail banking, was not seen as a viable plan for general international application. It was regarded as a political reaction to an American problem, namely that the Securities and Exchange Commission inadequately regulated the investment banks, and that this was done from the narrow perspective of investor protection rather than from a prudential perspective and without effective regular supervisory oversight.

accounting for more than 80% of GDP in Asian economies, 'the rebalancing of global demand is already taking place.' Consequently, Asia was becoming a growing source, rather than just a recipient, of foreign direct investment. This had implications for corporate development too. Already one quarter of Fortune's top global 500 companies were Asian.

With social unrest erupting in Thailand only a few hundred miles away, there was an awareness that the Asian economic model, which has seen millions of people lifted out of poverty, has also left millions more unaffected and potentially, if not actually, disaffected. 'Thailand illustrates how we must not leave behind elements of the population,' one delegate said. 'We need stable, efficient and inclusive financial systems so that all participants can enjoy the new prosperity,' was one senior official's widely-echoed view.

Some pointed to the way telecommunications companies could be linked into the financial markets to deliver, for example, banking services to the unbanked, offering attractive openings in Asia where the mobile telephone has spread so widely because of the inadequacy of fixed line systems.

'With social unrest erupting in Thailand only a few hundred miles away, there was an awareness that the Asian economic model, which has seen millions of people lifted out of poverty, has also left millions more unaffected and potentially, if not actually, disaffected.'

In a special session on the European debt crisis, delegates expressed serious concerns about the stability of the single currency. European participants said failure to look seriously at the imbalances in current account deficits in the euro area produced important lessons. 'I used to be told that the current account did not matter in European countries that shared the single currency. Now we have learned that it clearly does matter, as also do fiscal deficits in spite of the ease we have seen in financing them in the first years of the single currency's existence,' one official remarked. Attention was drawn to President Sarkozy's recent remark that 'the Germans are still dreaming of the D-Mark.'

There was widespread agreement about the extremely damaging effect of past years of mishandling of the Stability and Growth Pact. Governments first failed to provide an effective mechanism for sanctions against errant states. And then they undermined the effectiveness of

Management of assets by central banks and sovereign funds

Diversification trend becomes more important, raising issue of IMF reserve reporting

The discussion on official holders' asset management included: liquidity and diversification; transparency, risk and regulation, Islamic finance, social benefit and non-investment goals. A relatively large amount of time was spent discussing non-investment goals, suggesting that this is an area of intense interest, especially in Asia as the area of largest reserves. This was notwithstanding continued emphasis on central banks' core responsibility of maintaining liquidity and asset security. With reserves on a general upwards trend, different diversification strategies had become important, particularly with regard to two areas:

Gold had shown elements of price counter-cyclicality and could therefore display protective qualities within a portfolio. When the financial crisis was at its height, one particular country was able to swap out gold at "normal" market prices rather than having to sell conventional financial market assets at fire-sale prices.

Asian currency-denominated bonds had been increasingly part of regular portfolios and this sector has seen phenomenal growth in the last 12 months. Given the importance of these investment grade bonds to investors, it was recommended that the IMF be requested to include Asian currency denominated bonds within the reserves reporting template.

The group discussed how the finance industry could potentially focus on ensuring that traded instruments in the financial markets could have a socially useful focus. The introduction of a more stringent capital adequacy framework was seen as positive; however introduction of changes had to be sensitive to the local market.

Among the group's recommendations, it was suggested that the IMF's 'COFER' arrangements for reporting the currency breakdown of foreign exchange reserves had deficiencies, partly because it did not include China and other large reserve holders among emerging economies. it was felt that an approach should be made to the IMF to establish whether this state of affairs could be improved.

Any attempt to improve reserve coverage could be a major step forward in improving analysis of the balance between central banks' asset management practices and the need to promote development of financial services in emerging markets, crucially through increased use of local currrencies in capital market transactions.

the pact as an instrument for economic correction, with Germany itself (under former Chancellor Gerhard Schröder) setting a bad example in 2003. One delegate commented that the period 2000-10 had been a wasted decade in the industrialised world because too much money had flowed into consumption rather than investment. Low interest rates had been an unwelcome source of stimulus: 'Cheap money makes you stupid,' commented one European delegate.

Participants were divided in their view of the European Central Bank's interventions in the euro area under the €750bn euro area support package decided by the European Union and the International Monetary Fund announced on 10 May. There was some disquiet about the measure because it was combined with an about-turn from previous ECB declarations that it would not purchase euro government bonds. Some central bankers present insisted that this measure did not amount to 'quantitative easing,' since the central bank money used would be withdrawn through sterilisation.

'You have got markets in panic, brokers had stopped dealing in some securities, investors had stopped buying bonds…this is a case where intervention could be successful because markets were so vulnerable.'

On this view, the ECB's U-turn on policy was more like central bank intervention in the foreign exchange markets, necessary to ease functioning of the bond markets, and therefore not a fiscal support operation. 'You have got markets in panic, brokers had stopped dealing in some securities, investors had stopped buying bonds… this is a case where intervention could be successful because markets were so vulnerable,' one central banker said.

But others argued that the ECB had 'crossed the Rubicon,' in becoming involved in an indirect support operation for euro governments. Even supporters of the initiative insisted that it had to be followed up by the creation of a fiscal watchdog with teeth, which would involve euro members surrendering sovereignty.

An Asian participant added that the single currency's troubles served as a warning to Asian countries examining prospects for closer monetary cooperation. This was a matter of concern for those who believed that rapid progress in this direction should be on the Asian agenda. 'The European route is not for us,' said one senior official.

Building an Asian consumption economy with financial innovation

How to create an environment that fits the challenges and stimulates innovation

Delegates emphasised the key to future success was to asses the opportunities and challenges from developing financial services and create an environment that stimulates innovation. Over-regulation should be avoided and initiatives by banks to increase accessibility should be heavily promoted.

The key points were said to be that consumption is a more stable factor in the economy than investments; that higher consumption can contribute to reducing current account imbalances; and that savings statistics can be somewhat misleading due to skewed income distribution. Regarding the overall Asian market, the top 10% of the population was regarded as well served but the poorest 90% needed attention/access. A country-by-country view needs to be developed on the desired level of consumption. A responsible increase is desired (not up to the US or European level). Consumer lending including mortgage lending should be between 100 and 200% of retail savings.

High savings are driven by uncertainty due to shortcomings in pension, health care and unemployment benefits. An IMF study on China found that Rmb1 increased spending on health care would lower savings by Rmb2. Education to increase financial literacy can also contribute to increased consumption.

Business culture and organisation are crucial to fostering retail finance innovation. Having dedicated retail entities not dominated by corporate bankers with proper transfer pricing is desirable. Forms of community or cooperative banking organisation can contribute to developing a sustainable retail banking market. Innovation in low cost distribution models is a key issue for reaching mass populations. There are important lessons from micro finance started by NGOs and later community banks – with mainstream banks joining later

Mobile telephone and internet banking were widely held to represent the future pattern of growth. There are 4.5bn mobile phones around the world and only 1.5bn bank accounts. Retailers offering cash back facilities and others such as telecommunications companies can be valuable partners for expanding access to retail financial services. Mass products to address pension and health care needs are needed. Payroll deduction should be stimulated. Product 'bundles' to cover multiple needs are an important innovation. Low-risk products with guarantees are desirable in view of low financial literacy.

A monthly foray into monetary secrets hidden in archives

Hiding Germany's strength through Europe

Schmidt requests Bundesbank help to play down the legacy of his country's power – but successor Merkel has brought the issue back to the agenda

In the post-war era, the issue of German power within the European economic and political framework has always been a topic of huge sensitivity. Successive German Chancellors have skirted around the subject, while French presidents have brought it up more or less overtly and used Germany's own sensitivities to try to extract concessions – an enterprise that has not always succeeded.

German economic prowess has been closely tied up with the question of trade surpluses, which have accompanied Germany's economic rebirth in a continual process since the 1940s. During times of exchange rate unrest, France and other countries (often including Britain and the US) have charged that the burden of adjustment should be imposed 'symmetrically' on surplus and deficit countries, whereas the Germans have argued that the deficit nations should carry the main responsibility for adjustment.

With the forging of a single currency for Europe, and the sinking of individual countries' individual interests into what has been called, with justifiable theatricality, the 'joint community of fate' of the euro, the long-standing argument about symmetry and asymmetry seemed to have ended. But it has now been revised with a vengeance as a result of Chancellor Angela Merkel's candid statement in the Bundestag on 19 May that the future rules of 'stability culture' in the euro area would be incontrovertibly set in the interests of the strong countries, and not the weakest. The statement was made from a position of both strength and weakness: strength because Germany is by far the most robust economy in the euro area; weakness, because, for the first time, Merkel said Germany's own currency is under existential threat.

Her predecessor 30 years earlier, Helmut Schmidt, had to wrestle with similar complexities when setting up the European Moneyary System. Here is how he tackled them, in extracts from a long and impassioned speech to the Bundesbank Council in Frankfurt on 30 November 1978.

'We are economically the second strongest Western power in the eyes of the world, as we are also militarily, by the way, and most politicians out there in the world know it. With the exception of nuclear weapons, that we do not have, thank God, we are the second strongest military power of the West. The number of our soldiers alone is greater than that of the Americans, without our having increased it in the course of the last twelve years, rather all the others have disarmed so much. By holding firmly to our duties we have grown ever stronger relative to our own Western allies. And we have also attained very great political weight in their eyes. It is all the more necessary for us to clothe ourselves in this European mantle. We need this mantle not only to cover our foreign policy nakedness, in areas like Berlin or Auschwitz, but we need it also to cover these ever-increasing relative strengths, economic, political, military, of the German Federal Republic within the West. The more they come into view, the harder it becomes to secure our room for manoeuvre….'

'On the other hand, I said the European Monetary System involves risks. I repeat: it involves essential chances too, especially if it is successful, the chance for us that the European Community will not decay. It is really a vital precondition for German foreign policy and its autonomy. It offers chances of the economic sort too, which I have not placed in the foreground of this presentation, but which I do not wish to hide.'

'It is all the more necessary for us to clothe ourselves in this European mantle. We need this not only to cover our foreign policy nakedness, but also to cover ever-increasing relative strengths, economic, political, military strengths.'

Sources: Source: Bundesbank Historical Archives, translation courtesy of Thatcher Foundation. See http://www.margaretthatcher.org/archive/displaydocument.asp?docid=111554

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The 'D'-Mark stood for danger

Germans know what 'existential' means

William Keegan, Chairman, Board of Contributing Editors

'The euro is in danger,' Angela Merkel said during the gathering financial storm which prompted her and her fellow European leaders to introduce that mega rescue package. She also spoke of 'an existential' crisis.

These remarks made many people sit up, including your correspondent. In my long career as a financial journalist I have witnessed many a currency crisis, not least concerning the pound sterling. Indeed the good old pound is under pressure as I write: the markets sell because they are worried about the UK's fiscal deficit; and they sell again on fears that action to reduce that deficit will abort an incipient economic recovery – and prevent a reduction in the deficit... But nobody is saying that the pound is 'in danger' or that sterling is experiencing an 'existential' crisis. Chancellor James Callaghan did not say that during the devaluation crisis of 1967. Chancellor Denis Healey said no such thing during the British 'IMF crisis' of 1976. And even at Black Wednesday time in September 1992 'in danger' and 'existential' were absent from the rhetorical vocabulary.

What Chancellor Merkel was referring to was, as the word 'existential' makes clear, the very existence of the euro. The one major European currency that was in jeopardy not so long ago was the redoubtable 'D'-Mark itself. The 'D' stood for danger because the reunification of Germany had so frightened President François Mitterrand of France that he wanted to 'tie Germany down' in Europe, and avoid the nightmare of a resurgent Deutschland dominating Europe. This involved rapid acceleration of the timetable for a European single currency – an old idea, dating back to the stillborn Werner Plan of the early 1970s, and revived by the Delors Report of 1988-89.

The one major European currency that was in jeopardy not so long ago was the redoubtable 'D'-Mark. The 'D' stood for danger because reunification so frightened President François Mitterrand that he wanted to 'tie Germany down'.

What made Mitterrand's vision realisable was that Chancellor Kohl – the very architect of the German monetary union that followed unification – shared these fears, and expressed them publicly in some historic speeches. (Chapter and verse can be found in David Marsh's book The Euro which proves to have been very timely indeed.) The danger for the 'D'-Mark indeed proved to be 'existential', to the annoyance of many Germans. Some distinguished professors took their existential fears all the way to the Constitutional Court – but in vain.

It is notorious that we British were, to say the least, not keen on the single currency. Indeed, Mrs Thatcher had hoped that the man she chose to be Governor of the Bank of England, Robin Leigh-Pemberton (now Lord Kingsdown), would use his position on the Delors Committee to sabotage plans for a single currency. Instead, to her consternation, he 'went native'.

Mrs Thatcher was viscerally opposed to German unification. Indeed, an aide of hers once told me, 'Mrs Thatcher's views on Germany were set in stone in 1944'. Paradoxically, although against unification, she was also against the monetary union that was designed to 'tie Germany down' in Europe and allay fears of a resurgent, nationalist Germany.

Now, the fears of those of us who, while wishing the single currency well (unlike Mrs Thatcher), thought it was badly designed have proved well-founded. The euro area lacked a large, central budget (a fiscal backup, as in the US monetary union); and the 'one size fits all' monetary policy certainly contributed to the laxity and excessive indebtedness of the 'Club Med' countries. Currency adjustments through devaluation were ruled out. And it suited the Germans that countries like Italy could no longer use this route to regain competitiveness.

What we see now is a concurrence, and intertwining, of a crisis in the euro area and a crisis of what the Left used to refer to dismissively as 'finance capitalism'. The financial markets that almost brought down the world's economic system in 2007-08 are now playing havoc with the euro. Many people have lost money underestimating the strength of political will behind the 'European ideal'. Many 'players' in the markets are trying to make money by fomenting the 'existential' crisis, and testing that political will to the limits.

Looking ahead – diary dates

OMFIF Asia Award Dinner
30 June 2010
London

OMFIF Meeting in Middle East
31 October – 3 November 2010
Abu Dhabi

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