OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

September 2011

Europe's debt lessons from 1930s

Austerity and taxation expose democratic deficit

John Nugee, Deputy Chairman, Advisory Board

In the realm of international money, 2011 brings two notable anniversaries. It is 40 years since the US ended the dollar's convertibility into gold by closing the 'gold window' in August 1971. Precisely twice as long ago, the UK did the same for its own currency when Britain left the gold standard in September 1931.

These episodes are reminders of the parallels for Europe's present crisis of national solvency and excessive government debt. And they perhaps provide important lessons for today's policy-makers. We are not doomed to re-run the 1930s. We can learn from that dreadful decade, as our forefathers did 50 year ago.

We do have alternatives to crushing austerity. But the current path in Europe, in which the political leadership imposes hardship with neither explanation, nor discussion, nor consent, risks repeating some of the blackest periods of Europe's recent history. These are lessons we must heed.

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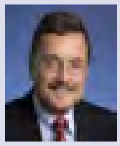
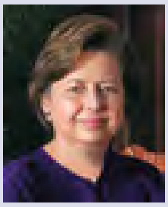
Stark departure throws European Central Bank into new turmoil



The surprise announcement on 9 September that European Central Bank board member Jürgen Stark is leaving the bank over differences on the ECB's sovereign bond purchase programme brings economic integration in Europe into a new phase of turbulence. **SEE ARTICLES ON ECB FUTURE ON P. 7-11**



Zeti expounds 'transformation that will reshape the world'

Governor Zeti Akhtar Aziz of Bank Negara Malaysia explains 'a major global transformation at an unprecedented scale and speed' – the shift in economic power to the East. 'The pervasive nature of this transformative change is the result of mutually reinforcing global shifts – economic, financial and monetary, with far-reaching implications. The realignment is a structural transformation of historical significance that will reshape the world.' **FOR FULL ARTICLE BY GOVERNOR ZETI SEE P. 19-20**

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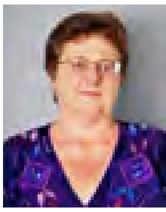

Leadership test

Painful path ahead

Gill Marcus, S. African Reserve Bank

The inability of the leadership of the euro area economies to agree on a credible and durable solution for the region has undermined support not only for the leaders but also for the whole euro project, according to Gill Marcus, Governor of the South African Reserve Bank.

In an address to the August OMFIF meeting at the South African Reserve Bank in Pretoria, Governor Marcus said the poor outlook was compounded by the 'damaging' US debt ceiling debate and the American ratings downgrade.

Pointing out that recessions involving financial crises took longer to work through, she said 'significant financial commitments' would be needed to head off a new growth slowdown. 'These need to be big enough to put a stake in the ground.' However, because of the monetary and fiscal firepower already expended, she admitted that room for action was limited. 'There is a long, painful path ahead for all of us.'

FOR FULL ARTICLE BY GOVERNOR MARCUS SEE P.24-25

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A red-meat summer

OMFIF casts its net wider

David Marsh, Co-chairman

What a summer this has been! Not red-hot (at least in the UK), but red-meat. As many people have observed, August is not a good time to take your eye off the ball. Wars, riots, insurrection, unrest, currency crises and damaging press leaks tend to break out during the traditional holiday month of the northern hemisphere. Seldom, though, as in 2011, all at once

For OMFIF, it has been a busy few weeks, where we have cast our net ever wider. And on the broader international stage, the last few weeks have been rich in portentous events. Not a season for the faint-at-heart. Paying testimony to an extraordinary period, the Bulletin contains a bumper outpouring, with contributions in this edition from a record 12 advisory board members.

For the first time, our advisory board chairman and all three deputy chairmen burst into print simultaneously. Meghnad Desai exposes the tendency of countries that acquire independence to enact economic nonsense in their early years. He notes, with due sobriety, that South Africa (where OMFIF has just held its Inaugural Meeting in Africa) may be exhibiting this trend – a sentiment backed up by new advisory board member Peter Bruce. John Nugée cheerlessly outlines a 1930s throwback to today's apparently doomed policy of austerity in the euro area. Songzuo Xiang extols a ground-breaking OMFIF symposium in Beijing on renminbi internationalisation, where Chinese officials outlined both hopes and qualms about wider use of the currency. Frank Scheidig pleads with his fellow Germans to back more funding to save the euro from which they derive (he says) so much benefit.

We are fortunate to record the views of two formidable governors on the international central banking circuit, Zeti Akhtar Aziz of Bank Negara Malaysia, and Gill Marcus of the Reserve Bank of South Africa, both of whom addressed OMFIF gatherings during the summer. Governor Marcus is unremitting in her judgment on poor policy leadership in the industrialised world. Governor Zeti throws light on the shift of economic power from West to East, a transition illustrated, too, by John Kornblum, who describes European and US shortcomings in dealing with globalisation.

Darrell Delamaide, in addition to his monthly round-up of Federal Reserve opinion and policy action, savages Standard & Poor's for the rating agency's downgrade of US debt. In the euro area, Niels Thygesen, Michael Kaimakliotis, Hans-Olaf Henkel, Ruud Lubbers and Paul Seters provide their own assessments and recommendations. Further afield, Junko Nishioka laments the new Japanese prime minister's lack of promise. Jonathan Fenby sees continued Chinese inflation pressures. Malan Rietveld shows how sovereign funds are starting to team up – and outlines the new challenges for the Libyans. Michael Lafferty is unhappy about British banks' successful lobbying against financial reforms, while Steve Hanke salutes the IMF's policies on Mexico.

We welcome six new members – as well as Peter Bruce, Haihong Gao, Thomas Laryea, Ashley Eva Millar, Hendrik du Toit, and Gerard Lyons – on to our advisory board. We provide an overview of the plenary OMFIF meeting at the South African Reserve Bank – held under the Chatham House rule, which means that no-one can be quoted – as well as other OMFIF gatherings during the summer. William Keegan serves his inimitable postscript on weeks of divisiveness, dislocation and disruption. And that was just the Labour party! A series of noises on- and off-stage that we confidently expect to become ever more cacophonous. Welcome back from your holidays. Things can only get worse.

David Marsh

Battle ahead for Atlantic United

US and Europe swamped by globalisation

John Kornblum, Advisory Board

'International markets do not really understand the very specific construction of the euro…. We need to convince the international public and international markets that this is a new form, very specific to meeting the demands of the 21st century.' - Wolfgang Schäuble, German finance minister, Financial Times, 5 December 2010

'We're broke. It's time we got serious about cutting the budget.' - John Boehner, Speaker of the House of Representatives, CNN, 27 April 2011

Nine months after his comments, it is probably now beginning to dawn on Schäuble that it is not the markets, but the European Union itself, which needs convincing about the euro. In the intervening period, euro area leaders have virtually lost control of their monetary policies not only to markets, but also with regard to their own public opinion.

As for John Boehner, his thrifty ways seem to stop at the state line of his native Ohio. He has come out loudly against the Army's plans to close a tank maintenance facility in the county next to his home district. Even though the US Army no longer needs main battle tanks, in this case, saving 11,000 jobs seems to be more important than thrift.

Schäuble and Boehner are not alone. Their mutual confusion is one of the major sources of economic uncertainty and voter anger on both sides of the Atlantic. As Federal Reserve chairman Ben Bernanke stated on 24 August, if banks got us into this mess, it is the political leaders who have been slow to understand how to get us out of it. While the details may be different, there is an uncanny similarity between Europe and the US. Some want to save, others wants to spend more. Stimulus or fiscal responsibility: that's the question on both sides of the Atlantic. But these debates are in many ways a surrogate for the real problem. Governments and business have lost public confidence in their ability to return jobs and growth to battered economies.

As Federal Reserve chairman Ben Bernanke stated, if banks got us into this mess, it is the political leaders who have been slow to understand how to get us out of it.

Each side of the Atlantic is steering towards a major crisis, caused essentially by the inability of leaders from both government and business to deal successfully with globalisation in ways which actually make sense to their constituents. If they don't learn soon, they both could be engulfed with a wave of populist anger not seen on either side of the Atlantic since the 1930s.

Atlantic nations are unlikely to pull out of this tailspin until their leaders are subjected to a cold shower of reality. The only question will be how much damage must first be inflicted before the cold water begins to flow. At a time when politicians such as Michelle Bachman or Rick Perry are using the Bible as the basis for their economic theories, when the Fed chief is accused of treason and some Germans are now again calling for a United States of Europe, it's clear that there's no common vocabulary to define the reality we are seeking.

Here are the elements of the confusion. Rather than being guided by Scripture, our own western corporations have used modern technology to create a radically new global marketplace. Our economic and cultural lives are steadily merging into globalised networks where the impact of time and space has been altered dramatically. Local economies increasingly function within whatever boundaries and scope the globalised environment extends to them. No amount of local effort can protect jobs and industries from the global juggernaut.

Even Alan Greenspan has questioned his own efficient market theory. Rather than increasing stability, he now believes that the speed of globalised networks makes it impossible to protect local economies from risks originating on the other side of the globe. An example from America's heartland illustrates the dilemma. Nearly 7,000 people from

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Europe's debt lessons from 1930s *(continued from page 1 ...)*

Sovereign debt crises are not new. In less than 100 years, Europe has twice faced debt crises of this magnitude, after both world wars. Nor was it only the vanquished who faced huge debts and (in Germany's case in the 1920s) official reparations. Even the victors faced public debt to GDP levels well above 200%. But the response to the two post-war crises could not have been more different.

In the 1920s and 1930s, Europe joined with most of the rest of the world in believing in fixed exchange rates (i.e. the gold standard) and a general orthodoxy that government budgets should be broadly balanced.
Through fiscal retrenchment, austerity and a deflationary depression, debts were largely paid off 'the hard way', i.e. in real terms, albeit at the cost of social unrest and hardship. In the 1950s and 1960s, on the other hand, the policy recipe contained devaluations, demand management through fiscal actions, and inconvertible currencies protected by exchange controls. The eventual result was multi-decade inflation that remains unmatched in peace-time history. National debts were in effect inflated away, with much less hardship – except to creditors.

We must realise that European policy-makers made a conscious decision to allow inflation as the way out of their post-Second World War debts. No-one wanted to recreate the vicious cycle of the 1930s under which bank failures led to government bailouts, fiscal strains, austerity measures, deep recessions – and more bank failures.Turning now to the present upheavals, it is clear that in almost every way – the fixed currency backdrop, the preference for balanced fiscal budgets, the austerity regimes – the outlook for the euro area's debtors is now closer to the 1930s than to the looser Keynesian times of the 1950. A key factor is the policy stance in Berlin. Federal President Christian Wulff has thrown his weight behind Chancellor Angela Merkel, decrying proposals for collective borrowing, and declaring that ECB purchases of weaker countries' bonds may be illegal.

In the previous two debt work-outs in Europe, the winners and losers were very clear. In the 1930s, with austerity and deflation, there was a transfer of real wealth from debtors to creditors. In the aftermath of the 1950s, inflation transferred real wealth from creditors to debtors. Today Germany, the most powerful country in Europe and the largest creditor, naturally seeks to protect and preserve the real value of its assets. This drives the EU belief that belt-tightening and a drive for greater competitiveness are both necessary and sufficient for restoration of weaker states' finances.

The challenge is to make the austerity programmes demanded by the creditors economically realistic and politically achievable. The economic realities that Europe faced 80 years ago are still valid. Sharp fiscal tightening risks undermining the economic activity that forms the tax base. This threatens to make resolution of the debt not less but more difficult. In addition, there is a lack of popular consent. The austerity measures stem from the EU, which is underpinned by inter-governmental treaties rather than primary legislation or the consent of its peoples.

This is an enormous challenge for Europe's leaders. The euro was introduced with minimal popular consultation. That may have been one factor behind its flawed construction, and behind today's crisis. However, a democratic society requires widest popular involvement in working out a solution, and plotting the course back to financial stability. Political leaders must realise how estranged the people are from 'Europe' and how much this puts the EU at risk. It is not enough for the EU leadership to declare there is no alternative to austerity measures in the indebted states. They should enter into a proper debate with the people of Europe and explain why this is so, and be prepared to argue for their proposed action.

Battle ahead for Atlantic United *(continued from page 3 ...)*

Clinton County, Ohio once worked at the regional hub operated by DHL, the German-owned logistics company. But in 2008, DHL management in far-away Bonn decided to leave the American market. The jobs all disappeared. They have not been replaced.

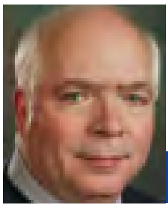
The drama was repeated a year later in Germany when General Motors managers in Detroit were considering selling or closing their Opel subsidiary in Rüsselsheim. Chancellor Merkel's wild scheme to sell Opel to an Austrian-Russian partnership was a desperate effort to save jobs in Germany, just as DHL was cutting them in Clinton County. But it wasn't possible to bargain between the two. General Motors ultimately stayed in Germany, but DHL left Clinton County forever.

Not surprisingly, Clinton County is home to an active chapter of the Tea Party movement. But before he joins them in condemning globalisation, their representative in Congress, Republican Michael Turner must remember that he also has in his district major headquarters of General Motors, which continues to own Opel, and other Fortune 500 companies.

He is torn between these perpetrators of globalisation and the 42,000 increasingly impoverished residents of Clinton County, who are getting angrier by the day.

This example could be repeated in many constituencies in the US and Europe. For the first time since the Second World War, the core segments of Atlantic society, the workers and middle managers, are beginning to fear that the behaviour of great corporations is threatening to destroy their way of life, rather than providing a foundation for their prosperity.

Government and business have a common interest in avoiding radicalisation of the debate. They will be helpless until Atlantic nations build a vocabulary to define the pressures of globalisation in terms relevant to voters. For the moment, though, theology is still holding strong.



Time to downgrade S&P

US action exposes agencies' unaccountability

Darrell Delamaide, Board of Contributing Editors

After being feted for a while now as the most powerful person you never heard of, David Beers has had his 15 minutes of celebrity. The head of Standard & Poor's sovereign ratings has become famous as the man who decided US government debt is no longer the safest risk in the world. He has earned the footnote that history will reserve for him. Whether he enjoys it is another matter.

The US downgrade may be the wake-up call that bond-holders, government officials and policy-makers needed to lower the overweening importance of rating agencies. In the ratings battle, the supreme demotion may be suffered not by the US government, but by the agencies themselves. Beers, we know now, is an inveterate chain-smoker and 'likes a good scrap.' He is an American with a master's degree from London School of Economics and lives in London. It was Beers, his deputy John Chambers, North American analyst Nikola Swann and an unspecified number of their colleagues at S&P who decided on the evening of 5 August to downgrade US long-term debt from AAA to AA+.

Beers succeeded in lowering S&P's credibility even below that of US Treasury Secretary Timothy Geithner, whose own stature was tarnished before he took office by revelations he had not paid enough tax. But there are wider repercussions, too. The furore may accelerate a process under which S&P, Moody's and Fitch lose their near-tyrannical power on capital markets. In exposing the limitations of the economists and analysts who work at these organisations, Beers and his colleagues may have accomplished what regulators have been too timid or incompetent to do – put these overrated rating agencies in their place.

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Geithner did not mince words in condemning the downgrade. 'I think S&P has shown really terrible judgment, and they've handled themselves very poorly,' the Treasury Secretary said immediately afterwards. 'And they've shown a stunning lack of knowledge about basic US fiscal budget math.' Geithner put his finger on a salient point: 'The judgment by S&P changed nothing. It added nothing to what people know about this country. There's no risk the US would never meet its obligations.' The market backed Geithner and pushed US Treasuries to their lowest yield ever. Two weeks later, Deven Sharma, S&P chief executive, said he was leaving to pursue other, unspecified activities. Reports surfaced that a US Justice Department investigation of S&P malfeasance in assigning triple-A ratings to toxic mortgage-backed securities, begun well before the downgrade, was proceeding apace.

What appeared to be the capital markets' benign reaction was, of course, primarily a reflection of worries about a new recession and European sovereign debt. Intriguingly, a lot of damage stemming from the downgrade could affect Europe – and thus give a relative boost to America's credit standing. If the US is no longer triple-A, can France maintain that rating? If France is not triple-A, can the European Financial Stability Facility maintain that rating? And so on.

Controversy heightenss awareness of the agencies' inflated role. It's not enough that these organisations have been able to escape accountability for previous disastrous misjudgments by maintaining the fiction that they are just offering an 'opinion.' In other words, they should be shielded, like the editorials in the New York Times, by the First Amendment's protection of free speech. It's not enough that these agencies, as responsible as anyone for the evaporation of billions of dollars of assets because of their faulty models for assessing the risk in structured securities, have not – so far at least – been liable for their errors.

Now Messrs. Beers, Chambers, Swann et al. are willing to pit their 'opinion' against two centuries of flawless credit in a country that still accounts for a quarter of the world's economy and maintains the world's main trading and reserve currency. These credit rating agencies have grown too powerful. It's time to reduce their influence, truly, to that of a newspaper editorialist.

More euro funds will calm markets

Germany benefits but shies away from costs

Frank Scheidig, Deputy Chairman, Advisory Board

A cure for the woes of economic and monetary union (EMU) appeared tantalisingly close during the summer, but seems to have slipped from view in the last few weeks of market turbulence. Beyond all the technicalities and legalities, one imperative is clear. The EFSF rescue fund (or whatever acronym is applied to the permanent vehicle that will replace it) requires extra money and additional powers, so that the unpopular burden of supporting government bonds through intervention purchases can be taken away from the European Central Bank.

As the main beneficiary of EMU, Germany has to take the main responsibility for rescuing it.

Other measures are necessary, too. Europe needs to implement a clear framework to deal with a default of a sovereign borrower. It needs common rules for fiscal policies that will allow much more effective governmental coordination, sadly lacking up to now. And it needs a workable system for sanctions against governments that ignore the rules.

We are all aware of moral hazard. When Italian bonds were in deep trouble last month, with yields rising to the 6% level, Silvio Berlusconi, the Italian prime minister, promised drastic measures to lower debt by raising taxes, reducing expenditure and so on. But after the ECB stepped in and bought Italian government bonds, it turned out that Italy's ability to enact the programme suddenly became limited. Government support mechanisms must encompass steps to constrain this kind of 'free rider' behaviour.

None the less, the greatest requirement is to put serious sums of money on the table, of sufficient size to impress capital markets. Much higher financing volume is needed to ward off the threat of renewed rises in bond yields and allow time for austerity in hard-pressed countries to yield desired results. This is a view I put forward at the beginning of the year [OMFIF Bulletin, January 2011, p.7]. The necessity is now still more evident. A sum is required for the EFSF that meets the needs of Greece, Ireland and Portugal and provides enough firepower to cover countries like Italy, too.

Germany has benefited enormously from the euro, and has a strong economic and political interest in sustaining it. It remains a key task for Germany's political leadership to bring this critical message to the ears of a German public who enjoy the benefits of monetary union but are strangely reluctant to pay for it. The performance of the German government and the rest of the euro political leadership during the spring and summer has been highly uninspiring, with Chancellor Angela Merkel's position not helped by splits over the euro in her own coalition. Nevertheless, it is not too late for remedial action.

This approach has to include the possibility of collective euro area borrowing through eurobonds. Putting into place the preconditions for eurobonds might take some time, probably years rather than months. The judgment from the German Constitutional Court on 7 September makes this clear. The implementation process would require approval by more than a dozen parliaments, including a referendum in some countries. There may even be the necessity for a new European treaty. We all remember how long the last one took to agree. Yet I am convinced that eurobonds will support the euro in the long run. They are the next logical step in the European integration process.

To those who claim that this will unreasonably raise Germany's funding costs, I pose this question. In the absence of the sovereign debt crisis, but given the present above-average growth rate and tight labour markets in Germany, at what price do you think Germany would borrow on bond markets? At 1%? Or rather closer to 5%?. Such reflections show how Germany has gained greatly from present upheavals. Control of public finance is critical. The unpalatable truth is that the only way out for countries in this drama is through belt-tightening. This brings pain and unpleasantness. To cushion the adjustment, support financing through the EFSF and, later, eurobonds has to be available. As the principal beneficiary of EMU, Germany has to take the main responsibility for rescuing it.

Saving Europe, not the euro

Creditor nations should form a new currency

Hans-Olaf Henkel, former President, Federation of German Industries

Economic and monetary union (EMU) suffers from three discrete diseases. First, as a result of the financial crisis, many banks are still instable. Second, the fusing of exchange rates among countries with different levels of prices and productivity has led to big losses of competitiveness for many euro members – not just Greece, Portugal, Ireland and Spain but also Belgium and France. Third, a huge level of debt has built up among euro members as a result of payments deficits caused by the 'one size fits all' monetary policy and the ensuing competitive distortions.

Instead of addressing the true causes, politicians prescribe pain- killers. There is no easy way out. But there is a workable alternative. It lies in Germany, together with some other creditor nations, leaving the euro and forming a new currency. The euro would be split into two groups – north and south.

Let us look at the options. 'Plan A' is to 'defend the euro at all costs' - pronounced by European Commission chief José Manuel Barroso and others. The end result would be detrimental to all. Rescue packages have led the euro area towards the organised irresponsibility of a transfer union. Collective EMU-wide borrowing through eurobonds, as suggested by many politicians, but rejected by the German government and others, are not the answer. If everybody is responsible for everybody's debts, no-one is. Competition between euro politicians would focus on who gets most at the expense of the others. The result would be more debts, higher inflation and lower standard of living. The euro area's competitiveness would fall behind other world regions.

Under 'Plan B', people such as George Soros have suggested that Greece could default or leave the euro without disorder. But a Greek default or departure brings high risks. First in Athens, then Lisbon, Madrid and perhaps Rome, people will storm the banks as soon as word gets out. A 'haircut' would not improve Greece's competitiveness. Soon, the Greeks would have to go to the barber again. And we would hear more talk about Portugal, Spain, Italy and, I am afraid, soon France.

That's why we need a 'Plan C'. Germany together with Austria, Finland and the Netherlands would leave the euro, and create a new currency, leaving the euro where it is. If planned and executed carefully, a lower valued euro would improve the remaining countries' growth and competitiveness. Exports from the 'northern' members might suffer from the new currency's higher value, but this group would also have lower inflation and this would, over time, help competitiveness. Some non-euro countries such as Sweden, Denmark and maybe even Switzerland would probably join this second monetary union. Depending on performance, flexible membership between the two should be possible

Implementing 'Plan C' requires that four underlying problems are addressed. We must rescue banks, not countries. Bank stabilisation on a national level should replace current European umbrellas. In many cases, this requires temporary bank nationalisation. Second, Germany and its partners in a new currency must implement a significant portion of their already-agreed guarantees to help refinance Greece, Portugal and others. Much of the money will be called upon and will be lost. But this is an acceptable price for an 'exit ticket'. Third, there must be a new central bank based on the Bundesbank, preferably not led by a German. The new currency should be called not the D-Mark but perhaps another historical name that was put forward before the euro was formed.

Fourth, entry mechanics would be similar to those for joining the euro. If it was possible to form one currency out of 17, it should also be possible to form two out of one. Such a solution would require politicians from the north and the south to show more conviction and courage than they have done hitherto. This is not simple, but it can be done. We must focus on saving Europe, not the euro.

The new currency should be called not the D-Mark but perhaps another historical name that was put forward before the euro was formed.

Monetary hands tied everywhere

Institutional levers for growth are increasingly blocked

Michael Kaimakliotis, Quantum Global Wealth Management

Markets are gradually coming to terms with a large-scale impediment to growth. Almost everywhere, governments are fiscally over-stretched, and room for further monetary easing is enormously constrained. In the US, Federal Reserve chairman Ben Bernanke is under great pressure not to ease money further. New European Central Bank president Mario Draghi, who takes office in November and has his own set of communications challenges [see below], will find it very hard to cut interest rates.

> *Unfortunately the Fed has little to show for QE2 other than a spike in inflation and rising equities and commodity prices.*

In the US, the 2012 presidential election looks likely to be won or lost on Main Street. Right now, Governor Rick Perry of Texas appears to lead the candidates for the Republican nomination. He has focused on fostering the image of Fed monetary policies as supporting Wall Street and President Barack Obama. 'Printing more money to play politics,' he says, 'is almost treasonous in my opinion.'

Figuratively at least, the noose is tightening around the Fed's neck. While there's a chance the Fed may announce another round of quantitative easing at the September FOMC meeting, next year the Fed will increasingly have its hands tied since it will not want to become the central figure in the election. Enacting policies likely to create popular discontent would not be strategically wise. And unfortunately the Fed has little to show for QE2 other than a spike in inflation and rising equities and commodity prices.

Worryingly, around the world, institutional mechanisms that could support economic growth are increasingly blocked. Europe is in full austerity mode. Spain has just announced a balanced budget amendment to the Constitution. The Japanese have chosen a fiscal hawk for prime minister. Draghi, as an Italian, will have to appear ultra-conservative to win credibility at the ECB. China is unlikely to rush to implement another fiscal stimulus until the bad loans made as a result of the former expansion moves are cleaned up. Markets will ask themselves: Where's growth coming from? And there'll be no obvious answer.

Collective leadership in Frankfurt

ECB boss Draghi should involve his colleagues

David Marsh, Co-chairman

The European Central Bank can no longer rule unhampered as Europe's sole fully-functioning crisis manager, as a result of discord on its governing council over purchases of states' government bonds. The ECB's fragmentation is a dangerous sign of dislocation. But the pending retirement of Jean-Claude Trichet could bring a new beginning. His successor, Mario Draghi, needs to embrace collective leadership to reflect the ECB's difficult external circumstances as well as its increased internal plurality.

Trichet has always practised an imperial style, accentuating the pattern of predecessor Wim Duisenberg. My suggestion is that, from 1 November, Draghi should appear before large audiences only with other members of the ECB's executive board. Above all, Draghi should insist that at the ECB's monthly press conferences he is accompanied by an appropriate number of board colleagues.

Not only, as happens up to now, vice president Vítor Constâncio should appear before the media. In addition, Draghi should allow his colleagues actually to speak. Collective leadership would not be a permanent fix for the euro's woes. But it's a good way for the ECB to overcome its obvious fragility and mount a more effective public presence.

EMU proposals remind us of history

Why Europe's status quo is better than the alternatives

Niels Thygesen, Advisory Board

Two proposals in the OMFIF Bulletin for 'improvements' in the running of economic and monetary union (EMU) are hardly likely to produce a positive outcome. However, they both remind us of long-running arguments about European monetary integration which go back to the period before the single currency's establishment.

David Marsh argues for a new method of communicating the governing council's decisions, notably by involving 'an appropriate number of board colleagues' in the ECB president's presentation at the monthly press conferences. And Hans-Olaf Henkel argues that the euro area is too diverse for a single currency and should be split up into two.

Let us take these proposals separately. The main argument for what Marsh calls 'collective leadership' is that disagreements over monetary policy and, particularly, over the ECB's purchases of sovereign bonds have become a subject of public speculation and concern. The proposal seems unlikely to win favour. What the press and informed public opinion must expect from a press conference after a council meeting is a careful presentation of the rationale for the decisions (or non-decisions) – not a resumption of the debate that may have preceded them. That will involve, in situations of assumed lack of unanimity, questions to the president about diversity of views.

If spokesmen for minority views appeared together with the president, that would open up centrifugal processes; ECB collegiality would suffer by direct exposure to questioners more interested in divergences than in decisions. That in turn would put additional pressure on the members of the ECB's governing bodies to move closer to reflecting national political views – a development the ECB (with some success) has sought to avoid.

The proposal to adopt more collective communication – which should really be labeled cacophonous – takes us back to the drawing board before the ECB started. Then and in the early years after 1999 there was intense debate whether, for reasons of transparency and accountability, any published minutes of ECB Council meetings should attribute views to individual members. Some national central banks, notably the Bank of England and the Fed, follow such practices, but the members who vote on monetary policy in these countries operate in very different circumstances, since they are not part of the individual national constituencies that make up the euro membership. The proposal was therefore rejected. It is still undesirable to depart from what has become a well-tried and successful practice.

The proposal to adopt more collective communication – which should really be labeled cacophonous – takes us back to the drawing board before the ECB started.

What about the Henkel suggestion? His proposals would launch us back to a situation similar to the five years (1974-78) before establishment of the European Monetary System, when currency arrangements had degenerated – or crystallised, according to one's perspective – into a Deutsche Mark zone with the Benelux and Scandinavian currencies (and Austria) keeping a DM peg. The remaining national currencies, including the French franc and the Italian lira, were floating individually over a very wide range.

There were several reasons why all the then members of the European Community – the UK being the only exception – agreed a more comprehensive structure with the setting up of the EMS. But, if we confine ourselves only to German motives for this course, two obvious ones come to mind. First, with currency links to only a few, relatively minor European neighbours, the D-Mark was subject to strong swings which were seen as harmful to investment and growth in Germany. Second, in relative currency isolation, Germany was constantly subject to demands in global policy discussions to expand domestic demand and/or to appreciate its currency. That remains an unattractive position to be in, maybe even more so in today's world than two or three decades ago when capital was less mobile. When one adds to this picture the dislocations of the internal market and of Franco-German leadership that would follow a break-up of the euro, the rationale for keeping to the status quo becomes easily understandable.

G20 must promote new order

ECB should back financial discipline

Ruud Lubbers & Paul van Seters, Advisory Board

This autumn sees a new president at the European Central Bank and a key G20 summit, both capable of seriously influencing the shape of a new global monetary order. What is needed most are wise, consistent decisions by the politicians. It is time for them to produce a New Deal on 'green growth' for sustainable world development, guided by the principle of common but differentiated responsibilities. This must be backed by a new Bretton Woods system reflecting today's realities, involving OECD and BRICS countries.

Unfortunately, this summer will be remembered for monetary calamities in the US and Europe. The next G20 meeting is on 3-4 November in Cannes, where international monetary reform is high on the agenda. The Financial Stability Board (FSB) recently published an overview of reports for this meeting. But the monetary events of the past two months threaten to overwhelm the change the G20 is supposed to achieve in Cannes.

In July, euro area governments decided a second bail-out package for Greece, including a considerable expansion of the means and mandate of the EFSF rescue fund. Yet it soon became clear that the package was inadequate to stop massive speculation against weaker euro countries. In August, we saw lack of fundamental agreement among US politicians on reducing the budget deficit, the US debt downgrading, and the sharp rise in ECB purchases of Italian and Spanish bonds. On 15 August Chancellor Angela Merkel and President Nicolas Sarkozy agreed to set up a 'European Economic Government', to be headed by Herman Van Rompuy, European Council president. This is as a step in the right direction, yet it will not by itself resolve the euro crisis. Instead, in the US as well as in Europe, much more consistent political action is necessary.

The US needs a political breakthrough not just on budget cuts, but also on raising taxes. Yet the Tea Party's influence appears to block any reasonable way forward. In Europe, financial discipline needs to be soundly enforced, backed up by political agreement to allow the ECB to issue euro area-wide bonds, under the condition that the bank simultaneously gets the power to impose stringent austerity measures. An ECB 'with teeth' is the only way effectively to implement austerity measures in weaker euro countries that reduce the costs for stronger ones.

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ECB president Jean-Claude Trichet has stretched the bank's mandate to the utmost. But Trichet does not have the formal power to create or issue euro bonds; that would need to be handed to the bank by the euro countries – on strict financial conditions. On 1 November Mario Draghi, governor of the Bank of Italy, will take over at the ECB. This is an historic opportunity to give the ECB new powers to enforce financial discipline and issue euro bonds. In our view, Draghi should decline his new job unless the politicians give him these new powers. The G20 summit in November equally requires political action. The time of the dollar's monopoly is over. Euro bonds would enhance the euro's reserve currency position, but not make it the replacement for the dollar. As the emerging economies' rise continues, their currencies, especially the renminbi, will steadily grow in strength, but there will not be another reserve currency that displays the same 'exorbitant privilege' as the dollar.

Many people such as US economist Barry Eichengreen envision a new order based on the dollar, the euro and the renminbi. But it would be more sensible first to decide a new governance system for the International Monetary Fund, allowing more influence for the emerging economies, especially the BRICS countries. This reform should be the highest priority in Cannes. Once there is consensus about reconstituting the IMF, one can start to think about expanding the IMF's currency basket, the Special Drawing Right, enabling it to become over time the prime global reserve currency. In short, the G20 summit in Cannes should be about monetary stability and a new monetary order. Both elements are crucially necessary to restore confidence.

South Africa's vulnerability

Pressure on Zuma as monetary dream crumbles

Peter Bruce, Board of Contributing Editors

The year 2021 should be a big one for South Africa's ruling party and its government. By then, they have promised to create 5m new jobs. And that's the date when a single African currency is scheduled to be introduced, an idea strongly supported by the African National Congress. In fact, neither event will happen. It's all a dream. We live in an age of political fantasy. The government is always revolutionary. Business is always reactionary. And world power is, of course, permanently and unfairly in the hands of the West.

The South African Reserve Bank deserves sympathy. It is a centre of excellence, with sensible, orthodox policies. Its officials have to feign enthusiasm about African Monetary Union (AMU). Privately, they express grave doubts. The previous governor, Tito Mboweni, was not always discreet about his disdain. 'When we set targets and dates, we think they won't come,' he said in 2007. 'I'm personally critical of the approach taken to establish the ACB (Africa Central Bank). It is easy to go to meetings and agree on these things but the challenges we face are much bigger than the niceties of brotherhood and sisterhood.'

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Nevertheless, the South Africans have to play the game. From the start the idea has been to establish an African Central Bank in Nigeria. The Nigerians are very keen. South Africans often find their reservations drowned out in a wider, largely unthinking pan-African enthusiasm. Gaddafi's departure brings a big loss of momentum for AMU. Already, though, the idea looked impossible. There are few reliable African economic statistics outside of South Africa. There is almost no joined-up infrastructure. In most countries there's hardly any infrastructure at all. Tax collection is rudimentary. Even if you include Egypt, South Africa generates more electricity than the rest of Africa combined. At a political level, the African Union is ineffective and efforts to create a pan-African parliament have resulted in little more than expense for South Africa, which hosts its sessions in an exhibition centre near Johannesburg. There are no elections anywhere for members of the parliament.

Nigerian-South African rivalry is pervasive. Former South African President Thabo Mbeki had a grip on continental politics that his successor Jacob Zuma lacks. Even then, when Mbeki launched Nepad, a new partnership for African development, the Nigerians appropriated it. There's still a notional Nepad infrastructure in South Africa but the Nigerian wing is the one with money and ambition. This is part of a new narrative in which South Africa, still tangled in post-apartheid settling of scores and redistribution of wealth, is losing ground to Nigeria (and to a lesser extent Kenya) as the African investment destination of choice.

Economic and social policy uncertainty in South Africa greatly assists its African rivals. A ruinous debate inside the ANC on the possible nationalisation of mines and banks is playing out at party headquarters, where the head of the ANC Youth League, a clever populist politician called Julius Malema, faces charges of indiscipline and of bringing the party into disrepute – part of a wider Zuma versus Malema political struggle.

The ANC, while enriching a sizeable group of business supporters, has been able to do little for the poor. The greater the pressure on the party and government, the more eccentric the policy-making. The government's approach is to build infrastructure and to involve the state more in the economy. But it risks squeezing out a vibrant and well-managed private sector. It will not (indeed cannot) relax rigid labour legislation that makes it extremely difficult to shed jobs. Unemployment runs at 26% and is double that for people under 30.

Somehow government and business will have to build bridges. But there are few signs of progress. A victory over Malema might embolden Zuma in economic policy, but he does not have much political space. The Reserve Bank doesn't have much room, either. There's little reason to believe further interest rate cuts would help. The problem isn't credit. It's confidence. Meanwhile, other parts of Africa open to foreign investment are exploiting investor nervousness about South Africa for all they're worth.

Age of Wisdom takes time

Countries grow up and leaders learn

Meghnad Desai, Chairman, Advisory Board

India has not had much opportunity to celebrate the 20th anniversary of liberal reforms inaugurated under Narasimha Rao, prime minister in 1991-96. But the issue illustrates a wider point. Newly-independent nations take a while to grow up and come to their senses about economic imperatives. We have seen it in China. We saw it in India. And we are seeing it today in South Africa.

To empower the black people, South Africa needs a radical skilling initiative to make jobless black workers employable.

In the first flush of nationhood, leaders indulge in half-understood rubbish they picked up in their youth. Such economic nonsense is built on rejection of reality, especially reflecting homely nostrums on alien rule. Such idealism is easy to acquire and hard to shed. The Age of Wisdom takes time to arrive. But, thankfully, it normally does. In India, the decisive shift in economic policy-making under Manmohan Singh and P. Chidambaram in their finance ministry positions in the past two decades has been vindicated. India is now a byword for economic competence, a high- ranking member of the G20. Of course, we have detractors of Indian reform. The excessive corruption we have seen exposed is blamed on reform, as if the first 40 years of independence were squeaky clean. People say inequality has increased. We see more of it now that the media are free. But inequality was never absent from India; it was perhaps better hidden.

The real question is not whether the reforms have worked but why it took India so long to stumble on the right model. After all, India never became a completely planned economy like China. Deng Xiao Ping saw the writing on the wall and in 1978 changed Chinese economic policy root and branch. A life-long Leninist, he realised everything he had believed about capitalism was mistaken. The decisive change came after 29 years of economics based largely on the fantasies of an ageing Mao Zedong. The result was the largest famine of modern times. Taiwan, held beneath contempt by the Communists, had become a miracle economy. The mainland Chinese were left with an iron bowl containing precious little rice.

Compared with China's 29 years, India took 44 years to correct its course. But the change was less abrupt. At their very worst Congress policy-makers were never as cut off from the people as the Chinese Communist Party. India never had a famine; just endemic starvation. That was thanks to democracy. This has happened elsewhere. I have heard Julius Nyerere, the charismatic former Tanzanian leader, confess that his Ujama policy – uplift of the poorest – ruined the economy because it was based on an idea of socialism borrowed from the Soviet Union , totally unsuitable for Africa. Mozambique has had 36 years of independence. The first 25 were spent on unfeasible economic programmes. Now it is a shining example of macroeconomic responsibility, enjoying some decent growth at last.

Similarly, South Africa is running through a fundamental debate. Apartheid ended only 17 years ago. The Age of Wisdom has not yet arrived. South Africa is the most prosperous of all sub-Saharan African countries and always has been. Before apartheid's collapse, the country had a high public ownership and trade unions were strong, features designed to uphold white minority power. The debate now has swung back to nationalisation. The mining sector has shed labour. Black economic empowerment has not been working as hoped. Black unemployment remains stubbornly high.

Populist politicians say: Nationalise the mines. Yet I fail to see how nationalisation would create jobs, rather than wrecking the mining sector by making it uncompetitive. To empower the black people, South Africa needs a radical skilling initiative to make jobless black workers employable – plus a programme for supporting small and medium enterprises, the engine for job growth in all economies. But African Nationalist Congress politicians are intrinsically suspicious of the private sector. There's little hope that they'll embrace the idea that small businesses will create jobs. Politicians will manipulate and expand the public sector. The result will be economic nonsense. In 10 years or so, wisdom may prevail.

IMF gets it right on Mexico

Basle III shows its limitations

Steve Hanke, Advisory Board

The new Basel III mandates for higher capital requirements put a damper on broad money growth rates and throw yet another cloud over prospects for a healthy economic recovery. In short, the imposition of higher capital requirements on banks in the middle of an anaemic rebound from what I call the Panic of 2008-09 is bad medicine, as I stated in 'Why Basel III lowers growth: Higher capital-asset ratios destroy money' [OMFIF Bulletin, April 2011, p.6.]

It's easy to see why higher capital-asset ratios are 'deflationary.' If we hold the level of a bank's capital constant, an increase in its capital-asset ratio requires that the level of its assets must fall. This, in turn, implies that the banking system's liabilities – demand deposits – must contract. Since the money supply consists of demand deposits, among other things, the money supply must, therefore, contract.

Alternatively, if we hold assets constant, an increase in the capital-asset ratio requires an increase in capital. This destroys money. When an investor purchases newly-issued bank shares, for example, the investor exchanges funds from a bank deposit for the new shares. This reduces deposit liabilities in the banking system and wipes out money.

It's no surprise that Sir John Hicks – a high priest of economic theory and 1972 Nobelist – thought there was nothing more important than a balance sheet.

After those simple analytic reflections, we arrive in Mexico. At present, contrary to the picture in the US, UK and the euro area, Mexico's rate of growth in broad money (M3) is rather robust.

The International Monetary Fund has connected the dots. It is clear from the IMF's July 2011 report on its Article IV consultations with Mexico that the IMF staffers concluded that further increases in the Mexican banks' capital-asset ratios would take some steam out of Mexico's money supply growth and jeopardise Mexico's economic recovery. The IMF hit the nail on the head when it expressed concern that the introduction of new capital surcharges and higher capital-asset ratios in Mexico could negatively affect the economy. It's time to call 'time out' on Basel III.

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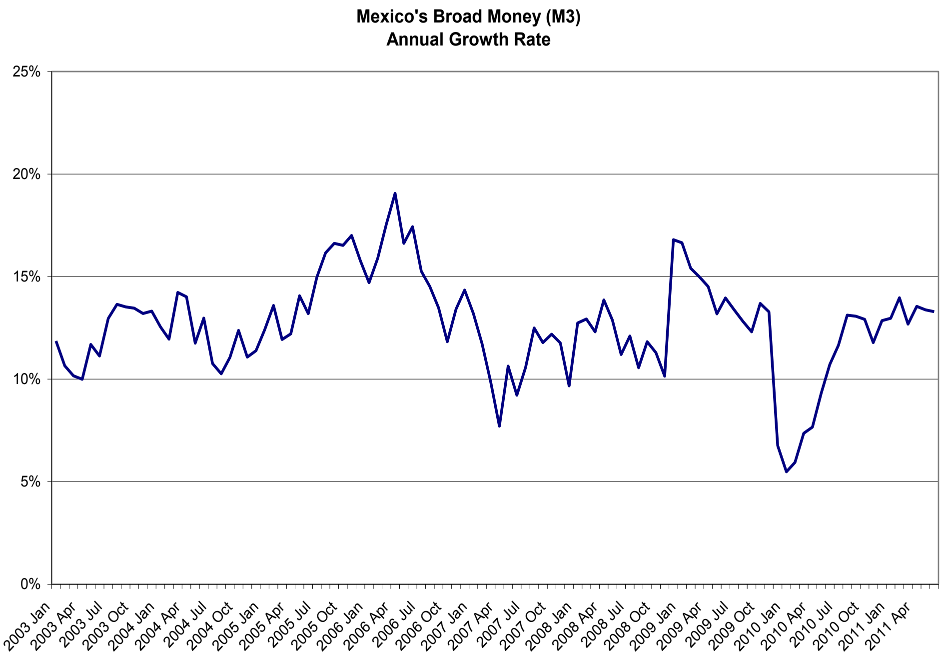


Sources: International Monetary Fund, International Financial Statistics and Author's Calculations.

Sovereign issue for Libya

Investment fund could set new standard

Malan Rietveld, Chief Economist

The Libyan Investment Authority (LIA), the sovereign fund of the North African country newly-liberated from despot rule, has every chance of setting a new standard for management practices among the international public asset owners. But its first task will be to sell the most liquid of its estimated $65bn in assets to fund pressing activities of the government-in-waiting. Under Rafik al-Nayed, the newly-appointed LIA chief executive, the fund faces urgent tests in handling unfreezing of foreign assets. This will be a pressing priority presuming the new government can take power in Tripoli and effect an orderly hand-over – a development that is conditional on a speedy disarming and dispersal of Muammer Gaddafi's supporters, as well as tracking down the wayward Colonel.

In view of Libya's oil resources and favourable geographical position, with luck and good judgment, the LIA in a few years could be a paradigm for excellent sovereign fund management.

The National Transition Council (NTC) has to decide a strategy for the LIA's holdings of listed equities, private equity and infrastructure investments, often representing pet projects of Gaddafi's deposed regime. Later, the NTC has to decide what role the LIA plays in managing Libya's oil revenues once production resumes at normal levels.

Al-Nayed says the LIA has already started a sweeping forensic audit of LIA's assets and transactional arrangements, looking for holdings that may be hidden in foreign bank accounts tied to the old regime. This could take months. The LIA's books are an utter mess. The new government has to work with moderate officials and technocrats from the Gaddafi regime in uncovering all positions. This seems already to be happening, indicated by the appointment as chairman of Mohammed Layas, the LIA's former chief executive. The LIA should make full use of international and professional assistance. It can assimilate best practice through its membership of the International Forum of Sovereign Wealth Funds. Once the audit has been completed, it should disclose a broad breakdown of its portfolio.

The LIA's sizeable investments in equities, private equity and infrastructure are likely to be used as collateral for new loans to the fledgling government. This is far from best practice for a sovereign fund – but Libya's unusual challenges makes this a short-term imperative for raising cash until it devises a longer-term capital market strategy.

Once the conflict is settled, and the economy and oil production gets back on track, the LIA could provide an important international exemplar for sovereign funds. The Libyan authorities would be advised, within 12 months, to write a new law for the sovereign fund, unequivocally stating objectives, funding and spending rules, governance and operational structures, and who has the authority to set and change its investment strategies.

Once the fund's core principles are established in law, the largely technical task of defining its investment strategy should begin. Key ingredients include estimating the net inflows to the fund (based on expected oil extraction and associated government revenues) and anticipated withdrawals (based on the fund's spending rules). Officials need to define and compute the fund's risk tolerance and its investment horizons, and make a fundamental decision over the fund's investment balance between foreign and domestic activities.

The fund should be encouraged to draw on existing international resources for fund management, notably the World Bank Treasury's Sovereign Investment Partnerships (SIP) team. The next generation of internal managers and fund guardians should be adequately trained, skilled and incentivised. Here Libya can bring together a mixture of central bank officials, expatriate investors and bankers, as well as recruits from international fund management companies. They can work alongside experienced private sector partners. With luck and good judgment, the LIA in a few years could be a paradigm for excellent sovereign fund management. Rebuilding the LIA may not be the most urgent of the north African country's many priorities. But, in the years ahead, fulfilling this task could make an enormous difference to the way the country is run, as well as to its reputation with the international financial community.

China's problems amid the growth

Inflation stokes fear of social crisis

Jonathan Fenby, Board of Contributing Editors

Despite the continuing jeremiads of the China bears, the world's second largest economy seems set to avoid the hard landing widely predicted earlier this year. Growth will slow down over the next 12 months but not to below 8%, while foreign trade will not suffer a catastrophic fall, unless there is a fully-fledged double dip recession in the OECD area.

Perennial problems remain. They include the tasks of achieving an increase in consumption sufficient to reduce the reliance of fixed asset investment, lack of structural reforms, and caution during the period of leadership change starting in the autumn of 2012. The currency remains under-valued and will still be so come 2012 and, quite likely, for some time thereafter. There is a strong undercurrent of social protest and the pollution crisis is proving quite resistant to Beijing's best efforts. Yet the main challenge is inflation. The era of consumer price rises in the 2% range is gone for ever. After the 6.5% annual increase in July, keeping price rises as near to 4% as possible is the official priority. The figures may improve in the second half of this year as controls kick in and the base effect from the rises of late 2010 affects year-on-year comparisons.

The inflation figures may improve in the second half of this year as controls kick in and the base effect from the rises of late 2010 affects year-on-year comparisons.

But the fundamentals are moving towards continuing inflationary pressure. Food prices, which have led the recent surge, are subject to temporary factors such as the weather or excess liquidity that spurs speculation. Herbs for Chinese traditional medicine have been a favourite target for hot funds recently. However, it is the underlying factors that are the greatest cause for worry. Most farms are uneconomically small and, in the absence of ownership rights, that will continue.

Urbanisation, to which the government is committed, eats up arable land. There is desertification and pollution. The water table in northern China is falling fast, affecting fields round Beijing and the main wheat belt. Use of poor quality fertilisers leeches out the soil. Refrigerated transport is scarce and distribution systems are poor. Some vegetable wholesale markets are organised on old command economy lines.

Meanwhile the middle class has grown accustomed to a varied diet and the rise in blue collar wages is spurring demand from industrial workers. Those pay increases are also bound to fuel wage inflationary pressure at some point and may bring a nasty conundrum for policy-makers in the middle of this decade. For the moment, big firms can offset wage pressure by moving from Guangdong to lower-wage regions of central and western China. But a doubling of the minimum wage planned by 2015 means that, at some point, relocation will no longer be sufficient to absorb higher labour costs . Some firms will go for increased mechanisation. Foxconn, the giant IT manufacturer-assembler, has just announced plans to install a million robots in its mainland factories by 2015.

That is in keeping with the emphasis in the new Five Year Plan on China moving up the value chain with more advanced machinery. This is part of a move away from the cheap labour model of the 1980s, at a time of competition from countries where pay is even lower. But this raises a different issue – unemployment, put officially at an understated 4%. The authorities know that a serious increase in the number of people out of work might provide the seedbed for protests and social instability they are so anxious to avoid. Already, China has an estimated 150,000 to 180,000 protests a year but they are on single isolated issues. A spike in unemployment could change that.

So China faces a difficult dilemma. It wants to boost consumption through higher wages. It wants to move up the industrial value chain. The demographic shift arising from the low birth rate and greater longevity will kick in one day, but that may not be until the next decade. So a delicate balancing act is in prospect alongside all the other tests the leadership faces. Compared with the exacting tasks that lie ahead, the challenges of China's first three decades of economic reform may appear one day as the easy part.

Noda faces yen pressure

Longer-term rise 'hollows out' Japan industry

Junko Nishioka, RBS Tokyo

Yoshihiko Noda, Japan's sixth prime minister in five years, has taken office promising unspecified action to curb the rise of the yen – widely felt to be one of the largest negative factors overhanging the economy. Beneath the headlines of the GDP contraction since the tragic earthquake and tsunami on 11 March, the short-term picture is improving. Yet the economy faces deep longer-term difficulties which the reshuffling of responsibilities in the ruling Democratic Party of Japan (DPJ) is unlikely to resolve.

Business activities have been more robust than expected, largely thanks to the private sector's resilience despite the unstable supply of electric power. Although second quarter GDP showed a 1.3% annual fall, the third consecutive quarter of negative growth, the economy hit bottom in the April-June period and we will see a V-shaped recovery in the second half, with the economy growing at a forecast annual rate of 3.7% in each quarter. The main reason for the GDP collapse and subsequent rebound has been supply chain disruption, reflecting the high proportion of intermediate goods in Asian countries trade and strong manufacturing interdependence with neighbouring trade partners.

Market expectations for the Japanese economy remain highly restrained, overshadowed by the electric power issue and worries over public finance and an aging society – reflected in lowered credibility of Japan sovereign debt and recent government bond downgrades by rating companies. Noda's new DPJ administration is not expected to speed up constructive law-making in parliament as a result of confused decision-making structure in the Diet. One area that badly needs resolution is whether consumption tax can be increased to help finance reconstruction in the disaster area. The new administration is unlikely to win sustained public approval ahead of general election scheduled in 2013.

Along with political in-fighting, the threat of a prolonged yen rise is the most critical issue for the economy. If the yen rises further against the problem-hit dollar and euro, the finance ministry and Bank of Japan are likely to resume market intervention, in line with the sporadic dollar purchases during the past year enacted by Noda in his previous job as finance minister. The yen's appreciation hits corporate earnings as a result of declining sales values and loss of global competitiveness. Despite progress in companies' hedging techniques and a gradual shift in the currency used for trade settlements, our estimates show that a 10% yen appreciation decreases export volumes by an average 9.2%, making a 1.4% negative contribution to GDP. Based on empirical analysis, the dollar-yen rate is likely to remain around 80 for some time. Responding to mounting calls from the industry, the finance ministry conducted Y4tn of intervention on 4 August and the Bank of Japan followed up with an increase in its asset purchase programme. However, US economic weakening and more expected easing by the Federal Reserve have precipitated a further dollar slide.

In the light of long-lasting yen appreciation and the outlook for a prolonged period of domestic deflation, sluggish profitability and political uncertainty, Japanese industry faces a further bout of 'hollowing out'. Already over the past 20 years, Japanese companies have made significant shifts of production abroad. The proportion of foreign sales for giant companies such as Toyota and Sony was above 70% in 2010. This tendency will accelerate if the yen continues strong or goes even higher. Major companies will also be increasingly encouraged to sell their domestic business, following a trend that has already been seen in recent years. As well as weakening Japan's industrial base, this would have a negative effect on overall productivity. Compared to other advanced economies, the Japanese economy faces the problem of low productivity in the non-manufacturing sector as a result of over-regulation and poor mobility. Long-term yen appreciation, creating the headache of excess labour in shrinking export industries, increases pressure to find solutions for fostering the non-manufacturing sector – just one of the many priorities the Noda administration must now confront.

Compared to other advanced economies, the Japanese economy faces the problem of low productivity in the non-manufacturing sector as a result of over-regulation and poor mobility.

Why renminbi should go global

OMFIF seminar favours reform with prudence

Songzuo Xiang, Deputy Chairman, Advisory Board

One of the most crucial questions at the heart of the international monetary system is the need to develop a strategy for internationalising the renminbi in a way that is consistent with both Chinese and global needs. This issue is an indispensable part of efforts towards international reform.

Many experts agree that, under the dominance of the dollar, the monetary system has many systematic defects. Yet it will not be practical in the foreseeable future for one currency to displace the dollar. The most likely outcome is that the dollar will remain the most important part of the system, and that other currencies will take on increasing roles without displacing US preeminence. The challenge for Chinese policy-makers is to devise a route map for renminbi globalisation that satisfies basic requirements for Chinese economic and financial development and provides, too, benefits for the rest of the world. These were the themes discussed in a ground-breaking Beijing seminar held on 22-23 July at Renmin University of China, entitled 'Increasing International Use of the Renminbi.' Organised by OMFIF, Liu Hongru Financial Education Foundation and Renmin University of China, and with State Administration of Foreign Exchange (SAFE), Royal Bank of Scotland (RBS) and DZ Bank as co-organisers, the seminar attracted over 60 delegates. They included representatives of People's Bank of China, SAFE, China Banking and Regulatory Commission and China Insurance Regulatory Commission.

The challenge for Chinese policy-makers is to devise a route map for renminbi globalisation that satisfies basic requirements for Chinese economic and financial development and provides, too, benefits for the rest of the world.

Three main issues were discussed. First, international economic and financial case studies, past and present. Second, the pros and cons of renminbi globalisation. Third, the wider issues of international monetary reform, development of international trade, reforms on foreign exchange reserve, two-way flows of investment, etc. The discussion ranged from technical questions of money and finance to systemic economic issues, and social aspects. More than 90% of participants agreed the necessity for renminbi globalisation, emphasising the benefits, which include easing inflation pressure, improving terms of trade, prompting financial service development, broadening financial channels, acquiring pricing power, increasing the renminbi's influence on international markets and gaining seignorage revenues. However, renminbi globalisation should be conducted prudently. Many speakers listed risks, including increasing difficulties of macroeconomic control, possibly worsening trade balances, disruptions to economic stability and raising pressure for renminbi appreciation. One expert said that freeing controls would lead to greater volatility; the renminbi would not necessarily only appreciate. The mood of the meeting was that globalisation had still a long way to go, and China had many problems to solve.

Participants held different views on specific processes. But there was general agreement on the need for China first to settle some internal problems such as liberalising capital account transactions, reforming interest rate policy, improving the financial system and adapting China's political regime. Yves Mersch, governor of Banque centrale du Luxembourg, underlined the importance of macroeconomic fundamentals and the overall requirement of currency stability. There was support for the idea that China needed to balance different areas of renminbi development. Woon Khien Chia, an Asian strategist for RBS, believed that an offshore market should be set up first and London could be a renminbi trading centre after Hong Kong and Singapore. There was general agreement on this.

Wenhong Li, deputy director of CBRC's research bureau, placed emphasis on prudence, arguing that renminbi globalisation should be in step with the gradual maturing of the Chinese financial market. Geng Xiao, director of Columbia Global Centers of East Asia, emphasised that China needed a vehicle currency that would accompany foreign trade and investment independently of politics. He said the Chinese authorities could take advantage of experience with the Hong Kong dollar if it was pegged to the Special Drawing Right. Min Tang, counsellor at the State Council, said China's large foreign reserves should be used to help Chinese companies extend their reach and invest in foreign countries.

An end to western dominance

How change will ripple out across the world

Zeti Akhtar Aziz, Governor, Bank Negara Malaysia

We live in the most extraordinary of times. A major global transformation is taking place at an unprecedented scale and speed. The pervasive nature of this transformative change is the result of several mutually reinforcing global shifts – economic, financial and monetary. The ramifications will have widespread and far-reaching implications. The realignment of the global economic and financial landscape will not be transitory. It is a structural transformation of historical significance that will reshape the world.

The world is confronted with wide-ranging challenges – sustaining growth accompanied by job creation, ensuring effective and efficient functioning financial systems, reining in rising inflation, dealing with fiscal imbalances and excessive indebtedness and living with volatile and destabilising cross border financial flows. Yet it is also important to recognise the significance of these underlying shifts.

The economic shift is resulting from cumulative changes in global consumption, investment and trade. For more than two centuries, the centre of global economic power has been with nations with less than 20% of the world population. But in these recent two decades, the concurrent rise of the emerging economies is contributing towards a major realignment of the global landscape. Furthermore, this process has been further accelerated by the financial crisis that is resulting in a global recovery that is uneven, with slow and fragile recovery in the developed world and robust and stronger growth in the emerging world.

The rise of the emerging economies is shifting the economic centre of the world towards an environment in which economic power is more dispersed – an increasingly multi-polar world. While growth has been most visible in Asia, strong growth has in fact been experienced in most of the emerging world in this recent decade. The emerging economies today collectively contribute almost three-quarters of global growth, while their share of economic output is projected to account for almost 60% of total world output by 2030.

Rising incomes, growing employment opportunities and conscious policies to promote domestic demand are increasingly shifting the locus of global consumption from the advanced to the emerging economies. The emerging economies are already – on average – adding 125m people into the middle class each year, equivalent to more than twice the UK population. This will about double the global middle class population to 3.2bn by the end of this decade. Highly visible are the new consumer retail centres that are emerging in Asia, the Middle East and Latin America. By 2020, Asia alone is projected to comprise more than 50% of the global middle class population, accounting for more than 40% of global consumption. This is reinforced by a demographic structure that indicates a relatively young population with a relatively higher propensity to consume.

Rising incomes, growing employment opportunities and conscious policies to promote domestic demand are increasingly shifting the locus of global consumption from the advanced to the emerging economies.

Other measures that have enhanced the potential for increased consumption are social safety nets, including for health and education, improvements in public transport, and institutional arrangements that reduce the need for precautionary savings, involving the development of pension funds and insurance. And finally, the development of the domestic financial system has ensured continued access to financing.

This geographical shift of global consumers is transforming the patterns of international trade. As final demand increasingly originates from Asia, the Middle East and Latin America, the final destination of exports is gravitating to the emerging economies. The direction of trade is expected to shift, as advanced economies will increasingly be exporting to the emerging economies. This will contribute to the unwinding of global imbalances. Trade between the emerging economies is increasing substantially. Not only will there be greater intra-regional trade within Asia, but trade between the various regions of the emerging world, in particular, between Asia and the Middle East and Latin America, is gaining importance.

As the emerging economies become global consumers, away from being global producers, the concentration of trade will shift from intermediate manufactured inputs to final consumer goods. While world trade has expanded by almost four-fold, trade among the emerging economies has increased by more than ten times. Within the last decade, Asia has emerged as the largest trading partner for the Middle East, accounting for more than half of the region's total trade.

These profound changes have been accompanied by a secular shift in investment flows into the emerging economies. Initial investment flows to the emerging world were prompted by the presence of resources, labour supply, the lower costs of doing business and the growing scale of the domestic market. These factors have produced vast investment opportunities in the emerging economies. In particular, in the last two decades there has been a massive shift in manufacturing capacity from advanced economies to emerging economies.

This also applies to investment flows. Today, more than one third of foreign direct investment (FDI) into emerging economies originates from the emerging economies themselves, and this share can be expected to increase further. As firms in the emerging economies grow in size and strength, they can be expected to expand their operations beyond their domestic borders, creating a new generation of multinational companies. The increasing regionalisation and internationalisation of such firms will provide not only capital to the other emerging economies, but also talent and expertise. The number of emerging market companies in the Fortune 500 has more than doubled in the last four years..

The change in the direction of capital flows will contribute to reinforcing the growth potential of the emerging economies.

This change in the direction of capital flows – from the advanced into the emerging economies, and among the emerging economies themselves – will contribute to reinforcing the growth potential of the emerging economies. Additionally, the increasing allocation of capital towards productive investment opportunities in emerging economies will contribute to global economic rebalancing.

Another substantial shift is in the financial field. As economic activity becomes more dispersed, the distribution of financial centres will become more dispersed too. International financial centres are still dominated by financial centres in the developed world. The global financial system is characterised, too, by a network of financial institutions that originate from such financial centres – mainly from the US, Europe and Japan – with a presence in different parts of the world, serving clients with international businesses and to finance trade. Increasingly, new centres of financial activities will emerge to serve growth centres in the emerging economies and new businesses with operations in their respective regions and other parts of the world. This will promote greater interlinkages between financial systems, especially among the emerging economies.

Several features will prompt greater intra-regional financial intermediation. First, the higher savings rate in most emerging economies, providing opportunities for more effective mobilisation of savings within and between regions. Regions with surplus funds such as the Middle East have the opportunity to channel these funds to other regions with investment opportunities. Second, deregulation and financial reform that allows for greater flexibility and predictability in the functioning of the financial system. Third, greater liberalisation – both in elimination of barriers to entry and also in lifting of capital account restrictions. These developments have been reinforced by the development of financial markets in emerging economies, as well as by the expansion of emerging market financial institutions beyond their national borders.

Financial institutions from the emerging economies have grown significantly in size and strength over the recent decade, accounting now for almost half the worldwide financial industry market value. In fact, the world's two largest banks by assets are today from the emerging markets. Not only have financial institutions gained presence by way of establishing subsidiaries or branches in new jurisdictions, but there has also been increased cross-border mergers and acquisitions. This trend has further facilitated cross-border financial intermediation and has enhanced the economic interlinkages between emerging economies.

Another key trend in the international financial landscape is the internationalisation of Islamic finance and its role in contributing to supporting overall economic growth and financial stability. This recent decade has seen the expansion of Islamic finance as a competitive form of financial intermediation. The internationalisation of Islamic finance enhances economic interlinkages not only in Asia and the Middle East, but also with the rest of the world.

The third global shift is in the international monetary system. The increased share of emerging economies in the global economy and in trade and investment will raise the emerging economies' role in the international monetary system. When the euro emerged as an international reserve currency, it was thought that three international reserve currencies would prevail in the international financial system - the dollar, the euro and the yen. Given the dollar's internationalisation, and the size and liquidity of US financial markets, the dollar has dominated as an international reserve currency. In future, reserve currency functions will be taken by those currencies that can effectively act as a medium of exchange for cross-border transactions for trade and investment.

There are three basic scenarios. First, a single currency dominates. Second, multiple currencies exist as international reserve currencies. Third, a global currency emerges such as the Special Drawing Right. The key factor is the currency's relative stability and its ability to withstand destabilising developments. Prior to the sovereign debt crisis in Europe and the financial crisis in Japan, there was ready acceptance of the euro and the yen as important reserve currencies. The recent developments in Europe should be viewed as a temporary setback. After the crisis is resolved, the euro can be expected to resume developing as an international reserve currency. In addition, China's emergence as a significant participant in the international financial system will enhance the renminbi's prospects as a reserve currency. China is already the largest trading partner of many countries, with the renminbi used in bilateral trade settlements. Increasingly, central banks and sovereign funds are already investing in renminbi-denominated assets. This trend can be expected to increase.

The third scenario is the emergence of a global currency. The smaller emerging and developing economies may regard as compelling the case for a global currency that represents a composite basket of currencies. This would be expected to provide greater stability than an individual currency – an important factor in stabilising trade earnings. The transition to any new monetary order will be gradual. History shows the inertia in internationalisation of currencies. There will be only gradual internationalisation of the euro and renminbi as complementary reserve currencies. The dollar will benefit from occasional reversals during periods of heightened risk aversion. Among the important preconditions for the transition to a multi-polar international reserve system is the strengthening of the depth and liquidity of foreign exchange and other financial markets.

As the emerging economies increasingly take centre-stage, emerging economies need to be accorded greater representation and responsibility in global governance.

As the emerging economies increasingly take centre-stage, emerging economies need to be accorded greater representation and responsibility in global governance. The transition from the G7 to the G20 is a positive step. But G20 representation remains limited by the size of economies and not by groups of countries. Small and medium-sized economies need to be part of this global governance. Increasingly, regional blocs are undertaking their own surveillance and establishing facilities and mechanisms to safeguard stability. Higher interconnectedness in the global economic, financial and monetary landscape makes the global agenda for growth and financial stability a shared responsibility. Global challenges require global solutions and accountability. Policies can no longer be devised only on national considerations. The new global architecture must take into consideration greater economic interdependence and the need for greater cooperation.

All these issue fundamentally transform the landscape. As we head towards a 'new normal' of greater economic and financial interconnectedness, we must recognise the impact on global governance, cooperation and coordination. The common agenda is to achieve a new world that is more balanced, more stable and more sustainable.

This article is an abridged version of the address by Governor Zeti to the OMFIF-Lafferty World Banking Summit in London on 30 June 2011.

OMFIF meetings

Maria Ramos, chief executive of South Africa's Absa Bank, joined other experts in analysing the changing shape of world banking in the light of regulatory changes on 29 June, the first day of the World Banking Summit in London.

Governor Linah Mohohlo of the Bank of Botswana is presented with an OMFIF Lifetime Achievement Award for services to central banking in her home country and internationally by Hendrik du Toit, chief executive, Investec Asset Management and a member of the OMFIF advisory board. This was at a dinner at the South African Reserve Bank on 23 August in Pretoria.

Governor Zeti of Bank Negara Malaysia delivers a keynote speech in London on the shifts in the international economy on the second day of the World Banking Summit on 30 June.

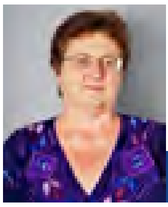
Dr. Monde Mnyande, Chief Economist at the South African Reserve Bank, receives an Honorary Fellowship at the newly-founded OMFIF International Academy of Central Banking by Michael Lafferty, OMFIF Co-chairman in Pretoria on 23 August.

Paul Volcker, former Chairman of the Federal Reserve Board, shares a joke with OMFIF Co-chairman David Marsh during his Golden Series Lecture on 'World economic imbalances & the outlook for international monetary cooperation' in London on 14 July.

Governor Gill Marcus of the South African Reserve Bank holds a keynote speech at dinner on 22 August on the first day of OMFIF's Inaugural Meeting in Africa at the Reserve Bank's conference centre.

Governor Yves Mersch of Banque centrale du Luxembourg confers with Songzuo Xiang and Frank Scheidig, OMFIF advisory board deputy chairmen, and David Marsh at the OMFIF - Renmin university - Liu Hongru Foundation seminar in Beijing on 22 July.

Jacques de Larosière is awarded a OMFIF Lifetime Achievement Award at a ceremony in London on 29 June by State Street's Marshall Bailey following a career at the helm of the International Monetary Fund, Banque de France and European Bank for Reconstruction and Development.



Little leeway for monetary policy

Long struggle to resolve debt burdens

Gill Marcus, Governor, South African Reserve Bank

Recent developments have resulted in a high degree of market turbulence. These include the realisation that the outlook for US growth is not as favourable as previously believed, the damaging US debt ceiling debate and the consequent ratings downgrade of US debt, and the further deterioration of the European sovereign debt crisis which has now spread from the periphery to the core, and potentially to the European banking system.

What started in 2007 as a banking crisis related to the US housing market has turned into a sovereign debt crisis. Recent events in the US and Europe illustrate how quickly the crisis can mutate. At the heart of the problem is a lack of strong unified and credible leadership, leading to a loss of confidence and trust in this leadership and potentially in the system as a whole. Behind the statistics are real people who find their lives in turmoil and livelihoods and future ambitions at risk. And in these circumstances those presenting easy answers to what are very complex and difficult issues can readily gain support.

What we are witnessing is not a new crisis, nor is it part of a normal economic cycle. Unlike normal economic cycles or recessions, financial crises are protracted affairs. In conventional recessions, the economy generally makes up lost output and resumes its pre-recession growth trend within a year. A recession involving a financial crisis does not only bring loss of output and employment. In addition, it applies to debt, credit and deleveraging, which takes much longer to work through.

Normal cyclical downturns are often reinforced by tight monetary policies in response to an overheating economy and inflationary pressures, and the downturn can be effectively moderated by a reversal of the monetary policy stance. Unfortunately we are not in a normal cyclical downturn, and the crisis cannot be solved through monetary policy alone. Households in the advanced economies are still deleveraging and repairing impaired balance sheets. Monetary policy can help only to an extent.

The US faces uncertainty over the sustainability of private sector consumption. At the start of the crisis, the gap left by the consumer was filled in part by increased government expenditure. The earlier consensus view was that, by mid-2010, the US economy would be on a self-sustaining recovery path. The focus then was on exit strategies or monetary and fiscal normalisation. By mid-2010 it became apparent that this positive outlook was misplaced. An additional fiscal stimulus followed through extension of Bush-era tax cuts, along with a further round of quantitative easing. The result of this, however, was a further build-up of public leverage. The slowdown in the US economy in the first half of the year was widely interpreted as a temporary soft patch, attributed mainly to supply chain issues relating to the disasters in Japan. But there is now more general recognition that the US economic recovery is weaker than anticipated.

Unfortunately the outlook is no better in the UK and the euro area. For some time the sovereign debt problems of peripheral European economies have been a preoccupation. Policy pronouncements and packages have not been fully followed through, or have generally disappointed the market. Countries such as Greece have been forced into austerity programmes which are likely either to be politically unsustainable, or – if they do manage to achieve the proposed expenditure reductions – to lead to declines in real growth rates which would reinforce negative debt dynamics.

The failure of the euro area economies to deal decisively with the issue has resulted in a spill-over to the broader region, with the focus leap-frogging firstly Spain and then both Spain and Italy, and on to France, where the markets are now questioning the sustainability of the country's AAA rating. The interconnected nature of these economies is reinforced by the exposure of the banks in France and Germany in particular to the debt of the peripheral European economies.

There is now more general recognition that the US economic recovery is weaker than anticipated. Fears of a possible return to recession have replaced the earlier confidence.

We have seen a banking crisis turning into a sovereign debt crisis, which in turn has the potential to undermine the banking sector recovery in Europe. Banking systems rely on confidence, and a collapse of confidence relating to counter-party risk can cause a liquidity crisis to translate into a solvency crisis with negative feedback effects to the real sector of the economy. For this reason it is important for central banks to stand ready to support their banking systems by providing appropriate liquidity support if and when required.

We are living in difficult times. The global economy is on the brink of falling back into what could be a prolonged recession unless purposeful and coordinated action is taken.

As the financial crisis gathered momentum in 2008, the synchronised nature of the downturn was widely recognised. Current developments are disturbingly similar. It is unclear at this stage if a reversion to recessionary conditions is likely, but at best the advanced economies appear to be in a stalled state. So what can be done? The cumulative nature of this crisis means that many parts of the world have sold off most of the family silver. In 2008, the coordinated response by many countries resulted in fiscal and monetary policy reactions which are simply not possible this time round. The response at this stage has been limited as governments generally face fiscal consolidation, and their room for manoeuver appears to be constrained. In most of the advanced economies, monetary policy remains extraordinarily accommodative. As interest rates in many of these countries are close to the zero bound, the scope for further reductions is limited apart from further quantitative easing and actions to provide liquidity or support to dysfunctional parts of financial markets.

There is no doubt that the burden of the policy response will fall disproportionately on monetary policy, but it is unclear if such actions will be effective in providing additional stimulus as opposed to simply facilitating the functioning of markets. The lack of fiscal space creates a real policy dilemma. On the one hand countries require a fiscal stimulus to try and counteract the slowdown, while the inevitable further build-up of debt means that sustainability issues become paramount. Ultimately the policy focus has to be on growth, which will help with fiscal sustainability, rather than on debt reduction in the short run. There needs to be a clear distinction between short and medium term needs, with a clear commitment to medium and long term fiscal sustainability.

Unfortunately this is easier said than done. In order to avoid a replay of 2008, there needs to be a cohesive understanding of the situation, and a unity of purpose at the global and national levels. An effective response requires confidence and trust in leadership, and this appears to be lacking. The fractious nature of political processes seems to be making it difficult to have the level of coordinated and purposeful responses that the crisis demands. This is well illustrated by the debt-ceiling debacle in the US, where some factions were willing to take the country and indeed the world over the brink. Similarly, the inability of the leadership of the euro area economies to agree on a credible and durable solution for the region has undermined support not only for the leadership but for the whole euro project. Until now, there have been piecemeal responses to the European crisis, which have merely delayed the need for a credible solution. There are no easy or painless solutions, but the longer they are delayed, the more difficult and painful the outcome will be. It is not just the markets that have lost confidence, it is the ordinary people who are bearing the brunt of the consequences of the crisis. These social and the social consequences are becoming increasingly apparent and disturbing with a growing structural unemployment problem, particularly among the youth in some countries and, in some instances, civil unrest.

We are living in difficult times. The global economy is on the brink of falling back into what could be a prolonged recession unless purposeful and coordinated action is taken. There are no easy or automatic solutions, but to date policy responses have been incomplete and irresolute. Not only the markets have lost confidence, but also the ordinary people behind the statistics. As austerity programmes bite further, we are likely to see more scenes similar to those played out in London and Athens. The challenge for leadership is to rebuild this trust and confidence. It can't be through more talk. There has to be action, but the room for action is limited. Any measures taken are likely to entail significant financial commitments, and these need to be big enough to put a stake in the ground. Such costs should not be looked at in isolation, but in relation to the costs already incurred, and the costs of not resolving the crisis. There is a long, painful path ahead for all of us.

This article is an abridged version of the address by Governor Marcus to the OMFIF meeting in Pretoria.

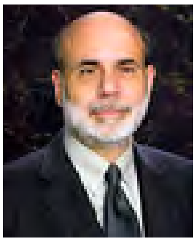
Fed debates further stimulus

QE3 discussion picks up as economic news worsens

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently five with two unfilled positions) and all 12 heads of the regional Fed banks take part in the regular monetary policy meetings of the Federal Open Market Committee, but the only ones who vote are the governors, the NY Fed chief and four other regional bank heads in a three-year rotation. For the time being, the Fed is keeping its powder dry on another round of quantitative easing. As more bad news on the economy and job creation surfaces, and dissent on the FOMC about the accommodative interest rate policy gains wider attention, the debate on QE3 will not go away.

Bernanke keeps helicopter grounded, for now



Ben Bernanke

It was a year ago at the annual Federal Reserve gathering in Jackson Hole, Wyoming, that chairman **Ben Bernanke (voter)** met market expectations for 'Helicopter Ben' going aloft and throwing money down on the economy by affirming that the Fed would engage in a second round of quantitative easing - promptly baptised as QE2.

This year Bernanke kept the helicopter on the ground and was mute on the subject of a possible third round of inflating the Fed balance sheet through securities purchases.

But the Fed chairman did massage the market a bit. He had no announcements now, but the Federal Open Market Committee has added a second day to its September meeting to fully discuss the economic outlook and the Fed's policy options.

'The Federal Reserve has a range of tools that could be used to provide additional monetary stimulus,' Bernanke said at Jackson Hole, adding that the Fed 'is prepared to employ its tools as appropriate to promote a stronger economic recovery in a context of price stability.'

Minutes of the August FOMC meeting, released after Bernanke's speech, indicated there was some support for further accommodation. Short of further expanding its balance sheet, the Fed could change the composition of its securities holdings or reduce the interest rate it paid on banks' excess reserve balances, some participants suggested.

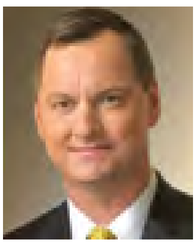
Bernanke had a couple of good reasons for not committing himself. One is that he wanted to put some pressure on the administration and Congress to do their part – balancing a long-term plan to put the US deficit on a sustainable path while avoiding any measures that would further dampen the feeble economic recovery.

Bernanke's statement came in advance of President Obama's major speech in early September with measures to stimulate job creation and recommendations for long-term budget adjustments. A 'super committee' of legislators created by the debt ceiling compromise is supposed to agree by November on further measures to reduce the deficit.

Bernanke had another reason to keep quiet now. After three members of the FOMC dissented from the August statement that the Fed would keep interest rates low through mid-2013, the chairman needs to spend some time in rebuilding consensus on the panel.

The three regional Fed chiefs who dissented – Richard Fisher of Dallas, Narayana Kocherlakota of Minneapolis, and Charles Plosser of Philadelphia – would have preferred a vaguer timeline.

Chicago's Evans favours aggressive measures



Charles Evans

While some of the regional Fed chiefs want to soft-pedal monetary accommodation, Chicago Fed president **Charles Evans (voter)** loudly declared his desire for more aggressive measures to stimulate the US economy and bring unemployment down.

'I'm in favour of some of the most aggressive policy actions of anyone on the committee,' Evans said in a television interview, just days after Fed chairman Bernanke said at Jackson Hole that the Fed remained ready to act if necessary.

'It's difficult to characterise the labour market as anything other than consistent with being in a recession,' Evans said. The economy is 'really going sideways more than anything else.'

The Chicago official said the Fed should clarify its policy intentions by setting targets, vowing to keep interest rates low as long as medium-term inflation remained below 3% and until the jobless rate falls to more acceptable levels.

St. Louis' Bullard cautious on new QE


James Bullard

Although he was an early fan of the Fed's original quantitative easing, St. Louis Fed chief **James Bullard (non-voter)** said he would have joined the three dissenters in the FOMC's August meeting if he had a vote because he doesn't think the Fed should be boxed in about just how long it will maintain low rates.

'Policy should be set according to the state of the economy, not according to the calendar,' Bullard said in a press interview. 'I didn't like putting calendar dates in.'

Fed policymakers need more information about how the economy is going to perform in the second half before making any decisions about further stimulus. His expectation is that growth will continue at a moderate pace.

'If the economy is substantially weaker than expected,' Bullard added, 'we could take more action, especially if it was coupled with a renewed deflation risk.'

Some analysts had taken the Fed's declaration of low rates through mid-2013 as a signal that a third round of quantitative easing was being planned.

'I think it is a much tougher call to do more QE this time around than it was last year,' Bullard told Bloomberg News. 'The inflation picture is different this year than it was last year and the risk of deflation is much more remote than it was last year.'

Dallas' Fisher indirectly chides Texas governor

It's not every day that a US presidential candidate accuses the Federal Reserve chairman of 'treasonous' behaviour and threatens him with 'pretty ugly' treatment, but those were exactly the words Republican Rick Perry used when asked about the possibility of Ben Bernanke 'printing more money.'

The Texas governor, who launched his bid for the presidential nomination in August, refused to retract his harsh words when even some other Republicans said he had gone too far. So naturally the press was interested in hearing from Dallas Fed president **Richard Fisher (voter)** what he thought of his governor's remarks, and just as naturally Fisher declined to comment directly.

But he did comment obliquely in a speech in Midland, Texas. 'Pointing fingers at the Fed only diminishes credibility,' Fisher said. 'The ugly truth is that the problem lies not with monetary policy but in the need to construct a modern, appropriate set of fiscal and regulatory levers and pulleys to better incentivize the private sector to channel money into productive use.'

Fisher, a former Wall Street banker who served in two Democratic administrations and who ran for senator as a Democrat, also went so far as to point out that Texas policies credited with boosting job creation in the state preceded Perry's tenure (Perry succeeded George W. Bush as governor when Bush was elected president in 2000).

And Fisher noted that the state suffers from 'severely limited social services' and 'an education system that faces great challenges.'

It's not every day that a US presidential candidate accuses the Federal Reserve chairman of 'treasonous' behaviour and threatens him with 'pretty ugly' treatment.

Rewards through partnerships

Joint investments by official investors make sense

Malan Rietveld, Chief Economist

Joint investments by sovereign funds are on the rise. These are the official sector behemoths of global finance that include sovereign wealth funds, sovereign pension funds, public employees' pension funds, development banks and public investment funds.

A joint approach to long-term investment is a sensible response to the challenges, obstacles and risks official investors face.

For a number of reasons, this joint approach to long-term investment is a sensible response to the challenges, obstacles and risks official investors face. But what benefits do joint investments offer? What are the risks? Building on the insights of scholars of sovereign funds from Oxford university, it's useful to start by identifying a number of theoretical arguments in support of joint investment:

Economies of scale It's well documented that scale brings competitive advantages in financial markets. While official investors tend already to have size on their side, the scale effect can be multiplied when two or more large investors combine forces. At the very least, joint investments mean that individual official investors can achieve scale without having to lock up a large share of their own capital in a single project. In short, by teaming up with other like-minded players, official investors can capture scale benefits without compromising portfolio diversification.

Information asymmetries and local knowledge One of the single biggest constraints to investments in under-developed markets with higher-expected returns over the long run is the lack of information – or, at least, the risk buyers face when they are confronted with less, or lower-quality, information than sellers. While by no means fully informed, local partners are likely to know more about local conditions and investment prospects. This has been a major factor behind investments by large official investors that have involved local partners.

Consortium benefits So-called 'club deals' became a buzzword in private equity in the first few years of the 2000s. While the practice has taken a back seat in recent years, as the global financial crisis put an end to the private equity bonanza, experience and academic research indicates that private equity consortiua have been able to negotiate an average of 10% lower prices on leverage buy-outs when compared to single firms. While there is no research to test whether this holds for official investors, who tend to make larger deals and typically are not leveraged, it seems likely that the club deal concept could apply here too.

Political risk management Partnering with a local investor is often the best step foreign investors can take to avoid political controversy and a nationalist or protectionist backlash against their presence. In countries with tendencies towards political and judicial instability a local partner can sometimes be of essential assistance.

Regulatory requirements In a number of investment destinations, regulations and investment law may insist in a local investment partner, particularly for investments in strategic sectors, such as mining, public infrastructure or agriculture.

Skills shortages Some so-called 'frontier' markets that appear to hold increasing appeal to official investors do not (yet) have major international financial centres. This often means that they have difficulty finding skilled individuals and financial services firms in the local market. Often the most skilled and knowledgeable investment professionals work in local official investment funds and companies, making investments with them the most effective way for outsiders to access key services needed during the investment process.

Due diligence and risk analysis The old adage that 'two pairs of eyes are better than one' could apply to due diligence and risk analysis. Different investors are likely to bring different investigative and analytical tools to the table. It is important that all the parties involved with an acquisition complete their own in-house research, due diligence and analysis. But a joint investment results in sharing the findings of these processes, reducing the risks that could undermine a sound investment.

If there is a danger that an unexpected increase in liabilities could require one partner to pull out of an investment prematurely, the partners need to have a clear arrangement for such an exit.

Reinforcing commercial objectives Partnering with a like-minded, commercially-driven official investment partner can help sovereign funds underline their own commitment to basing their decisions on the achievement of long-run returns. Simply put, having a credible partner next to you in an investment can be extremely useful when politicians and other stakeholders are pushing for your fund's resources to be allocated to politically expedient alternatives.

Of course joint investments between official investors are not without risks and possible areas of concern. The following risks and costs relating to joint investments need to be balanced against the benefits.

The cost of co-ordination can be high Co-investors are often from widely different parts of the world, requiring frequent travel. In addition, management of information flows, exchange of ideas and joint budgeting can be costly and time-consuming. The more complex the relationship or the more divergent the policies, practices and cultures of the respective investors, the more costly joint investment becomes.

Principal-agent and moral hazard problems There is a real danger that one party (or worse still, both) will neglect tasks that are assigned to it, given that the cost of failure to perform these tasks will not be borne by them alone. All the traditional solutions from these problems of asymmetric information – greater disclosure and monitoring, appropriate structuring of incentives between the parties involved, etc. – need to be adopted for joint investments.

The double-edged sword of politics The political dimensions of investing feature prominently among the factors in favour of joint investment. But they can easily pose problems, too. This is particularly relevant where regime change leads to a purging of all forces associated with the previous establishment.

This is no longer as big a concern as it was a decade ago in many frontier markets. Many developing countries have made great improvements in promoting institutional and political stability. It is clear that political considerations should never become dominant. Sound commercial and return prospects should always take precedence, for the sake both of the specific investment and of the long-term credibility and operational independence of official investors.

Divergent objectives, practices and risk profiles Official investors are by no means a homogenous group. If we cast our net wide enough, the global population of sovereign funds includes sovereign wealth funds, sovereign pension funds, public employees pension funds, development banks and public investment funds – and possibly even state-owned banks and enterprises (which at the very least are candidates for partnerships with sovereign funds).

Their often contrasting investment objectives, operational practices and risk/liability profiles need to be carefully assessed when scouting for prospective partners. For example, liability-driven investors face different risks to pure wealth managers.

If there is a danger that an unexpected increase in liabilities could require one partner to pull out of an investment prematurely, the partners need at the very minimum to have a clear arrangement for facilitating such an exit in a way that minimises the cost to the remaining partner.

While these risks and costs are important, they are not insurmountable. The opportunities abound for official investors to band together. Local partnerships could well be the essential ingredient to securing attractive returns on the new frontiers of global investment.

More stable outlook for Africa

Harnessing investment for brighter returns

OMFIF's Inaugural Meeting in Africa in Pretoria on 22-24 August 2011 set out an overall brighter outlook for the continent, based on greater political stability, broader wealth creation, reduced debt burdens and more efficient financing. Crucial requirements for the future included progress in fighting corruption, strengthened trade integration with other faster growing regions and more success in harnessing domestic and foreign savings for investment and development – including from sovereign funds and other public and private sector asset managers in Africa and further afield.

The gathering discussed possible setbacks for Africa caused by the threat of a new recession in industrialised countries which would reduce trade integration, soften commodity prices and lower investment flows. But it concluded on a note of cautious optimism about Africa's ability to cope with its own problems. It was felt that the dampened prospects in the industrialised world might conversely help Africa by brightening investors' perception of returns on the continent compared with those available on more established markets.

The meetings at the conference centre of the South African Reserve Bank were built around the theme 'The New African Market: Development and Diversity' - focused on discussions on the macro-economic picture, asset management, commodity/resource/infrastructure questions and regulatory/supervisory issues. The Seminar brought together a total of delegates from 69 institutions and 28 countries. The gathering followed the first three meetings in 2010, at Deutsche Bundesbank in Frankfurt in March, Bank Negara Malaysia in Kuala Lumpur in May and U.A.E. Central Bank in Abu Dhabi in October-November, as well as the meeting at De Nederlandsche Bank in Amsterdam in March 2011.

There were also separate breakout sessions on 'Developments on African banking and finance'; 'New regional investors and trends in asset management'; 'The commodity landscape – managing Africa's mineral wealth'; 'Prioritising infrastructure investments and assessing needs'.

Among the main findings were

- The gathering concluded that generating sustainable growth and investment in Africa depended on a variety of macro- and microeconomic circumstances, including political stability, improved infrastructure and a more convincing all-round public policy environment.

- The meeting agreed that – despite, yet also in some ways because of – the negative international background, overall conditions for African growth and stability were better than they had been for some years. The world economic slowdown was a threat, but also an opportunity, because fund managers – disquieted by the poor investment outlook elsewhere – now had much greater appetite for emerging markets (or rapid-growth economies) in general and Africa in particular.

- An important policy finding was that there was no single model for African development. Profiting from experience in former communist-run countries in central Europe after the fall of the Iron Curtain two decades ago, each country had to rely for its policy course on individual economic, political, cultural and societal factors, as well as judicious use of foreign aid and foreign investment. It was widely felt that Latin America provided more appropriate economic policy models for Africa than Asian countries.

- Competition among different countries on promoting favourable investment conditions, aided by better information and more transparency, could be an important stimulus for more efficient and effective investment that would be both profitable and support sustainable development.

- There was a general warning against grand plans for African integration and a potential African single currency. Building regional blocs in an organised yet flexible fashion was seen as more propitious.

Three inter-related themes permeated the discussions:

1. Stability, growth and governance in Africa

The meeting noted signs of more resilient growth patterns and better governance despite considerable problems and numerous false starts in recent years. The effects of the 'Arab Spring' were still uncertain, with the rebellion in Tripoli (where the government had given great priority to various economic and monetary initiatives of the African Union) coming to a head during the meeting. Although a number of conflicts persisted, Africa had become a more stable place. Central banks and other public institutions had become stronger and more independent and this would continue to generate policy improvements. Assessments of the 10-year outlook were generally very positive.

There was widespread recognition of the danger of imbalances within and between different parts of Africa, reflected in persistent inequality which had negative results in both the political and economic sphere and raised the need for much harmonised and broad-based wealth creation. In this context, considerable attention was paid to the need to ensure that increases in commodity prices fed through more smoothly into sustainable development rather than into enriching elites. As one fund manager put it, 'Africa as a whole will be better off. The question is how much - and who?' Various financial techniques were discussed for moderating sharp fluctuations in commodity prices – including the innovative use of sovereign funds and buffer funds. Promoting 'capacity of states' and empowering public officials (including central bankers) to be genuinely independent – acting 'without fear or favour', as one speaker said, in standing up to overbearing, corrupt or incompetent ministers or officials – was hailed as an important objective.

2. Economic problems in industrialised counties and their effect on the developing world

The meeting took place amid controversy and disagreement in America and around the world about the US Federal Reserve's monetary relaxation and after further signs of disarray in the European Union. Europe's problems were widely seen as a posing economic problems for Africa, in the light of intensive trade links and also the possible effect in lowering capital flows and softening commodity prices. Further, difficulties over EMU were regarded as a cautionary signal for far-reaching African plans for monetary union in the early 2020s. As well as the general low growth environment, other negative factors such as worsening demographic conditions, rising health care costs and endemically low savings in many countries were seen as weighing on industrialised country prospects.

There was particular concern about a 'debt deflation cycle' in the euro area. The problems faced by EMU members and also the relatively good experience outside EMU of countries like Poland were said to provide lessons for Africa. One prominent speaker, castigating poor leadership and faulty policy direction in Europe, said Africa had to digest EMU's lessons and spoke of 'inordinate haste' in promoting Africa's plans for monetary union, widely seen as over-ambitious and deflecting attention from more important priorities. Summing up the contrasts between the regions, one prominent delegate said, 'Western economies are no longer able to benefit from a demographic dividend – baby boom generation is aging, and labour supply is falling. On the other hand, the change in Africa's economic performance has been largely endogenous – driven by better policymaking. African economic policy has come of age.'

3. Building effective conditions for African growth and development – including financing

In view of a likely squeeze on world savings flowing from Asia, there was considerable discussion of the need to generate more efficient pan-African capital markets, both to attract financing from outside the continent and to recycle savings from within Africa. One prominent speaker said African asset managers were more risk-averse than those outside the continent, although this was contested by others. There was general accord on the necessity of organising partnerships with foreign providers of capital, which might themselves be more willing to allocate capital to Africa if general investment conditions and perceptions of African stability improved. The unpropitious international environment had two contradictory effects, by making international investors more cautious, but also increasing the relative attractiveness of Asia because of poor returns in other regions. There was support for the idea of producing an 'investment scorecard' recording the attractiveness of individual African economies and their capability of securing investment returns.

The unpropitious international environment had two contradictory effects, by making international investors more cautious, but also increasing the relative attractiveness of Asia because of poor returns in other regions.

OMFIF Advisory Board

Six new members for OMFIF Advisory Board

During the summer, new members joined the Advisory Board: Peter Bruce, editor of Johannesburg–based Business Day, Haihong Gao of the Chinese Academy of Social Sciences, Thomas Laryea of international law firm SNR Denton, Ashley Eva Millar of University of Cape Town, Hendrik du Toit of Investec Asset Management, and Gerard Lyons of Standard Chartered Bank. We look forward to their contributions to OMFIF and its activities.


Meghnad Desai*


Songzuo Xiang**

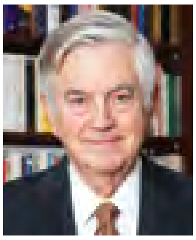

John Nugée**


Frank Scheidig**


Katinka Barysch


Paul Boyle

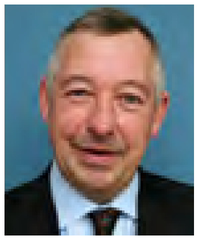

Mario Blejer


Frits Bolkestein


Nick Bray


Albert Bressand


Peter Bruce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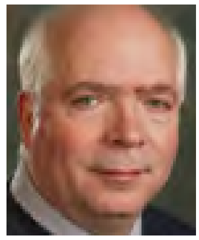
Hon Cheung


YY Chin


Neil Courtis


John Cummins


Jon Davis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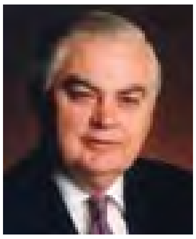
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Michael Stürmer


Paola Subacchi


Jens Thomsen


Niels Thygesen


Makoto Utsumi


Peter Walton


John West


Ernst Welteke


Derek Wong


Sabrina Wong

The Advisory Board under the chairmanship of Prof. Lord Desai has grown considerably from OMFIF's inception in January 2010. The Board is divided into sub-groups for Public Policy, Research & Economics, Education, Editorial & Commentary, Banking, Capital Markets. The three deputy chairmen are Songzuo Xiang (Renmin University), John Nugée (State Street Global Advisors) and Frank Scheidig (DZ Bank). OMFIF is building up the Advisory Board particularly in fast-growing emerging markets. The Advisory Board includes a number of ex officio members whose names are not publicised.

Clear weakness in Europe and the US

Chinese economy losing steam

DZ Bank Economic Forecasts			
GDP growth			
	2010	**2011**	**2012**
US	3.0	1.5	1.7
Japan	4.0	-0.7	2.1
China	10.3	9.0	8.2
Euro area	1.7	1.7	1.4
Germany	3.7	3.0	1.8
France	1.4	1.8	1.5
Italy	1.2	0.8	0.7
Spain	-0.1	0.6	0.6
UK	1.4	1.1	1.6
Addendum			
Asia excl. Japan	9.3	7.6	7.3
World	4.9	3.7	3.8
Consumer prices (% y/y)			
US	1.6	3.0	2.4
Japan	-0.7	-0.3	0.4
China	3.3	5.6	3.4
Euro area	1.6	2.6	2.0
Germany	1.2	2.4	2.1
France	1.7	2.2	2.0
Italy	1.6	2.5	2.0
Spain	2.0	2.9	1.6
UK	3.3	4.2	2.2
Current account balance (% of GDP)			
US	-3.2	-3.1	-3.2
Japan	3.6	2.0	2.9
China	5.2	4.5	4.3
Euro area	-0.4	-0.7	-0.6
Germany	5.7	5.1	4.7
France	-2.2	-2.4	-2.6
Italy	-3.3	-2.9	-2.5
Spain	-4.7	-4.6	-4.0
UK	-2.5	-2.0	-1.8

Produced in association with DZ Bank group, a partner and supporter of OMFIF

Signs that global growth is losing momentum are becoming increasingly clear. While data for July in the US and Europe showed an upturn compared with the almost universally weak spring quarter, in August confidence slumped massively on both sides of the Atlantic. The financial markets have been shaken to the core by the sovereign debt crisis.

This uncertainty has damaged sentiment both in manufacturing and among private households. There is a danger that reduced investor and consumer confidence will provide the mechanism that transmits the financial markets' heightened risk aversion directly into a downturn in the real economy.

The American budget battle between the Obama administration and the Republican opposition was a principal cause of collapsing confidence. Sentiment in manufacturing suffered a veritable slump in August, and companies now rate their prospects for coming months much more negatively than just a month ago. Pessimism is the outstanding feature of the latest consumer confidence surveys, too. This leads us to see little prospect of a broad-based economic recovery in the months to come.

The unsatisfactory jobs market is severely constraining US households' spending appetite, and residential construction will not be injecting positive stimulus any time soon. We have revised down our forecasts for the US economy both this year and next; we now see growth of just 1.5% and 1.7% respectively.

The euro area's business confidence indicators have a been softening noticeably for several months now. The second-quarter GDP numbers signalled a euro area slowdown. With the consequences of the debt crisis likely to provide a continued drag on both state sector and private demand in coming quarters, there is little scope for the euro area economy to strengthen. Economic growth will remain very weak at 1.7% and 1.4% in 2011 and 2012 respectively.

The prospects for the Chinese economy have also deteriorated. This is not only because of the sharp downturn of confidence in the country's manufacturing sector, where the most recent purchasing managers' indices showed sentiment stabilising at a depressed level.

The much more pessimistic outlook for American growth is spilling over into reducing Chinese export prospects. This is important, considering that 20% of Chinese exports go to the US. None of the other big sales markets for Chinese goods can be expected to make up the shortfall, since European and Japanese growth is also likely to turn out weaker than predicted.

This has led us to cut our forecast of China's growth next year from 8.7% to 8.2%. For the current year, we predict slightly slower GDP growth of 9%.

OMFIF
Official Monetary and Financial Institutions Forum

Ring-fencing in UK – but not yet

Chance missed for forging standalone retail banks

Michael Lafferty, Co-chairman

UK banks have fought long and hard to head off radical changes in their structure that they say would lower profitability and damage lending to enterprises. They have won a significant victory – but at the cost of delaying reforms that would have made Britain's banking set-up a lot more friendly to retail customers and, ultimately, less prone to the disastrous mistakes that brought the 2008-09 credit crisis.

If the ICB recommendations are implemented over the next five years, this could serve as a beacon for many other countries – rather like former prime minister Margaret Thatcher's privatisation policy 30 years ago.

The banks have been engaged in a lobbying campaign against the wishes of the Independent Commission on Banking (ICB), headed by Sir John Vickers, former chief economist of the Bank of England, to break up the powers of the universal banks. In particular, they have railed against efforts to separate retail and investment banking activities. These would have involved the banks allocating to these different operations capital that at present is effectively pooled across their businesses – resulting in a considerable capital charge on risks that would have made investment banking much more expensive.

The banks' lobbying in the media and in politics paid off. Even before the ICB's final report on 12 September, the Government decided to delay implementing any idea of 'ring-fencing' investment banking and retail banking (which was put forward already in the interim report in April). Such steps will be postponed at least until 2015 – after the general election. The investment bankers who head many UK banks are a relatively new phenomenon in the City of London, dating roughly from the 1990s when restrictions between commercial and investment banking disappeared in the US and the phenomenon moved effortlessly across the Atlantic.

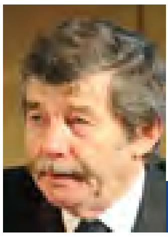
The banks' media campaign has been notable. Columnists like Prof. John Kay – well known for his excoriating opinions about the banks, who writes weekly for the Financial Times – were in no doubt that retail banking had to be ring-fenced and ideally should be totally separated in a new industry. However the press has been full of scare stories that a break-up would be disastrous for business credit and for UK growth at a time of worrying economic weakness. The news has been a setback for Sir Mervyn King, governor of the Bank of England who has long been a vocal advocate of total separation of retail and investment banking.

Passing up the opportunity for reforms is a pity. The chance has been lost to shield taxpayers from the costs of another banking crisis, and also to bring greater transparency into the reward structure profiting those in senior positions in universal banking. If retail banking was indeed ring-fenced, with little or no scope for cross-subsidisation of investment banking, then this latter activity would bear much higher funding costs. Some investment banks would go out of business, and investors would eventually demand the complete break-up of banking conglomerates.

The outcome would be that an independent retail banking industry would thrive, unfettered by the conflicting cultures of investment and corporate banking, and that investment banking would be reduced to realistic proportions. Unfortunately, in the debate in the UK and elsewhere, too little attention has been paid to retail banking and its future. There are strong grounds for arguing that retail banking today is in reality an outgrowth of corporate banking, designed primarily to serve the needs of wholesale customers. This might explain why ordinary people have a less than positive opinion of their banks in many countries.

If the ICB recommendations are implemented over the next five years, this could serve as a beacon for many other countries – rather like former prime minister Margaret Thatcher's privatisation policy 30 years ago. The eventual result could be the emergence of a stand-alone retail banking sector. This would be beneficial for Britain and other countries. But it's the last thing those at the helm of British banks want to see. That's a strong reason why, during their remaining banking careers, this is a fate they will probably avoid.

A regular round-up on international monetary affairs



Riots, leaks and back-stabbing

If only Eddie George had still been there ….

William Keegan, Chairman, Board of Contributing Editors

There were riots in the streets when I left London for a break in North Wales and South Turkey (spot the difference) and riots in the British Labour party when I returned.I exaggerate about the Labour party. But there was certainly an atmosphere of recrimination as 'leaks' and extracts from former Chancellor Alistair Darling's memoirs dominated the airwaves.

The word 'leaks' is in quotation marks because it turned out that the most damaging charges, such as the report that Darling regarded the wife of shadow Chancellor Ed Balls, Yvette Cooper, when Treasury chief secretary, as a 'spy in the Treasury', turned out to be figments of journalists' imaginations. Also, Darling did not, as widely reported in advance, call bankers 'stupid'. How could he, when he knows they have been getting away with blue murder?

But the timing of Back from the Brink: 1,000 days at Number 11 by Alistair Darling has understandably upset the Labour opposition, opening up, as it does, all that dangerous talk of divisions, and diverting attention from the manifold problems of the ruling Conservative-Liberal Coalition.

The real riots were big news around the world, and not surprisingly. Britain is supposed to be one of the strongest economies in the world, with a welfare state that is meant, among other things, to quell any of the kind of social discontent that is thought to give rise to rioting. Now, I'm not going to spend too long on the causes of those riots. Sociologists are working overtime on the subject, and, as an economist, I'm a great believer in the division of labour (although I do not think it is good for British politics when Labour is so divided).

But I was reminded, when the riots broke out, and the horrific scenes of looting were there for all to see, of the remark by Michael Heseltine, a cabinet minister in Margaret Thatcher's government, about the riots in Liverpool in 1981. Heseltine, a good, decent and formidable politician, was put in charge of what was in essence an economic rescue operation for Liverpool, which had long been needed. His poignant remark was: 'It took a riot….'

Prime minister David Cameron talks vaguely about 'The Big Society'. Yet, so far from being inspired to 'do something', the coalition seems set on ploughing on with spending cuts.

Lord Heseltine is now well into his seventies, and, while always worth listening to, does not have the energy he had then. There has been no sign of a successor to Heseltine getting to grips with rising social discontent. Prime minister David Cameron talks vaguely about 'The Big Society'. Yet, so far from being inspired to 'do something', the coalition seems set on ploughing on with spending cuts in most of the areas where it might otherwise be able to alleviate social discontent.

Meanwhile the economic news seems even gloomier in September than it did in July. Any hope that the UK, with its competitive exchange rate, can rely on an export-led recovery is dampened by the sobering fact that, in a world of severely depressed demand, almost every other economy is trying to do the same. Even the few 'hawks' at the Bank of England have turned dovish as the magnitude and prolonged nature of the crisis strikes home. There is more and more concern about a 'double dip' recession, although it is a moot point whether we ever emerged from the first dip.

Which brings us back to former Chancellor Darling. As an accurate messenger of the scale of the financial crisis and its prolonged duration, he made himself highly unpopular with former prime minister Gordon Brown, a fellow Scot with whom he had been on friendly terms for decades.

Darling's account of the strained atmosphere between 10 and 11 Downing Street during the financial crisis has reopened old wounds, in perfect timing for the annual British party conference season. The Conservatives and usual suspects in the media have been rubbing their hands and doing their best, on the basis of the in-fighting reported in the book, to stir up trouble for Ed Balls, at a time when he had been a consistently powerful critic of the government's austerity plans.

But perhaps, from the point of the international financial community, the most damning criticism in Darling's book is reserved for the Bank of England in general and Governor Mervyn King in particular over the sluggishness of their response to the financial crisis. Sadly, the Bank became too obsessed with monetary policy, and took its eye off the banking system. Darling reflects ruefully on how different things might have been if Eddie George had still been there. But it is only fair to add that King learnt pretty fast after that, and the Bank played a major behind- the-scenes role in the 2009 G20 rescue operation.