OMFIF BULLETIN

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December 2010

Ending hostility over the renminbi

Five-point plan to lower US-China tensions

Songzuo Xiang, Deputy Chairman, Advisory Board

If the US and China single-mindedly keep putting forward their own unemployment and social problems as a reason for their respective positions over the renminbi, then we will be stuck in a permanent stalemate. There has to be a better way forward.

The persistent US accusation of Chinese currency undervaluation is based on estimates by US think-tanks as well as by the International Monetary Fund, none of which is particularly convincing. Moreover, there is no direct correlation between the renminbi exchange rate and 6m jobs lost in US manufacturing. And projections that a substantial renminbi appreciation would correct the US trade deficit are not borne out by historical evidence. Neither the rise of the Chinese currency since 2005, nor D-Mark and yen appreciation in the 1970s and 1980s, supports this argument.

To find a way out of mutual hostility and misunderstanding, we must take a new path of reality and pragmatism. Here are five precepts for action.

1. The US should give up its policy of loudly blaming the renminbi exchange rate for all its ills, threatening regularly to label China as a 'currency manipulator', and encouraging legal action against Chinese exporters. Such an approach has not fixed problems in the past and will not do so in the future.

2. By producing practical indicators and milestones, the Chinese government should make its international economic policies much more explicit and convincing. We must demonstrate once and for all that mercantilist objectives for trade surpluses and foreign reserve accumulation are not part of Chinese economic policy. Indeed, a major plank of the Chinese government's next Five Year Plan for 2012 to 2017 is focused on domestic demand-led development and growth, enhancing incomes and living standards of ordinary people, and further reforming and opening the Chinese economy.

3. Both China and the US should take further measures to open their markets and grant foreign enterprises and investments favourable national treatment with regard to taxation, employment and other issues. China should speed up tackling the market-impeding monopoly positions of state-owned enterprises and reducing entry barriers, creating equal conditions for domestic and foreign private investors, and eliminating export-promoting policies such as tax

(continued on page 12 ...)

Contents

Schmidt's view

Narrower Europe

Helmut Schmidt, former Chancellor

The European Union made 'great mistakes' by deciding to start economic and monetary union (EMU) in the 1990s with a wider rather than a narrower group of countries, according to former German Chancellor Helmut Schmidt. One of the political architects of the single currency, Schmidt told the OMFIF Bulletin that a 'hard core' European Union was likely to emerge in 20 years, including Germany and France but not the UK.

Speaking of the present strains within EMU, Schmidt said: 'They not only invited everybody to become a member of European Union but they also invented the euro and invited everybody to become a member of the euro area. And this was done without changing the rules or clarifying the rules beforehand.' He said Europe should have taken more note of rising current account deficits in the peripheral countries and stated Chancellor Angela Merkel was 'not a very smooth operator'.

FOR FULL INTERVIEW WITH HELMUT SCHMIDT SEE P. 8-12

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Festive air running thin

Seasonal tendency to chaos

David Marsh, Co-chairman

There is little to indicate any festive character to the end-year edition of the OMFIF Bulletin, for the season of uncertainty tending towards chaos appears to be upon us. We bring an array of contributions that delve into the economic and monetary issues overhanging the Christmas period. Songzuo Xiang at least puts forward some constructive thoughts in outlining his five-point plan to resolve the Sino-American monetary impasse.

Helmut Schmidt – as well as telling us that the quality of leadership was better in his day (which is arguably true) – offers a set of perspectives for Europe that can hardly be termed optimistic but are none the less thoroughly realistic. 'Muddling through' – a precept applied to the UK which Schmidt always regarded as second-best – now appears, he says, to be the watchword.

A number of our commentators writing in this issue have been consistently prescient throughout the year and it is worthwhile recording this. Meghnad Desai, who writes on the need for a 'gold-plated SDR', put forward the idea of a gold reference point for world currencies well before Robert Zoellick, the president of the World Bank, backed the concept in November.

Niels Thygesen some months ago advocated the need for weaker countries within economic and monetary union to be able to reschedule their debts in a way that would bring write-downs for private creditors. This thought, unpalatable though it may be, has now been accepted as part of a hoped-for 'permanent crisis resolution mechanism' (an oxymoronic phrase, if ever there was one) for EMU. John Nugée put forward a similar idea two months ago. ['Permanent fund for Europe', OMFIF Bulletin, October 2010, p.6.] John Plender has maintained a strong note of ruminative caution throughout the year, maintained now as he gingerly peers towards 2011.

Jonathan Fenby has argued with great stamina during the past 12 months that any renminbi revaluation would be modest. A large consensus of US decision-making opinion now agrees. Stewart Fleming has been pointing out how the G20 process is running out of steam. In this month's edition he investigates where that leaves us on the issue of regulation.

Stefan Bielmeier advocated in the November Bulletin that Ireland should tap the European Financial Stability Facility; lo and behold, after much confusion and perturbation, it has now come to pass.

Another member of our advisory board, Pawel Kowaleski, expresses what many are saying sotto voce: that the Maastricht criteria for monetary union enshrine a two-speed Europe. We look at the Fed's latest moves with Darrell Delamaide, at the presidential succession at the Nederlandsche Bank with Roel Janssen, at the changing shape of UK regulation with Robin Gordon-Walker and at the new attempts to cooperate between the worlds of banking and accounting with Peter Walton.

And, to end on a note of seasonal hope, Malan Rietveld explores what we can learn from the unashamedly conservative philosophy of Canadian banking regulation. We wish you a happy, not necessarily well-regulated, Christmas and holiday period.

David Marsh

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Dutch room at the top

Rich array of candidates for Wellink job

Roel Janssen, Board of Contributing Editors

The one important moment when politics interferes in a big way with the running of an independent central bank is when the government appoints the head of the institution. The Dutch government is starting to prepare the succession to Nout Wellink, the veteran president of De Nederlandsche Bank, who steps down on 1 July 2011 – an extremely political appointment. For a maximum period of 14 years the next DNB president will be the public face of the monetary and regulatory authority in the Netherlands.

The decision is all the more important as the central bank – and Wellink himself – have come under much closer scrutiny after the financial crisis. For the past four years, Wellink has been chairman of the Basle committee of bank supervisorors. Adding piquancy, the decision will be made by the Netherlands' first-ever minority government. The coalition of the conservative and Christian Democratic parties relies on the support of the anti-Islam party of Geert Wilders, a right-wing anti-establishment populist who earlier demanded Wellink's resignation.

As yet, Wellink's succession is not officially on the public agenda. However, rumours about possible candidates are rife. One name increasingly mentioned is that of serial prime minister Jan Peter Balkenende, the leader of the Christian Democrats who was defeated in the last general elections. Balkenende headed four governments since 2002, none of which completed its full term. In 2009 he failed to become the first president of the European Council and recently became a part-time professor at Rotterdam's Erasmus University.

As prime minister, Balkenende showed scant interest in central banking. In spring 2007, he famously refused to meet Wellink who urgently wanted to discuss the future of ABN Amro, the oldest Dutch bank, which was about to be sliced up between Royal Bank of Scotland, Banco Santander and Fortis Bank. Wellink opposed the split, but failed to get political backing from the Balkenende government. When the financial crisis deepened in 2008 – and the government nationalised the Dutch parts of ABN Amro and Fortis Nederland – it was finance minister Wouter Bos and DNB president Wellink who took most criticism.

For a while, it was thought that Bos – now a consultant at KPMG – might be Wellink's natural successor. In 2008, he was lauded for the way he handled the crisis in the Dutch financial sector. However, he is the former leader of the Social Democrats and his party, now in opposition, can count on little sympathy from the coalition parties. For different reasons, another able candidate seems out of the question. Gerrit Zalm, the Netherlands' longest serving finance minister, now heads the state bank ABN Amro, in charge of merging it with Fortis Nederland. Eventually, the new bank will be privatised and Zalm has indicated he aims to bring that process to a succesful completion in 2013 at the earliest. All three, Zalm, Bos and Balkenende, have been tainted by the collapse in 2009 of DSB Bank, a consumer credit bank owned by self-made millionaire Dirk Scheringa.

Among outsider names circulating as possible candidates are Kees van Dijkhuizen, a former top official at the finance ministry, now chief financial officer at NBIC Bank; Jeroen Cremers, also a former finance official, currently at RBS; Angelien Kemna, chief investment officer at state pension fund APG; Willem Buiter, who was previously on the Bank of England's monetary policy committee amd is now chief economist at Citicorp; and Joop Wijn, a former politician and now at ABN Amro.

And then, there is the obvious insider: Lex Hoogduin, an affable monetary economist who has spent most of his career at DNB and was the personal assistent of Wim Duisenberg when he headed the European Central Bank. After a brief spell as chief economist at investment fund Robeco, he joined the DNB board in 2009. To politicians who wish to display an 'all change' sign at the central bank, Hoogduin's insider status may however represent a serious handicap to possible promotion.

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China perturbed by inflation risks

G20 blockage on Sino-US money dispute

Jonathan Fenby, Board of Contributing Editors

The run-up to President Hu Jintao's visit to Washington January will, no doubt, produce a fresh flurry of speculation about a basic shift in China's currency policy. But the G20 summit in Seoul in November gave China no reason to change its currency policy. The message from Beijing is clear: if the world has problems, this is due to a failure of US economic policy.

At Seoul, the Chinese found themselves comfortingly surrounded by critics of US quantitative easing. The argument that emerged at the time of the International Monetary Fund and World Bank meetings in Washington in October is now set in stone. Chinese consumer price inflation of more than 4%, together with the nominal 3% which China will allow the renminbi to rise, adds up to a real appreciation of 7% against the dollar, given that US inflation is close to zero. That is all Washington can expect, particularly in view of uncertainties about the global trade outlook.

One sign of how China wants to steer its own course is its rejection of the US suggestion of capping trade surpluses as a proportion of GDP. Beijing wants to avoid being subject to any international agreement that would cramp its policy autonomy on the economy.

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Rather than the currency, it is domestic price rises that most concern Chinese leaders right now. The 4.4% October annual rise in the consumer price index, which does not take account of property price increases, was unexpectedly steep. In reaction, the People's Bank of China raised the reserve requirement ratio for banks by half a point on 19 November and announced a quarter-point rise in the benchmark one-year lending rate to 5.56 per cent in October. Further monetary tightening is likely, including a reduction in the target for new loans from this year's Rmb7.5tn to Rmb6.5-7tn in 2011.

This focus on interest rates and reserve requirements, however, will have little effect in bearing down on the key element in China's inflation. Manufactured goods prices are not the problem. Food accounts for three-quarters of the rise in the CPI rise this year, and the government followed the monetary measures with steps in late November designed to ensure adequate food supply and to tighten controls as well as extending subsidies to the poor.

But these measures do not address deeper structural problems. The government wants to boost rural incomes as part of its effort to reduce wealth disparities; so it is loathe to clamp down on farm earnings. Demand has risen strongly as the diet of many Chinese has changed with more meat and diary products, but supply is hobbled by a range of constraints.

The decision to shy away from private ownership of land taken at a Communist party plenum two years ago means too many farms are too small to be efficient. The urbanisation policy reduces arable land area. Pollution and desertification, poor irrigation and lack of water in the central-northern wheat lands add to the problems, as do backward food distribution logistics. Nitrate fertilisers leach out the soil and introduction of high-yield seeds has ben slow.

As long as China sticks to its policy of 95% food self-sufficiency (except for soy), it will remain prone to inflationary pressures from the mismatch between food supply and demand. There may well be further monetary measures with another interest rate rise and further increases in reserve requirements. But the true problems lie in areas that cannot be tackled by straightforward monetary policies. While international attention focuses on the currency, the structural causes of Chinese inflation need to be given due regard – because this may turn out a major negative influence on world markets in 2011.

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Gold-plated SDR to stop the rot

Zoellick's statement moves us forward

Meghnad Desai, Chairman, Advisory Board

The G20 circus has plenty of jugglers but seems to have run out of horses. Maybe it could do with a new act – the gold-plated Special Drawing Right. Let us hope that in 2011 we can make some real progress on moving towards a more convincing performance.

Everyone says financial imbalances remain a key problem for the world economy. But no-one – least of all at the G20 – seems able to do anything about them. One solution would be to boost the International Monetary Fund's SDR as a super-currency in which countries could park their reserves. The IMF could swap the SDRs for the financial surpluses and then lend them out.

But for this to happen, the SDR has to be a means of payment and store of value, not just a unit of account. For the moment, despite all the economic sins the US is heaping on the world, the dollar is the chosen currency in which the surplus countries invest their balances. The euro is a mild alternative but not a close substitute. For all these reasons, it has been evident to me for two years that we need a gold-backed SDR. The IMF's composite unit should be a mix not just of the main currencies which madly fluctuate against each other but also of commodities including and especially gold.

A currency and commodity portfolio for an international reserve currency is an idea that has been around ever since the Bretton Woods system collapsed. Nicholas Kaldor and Albert Hart worked on these proposals in the 1970s. Time has now come to revive those ideas. I made a modest proposal in this direction in the OMFIF Bulletin in February. This is why I welcome the call in November by Robert Zoellick, the president of the World Bank, for a multi-currency reserve system using gold 'as an international reference point of market expectations about inflation, deflation and future currency values.'

Zoellick's recommendation partly represented a statement of the obvious. We have in gold not an invariant but a slowly fluctuating standard against which all the currencies can be measured. In the 19th century, we had the Gold Standard when for 300 years the price of an ounce of gold had been fixed by Isaac Newton at £3 17s 9d. Later, after the currency breakdowns brought by the First and Second World Wars, Bretton Woods re-established a new price at $35 per ounce and the American Treasury stood ready to do (for official balances) what the Bank of England once did. Alas, the Americans reneged on that promise on 15 August 1971 – a day that will live in infamy. The European Monetary System was invented in the late 1970s by Helmut Schmidt and Valery Giscard d'Estaing as the latest stage in a long struggle for a revived fixed exchange rate system. The euro is its latest, somewhat unsatisfactory avatar.

The best we can hope for is that the various international fora provide a framework for thrashing out genuine progress on international monetary reform. But, for now, the debate is unduly dominated by American obsession with the renminbi. Anti-China rhetoric fuelled much of the mid-term US elections on both sides. Now, with the Republican majority in the House, that will continue.

The US would prefer to blame the world's ills on China, while Beijing has hit out at America's latest quantitative easing. Because of China's relatively high inflation rate, the renminbi's real exchange rate has appreciated much faster than the nominal one, so China has a perfect alibi. Logic would dictate that the developed debtor countries that in the short term are trying to reflate their economies should become savers in the medium run, while the developing countries that are now among the principal creditors should do the opposite. But there is no neutral umpire to adjudicate. The IMF once could have played this role. But now we have no world monetary ringmaster – only the Americans and Chinese behaving like fishwives. If we are to fill the vacuum and stop the rot, the time has come to get serious about a gold-plated SDR.

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Limited progress on G20 rules

Emerging economies go for 'pick-and-mix'

Stewart Fleming, Board of Contributing Editors

Financial market regulation is the one area where the G20 is making some progress in efforts to develop more effective international cooperation. But only if progress is carefully defined. Do not fall into the trap of expecting the G20 to deliver global harmonisation of financial market regulation.

In its report to the Seoul summit in November assessing G20 process, the International Monetary Fund insisted that progress had been made towards a reformed financial system designed to mitigate the risk of future financial crises. It cited the Basel III objectives of establishing new, more demanding, capital requirements for banks, enhancing national regulation and supervision and moves towards greater transparency in financial markets. But, it added, the pace of implementation varies across countries. It could also have pointed out that, even across the Atlantic, there is little evidence of detailed national cooperation.

A more objective assessment would have pointed out, too, that the interests of G20 members vary. So, Indian officials, for example, are quite clear that they want to support the idea of promoting international financial stability and integration. They can see advantages to their country and its companies from being able to borrow in globalised financial markets and, eventually, to their banks from participating in them. Turning Mumbai into a major regional, even international, global financial centre has been a long-standing objective of Indian policymakers. They are well aware, too, that important parts of their banking and financial system are riddled with corruption and fraud, as November's arrest of eight prominent financial services executives underscored.

But like other emerging market economies, the Indians are in no mood to take lessons from the trans-Atlantic countries whose hopelessly inadequate regulation so recently brought the world financial system to the brink of disaster. Moreover they are critical of moves to bolster bank capital requirements or bring in new, more stringent liquidity rules. So such countries will adopt G20 advocated reforms on a 'pick- and-mix' basis and implement them at their own pace according to local requirements.

As a result, the idea that the G20 financial reform process will produce globally harmonised financial market regulation is moonshine. Even the European Union, which has been trying to move in this direction for at least 20 years, and much more actively since the launch of the single currency and the Financial Services Action Plan in 1999, is still a long way from achieving this objective, which, incidentally is not shared by all its members.

As with the macro-economic dialogue in the G20, do not expect too much. Unless the global economy slides again to the brink of disaster, the G20 is a place where the foundations of the new global financial dialogue are being laid, not the forum were big decisions will be taken. Unexpectedly, indeed, as the European debt crisis has worsened, the pendulum has been swinging back to the larger industrial countries. The G7 remains a critical, potentially decision-making, forum for international cooperation, as its involvement in both the Greek and Irish sovereign debt crises demonstrates.

Once again, as with Greece in May, the speed with which Ireland's debt crisis has begun to spread to Portugal and Spain seems to have surprised euro member governments. The severity of the threat of contagion was underlined by the European Commission on 29 November when it joined the IMF and the OECD in warning that the debt crisis could undermine Europe's economic recovery. All three organisations are predicting that advanced economy growth will slow significantly in 2011 after a feeble recovery this year from the 2009 slump. If growth in the EU, US and Japan were to peter out, it is questionable whether emerging economies could again avoid being hit by another trans-Atlantic downturn. China has already moved to curb credit growth and its export-led economic model would be hard pressed to deal with another trans-Atlantic downturn.

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The search for burden-sharing

Accord on debt restructuring was inevitable

Niels Thygesen, Board of Contributing Editors

European politicians are wracking their brains over the permanent mechanism for resolving the European debt crisis to replace the European Financial Stability Facility (EFSF) set up with great fanfare in May. One of the reasons for the sharp rise in bond market interest rates for peripheral countries was the wholly unsurprising agreement in late October between Chancellor Angela Merkel and President Nicolas Sarkozy that the ESFF's successor could involve contributions from existing creditors. Planning for the permanent mechanism has been accelerated as part of measures to prevent borrowing conditions for Portugal and Spain from worsening after agreement on the €85bn bail-out package for Ireland at end-November.

Even when it was hastily clarified that private sector involvement was conceivable only from June 2013, financial markets remain highly agitated. Governments face a difficult balancing act between shoring up the euro area in the immediate future and defining reinforced policy surveillance and the post-2013 crisis mechanism. If the immediate problems are not resolved, then longer-term efforts will look like pure escapism.

As I have been saying for several months [OMFIF Bulletin, September 2010, p. 8-9], for the future governance of the euro we need a mix of government rules and market discipline. Debt restructurings cannot be excluded over the next couple of years. This is a result of growing doubts about the feasibility of the large-scale economic adjustments in the peripheral countries as well as the potential need for capital replenishment in these countries' banks. Increasingly obvious political considerations make necessary an appropriate sharing of burdens among domestic taxpayers, financial institutions and foreign taxpayers.

Debt restructurings cannot be excluded over the next couple of years. This is a result of growing doubts about the feasibility of the large-scale economic adjustments in the peripheral countries as well as the potential need for capital replenishment in these countries' banks.

The European Central Bank, the only currently fully operational institution in the euro area, must not be expected to take on an even larger role in lending to governments and financial institutions in the peripheral states. European governments must affirm that EFSF resources will be maintained at an adequate level, which would require possible top-ups if the safety net proves underfunded. They should also provide predictability over the procedures in case of a sovereign restructuring, including the maximum 'haircut' to be faced by holders of bonds issued by a country that agrees a programme with the EFSF/IMF.

One must have sympathy for the Task Force of finance ministers under European Council president Herman Van Rompuy. They provided a detailed roadmap for the longer-term – though initially without a crisis mechanism – but have been obliged to recognise a lack of political guidance on how to get from the current crisis to the place where the roadmap begins. The roadmap may not look very different from what was intended with the existing fiscal rules, but those good intentions were not implemented, mainly due to excessive mutual forbearance among euro area governments and inadequate analytical understanding of underlying fiscal weaknesses. The rules could work better in the future, partly because the focus has widened to general economic performance, beyond the more narrow issue of public finances. But the main reason for any increased confidence lies in the dramatic reminder of the role of financial markets in disciplining government, rather than in the vigorous restatement of rules of good conduct.

This is a complete contrast to the position in the first 10 years of the euro, when the markets irrationally suspended any scepticism about the economic vulnerability of the peripheral states. As late as the early autumn of 2009, Greek government bonds traded at only 30 basis points above German levels. This past market failure has now been replaced by the opposite: an obsession with the default risk of some sovereign bonds. Presumably, at some stage the markets will settle down to a 'happy medium' between these extremes. Much will depend on how well European governments respond to their diverse challenges before the next European Council Meeting on 16-17 December. In the meantime, it would be foolish to deny the potential for fresh unrest.

Wanted: leadership in Europe

Former German Chancellor points the way forward

David Marsh, Co-chairman

Celebrating his 92nd birthday in December, former German Chancellor Helmut Schmidt is as penetrating as ever in his political and economic judgments, as a long conversation with him in his Hamburg office shows.

Marsh: For many years Germany had twin policies on parallel lines: commitment to financial and monetary stability on the one hand, commitment to European integration on the other. With the crisis in economic and monetary union, do you think that the two policies are no longer compatible?

Schmidt: Let me give you an answer first about the general political environment. I don't know about the British government – they are rather new in office and I do not know the leading people. So I exclude the British from my general answer. But I would say that, in general, Europe lacks leaders. It lacks people in high positions in the national states or in the European institutions with sufficient overview of domestic and international questions and sufficient power of judgment. There are a few exceptions such as [Jean-Claude] Juncker [prime minister] of Luxembourg, but Luxembourg is a bit too small to play a substantial role. More specifically, I do not think that the Germans in general or the German political class in Germany have given up on stability. The circumstances in 2008-10 forced them – like almost everyone else in the world – to violate their stability ideals, but this was not an act of free will, it was the result of economic downturn.

Additionally, the present German government is composed of people who are learning their business on the job. They have no previous experience in world political affairs or in world economic affairs. German finance minister Wolfgang Schäuble is a man whom I wish well and for whom I have great personal respect. He well understands budgetary and taxation problems. But when it comes to international money markets or capital markets or the banking system or the supervision of banks or shadow banks, this is all new to him. The same goes for [Chancellor Angela] Merkel. This is not to say anything negative about Schäuble or anything negative about Merkel, but we need people in high office who understand the economic world of today.

'The present German government is composed of people who are learning their business on the job. They have no previous experience in world political affairs or in world economic affairs.'

A man of unique authority exposes political vacuum at heart of Europe

OMFIF commentary

It is often said that the euro is an eminently political project, developed over the past 20 or 30 years by the governmental and business elites of Europe.

Yet, as Helmut Schmidt points out, the politicians who should be shoring up the euro have proven lamentably ineffectual. Instead of marshalling the Old Continent, political leaders in the 16-nation bloc have been shunting blame for the euro's shortcomings among themselves and the financial markets.

As Schmidt says, the only helmsman to emerge with any credit is Jean-Claude Trichet, president of the European Central Bank, who is using the ECB's firepower and his own crisis-fighting skills to fight a rearguard action against the markets. And yet Trichet retires in less than 11 months – leaving a vacuum at the heart of Europe.

Schmidt delivers his judgments from a position of unique authority. He will be 92 later in December. Not in the best of health and still grieving the loss of his beloved wife of 68 years, Loki, who died only six weeks ago aged 91, Schmidt speaks unhurriedly in sharp, piercing phrases. He mixes criticism of the present generation of European leaders with hope that they will do better in a few years – though he thinks that this will happen through the emergence of a 'core Europe', a goal he outlines more clearly than ever before.

Schmidt became chancellor of West Germany in 1974 when UK Prime Minister David Cameron was seven years old and Barack Obama, Angela Merkel and Nicolas Sarkozy were in their teens. He has now been out of office for 28 years, more than twice as long as the period when he successively was defence minister, finance minister and chancellor. Earlier this year Schmidt surpassed Konrad Adenauer – the first West German chancellor, who served until he was 87 (in 1963) and died at 91 – as Germany's oldest-ever leader.

Marsh: But some people would say the problem goes deeper than that. By going into a monetary union without political union, and without the perspective of a political union, some people would say that this was a fundamental birth defect.

Schmidt: This is what the Bundesbank have been repeating it for 30 years. In their innermost heart they are reactionaries. They are against European integration.

Marsh: Who do you mean precisely? Who are you thinking of because people like [former Bundesbank president Hans] Tietmeyer are no longer playing an important role?

Schmidt: But his successors, more or less with one exception, are reactionaries with regard to European integration. They are not really characterised by liberal thinking. They tend to act and react too much under the aspect of national interests and haven't understood the strategic necessity of European integration.

Marsh: There is this expression: 'Beim Geld hört die Freundschaft auf.' ['Friendship stops with money.'] One has the feeling that the Germans are now being asked as a collectivity to help the poorer states. And the Germans find this very difficult.

Schmidt: The mistake was made around the time of Maastricht, in 1991-92. At this time we were 12 member countries in Europe. They not only invited everybody to become a member of European Union but they also invented the euro and invited everybody to become a member of the euro area. And this was done without changing the rules or clarifying the rules beforehand. This was when the great mistakes were made. What we are suffering now is the consequence of that failure.

'The mistake was made around the time of Maastricht, in 1991-92. At this time we were 12 member countries in Europe. They not only invited everybody to become a member of European Union but they also invented the euro and invited everybody to become a member of the euro area.'

Marsh: Should the EU states have decided the euro just for a small group of countries?

Schmidt: This is my view – and also they should have defined more strongly the rules on the economic behavior of the participants. The so-called Stability and Growth Pact is not an instrument of law. It's just an agreement between governments. And it was not helpful that, early in this century, both France and Germany violated the rules of the pact. Merkel would like to correct these mistake, but her chances of prevailing are rather small, particularly because she is not a very smooth operator.

Marsh: In his heart of hearts, Hans Tietmeyer didn't want the Italians in EMU. You criticised him in the mid-1990s for being a German nationalist because he said then that we should have a hard core. Aren't you now backing the same argument?

Schmidt: In the meantime many things have happened, the globalisation of speculation, the globalisation of money and capital markets, the globalisation of financial instruments. We have seen the failure of a draft for a European constitution. We have seen this complex Lisbon treaty, many things have happened and at the same time figures who could lead have become scarce. One very important figure was Jacques Delors. He has been replaced by people whose name one doesn't really know. And the same goes for permanent secretaries and the chairmen of various commissions and for prime ministers and – what is his name – Van Rompuy? And he has a so-called foreign secretary – a British lady, her name is not necessary to know either. The same goes, more or less, for the European Parliament. The only figure who sticks out in the European institutions is [Jean-Claude] Trichet. I'm not sure how strong he is inside the European Central Bank, but as far as I can see, he hasn't made a major mistake so far.

Marsh: But of course the clock is now ticking for him. His mandate runs out at the end of October and he cannot be renewed.

Schmidt: Yes I know. But of course he's totally independent. In a way this could give him the freedom to speak up , but the question is who would listen to him now that he has to leave his office in less than 12 months or so.

Marsh: Greece and Portugal went into monetary union with a net foreign balance more or less of zero: their foreign assets and foreign debts were more or less equivalent. Then they ran current account deficits every year for around 10 years of 10% of GDP. You don't need to be a genius to work out that they now have a net foreign debt of 100% of GDP.

Schmidt: The question is: How come that no-one took any notice – in Basle or in Brussels or in some Statistical Office? No-one seem to have understood. By the way, for a long period the German political elite didn't understand that we were recording surpluses on our current account. We are doing the same thing as the Chinese – the great difference is that the Chinese have their own currency and we haven't.

If we had our own currency it would have been revalued by now. To have kept the D-Mark, as Tietmeyer would have liked, would have led to speculation against the D-Mark at least once if not twice in the past 20 years in an order of magnitude worse than we have seen with Greece or Ireland. So far the idea of a common currency still has my full backing, even if the European leaders did fail to set the rules and made the enormous mistake to take in anybody.

Over the next 20 years, I think it is rather likely, at least 51% likely, that a hard core of the Union will emerge. And it would comprise the French, the Germans, the Dutch – I'm not so sure about the Italians. I'm rather sure than the British would not be part of it, the same may come true of the Poles. It would not be a hard core in written paragraphs of paper but it would be a hard core de facto and not de jure.

'Over the next 20 years, I think it is rather likely, at least 51% likely, that a hard core of the European Union will emerge. And it would comprise the French, the Germans, the Dutch – I'm not so sure about the Italians. I'm rather sure than the British would not be part of it.'

Marsh: And of course the Benelux states would be part of this and Austria and probably Denmark and Sweden

Schmidt: Probably Austria, conceivably Denmark and Sweden. The Danes are very cautious – they would still look to London.

Marsh: I remember you saying many times, if the Germans keep the D-Mark we will make ourselves unpopular with the rest of the world; our banks and our currency would be the Number 1, all the other countries would be against us and that was why we should have the euro to embed us in a larger European undertaking. It's all rather ironic, because people are saying that Germany has profited a great deal from the euro because the D-Mark has been kept down and this helps German exports ….

Schmidt: I ask myself whether this profit really is a profit? I wonder whether running perpetual current account surpluses really amounts to a profit. In the long run it is not a profit…

Marsh: Because in the long run these assets will have to be written down because people won't pay them back …

Schmidt: Yes … it means that you sell goods and what you get back is just paper money and later on it will be devalued and you will have to write it off. So you are withholding from your own nation goods that otherwise they would like to consume.

Marsh: Would you say that in 20 years, if we have a hard bloc, that the currency would be higher than now?

Schmidt: Not necessarily would this [the hard core] pertain to the field of currencies but it would probably pertain to the field of world policies whether vis-à-vis China, Iran, Afghanistan or a new coalition of Muslim states, which is one of the great dangers of the 21st century, that you get a coalition of Muslim states. If there was a president in Washington and he wanted to drop the atomic bomb on Tehran, the Europeans would be strong enough to say: 'We are not part of it.' Right now, no one is strong enough in Europe to be in that position.

Marsh: And what about France? They are always torn both ways – to the south but also to Germany. Do you think it's irrefutable that France will always opt to go along with Germany in a smaller core monetary union?

Schmidt: It's difficult to say. I said the probability would be 51% – that makes 49% left. I am not a prophet. I don't know. It depends very much on the behaviour of the Germens. When I was in power, I would always let the French march ahead on the red carpet. I never appeared as the leader, apart from once – over medium-range nuclear missiles that were targeted against German cities – and in the end that cost me my office.

Marsh: And of course [former French president François] Mitterrand came to Bonn in January 1983 after you had left office – the invitation came from you when you were Chancellor. He made his great speech [supporting West Germany on medium-range missiles] and Kohl reaped the benefits of that French solidarity. It is ironic how history turns out….

Schmidt: Yes, but this has had a good effect, since in 1987 they abolished all these weapons on both sides.

Marsh: People always said: 'We don't want a German Europe but a European Germany.' However, there is now a belief that, because of Germany's power as the greatest Europe creditor nation, it is throwing its weight around too much in Europe.

Schmidt: My feeling is that Merkel doesn't know she does it.

Marsh: Maybe if you are a creditor, maybe you're vulnerable, you feel that your assets are going to be written down. Maybe it's not good to be a creditor because it makes you unpopular. Maybe it also means that your bank balance, your reserves are always going to be less high than you thought they would be, because people are not going to be able to repay their debts …

Schmidt: It goes far beyond the question of currencies and currency reserves. And therefore it applies to psychology … I am speaking of the psychology of nations and their public opinion and their published opinions. [Because of the Nazis and the Second World War] Germany will remain in debt for a long time – for all of the 21st century, maybe even for the 22nd century too. The Germans indeed sometimes behave like the strongest nation, they tend to give lessons to everybody. In fact they are more vulnerable than they think.

Marsh: But the Germans themselves don't feel strong, the man in the street feels, I think, somewhat uncertain, the wages in real terms have been under pressure for many years. The average Germans don't feel strong and confident, I think.

Schmidt: That is probably correct. But that does not include the political class. That does not necessarily include the right wing of the Christian Democrats. And it doesn't necessarily include the extreme Left.

'Germany will remain in debt for a long time – for all of the 21st century, maybe even for the 22nd century too. The Germans indeed sometimes behave like the strongest nation, they tend to give lessons to everybody. In fact they are more vulnerable than they think.'

Dispute over euro bonds lays bare contentious issues that have dogged single currency since birth

OMFIF commentary

A swirling dispute between Germany and other euro members about issuing joint euro bonds to pool sovereign debt brings to a head a contentious question that has been simmering since the earliest preparations for the single currency several decades ago.

Wolfgang Schäuble, the German finance minister, says joint bond issuance would undermine the commitment to discipline at the heart of economic and monetary union, without which, he opines, 'The euro would fail.' The backers of the euro bond plan say the opposite: without greater fiscal solidarity, the euro sooner or later will collapse. The supporters of joint bond issuance produced a joint article in the Financial Times on 6 December by Jean-Claude Juncker, Luxembourg prime minister and chairman of the Eurogroup of finance ministers, and Giulio Tremonti, Italian finance minister. They called for a European Debt Agency which could take over debt of up to 40% of European Union of GDP. The authors say urgent steps are needed to display the 'irreversibilty' of the euro, underscoring fears that in its present form it may not be around for too long.

Marsh: Europe thought it could put crises behind us by getting rid of its internal exchange rates and forging monetary union. But it now seems that, because of the globalisation of finance, the speculators will now attack the spreads [between different countries' bond markets]. Before they attacked the currencies. Now they attack the bond markets.

Schmidt: One of the weakest points in the global economy is that there is no control of the behaviour of financial managers. You can divide mankind into three categories. In the first category are normal people like you and me. We may have once stolen an apple from a neighbour's trees when we were boys, or we may have taken a bar of chocolate from a supermarket without paying for it. But otherwise we are dependable, normal human beings. Then secondly you have a small category of people with a criminal character. And thirdly you have investment bankers. That includes all the dealers and the dealmakers. They all sail under different names, but they're all the same

Marsh: What about Britain? You had a very good relationship with [former UK Prime Minister James] Callaghan but he didn't join the European Monetary System. Do you think we did right to steer clear of monetary union? I know you think we will be outside for a long time and I think you're right. Do you think that was fundamentally the correct decision?

Schmidt: Fundamentally I think de Gaulle was right – long before the European Monetary System

Marsh: You mean he was right in believing that the UK would always choose the US over Europe?

Schmidt: I used to believe in British common sense and the British state rationale. I was brought up in a very Anglophile way. I was a great supporter of Edward Heath who brought Britain into the European Community. But then we had Harold Wilson and Margaret Thatcher, who didn't always behave so sensible. And then we had Tony Blair who brought himself into a position of far too great a dependence on America.

You can't have this dependence on America and at the same time play a responsible role in Europe. The British have always been good, though, at muddling through – and this is what we are doing now in Europe, muddling through.

'You can divide mankind into three categories. In the first category are normal people like you and me: dependable, normal human beings. Then secondly you have a small category of people with a criminal character. And thirdly you have investment bankers.'

Ending hostility over the renminbi *(continued from page 1 ...)*

refunds for exporters. The US should further open its high-tech exports to China and open its financial and investment markets to Chinese capital.

4. The US and China should work together and collaborate with other important countries to promote the stability of international monetary order and financial markets. The cornerstone is stability of the leading exchange rates, particularly among the dollar, euro, yen and renminbi. We need to set a framework to make exchange rate relationships and movements predictable and as calculable as possible and thus give world financial and goods markets a reliable multi-year basis for spending and investments.

5. The Chinese authorities should make their policy on renminbi internationalisation far more transparent and detailed. The Chinese authorities should turn renminbi internationalistion – including the progressive move to full convertibility on capital account – into a fully-documented strategy. Increasing use of renminbi in international trade and investment would reduce the propensity of the Chinese to build up large dollar reserves that form a threat to both domestic and international stability. Facilitating greater access by foreign borrowers to the renminbi markets would allow welcome diversification of international funding and take some of the pressure off the renminbi exchange rate. Moreover, lowering international reliance on the dollar as the world's No.1 currency would create over time a more stable and better-functioning world monetary system.

The challenge for policy-makers is to lift our eyes beyond overblown utterances accompanying the 'renminbi wars'. With commitment and commonsense, we can work our way out of the present exchange rate imbroglio and find solutions that will meet the greater interests of China, the US and the world.

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Low growth, not no growth

Policy on divergent track as imbalances persist

John Plender, Board of Contributing Editors

The striking feature about the rebound in the global economy in 2010 was the unevenness with which growth was distributed. Emerging market economies behaved like greyhounds out of the trap, while the US saw only a fragile recovery despite hugely expansionary fiscal and monetary policy, combined with dollar devaluation. Continental Europe split in two, with northern Europeans growing faster than expected, while over-indebted southern Europe, plus Ireland, suffered from debt deflation. Japan, like Germany, bounced back strongly.

When all the major economies embark on exceptional measures to address global recession, the lesson of the last two years is that policy works - but only after a fashion.

Cobbling together plausible futurology for 2011 is a considerable challenge for economic forecasters. The safest bet may be on a muddle-through scenario for 2011: low growth rather than no growth. When all the major economies embark on exceptional measures to address global recession, the lesson of the last two years is that policy works. But only after a fashion: where there are huge accumulations of debt after property bubbles, as in the US, the UK and Spain, recovery tends to be anaemic as the private sector rebuilds its over-stretched balance sheet and banks de-leverage.

Policy is now on a divergent track, with the US returning to quantitative easing (QE2), while the big surplus countries – Japan, Germany and China – retreat from emergency fiscal and monetary stimulus. So global imbalances are still with us. And despite the biggest financial shock for 80 years, the policymaking establishment has done little to change its analytical framework. QE2, plus incremental change in financial regulation, looks worryingly like a recipe for further bubbles and another financial catastrophe before too long. Small wonder that investors are swinging manically between depression and euphoria, especially in sovereign debt markets for members of economic and monetary union (EMU).

The big question in the advanced countries is whether the corporate sector will pick up the baton from the public sector to offset the withdrawal of fiscal stimulus. The best guess for the US is that QE2 will not have much beneficial impact; the economy will rebalance less than would be sensible because consumers will show diminishing enthusiasm for rebuilding savings; and with the Obama administration and the Congress at loggerheads, fiscal policy will be deadlocked except at the margins. In the short run that will allow the worlds' excess savers to carry on without confronting deflation. But this is not a durable solution for curbing imbalances.

Europe, meantime, will confront unpleasant truths because the sovereign debt crisis is far from over. The markets are saying, rightly, that the problems of the peripheral economies are not just about liquidity, but about solvency. Moreover, Germany's somewhat arrogant manner towards the weaker countries may prove ill-judged. The strength of its recovery is more a reflection of the depth of the preceding downturn than of innate strength. While consumer expenditure is showing a flicker of life, the economy is still substantially driven by net foreign trade. With no shared vision of 'fiscal Europe', the markets' scepticism could soon pose a severe test. Since the treaties make no provision for exit, the differential speeds with which markets and policymakers address the weaker countries problems could lead to financial crises in which depositors pull out of their domestic banking systems en masse.

Perhaps the greatest conundrum concerns China. With slower global growth it is becoming clear that both advanced and emerging market countries are losing patience with China's habit of grabbing market share through an undervalued exchange rate. Unlike others, China does at least have flexibility in both fiscal and monetary policy. It could helpfully rebalance its economy towards consumption if it chose to implement its own five year plan, which calls precisely for a tilt in that direction. It is uncertain whether policymakers in Beijing have grasped the extent of the protectionist threat. We may see be able to form a more precise judgment during 2011. The hope must be that this clarity will evolve gradually and constructively rather than in a blinding flash.

Reforming the Maastricht criteria

Disquieting parallels between time and money

Pawel Kowalewski, Advisory Board

If only you could manipulate economies as smoothly as you set the clocks. There are uncomfortable parallels between the celebrated Maastricht criteria established in 1991 as benchmarks for countries joining economic and monetary union (EMU) and Germany's invention of Central European Time (CET) in 1893 by to unify the time zones of the emergent German empire. Most of the states in the 16-nation euro area (and of the 27-member European Union as well) use CET, which stretches more than 3000 km from the Slovakian-Ukraine border to the remote Atlantic shore of Finisterra in western Spain.

Putting these disparate regions on to the same time zone causes obvious distortions. History tells us that some countries that joined CET in previous decades (such as France) did so as part of an occupation zone, and did not return to the previous settings until they regained independence. So sensitivity is needed in dealing with these questions. Slovakians living in the extreme east of their country see dawn and sunset occurring around 3 hours earlier than Spaniards living in the extreme west of Spain. The natural rhythms of day and night are associated with different notions of time across Europe. This is an apt metaphor for the considerable disparities now opening up within the euro area.

Putting these disparate regions on to the same time zone causes obvious distortions. History tells us that some countries that joined CET in previous decades did so as part of an occupation zone. So sensitivity is needed.

We all hope EMU overcomes its present turbulence and continues as a central instrument of European integration. Whatever happens, it would be advisable to recast the Maastricht criteria in coming years to allow more leeway for membership by countries growing faster than the EMU 'core' – which therefore naturally have different notions of what should constitute stability-orientated economic behavior.

Reflecting on the experiences of CET, we should look at another easterly EU member, Lithuania. In 1998, the Lithuanians displayed their European credentials by adopting CET at the expense of Eastern European Time (EET). In 1998-99 they were severely hit by the Russian financial crisis which exposed severe weaknesses in their tiny economy. The Lithuanians concluded that economics was more important than time zones, returned to EET and focused on economic reforms. The strategy paid off. Lithuania successfully joined the EU in 2004 without artificially altering its time settings.

This episode contains lessons for other countries. Just as CET coordinates the watches of the majority of Europeans, the Maastricht criteria are designed to do the same in the realm of economics. The antecedents go back to the fall of the Berlin Wall in November 1989 which brought German unification into sight and produced an opportunity for President François Mitterrand of France to re-catalyse stalled talks with German Chancellor Helmut Kohl over the monetary and economic unification of Europe.

Kohl realised he had to support EMU to placate the fears of France and other countries that united Germany would dominate Europe. But Kohl also knew he risked disagreement over EMU with the Bundesbank, which through its conservative monetary policies had contributed to the downfall of several of Kohl's predecessors. So EMU had to be carried out on Germanic lines enshrining the Bundesbank's sound money policies. These complex circumstances paved the way for the Maastricht criteria – a set of economic yardsticks for budget deficits, government debt, interest rates and inflation based on the average not of the EU as a whole (as France had favoured) but rather of the three best performers, more in line with German wishes.

The Maastricht criteria reflected the times in which they were created. At the beginning of the 1990s, inflation was already in retreat but was still perceived as a serious danger. Disinflation had been achieved at the expense of fiscal deterioration. The 1970s and the 1980s had seen a drastic increase of public debt. Little wonder that restoring fiscal stability was of paramount importance.

Additionally, the criteria predominantly addressed the real, goods-based sector of the European economy and left unanswered questions connected to the financial sector as it started to gather importance during the 1990s.

A lot of attention was focused on the fiscal criteria, especially the target to make budget deficits less than 3% of GDP. The criteria were somewhat arbitrary, determined more by the recent experience of the two largest members, Germany and France, rather than by sound economics applied to the overall EU economy. Why 3% instead of 4%? Some economists claimed that a deficit of 4% for two years would be less inflationary than a budget surplus of 2% one year and a deficit of the same magnitude the next, a combination within the permitted range that would be produced by destabilising economic over-heating. (The validity of this point has been confirmed by the experience of Ireland and Spain, which both ran budget surpluses in 2004/5-2007 and have now sunk into unsustainable deficits as a result of the credit-fuelled expansion of the private sector.)

Their macro-economic nature makes the Maastricht criteria totally inappropriate as conditions for an optimum currency area, which are essentially micro-economic. The late Eddie George, former governor of the Bank of England, asked why the Maastricht criteria made no reference to the crucial area of labour markets. As a result, it is entirely possible that a country could meet all the Maastricht criteria but would be unsuitable as part of an optimum currency area. Consider the contrast with the five rather sensible criteria for the UK to join the euro, set by the previous British Labour government. A central component of the so-called 'five tests' is that the British economy should display the necessary flexibility to adjust to changes, reflecting what the Treasury rightly defined as 'the inevitable loss of domestic control over monetary policy' and the risk of future economic turbulence.

Their macro-economic nature makes the Maastricht criteria totally inappropriate as conditions for an optimum currency area. The late Eddie George asked why the Maastricht criteria made no reference to the crucial area of labour markets.

The most important point of the Maastricht criteria – and potentially the most disquieting – is this: whether or not this was the intention of the authors, the criteria enshrine the concept of a two-tier Europe. Significantly, the inflation criterion gives little leeway for countries which differ substantially from the core. Both Spain and Ireland, for example, recorded excessive inflation rates throughout the first 10 years of the euro. There was nothing fundamentally bad about this: inflation should be perceived as the oil needed to run a car engine. The higher the engine speed, the more oil is needed to stop the engine seizing up. Hence countries which are catching up (or growing rapidly) will most probably score inflation above the permitted 1.5 percentage point divergence from the average of the three best performers. Such countries, as a result, are stigmatised as infringing the criteria – even though such divergence is inevitable.

During the financial crises of the past three years, fulfillment of these criteria – and their effective policing – has come to a virtual standstill. However, in a hitherto unexplained development that has not been widely remarked upon by EMU observers, an unexpected tightening of the inflation criterion has taken place. The result of this is that the catch-up process for poorer economies seeking to join the euro in coming years will be even more difficult than it has been up to now. This reflects an essentially technical factor with wide-ranging consequences.

Until the crisis, countries with negative inflation rates were considered as outliers and excluded from the calculation for the inflation criterion. Now, the process has been changed so that, in order to be excluded from the calculation, the negative inflation rate must go hand in hand with deflationary expectations. That means that some countries with negative inflation rates are now included in the calculation. This raises the barriers for countries wishing to join – and does not bode well for the speedy economic integration of Europe.

No-one has any interest in seeing the Maastricht criteria meeting the same fate as the language of Esperanto – a worthy instrument for promoting international harmony that ended up as a by-word for futility and irrelevance. Next year sees the 20th anniversary of the Maastricht treaty and the break-up of the Soviet Union. This would be an apt time for reflection and action on how the EMU criteria should be redrawn to allow the further functioning and enlargement of the euro area.

QE2 sparks defence and dissent

Bernanke faces backlash as programme draws fire

Darrell Delamaide, Board of Contributing Editors

All members of the Federal Reserve Board of Governors (currently six with one unfilled position) 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.

The FOMC came under considerable criticism for its November decision to increase its purchases of longer-term securities. The backlash provoked a spirited defence from Fed chairman Ben Bernanke and some his allies – but also bared dissent within the Fed.

Ben Bernanke

Bernanke ripostes Fed critics

If everyone from Chinese government officials to conservative American politicians feels free to criticise an independent central bank for its conduct of monetary policy, well, then, that central bank might feel free to dispense some advice in the other direction.

Fed chairman **Ben Bernanke (voter)** came to a European Central Bank symposium in Frankfurt last month ready to respond to the slew of QE2 critics.

In a speech encoded in central bank-speak, Bernanke responded to politicians who might be, he suggested, neglecting their duties on the fiscal front and failing to respond to an unemployment situation that is 'unacceptable.'

'Monetary policy is working in support of both economic recovery and price stability, but there are limits to what can be achieved by the central bank alone,' Bernanke said. With a disclaimer that the Fed is, of course, 'non-partisan,' he went on to suggest that 'a fiscal program that combines near-term measures to enhance growth with strong, confidence-inducing steps to reduce longer-term structural deficits would be an important complement to the policies of the Federal Reserve.'

Bernanke also had some advice for the Chinese. Noting that 'many emerging markets' have kept their currencies from appreciating in line with market fundamentals as 'part of a long-term export-led strategy for growth and development,' Bernanke warned: 'Increasingly over time, the strategy of currency undervaluation has demonstrated important drawbacks, both for the world system and for the countries using that strategy.'

And another thing...

Stop calling it quantitative easing! In his Frankfurt speech, Bernanke said the Fed's program of securities purchases should not really be called quantitative easing because that was not the central bank's objective.

Adding to bank reserves is not currently an effective means of stimulating the economy. However, buying securities to lower longer-term interest rates and encourage other forms of investment could help.

Almost inescapably, of course, whenever the Fed buys securities, it adds to bank reserves, and, conversely, when it adds to bank reserves, it generally does so by buying securities.

So there is now new philosophical distinction to join those about whether the glass is half-empty or half-full, or how many angels can dance on the head of a pin.

James Bullard

Bernanke ally sees success despite backlash

The wave of negative publicity greeting the Federal Reserve's decision to expand securities purchases cannot undermine the Fed's action, one top official implied, because the market had largely discounted the so-called quantitative easing, or QE2, by the time it was made official.

'The policy change was largely priced into markets ahead of the November FOMC meeting,' **James Bullard (voter)**, president of the St. Louis Fed, said in a presentation to the New York Society of Security Analysts.

'While asset purchases are sometimes viewed as unconventional, the financial market effects have been entirely conventional,' Bullard said in his power point just days after the meeting of the Federal Open Market Committee on 2-3 November. 'In particular, real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose.' The effects on the real economy will follow in six to 12 months, and will be difficult to discern among all the other factors affecting the economy, Bullard went on to say.

The St. Louis Fed chief, considered to be dovish-leaning, has supported the policy from the beginning and was in the forefront of officials preparing the markets for the step in the months preceding the actual decision. The measure was necessary, Bullard said in New York, because the pace of recovery had slowed, creating a disinflationary trend and the Japanese experience indicated that a near-zero nominal interest rate, mildly deflationary equilibrium exists and is difficult to escape.


Thomas Hoenig

Dissenter-in-chief delivers apologia

Despite his name, Kansas City Fed chief **Thomas Hoenig (voter)** seems to think you catch more flies with vinegar than with honey. The central bank veteran justified his long string of dissents as a voting member of the FOMC this year, declaring if you don't have dissent, you wouldn't need a committee. 'I have very strong views on that,' Hoenig said in an interview with The Wall Street Journal in the week following the November FOMC meeting. 'A committee is a deliberative body. If you didn't have differing views, you don't need a committee. You really need to have those different views.'

The Kansas City official has dissented in seven straight FOMC votes on everything from communicating interest rate expectations to expanding the Fed's securities purchases. Hoenig said that because he's been engaged in central banking longer than any other member of the committee, he might have a better appreciation of the consequences of its actions, including unintended consequences. He joined the Kansas City Fed in 1973 and became president in 1991. In two earlier periods of negative interest rates, in the 1970s and 1980s and again in the 2000s, the Fed had been unable to prevent financial bubbles and crises from occurring, he noted.

Hoenig has generally been the lone dissenter among voting members. 'I think that serves a very useful purpose and I feel very good about it,' he said. 'Going along to get along is not something that's healthy for any deliberative body.' In the November decision on QE2, the majority weighed the risks differently and went ahead over his objections, he acknowledged. 'I hope they're right,' Hoenig said. 'I hope things turn out extremely well.'


Kevin Warsh

Et tu, Brute?

Fed chairman Ben Bernanke seems able to weather the external criticism for the expansion of the Fed's securities purchases, but the dissent within might be more worrying for him. While Kansas City's Hoenig was the only FOMC member on the record with his dissent, others also demurred to some extent. Fed governor **Kevin Warsh (voter)** raised a lot of eyebrows when he appeared to rebut the measures that he had voted in favour of only days earlier.

'The Federal Reserve is not a repair shop for broken fiscal, trade or regulatory policies,' he said at a meeting of an industry group in New York. Warsh, who served as an economic aide in the Bush White House and was, at age 35 in 2006 when he took office, the youngest person ever appointed to the Fed's Board of Governors, added: 'Given what ails us, additional monetary policy measures are poor substitutes for more powerful pro-growth policies.' The added securities purchases pose 'non-trivial risks that bear watching,' he warned. 'The Fed can lose its hard-earned credibility—and monetary policy can lose its considerable sway—if its policies over-promise or under-deliver.'


Richard Fisher

The dissent was bipartisan (though Fed officials are by and large above party politics). Republican Warsh was joined in his demurral by someone with a long Democratic pedigree as Dallas Fed president **Richard Fisher (non-voter)**, who once was a Democratic candidate for the US Senate, voiced his dissent as well. He is not a voting member in 2010 but rotates into a voting position in January. 'The remedy for what ails the economy is, in my view, in the hands of the fiscal and regulatory authorities, not the Fed,' he said in a speech in San Antonio, Texas.

While he was doubtful that the measure would lead to job creation, he had a veritable catalogue of potential bad effects. 'I could envision such action would lead to a declining dollar, encourage further speculation, provoke commodity hoarding, accelerate the transfer of wealth from the deliberate saver and the unfortunate, and possibly place at risk the stature and independence of the Fed,' he said.

Ireland caves in to mounting pressure

Different economic challenges outside euro area

DZ Bank Economic Forecasts			
GDP growth			
	2009	2010	2011
US	-2.6	2.7	1.9
Japan	-5.2	3.0	1.7
China	9.1	10.2	8.5
Euro area	-4.7	1.7	1.2
Germany	-4.7	3.8	2.5
France	-2.5	1.6	1.4
Italy	-5.1	1.0	0.8
Spain	-3.7	-0.2	0.0
UK	-5.0	1.7	1.0
Addendum			
Asia excl. Japan	6.1	8.9	7.3
World	-0.7	4.5	3.7
Consumer prices (% y/y)			
US	-0.3	1.6	1.5
Japan	-1.4	-0.9	-0.3
China	-0.7	3.3	4.2
Euro area	0.3	1.5	1.5
Germany	0.2	1.1	1.4
France	0.1	1.7	1.6
Italy	0.8	1.6	1.3
Spain	-0.2	1.7	1.2
UK	2.2	3.2	2.8
Current account balance (% of GDP)			
US	-2.7	-3.0	-3.1
Japan	2.8	3.3	3.4
China	6.0	4.7	5.2
Euro area	-0.6	0.2	-0.2
Germany	4.9	5.5	5.6
France	-2.0	-2.2	-2.4
Italy	-3.2	-3.0	-2.9
Spain	-5.1	-4.7	-4.6
UK	-1.3	-1.8	-1.0

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

The Irish government has now caved in to mounting pressure from the financial markets and other European states and has agreed support from the European Financial Stability Facility (EFSF). The advantage for Ireland is that it will bring much cheaper refinancing than if the country had turned to the markets; the disadvantage is that it will have to adhere to strict economic and financial conditions laid down by the European Union and International Monetary Fund.

The Irish government will have to make further savings of €15bn by 2014, which corresponds to just under 10% of GDP. Ireland's deficit has to be brought back down from 32% of GDP this year (mostly brought about by special payments to the stricken banking sector) to below the 3% mark. Further austerity measures are likely to be required in other highly indebted peripheral states to meet deficit targets set by the European Commission. We are moving towards a two-speed EMU. Whereas economic recovery is progressing rapidly in the relatively solid core - mainly Germany and neighbouring countries - growth in the peripheral states has yet to get into gear. Tax hikes and spending cuts are depressing consumer demand. In the case of Greece and probably also Ireland, it is likely to be some time before the adjustment recession can be overcome.

Big nations outside the euro area are facing very different economic challenges. In the US, the recovery is fairly weak so far and has not proved robust enough. Unemployment remains high and inflation has recently fallen to its lowest level for decades. The Fed has decided to embark on a new round of expansion through another bond purchase programme to fight off the threat of deflation and kick-start the economy. However, the US seems largely to have exhausted any scope in terms of fiscal policy. Japan is already facing deflationary trends. The Bank of Japan has recently revised its policy rate target zone down to 0-0.1% and will purchase further assets to improve its credit easing measures.

The situation in China is just the reverse. The central bank is fighting undesirably high inflation and seeking to cool the threat of overheating in the property market. If anything, the economy has to be slowed rather than stimulated. For this reason, the People's Bank of China now has to take much more energetic measures since a renewed upturn in the housing market would truly jeopardise the aim of a soft landing. We therefore expect further restrictive monetary measures in the next few months. This should effectively cool the housing market, which would then damp the economy as a whole in 2011 through noticeably slower building activity.

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Prepare for end to QE2 euphoria

Liquidity promoting exuberance – but not for ever

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

In monetary policy, Europe and the US are drifting further apart They were largely in agreement two years ago after the Lehman Bros collapse, but the central banks in Frankfurt and Washington are now pointing in different directions.

The European Central Bank is sticking to its full allotment policy in its tender operations to mitigate the problems at the banks, especially in the periphery euro members. What's more, I do not believe that key interest rates will be raised in the euro area in the coming year. Nevertheless, the ECB has already been working on the exit for some time now. The monetary base has been falling since summer, the duration of its tender operations has been shortened again and money market rates, which have been significantly below the key rate at times, are rising slowly again.

The situation in the US is completely different. At the beginning of November the Fed launched the second stage of quantitative easing. A reduction of the monetary base, which has broadened by around 250% since the Lehman failure, is thus receding into the distant future. While the ECB's main concern is to support the banking sector in the euro area's southern periphery states and in Ireland, the Fed is aiming to ward off the danger of deflation and stimulate the economy. To head off deflation, the Fed is seeking to influence market players' expectations. Deflationary expectations are to be prevented by all means. So far, this strategy seems to be working: inflationary expectations, measured in terms of forward inflation derived from the inflation swaps, increased steeply again in September and October and at the same time real rates fell accordingly.

The repercussions of QE2 are visible in the bond markets. Since-mid September, when the discussion about QE2 began, yields have fallen again significantly both with respect to quasi-money-market maturities as well as longer-dated bonds. The trend in the bond market is increasingly decoupling from fundamental developments.

The DZ Bank Surprise Indicator, which measures the gap between the outcome and the Bloomberg consensus for the most important US market movers, has been pointing upwards again for some time now. This means that on average the published data are better than analysts had expected. In such an environment, yields should really be rising. This is also usually the case. But in the past few months we have seen the opposite: the Surprise Indicator has risen, but yields have tended to fall.

Also conspicuous is the fact that the constellation of 'rising equity markets – rising yields' usually seen in the US during the last few decades has no longer applied in recent months. Here, too, the explanation is liquidity. Alone the expectation that QE2 will make more liquidity available is sending the equity and bond markets equally into a state of euphoria – with the result that share prices are rising and yields are falling.

High liquidity seems to be contributing to tightening of spreads in the corporate sector and emerging markets. Investors are looking for yield and they have found a yield pick-up in emerging markets and the corporate sector. Both emerging markets (bonds and equity) and corporate bonds rallied strongly in recent months and both markets have become relative expensive. The last resort of relative cheap investment opportunities is the equity markets in the advanced economies, but this is changing. Thus equity markets in the advanced economies could rise further, but will not trigger a strong rise in bond yields.

This state of affairs is not sustainable. Although liquidity can drive markets for a certain time, the past teaches us that this constellation is not stable. When the Fed's purchases decline, but probably much earlier, the markets will return to their normal patterns – and financial markets will correct their recent exuberance.

The expectation that QE2 will make more liquidity available is sending the equity and bond markets equally into a state of euphoria – with the result that share prices are rising and yields are falling.

In search of the Canadian model

The need for a conservative philosophy

Malan Rietveld, Chief Economist

In the aftermath of the financial crisis, the Canadian model of financial supervision has been singled out for praise. Politicians and technocrats have fixed their gaze on Ottawa in search of what it is the Canadians did right. What exactly is the Canadian model and how easy is it to replicate? Canadians themselves are self-effacing over the secrets of their success. There is no single 'secret ingredient' to their system. Rather, their success relates first to a conservative approach to finance, and second to comprehensive oversight that combines vigilance over aggregates, interlinkages and other 'macro-prudential' factors with an almost obsessive focus on micro developments and data.

Canda's success relates first to a conservative approach to finance, and second to comprehensive oversight that combines vigilance over aggregates, interlinkages and other 'macro-prudential' factors with an almost obsessive focus on micro developments.

On the macro side, one particular feature of the Canadian approach stands out: the inter-institutional arrangements between official sector institutions. Perceived 'grey areas' over the responsibilities of rivaling institutions have resulted in various regulatory shake-ups in other advanced economies. Yet the Canadian institutional framework for financial stability, centred on rather informal exchanges between the Bank of Canada, the Department of Finance, and the Office of the Superintendent of Financial Institutions, worked perfectly fine. The system effectively monitored emerging risks; and, on the rare occasions when prompt action was required, such as when interbank and commercial paper markets froze up and bank debts had to be guaranteed, the Canadians were able to move with the requisite speed and clarity.

The real meat on the bones of the Canadian model lies in its extensive micro-prudential surveillance and regulatory framework:

- High-quality capital: Not only were Canadian supervisory capital requirements noticeably more stringent than those other advanced systems (with 7% and 10% respectively for Tier 1 and Total Capital ratios), but the quality of capital was much higher. Common equity formed the predominant share (75% leading up to the crisis) of Tier 1 capital, while the Basel rules effectively required only 2% of common share capital.

- Comprehensive leverage ratio: Canada, like the US, has a regulatory limit on leverage for banks, which is referred to as the 'assets-to-capital multiple'. Unlike the US, however, the Canadian included off-balance sheet items in the calculation of the multiple.

- Mortgage regulation: The Canadian authorities refused to allow their mortgage market to expand along the lines of their neighbours to the South, eschewing features like the development of a subprime sector and tax deductibility of mortgage payments.

- Household data: Canadian supervisors enjoyed unrivalled access to micro data on the various economic and financial agents. In particular, their access to household data was, and continues to be, extraordinarily granular, enabling a detailed and disaggregated assessment of the build up of dangerous credit exposures.

These measures amount to a rather tight oversight regime and did not put such objectives as 'the international competitiveness' of Canadian banks at the core of the philosophy. This approach did not arise from nowhere: it developed in response to various episodes of financial turmoil Canada experienced in the 1970s and 1980s. Of course, some observers would argue that Canada's success has more to do with the structure of its banking system – only six large, domestically owned banks. But this would diminish the role of Canada's overall regulatory philosophy and framework. Many advanced economies have announced grand rearrangements of supervisory and regulatory authorities and responsibilities. Yet the Canadian example suggests that institutional issues secondary. The hard part lies in embracing a conservative approach to the development and oversight of the financial sector, and constructing a robust micro-prudential framework. Other countries in the midst of financial reform need to take these lessons to heart.

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New UK framework takes shape

Distraction ahead but less fragmentation than feared

Robin Gordon-Walker, former Associate, Financial Services Authority

Fragmentation of the UK's new financial regulatory framework to replace the Financial Services Authority (FSA) at the end of 2012 will be less severe than earlier believed. But there are still fears in the City and in politics that the lengthy implementation of the new set-up will hamper the effectiveness of the new organisations.

Following the UK coalition government's decision to regroup regulation under the overall authority of the Bank of England, FSA chairman Lord Adair Turner puts a brave face on the restructuring: 'Once we go through the transitional pain, the new system will be a better one than at the moment.' However the reorganisation will represent a considerable distraction from the FSA's main operating priorities. The danger of a possible staff exodus has been highlighted by recent announcements of the exits of David Strachan and Dan Waters, two long-serving and respected directors. Recent clarification of the scope of the regulatory changes may however damp fears of a flood of departures. Under key decisions announced by the Treasury in November, it was confirmed that:

The reorganisation represents a considerable distraction from the FSA's main operating priorities. Recent clarification of the scope of the regulatory changes may however damp fears of a flood of departures.

- The Bank of England will have control of macro-prudential regulation operating through a Financial Policy Committee of the Bank.
- A new Prudential Regulation Authority (PRA) will be created responsible for the safety and soundness of banks and insurers (micro-prudential regulation) – it will be a subsidiary of the Bank, which will have oversight of the PRA's delivery of its remit.
- There will be an independent Consumer Protection and Markets Authority (CPMA).
- The FSA's UK Listing Authority (UKLA) which oversees companies listing on London exchanges will be part of the CPMA's markets division rather than be hived off to the Financial Reporting Council.
- Criminal prosecution of market abuse and insider dealing will go from the FSA to the CPMA rather than to the planned Economic Crime Agency.

The combination of the last two points will raise the profile of the CPMA and allay City fears that market supervision would be fragmented across several agencies.

Mark Hoban, financial secretary to the Treasury, said the City had made a strong case for the UKLA going to the CPMA, arguing that the same body should regulate both the new listing of companies and the trading of existing securities. Meanwhile the decision that criminal prosecution should go to the CPMA follows strong arguments by the FSA that keeping criminal and civil enforcement together within the markets regulator is critical to its effectiveness. The decision recognises the work of Margaret Cole, the FSA enforcement director, who has built up a formidable team of more than 400 staff. During her tenure, the FSA has won six criminal convictions for insider dealing and has cases pending against 11 more people. Its civil arm handed down a record £84m in penalties in 2010.

Early in 2011, the FSA will split itself into prudential regulation and consumer protection/markets arms ahead of the formal break-up and creation of the PRA and CPMA at the end of 2012. FSA chief executive Hector Sants recently told the Treasury Select Committee that the FSA will be concentrating on reorganisation and will curb the introduction of new rules and policies over the next two years except as mandated by the European Union. It has been announced that Hector Sants will be chief executive of the PRA and there is much speculation as to who will be chief executive of the CPMA, under a decision to be announced next spring. Margaret Cole, who recently joined the FSA Board, is mentioned as is Carol Sergeant, who is leaving her job as Lloyds Banking Group's chief risk officer in January. She was formerly an FSA managing director and board member from 2001-2003.

An occasional look at the great characters of world finance

The anarchist banker in Harry's Bar

Giving the people the show they want

Frederick Hopson, Advisory Board

FREDERICK HOPSON, WHO RETIRED FROM A GERMAN LANDESBANK BOARD IN 2000, DESCRIBES A SEASONAL ENCOUNTER WITH A DENIZEN OF THE INVESTMENT BANKING FRATERNITY

Harry's Bar was quite busy. The buzz was back to pre-crisis pitch. I stood at the counter and waited for Bertram who I knew would be there exactly on time. I sipped my Bellini watching the rich, the famous and those who simply aspired to join the club.

'Hello Bertie,' I ventured, as a sleekly sun-tanned alpha male strode towards me. His suit exuded the distinctive glitter of money.

'You're looking good, much better than last Christmas when the state bailed out your ailing institution and your bonus was cancelled!'

My companion affected an air of pain. 'My dear Rod, the bonus was deferred, not cancelled, as you know very well. As we now indirectly own the state itself, you could call this an extremely positive outcome.'

I looked around and wondered if anybody had heard this embarrassing claim. But somehow, in the glitzy atmosphere of South Audley Street, it all seemed to ring true.

'Anyway let's sit down and have some lunch. Would you like a touch of Sassicaia? The 1985 is really quite palatable now.'

We perched on the low stools and savoured the exquisite bites so beloved by this institution's hallowed customers.

Now Bertram of course is quite wealthy, although I wouldn't call him super rich. His official fortune is probably $25m to $30m. His offshore nest egg is of course hard to quantify. Especially by the Revenue.

He had been rather quiet during the crisis but always tended to call me around Christmas in order to discuss the state of the economy. He loved to bounce his ideas off poverty-stricken journalists to see if he had correctly gauged the mood of the public.

'So you see Rod, I was right: I told you the banks would be saved and a good job too. After all, we didn't do anything wrong really. We just did what the market dictated. The pressure was enormous. We investment bankers had to make more and more money or go under.'

'But Bertie, I don't get it. You almost destroyed the whole economy. You put millions out of work. And you're now are in the process of destroying the creditworthiness of whole nations that have been foolishly backing you till the end. Don't you see anything immoral in all that?'

'My dear Rod, you really don't understand. It was the fault of the regulators. They should have stopped the race, or at least slowed it down. They had every chance of seeing what was going on. It was their job to prevent the banks getting themselves into trouble!'

I couldn't help chuckling, 'So if you were driving a car and you were drunk then it would be the fault of the police, they should have stopped you getting behind the wheel?'

'Well, I take your point, but it's not quite the same. We perform a service for the public. We fulfil their dreams. We help struggling politicians. After all, money makes the world go round, always has….' A sarcastic smile played around his florid features, phosphorescent in the dimming light.

'We keep the economy going. We give the people what they want. We are the X Factor of the economic show. Of course it's rigged, but people love it. Every year when it returns they tune in again. The human race likes success even if they are paying for it. As long as the show runs, everyone gets richer. The fact that we get richer than anyone else is hardly noticeable. And when it stops, there's a short hangover. Then we blow up the balloon again and start afresh.'

I looked at him in sheer amazement. 'Surely you don't really believe that! You personally get paid exorbitant amounts for investing state subsidised loans in new instruments that are programmed to make money. And you think you're doing a public service? You're doing what any idiot could do with a banking licence: borrow at close to zero and lend to peripheral states in Europe – in the process, making huge profits. And all at the taxpayers' expense!'

'Rod don't you see: the world today is like a huge funfair. If we stop this carousel, the momentum will cease, the revolving chairs will fly off right into the mass of happy onlookers. The whole fair will be destroyed! Don't imagine for a moment that our politicians want that!'

'Obviously you guys in the press can have your day in the sun. You make a few noises to identify the so-called villains but in the end reality sets in and you cheer with the rest of the masses. I mean, what do you expect in a society where Alan Sugar becomes a Lord and plays a manager on TV?'

'The real money is only for a chosen few. Those who ignore that are like proles in George Orwell's 1984. If you choose to be an onlooker, you can vote in the contest, but it's all pre-arranged. And obviously you don't really have a say. If you wish, on the other hand, to be part of the elite, you have to play by the ideology and rules of those who control society.'

Bertram looked vaguely pensive, an attitude he cultivated once in a while when making a philosophical point. Actually, I have to say, because he did it rarely, this is something he does quite well. 'We bankers have evolved over the years. We are no longer the actual owners of money. We are the brokers, we are the true anarchists as so aptly put by Pessoa. The big fortunes are in the hands of those who created industries and products. We are just playing a game with money. And to hell with the consequences! Our productivity is not relevant. Talk of financial innovation and shareholder value are sound-bites to appease the masses. We are only the producers of the show. We deliver what the public wants and our motto is: The Show must go on.'

This was quite a long speech by a man normally given to speaking in short staccato sentences. He looked quite exhausted.

'Bertie, I always thought you were a cynic. But I never realised that you actually thought about the malaise of society. You even seem to have read a book or two. I have obviously underestimated you.'

'Rod, I confess to being cynical but I truly believe in what I say. I honestly see nothing wrong in my convictions. If we bankers didn"t exist to channel the hopes and dreams of the masses into ever new products of speculation we would probably have other forms of addiction. Just look at the statistics on national television. Every week 10 to 15 million people tune in to the X Factor and The Apprentice.'

Bertie paused and took a long sip. 'We bankers have created a show for the middle classes. At least this way the slightly better-off man in the street seems to have a fighting chance of winning from time to time. What they don't realise is that in the end we always determine the outcome. We can always change the rules if necessary. Merry Christmas, Rod. Have another drink. The crisis is over!'

Bertie gazed around the bar, his eyes alighting on an alluring figure in shoulder straps.

I looked at him quizzically. The Christmas show seemed, indeed, more or less secure. Then, afterwards, there would be the New Year's Special. I couldn't help wondering whether that might contain a few surprises.

Banking and accounting movement

Post-crisis efforts at greater cooperation

Peter Walton, IFRS Director, ESSEC-KPMG Financial Reporting Centre

For years, law-makers have mostly preferred to ignore accounting, and governments have certainly not been prepared to spend money on creating accounting standards. But all that changed with the financial crisis. Governments in Europe and elsewhere suddenly realised they had handed over responsibility for rule-making to an NGO, the International Accounting Standards Board (IASB). And as a result the governments set about re-asserting their authority.

Listed companies in more than 100 countries round the world, including the European Union, use International Financial Reporting Standards (IFRS) as the basis of their financial reporting. Two key standards have been intimately related to reporting by banks: IAS 39 on the recognition and measurement of financial instruments, and IFRS 7 on financial risk disclosures.

IFRS 7 is thought to have withstood the test well, only failing perhaps to deal adequately with structured entities in which sponsoring banks had no shareholding. But the phenomenon was new and could be addressed by a small amendment. IAS 39, on the other hand, was thought by some at least to have exacerbated the crisis, if not having actually caused it.

IAS 39 requires many financial assets to be carried at market value ('fair value'). Its critics say that as markets rise, it creates paper profits, inflating the capital base. As they fall, it creates paper losses, exaggerating the market cycle. The standard is also complex. As Sir David Tweedie, chairman of the IASB, used to quip before the crisis: 'Anyone who says he understands IAS 39 hasn't read it properly.'

IAS 39 was thought by some to have exacerbated the crisis, if not having actually caused it. It is also complex. As Sir David Tweedie, chairman of the IASB, used to quip: 'Anyone who says he understands IAS 39 hasn't read it properly.'

The IASB was fairly slow to react to the crisis. It was busy working on its convergence programme with the US, preparing for countries like Japan, India, Brazil, Canada, Korea and China to move to international standards, and hoping the US would use them too. 2011 is a key turning point with many new countries moving to use IFRS and the US Securities and Exchange Commission (SEC) due to decide if the US will also take that road.

It took the G20 and the European Commission to start questioning the IASB before its focus changed. The G20 eventually tasked the re-formed Financial Stability Board, based in Basel, to oversee work by the US and IASB on their financial instruments standards.

At the Pittsburgh summit (September 2009) the G20 told the Financial Accounting Standards Board, as the US standard-setter, and the IASB to ensure that they fulfilled their plan to converge by June 2011 – and include in that target new financial instruments rules that used market values less and had better loss provisioning. They also told them to liaise more closely with bank regulators.

Banks were initially concerned about the impact of two aspects of IAS 39. The first was that the market had fallen away, so how did you find a 'fair value' for a financial asset that you could not sell? Financial reporting uses a hierarchy for fair value (borrowed from the US literature) where there are three kinds of fair value measurement.

Level 1 is an observed market transaction for an asset that is the same as the one you want to value. Level 2 is an observed market transaction for a similar asset from which a value can be derived. Both of these 'mark to market'. Level 3 uses a model, such as discounted expected cash flows, to estimate fair value ('mark to model').

Entities have to make a lot of disclosures about Level 3 valuations. The market tends to discount Level 3 valuations, and auditors do not like them either. In the financial crisis this created a big problem because banks did not want to move off Level 1 even to Level 2.

However the bottom had fallen out of the market and prices, where available, were significantly below the cash flows assets were expected to yield. The use of fair values added to perceived losses.

Pressed by the G20, the European Commission, and banks, the IASB set up an Expert Advisory Panel (EAP), consisting mostly of large banks and regulators. The EAP provided a guidance document about how to address valuation issues under IAS 39. At the same time the FASB issued guidance pointing out that Level 1 and Level 2 valuations could only be used when observed in an active, liquid market. If the market was inactive, the prices did not give fair value for accounting purposes.

A second immediate issue for banks was that IAS 39 was written with a strong anti-abuse bias. It required that you had to classify a financial instrument when you acquired it and could never subsequently re-classify.

So if you had a bond that you put in your trading book, it had to be accounted for at fair value. If you decided later that you would achieve better cash flows by holding the bond for its underlying cash flows, you could not take the bond out of your trading book, and could not switch to normal historical cost measurement.

European banks, and French banks in particular, took exception to this. The French government was persuaded that EU banks were disadvantaged by comparison with US banks. The EU Regulation adopting international standards requires a level playing field, and France was able to persuade the EU to take action. In October 2008 the EU Finance Ministers told the IASB to amend IAS 39 in the next two weeks, or face the EU amending the version used in the EU.

IAS 39 had already suffered once at the hands of the European system, with a 'carve-out' of one paragraph in 2004. The IASB took the view that a second carve-out would damage the credibility of convergence much more than allowing re-classification, and moved quickly to do that. The SEC was not impressed and has questioned the IASB's independence from government interference ever since.

With the immediate fire-fighting out of the way, the IASB set to review IAS 39. It set up a Financial Instruments Working Group on which sit Credit Suisse, Goldman Sachs, HSBC, ING and UBS, with the Basel Committee and bank regulators acting as observers.

The Board decided that it would change the rules piecemeal, first dealing with assets, then liabilities, then addressing loan provisioning, hedging and de-recognition. In October 2009 it issued IFRS 9, which will replace IAS 39. The standard introduced a two-way classification instead of the previous four. Under this standard, equity instruments and debt instruments held for trading are carried at fair value, and debt instruments held for contractual cash flows are at cost.

What is proving more problematical is revising the loan provisioning rules. IAS 39 only recognised a loss when the bank could identify a non-performing loan. Critics say that this causes too much interest income to be recorded in the early stages and recognises losses too late. The IASB has now proposed provisioning based on expected cash flows – an element of loss is anticipated from day one.

This is more what the Financial Stability Board would like to see, but bankers say they do not have the systems to do it. The IASB has appointed another EAP to comment on this proposal. Members of this include ANZ, Barclays, BBVA, Citigroup, Deutsche Bank, Standard Bank and the Bank of Tokyo-Mitsubishi. They say that in an open loan portfolio their systems do not let them track credit risk on individual loans.

The IASB is still working on it, as also on accounting for hedges. It has promised to simplify hedge accounting and try to reflect more closely the way banks manage risk. The task is not simple, but they hope to issue a draft document before the end of the year.

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The financial crisis has certainly caused the IASB to step up its involvement with the banking world in a major way. In the past the staff and Board would go into a huddle and after some months a document would be thrown to the outside world for comment. Now staff talk with banks, auditor and regulators all the time: they tell them the latest IASB thinking and ask for feedback.

The G20 nominated the Financial Stability Board as the IASB's main liaison in the reform of financial instrument accounting, in succession to the Financial Stability Forum. The IASB is also a member of the Financial Stability Board. Consequently liaison is more in the form of Sir David Tweedie attending meetings of the FSB (he was at the October meeting in Seoul even though the IASB was meeting in London at the same time) than FSB staff observing standard-setting meetings.

However, the whole question of bank regulators being involved in shareholder reporting is itself problematical for the US and international standard-setters. The IASB's mandate is to produce high quality financial reporting standards for the capital markets. Its conceptual framework says reports are designed to give information that is useful for investment decisions – no mention of bank regulation or financial stability.

Of course the IASB has for years liaised with the Basel Committee, and regulators now adjust shareholder accounts for regulatory purposes rather than have the banks file special statements. However this is a different thing from having regulators help you frame the standards, even if in 2009 a Brazilian bank regulator was appointed a member of the Board.

The IASB seems to have managed the adjustment, with Board members talking quite freely in standard-setting meetings about not doing this or that because the regulators would not like it. The FASB has less obviously learned to live in a post financial crisis world. It developed a new approach to financial instruments separately from the IASB. While its approach shared a similar two bucket classification approach to that of the IASB, all instruments would be measured at fair value.

The Financial Stability Board has repeatedly criticised the proposed US approach. In its communiqué from the Seoul meeting last month it noted: 'The FSB reaffirmed its support of standards that do not expand the use of fair value measurement for lending activities'. People close to the process say that they expect the FASB under its new chairman (the previous incumbent resigned unexpectedly in August) to re-think its financial instruments proposals.

IAS 39 was passed as a 'temporary standard' under the pressure of a deadline from the International Organisation of Securities Commissions in 1999. Subsequently the standard had many detractors but no-one was willing to devote the considerable resources and political capital necessary to replace it.

The reporting community eventually preferred the devil it knew, and so temporary became permanent. It has taken the political stress of the financial crisis to force the world's two major standard-setters to re-think accounting for financial instruments. The IASB's solution looks to recognise banking realities better than IAS 39. We hope the FASB gets the message.

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Stimulus not sufficient

Echoes of the 1930s are still with us

William Keegan, Chairman, Board of Contributing Editors

In last month's commentary I suggested that, notwithstanding the success of the G20 in warding off a recrudescence of the Great Depression, we might yet find that the aftermath of the financial crisis – what IMF Managing Director Dominique Strauss-Kahn memorably termed The Great Recession – could bring uncomfortable echoes of the 1930s.

One fears that after the exiguous results of the much-hyped G20 meeting in Seoul, those echoes can now be heard. Taken with the manifest existential crisis of the euro area, the failure of the G20 even to paper over the cracks bodes ill for those of us who had hoped that the lessons of the 1930s had been learned.

Now, we know that those lessons were embodied in the Bretton Woods Institutions – which, in addition to the International Monetary Fund and the World Bank, included the General Agreement on Tariffs and Trade (GATT), subsequently renamed the World Trade Organisation.

For many years I used to refer to the GATT as the General Disagreement on Tariffs and Trade. In the days of the WTO that joke no longer works, although the state of the famous Doha Round merits an updating – perhaps the Doha Merry-go-Round – or Never-go-Round. Britain's Dr Johnson described patriotism as 'a last refuge of the scoundrel'. Johnson, who died in 1784, lived at a time of European nationalism on a grand scale, when the relationship between nationalism and patriotism was often less subtle than it should be.

I am tempted to say that appeals to the resumption and successful completion of the Doha Round are indeed a last refuge of the scoundrel. They were certainly very prominent in Seoul, as it became embarrassingly clear that there was not much physical movement in the tug of war between Washington and Beijing.

So, what are the echoes of the 1930s? First and foremost, high unemployment in the western industrial countries, and a general impression that, after stopping the rot at the London G20 summit of April 2009, policymakers have thrown in the towel to the financial markets that made such a generous contribution to the crisis in the first place.

As President Obama discovered in the recent Congressional elections, you do not get thanked for policy actions which limit the official unemployment rate to 10%, and not the 25% of the early 1930s. As is obvious to any visitor to the US, there is a lot of social pain and public anger over there. Extreme right-wing claims that the stimulus 'has not worked' are ignorant, and wide of the mark. The fact is that the stimulus was necessary, but not sufficient; it has worked up to a point, but not enough.

As President Obama discovered, you do not get thanked for policy actions which limit the official unemployment rate to 10%, and not the 25% of the early 1930s. As is obvious to any visitor to the US, there is a lot of social pain and public anger.

Federal Reserve Chairman Ben Bernanke was the object of heavy, indeed outspoken, criticism from the Chinese and Germans on account of his latest attempt at quantitative easing. However, as Bernanke himself has made plain, he would rather see further fiscal easing, but knew when he made the announcement that this was ruled out by Congressional deadlock.

The two other echoes of the 1930s are the ramifications of the banking crisis – threatening the very future of the euro area – and the strong feeling that beggar-my-neighbour policies are in the ascendancy. Call it patriotism; call it nationalism; call it what you will. But at a time when, both in Washington, at the World Bank/IMF meetings, and in Seoul, the international organisations (and the US) were urging policymakers to take account of 'spill-over' effects of their actions, the actions of policymakers seemed to point in another direction.

An irony of history is that the US was not interested in discipline for surplus countries when the IMF was set up in the 1940s; now, for obvious reasons, it is, but China is not.

Looking ahead – 2011 diary dates

OMFIF Meeting with
De Nederlandsche Bank
23-25 March 2011, Amsterdam
Europe's Place in the World Economy

OMFIF Meeting with
Banque centrale du Luxembourg
15 September 2011, Luxembourg
The New Forces in World Banking

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