COMMENT

In a crisis, it will take a firewall not a ringfence

Alistair Darling

Fortunately I've only ever had to take one telephone call that made my blood run cold. On the morning of October 7, 2008, Sir Tom McKillop, the then chairman of Royal Bank of Scotland, called me to say that his bank was fast running out of money. He asked me what I was going to do about it.

This was three weeks after the collapse of Lehman Brothers. The markets were in a panic. RBS shares were in free fall that morning. We were on the brink of an international banking collapse.

I had no doubt what had to be done. If RBS closed its doors people would panic. The cash machines would close down. There would be no way for customers to get their money out. That panic would have spread to other British banks and then to the US and beyond.

The UK government had seen what happened 12 months earlier with the run on Northern Rock. Yet it was a comparatively small bank where, in reality, depositors' money was guaranteed by the government.

So that October morning I had no choice but to bail out RBS, to do whatever it took to stop a catastrophic banking collapse across the globe. It was not an easy decision. RBS, one of the largest banks in the world, had a balance sheet about the same size as Britain's gross domestic product. Added to that, we knew we would have to bail out HBOS. It was in the same precarious position.

We did what was needed. But it was at a substantial cost. I hope that none of my successors are ever faced with the same scale of horrors.

It is against this background that I looked at yesterday's announcement by Chancellor George Osborne on ringfencing, made as part of a speech on banking reform. Would a ringfence, or even the "electrified" version he now proposes, have made any difference? I don't think it would. A partial bailout would not have worked in those febrile times.

The theory is that if a bank is divided so that its retail and investment activities are separated then it would be possible to save one part but let the other go to the wall. The argument runs that I could have saved RBS's high street activities and abandoned the investment arm to its fate.

I am not so sure that would have worked. In the face of blind panic and a total collapse in confidence, the government needed to erect a firewall to show that it was not prepared to let the banking system collapse.

After all, Lehman Brothers was just such an investment bank. The Americans let it go. Its collapse was not the cause of the ensuing crisis but it was certainly a major catalyst.

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Ringfencing will not avert the possibility of bank bailouts in a time of acute crisis. No government can say that it will never again have to bail out a bank or intervene in the face of such crisis. It should be different in more tranquil times, when there is no reason that a failed bank cannot be treated like any other failed company and face the consequences.

Ringfencing is a perfectly sensible measure. It would help in identifying good and bad assets. It took months to discover the sheer horror of the scale of RBS's problems, particularly outside of the UK. But ringfencing – even with electrification, whereby regulators will have the power to break up a bank – has its limits.

The proposals by the Independent Commission on Banking – headed by Sir John Vickers – were entirely sensible. The banks should adopt them and they are entitled to ask that there are very clear rules in place if in future the regulators are to take enforcement action.

But there are two other elements of the Vickers proposals, and surely the most important is the capital that banks are required to hold and the lending ratio they are allowed to support. Vickers recommended capital of 4 per cent, a lending ratio of 25 to 1. The chancellor, in an apparent sweetener to the banks, has said the ratio should be 3 per cent, allowing a 33 to 1 ratio.

A requirement to hold more capital and to be more prudent about the amount of money that can be lent will, I suspect, be a far greater buffer against calamities than a ringfence.

Nor have we heard how, in future, bond holders will be made to take some losses in the event of such failure. We have to end a situation where in the good times they profit, but in the bad it is the taxpayer who loses out.

A lot of work has been done on "bail in" for bond holders. That needs to be developed into a set of firm proposals. Sadly, when normal companies go bust there is some pain, but not in banks.

Finally, we can never sort out our banking problems in the UK until the eurozone does the same. The putative banking union will not work in its present form. The recommendations of Erkki Liikanen, governor of Finland's central bank, which were meant to mirror those of the Vickers commission, appear doomed. The French and German governments – and more particularly their banks – have made it clear they will not accept ringfencing.

This presents further risk to add to that of failing to recognise that some of Europe's banks still badly need more capital and further write-offs.

Ringfencing is a useful tool to help manage banks but it is certainly not a complete answer. Too many risks still remain.

The writer is a former UK chancellor of the exchequer

Remember the effect of QE on the emerging economies

Felipe Larrain

The surge of quantitative easing around the world should be a reason to worry for many emerging economies. In a recent wave of announcements, Japan, under new prime minister Shinzo Abe, has followed the lead of the US and the eurozone by introducing greater liquidity into the markets.

Developed countries are acting to support their economies, but it is emerging markets that have absorbed the bulk of the severe currency appreciation that follows every round of QE – and in particular those countries committed to flexible exchange rate regimes and open markets. This is particularly true in a world where China continues to manage its exchange rate. After all, currency wars are zero-sum games.

This is the case for the most successful Latin American economies – Colombia, Mexico, Peru and my own, Chile – which experienced appreciations of close to 10 per cent against the US dollar in 2012. In the same fashion, in developed open economies such as Australia and New Zealand, currency appreciation against the greenback has reached almost 15 per cent since 2010.

Certainly, Chile's annual average growth rate of almost 6 per cent in the past three years has had a role to play. This is high compared with most industrialised economies but the appreciation we have seen cannot be explained by this fact alone. The price of copper has not been on a clear upward trend since 2010, so it bears little or no blame for the exchange rate picture. It is hard to escape the conclusion that a significant part of the appreciation we have seen in Chile is the result of the various rounds of QE.

In our economy, which is fully integrated with global capital and product markets, a cheap US dollar is a cause of concern for export sectors, such as copper.

Severe pressure upon domestic currencies entails the risk that countries embrace the appeal of capital controls

Seen from Santiago, three questions must be asked by countries currently pursuing unconventional monetary policies. First, how long can loose money be maintained without undermining the desired outcomes – growth, higher employment and so on – for those countries actively pursuing it? Monetary policy can be a useful tool to cope with particular demand problems in the short term but it is rather ineffective in fostering sustainable growth over the long term.

Second, is QE effective in a scenario with zero or negative real interest rates? The risk is that a liquidity trap – as notoriously depicted by Japan's prolonged stagnation of the past two decades – is just around the corner.

Third, will the quick fix of QE mean that countries avoid facing the urgency of implementing much needed structural reforms?

These questions are, ultimately, for the governments of developed countries. But assuming that QE is not going to stop soon, what should emerging economies do?

The answer begins with a responsible fiscal policy that keeps public spending in check so that appreciation can be limited.

In Chile we have pursued this objective by expanding public spending significantly less than the growth of gross domestic product in the past two years.

But sometimes that is not enough. Countries can also fight appreciation through foreign exchange purchase programmes, but this is an expensive tool that would probably generate losses for central banks' balance sheets. Purchase programmes could, though, be complemented with so-called "macroprudential" measures such as limits on banks' foreign exchange exposure. These measures could therefore prevent short-term speculative capital inflows.

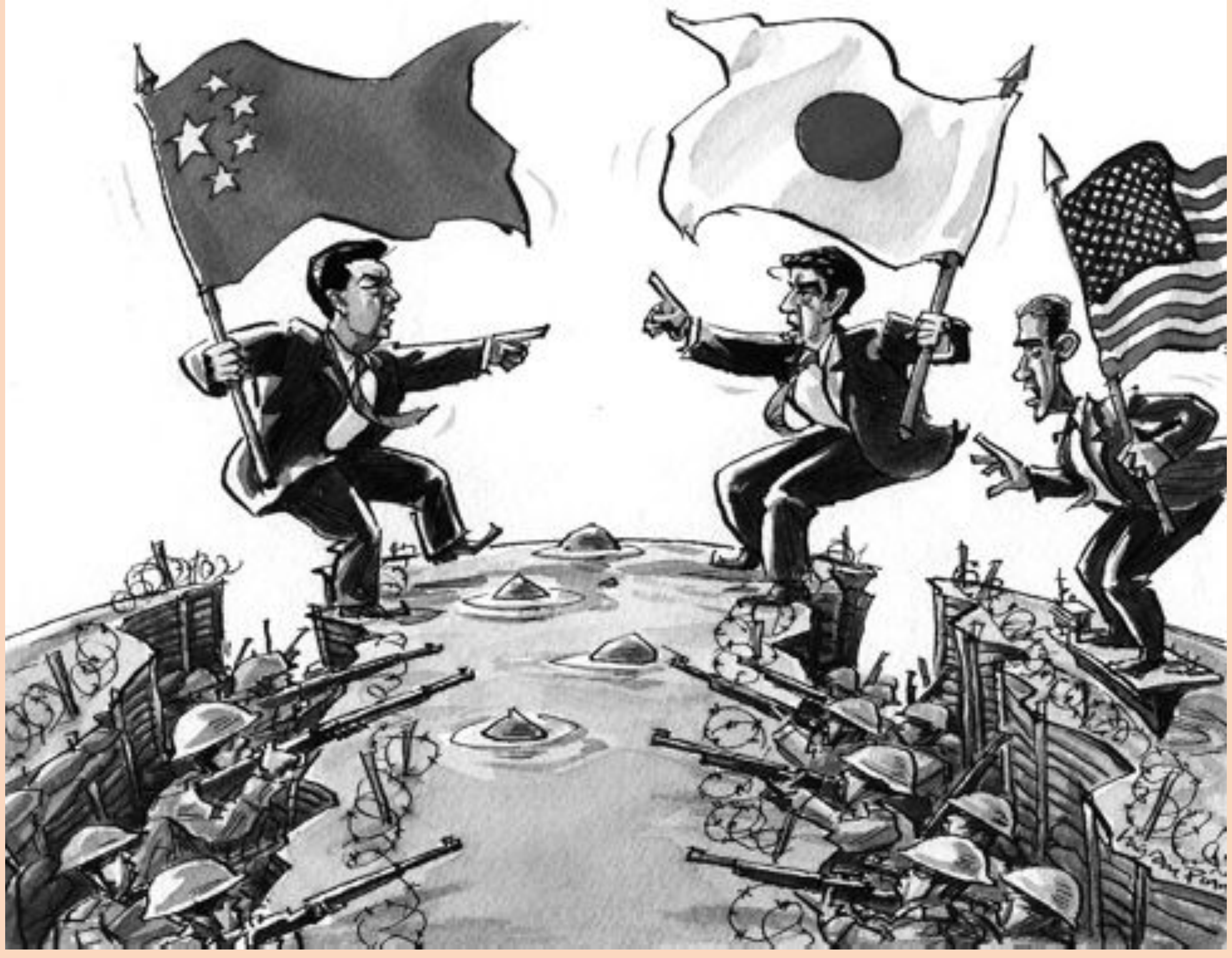
Less virtuously, severe appreciation pressure upon domestic currencies entails the risk that countries embrace the appeal of capital controls. In addition, the detrimental effect of real exchange rate appreciation on exports could induce the temptation of new forms of trade protectionism.

One thing is unmistakably clear: the greatest share of the exchange rate adjustment costs resulting from quantitative easing is absorbed by a small group of developing and open economies, particularly in Latin America.

This is the real world effect of the beggar-my-neighbour policies pursued by developed countries. By seeking relief at the expense of other economies, QE is, in its essence, a globally counterproductive policy.

The writer is Chile's minister of finance

The shadow of 1914 falls over the Pacific Ocean



Gideon Rachman

The flickering black and white films of men going "over the top" in the first world war seem impossibly distant. Yet the idea that the great powers of today could never again stumble into a war, as they did in 1914, is far too complacent. The rising tensions between China, Japan and the US have echoes of the terrible conflict that broke out, almost a century ago.

The most obvious potential spark is the unresolved territorial dispute between China and Japan over the islands known as the Diaoyu to the Chinese and the Senkaku to the Japanese. In recent months, the two countries' aeroplanes and ships have shadowboxed near the islands. Alarmed, the US dispatched a top-level mission to Beijing and Tokyo in late October, made up of four senior members of the US foreign policy establishment: including Stephen Hadley, who ran the National Security Council for George W. Bush, and James Steinberg, who served as Hillary Clinton's number two at the State Department.

This bipartisan US delegation made clear that a Chinese attack on the islands would trigger the security guarantees that America has made to Japan. The obvious danger is that, as in 1914, a small incident could invoke alliance commitments that lead to a wider war.

The American group was well aware of the risks. As Joseph Nye, a Harvard professor who was part of the four-person mission puts it: "We discussed the 1914 analogy among ourselves. I don't think any of the parties wants war, but we warned both sides about miscommunications and accidents. Deterrence usually works among rational actors, but the major players in 1914 were also rational actors."

Graham Allison, Mr Nye's Harvard colleague, who has written a classic study of the Cuba missile crisis, also believes that there is a danger of war by miscalculation. He says: "The mechanism in 1914 is instructive. Who could imagine that Serbian terrorists could kill an archduke no one had heard of and trigger a great war, at the end of which all contestants were devastated. My view is that the Chinese leadership has no intention of challenging the US militarily, yet. But what about the hothead nationalists in China or Japan?"

Such "hotheads" could be very low down the chain of command. In September 2010, a crisis over the islands was provoked when a Chinese trawler captain confronted Japanese patrol-ships. It later turned out that the captain had been drunk.

Back then, the Japanese government took a fairly conciliatory approach. However, the US is concerned that the new Japanese cabinet is full of hardline nationalists, who are more inclined to confront China. Shinzo Abe, the new Japanese prime minister, is the grandson of a wartime cabinet minister and rejects the "apology diplomacy", through which Japan tried to atone for the war.

America's security guarantee is meant to reassure Japan, but there is also a danger is that it might tempt Japanese politicians to take unnecessary risks. Some historians argue that in 1914, the German government had concluded that it needed to fight a war as soon as possible – before it was encircled by more powerful adversaries. Similarly, some Japan-watchers worry that nationalists in the government may be tempted to confront China now – before the gap in power between the two nations grows too large, and while the US is still the dominant military force in the Pacific.

China now, like Germany 100 years ago, is a rising power that fears the established great power is intent on blocking its ascent

The Americans' concern about the nationalist turn in Japanese politics is amplified, because they see the same trend in China. China now, like Germany 100 years ago, is a rising power that fears the established great power is intent on blocking its ascent. Deng Xiaoping, the father of modern China, pursued a foreign policy based on the adage: "Hide your strength, bide your time." But his generation has been replaced by a new leadership group, which is more confident and assertive. The Chinese military is also increasingly influential in shaping foreign policy.

The analogy with Germany before the first world war is striking – as the adept leadership of Otto von Bismarck gave way to much clumsier political and military leadership in the years before war broke out. The German ruling elite felt similarly threatened by democratic pressures from below – and encouraged nationalism as an alternative outlet for popular sentiment. China's leaders have also used nationalism to bolster the legitimacy of the Communist party.

It is, at least, encouraging that the Chinese leadership has made an intense study of the rise of great powers over the ages – and is determined to avoid the mistakes of both Germany and Japan. The fact that we are living in a nuclear age also makes the 1914 crisis much less likely to be replayed.

If things got really dangerous, there is also some wiggle room in the US-Japan security treaty. Article V of the treaty is commonly believed to commit the US to defend its ally by military means. In fact, it simply commits the two nations to "act to meet the common danger" in the event of an attack on Japan. That ambiguity could be dangerous, if it tempts China to call America's bluff. But it could also be useful at a time of crisis.

In July 1914, leaders on all sides felt helpless, as they were swept towards a war that most of them did not want. A study of that history might help the Chinese, Americans and Japanese to avoid a similar fate, in 2014.

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The A list

How the US should avert a fiscal crisis

A consumption tax and revising the accounting process can help restore discipline to the budget, writes **Glenn Hubbard**

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Time for Cameron to stop appeasing his party

Janan Ganesh

A decade ago, George Osborne began work on a book chronicling progressive reforms by Conservative British governments. The UK chancellor of the exchequer, then a young MP, planned chapters on the Factory Acts, women's suffrage and the abolition of slavery.

The point was to challenge the left for the moral high ground. Had the book materialised – it was a victim of Mr Osborne's vertiginous promotion – the introduction of same-sex marriage might have been the epilogue of an updated version.

Today, the Conservative-Liberal Democrat coalition is set to pass the marriage law, which will allow same-sex unions – despite resistance from 100 or more Tory MPs. Opponents are right that David Cameron, prime minister, did not herald the change in the party's last manifesto, but that is a procedural grievance not a principled one. Yet MPs who question their leader's decision to make it a priority amid an economic malaise look suspiciously like those who hounded him into calling a referendum on Europe, a subject low on the list of voters' concerns.

As for the claim that gay participation will redefine marriage, it is too late for that. If anything has changed marriage, it is the 42 per cent divorce rate. The idea that gays represent the first alteration of an institution that heterosexuals have conscientiously preserved in its original form is, at best, very droll.

Enemies of the reform are right about one thing. Mr Cameron and his chancellor are motivated by politics as well as conviction. They see same-sex marriage as a rare and economically costless opportunity to broaden the Conservatives' appeal. Their project to "modernise" the party – to "detoxify" the Tory brand – was interrupted by the financial crash and has not recovered its initial vigour since.

The unexpected scale of the hostility to gay marriage from their fellow Tories changes the calculation. Instead of revising their opinion of Conservatives as a whole, voters, who broadly support the reform, are likely to conclude that Mr Cameron is a reasonable man in charge of a mean-spirited party. That was already their hunch, one which made them shy of granting the Tories an outright victory at the last election in 2010.

But while the electoral implications of the vote are marginal, it is politically instructive nonetheless, for it reveals exactly what the modernisers have been up against all these years.

Some Tories will vote against the bill because they believe gays should not marry. Others will do so out of fear of deselection by seething local activists. It is hard to know which augurs more badly for the party: the discomfort with modern social mores or the sheer ungovernability that starts at the grassroots.

Swirling around the narrow issue of same-sex marriage are broader enmities, resentments and even plots against Mr Cameron, largely emanating from MPs to his right who regard him as neither a winner nor a real Tory.

The PM sees same-sex marriage as a rare and economically costless opportunity to broaden the Tories' appeal

The existential menace to his position is small but capable of quickly metastasising into something that Downing Street's underpowered political operation could not withstand. Insiders speak of distinct "cells" of malcontents that are barely aware of each other's activities. Were a move to be made against Mr Cameron, perhaps after a drubbing at the European and local elections next summer, his enemies might themselves be surprised by the numbers they could command.

The prime minister bears some blame for the latest round of sedition, but not in the way his enemies claim. True, he is aloof from his backbenchers and transparently insincere on the rare occasions he tries to charm them at hastily convened drinks receptions.

But bad manners are no grounds for dissent. His real culpability lies in his endless willingness to do deals with people who are essentially unbiddable.

It is only two weeks since he promised the EU referendum his party has been hankering after for decades. This bought him perhaps 72 hours of peace. The iron rule of Tory politics is that sops to the right are met with scant thanks and vociferous demands for more.

This is a government imposing the most sustained austerity since the second world war, reforming public services that Margaret Thatcher barely touched during her time as prime minister in the 1980s and committed to at least a thinning of relations with the EU. Yet much of his party has Mr Cameron down as a wishy-washy managerialist.

The folly of this game of appeasement is not merely that it encourages his enemies. It is also the gradual accumulation of very orthodox Tory positions. By the next general election in 2015, Mr Cameron could find himself reluctantly in possession of what modernisers call a "trad" offering: welfare cuts, euroscepticism and austerity.

Fear of that eventuality explains his determination to legislate for same-sex marriage. But the insurrection it provokes will doubtless be bought off with another concession somewhere down the line. And so the grim cycle will roll on.

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