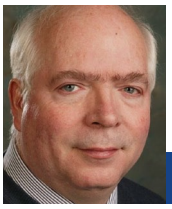
OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

September 2010



Another sortie for 'Helicopter Ben'

Bernanke, feeling lonesome, prepares to go airborne

Darrell Delamaide, Board of Contributing Editors

A yawning gap in economic policy has opened up in President Barack Obama's administration, heralding further problems for world economic governance as US growth slows and signs of potential deflation or double-dip recession unsettle financial markets.

The policy vacuum resulting from disarray in the economic team places even more responsibility on the shoulders of the Federal Reserve. At the generally gloomy annual central bankers' gathering at Jackson Hole, Fed chairman Ben Bernanke pointed out plaintively, 'Central bankers alone cannot solve the world's economic problems.' Bernanke made clear that the Fed stood ready to act if necessary to ward off renewed threats to growth. But his lacklustre comments lent further sobriety to the downbeat picture on financial markets. This mild-mannered monetary helmsman now seems the only buffer between Americans and a fresh bout of economic melancholia.

In a 2002 speech on deflation, Bernanke referred to a remark of Milton Friedman's about the Fed being able to make a 'helicopter drop' of money by resorting to the printing press. The markets are now waiting in some trepidation to see if 'Helicopter Ben' dons his goggles and prepares to go airborne again to shower the world with dollars.

The central bank, Bernanke said, 'is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, especially if the outlook were to deteriorate significantly.'

Bernanke's cheerless tone may reflect how he's feeling lonesome. The Obama administration needs to deal with an ominous downward turn in the economy. But numerous setbacks have rocked the administration weeks away from midterm elections predicted to produce an Obama meltdown.

The Fed chairman told listeners at the Wyoming resort, 'A return to strong and stable economic growth will require appropriate and effective responses from economic policymakers across a wide spectrum, as well as from leaders in the private sector.'

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Flurry on Zhou

Beijing escapade

Jonathan Fenby , Advisory Board

China watchers were amused by a short-lived on-line end-August flurry involving the Governor of the People's Bank of China (PBoC). A posting to a mainland internet discussion forum erroneously reported that Governor Zhou Xiaochuan had been accused of responsibility for losing more than $400bn in China's foreign exchange holdings and had fled to the US as a result.

The story was said to have come from the Hong Kong newspaper, Ming Pao. It was nonsense. China's published reserves have continued to rise. Far from seeking a haven across the Pacific, Governor Zhou was busy receiving visitors from Japan and attending a meeting of the Communist Party Committee at the PBoC. Whether the rumour was an attempt to manipulate the market or the work of an isolated individual or an organised group trying to cause the Governor harm is not known, but it caused high excitement for 24 hours.

While he can shrug off the bloggers, Governor Zhou has faced tougher opposition to the desire often attributed him for appreciation of the renminbi.

(continued on page 4 ...)

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Extending our scope

The link between East and West

David Marsh, Co-chairman

OMFIF has built up additional operating scope and strategic muscle during the summer. We have launched new bridgeheads in Latin America, Asia and North Africa. We are developing an array of activities in fields ranging from personnel development to publications.

We welcome nine new members of our now 41-strong Advisory Board: Hon Cheung of State Street Global Advisors in Singapore; John Cummins of Royal Bank of Scotland; Mumtaz Khan of Middle East and Asia Capital Partners in Singapore; Saker Nusseibeh of Hermes Fund Managers in London; Rakesh Mohan, former Deputy Governor of the Reserve Bank of India, currently teaching at Yale; David Owen, former UK Foreign Secretary; Ila Patnaik of Delhi's National Institute of Public Finance and Policy; John West of the Asian Development Bank Institute in Tokyo and Derek Wong of Dah Sing Bank in Hong Kong.

In these pages, featuring a record number of contributors (10 of whom are from the Advisory Board), John Plender provides us with an over-arching view of where it's all going wrong and proposes 10 reforms to save the world. The policy vacuum opening in the Obama administration preoccupies Darrell Delamaide. But, as Jonathan Fenby and Meghnad Desai record, China and India are still forging ahead.

The ructions over the euro provide material for a trio of contributors: David Owen, who dwells on possible actions by the German Constitutional Court, Niels Thygesen, who looks at the balance of financial discipline wielded by the markets and governments, and Stewart Fleming, who explores the workings of the new European Financial Stability Facility. Igor Luksic, Finance Minister of Montenegro - a non-European Union member that has adopted the euro without any formal process - writes enthusiastically on the single currency: a reminder that the greatest EU enthusiasts are outside its borders.

Matters of personality are always intruding, often without invitation, into the ruminations of central bankers. We look at how the meanderings on race and immigration of an obscure German functionary promoted to the Bundesbank board are hampering the work of European monetary union. Roel Janssen explains how the acting Dutch finance minister has dispossessed the long-time president of the Nederlandsche Bank. Ousmène Mandeng describes the personal crusade of President Nicolas Sarkozy in favour of global monetary reform, and suggests he should learn from Bismarck.

In the first of a monthly series, Stefan Bielmeier of DZ Bank gives us an overview of the world economy, suggesting that growth is slowing but we'll avoid a double-dip recession.

Julia Leung, under-secretary in the Hong Kong Financial Services and Treasury department, unravels the intricacies of renminbi internationalisation. Rakesh Mohan suggests the West can learn from India on macro-prudential policies. Malan Rietveld outlines a more logical global nomenclature for sovereign funds. Global Analysis looks at the rise of the Singapore-based Amro research organisation, part of Asia's attempts to extend financial self-sufficiency. Harold James delves back into history and finds that today's policy-makers' language on global imbalances bears uncanny resemblance to what went on in the past.

We hope revived acquaintance with ancient conundrums proves suitably stimulating.

David Marsh

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Stability fund with German muscle

'Federalist' organs pushed into background

Stewart Fleming, Board of Contributing Editors

The European Financial Stability Facility (EFSF) set up to underpin weaker euro members provides one more example of how the trans-Atlantic financial crisis has helped strengthen the role of the EU's big nation states, led by Germany. Yet, indicated by rising borrowing spreads on troubled euro members' debt, financial markets are unconvinced that embryonic European measures for better economic governance can heal the effects of the last crisis, let alone forestall new ones.

The promise of massive liquidity helped stabilise markets, but in the last few weeks interest rate spreads have risen ominously again.

Providing guarantees worth up to €120bn, Germany is, reluctantly, by far the largest underwriter of the Luxembourg-based €440bn sovereign bail-out mechanism, which became operational on 4 August. The 'federalist' institutions in Brussels have been pushed into the backseat, as first France and then Germany brought their weight to bear at the negotiating tables.

Germany will provide the key influence on the EFSF's decision-making, including its eventual borrowing operations. Berlin has placed one of its most experienced international economic policy-makers, the taciturn 59-year-old Klaus Regling, at the EFSF's helm. If Bundesbank President Axel Weber becomes head of the European Central Bank next year as many expect, this will further buttress Germany's role in the EU and the euro area.

Regling, whose last official post was as Director General for Economic and Financial Affairs at the European Commission, has spent much of his working life in Germany's finance ministry and at the International Monetary Fund. Regling's links to Brussels and the IMF are critical. For, as with Greece, the IMF will play a central part, with the European Central Bank and the European Commission, in overseeing any future euro bail-outs.

The EFSF was born in May after the EU's Greek bail-out failed to calm financial markets. The promise of massive liquidity in case contagion spread to Spain, Portugal and Ireland helped stabilise markets, but in the last few weeks interest rate spreads between these countries' bonds and best-priced Germany's have risen ominously again.

Spreads on Irish debt have increased to well above 3 percentage points, compared with less than 2 in the aftermath of the May package. Ireland has rejected speculation that it could be the first euro member to borrow from the EFSF. The Dublin government worries that this would bring unwarranted stigma after it has voluntarily taken extremely tough steps to tackle the problems created by previous failures to rein in a bubble economy.

A root and branch review of EU economic governance is being conducted by EU finance ministry officials led by the wily and impressive Herman van Rompuy, president of the European Council, who took office in December 2009. An ECB submission to the van Rompuy task force calls for a wide range of reforms. These would include strengthening oversight of member states' fiscal policy, including tougher, quasi-automatic sanctions for countries which breach the Stability and Growth Pact, and more effective surveillance of euro members' competitiveness.

On another track designed to promote EU financial stability, Europe is beefing up financial regulation through implementing proposals in the 2008 de Larosière Group's report. The euro crisis has focused attention on the negative interactions between troubled European sovereign borrowers and excessively leveraged banks, and the inadequacy (long recognised by the ECB) of too narrow a focus on goods inflation in monetary strategy. Policy-makers now recognise the importance of linking improved financial market supervision and regulation with better economic oversight and fiscal discipline. Yet the message from the latest rise in spreads is that financial markets are still not persuaded that the EU's revamped mechanisms for crisis prevention and management are sufficient to avert further upheavals.

Helicopter Ben prepares further sortie *(continued from page 1 ...)*

But some of these policy-makers have already headed for the exits. President Obama's budget director Peter Orszag quit earlier this summer and Christina Romer, the chairman of the Council of Economic Advisers, has scheduled her departure for mid-September.

House minority leader John Boehner last month called for Obama to make a clean sweep of his economic team and also get rid of senior White House adviser Larry Summers and Treasury Secretary Timothy Geithner. Obama pointedly did not interrupt his vacation on Martha's Vineyard to defend his top two economic aides.

Compounding the impression of rudderlessness, the White House has delayed the appointment of the first head of the newly-created Consumer Finance Protection Agency, even though it was promoted as a keystone of the administration's financial reform.

Harvard professor Elizabeth Warren, who virtually created the concept of the agency, was widely expected to get the nod, but the White House has yet to make an announcement.

The combination of White House vacillation and the dynamics of midterm elections is also hampering the Fed. After leaving two vacancies on the seven-member Fed board unfilled for a year, in April Obama finally put forward nominations for those two seats and for the vice chairman post being vacated by Donald Kohn.

Although all three nominees were approved by the Senate Banking Committee in July, the Senate dispersed for summer recess without voting on the appointments, leaving the Fed board depleted as it faces crucial decisions on how much further monetary stimulus to supply to the economy.

All this comes as unemployment remains stubbornly high, the housing market takes a new dive after government incentives expired, and a volatile stock market reflects widespread business and consumer uncertainty.

Flurry over Zhou *(continued from page 1 ...)*

The previous de-pegging from the US dollar in 2005 saw a steady rise in the value of the Chinese currency until the export market flagged in 2008. But China's move in June from the de facto restored greenback peg to a flexible basket has not seen any lasting appreciation. After rising by less than 1% against the dollar following the PBoC announcement, the currency has fallen back to around the mid-June level. So much for great market expectations of the long-awaited appreciation.

A sign of the underlying tensions in the Sino-American currency relationship came in an article written by Hu Xiaolian, PBoC deputy governor, warning of potential risks to China's foreign exchange reserves from a loss of confidence in the US currency. 'Once a reserve currency becomes unstable, there will be quite large depreciation risks for assets.'

As I have argued in past editions of this Bulletin, a substantial rise in the value of the renminbi is unlikely to be approved by the Communist Party and government decision makers who out-rank the PBoC chief. Such approval will come only if they are convinced that external demand will be strong enough to cushion a revaluation – especially considering it will take quite a while for China to achieve the vaunted economic rebalancing to domestic demand.

In that respect, China's currency policy is largely driven by external factors. The subdued economic outlook in the US and EU hardly buttresses perspectives for renminbi appreciation. Governor Zhou remains in office - and the complex array of factors making up China's monetary policy remains in place, too.

Three other factors are in play:

- Recent wage rises are unlikely to have a big effect on export competitiveness despite the warnings of some foreign commentators who argue this spells the end of the Chinese export boom. But they will be used by the export lobby as a fresh argument for not relinquishing the currency advantage.

- The effect on inflation would be small since CPI rises are driven primarily by agricultural prices, and China retains its 95% self-sufficiency policy for food.

- Political tensions with the US over the South China Sea, Korea, Iran and climate change make it all the more unlikely that Beijing will do anything that could be seen as kowtowing to Washington.

Some sources in Beijing talk of a 5% upward move after the US mid-term elections. As I have argued repeatedly in past OMFIF Bulletins, I am sceptical about whether this is likely to happen in the near future.

Meanwhile, monetary tightening continues to be the domestic policy watchword. The authorities needed the first six months of the year to start to control the new lending explosion of 2009. Getting the tiger back in the cage (or, in this case, the dragon back into its cave) is always a longer process than the previous loosening. But the total of new loans in July at Rmb533bn ($78.6bn) was down from Rmb603bn in June.

The figure for the first seven months of the year, Rmb5.2tn compared with Rmb7.7tn in the same period of 2009, is in line with the Rmb7.5tn target for the whole year, a 25% drop on 2009. Indeed, since lending in the second half of the year is traditional significantly below that in the first half, there may be room for easing in the last quarter if the authorities get worried about the downturn they have engineered in the property market.

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Ten reforms to save the world

Tackling imbalances key to progress

John Plender, Board of Contributing Editors

In the policy response to the financial crisis, too little attention has been directed at the most important underlying cause: global imbalances. In part, that reflects the reality that most policy-making in this globalised world remains national. In part, it is because many of the policies that are essential to a rebalancing of the global economy are simply not going to happen, at least in the short run.

Many of the policies that are essential to a rebalancing of the global economy are simply not going to happen, at least in the short run.

An appreciation of the renminbi, for example, would help shift what is now the world's second largest economy towards consumption-driven demand instead of relying on exports and over-wasteful investment to do the job. That would create a new source of demand for the world which would allow deficit countries to reduce excessive debt without throttling their own economies.

Such a move would also be in China's own interest since a failure to allow the renminbi to appreciate means that Beijing cannot prevent inflation and asset price bubbles without knocking the stuffing out of the economy. Yet the constituencies against change are such that China will persist with its export-led growth model until imbalances are corrected by deflation and/or protectionism.

Other adjustments will happen whether governments want them or not. Debtor countries, unlike creditors, are subject to market pressure. Excessive public and private debt will therefore come down. The questions for policy-makers are about timing, quantum and the means of pulling of a politically difficult trick.

That underlines the point that any proposal for changed policies and attitudes to address global imbalances is fraught with political difficulty. There are few worthwhile policies that do not call for political leadership if they are to stand any chance of being implemented. So with that caveat in mind, I would like to put forward 10 proposals to address both global imbalances and the regional imbalance in Europe.

PLENDER PROPOSAL 1 - PENSION AGE

Few policies to help rebalancing can be put in place by both debtor and creditor countries. One that does serve this double bill is increasing the pension age. It provides a good debt reduction tool in deficit countries, while in the surplus countries it makes room for tax cuts that would help increase consumption. Those who worry that longer working lives will deprive the young of jobs should be sent back to their economic textbooks to study anew the lump of labour fallacy. It may be politically difficult, but it is probably inevitable if the growing problem of ageing is to be addressed. The new British coalition government has already embarked on this course, albeit too timidly.

PLENDER PROPOSAL 2 - MIGRATION

Another policy that could work for both creditors and debtors is migration. The fiscal pressures of ageing will be hard to resolve if young immigrants are not allowed into developed countries to expand the workforce and broaden the tax base. Of course the flows have to be carefully managed to be politically acceptable. But without them serious inter-generational friction may be in prospect. At the other end of the age spectrum, there is a strong case for retirement migration, which would reduce retirement costs for developed world retirees whose pensions are inadequate, while boosting incomes in the developing world.

(continued on page 6 ...)

PLENDER PROPOSAL 3 - CAPITAL MARKETS

Creditor countries in non-Japanese Asia need to develop their capital markets and extend their funded pension networks. In China, state shareholdings in industry and banking could provide a useful grub stake for a new funded system, as suggested by Raghuram Rajan, former chief economist of the IMF. This forms part of establishing a better welfare safety net, a pre-requisite of reduced household savings.

PLENDER PROPOSAL 4 - RETAIL BANKING

Retail banking needs to be further developed in China and other Asian countries so that people do not have to save before they can spend and are able take a lifecycle view of their finances.

PLENDER PROPOSAL 5 - EQUITY PURCHASES

While imbalances persist, the Asian excess savers and the petro-economies should shift more of their capital outflows from US bonds into higher-yielding equities. This could most easily be achieved via sovereign funds, but a better and politically less sensitive route is to allow the households sector to export its savings. In countries like China, where the real return on savings is negative, this would be an attractive option, though it would help if the Chinese let the renminbi float upwards first, so that savers were less worried about currency risk.

PLENDER PROPOSAL 6 - FEMALE WORKFORCE PARTICIPATION

The Germans and Japanese should increase female participation in the workforce to boost consumption. This might require changes to school hours in Germany – difficult – and there are big cultural obstacles in both countries. Would feminists please rise to this challenge?

PLENDER PROPOSAL 7 - LABOUR MARKETS

Southern Europe needs to loosen up the labour market to make it easier for employers to hire and fire. This will reduce the unemployment cost of restoring competitiveness, without which the prospects for Greece, Portugal, Spain and Italy will be bleak.

PLENDER PROPOSAL 8 - NARROWER MONETARY UNION

Northern Europe needs to recognise that the euro area is not an optimal currency area and start contingency plans for a much narrower monetary union with Germany at its centre.

PLENDER PROPOSAL 9 - MACRO-PRUDENTIAL POLICIES

Central bankers should abandon the intellectual habits of a lifetime and recognise that markets are often inefficient. The obsession with inflation-targeting as a singular policy goal is the most egregious form of one-club golfing, while the cost of letting things rip and cleaning up after the event has been shown to be horrendous. It is necessary to lean against the wind when booms are getting out of hand, as well as adopting counter-cyclical macro-prudential policies. Time to admit that central bankers can and should make judgments about when to take away the punchbowl.

PLENDER PROPOSAL 10 - EXCESS CREDIT

Everybody should learn to recognise that from a macro-economic perspective, excessive credit is as dangerous as excessive debt. Yet banks should remember the adage of a wise banker who remarked that it is better to have lent and lost than not to have lent at all.

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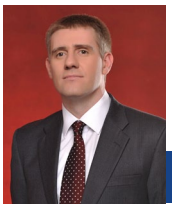


Why Europe must stick together

The compelling economics of euro enthusiasm

Igor Luksic, Finance Minister, Montenegro

Anti-euro diatribes are increasingly fashionable. There are many purely economic arguments against the euro. Economists such as myself have to take them seriously. However, that is not the whole story. When it comes down to the lives of real people, sheer logic isn't always the most fruitful approach.

Unifying Europe through the euro was a political decision that can be priced economically. And the benefits are immense – often, far bigger than those that can be valued on a purely economic basis. We should think of the euro as an apartment with different roommates. When times are bad, the inhabitants tend to forget the advantages of having a common place to live.

There is an analogy between the euro and the lives of humans in a crisis. Epidemics spread faster in large cities. But this doesn't encourage masses of people to rush to the countryside. They prefer proper public healthcare, which can only be achieved through joint cooperation. They prefer to stay where they belong: together.

There is an analogy between the euro and the lives of humans in a crisis. Epidemics spread faster in large cities. But this doesn't encourage masses of people to rush to the countryside.

In all the troubles that the euro faces, the experience of smaller countries needs to be taken into account. This includes states such as Montenegro that are outside the EU and outside formal monetary union, yet are deeply integrated with the rest of Europe.

Eliminating barriers to trade paves the way for peace and prosperity. Tightening political ties between member states ensures that these barriers won't be re-erected. Costs fall and prices are kept low. Small nations find shelter and a stabilising anchor in the common market, as we Montenegrins did in the 1990s when we introduced the D-Mark.

Europeans are experiencing a tremendous, previously unknown, sense of liberty because their currency is accepted all over the entire continent. This is a major contribution to wellbeing.

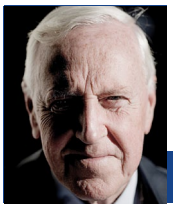
The euro helps us to realise the difficult reforms we need to improve our competitiveness.. Economic experts agree that the euro helped Montenegro achieve stability and low inflation. The country has become more attractive and safer for foreign investment. The fact that Montenegro already uses we the euro does not exonerate from us from fulfilling the conditions to enter the euro area. Indeed, it makes that requirement more compelling.

For Montenegro, introducing the D-Mark in the 1990s was a serious step towards independence. When Germany introduced the euro, we did likewise. It was a declaration that our economy would choose a future in the European Union: a politically-motivated step towards political and economic goals.

Montenegro needs a place at the table for decision-making on the European currency. We have a moral duty to prove we are no mere free-rider on the path to monetary stability. Europe is a continent built on financial stability. I am convinced it will recover in the medium term, and the benefits of euro membership will once again outweigh the drawbacks.

The advantages become even more conspicuous when we consider that there has been no armed conflict on European soil since the Second World War – with the exception of the civil war in Yugoslavia which has affected us so deeply and from whose repercussions we are now trying, with the utmost effort and willpower, to escape.

A common economic purpose reduces the chance of conflict. The tighter we knit together Europe's economic fabric, the less likely conflicts are to occur. The common currency embodies the process of unifying Europe's economies. If we abolish the symbol, the rest will evaporate, sooner or later. That is a chilling thought. But it puts into perspective the billions that have been spent on rescuing the common currency. And, ultimately, it makes that investment worthwhile.



Markets must instil discipline

In extreme circumstances states may default

Niels Thygesen, Board of Contributing Editors

A semblance of calm has returned to the euro area since the first few months of 2010. The most exposed economy, Greece, has embarked on strong fiscal adjustment as well as structural reforms, bringing clear acknowledgement from the International Monetary Fund and the European institutions.

For a while, the deterioration of international borrowing conditions for Greece as well as for three other economies affected by a mixture of Greek contagion and their own fiscal and external positions – Spain, Portugal and Ireland – came to an end. However, the interest rate spreads faced by these borrowers remain stubbornly high, quite close to what was observed in the markets just prior to the massive official initiatives of May 2010.

European finance ministers are still grappling with the task of building a more reliable and robust framework for euro area governance, geared both to preventing and to managing crises. In future, a mixture of official surveillance and market discipline will be needed. And these arrangements will include, implicitly, the assumption that, in extreme circumstances, some countries may eventually default on their debts.

This may be unpleasant for the countries affected by uncertainty. Maintaining 'constructive ambiguity' over possible defaults is the key condition for capital markets to exert a salutary policing effect by demanding adequate risk premia.

Thanks to the unprecedented May initiatives, Europe has plainly won valuable time. These measures comprised official financing for Greece, obviating its need to return to the market for a couple of years; a very large safety net for the eventuality of major external difficulties in other euro members – both of these initiatives closely coordinated with the IMF; and (sterilised) interventions in segments of sovereign bond market which had become 'dysfunctional', i.e. where investors were seen to have excessively negative views of the borrowers.

All three initiatives were seen as highly controversial, though temporarily defensible, in the light of severe financial market reaction to previous delaying tactics. Some uncertainties remain about the longer-term sustainability of the adjustment efforts. But by far the most important issue concerns euro area governance - the agenda of the task force of EU finance ministers, linking all 27 countries, headed by Herman von Rompuy, president of the European Council.

A final report will be submitted to the European Council in October. However, interim reports and the European Commission's publicly available contributions allow a tentative anticipation of the conclusions.

Understandably, the main efforts have been directed at more effective mechanisms for preventing crises. Such a framework would involve both intensified surveillance, backed by sanctions - possibly even before the ceilings of the Stability and Growth Pact (SGP) are reached. Also under review is a widening of indicators beyond the fiscal ones, notably bringing in real exchange rates and intra-euro area external imbalances. Such moves are welcome and imply that Europe would not tolerate the large-scale differentials in public finances and competitiveness of the single currency's first decade.

Yet doubts remain on how this surveillance would be policed. On current ideas, finance ministers would rely largely on the persuasive qualities of discretion rather than on automaticity as originally proposed for the SGP; the country in difficulty would bear primary responsibility for correction. Excessive mutual forbearance was the main reason why this approach did not work well in the past. It may function better now that financial markets recognise the need for much more careful differentiation of euro area sovereign debt.

Under review is a widening of indicators beyond the fiscal ones, notably bringing in real exchange rates and intra-euro area external imbalances.

This approach implies that the risk of debt restructuring cannot be excluded. Euro area policy-makers, in common with the governments of the most exposed countries, say their actions in the spring of 2010 have removed this risk, at least for a couple of years.

But an important question remains. Should there not be a 'Plan B' in the shape of a more permanent crisis management mechanism - or provisions for 'orderly debt restructuring', to use a term from the German debate – to meet the possibility of failure of austerity commitments backed by hastily improvised financing measures?

This question is still on finance ministers' agenda, but it seems unlikely that agreement can be reached beyond the improvised, intergovernmental arrangements devised for a transitional period of three years. Reflecting the lack of a concrete permanent framework, ambiguity about debt restructuring should be seen as a constructive element, enhancing the market discipline faced by sovereign borrowers.

Adopting the euro gave member countries an escape route from the discipline imposed by possible currency crises. Well aware of this, the European governments imposed rules for national fiscal policy, later elaborated into the SGP. The closer monitoring now being prepared does not make stronger elements of market discipline superfluous.

On the contrary, governments and markets could reinforce each other constructively, provided they do not continue to follow the temptation to dismiss each other's messages.

Governments have tended to see markets as excessively suspicious of adjustment prospects. Market participants have been critical of goverments' unwillingness to recognise sovereign risks. Both need to listen more, and to appreciate the constraints which their different roles impose.This point needs to be understood, too, by the European Central Bank. The ECB's dramatic step to buy sovereign bonds will almost certainly prove to be an exception.

Only in very unusual circumstances should the monetary, rather than political, authorities step in to try to influence relative debt prices. May 2010 was one such occasion, but the move was highly controversial, not only in Germany, and will not be readily repeated. The ECB now has to hand over the task of crisis management back to governments, which is where responsibility primarily belongs. The message for the future is that both governments and markets will shoulder the task of enhancing discipline. The precise balance between these influences is a matter for conjecture; how that balance works out will be the issue that determines whether we can avoid future upheavals.

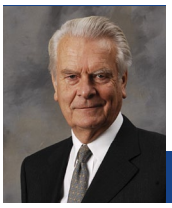
Adopting the euro gave member countries an escape route from the discipline imposed by possible currency crises.

The collapsing bubble, according to the Central Bank of Ireland

During a tour of Asia, organised by OMFIF between 13 and 20 August, Patrick Honohan, the Governor of the Central Bank of Ireland, presented an unvarnished view of the linkages between banking and budgetary arithmetic.

In a lecture at Renmin university in Beijing, he said, 'From 2003 to 2007 the Irish banking system imported funds equivalent to over 50% of GDP to fund a runaway property and construction bubble. The tax revenue generated by the boom came in many forms: capital gains on property, stamp duty on property transactions, value added tax on construction materials and income tax from the extra workers – immigrants swelled up to account for about 13% of the numbers at work. For over a decade the budget was in surplus almost every year. No need, it seemed, for restraint in spending, and so, after years of relatively disciplined government budgeting, there was a relaxation of spending controls.

'Alas, that the apparent solidity of the public finances was all a mirage was brutally exposed when global financial confidence collapsed. Already the Irish boom was well over: house prices were falling and the government deficit widening from early 2007. The global recession did its damage to the budget also through the direct effect on world trade and accordingly on economic activity, given the very open nature of the Irish economy.'



Prospect of a new start over EMU

German court ruling may offer UK opportunity

David Owen, Advisory Board

The aftermath of the crisis in Europe's economic and monetary union (EMU), including the possibility of landmark change in the guiding treaties on European governance, provides an important potential means for Britain and other non-EMU states to put their relations with the EU on to a new footing.

David Cameron, the prime minister, is understandably reluctant to propose that the UK coalition government advocates further European treaty amendment. But he may find the German Constitutional Court opens up the possibility of treaty changes that would provide the UK with an opportunity to free itself from any involvement in the onerous financial transfer mechanisms being developed to rectify huge monetary and capital imbalances within EMU.

Four months after the €750bn support package for indebted euro countries from EU governments, the International Monetary Fund and the European Central Bank, the future of EMU remains uncertain. Beyond the evident economic challenges, one important reason for doubts rests on the possibility of far-reaching intervention over euro support arrangements by the German supreme court. The Karlsruhe-based body, which has taken on the task of safeguarding German citizens from the encroachment of European treaties, has been adopting an increasingly restrictive line on the application of European law to German policies.

Although the Karlsruhe court in recent months has turned down applications by German plaintiffs for emergency injunctions against EMU aid packages, the judges are plainly taking seriously various lawsuits against the bail-outs and will continue deliberations for several months on whether they are in line with the German constitution. There is no firm date for a judgment, but it is generally expected early next year.

German Chancellor Angela Merkel has spoken of the possible need for a new European treaty to underpin newly-decided financial solidarity backed by enhanced economic conditions. These could include, according to Berlin, the ultimate sanction of declaring a member state insolvent, or even suspending it from EMU. Such legislative changes would also be needed to back the even more far-reaching governance proposals outlined by French President Nicolas Sarkozy.

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Constitutional Court shift to restrictive interpretation

For some time the German Constitutional Court has been edging towards an increasingly restrictive interpretation of the EU Treaties in relation to the German Constitution. Its judgment of 30 June 2009 opened the way for Germany's later ratification of the Lisbon treaty. The Court laid down general guidance as to how it might be possible to establish a narrow interpretation, setting limits and parameters, perhaps in a new protocol, or perhaps by amendment of the treaties, for the future development of social and employment policies within the framework of the Lisbon treaty.

This guidance is of considerable importance to people in other member states who see deep contradictions in the functioning of the European Union. Much of the practice of the EU seems to lie in encouraging greater integration. But the objective in the EU treaty of continuing the process of 'creating an ever closer Union among the peoples of Europe' is balanced by the condition that it should be a Union 'in which decisions are taken as closely as possible to the citizen in accordance with the principle of subsidiarity.'

It appears possible that the Karlsruhe court will eventually validate the bail-out measures only on the condition that EU treaty language is tightened to formalise greater surveillance and controls over euro economies. This would involve laborious ratification procedures, including some referendums across the 27 member states. Many EU members are highly sceptical about a new legislative process, in the light of the wearisome difficulties in agreeing the last major changes under the Lisbon Treaty. The European Commission, too, views such an eventuality with extreme distaste, and would much prefer to maintain its customary creativity in interpreting the current treaties, backed by the European Court of Justice if necessary.

However, rather than showing qualms over a new treaty saga, the UK coalition government should welcome the idea. It should declare that it will support a referendum on new Europe-wide legislation - but only if a new treaty grants the UK a permanent exclusion from the obligation to become part of EMU.

A new treaty as advocated by Karlsruhe could be made to enshrine a permanent UK opt-out from the support networks under which stronger countries assist weaker countries, led by Greece, Spain and Portugal. Separating Britain from this expensive and potentially explosive carousel would be in the UK's best interests. It should also be a priority for other EU members with strong economies that are currently outside EMU, principally Denmark (which like the UK has an opt-out under the Maastricht treaty process) and Sweden (which does not officially have an opt-out).

Given the structural imbalances within EMU, Europe's monetary authorities have been extremely dilatory in allowing the weaker countries to build up cumulative payments deficits during the past decade of close to 100% of GDP. Since the private capital markets are no longer ready to finance these extreme imbalances without large risk premia, governments realise that the only alternative is to turn to fiscal transfers on a massive scale, albeit with much greater conditions than hitherto.

In this year's escalating euro troubles, the German court has played an important behind the scenes role. Karlsruhe is reviewing two partly contradictory clauses of the refashioned European legislation under the Lisbon treaty. Article 125 enjoins the EU or its member states against assuming the commitments of other countries' public authorities. However, the general safeguard clause of Article 122 allows European governments 'under certain conditions' to grant financial assistance to member states beset by 'exceptional occurrences beyond its control.'

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Constitutional Court wording in full

The wording of the judgment on 30 June 2009 is as follows:

'European unification on the basis of a union of sovereign states under the Treaties may, however, not be realised in such a way that the member states do not retain sufficient room for the political formation of the economic, cultural and social circumstances of life. This applies in particular to areas which shape the citizens' circumstances of life, in particular the private space of their own responsibility and of political and social security, which is protected by the fundamental rights, and to political decisions that particularly depend on previous understanding as regards culture, history and language and which unfold in discourses in the space of a political public that is organised by party politics and Parliament.'

'Particularly sensitive for the ability of a constitutional state to democratically shape itself are decisions on substantive and formal criminal law, on the disposition of the monopoly on the use of force by the police within the state and by the military towards the exterior, fundamental fiscal decisions on public revenue and public expenditure, the latter being particularly motivated, inter alia, by social policy considerations, decisions on the shaping of living conditions in a social state and decisions of particular cultural importance, for example on family law, the school and education system and on dealing with religious communities.'

The delicate interplay between two apparently contridictory clauses is at the heart of German government fears that the Karlsruhe judges might rule that German-backed bail-outs are illegal. According to people who have spoken to Chancellor Merkel, she has expressed these worries fairly freely in private conversations in recent months. Fear of such a ruling spurred the board of the Bundesbank, the German central bank, to oppose, in a secret meeting on 9 May, the ECB's controversial decision (finally reached in the early hours of 10 May) to start purchasing the bonds of weaker states.

The court has already displayed leanings towards a narrow interpretation of the European treaties, in a judgment in June 2009 on the Lisbon Treaty that opened the way for Germany's later ratification. The court laid down general guidance on a narrow interpretation of European treaties, backing the principle of subsidiary (in which decisions are taken as closely as possible to the citizens) in particular in relation to "fundamental fiscal decisions on public revenue and public expenditure."

In an eventual decision over the euro bail-outs, the Karlsruhe court is likely to take a longer term view. It might link its judgment to further treaty amendments necessary for the EU accession of Croatia and Iceland in the next few years. The exact nature of Constitutional Court ruling is still far from clear, and it will almost certainly be politically-influenced. But, when it is announced, it could spark off a new upheaval in the political and economic framework of EMU. Governments around the EU, as well as the financial markets, should be prepared.

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Next EU treaty expected to cover enlargement

The next EU treaty is expected to cover enlargement to Croatia and possibly, Iceland. The exact timing is uncertain. Croatia hopes for entry earlier but it may slip to 2013. The Treaty may cover other aspects as part of the horse-trading over fixing the budget due in 2013. The Irish government will wish to put into this Treaty all the verbal assurances that they extracted from other member states before voting in a second ballot to accept the Lisbon Treaty – though it will be argued by some member states that these were no more than assurances as to the true meaning of the Treaty.

The 'no bail-out' clause of European Monetary Union

The European treaty Article 125 is popularly referred to as the 'no bail-out' clause:

'The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any member state, without prejudice to mutual financial guarantees for the joint execution of a specific project. A member state shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another member state, without prejudice to mutual financial guarantees for the joint execution of a specific project.'

However, Article 122 provides a general safeguard clause on which the German government, among others, has relied in claiming that it have acted lawfully in backing recent bail-outs, notwithstanding Article 125:
'Without prejudice to any other procedures provided for in the Treaties, the Council, on a proposal from the Commission, may decide, in a spirit of solidarity between member states, upon the measures appropriate to the economic situation, in particular if severe difficulties arise in the supply of certain products, notably in the area of energy.....Where a member state is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the member state concerned.

Sarrazin imbroglio adds to uncertainties over euro stewardship

David Marsh, Co-chairman

One more source of uncertainty over the governance of EMU stems from an affair over allegedly racist ruminations of an obscure German functionary catapulted into a top post at the Bundesbank. The case of the German central bank's enfant terrible, board member Thilo Sarrazin, will have a crucial bearing on who takes over as ECB president when Jean-Claude Trichet retires at the end of October 2011.

Bundesbank president Axel Weber, an academic who took over in 2004, is widely seen as the front-runner. Sarrazin stirred controversy by saying Jews shared 'a certain gene' and Muslims were unwilling to fit into German society. Weber's people-management skills have been placed under international scrutiny. If he cannot rein in a querulous board member's comments on immigration, Weber's adversaries will question his likely deftness in handling far more complex policy dilemmas in a multinational and increasingly fractious monetary council.

The Sarrazin case strikes at the heart of central banking independence. The Bundesbank, in reaction to previous excesses during the Weimar republic and Third Reich, has built up a privileged place in German society above the cut-and-thrust of politics. But successive Bundesbank's leaders have earned and nurtured their independence by confining it to matters of money – a legacy that has since passed to the ECB. Sarrazin's sin has been to branch out into an area that has nothing to do with the Bundesbank's prime area of responsibility.

When it comes to personnel matters, the Bundesbank's legendary status has not always protected it from upheavals. Viktor Wrede, a board member of the Bank deutscher Länder (BdL), the Bundesbank's post-war predecessor, was forced to resign in December 1950 after running up large debts and committed suicide with his wife shortly afterwards.

Autocratic BdL President Wilhelm Vocke was prevented from staying on in 1958, after the Bundesbank was established, following discord with Chancellor Konrad Adenauer. Otmar Emminger, the peppery economist who took over in the late 1970s, was dislodged by Chancellor Helmut Schmidt (although the Chancellor had to wait until the end of Emminger's 2-½ year mandated term.) His successor, Karl Otto Pöhl, the best-known Bundesbank helmsman, resigned spectacularly in 1991 following a bitter dispute with Chancellor Helmut Kohl. And Weber's predecessor Ernst Welteke had to resign six years ago over a murky expenses scandal accompanied by a strong whiff of governmental intrigue and score-settling.

'Will no-one rid me of this turbulent priest?' The question put 800 years ago by English King Henry II must have been ringing in the ears of Axel Weber, the Bundesbank president. Henry II called down royal wrath on the head of his former chancellor Thomas à Becket, who had been a strong supporter of the King until he was made Archbishop of Canterbury.

In central banking literature the term 'Becket effect' is frequently applied to the well-known phenomenon under which previously staunch supporters of prime ministers and presidents become stubborn-mindedly independent when they become heads of central banks. In the 12th century, Becket paid for his insubordination by being murdered by the King's knights – a fate that has not yet befallen modern-day heads of central banks.

The Bundesbank has now asked Christian Wulff, the German federal president, to dismiss Sarrazin in an effort to draw a line under the episode. Pressure for action has risen since Chancellor Angela Merkel urged the central bank to discuss Sarrazin's statements, made during the launch of a book on immigration. A protracted legal wrangle over a potential Sarrazin suit for wrongful dismissal could hold the Bundesbank in an unwelcome spotlight for several months. It is sometimes forgotten that Trichet's move into the top ECB job was held up for months in 2002-03 by a long legal fight over whether he had been partly responsible for large losses at the state-owned French bank Crédit Lyonnais – an episode that added to the teething problems of the European single currency.

Sarrazin, a former finance minister from hard-up city-state of Berlin, is well-known for his petulant, devil-may-care nature. He joined the Bundesbank in May last year under a clause in the Bundesbank Law that allows the federal states to choose the central bank's senior officials on the basis of political utility rather than competence.

Before it handed over to the ECB its powers as Europe's seminal central bank, the Bundesbank used to be respected and feared in equal measure. Sarrazin has now single-handedly made Germany's most august post-war institution into an object of derision mixed with sympathy at home and abroad. The Sarrazin affair demonstrates the need to reform the Bundesbank Law to put nominations to the bank's board in the hands of the government rather than the federal states, so that qualified officials rather than publicity-seeking showmen are selected for a job that still commands a great deal of authority.

World heads towards slower growth

But renewed slump in demand is unlikely

DZ Bank economic forecast			
GDP growth			
	2009	2010	2011
US	-2.6	2.7	2.4
Japan	-5.2	2.8	1.7
China	9.1	10.2	9.0
Euro area	-4.1	1.4	1.0
Germany	-4.7	3.3	1.6
France	-2.5	1.6	1.4
Italy	-5.1	0.9	0.8
Spain	-3.7	-0.5	0.0
UK	-4.9	1.3	0.8
Addendum			
Asia excl. Japan	6.1	8.6	7.5
World	-0.7	4.3	3.8
Consumer prices (% y/y)			
	2009	2010	2011
US	-0.3	1.6	1.8
Japan	-1.3	-1.1	-0.3
China	-0.7	3.0	3.7
Euro area	0.3	1.5	1.3
Germany	0.2	1.1	1.1
France	0.1	1.7	1.6
Italy	0.8	1.5	1.1
Spain	-0.2	1.7	1.3
UK	2.2	3.1	2.8
Current account balance (% of GDP)			
	2009	2010	2011
US	-2.7	-3.0	-3.1
Japan	2.8	3.7	3.5
China	6.5	5.7	5.5
Euro area	-0.6	0.1	-0.2
Germany	4.9	6.0	5.6
France	-2.2	-2.5	-2.5
Italy	-3.2	-3.0	-2.9
Spain	-5.1	-4.7	-4.6
UK	-1.1	-1.2	-1.0

In the last few weeks, sentiment on the capital markets has been shaken by disappointing economic data from the US. It seems that forecasters are no longer ruling out either a renewed, double-dip recession for the US economy nor a slide into deflation which could bring a fairly lengthy period of falling consumer prices. In this respect, Japan may be seen as a frightening example, since deflation in the country led to a lost decade with an ailing economy, which was virtually impossible to combat effectively with either monetary or fiscal-policy measures.

Indeed, the latest US data show that the country has not yet overcome the consequences of the economic crisis. After a strong winter half year, GDP growth has fallen back to an unsatisfactory 1.6% in spring, and a strong acceleration in growth is hardly likely over the rest of the year. However, growth rates below 2% will not be enough to reduce high unemployment, which would be a prerequisite for a recovery of consumer confidence. Consumer spending, which has often driven recovery in the past, is unlikely to set the pace.

If anything, we therefore expect a fairly lengthy period of relatively disappointing growth for the US economy.

For the moment, both private households and the government, which stepped in with generous economic programmes in the last two years to stimulate private demand, will have to concentrate on consolidating their budget in order to achieve a more sustainable growth model for the US economy. Although this will limit spending scope, it is unlikely to lead to any renewed slump in demand. We therefore rule out either a double-dip recession for the US or deflation, despite all the signs of weakness.

The Chinese economy is likely to lose further momentum in the next few months, reflecting first a cooling in the global economy, and second the prospective dampening of China's internal economy as a result of a significant downturn in private construction activity.

The most recent growth figures for the euro area were more pleasing than US data; even so, however, the European economy will hardly be able to avoid further problems. The debt crisis requires further adjustments in a number of EMU countries, and the global economic cooling is expected to dampen the rise in exports next year. We expect a decline in the euro area growth rate to 1.0% in 2011 from 1.4% in 2010.

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

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German pay restraint to continue

Enduring gap between profits and wages

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

German corporate earnings and profit margins have increased surprisingly steeply in the last few months as the global economy has accelerated thanks to government support. Hardly surprisingly, but somewhat sooner and louder than expected, calls for bigger pay increases are growing in intensity. The previous priority given to securing jobs in collective pay negotiations is now shifting to the issue of redistribution.

Besides a fitting slice of the growth in profits, German workers' representatives are now demanding compensation for previous wage restraint. Indeed, the very moderate pay settlements of the past, especially in 2003 to 2005, contributed substantially to the improvement in Germany's competitive position.

Wages even fell in real terms until 2008 and the wage ratio – around 70% in the past few decades – fell below 64% by the end of 2007. This undoubtedly made international business easier for German companies. Consequently Germany's share of EU internal trade has increased over the last 10 years by 1 percentage point to 23% and its share of the EU's external exports has risen by 1.5 percentage points to 27%.

Does Germany face tough wage negotiations in the near future? The argument that the domestic economy can best be supported by higher wages and salaries has even been condoned recently by European policy-makers. The view has gained ground that countries need to help each other by stoking up internal demand to haul the euro economy out of the mire. Such talk has been given a fillip by Germany's surprisingly strong GDP growth in the second quarter.

The argument that the domestic economy can best be supported by higher wages and salaries has been condoned recently by European policy-makers.

Not all such arguments can be dismissed completely. But Germnay needs to take care not to repeat the mistakes of the past, seen especially recently in other euro area countries. Wage restraint together with the Schröder government's employment-market reforms played a major part in reducing the number of unemployed in Germany by almost 2m since 2005 – despite the financial crisis – while it has risen massively in some parts of Europe.

Is this talk about pay increases the start of a fundamental change in the German economic model, away from export-driven growth and towards growth that is driven by personal consumption? Hardly. The German economic model is geared to exports. The service sector is relatively under-developed and is unable to provide the neccessary stimulus for employment and incomes that would be needed to sustain such a transformation over time.

The real danger in the present debate is that collective pay agreements from successful export sectors are used as a basis for pay talks in sectors of the economy that are in far worse shape. The average increase in pay would then be too high. This would not only worsen Germany's competitive position, but could also spill over into other European countries. The European Central Bank might feel obliged to raise interest rates – hardly the right policy for some member states at the moment.

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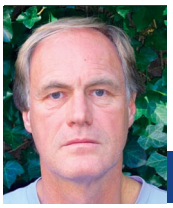

End of an exceptional career

Wellink pays price of lost confidence

Roel Janssen, Board of Contributing Editors

The announcement of the ending of Nout Wellink's exceptional career did not come as a complete surprise. Yet few were prepared for the blunt manner in which the Dutch government revealed Wellink's spell at the helm of the Nederlandsche Bank would soon be over.

Head of the central bank since July 1997, Wellink was a long-time collaborator of the late Wim Duisenberg, former president of the European Central Bank. Wellink is one of the only four members of the 22-person ECB Governing council who have been part of the body since it started in 1998. Generally recognised as an excellent central banker, Wellink is chairman of the Basle Committee of Banking Supervision that recently published tighter capital rules for banks. Up to 1982 he was a senior official in the Dutch finance ministry.

This career-long public servant has fallen foul of considerable public criticism emanating from a series of banking setbacks in the Netherlands. He nedver shirked confrontation and debate over the issue. But, in an atmosphere of widespread distrust against all kinds of bankers and the authorities in general, he lacked the political support needed to survive. On 16 August acting finance minister Jan Kees de Jager announced a new legal provision limiting the Dutch central bank president's tenure to a maximum of two terms of seven years. Wellink will end his second term in June 2011 – and then he must step down.

Wellink, who just turned 67, has come under increasing pressure over three setbacks that shook the confidence in the central bank. The first was the demise of the best known Dutch bank, ABN Amro, split up in 2007 between Royal Bank of Scotland, Banco Santander and Fortis Bank. Wellink, who favoured a merger of ABN Amro with rival bank ING, vehemently opposed the slicing up of a 'systemic' bank. But he did not block it, partly because he did not get the political backing he deemed indispensible. When questioned about this episode in early 2010, he averred that he had no legal option but to approve the takeover.

Second, the Dutch public was shocked when Icelandic internet bank Icesave collapsed in summer 2008. Though most savers recovered their money, the Dutch central bank was blamed for permitting Icesave to operate in the Netherlands in the first place, and for not alerting the public about the risks.

Third, a year later, the consumer credit bank DSB – Dirk Scheringa Bank, named after Dirk Scheringa, a self-made banker, owner of premier league football club AZ was forced into receivership. Depositors were outraged. Again, the Nederlandsche Bank was blamed: its supervision was thought to have been too lenient, it was slow in detecting the weaknesses of the maverick bank.

Wellink was forced on to the defensive. Dutch politicians have been eager to put the blame for banking failures not on their failures as lawmakers, but on the 'culture' of the central bank.

But there may be a twist in the story. Next year Trichet steps down as ECB president. The list of possible contenders to succeed him is getting longer. Might the Dutch government put forward Wellink's name? Age counts against him - he is only eight months younger than Trichet. It is difficult to see the other EU members countenancing the second Dutchman in a decade to head the ECB. But the most important point may be that the government's implicit disavowal of the stewardship of the Nederlandsche Bank hardly forms the best springboard for a leap into the hot seat in Frankfurt.

Wellink was forced on to the defensive. Dutch politicians have been eager to put the blame for banking failures not on their failures as lawmakers, but on the 'culture' of the central bank.

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Sarkozy's Bismarckian challenge

Balancing act on global monetary reform

Ousmène Jacques Mandeng, Ashmore Investment Management

French President Nicolas Sarkozy has thrown down the gauntlet in global policy-making by stating that he wants international monetary reform to be a priority when France assumes the G20 presidency in November.

'Since the 1970s, we've been living in a non-existent international monetary system,' he told a phalanx of French ambassadors at the end of August, Sarkozy called into question the suitability of an international monetary system dominated by a single currency, hinted at the need for a supra-national reserve asset and called for a new framework on capital controls and for consultation on foreign exchange developments. This was a not-so-elliptical side-swipe at the so-called 'exorbitant privilege' granted to the US monetary authorities by the pre-eminence of the dollar – a thorn in the side of successive Elysée Palace incumbents for more than 40 years.

Sarkozy's ideas for greater exchange rate stability and reduced external imbalances recognise the relationship between international monetary stability and prospects for the global economic recovery. He suggested that a conference of experts could be held, possibly in China, to discuss the future of the monetary system without 'taboos.'

Sarkozy's most difficult task may lie in convincing his fellow G20 members that international monetary reform is the right policy priority. He may also have to demonstrate that stability of the euro can only be achieved sustainably as part of a broader international monetary reform. The debate about possible reforms seems divided between two poles. On one side are those who prefer a system based on centralisation, with the predominant role of the dollar and a few other currencies. On the other side are supporters of a form of federalism with several currencies.

Those in the 'centrist' camp emphasise that money as a medium of exchange benefits greatly from economies of scale. The centrists can point to the relative successes of the current regime, and highlight that there are no alternatives. And they would contemplate propagation of the IMF's Special Drawing Rights, on the basis that they already exist and may even presage the creation of a global currency.

The 'federalist' agenda would take the view that centralisation brings undue concentration of risks and is not representative of the global economy. According to this view, the travails of the European Monetary Union point the way towards how adoption of a multi-currency regime could promote monetary integration of emerging markets. The opposing forces of centrists and federalists will complicate any agreement on the direction of reform. While the G20 represents the ideal forum to establish necessary alliances, it also links a group of countries with sharply differing interests. The multiplicity of today's challenges suggests that a credible reform will need to accommodate existing and new elements.

This confronts protagonists with a balancing act of the same complexity as that which faced Otto von Bismarck, the German Chancellor, in 1871-75 when he brought about the unification of Germany accompanied by the birth of the Mark and the Reichsbank. Bismarck established a system that granted plurality between regional and federal currency issuance where the Reichsbank played a dominant but not monopolistic role. Bismarck seems an unlikely ally for guiding a reform of the international monetary system. But the Iron Chancellor was aware of the acute need to create an equilibrium - in the political, military and economic spheres - as a prelude for sustainable success.

Note: The author has spoken out in past writings and speeches in favour of introducing greater weight in world monetary affairs for the BISMARCK currencies, standing for Brazil, India, South Africa, Mexico, Saudi Arabia, Russia, China and Korea.

Bismarck appears an unlikely ally for guiding a reform of the international monetary system. But he was aware of the need to create an equilibrium as a prelude for success.

Renminbi goes international

Route map for capital market integration

Julia Leung, Under Secretary, Financial Services & Treasury, Hong Kong

Slowly but surely, China is moving towards internationalising the renminbi. By allowing greater use of its currency beyond its borders, China is taking highly important steps towards creating a more stable world financial system.

In the latest move, the Chinese government is allowing offshore banks and institutional investors to invest into the mainland interbank bond market renminbi they accumulate through a recently announced trade settlement scheme. This follows the pilot scheme announced in April 2009 to allow designated enterprises in five Chinese cities to use renminbi to settle cross border trade with Hong Kong, Macao and the Asean countries., In June 2010 the arrangements were expanded to enterprises in 20 cities and provinces, with coverage enlarged to services as well as merchandise trade and broadened to beyond Asean to the rest of the world.

Hong Kong looks set to play an important role in the development of an international, liquid offshore renminbi market. Hong Kong is geographically close to China with many businesses that trade with the mainland. And it also hosts a distinct market with its own economic regulations and a highly developed financial system. That makes the territory an ideal testing ground for renminbi internationalisation.

Of renminbi business conducted between mainland China and the rest of the world, at end-June 75% was handled through banks in Hong Kong. The territory looks likely to become the offshore renminbi centre, much the same way as London's Eurodollar market played a critical role in the internationalisation of the dollar in the 1960s and 1970s.

Of great importance for the Chinese authorities, full renminbi convertibility can be tested in HK without bringing risks to mainland China's market. Under this "two track approach', in Hong Kong, the renminbi can be made freely convertible among non-residents, providing important indications to mainland China for the next stage of reform. In mainland China itself, however, capital market liberalisation can proceed much more slowly in a way that takes account of lessons learned from Hong Kong.

Beijing's pilot programmes are still relatively small, and the measures are billed mainly as reforms to facilitate international trade. But they can help significantly in curbing global macroeconomic anomalies that contributed to the 2007-08 trans-Atlantic financial crisis.

China is the world's largest exporter and now the second-largest economy, yet it is the only major trading nation that does not trade and settle in its own currency. Beijing still maintains capital controls that involve sterilising the flow of money into the economy. Since so much of China's trade is denominated in dollars, the government must accumulate huge dollar reserves, which constitute the bulk of China's $2.45tn in foreign reserves. Since this money is reinvested mainly in US Treasury securities, it artificially increased the US money supply and helped lower interest rates during the bubble years.

There are very large and evident discrepancies between, on the one hand, the make-up of world trade and, on the other, the world's monetary and capital market balances. The US accounts for roughly 10% of world exports, the European Union 16%, Japan 6.5% and China 12%.

China is the world's largest exporter and now the second-largest economy, yet it is the only major trading nation that does not trade and settle in its own currency.

However, the currency composition of official reserves is skewed overwhelmingly to the dollar and the euro. Currency reserves are held 62% in dollars, 27% in euro and 3% in yen. The dollar percentage has fallen from 71% a decade ago, but the dollar's reserve status is far bigger than implied by trading patterns.

The anomalies are particularly evident in financial markets. The combined worth of the Shanghai and Shenzhen stock markets now ranks fourth globally – well behind the front-runner, the New York stock exchange, but only marginally below the standing of the Tokyo Stock Exchange and the technology exchange NASDAQ. In addition, the combined turnover of China's futures exchange is already the largest in the world. However, because China allows only restricted channels for inward and outward portfolio investments, world equities and commodities prices do not take into account China's supply and demand, even though they are among the largest in the world.

Unless action is taken in the meantime, these discrepancies look likely to get bigger over the next decade. In 2020, assuming export growth matches GDP growth in key countries, the US will account for 7% of world exports, on Goldman Sachs projections, while the EU will have 11% and China 21%. All this indicates that the renminbi will have to play a much larger role in the price discovery process for capital and commodities markets.

The dollar is likely to remain the dominant international reserve currency. But allowing a greater role for the renminbi in international trade will alleviate some of the pressures created by excess reliance on the dollar. The question for policy makers in Beijing is how to achieve that result with minimal disruption.

A number of recent moves by Beijing indicate how that process will take place. The expanded renminbi trade-settlement scheme is a significant component. Before Beijing started the pilot programme, there were very few legitimate paths for renminbi to the outside world. As a sign that the trade settlement scheme is gaining traction, renminbi deposits in Hong Kong have grown 50% to nearly Rmb90bn ($13.3bn) at end-June compared with end-December 2009.

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China is enabling the offshore reservoir of renminbi to increase in breadth and depth. Hong Kong has taken a big step in this direction by lifiting restrictions on bank transfers of renminbi funds between individual accounts, leading to development of a nascent offshore renminbi asset market.

Significantly, China is allowing offshore renminbi to flow back to the mainland in a controlled and regulated manner that alleviates concerns about hot-money flows. Opening up offshore investors' participation ion in the mainland interbank bond market is part of this effort. Beijing also is considering allowing renminbi securities funds in Hong Kong to access the mainland's listed fixed-income and equity securities under a quota system. Beijing would probably like to see a vibrant offshore market in Hong Kong to test the acceptability of renminbi among international investors.

Beijing's interest in international monetary reform was highlighted by the much-publicised statement in March 2009 by Zhou Xiaochuan, Governor of the People's Bank of China, urging expanded use of the IMF's Special Drawing Right, the composite currency unit currently including the dollar, euro, yen and sterling. The Chinese State Council has also announced the decision to build Shanghai into an international financial centre by 2020 commensurate with enhanced international status for the renminbi.

The main milestones are now discernible in China's route map for integrating its capital market with that of the rest of the world. This will, we hope, help create a more stable international monetary system,with a better balance between East and West.

Learning lessons from India

West should heed emerging economies' experience

Rakesh Mohan, Advisory Board

In the flurry of debate about preventing and managing financial crises, we need to pay attention to precepts from the emerging market economies (EMEs). In common with other parts of Asia and Latin America, India escaped relatively unscathed from the North Atlantic financial crisis. Although the EMEs suffered economic setbacks as a result of the past three years' international turbulence, their financial sectors exhibited relative stability. No important financial institutions in these economies were affected in any significant fashion. And, unmistakably, the emerging economies have been leading the world out of recession. Of course, there are many reasons for success and failure in economic policies. But the relative resilience of these countries' economic governance systems provides useful indicators for consideration elsewhere.

Are there any particular lessons that should we learn from India? Having worked in both the central bank and the Treasury, I believe that macro-prudential or financial stability oversight can be effective only if the central bank is at the helm of this activity. The Reserve Bank of India, as both the monetary authority and the lead financial sector regulator, has been able to supplement its monetary policy with effective and consistent prudential actions. In different countries with important variations in institutional legacies, traditions and systems, no one size can fit all. None the less, it seems reasonably evident that, within any kind of arrangement deemed fit for a particular country, the central bank should have a lead role concerning financial stability.

The RBI's experience provides examples of how macro-prudential measures can be implemented that supplement more narrowly-implemented monetary policy. There are obvious practical benefits from such linkage. The central bank is the lender of last resort. It is the only agency which has an overall view of the economy. Compared with most Treasuries, it has exceptional stability in terms of staffing and continuity in thinking. And, if it is doing its job properly, it has its ear to the ground with respect to evolving developments in financial markets In the case of the RBI, its regular monitoring of credit aggregates, including movements in sectoral credit, has allowed the bank in recent years to take macro-prudential action when it observed excess credit growth, both on an aggregate basis and in particular sectors like real estate and housing.

As an example, the bank increased the cash reserve ratio (CRR) to curb overall credit growth and imposed higher provisioning and risk weights for lending to the affected sectors.

As part of its supervisory activities, the Reserve Bank monitors the incremental credit deposit ratio carefully and cautions banks when such a ratio is found to exceed acceptable norms. The RBI is also able to carry out forward-looking counter-cyclical capital buffering through increases in loan loss provisioning when needed. Further, when it observed regulatory arbitrage being practised by the lightly regulated non-banking financial companies in 2005-07, the Reserve Bank took measures to tighten their regulation towards reducing their potential ability to carry out excess leverage.

In regulatory frameworks in other countries, we see many examples of different degrees of fragmentation and concentration. The US Federal Reserve System has had significant regulatory responsibilities but otherwise the US has had a very fragmented regulatory structure. The UK, for its part, placed all regulatory responsibilities for all segments of the financial sector in the unified Financial Services Authority.

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In the rest of Europe, monetary policy became centralised in the European Central Bank but financial regulation has remained fragmented at national levels. Continuing efforts to undertake significant regulatory reform in the US, the UK and in the euro area illustrate the lack of consensus on what kind of regulatory structure constitutes best practice.

The UK is abandoning its experiment of separating financial regulation from the central bank and the FSA is now being folded back into the Bank of England. Mirroring arrangements in India, the governor of the Bank of England will now be responsible for monetary policy, financial regulation and financial stability.

A general belief seems indeed to have gained ground that a central bank can better exercise its responsibility for financial stability if financial regulation also comes within its purview. The US Treasury had initially proposed that all banking regulation be unified in a single agency, while placing greater responsibility on the US Federal Reserve for maintaining financial stability. In the reform bill that has finally been passed, systemic risk will be formally assessed by a new Financial Services Oversight Council, which will be composed of the main regulators and chaired by the Treasury Secretary. It will focus specially on Systemically Important Financial Institutions (SIFIs) in order to prevent institutions from getting too big to fail. Any emerging SIFIs, including non-banks, will be put under the regulation of the Federal Reserve.

Regulatory jurisdiction has been simplified and clarified, with the Fed handling systemic institutions, the Office of the Controller of the Currency looking after national banks, and Federal Deposit Insurance Corporation responsible for state banks. The only agency being eliminated is the Office of Thrift Supervision. It is yet to be seen how these new arrangements will function. What is clear, however, is that there is now much greater appreciation of the role of the central bank in maintaining financial stability and in regulating SIFIs of all varieties, not just banks.

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Sustained growth ahead – but inflation is the worry

Meghnad Desai, Chairman, Advisory Board

The Indian economy is now getting used to a growth rate of around 9 %. This is the expectation for the current year and latest data have buttressed my own prediction that it will be nearer 10 % when the final numbers are produced. The Government's successful reflationary package can now be unwound and the prospect for the deficit in this fiscal year looks pretty good.

The major economic problem since mid-2009 has been inflation. The rainfall last year was below expectations and drought was declared. Despite this clear forecast of low food-grains output, the Government mismanaged the supply situation and triggered a double-digit inflation in foodstuffs.

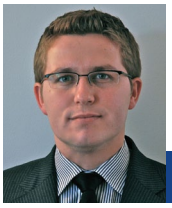
India is normally a low inflation economy and a double-digit inflation rate is a rarity. So this is a major challenge for the Reserve Bank of India as well as for the administration. Inflation as measured by the consumer price index does however appear to be slowing, down to 13.7% in June from 16.2% in January – but it is still unacceptably high.

We are now witnessing something of a catch-up with China. India is starting from a long way back, however. In the last 30 years China grew at 10% a year on average and its output has expanded 16 times to $5tn. India grew at 6% and its economy increased sevenfold to $1.2tn. We need to remember that India will add 136m people to its labour force over the next 10 years, China only 23m. So there is a lot to play for.

Sovereign funds

Country	Name of Fund	Description	Size of fund *(estimates where not publicly available)*
Algeria	Revenue Regulation Fund	Stabilisation fund	$55bn
Australian	Future Fund	Sovereign pension fund	$60.7bn
Azerbaijan	State Oil Fund	Natural resource fund	$18.2bn
Bahrain	Mumtalakat Holding Company	Sovereign development fund	$13bn
Botswana	Pula Fund	Natural resource fund	$7bn
Brunei	Brunei Investment Agency	Natural resource fund	$30bn
Canada	Canadian Pension Plan Investment Board	Sovereign pension fund	$123bn
Chile	Social and Economic Stabilization Fund	Natural resource fund	$22bn
China	China Investment Corporation	Foreign reserve fund/sovereign development fund	$200bn - $330bn
China	National Social Security Fund	Sovereign pension fund	$147bn
China	SAFE Investment Company	Foreign reserve fund	$320bn - $450bn
France	Strategic Investment Fund	Sovereign development fund	$28bn
Hong Kong	Investment Portfolio (HKMA)	Foreign reserve fund	$246bn
Ireland	National Pensions Reserve Fund	Sovereign pension fund	$30.75bn
Kazakhstan	Kazakhstan National Fund	Natural resource fund	$38bn
Korea	Korea Investment Corporation	Foreign reserve fund	$30bn
Korea	National Pension Service	Sovereign pension fund	$240bn
Kuwait	Kuwait Investment Authority	Natural resource fund	$210bn
Libya	Libyan Investment Authority	Natural resource fund/sovereign development fund	$70bn
Malaysia	Khazanah Nasional	Sovereign development fund	$25bn
New Zealand	New Zealand Superannuation Fund	Sovereign pension fund	$11.7bn
Nigeria	Excess Crude Account	Stabilisation fund	$0.5bn
Norway	Government Pension Fund – Global	Natural resource fund	$450bn
Qatar	Qatar Investment Authority	Natural resource fund	$65bn
Russia	National Welfare Fund	Natural resource fund	$90bn
Saudi Arabia	Public Investment Fund	Sovereign development fund	$6bn
Saudi Arabia	SAMA Foreign Holdings	Foreign reserve fund	$450bn
Singapore	Government Investment Corporation	Sovereign development fund/Foreign reserve fund	$250bn - $330bn
Singapore	Temasek Holdings	Sovereign development fund	$50bn - $130bn
Timor-Leste	Petroleum Fund	Natural resource fund	$6.3bn
Trinidad and Tobago	Heritage and Stabilisation Fund	Natural resource fund/stabilisation fund	$3.1bn
UAE	Abu Dhabi Investment Authority	Natural resource fund	$500bn - $800bn
UAE	Abu Dhabi Investment Council	Natural resource fund/sovereign development fund	Unknown
UAE	Invest AD	Natural resource fund/sovereign development fund	Unknown
UAE	Emirates Investment Authority	Natural resource fund/sovereign development fund	Unknown
UAE	International Petroleum Investment Company	Natural resource fund/sovereign development fund	$14bn
UAE	Investment Corporation of Dubai	Natural resource fund/sovereign development fund	$20bn
UAE	Mubadala Development Company	Natural resource fund/sovereign development fund	$13.5bn
UAE	Ras Al Khaimah Investment Authority	Natural resource fund	$1.2bn
USA	Alaska Permanent Fund	Natural resource fund	$34.2bn
USA	Permanent Wyoming Mineral Trust Fund	Natural resource fund	$3.6bn
Vietnam	State Capital Investment Corporation	Sovereign development fund	$0.5bn

OMFIF
Official Monetary and Financial Institutions Forum



Defining 'wealth' in sovereign funds

Why we need a new nomenclature

Malan Rietveld, Chief Economist

While the term 'sovereign wealth funds' has become part of the standard financial lexicon in recent years, a number of the funds themselves have rejected the moniker. This is in part due to the negative connotations the term acquired, but also because the funds do not always see themselves as wealth managers

While one could quibble about both the 'sovereign' part of the term (the Alaska Permanent Fund and Alberta's Heritage Fund, for example, are sub-national entities) and with their classification as 'funds' (many of these entities could better be described as holding companies, agencies or enterprises), these distinctions are trivial enough to ignore. But it is the idea that all sovereign funds manage official 'wealth' that is most problematic.

While a number of well-known sovereign funds – those from Norway, Abu Dhabi, Chile, Botswana, Kazakhstan and Azerbaijan are prime examples – do manage their nations' significant commodity windfalls according to long-term wealth management principles, the same does not apply to a large number of the funds commonly referred to as sovereign wealth funds. China Investment Corporation (CIC), for example, manages a pool of assets that were allocated to it through a debt-financed transaction between the country's central bank and finance ministry.

Given that many so-called sovereign wealth funds pursue investment objectives and philosophies that are far removed from the concept of long-term wealth management, it is better to simply to refer to this class of state-back investors as 'sovereign funds'.

Five types of sovereign funds can be identified, although the lines separating them can at times blur. First, there are natural resource funds, such as the Norwegian Government Pension Fund, Botswana's Pula Fund, the Chilean Social and Economic Stabilisation Funds and the National Oil Funds of Kazakhstan, Azerbaijan, Abu Dhabi, Qatar and Kuwait. These funds, which account for the majority of sovereign funds, typically manage the proceeds from the extraction of natural resources as national wealth, embracing a long-term view that promotes the inter-generational transfer of this wealth.

The idea that all sovereign funds manage official 'wealth' is problematic.

The second group consists of sovereign development funds. What sets them apart from natural resource funds is that they incorporate non-commercial objectives, such as the development of certain industries and sectors of the domestic economy, alongside obvious commercial concerns. These funds are typically transparent about their developmental objectives and how these translate into the provision of various forms of subsidies to strategically important firms and sector.

Prime examples of sovereign development funds include Bahrain's Mumtalakat Holdings, Malaysia's Khazanah Nasional, Vietnam's State Capital Investment Corporation, Abu Dhabi's Mubadala, Saudi Arabia's Public Investment Fund and France's Fonds Stratégique d'Investissement. Singapore's sovereign funds, Temasek and the Government Investment Corporation, could also be seen as sovereign development funds, although both have graduated towards a more long-term wealth management approach.

The third group consists of short-term stabilisation funds. These funds are similar to most natural resource funds to the extent that their assets typically come from the proceeds of extractive industries, but they are different in that they do not manage these funds with a long-term perspective. In contrast, assets are held in highly liquid, short-term securities, and the objective of the funds are simply to stabilise and smooth highly cyclical movements in macroeconomic variables, such as fiscal revenues, public investment and the exchange rate. Examples of short-term stabilisation funds include Nigeria's Excess Crude Account and Algeria's Revenue Regulation Fund.

The fourth group consists of foreign reserve funds that have adopted a more long-term, risk-orientated approach to the management of foreign exchange reserves than central banks, including investments in equities and other asset classes beyond fixed income. These funds differ from, say, natural resource funds in the sense that they do not manage net wealth, but rather a pool of assets that arise from structural imbalances. The most salient examples of these funds are China Investment Corporation, Korea Investment Corporation and the Exchange Fund (particularly the Investment Portfolio) of the Hong Kong Monetary Authority.

The fifth group consists of sovereign pension funds, which manage a well-defined pool of assets transferred to them through a carve-out from the national (or sub-national) budget, with a view to assisting the government in meeting future public pension liabilities. These funds can be distinguished from various other public pension funds due to their global, diversified investment models. Prime examples are Australia's Future Fund, New Zealand's Superannuation Fund, the Canadian Pension Plan Investment Board, Ireland's National Pension Reserve Fund and Korea's National Pension Service.

Asia steps up drive to self-sufficiency

Amro surveillance unit in Singapore could eventually rival IMF

Across Asia, there is an unmistakable sound of monetary whip-cracking in the air. Asian central banks, with an estimated $1.5tn worth of euros in their official reserves, have emerged as strong supporters of financial stringency in errant southern European states belonging to economic and monetary union (EMU).

The word from Asia is music to the ears of Germany and other creditor nations that are stepping up calls for belt-tightening among cash-strapped euro members. The support for euro rigour goes hand in hand with Asian efforts to build up self-sufficiency in monetary affairs. The proximate cause of these efforts has been a campaign to prevent Asian countries falling victim to the liquidity nightmares they suffered during the 1997-98 Asian currency crisis.

In addition, Asian countries have been closely watching the shortcomings of EMU – and have declared that they will do better. Over time, this process could lead to Asia developing its own monetary and financial instruments and institutions that might rival the International Monetary Fund in global scope and influence.

For the large reserve holders among Asian central banks, led by China and Japan but also including Singapore, Hong Kong, Taiwan and Malaysia, reserve diversification has been one essential way of lowering their dependence on the dollar. The message from Asian policy-makers is that Asia will maintain and even build up its investment in the euro. The single currency is regarded as an essential antidote to the pre-eminence of the dollar – an ascendancy which, if unchecked, is seen as simply encouraging American profligacy. But the quid pro quo, the Asians say, is that European decision-makers must be unrelenting in enforcing discipline in the indebted outlying nations led by Greece, Portugal and Spain. So the Asians have emerged as the Germans' strongest allies in supervising long-overdue stringency in the euro's weakest states.

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Other steps towards self-protection from dollar travails have been illustrated by recent news that China has stepped up its holdings of South Korean treasury bonds denominated in won. That follows hard on the heels of record purchases of Japanese bonds in the first half of the year. Chinese holdings of won Treasury bonds stood at $3.4bn at the end of last year, according to official Korean figures. The Chinese State Administration of Foreign Exchange bought a record $20.3bn of Japanese government bonds in the first half of 2010, almost seven times its purchases for the previous record year of 2005.

In general, Asian initiatives to gain greater self-sufficiency in world economic and monetary affairs represent a delicate balancing act. On the one hand, Asian countries are far from being a cohesive bloc and they are still prone to economic or political shocks. They certainly do not wish to place themselves outside western-orientated mechanisms of international coordination, such as the International Monetary Fund, the Bank for International Settlements or the Organisation of Economic Cooperation and Development. Central bank credit swap lines with the Federal Reserve Bank of New York remain of paramount importance in times of crisis, whatever the talk of bilateral monetary support facilities built up under the so-called Chiang Mai Initiative (named after the Thai city where the policy agreement was reached in 2000).

On the other hand, signs of greater solidarity are unmistakable. Finance ministers from the 10 members of the Association of Southeast Asian Nations (Asean), plus China, Japan and South Korea, are slowly adding content and structure to their $120bn multilateral currency-swap mechanism that became operational earlier this year. An office carrying the somewhat unlikely acronym Amro is being set up in Singapore to monitor regional economies as part of the Chiang Mai Initiative (CMI).

The office, which will be established initially in the premises of the Monetary Authority of Singapore, is designated the 'Asean+3 Macroeconomic Research Office.' It is intended to be operational by May 2011. (Those responsible for the name clearly were not unduly concerned about a potential association with the Dutch bank ABN Amro hit by banking losses in 2007.) To enhance the effectiveness of bilateral swap lines agreed under Chiang Mai, the region's finance ministers agreed in 2006 to set up a larger framework of liquidity support, the so-called CMI Multilateralisation (CMIM). In 2007, ministers decided that the CMIM should take the form of a 'self-managed reserve pooling' arrangement – which has now become operational in the form of the $120bn scheme. Of the overall contributions, $24bn comes from Asean countries and $96bn from China, Japan and South Korea.

Amro will play an important supporting role in the chain of command by carrying out regular economic assessments on member countries.

All parties to the CMIM can access the facility. The maximum amount that each country can draw is up to a certain multiple of its contribution. Within such an amount, up to 20% can be drawn without linkage to IMF facilities. The rest of the funds can be drawn if an IMF programme already exists or a potential programme is to be in place. Each currency swap shall mature 90 days after the date of drawing, and can be renewed up to seven times.

Overall decision-making on CMIM is in the hands of Asean+3 ministers and central banks. Amro will play an important supporting role in the chain of command by carrying out regular economic assessments on member countries, linking both financial stability and macroeconomic indicators.

The Chiang Mai initiative could eventually grow into a reserves pooling scheme that could supplant the IMF as a conduit under which Asian countries make balance of payments loans. Amro could play an important part in this undertaking as a body that supplies not only technical assistance to central banks and governments but also enforces the conditionality of such loans. Such a development, which could mark a major challenge to the IMF, would be similar to the way in which European countries are making loans to countries like Greece subject to macro-economic conditions.

The ambitious aims behind Amro were laid down unmistakably by Singapore Prime Minister Lee Hsien Loong earlier this year. Describing Amro as a 'professional, objective and rigorous' organisation, he said 'It should be able to command respect, give useful advice and be accepted as a basis on which countries can make decisions, and whether or not and how to help a particular country in distress.'

'With Amro, we don't have to wait for the global fire brigade to come. Instead, we can do something among ourselves first,' said Lee. 'The question is how to do so in an effective way, one that maintains high standards and helps to solve problems rather than just let discipline slacken and make the problems worse.'

Singapore's prime minister made an outspoken allusion to Europe's monetary problems, pointing out that Amro could help forestall turbulence of the sort suffered by Greece and other countries. 'Greece is in quite a deep hole. It needs to continue to borrow money but the market isn't quite sure that, if they lend money to Greece, they can get it back. They may default,' he said. 'So how do you have a system where Greece can get help but at the same time it's not unconditional and there is some discipline enforced? This has vexed the Europeans a great deal.'

If something similar were to happen in Asia, Asean and its dialogue partners would face the same problems or even worse, Lee said. 'Our Asian institutions are even less developed than those in Europe, and we hope that Amro in Singapore will be the start of one of these institutions in Asia that can help us strengthen our regional cooperation in a constructive way, without losing our links to the International Monetary Fund and World Bank and other global "fire brigades" that will continue to be useful.'

Lee's words are prophetic. The West should watch for what happens next.

A monthly foray into monetary secrets hidden in archives

The unchanging language of money

How today's monetary tussles are couched in the same vocabulary as the epic financial struggles of the 1960s and 1970s

Harold James, Advisory Board

We are in a continual state of déjà vu. For the first part of this year, every few weeks, there was an announcement of a package that would rescue Greece from chaos, and maybe other Mediterranean countries too; but it was then followed by a new slide of confidence, doubts about the effectiveness of the proposed measures, and then new emergency action. Now these worries have resurfaced again, and alternate with doubts about the dollar to keep world currency markets nervous.

But déjà vu is actually even more déjà than that. What is being said, and how it is being said, is frequently identical to what was being said 20 or even 40 or 50 years ago. The phrases and the concepts used in long-forgotten discussions are coming up today as if they were completely fresh and original insights, and as if the issues that created the discussions simply arose yesterday.

The debates go back to the origins of European integration. Policy-makers in the 1950s, looking back to the turmoil of the interwar years, saw big current account imbalances and disputes about who should adjust as the major threat to a new European order. In the 1920s, the major surplus countries were France and the US, and the big debtor countries were in central Europe (especially Germany) and Latin America.

The views arose in much the same setting as today: as national governments worked out how regional arrangements were compatible with the domestic pressures and interests with which politicians needed to work. What is surprising is how ineffective European governments and policy-makers have been in producing answers.

France and the US, the accusation went, should not have conducted restrictive monetary policies. France in particular accumulated large gold inflows, and sterilised them so that they did not have any impact on French monetary conditions.

The architects of European integration, remembering the legacy of depression and the disintegration of the international political order, wanted to prevent any recurrence of the interwar debacle.

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Article 104 of the 1957 Treaty of Rome stipulated that: 'Each member state shall pursue the economic policy necessary to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while ensuring a high level of employment and the stability of the level of prices.' The emphasis on balance of payments equilibrium was a very characteristic way of drawing a lesson from the Depression.

In the late 1960s, new global imbalances began to emerge that strained relations both globally and on the European continent. In 1967 and 1968 Germany ran large surpluses; and Japan's trade and current account surpluses shot up in the early 1970s. The German surpluses, then as now, were interpreted as a problem not only for the US, but also for Germany's neighbours.

The political positions elaborated then became standard fare for the subsequent half century. That is not surprising. The views arose in much the same setting as today: as national governments worked out how regional arrangements were compatible with the domestic pressures and interests with which politicians needed to work. What is surprising is how ineffective European governments and policy-makers have been in producing answers to these problems.

First, the German surpluses were presented as a threat to the European and international monetary order. Germany, like France in the interwar years, was in the 1960s (and subsequently) thought to be stabilising its economy at the cost of its trading partners. Raymond Barre of the EEC Commission, in 1968 stated that Germany must take 'energetic measures for speedier growth and the stimulation of imports.' He started to devise institutional ways of putting more pressure on the Germans.

Second, the Germans did not want to deal with the mess of debtor countries on their own, and not in a purely European context, but wanted to bring in international institutions and above all the IMF. Trying to produce simply a European solution for the problems of the Mediterranean would just escalate political tensions. Bundesbank President Karl Blessing in 1964 stated that: 'The Italian problems are not short term and cannot be dealt with by short term measures. Let us hope that the Italians will go to the Fund.'

Third, French politicians and central bankers wanted more economic governance and more control of central banks. The Governor of Banque de France, Jacques Brunet, in 1962 stated that: 'The role of governments in monetary policy should be emphasised.'

Fourth, the Europeans could blame not just themselves but the global situation, and above all US consumerism by government and individuals, as a source of the word's monetary problems. This was the position taken most emphatically by French President Charles de Gaulle: 'The United States is not capable of balancing its budget. It allows itself to have enormous debts. Since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last.'

All these positions from the 1960s seem uncannily contemporary. But it was West German Chancellor Helmut Schmidt who in 1978 formulated most clearly the dangers inherent in seeing the world simply through the lens of current account imbalances. 'There are bad exaggerations around when each views it through national spectacles. One side prattles about an inflationary community, the others, English and Italians in particular, prattle about a deflationary community which would disrupt their whole national economy.'

Schmidt was right, although the critics in the US and in other countries would inevitably point out that his was a view that also suited German national interests.

It is sobering how little has changed in the tone of the debate, and how current account imbalances still provoke the kind of resentments that were first articulated long ago in the early modern era of mercantilism in the 17th and 18th centuries. At that point deficit countries worried about the surplus countries building up gold reserves that could be used to finance aggressive military action. And the surplus countries knew that the consequences of default by debtors would be destabilising and provide the opportunity for powerful states to expand their influence and control.

Perhaps these basic statements that were made in response to controversies long past could be usefully recycled, most usefully with their original citations, in major summit discussions at the EU and the global level.

It might help people to achieve greater modesty if they realised how stale and hackneyed their supposedly new ideas are. But, equally importantly, to know precisely when and why an argument was presented helps us understand how difficult international coordination is, how meagre is the capacity for real policy innovation, and how rare it is to establish really lasting institutional solutions.

Perhaps basic statements that were made in response to controversies long past could be usefully recycled, most usefully with their original citations, in major summit discussions at the EU and the global level.

Looking ahead – diary dates

Pierre Werner Memorial Lecture
14 October 2010, London
Yves Mersch, Governor, Luxembourg Central Bank

OMFIF Meeting in Middle East
31 October – 2 November 2010
Central Bank of the U.A.E., Abu Dhabi

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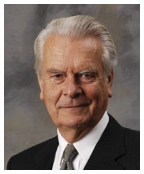
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