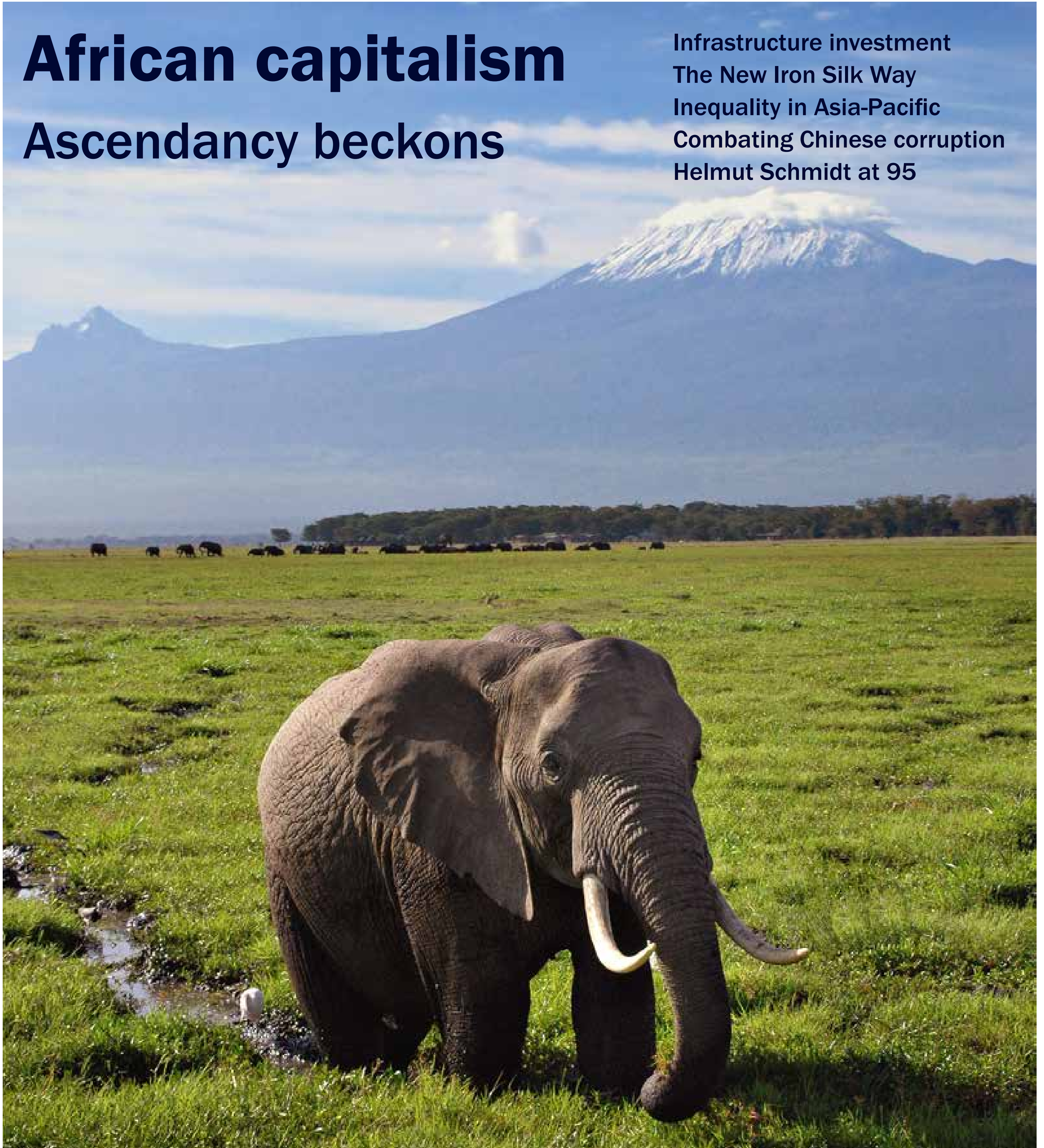
Bulletin

Global insight on official monetary and financial institutions

January 2014
Vol. 5 Ed. 1



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Cover story

For decades, Africa has been the continent waiting to catch up with the rest of the world. The challenges are no less daunting, but – in an unpropitious international environment – the continent looks better equipped than before to make good its relative decline. Launching OMFIF's Africa Focus 2014, we look at attempts around Africa to reinforce legal and regulatory frameworks for infrastructure, financial markets and trade/investment and to defeat corruption. For Africa's future ascent, Asia, rather than the US or Europe, holds the key. See p.32-39.

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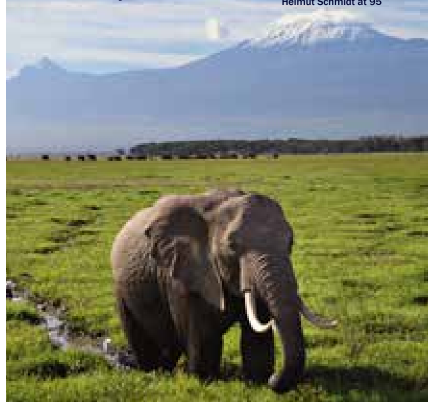
African capitalism
Ascendancy beckons

Infrastructure investment
The New Iron Silk Way
Inequality in Asia-Pacific
Combating Chinese corruption
Helmut Schmidt at 95



OMFIF

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Helmut Schmidt at 95

Following the death of Nelson Mandela, Helmut Schmidt, Chancellor of West Germany between 1974 and 1982, is the world's best known elder statesman. In a wide-ranging OMFIF interview shortly before his 95th birthday, Schmidt reviews the new German coalition, relations between Germany, France, Greece and other partners in economic and monetary union, and the future of China. He says Germany has no choice but to write off Greek debts – something no European politician wishes to do. He is critical about most world leaders – but surprisingly complementary about his successor Helmut Kohl. See p. 17-19 and www.omfif.org/media/470893/helmut-schmidt.pdf for full text.

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OMFIF

Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent globally-operating financial think-tank and a platform for confidential exchanges of views between official institutions and private sector counterparties.

Our overriding aim is to enable the private and public sector to learn from each other in different ways, promoting better understanding of the world economy and higher across-the-board standards. OMFIF's main areas of focus are economic and monetary policy, asset management and financial supervision and regulation.

OMFIF cooperates with central banks, sovereign funds, regulators, debt managers and other public and private sector institutions around the world.

Since its inception in January 2010, OMFIF has held 200 meetings in 40 host countries with the participation of 165 different official institutions.

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OMFIF's 147-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars, and other OMFIF activities. See p.22-23.

Bulletin

The OMFIF Monthly Bulletin features in-depth news and commentary on key developments in the financial industry and global capital markets – including changes in governance, banking structures and regulation.

The Bulletin reaches a wide audience of readers around the globe including public financial institutions, private asset management companies and professional services firms.

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Bulletin

Global insight on official monetary and financial institutions

Fifth year focus on Africa

Searching for a world-beating business model

David Marsh, Chairman

OMFIF starts its fifth year with a focus on Africa, following the concentration last year on the twin subjects of China and the renminbi and the Lusophone economies of the world – abiding preoccupations that will accompany us this year too. Ultimately all of these facets of the international political economy are interlinked. We give pride of place to a book by Kingsley Chiedu Moghalu, deputy governor of the Central Bank of Nigeria. In Emerging Africa, Moghalu extols a particular brand of African entrepreneurial capitalism that he believes has the ability to build a world-beating business model. During the year we will be exploring in different ways how this model can be developed.

David Kihangire, former Executive Director for Research at the Bank of Uganda who has recently taken up an assignment at the East African Community, argues in favour of African states establishing sovereign funds that are independent of state budgets. He makes this proposal in a review of the different ways that African nations can deal with windfall profits from oil and gas – an issue that was aired, too, at the OMFIF Main Meeting in Qatar in November, where we publish an extract from the summary of proceedings. In Africa's biggest oil-driven economy, Nigeria, Razia Khan looks at the difficult combination of political and economic circumstances confronting President Goodluck Jonathan. Ulrich Otto and Minesh Mashru survey the need for better conditions for financing African infrastructure.

Elsewhere in emerging markets, Juzhong Zhuang and Changyong Rhee describe rising inequality in Asia. Anthony Robinson investigates the implications of the Euroasian rail link financed by China and other state-owned interests in Asia and the Middle East. Winston Moore outlines ambitious plans by the four-nation Pacific Alliance to extend Mexico's trade and investment horizon southwards in partenership with resource-rich Andean nations. Steve Hanke comments that Venezuela seems to be descending into a Marxist economy, an experiment that only a precipitous decline in the oil price would end. Zeph Nhleko examines the economics of sovereign wealth funds in sub-Saharan Africa.

Europe has entered a new phase in economic governance with improved measures for coordinating national economics as well as the start of banking union, steps regarded with favour by Paul van Seters and Ruud Lubbers. François Heisbourg, a French federalist who believes full-scale political union cannot take place, supports an orderly dismantling of the euro. However unlikely this is, his arguments are worth reading – as are the counter-arguments marshalled by Laurens Jan Brinkhorst, who calls Heisbourg's ideas defeatist and politically unrealistic. Helmut Schmidt would certainly agree that monetary union would be very difficult to unravel, although in a long interview marking his 95th birthday he tellingly describes the old concept of the exchange rate mechanism as 'saner' than monetary union.

Moorad Choudhry investigates the relationship between money supply, bank liquidity and monetary policy and the implications for banks' treasury policies. Miroslav Singer, governor of the Czech National Bank, examines different precepts for 'forward guidance'. Gabriel Stein extends his analysis of divergent monetary trends in the industrialised economies. Darrell Delamaide takes the pulse of members of the Federal Open Market Committee after the decision to lower monthly asset purchases. Michael Kaimakliotis believes that the US recovery will proceed in a satisfactory enough fashion for the Federal Reserve to raise interest rates by the end of the year. William Keegan says economic thinkers such as Lawrence Summers propagating the idea of 'secular stagnation' in western economies are far too pessimistic. Keegan is against New Year predictions. All the same, we set out anew our 10 forecasts for 2014 and look forward to a busy year.■

David Marsh

Governments build up real estate assets – not just in the mainstream

Governments using sovereign financial vehicles to invest in foreign real estate will become more prevalent in coming years, *writes Efraim Chalamish in New York*. The trend is most noticeable in the US and the UK, but will be seen too in the rest of Europe as well as Asia and (later on) Africa.

Efforts by the larger funds, ranging from Norway and Singapore to Abu Dhabi and China, to build up specific real estate expertise, especially in the field of transaction structuring and tax, adds self-fuelling momentum to their market positioning. In many countries, commercial firms and parts of the public sector need to acclimatise to the reality that their landlords may be a foreign government.

Most sovereign wealth funds have added real estate allocation targets as part of a drive into 'alternative investments', diversifying away from global equities and bonds to improve non-correlated returns.

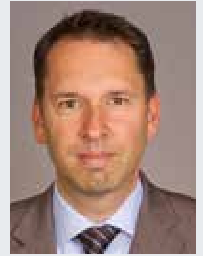
Although real estate shares some attributes of the fixed income market, it also offers the chance of long-term capital appreciation (depending on location and tenancies). The relative risk characteristics of real estate have been improved by increased perception of default risk from governments issuing bonds – a view that has gained ground as a result of the euro debt crisis.

Different governments have different views on appropriate target shares. While the Norwegian government pension fund (NBIM) has decided to move to a 5% allocation for real estate portfolios (its actual allocation is still under 1% because of the length of time needed to build up to a higher percentage), recent studies show about 10% of sovereign funds apportion 12.5% or more to real estate. Qatar Investment Authority, for example, has a 32% allocation. The nature of targeted assets has changed over time. The first sovereign investments in the

Continued on page 9...

ADVISORY BOARD

John Nugée (left), previously at State Street Global Advisors, the Bank of England and Hong Kong Monetary Authority, has become Senior Adviser, working to further OMFIF's cooperation with central banks, sovereign funds, regulators, debt managers and other public sector institutions. Sir Colin Budd, a former UK ambassador to the Netherlands (first right), and Frank Westermann (second right), Professor of Economics and Director of the Institute of Empirical Economic Research at Osnabrück University, Germany, have joined the Advisory Board, taking membership to 147. For full list, see p.22-23.



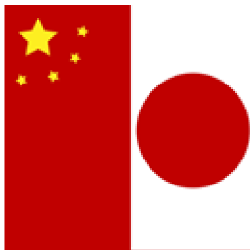
INTELLIGENCE

10 predictions for 2014: Instability in the East

From a stock market and currency point of view, 2013 was much more benign than many had forecast. World stock markets were buoyant. The euro (up 5% on a trade-weighted basis) finished on a surprisingly firm note against an otherwise generally strong dollar. The emerging markets, after a mid-year wobble, recovered some of their poise. With the possible exception of the US, optimism on international stock markets has run ahead of reality. The euro crisis has gone into remission. However, with the US toning down its monetary stimulus, tensions likely to return to the single currency area, and considerable potential for instability in the Far East and the Middle East, the next 12 months should see a more sobering state of affairs. OMFIF's 10 New Year predictions are laid out below and opposite.

US to lead on economic growth as Yellen eclipses 'secular stagnation' Summers

President Barack Obama will wonder why he ever toyed with making Lawrence Summers chairman of the Federal Reserve Board as Janet Yellen moves seamlessly into the job from 1 February. US growth will move into the upper end of the 2-3% range and could well surprise on the upside. Falling unemployment should allow the Fed to rein back its monthly asset purchases to zero by the end of 2014. The bad news is that Treasury bond yields will move towards 4%, or possibly even beyond, further boosting the dollar against all currencies, especially the euro – and damaging US firms' competitiveness.



East China Sea claims could unhinge stability, 100 years after start of First World War

Muscle-flexing between Japan and China over territorial claims in the East China Sea is likely to intensify and become a serious threat to international stability. Japanese prime minister Shinzo Abe's Christmas visit to the Yasukuni war shrine in Tokyo raised the stakes further, including with South Korea, which is bound up, too, with Chinese attempts to enlarge its sphere of sovereignty in east Asia. Although Japan has stated it seeks dialogue to calm tensions, there is a worrying absence of set procedures for handling confrontations.

Japan aim of ending deflation comes into sight as yen slide continues and bond yields rise

Abe will see his dreams fulfilled of an end to deflation. But the sought-after growth fillip and return to 2% inflation by the end of the year will be accompanied by an accelerating decline in the yen that may make the Japanese authorities alarmed about the risks of overshooting. As the Bank of Japan ploughs on with its extraordinary asset purchases, the Japanese currency will appear to be heading towards 110 to the dollar – prompting higher Japanese bond market interest rates as well as possible Ministry of Finance yen defence intervention to sell dollars if the rise in inflation is judged 'too far, too fast'.

China enjoys economically prosperous 2014, possibly tempted to try North Korea rapprochement

The new tandem of Xi Jinping and Li Keqiang will continue to preside over growth of close to 7%. The Chinese will continue to promote increasing the renminbi's use in international trade and investment. China's impressive-looking economic performance and willingness to do deals with President Obama could tempt Beijing into trying to push its restive client state North Korea into a rapprochement with the South. A Chinese coup-de-grâce against the North Korean regime would be a high-risk strategy and would need to be done with subtlety (which could be impossible).

OMFIF launches Africa Focus 2014

In the next 12 months, we will look at attempts around Africa to reinforce legal and regulatory frameworks for infrastructure, financial markets and trade/investment and to defeat corruption: in short, setting out how Africa can establish a world-beating business model. A Main Meeting will be hosted by Governor Henry Kofi Wampah, Bank of Ghana, in September. Forthcoming meetings will cover foreign direct investment opportunities, public-private partnerships, and reform of public and private sector institutions.

Instability in Islamic world worsens as fresh discord looms between Iran and Saudi Arabia
In North Africa and the Middle East, the position looks likely to get worse before it gets better. There is a high probability that, in some parts of the Islamic world, conflict between the Sunni and Shia denominations will escalate into full-scale war. Instability in Lebanon seems to be increasing. Syria may become ever more obviously a direct battle between Iran and Saudi Arabia. One spur driving Iran to settle its differences with America is Tehran's desire to focus energy and resources on fighting Saudi-backed militias closer to home. The situation in Egypt remains very unstable.

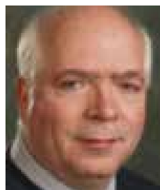
Imbalances in euro area will persist, deflationary pressures impede debt reduction
The euro area will have another poor year, with its fundamental imbalances showing little improvement. European growth will remain weighed down by creditor and debtor countries' inability to move to more effective fiscal burden-sharing, for example in a genuine banking union. The unexpected strength of the euro in 2013 has been a function largely of the extreme de facto restrictiveness of the European Central Bank's monetary policies. Credit to non-financial corporations has been falling in most euro member countries. All this makes self-sustaining recovery highly unlikely, and hinders debt reduction.

Greek prime minister, poised between statesman and spoiler, wants speedy debt relief
Antonis Samaras, the Greek prime minister, will play an awkward role, poised between statesman and spoiler. With public sector debt at 177% of GDP, Greece took on the six month presidency of the European Union on 1 January. In the forefront of this year's near-inevitable Greek debt rescheduling, Samaras has only one option – to focus on good news and try to avoid controversy. Greece can say that it has kept (mainly) to the terms of the 'troika' bail-out programmes. It's not his fault, Samaras will claim, that, with the economy struggling after a six-year recession, public debt is inexorably rising.

SPD heavyweight Gabriel to bid for lead over euro bargaining, pushing Schäuble onto sidelines
Sigmar Gabriel, the portly, pugnacious and wily Social Democrat (SPD) leader and deputy German Chancellor who was the clear winner in Grand Coalition negotiations with Chancellor Angela Merkel, will do his best to become the German government's new power centre. His position heading a Berlin super ministry combining economics and energy gives potential heavyweight stature to lead German deal-making over assistance for hard-pressed euro members. He has a chance of eclipsing veteran Christian Democrat finance minister Wolfgang Schäuble.

Britain to raise interest rates as growth spurts ahead of euro area and sterling remains strong
Britain will stand out in 2014 as benefiting from its non-membership from the euro area, even though a large part of UK trade is with continental Europe and the UK remains the euro area's largest trading partner, ahead of the US and China. GDP growth in the UK will be a percentage point or more above that in the euro area in 2013-15. Unemployment (which rose far less than expected in and after the 2009 recession) is now down to 7.4%, the lowest for five years – which means that UK interest rates are likely to rise by the end of 2014, much more quickly than Bank of England governor Mark Carney would like.

Many larger emerging market economies will have another bumpy ride
There are potentially game-changing national elections in 2014 in five key Group of 20 countries that in summer 2013 suffered currency and bond market sell-offs: Brazil, India, Indonesia, South Africa and Turkey. Against the background of dollar firmness as the Fed gradually lowers monetary stimulus, all five countries could see fresh volatility. There will be increasing diversity of performance. The appellation 'BRICS' to denote a mythical group of up-and-coming countries has never looked less useful.



Taper debate goes on as Fed board shifts

Some remain wary on economy, employment

Darrell Delamaide, US Editor

The Federal Open Market Committee faces several changes in the New Year, with a new chairman and four different regional bank presidents rotating into voting positions. But the debate remains very much the same: how quickly to taper the Federal Reserve's large-scale asset purchases.

After the decision last month to cut the bond purchases by $10bn to $75bn a month, opinions remain divided.

Boston Fed chief **Eric Rosengren**, who rotates out of a voting position in 2014, formally dissented from the decision to start tapering in December. Rosengren issued a statement after the meeting explaining his dissent.

While he agrees that the economy and employment situation in the US are improving, thanks in part to the Fed's quantitative easing, both inflation and unemployment remain far removed from Fed targets.

'Thus, my decision to cast a dissenting vote was focused on counseling patience in removing monetary accommodation,' the Boston Fed chief said. 'The US economy remains far from the 5.25% unemployment rate that I believe is consistent with full employment, and total personal consumption expenditures inflation, at only 0.7%, is well below the Federal Reserve's inflation target of 2%.'

Rosengren, one of the most outspoken doves on the committee, reiterated his standpoint at subsequent speeches in Hartford and Philadelphia.

Esther George, the head of the Kansas City Fed, was able to abandon her routine dissent based on concerns about the effects of quantitative easing and vote with the majority in favour of reducing the asset purchases. However, she rotates out of a voting position this year.

Richmond Fed chief **Jeffrey Lacker (non-voter)**, another hawk, explained his support for tapering at a bankers meeting in Baltimore.

'I supported this decision because it was consistent with the linkage the committee established between the asset purchase programme and the outlook for labour market conditions,' he said. 'I expect further reductions in the pace of purchases to be under consideration at upcoming meetings.'

For his part, **Richard Fisher**, head of the Dallas Fed and a non-voter in 2013, told a television interviewer that he had argued in favour of an even bigger reduction in bond purchases – $20bn instead of $10bn. 'I think the market could have digested that,' he said.

But support for the tapering did not come only from hawks. San Francisco Fed chief **John Williams**, a dove, also voted in favour and sees further reductions in coming months.

'With the economy having improved so much and the future looking brighter, it was time to start taking our foot off the accelerator and ease up on the monetary stimulus,' Williams told an audience in Phoenix.

Williams, who rotates out of a voting position this year, continued: 'Assuming the economic recovery plays out as we expect, we will likely continue to reduce the pace of those purchases, and eventually eliminate them, over this year.'

Charles Plosser, the hawkish head of the Philadelphia Fed who rotates into a voting position this year, raised the possibility that the Fed might not only slow monetary accommodation by reducing asset purchases but even tighten policy by raising interest rates. At an economic conference in Philadelphia, he said the Fed may find it necessary to act sooner than 2015 on interest rates.

William Dudley (voter), head of the New York Fed and a firm supporter of quantitative easing, confessed at the same conference that policy-makers don't really know just how it works.

'We don't understand fully how large-scale asset purchase programmes work to ease financial market conditions – is it the effect of the purchases on the portfolios of private investors, or alternatively is the major channel one of signalling?' he asked.

Most Fed watchers expect the rotation of voting members in 2014 to tilt the panel slightly toward the hawks, as super-doves Rosengren and Chicago Fed chief **Charles Evans** rotate out, and Plosser and Fisher rotate in.

However, Kansas City's George is also rotating out, while **Narayana Kocherlakota**, the Minneapolis Fed chief who has turned fiercely dovish in championing sharper reductions in unemployment, rotates in.

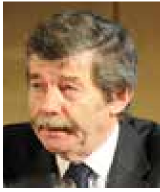
There is also a question mark over the Cleveland Fed, which gets a vote in 2014, as current president **Sandra Pianalto** prepares to leave once a successor is named.

In any case, the accession of Vice Chairman **Janet Yellen (voter)** to the chairmanship – the US Senate confirmed her appointment earlier this month – guarantees a continuity in policy.

The board of governors, which will be reduced to four when Chairman **Ben Bernanke (voter)** leaves at the end of the month and **Sarah Bloom Raskin (voter)** departs for her new Treasury post, generally votes as a bloc, and can easily tolerate a dissenter or two among the five regional presidents.■

Darrell Delamaide, member of the OMFIF Board of Editors, is a writer and editor based in Washington.

Janet Yellen with three Fed predecessors: from left, Paul Volcker, Alan Greenspan and Ben Bernanke, at the Federal Reserve building on 16 December, 2013, where the Fed's 100th birthday was commemorated with former, current and future chairmans.



You can have it so good – again

Why apostles of secular stagnation have got it wrong

William Keegan, Chairman, Editorial & Commentary Panel

Every January, the British financial press is replete with forecasts for the next 12 months. Even the OMFIF Bulletin has got into the act. Sometimes the pundits look back apologetically at what they got wrong; indeed one economics commentator almost used to boast shamelessly about his mistakes.

Your correspondent did not get where he is today by making such forecasts. I have always seen my role as to provide commentary and analysis, but not foolhardy predictions.

What struck me at the turn of 2013 and 2014 however was the way that some commentators and analysts were not confining themselves to cyclical predictions, but were also highlighting what they regarded as secular trends.

Let me hasten to point out that by 'secular' economists are not referring, as the Jesuit teachers of my youth were, to the 'non-religious.' No, they are looking for longer term developments, secular changes.

Shortly before Christmas, the American economist, Lawrence Summers, raised the question whether economic growth as we have come to know it could no longer be taken for granted. In this he was following his fellow American economist Robert Gordon, who had started this rather earlier.

What interested me about Summers was that here was a good Keynesian who, to my mind, had played an important role in attacking the 'economics of austerity,' implying that, at least until recently, he had been essentially optimistic about economic potential generally.

His particular concern is that in recent decades periods of expansion have been dependent largely on 'bubbles,' and that this was both unsatisfactory and hardly a basis for sustained expansion. He is thinking mainly of the US. But, even as I write, the British coalition government has given every impression of shifting its economic strategy from 'rebalancing' to reliance on a cynically-conceived boom in credit and house prices – indeed, the creation of the kind of 'bubble' that contributed handsomely to the 2007-08 finance crash.

Some more fatalistic political commentators are saying that there is no law that says each generation must be more prosperous than the last. Well, yes, we all know about the Decline of the Roman Empire, the ups and downs of China, and how Argentina lost its place during the 20th century from being one of the top four world economies.

But the story of recent decades has been of economic growth, and remarkable adaptation to those 'shocks'. When I was covering the economic news for the Financial Times in the early 1970s, there was much gloom about what the oil shock portended for economic growth, propagated in particular by the Club of Rome and the Massachusetts Institute of Technology.

Somehow the world adapted and growth resumed. Indeed, the 'stagnation thesis' tends to crop up every 40 or 50 years or so. It has its very own secular trend.

I am more impressed by the secular impact of climate change. We have our very own example in Britain, where the recent floods have even impressed some climate change 'deniers.' And in London the Thames Barrage has been used far more frequently than its designers expected.

Oh, and by the way, adapting to climate change ought to provide all sorts of technological breakthroughs to assist the continuation of economic growth.▪

William Keegan is Senior Economics Commentator at the Observer.

Governments build up real estate assets – not just in the mainstream (...continued from page 5)

North American market were trophy assets, for example in Abu Dhabi's 2008 purchase of 90% of the Chrysler Building in New York.

Sovereign funds are increasingly partnering with local real estate companies which can take over on-the-ground asset management. Sovereign funds have built up involvement in vehicles such as private funds and distressed funds. A study by Preqin in November 2013 shows that these entities invest in both core and non-core portfolios, with 74% of these investments going to opportunistic funds and 65% of them go to value-added funds.

Governments' penetration of real estate has multiple implications, ranging from the tax treatment of Real Estate Investment Trusts and related instruments in the US and elsewhere to issues of sovereign immunity and legal restrictions by host countries.

In the US, sovereign investors that become equity owners of REITs enjoy a favourable tax rate. The sovereign fund can sell its shares without being subject to US tax and all income is taxed as a capital gain. Further initiatives are underway to modify the rules to allow more sovereigns to invest in US infrastructure and real estate.

The US and Canada have a very supportive legal environment for foreign investors in local real estate markets – an attribute that North America shares with the UK.

The recession opened new opportunities for sovereign financial vehicles, which have started to enter the distressed real estate market. Sovereign funds started to express their interest in assets that have gone through bankruptcy procedures. GIC, one of Singapore's sovereign funds, served as a stalking horse bidder for MSR Resort Golf Course in 2012, when the pool of potential private buyers was limited. While the number of bankruptcy cases is declining with the economic recovery, foreign governments are likely to continue to penetrate distressed market. The transparent nature of the bankruptcy process helps private owners to interact with sovereign governments, a factor that can contribute to overcoming traditional reticence associated with perceptions of undue secrecy and conflicting interests.

The US administration screens foreign investments, but the limited transferability of real estate facilitate approval of potential transactions in many cases. Nonetheless, following the 2011 terrorist attacks, the US government identified hundreds of commercial skyscrapers that might be blocked for a foreign buyer.

Roughly 75% of state funds invest in the North American real estate market. Yet in a search for returns and diversification strategy, non-core markets, including in Africa, will gain ground in coming years as sovereign entities build up investment appetite and expertise outside the mainstream. ▪

Dr. Efraim Chalamish, member of the Advisory Board, is a law and economics professor and adviser.

More monetary divergence in 2014

ECB must take responsibility for broad money growth slide

Gabriel Stein, Chief Economic Adviser

For some time, differences in broad money growth among the major world economies have given rise to expectations of diverging activity in late 2013 and into 2014. I highlighted these concerns in the July 2013 Bulletin (p. 8-9); that prediction has since come true. Worryingly, broad money developments over the past six months imply more divergence in 2014.

US broad money growth

Annual US broad money growth (referring to my recreation of the broad money measure M3 that the Federal Reserve ceased to publish in March 2006) has held up reasonably well over the past year, generally oscillating around 5%. Assuming a US trend real growth rate of 2-2½%, an inflation target of 2% and a long-term decline in the velocity of money of slightly more than 0.5%, 5% annual broad money growth is barely consistent with medium-term trend GDP growth. Over the longer term, broad money growth should ideally be stable at between 4% and 6%.

However, the US economy is still exiting from a deep crisis; in the third quarter of 2013 real GDP was 5.5% above its pre-crisis peak in the fourth quarter of 2007. If GDP had grown at an annual 2½% since then (arguably, still a below-trend rate, given that trend growth in the early 2000s was estimated at 2½-3%), it would today be 15% above its 2007 level and close to 9% above its current level. It would therefore be more propitious for growth if US broad money growth were stronger than 5%, perhaps in the 7-10% range for the next six to 12 months.

The outlook for US broad money growth is muddied by issues related to the Fed's eventual tapering of its quantitative easing. On the one hand, credit data show that American households are taking on more debt, including some remortgaging loans to take advantage of higher house prices.

On the other hand, banks are being constrained by regulatory insistence on holding fewer risk assets. Banks have been able to expand their balance sheets (i.e. increase credit and broad money) by amassing large amounts of cash.

But, once the Federal Reserve begins to taper, that turns off the cash tap for banks. Which of these two forces is the strongest is the key to the outlook for the US economy in 2014.

The outcome is difficult to judge, but recent non-monetary data have generally been stronger than expected, implying that, although growth in the fourth quarter of 2013 is likely to have been weaker than it was in in the third, US economic activity should improve further in the fourth quarter of 2013.

In contrast with the US, the Chinese authorities have attempted to dampen broad money and credit growth in 2013. This has at best been met with limited success.

China M2 growth

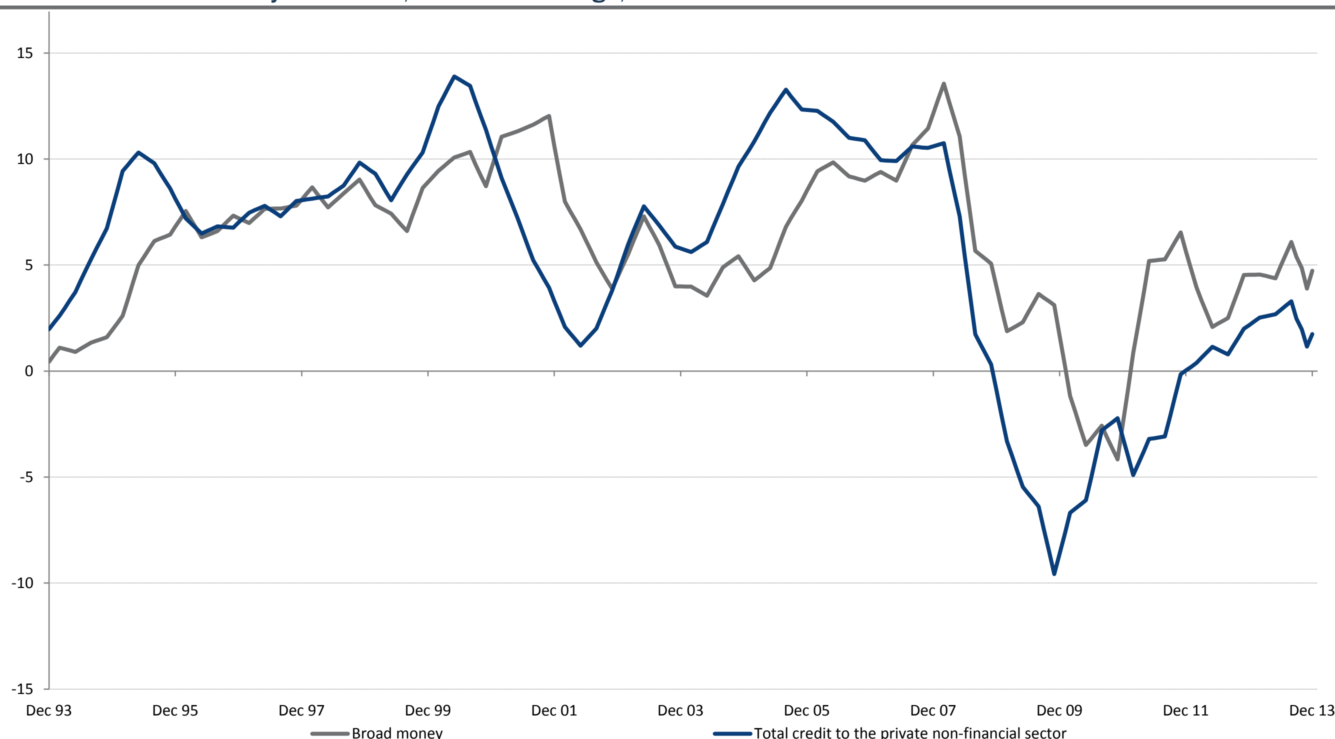
The People's Bank of China had a 13% target for M2 growth in 2013, down from 14% in 2012. In 2012, M2 growth averaged 13.5%, and ended the year at 13.8%.

By contrast, in 2013, the average 12-month growth rate over the period January-November was 15%; while November M2 was up 14.2% on a year earlier.

It therefore looks likely that broad money growth for the whole year will overshoot the central bank's target. The overshoot is not particularly large – around 1% – but what is significant is that it occurs at all. Money and credit growth picked up in 2013 instead of the intended slight easing.

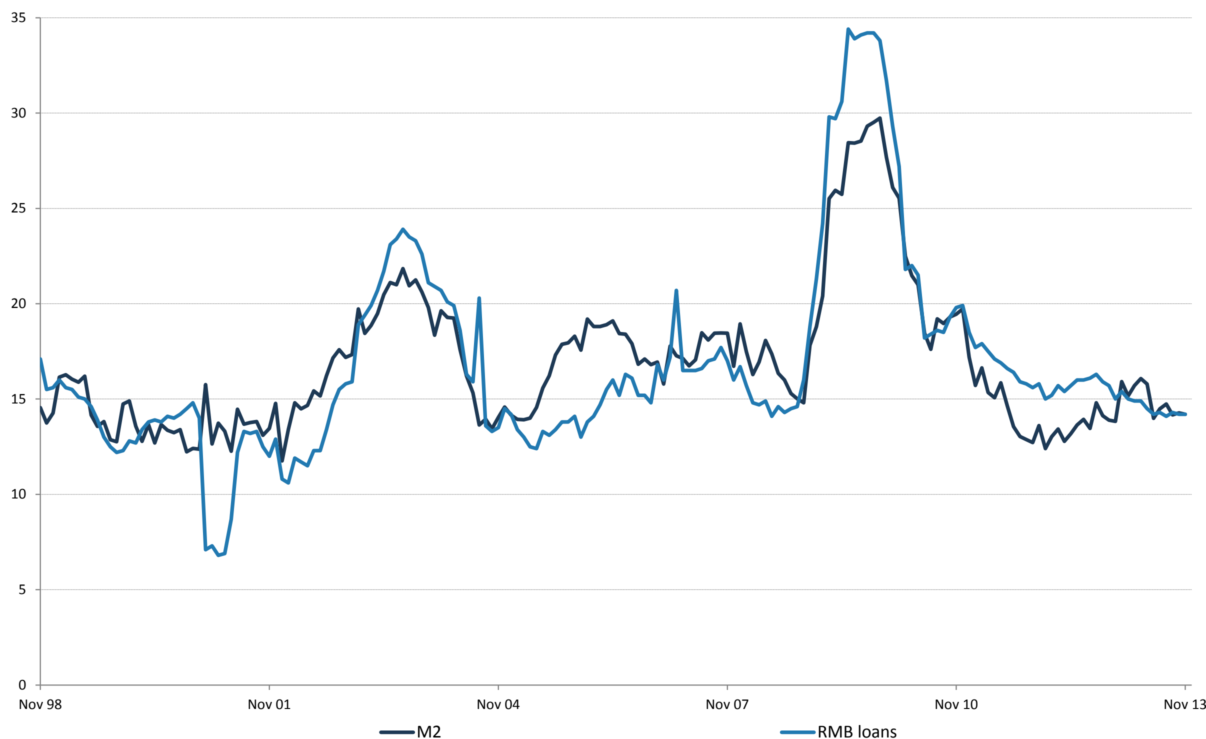
China's 13-15% broad money growth is slower than the average of the pre-crisis

Chart 1: US broad money and credit, 12-month change, %



Source: Federal Reserve, Stein Brothers

Chart 2: Chinese broad money and credit, 12-month change, %



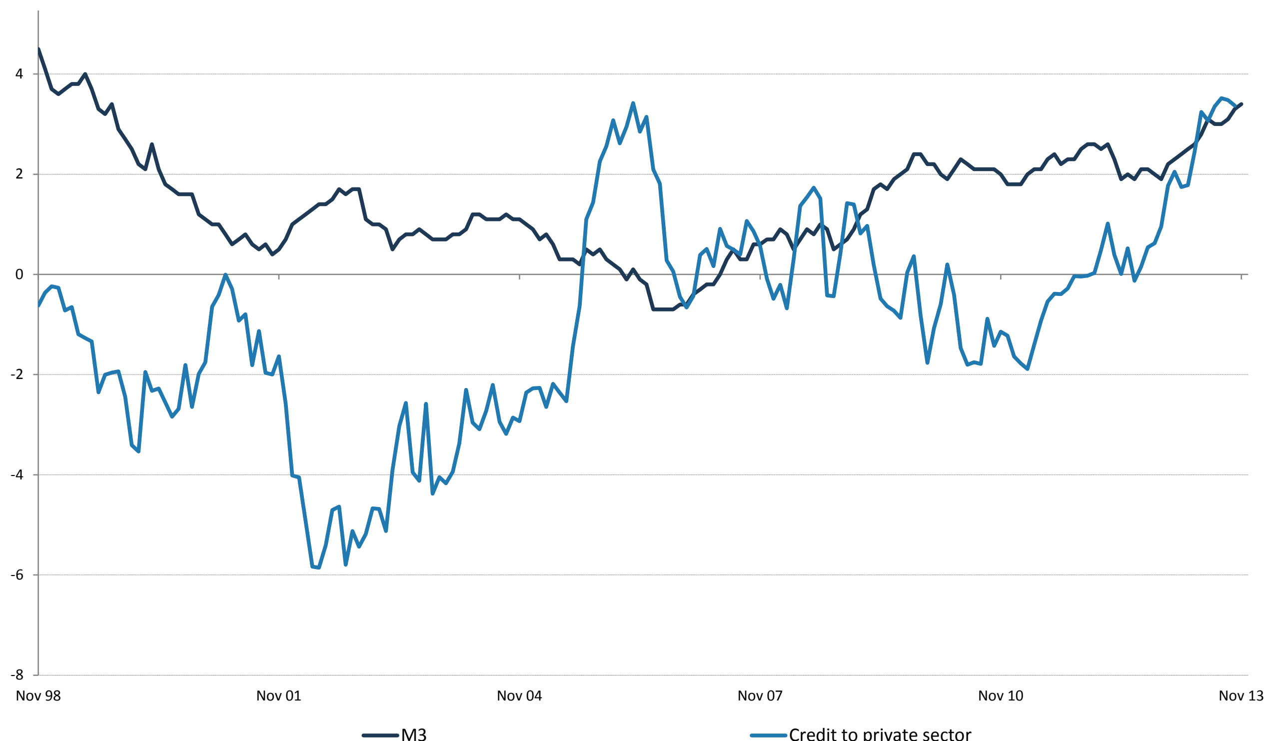
Source: Haver Analytics

2000s, which exceeded 16%. However, it is probably enough to be consistent with the likely 7% GDP growth target for 2014, which is probably China's trend growth rate. While there are question marks over China's medium- and long-term growth as a result of the economic reforms the leadership is trying to implement, the near-term outlook is still looking relatively positive. In a recovering world economy, China will benefit.

The UK and Japan resemble the US more than China. Broad money growth is healthy but should ideally be somewhat stronger. Nevertheless, in both countries, broad money growth has ended 2013 on a reasonable note, implying that economic activity will strengthen in 2014.

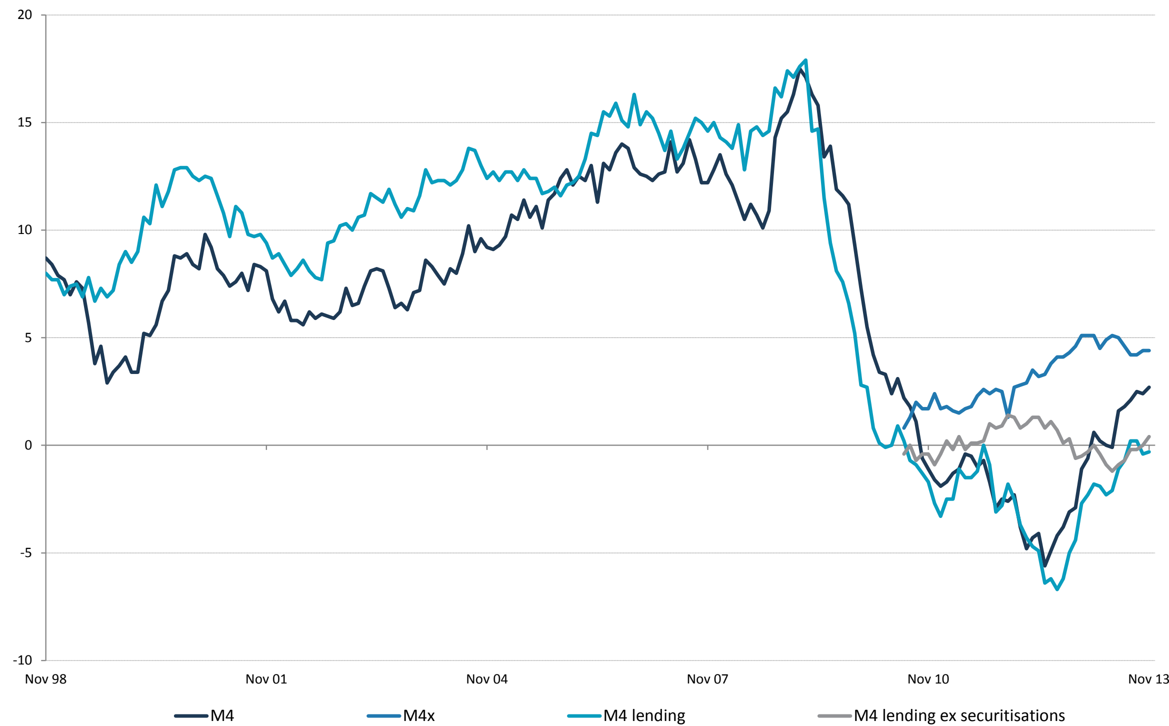
Even though the main thrust of Japan's 'qualitative and quantitative easing' has been aimed at boosting the monetary base, broad money growth has benefited. M3 grew by 3.4% in the year to November, the fastest rate since August 1999, primarily sustained by credit growth. M3 growth has been above 3% since last May. This should be enough to improve Japanese trend growth (estimated at around 1%). Japan needs growth above trend

Chart 3: Japanese broad money and credit, 12-month change, %



Source: Bank of Japan

Chart 4: UK broad money and credit, 12-month change, %



Source: Bank of England

to ignite inflationary pressures and fulfil the aim of overcoming deflation.

UK broad money growth is somewhat less positive than Japanese. Not because it is slower. In fact, it is faster, at around 4½%.

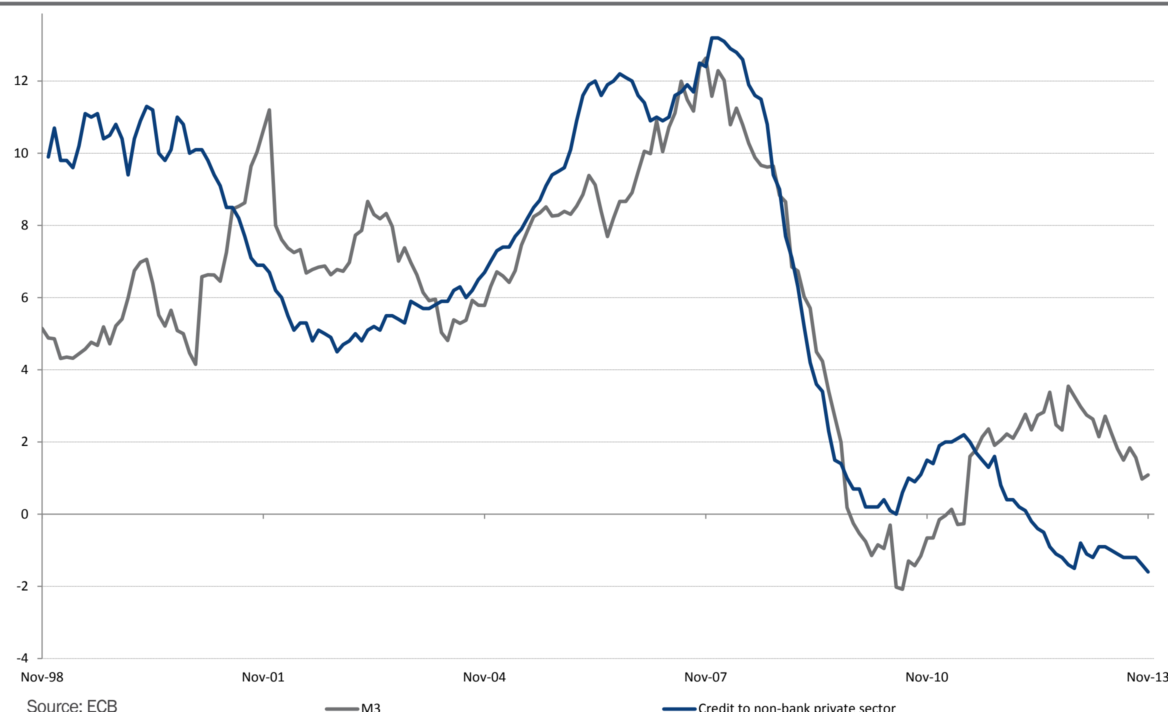
However, where Japanese broad money growth is accelerating, the growth of British broad money has eased slightly in recent months, from around 5% per annum to between 4½% and 5%.

In contrast with the Japanese situation, British broad money growth – supported by a Bank of England policy specifically aimed at increasing the stock of M4 – has not been accompanied by stronger credit growth. Credit has gone from contracting to being unchanged year on year.

Weak credit growth is not necessarily surprising. As I have pointed out before, central banks' myopic fixation with credit growth was always misguided. A debt-induced crisis cannot be solved by making the private sector take on more debt. However, as in the case of the US, British broad money growth is probably enough to improve trend growth in the medium term, assuming a trend growth rate in the 1¾-2¼% range and an inflation target of 2%, with a small fall in the velocity of money. In another parallel with the US, recent data have confirmed a clear recovery. This is likely to accelerate somewhat in 2014.

Broad money growth in the major economies has not been stellar, but has been

Chart 5: Euro area broad money and credit, 12-month change, %



Source: ECB

indicative of activity around trend. This is most emphatically not the case with the euro area. As I and other commentators have been pointing out for months, the continued deceleration of 12-month broad money growth, from above 3% at the end of 2012, to between 1% and 2% in the first half of 2013 and below 2% since then, is deeply worrying. In November, euro area M3 grew by 1.5% from a year earlier.

Sluggish growth in M3

The very sluggish growth in M3 is partly due to euro area banks continuing to shrink their balance sheets, including for regulatory reasons. Difficulties in agreeing on a European banking union are likely to exacerbate this trend.

The European Central Bank has made it clear that some banks will be found to fail its impending asset quality review (AQR). It therefore makes sense for banks to shed bad loans and accelerate the building up of buffers. (A case in point is Spain, where the private sector bankruptcies are increasing as banks foreclose on doubtful and bad loans to improve their balance sheets prior to the AQR.) These developments indicate that broad money growth will be further constrained in 2014.

The euro area trend growth rate is likely to be around 1%. Given an inflation target of 2% and a slight long-term fall in the velocity of money, the broad money trend growth rate consistent with medium-term trend GDP growth is likely to be in the 4-6% range.

As noted for the US, the UK and Japan above, in this phase in the cycle, it should ideally be considerably faster. The fact that it is not, implies that euro area growth is likely to disappoint in 2014. That, indeed, is the message from recent data.

The euro area recovery has already been weaker than in the US. While US GDP is 5.5% above its pre-crisis peak, euro area GDP remains 3% below that peak.

This growth divergence is likely to accelerate in 2014. And monetary policy, too, will remain divergent. The Federal Reserve has now initiated its QE taper; it will likely bring its asset purchases to zero over the course of the year.

Bank of England policy

The People's Bank of China is likely to continue its attempts to gently dampen M2 growth. Bank of England policy is likely to remain on hold, with the date for the first interest rate increase moving forward from 2016 to 2015 or possibly even late 2014.

By contrast, the Bank of Japan will continue its highly accommodative monetary policy. And the ECB will attempt to ease policy further, whether by cutting interest rates to zero or by introducing negative interest rates on reserves, by talking down the euro or by other means. ▪

Gabriel Stein is Managing Director of Stein Brothers.

US 'will surprise markets' by raising interest rates

In the January 2013 OMFIF Bulletin I wrote that, relative to 2012, the global economy would gain a bit of momentum but generally be disappointing, ***writes Michael Kaimakliotis Zurich.***

I predicted that policy-makers would increase the pace of monetary easing, investors would have to allocate more wisely as bond markets would fall and equities would rise (in 2012 everything went up) and that Japan's currency would fall, spurring equity market gains. This largely transpired.

Could 2014 be a repeat performance? One feature is likely to differ greatly. We can expect the Fed to raise interest rates before the end of 2014 as the US central bank seeks to boost the real economy by reducing financial repression.

Economic outlook

In 2014, the economic outlook is brighter than at the start of 2013. Fiscal tightening will slow. Growth should therefore accelerate moderately. There are areas of pent-up demand, so growth could surprise on the upside.

But the big picture is that the world is plagued by excess supply due to two factors: globalisation (the integration of emerging markets labour into the global supply chain) and investments that were made to meet credit-fuelled demand and are now proving to be unsustainable.

The remnants can be seen in high unemployment, low industrial capacity utilisation and a massive debt overhang. The fundamentals of the global economy are still deflationary. In such an environment it is difficult to see how a virtuous cycle can emerge.

With excess supply and modest demand growth, why should companies invest? Central banks have been doing their best to promote 'animal spirits'. But this is dangerous unless it's supported by improving fundamentals. I believe that the Fed may now seek to promote demand by reducing the strength of financial repression. The central bank can do this by raising interest rates.

This would act as a tax cut putting money in the hands of poor and lower middle class families. The financial sector would be a loser. But the federal government would suffer bigger losses as borrowing costs would rise.

Since the US has successfully slashed its budget deficits in recent years, a modest increase in borrowing costs could be accommodated.

I expect the Fed to surprise markets in 2014 by raising interest rates. The market places a likelihood of only 7% that the Fed will raise rates by the end of 2014. That means there would be a considerable element of surprise if my expectations prove correct. As the US tightens policy, Europe and Japan may ease further.

Many emerging market economies will be reluctant to raise rates if the Fed does. This could be the key theme for 2014 with investment implications across and within all asset classes.

Absolute returns

What does this mean for markets? Absolute returns may be shifted lower relative to 2014. But the relative performance across asset classes is likely to be similar. Bonds will underperform as investment flows favour equities and credit spreads will not be able to tighten to the degree they did in 2013.

The dollar will continue to strengthen (many investors fail to realise that the US currency has been quite strong despite its weakness against the euro). I see no signs that inflation will pick up; in fact, it will be restrained by falling oil prices.

This could be the 'neither too hot nor too cold' scenario investors dream of. Active management will remain crucial however. A strong dollar is a major risk for a world where 'debt crisis' will increasingly refer to emerging market economies rather than developed countries. This will be the second main feature of 2014.▪

Michael Kaimakliotis is Head of Investments at Quantum Global Investment Management.

Liquidity and monetary policy

Relationship between bank funding and central bank action

Moorad Choudhry, Advisory Board

There is a strong relationship between money supply, bank liquidity and monetary policy. The causality was viewed traditionally as being from monetary policy towards bank funding, with central bank base rate setting and open market operations a strong influence on bank lending volumes and funding costs. However five post-crash years of extremely loose monetary policy, including quantitative easing (QE), have complicated this relationship. Understanding the changing nature of this interaction has important policy implications.

Numerous studies demonstrate a strong positive correlation between bank balance sheet growth and the easing and tightening of monetary policy. This is more accurately described as a two-way relationship. Bank funding costs and capital market volumes react to changes in monetary policy concurrently. And central bank policy-makers have monitored balance sheet volumes of both cash and derivative instruments as key indicators when setting monetary policy.

Even before the crash we could observe a circular relationship, with banks in effect responding to monetary policy – which itself is set partly following observation of the behaviour of bank lending volumes. This reflective relationship poses problems when attempting to confirm causality. One of the most relevant issues that arises from this is: How can output be stimulated when monetary policy is already very loose?

Central banks need to consider both capital market and commercial bank lending volumes when setting policy. For example, data from the US market suggest that wholesale volumes have a closer alignment to policy rate setting than bank lending volumes (see Chart 1).

All market activity is sensitive to rates and the interest rate cycle, but Chart 1 shows commercial bank lending is slower to react. It would appear that monetary policy easing can act to release liquidity – at the macro level – but this doesn't feed through to commercial lending, at least not in the short term.

This is an important point for policy-makers looking to simulate lending growth and the wider economy. Easing policy to zero base rates does not necessarily drive down individual banks' overall cost of funds (COF). So, bank customers do not automatically experience a corresponding fall in borrowing rates.

Chart 1 shows the positive correlation between market volumes and the cycle of monetary policy. But after five years of near-zero base rates and QE, the direct causal relationship, to the extent that it ever fully existed, has broken down: a Japan-style scenario, reflecting the breadth and depth of the European recession. The wholesale markets are no longer the prime policy-sensitive indicator for central banks, as volumes have not recovered. At the short end, inter-bank lending remains depressed, while at the long end some product classes in certain markets such as corporate loan securitisation issuances have yet to recover to even 30% of their pre-crash levels.

The issue is complicated further by leverage. Financial institutions leverage levels generally are positively correlated with the economic cycle, so that central banks regard them to be another policy transmission indicator. The relationship is demonstrated in Chart 2.

In the conventional scenario banks exhibit greater leverage with larger balance sheets, and leverage levels are often considered predictors of economic output contraction. On this basis one would expect leverage to increase as the economy recovers. But in 2014 a significant challenge for the financial industry is the soon-to-be-implemented regulatory requirements of Basel III, which impose a 3% leverage ratio limit. National regulators have a desire to reduce leverage levels, adding opacity to the relationship of leverage levels to monetary policy.

When pondering today's relationship between liquidity, funding and monetary policy, we must accept that while monetary policy action can release liquidity, it doesn't necessarily feed through to reducing banks' COF and/or increasing lending volumes.

Fluctuations in the funding environment have an impact on macroeconomic variables, but commercial lending volumes have less predictive power, and are less influenced by monetary policy decisions than previously supposed. This has implications for both central banks and commercial banks.

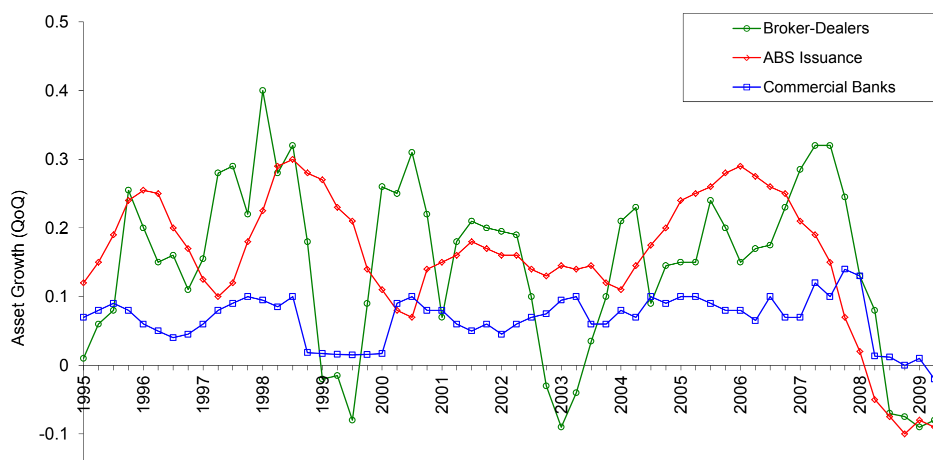
Consider the current environment of excess liquidity at the macro level, a result of policy easing by the US Federal Reserve, Bank of England and European Central Bank. (The ECB has not implemented an explicit QE programme but its implicit underwriting of euro areas sovereign bond credit risk together with its three-year term lending facilities have had a similar impact.) This central bank action has resulted in excess liquidity for the banking sector overall. But its impact on wholesale funding rates and the term liquidity premium (TLP), while marked, has not been commensurate.

The effect of surplus liquidity at the macro level combined with challenges over individual bank balance sheets and forthcoming regulation has been paradoxical.

Banks have reduced wholesale funding levels (in parallel with targeting greater volumes of customer deposits) via reduced issuance, debt buy-backs and so on, but still experience relatively high costs-of-funds – despite base rates being at zero. So central banks targeting the pre-2008 orthodoxy of wholesale volumes and interest rates will not be getting an accurate picture of the impact of their policies at the customer level.

Pre-crash the Libor term liquidity premium,

Chart 1: Growth rate of assets (QoQ), US market 1995- 2009



Source: US Flow of Funds, Federal Reserve

as measured by the spread between the overnight index swap (OIS) rate and the Libor rate, hovered around the 12-18 bps mark. In the immediate aftermath of the crash this widened considerably, up to 360 bps for dollar funding, before dropping back to pre-crash levels.

One would expect banks' TLP to fall back once central bank base rates fell to virtually zero. However this hasn't been the case, nor has there been any accompanying one-for-one reduction in bank term COF levels. Obtaining a specific individual bank TLP is somewhat problematic, as one has to strip out the bank's own issuer-specific risky credit spread. But wholesale rates indicate that both term TLP and COF are still high – despite sustained policy easing. For example, five-year term rates in euros for an A-rated European bank during the fourth quarter of 2013 were as follows, according to Bloomberg:

- Asset-swap 103 bps
- Pay-fixed interest-rate swap 95 bps

The sovereign five-year rate was 52 bps. For the bank in question this implies overall issuer credit risk of (103 – 52) or 51 bps. If monetary policy transmission was as influential as it was deemed to be pre-crash, the bank's five-year TLP should be low, perhaps less than the (103 – 95) or 8 bps implied by the cash versus swap spread noted above. But proxy indicators for the TLP suggest otherwise. For example:

- The vanilla swap rate versus the overnight index swap rate implied five-year TLP in euro of 39 bps. The secondary market own credit structure implied five-year TLPs of 53 bps;
- The new issue premium implied a five-year TLP of 29 bps.

After nearly five years of zero base rates, the term liquidity premium for a reasonably typical European bank is still up to twice pre-crash levels. This demonstrates the partial breakdown of the previously more direct relationship between liquidity, funding and monetary policy.

How should banks react proactively to changing monetary policy? They should start from recognition that financial intermediaries play a role in monetary policy transmission through credit supply. When setting funding policy, practitioners should note that central banks themselves see the main importance of short-term interest rate-setting as driving the long-term rate. This reflects orthodox finance theory which views the long-term rate as essentially the risk-adjusted expectation of future short rates.

While the short-term rate is important, its reduction to very low levels does not necessarily reduce the bank COF – which incorporates the credit risky curve – to equivalent low levels. European banks have reacted to this with a concerted effort to reduce reliance on wholesale term funding by building up 'customer' deposits. For example UK banks' customer funding gap has fallen significantly from more than £900bn in 2008 (see Chart 3).

Although customer deposits are behaviourally similar to contractual long-dated funds, they are not a complete solution. For many banks, there remains a need for recourse to some wholesale term liabilities. So far, central bank monetary policy action has not impacted materially the cost of such funds.

The implications are clear. A period of sustained zero base rates will inevitably be followed by a rise in rates, so wholesale COF will rise from already high levels. The liquidity requirements of Basel III are a challenge from the perspective not only of regulation but also of term funding.

For European banks, funding levels are still materially above Libor-flat across the term structure and long-term rates reflect a solid positive sloping curve. While the investment grade-rated sovereign curve may be fairly flat in the two-to-10 year space, banks' COF rates are not. In other words the transmission of monetary policy through to bank liquidity and actual bank term COF has broken down somewhat.

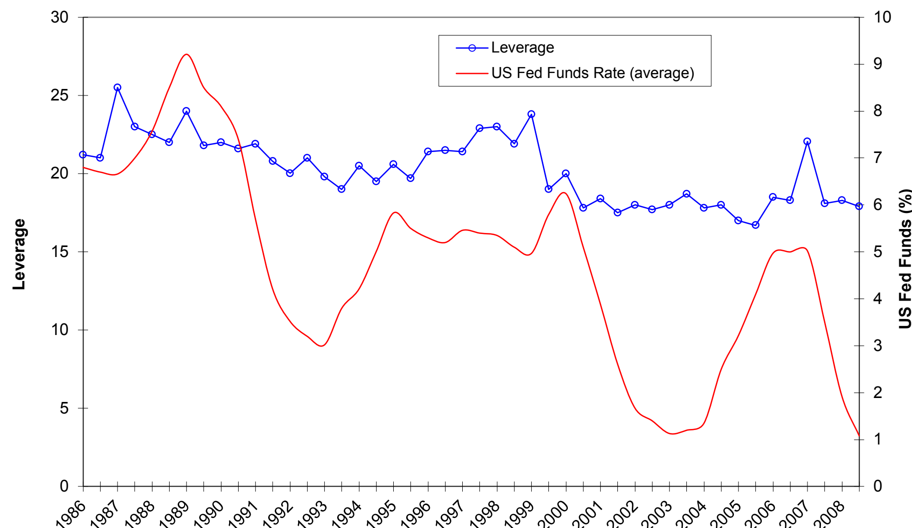
Central bank action has created a surfeit of liquidity at the macro level, and crucially depressed the market's Libor term liquidity premium but specific bank own-credit-issuer risk and TLP remain high.

The conclusions for funding policy are that banks' COF will rise as monetary easing is unwound. For a number of banks, wholesale term funding still looks difficult as a term funding option. Stable customer deposits, while not a panacea, remain highly important for ensuring banks' funding stability.

The market reaction, with respect to lending volumes and customer borrowing rates, remains the key item of focus for central banks once they start to unwind the loose monetary policy that has been in place since 2009.■

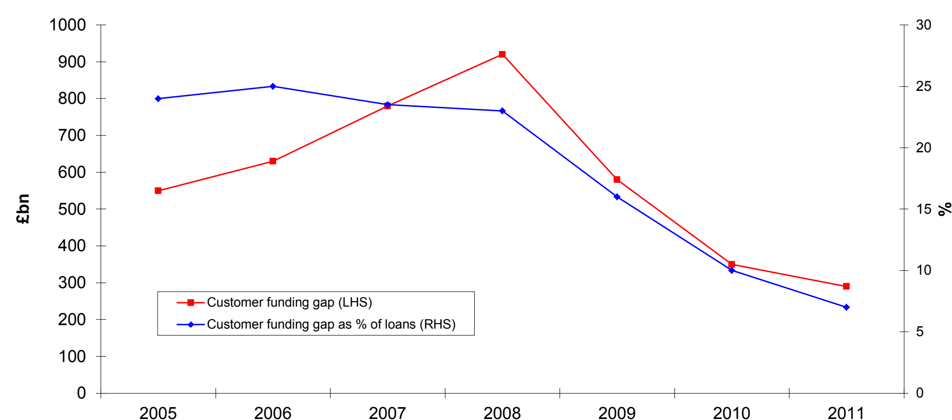
Prof. Moorad Choudhry is IPO Treasurer at RBS Group Treasury.

Chart 2: Average leverage of US primary dealers, 1986-2008 against Fed Funds Rate



Source: US SEC and US Federal Reserve

Chart 3: UK bank customer funding gap, 2005-2011



Source: Bank of England

The man who's seen it all before

Schmidt the realist celebrates 95 years with warning over Greece

Helmut Schmidt, West German Chancellor between 1974 and 1982, who celebrated his 95th birthday on 23 December, is still going acerbically strong, writes David Marsh. His no-nonsense views – on Europe, the US, China, Chancellor Angela Merkel, monetary union – are bathed in the relentless and somewhat wistful light of the man who has seen it all before. More forcefully than with many serving politicians half his age, they appear in line with reality.

He's far from euphoric about his Social Democratic Party, now recapturing a position in government in a Grand Coalition with Mrs Merkel's Christian Democrats. 'I believe that nearly everything in [the coalition agreement] is only of secondary importance. It would be of greater importance if it contained ways of overcoming our present problem: that European institutions are basically leaderless.'

In a country both obsessed with and afraid of tradition, which sometimes hesitates in reaching back through its history because of fear of what it might find, Schmidt has become an iconic figure. Iconoclastic, too. He seems to be the sole German exonerated from the country's strict anti-smoking regulations. During a 90-minute conversation with him in early December in his miniscule Hamburg office at the German weekly paper Die Zeit, I passively inhale the contents of half-a-dozen cigarettes.

Following the death of Nelson Mandela, Schmidt is probably now the best-known of the world's most elderly elder statesman. When he became chancellor in 1974, David Cameron and Enrico Letta, the present British and Italian prime ministers, were each aged seven. Barack Obama was 12. Poignantly, he admits to fellow-feeling with Wolfgang Schäuble, 71, who hails from the other side of the left-right divide, and has just been confirmed as Germany's finance minister. 'It's difficult for him to quit politics. Like me, he's in a wheelchair.'

On China, Mr Schmidt says: 'I am still optimistic. It's the only highly civilised country in the world that has existed for 4,000 years yet still exhibits signs of vitality. The Romans have gone, the Greeks have gone, the Ancient Egyptian have gone, the civilisations of Latin America have gone – we no longer have the Incas or the Aztecs – but the Chinese are still there. Perhaps it's a blessing for them that they never had a common religion but that they had an ethical, moral teacher called Confucius.'

With regard to the UK, he admits to permanent disappointment. 'My education has been pro-England. I have been an England-minded citizen of Hamburg and I am still in a way English-minded but I have been disappointed by the Brits over the years. I am not sure whether they will stay in the EU or leave it. …. The British claim to have a special relationship with the US, but if you mention this in Washington, no one knows what you are talking about.

Schmidt says the new German coalition government finally sworn into office three months after the 22 September general election should accept a strong dose of reality – but almost certainly won't. He says the country is rightly facing criticism of its high current account surpluses of around 7% of GDP. 'Neither the new German government nor the European Commission nor other member states will take serious action against it.'

Instead, with terrifying clarity, Schmidt says the come-uppance for Germany's high surpluses lies in inevitable debt restructuring for Europe's most disastrously over-borrowed country, Greece. 'The Germans will try to solve the problem by paying cash. The Greek debt problem remains with us. The Germans will pay by agreeing to reschedule the debt. …. European governments and the European Central Bank which are now among the most important creditors will have to write off some debts. The same is true for private banks and insurance companies. We will need a debtors' conference for Greece of the same kind that was convened to reschedule Germany's debts after the Second World War. …..Greece has a population of only 11m people. In comparison with the size of Germany against the rest of Europe after 1945, it is much smaller.'

Schmidt speaks precisely, pregnantly. German journalists who have been interviewing him (when they can) for 95th birthday articles and tributes to which he has reluctantly agreed are adamant: compared with his 90th birthday set-pieces, the man has become more concise. Schmidt cleaves through the infuriating obfuscation that is the hallmark of the German political class. Now well into his 10th decade, Schmidt has little time to spare.

What is your view of the coalition agreement between the CDU/CSU and the SPD?

I believe that nearly everything in it is only of secondary importance. It would be of greater importance if it contained ways of overcoming our present problem: that the European institutions are basically leaderless. But a major advance here is very unlikely to be the case. This problem will occupy us for the whole of 2014 and will spill over to 2015-16. In addition to that, Germany's huge, rightly-criticised current account surplus seems likely to persist. Neither the new German government nor the European Commission nor other member states will take serious action against it.

So how will Germany react to this criticism?

The Germans will try to solve the problem by paying cash. The Greek debt problem remains with us. For other countries, I am more optimistic. The Spanish debt problem will peter out in two, three or four years. The Italian problem is mainly domestic [because of the large amount of debt that the Italian state owes to Italian creditors].

So what will happen in the case of Greece? The government debt is 170% of GDP. That is surely unsustainable.

The Germans will pay by agreeing to reschedule the debt. I have just been reading the book 'This time it's different' by [Carmen] Reinhart und [Kenneth] Rogoff. It relates how many instances we have seen in the past where financial crises are brought on by states' failure to control budgetary debt….

Greece has had to default six times, I believe, since the modern Greek state was founded in the 1820s.

This is not new for Greece, it is not new for France and it is not new for Prussia. For Greece, European governments and the European Central Bank which are now among the most important creditors will have to write off some debts. The same is true for private banks and insurance companies. We will need a debtors' conference for Greece of the same kind that was convened to reschedule Germany's debts after the Second World War.

This could also be something like the Young Plan that was put together to reschedule Germany's debts after the First World War…

In the case of Greece, we need a Young Plan, a Dawes Plan. Greece has a population of only 11 million people. In comparison with the size of Germany against the rest of Europe after 1945, it is much smaller.

Are the German people ready for such a plan? No one has been speaking about this matter, in negotiating the coalition agreement.

That doesn't matter. The people will follow the government.

But the European Central Bank and the Bundesbank – the ECB holds about €30bn of Greek bonds – will say that rescheduling this debt is monetary financing of budget deficits and breaches the Maastricht treaty. What do you say to that?

That doesn't matter. It may of course not all happen in 2014. The wrangling will start then and it may take time. It will cost Mrs Merkel part of her personal credibility. But she can overcome that without too much difficulty.

The politicians will say that, by printing more money, the central banks can withstand the losses on their claims on Greece.

Of course, the central banks can print more money for the next two to three years. They can't do it for ever. It will spill over eventually into a higher rate of inflation. The higher prices we see [in Germany] at the moment in the form of higher asset prices and higher share prices may be warning signs. In the long run, inflation will occur…

You remember what Keynes said about the long run…

In the long run, we are all dead. At least I won't be around to worry about it. We can carry on at present without any great problems, at least for two to three years.

You have been analysing and speaking about the role of the European Central Bank for some time. What do you think of Mr [Mario] Draghi [President of the ECB], who made his famous statement 18 months ago promising to 'do whatever it takes' to save the euro?

He has to some extent enlarged the radius of action that he inherited from [Jean-Claude] Trichet. I don't have any criticism of him, nor of Trichet.

And what do you think of Mr Weidmann and the rest of your friends at the Bundesbank?

They are not my friends. Mr Weidmann is pursuing the normal strategy of the Bundesbank. Fortunately he's not the president of the ECB.

Mrs Merkel looks as if she is giving more support to the ECB than to the Bundesbank…

I wonder how much she has understood the complexity of the issues…..

Clearly she's worried that, if the euro were to break up, then this would lead to a colossal revaluation of the new German currency, which she thinks would be very bad for German exports.

Yes she knows that. But she needs to concentrate on the future of the European institutions. None of them is effective. Not the Commission. Not the president. Not Mr [Herman] Van Rompuy. Not Mrs [Catherine] Ashton. Not the European parliament. Not the regular meetings of the European heads of state and government. The only institution that works is the European Central Bank.

What will happen when the US Federal Reserve finally starts to withdraw the monetary stimulus? Could this be a rerun of 1979-80 when the Americans under Paul Volcker tightened credit – which you as Chancellor were calling for at the time? This led to a big fall of the D-Mark and the Bundesbank having to raise interest rates in the early 1980s, with great problems for the German economy?

The Americans, with their monetary easing, have been doing what Alan Greenspan did for a long time although with the introduction of the Euro the monetary setting in Europe has certainly changed. However, Europe can not influence the policy of the Fed. We should rather focus on reducing the structural imbalances within the Eurozone.

When you think back to the establishment of the euro, there were many great aspirations for Europe: to achieve political union, to improve the economy, to increase Europe's importance in the world, to stand up to the Americans. What has happened to that dream?

It was more than a dream, it was a self-delusion. The construction of the ECU [European currency unit] was much saner than that of the euro.

What do you mean by that? Do you mean the ECU was a common currency; it wasn't a single currency?

It was imaginary. You couldn't touch it. You revalued or devalued your own currency against the ECU.

But that was not a monetary union. That was just a mechanism. It was called the exchange rate mechanism. Are you saying that was better than the euro?

It's useless to philosophise whether it was better or not. We have the euro now, we do not have the old mechanism. All sorts of mistakes were made by letting in too many countries. The Greeks were in the rear of the grouping of 12 countries at Maastricht. In 1991, the Greeks were Numbers 10, 11 and 12 with the Portuguese and the Spaniards.

And then came the decision to enlarge the Community ….

Yes they made the ridiculous decision to increase the membership for 12 to 28 and they also invited anyone who wanted to participate in the European currency. But that's a fact of life, you can't change it. You can see it in the case of Ukraine. The people who run the Commission tried to enlarge the realm of the European Union, even though they know that the institutions of Europe do not command sufficient public credibility. If they had their own way, they would enlarge the European Union to Georgia and Armenia.

Do you think Europe should have been limited to a 'hard core' of nations?

That may be what we will end up with. That could happen in the 2020s; it won't happen in the 2010s.

You used to say that Germany would never make any initiative in Europe without the French there as well… France and Germany do not seem to be functioning too well these days.

Yes I wish that slogan were still true. [President François] Hollande is a weak leader. And Merkel is a weak leader too, although she appears to be strong. She has grown up inside the GDR [German Democratic Republic]. She

was always longing for freedom, for liberty, not for Europe. It seems she has accepted the model of the European Community rather reluctantly, without much enthusiasm. Now she has to ask herself whether she is ready to make sacrifices for it. Right now, there are no leaders in Europe, nobody in the mould of Jean Monnet or Jacques Delors.

What will be the effect of all this?

Maybe less than it appears. You see a lot about the mood of Europe in the newspapers and on TV, but this does not completely catch the true sense. Deeper down, below the surface, there is a strong Europe-wide sharing of values, a sense that we have the same common civilisation.

If you look at the weakness of the European commission, isn't this partly the governments' fault? They wanted a weak Commission…

The European Commission has partly itself to blame for this anti-European feeling. Having such a large Commission, with 28 separate Commissioners – what nonsense!

Are you worried about the likely shift to radical anti-European parties in the forthcoming European parliamentary elections?

The majorities may suffer from a move to the Right, but altogether it will not change too much. I still think some kind of putsch by the European Parliament is necessary as it has no right of initiative on legislation. For example, I would wish that Europe could push through laws by decree such as making the Volcker rule [forcing a separation of banks' proprietary trading activities from their commercial banking] obligatory for banks throughout Europe...

What about Eurobonds or the mutualisation of debt? Is that something else that you think, in an ideal world, would be decided by decree?

Mutualisation will inevitably come. If we have a debtors' conference, then that will be one of the outcomes. Of course they will not call it Eurobonds. They will call it something else.

I must ask you: What do you think of Britain's future in Europe? If Britain did leave, what effect would that have?

In the long run, it's not all that important; the role of the European Union has been declining from decade to decade. If you look at the share of world production and of population it has been falling since 1900.

The man who has seen it all before, Helmut Schmidt, overlooks the Chancellery in Berlin, with Angela Merkel.

When you look back over a long life, and reflect on the different chancellors of Germany since the Second World War, leaving yourself out of course, how would you describe their work and their achievements?

Adenauer was a great leader, but as an economist he was non-existent. The German economic recovery of the 1950s was carried out by Erhard; later on, Adenauer was right when he said Erhard should never be chancellor. The same was true for Kiesinger Brandt was not an economist; the same was true for Kohl. Schröder was important for two reasons: one was the Agenda 2010, the other was the non-participation in the war against Iraq. Kohl was very important. In the midst of a period of world uncertainty, also with regard to what was happening in Russia. In November 1989 in a speech in the Bundestag he seized the moment. If you read the speech it does not seem all that important; but it was in fact revolutionary.

Wouldn't any German chancellor have seized the moment in the way that Kohl did?
At least Kohl did it. This is not speculation on my part. This is a fact of history.

With regard to China: You have been saying for 30 years that this is the future. Are you still reasonably confident about China's development?

I am still optimistic. It's the only highly civilised country in the world that has existed for 4,000 years yet still exhibits signs of vitality. The Romans have gone, the Greeks have gone, the Ancient Egyptian have gone, the civilisations of Latin America have gone – we no longer have the Incas or the Aztecs – but the Chinese are still there. Perhaps it's a blessing for them that they never had a common religion but that they had an ethical, moral teacher called Confucius.■

On the web

For the full interview, see www.omfif.org/media/470893/helmut-schmidt.pdf

Breaking up the euro to save the Union

Without federalism that no one wants, EMU cannot survive

François Heisbourg, Fondation pour la Recherche Stratégique

I am a European federalist who favours the dissolution of the euro. In the fullness of time, the European Union should be as deeply integrated as Brazil, India or the US. However, I have come to the conclusion that the policies implemented to save economic and monetary union (EMU) will eventually lead to the destruction of the European Union.

I do not regard the dissolution of the euro with enthusiasm. But to paraphrase Churchill's description of democracy, it's the worst solution apart from all the others. The euro is a brave experiment that has failed. The single currency was supposed to generate unity, stability and growth in an ever closer union. Instead, the European Union is deeply divided economically, socially and politically.

The European project has ceased to be a broad collective enterprise and is now reduced to solely one dimension: saving the euro. Electorates are turning sour, either as a result of endless austerity and staggeringly high mass unemployment, or as the product of the fears of citizens in creditor nations that they are taking over the debtors' liabilities in a less than transparent fashion.

The European parliament elections may turn into a voters' revolt. Europe's GDP is still below the pre-crisis level of early 2008. Job losses are rampant. In Spain, a country which unlike France or Germany respected the Maastricht criteria before the crisis, unemployment stands at more than a quarter of the workforce. This is the fault of the policies which we are following to rescue the euro.

They produce economic stagnation, growing disaffection vis-à-vis European integration and the risk of a British exit from the EU with severe strategic and political consequences. In the pre-euro era, different national economic performances were resolved through devaluations or revaluations, without posing an existential threat to integration. This was not ideal, but was much less punitive than today's circumstances.

By contrast with the orderly break-up of EMU that I now advocate, my natural preference would be a European federal state. A sustainable and effective single currency in a continent of deep divergence implies a large federal tax base (over 10% of GDP), substantial internal social transfers and politically legitimate and fully empowered institutions. This is what allows the US, India or Brazil to sustain the dollar, the rupee and the real.

Non-federal liabilities are not transferred to the union level. In the euro area we do the exact opposite. There is no serious federal tax base, no strong EU executive or legislative, and a transfer by stealth of country liabilities to the union-level. But woe betide any politician who proposes a 10% federal tax in the midst of a crisis. There is no political support for a federation in any EU country.

As an alternative we have a catastrophic implosion of the euro. In the summer of 2012, by threatening to engage in peripheral country bond purchases through Outright Monetary Transactions, Mario Draghi, the president of the European Central Bank, brandished the financial equivalent of nuclear deterrence. The euro was preserved. Market operators who had taken positions against the euro's survival were burnt and will hesitate before trying again. However, in the absence of federal structures, the euro will sooner or later once again lurch to the brink.

Precisely because the ECB has bought us time, we should look seriously at an orderly dissolution, in three stages.

The first would be the euro's demonetisation and replacement by national currencies. The political process would have to be initiated by France and Germany, possibly with other countries.

Second, after a period of capital controls, the European authorities would set new parities and recreate the erstwhile European exchange rate mechanism. Last, in a move that would save political face, the euro would be retained as a common accounting unit.

Acknowledging failure is never enjoyable. However orderly, an unravelling of the euro would be painful and dangerous, and would require strong accompanying packages for structural adjustment, particularly in France.

My approach is less risky than a return to the brinksmanship of 2010-12, and less traumatic than deeply-entrenched mass unemployment. And it offers the hope of saving the Union.▪

François Heisbourg, special adviser, Fondation pour la Recherche Stratégique, is author of 'La Fin du rêve européen'. This article is based on an article that first appeared in Die Welt.

ECB becomes stabilising force

Why Heisbourg principle creates more problems than it solves

Laurens Jan Brinkhorst, Advisory Board

My reaction to the undoubtedly well-meant advice by the serious academic but political layman François Heisbourg is: if you cannot stand the heat, get out of the kitchen! I have never met the author, but in the past I have appreciated his well-reasoned comments on European events.

In his new thinking, the idealist that Heisbourg certainly once was has turned into a disappointed, fearful cynic.

His argument to plead for an 'orderly' dissolution of the euro not only is defeatist but also demonstrates a lack of political intelligence and flies in the face of European realities. One may question whether the earlier decision to create monetary unity in Europe without a parallel move towards political union was in all respects correct. But the economic and monetary facts created over the last 20 years cannot be simply swept under the carpet.

Strengthening single currency

Filling void left by Maastricht treaty unfinished business

Ruud Lubbers & Paul van Seters, Advisory Board

At its most recent meeting, on 19-20 December in Brussels, the European Council significantly strengthened economic and monetary union (EMU). The banking union made a huge step forward. A significant breakthrough was reached with agreement on 'contracts' – now called 'partnerships' – between member states and the EU.

The start of these new partnerships will be prepared in the first nine months of 2014. This new instrument will fill the void of the unfinished business of the Maastricht Treaty of 1992, and will link economic governance to political union as the best way of generating more jobs, a more stable Europe and a more sustainable future. The new partnerships provide the required balance between the responsibilities of member states and those of the EU.

The required new political phase of EMU can start only after the May 2014 elections for a new European Parliament, followed by the installation of a new Commission. Given the rise of populism and euroscepticism, further political development of EMU is an uncertain business.

Many member states see a sharpening of opinions on either side of the European debate. There is increasing controversy about what can be decided in Brussels and what needs to be left to the member states. We believe that the subsidiarity principle — implementing policies as much as possible in member states and as little as possible in Brussels — should prevail.

The latest EMU decisions were prefigured by the December 2012 plan from Herman Van Rompuy, president of the European Council. This plan consists of four linked building blocks: proposals for banking union, fiscal union, economic union, and political union.

On the first three, the European Council by now has achieved much more than anyone thought possible at the outbreak of the EMU crisis in 2010.

Fiscal union actually started over the past few months, with European Commissioner Olli Rehn at the helm. Already earlier in 2013, banking union made considerable progress with the setting up of the single supervisory mechanism, to be chaired by Danièle Nouy of France.

Now the European Council has decided on a single resolution mechanism, to go hand in hand with the supervisory mechanism. European banks have first to surmount an asset quality review and a stress test.

Under the EU's new partnerships, member states commit to reforms to stimulate growth, improve labour markets and increase competitiveness. The new partnerships have to reflect 'home-grown commitments' by member states. So we believe they form a test-bed for subsidiarity-in-action.

The European Council will take time to prepare for the start of these new instruments, including associated financial obligations, and to reach final conclusions only in its meeting of October 2014, after the dust of the European Parliament elections has settled.

Political union was insufficiently embedded from the start of EMU. Moreover, in his December 2012 plan, Van Rompuy gave the idea of political union hardly any substance. In fact, he seemed to suggest little more than national parliaments and the European Parliament playing a larger role in EMU decisions.

In its conclusion regarding the Van Rompuy plan, in December 2012, the Council even announced that a conference would be held in which representatives of all these parliaments should discuss EMU-related issues. That conference, however, has still not taken place. Instead, there is now the ambition to agree with the new European Parliament on the conclusions of the European Council of October 2014.

At the Maastricht summit in December 1991, the decision was taken to leave the political union for the future. That has turned out to be a dramatic mistake.

A combination of the impact of financial market deregulation and innovations, the case of Lehman Brothers, and the repercussions of the Basel regulatory framework have brought great challenges to the financial and economic governance of Europe.

Now, the European Council has at last shown signs it can firmly meet these challenges. Although more needs to be done for implementation, the December 2013 decisions bring Europe on to the right track.▪

Ruud Lubbers is former Dutch Prime Minister and Paul van Seters is Professor at Tilburg University.

To believe that the European Union (EU) can be saved by first creating new discord between its key players is not simply naive; it is a recipe for disaster and smells of political dishonesty.

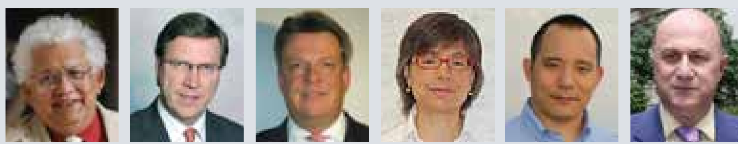
Heisbourg maintains in defence that he is a federalist by conviction, but this is a shallow gesture. Populists of the right and the left will rub their hands in pleasure.

Contrary to what Heisbourg pretends, during the last year the European authorities have taken serious steps to solidify the euro as the EU's currency.

The European Central Bank has become a major factor of stability, a point well recognised in the main world financial centres.

Even more importantly, the euro members have taken serious steps to create a banking union, with a common European supervisory authority, a resolution mechanism to set rules for insolvent banks, with corresponding financial commitments, backed up by European financial guarantees.▪

Laurens Jan Brinkhorst is former Minister of Economic Affairs, The Netherlands.



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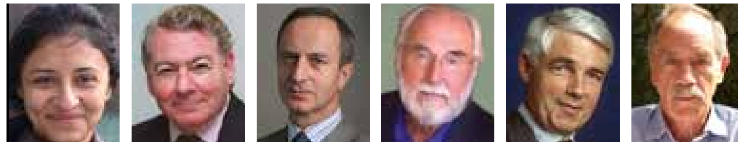

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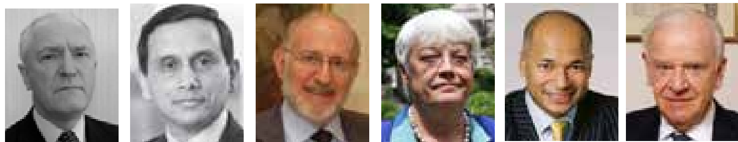

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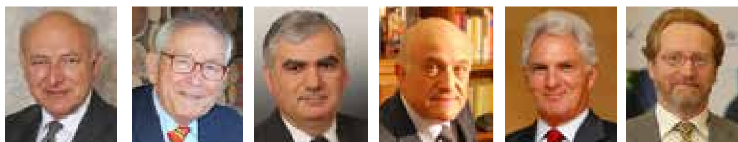

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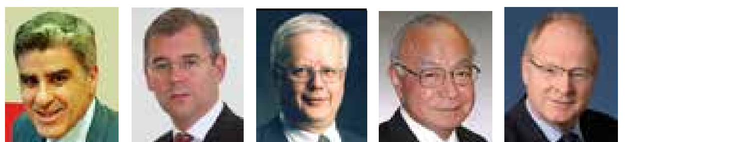

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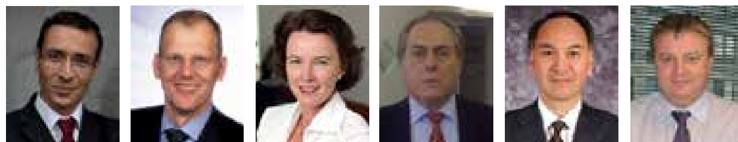

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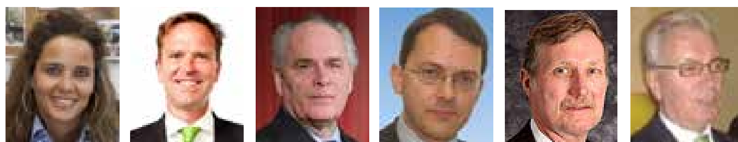

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Mixed messages on forward guidance

Central banks risk increasing rather than lowering uncertainty

Miroslav Singer, Czech National Bank

The sharp rise in the use of forward guidance by central banks stems from a perceived need to find new, more effective monetary policy tools at the zero lower bound, where the application of standard tools is seen as 'pushing on a string'. Numerous theoretical papers in recent years have been calling for new tools. It is worthwhile focusing on forward guidance and the problems associated with applying it – in particular, the danger that central banks end up giving mixed messages that create more confusion and uncertainty than they dispel.

The idea that central banks should not only care about the expectations of economic agents, but also provide them with guidance is nothing new. After inflation targeting became almost universally accepted, central banks found themselves getting increasingly involved in this activity.

Cryptic utterances

What started as cryptic utterances developed into code phrases and well-defined words (as used by the ECB). Central banks started publishing fan charts plotting the expected future path of interest rates and, in some cases (including the Czech National Bank), the exchange rate. All the same, providing higher quality, more detailed and explicit and more binding guidance appears to be de rigueur for any self-respecting central bank at or near the zero lower bound.

What is meant by forward guidance? Traditionally, central banks simply elaborated on and clarified their future expectations and forecast assumptions. The zero lower bound has pushed them into trying to do more. They have started to signal the bias that exists at the zero lower bound, i.e. that the risk of deflation must be taken more seriously than the risk of inflation, and to communicate the conditions under which they will exit their non-standard policies.

They have adopted mantras such as: 'We will not exit this or that policy until we see a significant increase in inflationary pressures.' Such statements effectively mean that the policy will not be ended until policy-makers are quite sure they will not have to restart it in the foreseeable future. I regard such communication as quite appropriate to the circumstances. It makes the discontinuation of a particular policy conditional on the policy-makers' subjective state of mind.

A more elaborate – and quite widely recommended – way of communicating this bias is based on making the end of a particular policy (often zero rates) conditional on achieving some above-target level of inflation for a specified period of time, for example, in the case of a 2% target, inflation of '3% or above for three years'. This takes us into a world where the reversal of a policy is conditional on quantitatively described values of a set of macroeconomic variables, as opposed to the board members' state of mind.

This sort of future commitment has gained popularity among academics and advisers because of its seemingly stronger nature. A more 'objective' commitment, the reasoning goes, will deliver a more effective change in economic agents' expectations, thereby enhancing the effect of the chosen set of non-standard macro-policy tools.

In practice, it appears that many central banks have succeeded in subjectively communicating their own individual perception of the risks associated with the exit from zero interest rates or other policy measures. However, the Federal Reserve's first forward guidance on tapering has been anything but an unqualified success. The Fed and the Bank of England have started providing forward guidance in objective form, making their policies conditional on the state of the world. I am afraid this may not improve the effectiveness of the policy message.

In most models, forward guidance that makes policy changes conditional on objective events, i.e. the values of particular variables, reduces the uncertainty of agents and therefore generates superior welfare outcomes. However, at the zero lower bound, where central banks face greater uncertainty, this is more an artefact of the model than a feature of the real world. But this feature implicitly assumes that the central bank correctly guesses three things: the state of the world in which it will want to change its policies; the current and future quantitative relationships between the different economic variables; and the future meaning and content of particular data series.

These are rather brave assumptions even under normal policy circumstances. However, in the normal case, one can argue that the central bank's knowledge of the economy gives it an advantage over other economic agents. Unfortunately, at the zero lower bound, there is not much difference between the knowledge of the average agent and that of the central bank.

Policy-making at the zero lower bound is partly an attempt to limit economic fluctuations, but it is also a special process where a central bank tries to navigate the economy from a transitional pre-crisis state to a more permanent post-crisis equilibrium. In addition, financial stability risks may force a central bank to end abruptly its unconventional policy measures.

Modern monetary policy

Modern central banks can operate under modern monetary policy frameworks – and under inflation targeting in particular – only because such frameworks involve the central banks constantly refining their procedures and models. This process enables the central bank to lead other agents. The problem is that a central bank that is supposed to be formulating objective forward guidance may not have accumulated sufficient knowledge about the zero lower bound economy.

This is why central banks are adding other, non-quantitative conditions to their numerically formulated forward guidance, conditions such as 'under normal circumstances' or 'unless something unexpected hits the economy'. But the additional 'small-print' of such forward guidance may confuse the original message.

We central bankers should clearly limit ourselves to subjective forward guidance, i.e. guidance that makes any change in policy clearly-conditional on the state of mind of policy-makers, not on the state of the world.

This approach may be less clear to economic agents, but they must learn with us the unknowns of the zero lower bound and how we communicate them. By admitting that the world is an uncertain place, central bankers may end up giving more effective guidance on interest rates than by setting complicated conditions which are then watered down or ignored.■

Miroslav Singer is Governor of the Czech National Bank.

Higher global growth rates in 2014

German economy to speed up markedly

Michael Holstein, DZ BANK

DZ Bank Economic Forecast Table

GDP change (%)	2011	2012	2013	2014	2015
US	1.8	2.8	1.8	3.0	2.8
Japan	-0.4	1.5	1.8	1.7	1.6
China	9.3	7.7	7.6	7.9	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.6	2.3	2.6
France	2.0	0.0	0.2	0.8	1.3
Italy	0.6	-2.6	-1.8	0.4	1.2
Spain	0.1	-1.6	-1.4	0.6	1.5
UK	1.1	0.1	1.4	2.1	1.6
Addendum					
Asia excl. Japan	7.6	5.8	5.8	6.5	6.3
World	3.8	2.9	2.6	3.6	3.6
Consumer prices (% y/y)					
US	3.2	2.1	1.4	2.1	2.5
Japan	-0.3	0.0	0.3	1.8	1.6
China	5.4	2.7	2.7	3.5	4.1
Euro area	2.7	2.5	1.4	1.4	1.9
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	1.2	1.7
Italy	2.9	3.3	1.3	1.3	1.2
Spain	3.1	2.4	1.5	1.5	1.9
UK	4.5	2.8	2.6	2.3	2.9
Current account balance (% of GDP)					
US	-2.9	-2.7	-2.5	-2.6	-2.8
Japan	2.0	1.0	1.4	1.6	1.7
China	1.9	2.3	2.1	2.2	1.7
Euro area	0.2	1.3	2.3	2.5	2.5
Germany	6.2	7.1	7.0	7.2	6.5
France	-2.5	-2.1	-1.7	-1.8	-1.5
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.1	1.0	2.0	2.3
UK	-1.5	-3.8	-4.2	-4.6	-4.5

Produced in association with DZ BANK Group, a partner and supporter of OMFIF.

In 2013, dealing with the after-effects of the 2008-09 economic and financial crisis remained the dominant theme. The big industrialised countries in particular have spent most of the year on economic policy initiatives designed to clear up the mess.

Although the US has already made considerable progress toward eliminating imbalances such as its excessive private debt, exaggerated housing market boom and deficiency of capital in the financial sector, the crisis remains the dominant influence on the US economy. Growth is sub-trend, unemployment still high, and inflation very low.

In Europe, the consequences of the crisis and the excesses that preceded it are even more painfully evident. Euro area GDP contracted again in 2013 – as in 2012 – while unemployment is at a record level. Several countries have had to be rescued from sovereign bankruptcy, and many remain extremely indebted.

The euro area's stubborn recession finally ended in 2013. There is good reason for optimism that the economy is stabilising. This will further support the German economy that, while avoiding recession, performed below its potential in 2013.

The emerging market economies lost momentum last year. Although Asia's GDP growth was still above 5.5% in 2013, this is its weakest performance since 2001. The slowdown is essentially due to the region's twin heavyweights, China and India, both far removed from the record growth rates they recorded in earlier years and contending with different structural difficulties.

This year is likely to bring greater dynamism for the world economy. There are many pointers to US economic improvement, not least because the Democrats and Republicans have rediscovered their ability to compromise, most evidently on the budget deficit and debt ceiling.

In China, while the extra thrust from the latest fiscal 'mini stimulus' is fading, foreign trade proves to be a source of growth again. Exports reached a new record value lately, while the balance of trade registered the biggest surplus in nearly five years.

Export activity seems to keep gaining traction, a trend that should strengthen this year as global economic growth picks up again. Monthly growth rates of above 8% are possible – something China has not seen in two years.

The euro area economy looks set to continue to stabilise after its extended crisis, and the German economy looks likely to speed up markedly in 2014.

Monetary policy will remain very expansive for an extended period to come – with both its positive and negative consequences.■

Michael Holstein is Head of Macroeconomics at DZ BANK.

Britain's modest fiscal consolidation pays off

Britain's economy has had a buoyant start to the year, fuelling speculation of tax cuts and higher pensions as David Cameron, the prime minister, kick-starts a long campaign to the general election in 16 months.

There are many reasons for the UK's better-than-expected recovery – at a time when large parts of the euro area (by far Britain's biggest trading partner) are still close to recession. But the overall explanation is that Cameron and his chancellor of the exchequer George Osborne have broadly followed the right strategy of bearing down moderately on the fiscal deficit and leaving room for accommodative monetary policy to bear fruit. The downside to the better economic news is that Mark Carney, governor of the Bank of England, will probably have to announce a rise in interest rates more quickly than he had earlier indicated – possibly by the end of the year. According to the November 2013 Economic Outlook projections of the Organisation for Economic Cooperation and Development, UK GDP is likely to expand 2.4% in 2014 and 2.5% in 2015 against 1.4% in 2013. This is around 50% higher than the 0.9% and 1.6% growth for 2013 and 2014 respectively projected by the OECD only a year earlier.■

Rising inequality in Asia-Pacific

Disparities depress growth potential

Changyong Rhee & Juzhong Zhuang, Asian Development Bank

Amid Asia's impressive growth, a new challenge is coming to the surface: inequality is on the rise. Over the last few decades, the region has lifted people out of poverty at an unprecedented rate. But more recent experience contrasts with the 'growth with equity' story that characterised the transformation of the newly industrialised economies in the 1960s and 1970s.

Income inequality has widened in 12 of the 28 economies with comparable data, including the three most populous countries – the People's Republic of China, India, and Indonesia. The 12 countries account for 80% of the region's population.

What have been the recent trends of inequality in Asia and the Pacific? What are the key drivers of rising inequality in the region? How should Asian countries respond to the rising inequality?

Recent trends of inequality

From the early 1990s to the late 2000s, the Gini coefficient of per capita household consumption expenditure – a commonly used measure of inequality – worsened from 32 to 43 in China, from 33 to 37 in India, and from 29 to 39 in Indonesia. For the developing countries of Asia as whole, the Gini coefficient rose from 39 to 46 in that period.

Asia's inequality levels are generally below those in other developing regions. The range of Gini coefficients in developing Asia is 28–51, compared with 30–66 for sub-Saharan Africa and 45–60 for Latin America and Caribbean.

But inequality declined elsewhere in the world, with the exception of the members of the Organisation for Economic Cooperation and Development (OECD), where the Gini coefficients are in the range of 25–40.

Inequality of opportunity is prevalent too, and is a crucial factor in widening income inequality in developing Asia.

Unequal access to public services, especially education and health, is central to inequality of opportunity. Household surveys show that school-age children from households in the poorest income quintile were three to five times as likely to be out of primary and secondary school as their peers in the richest quintile.

Infant mortality rates among the poorest households were double or triple the rates among the richest households. High gender disparities in tertiary education persist in south Asia and the Pacific.

These two forms of inequality – of opportunity and income – can lead to a vicious circle as unequal opportunity creates income disparity, which in turn leads to differences in opportunity for individuals and households.

Rising inequality can dampen the poverty reduction impact of economic growth and, beyond that, weaken the underlying foundations of growth. Simulation analysis shows that if inequality had remained stable in the Asian economies where it increased, the same growth in 1990–2010 would have taken about 240m more people out of poverty – equivalent to 6.5% of developing Asia's population in 2010.

High and rising inequality can curb long-term growth by wasting human capital, reducing social cohesion, hollowing out the middle class, undermining the quality of governance, and increasing pressure for inefficient populist policies.

That is why Asian policy-makers are becoming more concerned about the issue. This concern is increasingly addressed through medium-term development plans across the region, with explicit goals to make growth more inclusive, such as in China, India, Indonesia, Malaysia and the Philippines.

Factors behind rising inequality

Technological progress, globalisation, and market-oriented reforms have been key factors behind developing Asia's rapid growth in the last two decades, but they have also had significant distributional consequences. These forces have opened enormous new opportunities for economies to prosper, but have not benefited all people equally.

Together, they have affected income distribution through three channels: capital, skill, and 'spatial bias'. The bias towards physical capital reduces labour's share of national income while increasing the income share of the owners of capital.

Similarly, heightened demand for better skilled workers raises the premium on their earnings. And spatial disparities are becoming more acute: locations with superior infrastructure, market access, and scale economies (such as urban centres and coastal areas) are better able to benefit from changing circumstances.

Further, the impact of these distributional issues is compounded by unequal access to opportunity, caused by institutional weaknesses and social exclusion.

There is no shortage of empirical evidence to support these explanations. Between the 1990s and 2000s, the share of inequality accounted for by differences in education attainment increased in most Asian countries with available data. The increase was most significant in China, rising from 8% in 1995 to 27% in 2007, followed by India, from 20% in 1993 to 30% in 2010.

Between the mid-1990s and the mid-2000s, labour income as a share of manufacturing output in the formal sector fell from 48% to 42% in China and from 37% to 22% in India. An increase in the share of incomes earned by capital, which is less equally distributed, has contributed to rising inequality.

Inequalities between rural and urban areas and across provinces and states have increased significantly in many Asian countries during the last two decades. In the late 2000s, about 25%–50% of total inequality in countries like China, India, and Indonesia can be explained by spatial inequality.

Combating rising inequality

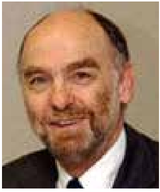
Policy-makers face a dilemma: the forces behind rising inequality are also the engines of productivity and income growth. So these forces should not and cannot be suppressed. A distinction needs to be made between two forms of income disparities.

Some of these arise naturally as economies and individuals take advantage of the opportunities of technology, trade, and efficiency-enhancing reforms. And others are generated by unequal access to market opportunities and public services.

To combat inequality, it is unequal access to opportunities and public services that should be the focus for policy actions.■

Changyong Rhee and Juzhong Zhuang are Chief Economist and Deputy Chief Economist, respectively, at Asian Development Bank.

This article is based on the book, 'Inequality in Asia and the Pacific,' edited by Ravi Kanbur, Changyong Rhee, and Juzhong Zhuang. See p.41.



China's attack on bloated financial sector

Anti-corruption fight vital for Beijing reforms

Stewart Fleming, Advisory Board

The slowdown in annual Chinese growth from around 10% in recent decades to nearer 7% at present will curb wasteful investment – and could also help the fight against the rampant corruption that has characterised China's economic modernisation.

One senior official even told me in Beijing that the stimulus programme of 2009-10 was an economic policy blunder because it was a factor supporting corruption.

A succession of background discussions in Beijing and Nanjing has revealed the full extent of anxiety felt by China's new leaders about graft and economic crime. The briefings included a conversation with top officials of the Central Commission for Discipline Inspection, the Communist Party's secretive and powerful 400,000 strong anti-corruption agency.

Corruption is seen as inflicting massive waste and inefficiency on the economy. Moreover, it is viewed as a threat to the legitimacy of the Communist party itself, and so to the stability of the one-party state.

Failure to expose and curb corruption among the 85m members of the Communist Party will, officials fear, undermine its dominant role in society. But attacking corruption aggressively could also weaken the party. Many of its members have been profiting from it, especially in the financial sector and related fields such as property development.

The bloated financial sector is a particular concern. The International Monetary Fund bluntly warned Beijing last year, following an Article IV review of its economy, that its ramshackle informal or shadow-banking system could pose 'a systemic threat to financial stability'.

It's no wonder the reform agenda which emerged in November from the epochal Third Plenum placed great emphasis on the financial sector and tackling corruption.

When looking at the financial sector, western analysts have tended to focus on China's highly visible big four banks, not least because of the bail out the banking sector needed at the turn of the millennium. In recent years, however, restrictions on the interest rates banks can pay on deposits and charge on loans – financial repression – have spurred the growth of alternative financing vehicles.

In this highly decentralised state, some are linked to powerful local authorities and others to the formal banking system, including so-called wealth or asset management trusts which are not constrained by official restrictions on deposit or lending rates. As a result this informal or shadow banking sector has, according to an IMF report, frequently been charging small and medium sized businesses 'usurious' rates of interest.

In the past three years, however, just as rapid credit growth triggered shivers of apprehension in some quarters in the years before the trans-Atlantic financial crisis hit in 2007, so in China the sheer pace of the credit expansion in China has become a source of growing concern. George Magnus of UBS estimated last year that China's aggregate debt, including non-financial corporate debt, had reached a worrying 250% of gross domestic product.

An official report from China's National Audit office in December suggested that local authority debt had soared by some 70% to $3tn between 2010 and 2013, close to one third of China's gross domestic product, intensifying fears that some local authorities may default.

The Third Plenum's endorsement of the idea of allowing selected local authorities to turn to bond markets to raise money, confirmed in the first week of January, is hardly surprising when seen in this context. Neither is its emphasis on financial sector reform. Behind the scenes, however, an intense debate is underway.

Some officials, especially in the People's Bank of China, the central bank, reportedly see the rapid internationalisation of the renminbi and the liberalisation of the capital account of the balance of payments as a way to sidestep powerful vested interests and put intense reformist pressure on the domestic financial systems. Others, including some IMF officials, worry that liberalising the capital account before ensuring that the domestic financial system is robust and well-regulated could be a recipe for disaster. ▪

Stewart Fleming is Senior Member at St Antony's College.

Capital account liberalisation in China

Gold, the renminbi and the multi-currency reserve system
January 2013

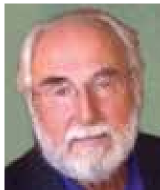
支付结算系统
China's challenges in clearing and settlement
Helping the renminbi become a world currency
June 2013

国际新前沿
认识中国的货币政策
The new global frontier
Understanding China's monetary policy
September 2013

中国资本账户自由化
从全球各国汲取经验教训
Capital account liberalisation in China
Guidelines from global experience
February 2014

As an integral part of OMFIF's Year of Renminbi Focus, we have published four documents on China in 2013, dealing with reserve diversification and gold, financial market settlements, monetary policy decision-making and capital account liberalisation in an international context.

Capital account liberalisation in China: Guidelines from global experience will be published in cooperation with the Chongyang Institute for Financial Studies, Renmin University of China. A Chinese version of the report will be published as a joint OMFIF-Chongyang Institute seminar in Beijing on 20 February, 2014.



State funds back Asia's transport revolution

China, Russia, Germany steer new land corridor

Anthony Robinson, Advisory Board

A new 10,000km Chinese-backed 'Silk Way' express rail corridor connecting China with Europe and the Middle East across Kazakhstan and Russia is likely to reshape world trade in a manner not seen since the building of the Suez and Panama canals.

This trans-continental rail link is the spinal column of a trillion dollar, decade-long modernisation and expansion of obsolescent Soviet and Chinese communist-era logistics networks to facilitate trade, attract investment and open up central China.

The inherited system was designed to haul bulk cargoes slowly across huge distances. The new infrastructure allows express container trains to take priority over lumbering traditional freight trains which will still move oil, coal, grain and metals – but on better tracks and with powerful modern locomotives.

Pooling the financial and logistics power of some of the world's most muscular sovereign funds and state corporations, the project will open up lucrative two-way trade between landlocked parts of China and key markets and suppliers a third of a world away to the west.

China, which has been quietly offering finance and technology to railway companies as far away as Bulgaria, is the main factor behind the multi-modal project which also closely involves major western logistics companies, including Germany's DB Schenker and air freight specialists Swissport and Flughafen Zurich.

The success of the ambitious project depends heavily on close cooperation between the railway systems of Belarus, Kazakhstan and Russia, which share the same broad gauge railway system inherited from Czarist and Soviet days and provide the crucial connecting links between Asia and Europe.

Eurasian Customs Union

All three authoritarian regimes are members of the new Eurasian Customs Union which Moscow is trying to persuade Ukraine and other former Soviet states to join. Russia hopes that successful co-operation in such projects will demonstrate the practical attractiveness of a union which some observers see as an attempt to re-constitute the Moscow-dominated Soviet Union in a new form.

The trio have created a new United Transport and Logistics Company (UTLC) and committed themselves to share technology, apply a common tariff and aim for a target of 1.7m containers a year by 2020 at the Silk Way launch ceremony in Astana's modern conference centre in November.

Russian Railways president, Vladimir Yakunin, emphasised Russia's acceptance of the equal status of all members and the importance of new IT and management systems in providing services such as real-time tracking of individual containers and electronic documentation.

Today over 99% of all container trade between China, south east Asia and Europe is carried by sea. It takes between 45 and 60 days to travel up to 20,000km around southern Africa or through the congested Suez Canal. By rail however it is only half that distance from the Silk Way's eastern terminus at the Yellow sea port of Lianyungang to European markets and suppliers, and only 7/8,000km from the fast growing, land-locked cities of western and central China.

Container trains running on passenger train style regular timetables, with their exact location monitored real time by satellites, can travel up to 1,000km a day across the Kazakh steppe, offering a 13 to 15 day East-West transit time which is less than a third of the maritime schedule.

For factories in central China sending goods west by rail also avoids the increasing delays and congestion at ports and access routes in China's coastal regions where China's growth has been concentrated to date.

One of the pioneers of the first new westward routes is Hewlett-Packard which built a large inkjet printer and computer assembly plant at Chongqing in central China three years ago. Hewlett-Packard opted for rail, despite initial concerns about security, possible breakage and the impact of harsh climatic conditions across the Kazakh steppe.

Hewlett-Packard vice president Tony Prophet says the new container trains take a third of the time of sea routes at a third of the cost of air cargo, which was Hewlett-Packard's original choice to transport its high value, low weight products.

Askar Mamin, chairman of Kazakh Temir Zholy (Kazakh railways KZT) says the attractiveness of this combination of relative speed and economy is behind estimates that by 2020 around 1.7m containers a year, some 8% of a higher total Euro-Asian trade volume, will be shuttling back and forth by rail across the Kazakh steppe like the US mid-west where freight trains link the Atlantic and Pacific coasts across the prairies.

The still expanding Silk Way is the fruit of a decade of planning, close co-operation between national rail companies and logistics companies, and massive, on-going investment.

Diverse sources of funding

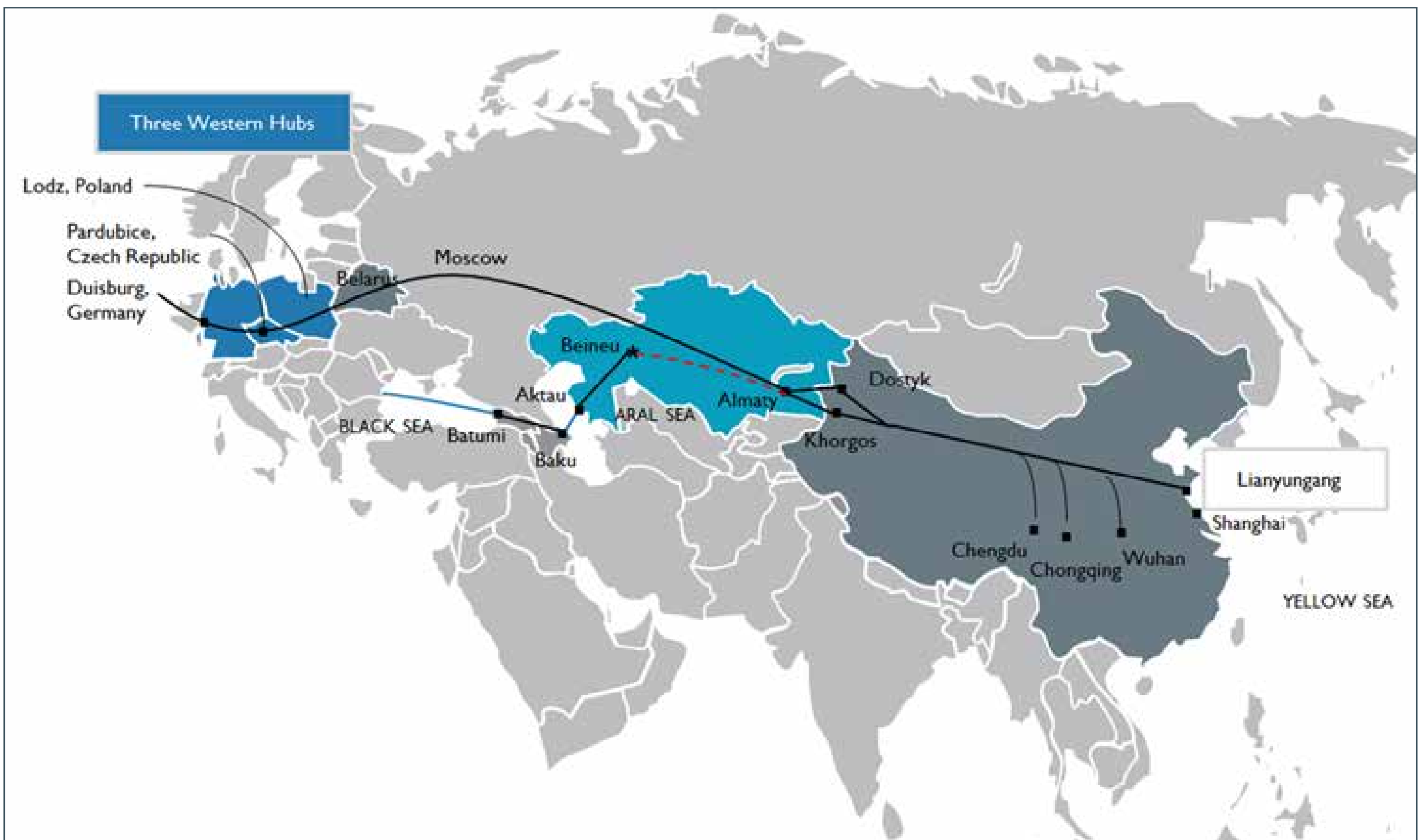
Funding has come from a wide variety of sources. They include sovereign wealth funds, such as Kazakhstan's Samruk-Kazyna or Dubai World, loans and export credits from Chinese state banks, loans and/or subsidies from governments for state run railways and targeted loans to specific projects from IFI's like the Asian Development Bank (ADB) and the European Bank for Reconstruction and Development (EBRD). Logistics companies are investing in joint projects to provide IT, monitoring and accounting systems and air, sea and land port facilities.

The driving forces are primarily economic – topped by China's urgent need to open up and develop landlocked central China and Kazakhstan's ambition to diversify its energy-led economy. Astana hopes to earn up to 12% of its GDP from transport services and transit fees by 2020.

Three Western hubs

Russian and European railways like the prospect of growing high-value freight volumes in both directions while cities such as Duisburg on the Rhine, Lodz in central Poland and Pardubice in the Czech Republic are gearing up as multi-modal distribution hubs to serve individual EU markets.

Thanks to a £1.5bn investment by DB World, 80% owned by Dubai World, the Gulf State's sovereign wealth fund, London has effectively become the western terminal of the Silk Road whose eastern end is marked by a new container terminal at the port to be completed this year at Liangyungan in a joint



The bifurcated iron spine of the New Silk Road container corridor splits west of Almaty. The northern route via Moscow connects with European logistics hubs. A new 899km line from Zhezkazgan in central Kazakhstan to Beineu will shorten the southern route to Aktau.

venture between Kazakh and Chinese railways.

DB World's newly opened 'London Gateway' container port on the Thames allows the world's largest container ships to sail up a 100km long dredged channel to within 39km of the heart of Europe's largest rich city, as well as smaller ships carrying rail-borne containers on their final short haul to destination.

Game-changing southern route

It has also put money and logistics know-how behind two joint ventures with Kazakh Railways at crucial points in the Silk Way project. These are a $273m tax free industrial zone on the new China-Kazakhstan rail crossing at Khorgos, only 200km from Almaty, Kazakhstan's business capital, and a new $160m container port at Aktau on the Caspian sea, over 3,000km away to the west.

These are vital parts of the game-changing southern route of the new Silk Way which offers East Asian exporters such as Japan, South Korea and Vietnam, as well as central China, direct access to the Middle East and southern Europe – without having to pass through Russia.

Container traffic to and from northern and central Europe will continue to use the traditional route through Russia. This runs west past Moscow, across Belarus, where cranes switch containers over to the narrower European standard gauge track at the frontier with Poland, or continue north to the Baltic ports. By offering quicker access to exporters European railways hope to stimulate eastward exports and reduce the current expensive imbalance between containers which arrive full of Chinese exports but return empty.

German, UK and other north and central European EU exporters will mainly use the traditional northern route across Russia and Kazakhstan. Russian Railways hopes that rapidly rising traffic through European Russia will compensate for the probable loss of traffic on the eastern section of its own Trans-Siberian railway.

Both northern and southern routes run through Kazakhstan but they diverge west of Almaty. Turkey, whose two-way trade with China reached $25bn in 2012 and is looking for $100bn by 2020, is among those well placed for the southern route.

Once across the Caspian Sea shippers have access to the Black Sea ports and the Turkish rail network, whose links to the European rail network have been sharply upgraded by the recently opened Marmary tunnel under the Bosphoros.

Looking further ahead, the new southern route also offers shippers the choice of heading south along the Soviet-era Turk-Sib railway from the Beineu junction to join up with a new rail line which penetrates deep into Iran via Turkmenistan. There is also much talk of a possible future rail link through Afghanistan to Pakistan and India.

Kazakh Railways is currently investing $5bn to build an 899km long railway across the parched central Kazakh badlands to create a short cut which will lop nearly two days off journey times down to Aktau port.

Due for completion in 2015 it runs from the dusty copper mining town of Zhezkazgan to Beineu on the main north-South line from Turkmenistan. There it joins an existing spur down to Aktau, a former closed Soviet nuclear city.

Modernising transport sector

The new line is a key part of a $60bn investment by President Nursultan Nazarbayev's regime to modernise all aspects of its transport sector, including new airports, warehouses, logistics centres and an all-weather east-west highway across the south of the country. Half is being spent on railways alone.

Kanat Alpesbayev, vice president of logistics of KTZ, illustrated the potential benefits of new rail links. Japanese or Korean cars sold in Almaty, only 200km from the Chinese border, used to be shipped by sea half way round the world to St Petersburg or Riga before being transported 7,000km back east by rail across Russia.

Now, goods can simply be transported across China which has already overtaken Russia as Kazakhstan's second biggest trade partner, after the EU.

Beijing has invested heavily in Kazakh oil and gas as well helping to finance Silk Way related projects.

With regular container services to Europe from several central Chinese cities, such as Chengdu, Chongqing and Xian already in operation, and other routes due before 2020, the Silk Way is crucial to the success of China's ambitious drive to diversify economic development away from the coastal regions.

The success of new Chinese President Xi Jinping's economic strategy hinges on rapid development of central and western China with $104bn earmarked for the restive but resource rich western region of Xinjiang alone in the next five years.

This includes investment by foreign companies such as Ford, Suzuki, Apple and Hewlett-Packard which have already set up plants in the interior.

The new iron Silk Way promises precisely the easier, faster and cheaper all-weather access to western markets and imported components needed to bind Europe and Asia closer as the 21st century develops. ▪

Anthony Robinson is former foreign correspondent at The Financial Times.

Putin's gas-fuelled bail-out of Ukraine

In November, Ukraine announced it would not sign an Association Agreement with the European Union at a forthcoming meeting in Vilnius between EU leaders and their counterparts in Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine, *writes David R. Cameron in Connecticut.*

The agreement would have committed the EU and Ukraine to creating a Free Trade Area that would lead to more trade and investment between Ukraine and the 28 member states of the EU.

Russia has long-standing economic, military and cultural ties with Ukraine. President Vladimir Putin wishes to expand the customs union with Belarus and Kazakhstan and eventually create a 'common economic space' and Eurasian Economic Union of the non-Baltic post-Soviet states. So it was clear Russia would do whatever it could to keep Ukraine from signing the agreement.

Ukraine's last-minute decision not to sign the EU agreement was thus, perhaps inevitably, cast in geopolitical terms. But the scale of the bail-out announced after a meeting in Moscow on 17 December between Putin and Ukrainian President Viktor Yanukovich made it clear that the impetus for Ukraine's decision was economic. And the struggle was one that Europe could have won.

Ukraine has been on the brink of insolvency. In 2013, it had a current account deficit equivalent to more than 8% of GDP and a budget deficit of over 6.5%. It must repay $8bn in foreign debt this year, including $3.7bn to the International Monetary Fund. And it must pay Russia about $12bn a year for gas.

Throughout 2013, the IMF and Ukraine discussed resumption of the $15bn stand-by arrangement that had been agreed in 2010 but suspended in December of that year when Ukraine refused to reduce its domestic energy subsidy, one of the conditions attached to the loan. It was clear from the outset that, both because of the severity of the economic crisis in Ukraine and the early suspension of the 2010 arrangement, any assistance would come with tough conditions. Among them would be greater exchange rate flexibility. Ukraine's managed float of the hryvnia has kept it pegged at an 8:1 exchange rate with the dollar.

In addition, Ukraine would be required substantially to reduce its budget deficit, which the IMF projected at almost 8% in 2013. It would have to reduce the subsidy for domestic consumption of energy. And it would have to reform the financial sector.

However beneficial those conditions might be in the long run, their immediate effect would be costly in political terms, not least for Yanukovich who faces re-election in early 2015. Greater exchange rate flexibility for Ukraine's currency would cause depreciation against the dollar, thereby increasing the already-high cost of imported oil and gas.

In February 2013, the EU agreed to provide Ukraine with €610m in 'macro-financial assistance' (MFA) if and when it reached an agreement with the IMF on a new stand-by arrangement – which, of course, would require acceptance of the IMF's conditions.

In the run-up to Vilnius, the EU offered – provided Ukraine signed the association agreement – to 'fast-track' disbursement of the MFA, to prepare a second package of financial assistance, and to assist it in obtaining the new IMF stand-by.

In view of the IMF and EU positions, it's not surprising that Ukraine looked eastward. In early November, Putin and Yanukovich agreed in two lengthy secret meetings that, in return for not signing the EU agreement and resuming talks about closer trade ties with Russia, Ukraine's disputed gas bill would be settled, the price of its future gas deliveries would be reduced, the recently-imposed customs controls and import quotas would be ended, and Russia would provide additional financial assistance.

Meanwhile, as the Vilnius summit drew near, it became apparent that any assistance from the IMF and EU would not only be accompanied by tough conditions but would fall far short of what Ukraine needed in order to avoid a default. The net amount of new assistance offered by the IMF was zero.

In return, Ukraine would have to increase substantially the domestic price of energy, freeze public salaries, pensions and social spending, and reduce the budget deficit. It was, as Prime Minister Mykola Azarov later told the Rada, 'the last straw.' The next day, 21 November, Yanukovich announced Ukraine would not sign the EU agreement.

On one level, the decision was not surprising. There are many in Kiev and western Ukraine who think of themselves as European. But there are many others, especially in the country's predominantly Russian-speaking industrial heartland in the east and in southern Ukraine, who feel linked by culture and economic interest to Russia.

If someday years hence, the world wakes up to the news that Ukraine has joined the Customs Union and committed itself to participating in the common economic space and Eurasian Economic Union that Russia envisions, historians will look back to late 2013 and ask why the EU and IMF didn't have the foresight to assist Ukraine when it needed their assistance. ▪

David R. Cameron, member of the Advisory Board, is Professor at Yale University.

Free trade boost from Pacific Alliance

Mexico looks south to its Andean partners

Winston Moore, Advisory Board

The Pacific Alliance, a four-nation group incorporating Chile, Colombia, Mexico and Peru, is promoting an innovative free trade and investment initiative in a region otherwise known for protectionism and resource nationalism, and Brazil's once unchallenged influence.

Often heralded as Latin America's China in view of its manufacturing strength, Mexico is looking south for opportunities for the first time since it joined the North American Free Trade Agreement two decades ago.

A plan to forge closer ties with Asia-Pacific basin countries through the Trans Pacific Partnership (TPP) is likely to enrol, too, other Latin American Pacific-rim nations like Costa Rica, Guatemala and Panama.

The Pacific Alliance has launched a new drive to pursue integration and improve cooperation by lowering barriers to trade, investment and financial flows. On signing a framework agreement in 2012 the presidents of the four Pacific Alliance member countries paved the way to defining a trade protocol that included the immediate elimination of 92% of tariffs on mutual trade.

Some observers consider the Alliance more a process than an agreement as it has no fixed secretariat, an unusual departure from past bureaucratic regional integration initiatives like Mercosur and the Andean Community custom unions.

The Alliance has recently registered an annual average 5% growth rate. With combined GDP of $1.7tn, a third of the Latin American total, the Alliance contributes half the region's trade valued at over $1tn. The four member countries topped the World Bank's rankings for 'Ease of Doing Business in Latin America', ranking well above Brazil, Russia, India and China.

Foreign direct investment

Foreign direct investment in the three Andean member countries (Chile, Colombia and Peru) was $58bn in 2012, a six-fold increase compared to 2000 and the largest such increase in Latin America. Chile led the way attracting $30bn in investment in 2012, half of which went into mining and a further 20% into the financial sector.

Colombia drew $15.6bn, with a similar distribution pattern with half these inflows earmarked for mining as well as hydrocarbons extraction. Peru followed suit with $12.2bn, again with 50% directed into mining.

Four presidents of the Pacific Alliance member countires: Enrique Peña Nieto of Mexico, Juan Manuel Santos of Colombia, Sebastián Piñera of Chile and Ollanta Humala of Peru.

In Mexico, by contrast, 60% of foreign investment flowed into manufacturing, with a further 18% going to retail or commercial operations. The asymmetries between Mexico and the other Alliance members stem from Asian demand for raw materials, especially minerals and metals like copper, iron ore and gold in exchange for low cost manufactured goods. Mexico has much to offer and benefit from a new arrangement with the other smaller countries in the Alliance. At present it has little demand for the raw materials and energy that could potentially be exported by its southern partners.

Economic and trade integration

However the value within the Pacific Alliance can be expected to unfold as the four member states engage in economic and trade integration assisted by the free movement of goods, capital, services and labour. This would continue a process of integration that began two decades ago.

Mexico will add muscle and weight to the Pacific Alliance's more broadly labelled Mercado Integrado Latino Americano (MILA), an integrated stock market. Mexico would add the critical mass required to bring MILA's market capitalisation up to a level parallel to that of Brazil's Bovespa.

Further value will come from the multiplier effect of market integration. Intra-Pacific Alliance trade amounts to barely 5% of its members' total foreign trade, compared with 16% in South America's Atlantic-facing Mercosur customs union including Brazil, Argentina, Uruguay, Paraguay, Venezuela and now also Bolivia.

The challenges faced by the Alliance's Andean member countries include closing the competitiveness gap by focusing on infrastructure improvements to reduce transport costs and open up market access for hinterland locations.

Alliance members are well placed to benefit from relatively high raw material prices and above-average Latin American growth. Boom conditions in the last decade resulted in poverty reduction, unprecedented social mobility, the emergence of new middle classes and urban expansion.

Reducing transport costs

The Pacific Alliance needs to address distortions arising from Asia raw materials demand that pushed its Andean members into specialising in transport-intensive goods, like minerals. This paradoxically resulted in an overall increase in transport costs, limiting export potential. Policies introduced by Alliance countries to reduce transport costs may have a significant impact on export opportunities by benefiting producers in remote areas through improved and lower-cost access to customs points and markets.

Trade liberalisation delivered lower

Continued on page 42...

Management of windfall oil revenues

Crucial role for sovereign fund to ensure fiscal sustainability

David Kihangire, East African Community

Oil and gas make up a high proportion of the economy for several leading African oil-producing countries. The oil sector in Angola accounts for about two-thirds of GDP, and close to 90% of government revenues. At a production rate of 2m barrels per day (bpd), reserves are projected to last for only 20 years.

In Nigeria, oil accounts for over 80% of government revenues, and over 90% of export earnings. In the Republic of Congo and Gabon, the share of oil in GDP accounts for over 50% and 37% respectively. In Uganda, oil revenues are projected to contribute over 20% of GDP once production starts. Commercial production of oil and gas in other countries of the East African Community is likely to generate windfall revenues in large proportion relative to the size of their economies.

East African agenda

This will generate opportunities as well as challenges. These circumstances coincide with the need for EAC countries to meet policy-making, legal and regulatory requirements as part of the East African Common Market and the planned East African Monetary Union – an integral part of the east African integration agenda.

The overriding objective for policy-makers in these circumstances is to manage resources efficiently and effectively and promote prudent policies to mobilise savings for investments in strategic areas. Given African countries' low GDP, commercial production of oil and gas provides an opportunity for governments to fast-track investments and sidestep budgetary constraints to address strategic infrastructure needs.

Yet there are grave risks of compromising macroeconomic stability. Establishing a well-functioning sovereign fund to husband excess revenues and ensure fiscal sustainability is an important priority. Countries dealing with the different implications of windfall revenues from oil and gas need to be aware of the history of other states that have weathered similar vicissitudes. Learning from past experience and marshalling an optimal array of macroeconomic, fiscal and monetary tools and policies form the best way of achieving a satisfactory outcome that will maximise development potential for the country and the people as a whole.

Naturally, oil production increases national income, and this brings a propensity to increase consumption and investment beyond sustainable levels. A rush to accelerate production to recover costs will accelerate income and aggregate demand, but this is juxtaposed with domestic supply-side limitations, posing the danger of higher inflation. Inelastic supply capacities lengthen the time needed for new investments in plant and equipment as well as in raising skill levels.

Dutch disease

The ensuing mismatch is likely to lead to inflation and real exchange rate appreciation. The result is a serious squeeze on the traded goods sector, requiring deep-seated structural policies to offset it: the components of the celebrated 'Dutch disease', named after the experience suffered by the Netherlands in the 1970s and

Warding off 'Dutch disease' on agenda at OMFIF meeting in Doha

The issue of windfall profits from oil and gas production in emerging market economies was a major feature of the OMFIF main meeting in Doha, built around two days of discussions on 27-28 November, hosted by the Qatar Central Bank.

Considerable discussion took place on the outlook for energy prices and supply as a result of the increase in shale oil and gas production in the US. In view of a likely increase in future US production costs, and the relatively low cost of production of Qatari oil and gas, Qatar could take the decision to lengthen the duration of oil and gas development, in a move that would also have an impact on markets for renewable energy.

A general discussion took place on commodity prices and the need for countries not to become over-dependent on national resources. It was pointed out that countries that had profited from the benign phase of the commodity cycle needed to deepen exposure to value-added industrial and service sectors. Countries in the Middle East and Africa had to try to avoid variations of the so-called 'Dutch disease' under which overreliance on energy or commodity exports could drive up costs and the exchange rate and lead to sluggish growth and high unemployment in sectors outside natural resources.

A leading Qatari delegate, surveying the surprising nature of the country's energy development in recent decades, praised the aim of Qatar's 2030 National Plan aiming to overcome problems faced by marginalised income groups.

The objective was to go beyond supply-side economics and extend successes in the oil and gas sector to other areas, above all in human development. The sectors that could be promoted in this way included management training and knowledge-based sectors such as education, health and R&D.

It was generally agreed that diversification away from oil and gas would play an increasing role in Middle East economic development. Expansion of manufacturing and services as well as travel, hospitality and tourism would all become progressively more important. Greater emphasis was being given to small and medium-sized businesses.

The decision on Dubai's staging of Expo 2020 was a major landmark. The reshaping of the Qatari central banking law to put supervision of all financial services in the country under a single authority through the central bank was hailed as a model for improving financial services capabilities in other countries as well. However one Middle East participant warned that achieving necessary legislative changes in this area was a very time-consuming process.

GCC countries were all developing their capabilities in areas like offshore banking, capital markets and insurance, offering opportunities for financial services firms in Europe as well as throughout the Middle East and North Africa region.

1980s after gas revenues came on stream.

Countries that reap oil and gas windfalls are likely to suffer exacerbated revenue volatility, with large-scale implications for budgetary spending and public debt. This reflects fluctuations in production, international prices and exchange rate, as well as fraud, corruption and money laundering. If not well managed, these factors pose the greatest risk to prudent fiscal policy management as well as debt sustainability.

These risks need to be set against significant opportunities. The macroeconomic policy framework can be refashioned to bring in better-functioning legal and institutional systems and frameworks to ensure sound governance and sustain growth.

Physical infrastructure

Physical infrastructures – roads, railways, ports and ICT – can be upgraded to lower supply-side constraints and boost productivity in the non-oil sector. This includes enhancing human resource development, through modernising systems for skills and training, as well as general education & health care, and introducing country-wide efforts to improve environmental protection.

The tasks for monetary policy are particularly acute. Excess oil revenues are the natural result of investors trying to recover their costs in the shortest possible time. This mounts a challenge for independent monetary policy under the modified inflation targeting regime practised by east African central banks, as pressures rise that are beyond the ability of central banks to contain alone.

Coordination is required between monetary, exchange rate and fiscal policies. Monetary and fiscal frameworks must be complementary. Pressures from oil revenues inflow will demand that fiscal policy bears a greater burden of macroeconomic management.

Exchange rate management

Exchange rate management is a priority. Significant fluctuations in oil revenues will trigger volatility of the nominal exchange rate as well as sharp appreciation of the real exchange rate, which may disrupt the economy. The authorities need to be open to policy innovations to shield the economy from excess volatility and minimise 'Dutch disease' effects.

It is important to ensure that oil revenues are collected directly in a central bank foreign exchange account. To minimise the first-round effects of undue currency movements, it is necessary that large oil entities open up foreign exchange accounts at foreign central banks.

Policy-makers need to establish arrangements for stepped-up issuance of government securities to absorb excess liquidity in the economy arising from fiscal injections. At the same time, attempts to lower the exchange rate should not include cutting interest rates to near zero, as this would lead to financial repression. The exchange rate needs to remain market-determined.

Arguably the greatest amendments are needed in the area of fiscal policy. The philosophy has to change in the direction of fiscal sustainability. A person who discovers a cache of honey should eat only what the stomach can comfortably accommodate, and keep the rest for future use. Following this approach, oil revenues should be saved where they exceed the sustainable path at which they can be spent. The right path is for these revenues to be invested in a sovereign wealth fund to safeguard macroeconomic stability and support future generations.

It is essential that prudent fiscal policy rules be established to guide macroeconomic policy. This should ensure that public expenditure is driven solely by what is judged to be sustainable revenue over the longer term.

So that windfall oil revenues do not compromise the overall tax regime, a sovereign fund in the form of a petroleum fund needs to be established as an entity that is distinct from the Government Consolidated Fund.■

David Kihangire, former Executive Director for Research at Bank of Uganda, is Regional Financial Sector Policy Adviser at the East African Community.

There was a discussion on potential conflicts of interest where central banks had to handle both monetary and supervisory/financial stability objectives, which could lead to central banks delaying necessary anti-inflation action for fear of damaging weak banks.

European and Middle East participants disagreed on the extent to which central banks could aggressively use monetary tools to overcome growth weaknesses.

In discussions with European experts from multinational development banks, parallels were raised with developments in European integration in the 1950s, starting with integration in coal and steel, and similar efforts being made across the Arab world in services and industry.

Both the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) were building up their activities in Arab countries. The EBRD was present on local markets in many of its 35 countries of operations which had been vacated by many private sector banks.

The degree of GCC trade integration was put at only 12-13%, lower than many experts and officials believed was satisfactory. Participants generally agreed that integration efforts needed to be intensified with the aid of both public and private sector initiatives, including by the Islamic Development Bank.

One delegate said greater political efforts were needed to combat destabilising competition between different Arab undertakings in airlines and shipping.

However there was no widespread support for the suggestion made in the November OMFIF Bulletin by Nasser Saidi that the Arab world needed its own development bank to overcome the threat of disruption after the Arab spring.■

The full summary of discussions is being circulated to OMFIF members.

Making African capitalism work

Public-private funding balance for global competitive edge

Kingsley Chiedu Moghalu, Central Bank of Nigeria

Small or medium-scale entrepreneurs in sub-Saharan Africa see inadequate infrastructure and lack of access to credit and capital as major impediments to business. SMEs often say the latter factor is the most critical hindrance. There is an apparent paradox: free markets are on the rise across the continent, but Africa is witnessing the dominance of capitalist economies, without capital.

Without this key ingredient, 'capitalism' – however defined – cannot work. The task for Africa is to overcome the manifold structural challenges so that private sector-led economic transformation can flourish across the continent.

African countries face these challenges at three levels. The first is whether or not there is enough capital to power growth and transformation. Do African economies have within them enough funds to finance big-ticket items such as infrastructure at a scale on which such infrastructure can make a difference?

Structural tensions

Second, finance may be available, mostly through the banking system, but there are valid questions about how effectively financial institutions are carrying out intermediation by transferring surplus savings to assets for productive use in the economy.

Other structural factors in the economy are as important as finance, if not more important. Thus, finance may be available but has not been turned into extensive credit, especially to small and medium enterprises (SMEs). There may be insufficient channels for accessing credit, often the case in countries with shallow financial markets dominated exclusively by banks.

The cost of credit may be too high because, for instance, inadequate electricity to power economic production and the add-on costs of generators render the costs of doing business – including for banks – exorbitant. Additionally, credit may be prohibitive because of anti-inflation monetary policy.

When such structural tensions exist, financial markets may function profitably, but not contribute significantly to economic growth, let alone transformation. Overcoming this difficulty involves tackling 'casino capitalism' which I define as the creation of wealth from finance but for individuals and not the wealth of nations, for consumption and not for production. It is akin to getting wealthy from gambling in a casino, where the lucky few prosper but the great majority end up as losers.

African capitalism

The third challenge flows from the need to adapt a form of capitalism that can avoid the extremes seen elsewhere and fit the characteristics across Africa. It is essential to have clarity of a philosophical point of departure about what type of capitalism each African nation needs; on the precise role of finance, financial institutions and markets; and, most importantly, on the role of the state, which is crucial.

The state needs to play a robust role in creating a robust financial architecture that supplies finance for development alongside private capital. Otherwise Africa's economic trajectory will ultimately be shortchanged by inadequate financing or by inefficient intermediation of what finance is available.

In general, greater financial depth, represented by higher ratios of total financial assets to national income or output, creates higher levels of productivity and thus income per person. Moreover, for transformation to succeed, more advanced financial structures are needed with migration from banks towards non-bank financial intermediaries, and on towards capital markets.

With few exceptions such as South Africa, the positioning of finance across sub-Saharan Africa is still weak relative to other continents. South Africa's exceptionalism in this regard is remarkable.

The World Economic Forum's Global Competitiveness Report for 2012 ranked South Africa third out of 144 countries for financial markets development – first in the regulation of securities exchanges and legal frameworks, second for financial services availability and bank soundness, and third for strength of local equity financing.

Deepening financial markets

Africa's financial markets need to be deepened to create a broader range of services and instruments for more efficient payment services, effective savings and investment decisions, and a broader menu of assets. While financial deepening can bring important benefits for macroeconomic stability and sustained growth, it can create risks and challenges from growing financial interconnectedness and unregulated financial innovation.

This highlights the need to maintain financial stability through effective risk management, and by avoiding excessive financialisation– a major reason for the financial crisis of 2008 and subsequent recession.

The depth of financial markets in Africa has improved significantly over the past decade, fuelled by a surge in commodity prices, high inflows of foreign direct investment, and domestic resources.

Despite the financial crisis, banking institutions, innovation and competition in the delivery of financial services have grown and remained broadly sound. African stock markets have witnessed considerable growth. From five stock markets across the continent in 1989, the numbers went up to 18 by 2007. By 2012, 29 exchanges represented the capital markets of 38 African nations.

Financial inclusion

Financial markets across Africa have also deepened through connecting up previously unbanked sections of the population through innovative means.

Nigeria has introduced microfinance and non-interest banking, while Kenya's Safaricom developed an innovative mobile payments solution that enables customers without access to a bank to transfer money. Kenya's success led to the deployment of similar products across Africa.

An IMF survey of financial inclusion indices in Africa reveals a rising number of commercial bank branches with attendant increases in deposits in Egypt, Kenya, Nigeria and South Africa. Outstanding deposits with commercial banks as a percentage of GDP were 74.0% in Egypt (as of 2010), 60.4% in Kenya, 40.5% in Nigeria, and 45.9% in South Africa as at 2011.

Accenture's Tipping Point Index has identified four levels of financial market development and depth in Africa based on

key factors such as financial infrastructure, consumer financial services and economic development.

These are 'established' financial services markets that are relatively deep and mature with diverse and successful financial sectors; the 'forging ahead' economies with institutionally developed markets that are undergoing reforms aimed at making them more attractive; the 'next mover' economies with high potential that are in the process of overcoming barriers to financial deepening such as low income, financial access, institutional or governance deficiencies; and the 'transitional' economies where market potentials are constrained by challenges such as poverty, difficult business environment, lack of financial inclusion and financial infrastructure.

South Africa and Mauritius have the most advanced financial markets in Africa; Egypt, Tunisia, Morocco and Nigeria are in the 'forging ahead' bracket; Botswana, Ghana and Namibia are at the 'tipping point'; Libya, Zambia, Senegal, Kenya and Uganda are 'next movers'; while Gabon, Angola, Tanzania, and Sudan are 'transitional' economies.

Financial market development

Africa's financial markets remain largely narrow and illiquid, limiting access to long-term financing and hindering countries' capacities for local debt financing. Several African countries have resorted to external debt financing by issuing Eurobonds.

Africa's financial markets lack transparency and accountability, leading to information asymmetry and the problem of adverse selection. They have inadequate regulatory frameworks. Infrastructure, including technological infrastructure that is essential for the efficient operation of financial markets, remains weak.

There is a high level of collateral requirement for bank lending in Africa – the world's second highest, averaging 137% of total loan value. The absence of widespread property rights and efficient land registration – a fundamental requirement for successful capitalism – constrains the ability of individuals and businesses to access credit.

Credit registries/ bureau – and reliable credit information on borrowers in general – are absent due to lack of unique identification systems.

Poor financial literacy and weak consumer protection mechanisms inhibit financial inclusion. Wide spreads between deposit and lending rates in countries such as Nigeria pose a major disintermediation risk.

For Africa's financial markets to thrive, important perspectives must be borne in mind. The first is that the growth of financial markets in an uncertain global environment will depend on sustained banking and economic reforms aimed at ensuring financial stability. Nigeria's far-reaching banking sector, capital market and pension reforms have laid a solid foundation and boosted wider investor confidence.

Second, finance and financial market development in Africa must be aimed not at following the path of western countries, based on a model of global flows of capital solely for profit. It should be targeted at achieving the purposes of transformation in the context not just of free markets, but also of developmental states.

The imperatives in this context include SME financing, financial inclusion, mortgage finance, venture capital, pension-fund finance, and development banking.

Venture capital

The absence of venture capital start-up funding for SMEs is the most important gap in the role of finance in Africa's economic transformation. The requirement is for funding companies specifically set up to make such investments. Although the venture capital market in countries such as Nigeria and Kenya is attempting to plug this gap, venture capital firms remain too few in Africa.

There are several reasons why venture capital is critical if finance is to play a meaningful role in Africa's economic transformation. It supports entrepreneurial capitalism, the small-scale approach to business that most fits the economic culture and history of most African societies – and powered the economic rise of the US.

Venture capital is directly associated with job creation: a major challenge with the continent's average unemployment at 21% and population growth outpacing employment. And venture capital focused on science, technology and innovation is necessary to diversify African countries away from a narrow dependence on natural resources.

This could provide a strong fillip to a desirable rise of economic sophistication and complexity in manufactured goods, which should be based on local technology that can give Africa a globally competitive edge.

Development institutions

The third overarching factor is the need for development or public finance institutions. They represent the last, crucial piece in the puzzle of financing for African transformation.

Together with the possibility of funding from pension funds, and capital markets fund-raising from fixed income instruments, development banks can address the challenge of large-scale funding for large infrastructure needs as well as long term capital.

There are several models of development finance. One model is the mega-development bank model epitomised by the Brazilian development bank BNDES, which powered Brazil's transformation by financing infrastructure with long term loans of minimum tenors of 20 years.

Another, advocated by the African Development Bank, is the use of foreign reserve surpluses for long-term finance. The idea is to combine technical know-how, private equity and debt, and assemble other financial instruments to fill the $50bn annual gap in supply of long-term capital for infrastructure.

Whatever the model, a combination of public sector and private capital is required for finance to fulfil its potential role in Africa's economic transformation. Public sector capital is needed because finance needs to be long-term to have transformational impact and the cost of capital sometimes needs to be subsidised.

Private capital is necessary because it is more efficient and more widely available, and the potential impact of development institutions owned solely by governments in many African countries has been blunted by political interference, weak corporate governance and inefficient asset allocation.

Getting the balance right between these two sources of capital is crucial to Africa's transformation.▪

Dr. Kingsley Chiedu Moghalu is the Deputy Governor for Financial Stability at the Central Bank of Nigeria. This article is adapted from his book 'Emerging Africa: How the Global Economy's Last Frontier Can Prosper and Matter'. See p.40.

Politics comes to the fore in Nigeria

Volatility on rise amid dispute on central bank independence

Razia Khan, Standard Chartered Bank

For the first time since the 1999 transition to civilian rule, Nigeria's ruling People's Democratic Party (PDP) faces a significant challenge to its dominance. Opposition parties have merged to form a new party, the All Progressives Congress (APC), and several rebel governors from the ruling PDP have defected to the new APC.

The government's Medium Term Expenditure Framework outlines relatively benign fiscal plans, including spending cuts in 2014, but the more contentious politics ahead of elections due in 2015 may cause these plans to change. While GDP growth may receive a short-term cyclical boost, the focus on long-term reforms, which are needed to drive structural transformation, may recede.

Key figure

The five-year term of Central Bank of Nigeria (CBN) Governor Lamido Sanusi will end in June 2014. The central bank governor, who is no stranger to government attempts to constrain his independence, is a key figure: the architect of reforms that stabilised Nigeria's banking sector, removed the minimum one-year holding period for offshore investors in federal government bonds, and moved to a more credible anti-inflation policy, with a commitment to foreign exchange stability.

Sanusi is well-known abroad and is closely identified with factors that contributed to Nigeria's 2012 inclusion in the Government Bond Index-Emerging Markets index. So investors will be watching the central bank's succession plans with great vigilance. Foreign investment in federal government bonds and bills was at c.$11.6bn as of September 2013.

Revenue shortfalls due to oil theft are likely to persist in 2014, creating a potential squeeze on the statutory sharing of oil earnings) and on state budgets. The finance minister estimates the amount of stolen oil at 80,000 barrels per day (bpd), and a Chatham House report estimates the trade to be worth $38bn a year.

The amount of production shut in as a result of vandalism to oil pipelines is much higher, costing Nigeria close to 20% of output, according to media reports. With domestic politics dominating in 2014, Nigeria is unlikely to make much progress on tackling oil theft.

The passage of the long-awaited Petroleum Industry Bill, an ambitious plan to reform the upstream and downstream oil sectors, is unlikely, since the PDP's majority in the National Assembly is looking increasingly tenuous.

Uncertainty over future fiscal terms has exerted a high cost on Nigeria's oil sector. The number of deep-water wells drilled in recent years lags far behind regional peers. Near-term, robust local appetite to buy onshore assets from international oil companies will be constrained by the availability of financing.

Power sector reforms will be a key influence on the economic (and possibly the political) outlook. GDP in the first half of 2013 was reduced by supply disruptions from the West African Gas Pipeline, driving power generation to new lows. Power supply may improve meaningfully only in the medium term.

Agricultural sector reforms and the focus on agriculture value chain should have a positive near-term effect. Recent data indicate falling food price inflation. Rising agricultural output should eventually be reflected in GDP growth.

Nigeria's GDP statistics are due to be rebased, and a 30-40% increase in the estimated size of the economy is likely. Some metrics, such as debt to GDP, will look more favourable. But the new statistical approach will probably reveal an even weaker ratio of non-oil revenue collection to GDP.

The 2014 budget was not presented in November 2013, in line with the typical timeframe. This was ostensibly because of disagreement over the benchmark oil price. The contentious political environment raises the risk that no budget will be passed by end-March 2014, the deadline for approving the budget. In addition, the oil output assumption is still ambitious (2.39m bpd versus 2.53m bpd in 2013) – as released oil production tends to be below government initial assumptions.

Because oil revenues are optimistic, savings in the Excess Crude Account (ECA) may be needed. This raises upside risks to borrowing projections. Given revenue constraints, the capital expenditure budget will be cut according to the Medium Term Expenditure Framework, with the share of recurrent expenditure set to increase to 74%. While the framework foresees a reduction in government expenditure to N4.5tn in 2014 from N5tn in 2013, the strengthening of the Opposition is likely to result in pressure for increased spending.

The outlook for interest rates now appears to have changed. While inflation slowed to single digits in 2013, this could be put at risk by higher pre-election spending, foreign exchange volatility (exacerbated by gradual withdrawal of Federal Reserve monetary stimulus), and investor concerns about the Sanusi succession.

Previously a rise in the central bank's monetary policy rate (MPR) by 200bps to 14% in 2014 to influence the naira level appeared likely. However, the central bank made clear after its most recent meeting that it would prefer to hike the public sector cash reserve ratio (CRR) further to deal more decisively with excess liquidity – should it arise.

Therefore a further hike in the public sector CRR to 100% (from 50%) is expected in the first half this year, especially if spending pressures emerge. The MPR increase is likely to be limited to just 50bps, most likely at the September 2014 policy meeting, to keep real interest rates positive. While central bank officials have spoken of adopting an informal 4-7% inflation target by 2015, inflation is expected to end 2014 at just above 12%.

Political activity

Political activity is likely to take centre stage in 2014 as alliances are built to secure the presidency. While the opposition APC is likely to be the favoured party in the southwest and the north, its choice of presidential candidate is still unclear.

While President Jonathan will enjoy the advantage of incumbency, Nigeria's constitution requires the president to win an overall majority, and at least 25% of the vote in more than two-thirds of Nigeria's 36 states.

The central bank is likely to defend the current foreign exchange peg (around a mid-point of 155 to the dollar up to a certain degree and to tighten policy to achieve this). However policy-makers are expected to show flexibility.

Should the naira trade consistently outside this band even after tightening, the authorities are likely to accommodate this, and accept currency weakening with the mid-point of the dollar-naira band shifting to 160 in 2014.■

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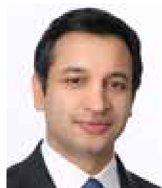

The catalyst must come from within

Africa needs better conditions for infrastructure

Minesh Mashru & Ulrich Otto, Quantum Global Investment Management

In the last decade sub-Saharan Africa has seen rapid GDP growth, amongst the highest and most sustained globally. In today's economic and investment community there seems to be widespread agreement that Africa is the continent to invest in now. The growth of physical infrastructure has however not kept pace with economic growth and has not seen any willingness to invest on a large scale, causing significant problems to industry and enterprise in Africa.

A recent World Bank study found that GDP growth was reduced by 2 percentage points per annum due to the lack of infrastructure and that business productivity was reduced by 40%. Overall, the World Bank estimates that there is a funding gap of $35bn per annum across Africa that needs to be met to fund new infrastructure and maintain existing infrastructure.

Infrastructure shortages

Infrastructure shortages are widespread across sectors and create substantial disadvantages for the African continent: Only a tenth of power is produced in comparison to elsewhere in the developing world (124kwh per capita per annum); only 16% roads are paved, less than Latin America and south Asia – therefore, only one third of Africans live within 2km of an all season road; 40% of the African population lacks access to safe water and 60% to basic sanitation; and transport costs in Africa are estimated to be among the highest globally – twice as high as in south and east Asia. It is estimated that deficient transport infrastructure (e.g. road, rail, ports) add 30-40% to the cost of goods traded in Africa.

The potential of sub-Saharan Africa is highlighted by being home to over 12% of the world's population, but accounting for only about 2% of world GDP. Combined with the abundant level of natural resources, including about 5% of proven global oil reserves and 40% of gold reserves, levels of growth are anticipated to be maintained into the foreseeable future.

However, this forecast is based on both the continuation of recent political stability in the region and other key factors in the improving business eco-system, of which infrastructure investment is arguably the most important factor in encouraging greater levels of foreign direct investment, creating employment and training opportunities, and improving competiveness of private industries.

Despite the requirement to rapidly improve infrastructure in sub-Saharan Africa, investment in infrastructure averages between 2-3% of GDP per annum across the region. This compares to other developed markets which continue to invest more, and developing markets such as India and China, estimated to be spending about 5% and 9% of GDP respectively on infrastructure. Initiatives in Africa to address this include the Programme for Infrastructure Development in Africa (PIDA), created to develop an integrated strategic framework for infrastructure development. Therefore, although the political will exists, key factors motivating investments still need to be addressed to support the required spending needed in the region.

Public policy is a key factor in driving infrastructure investment, both directly from the public sector and indirectly from the private sector. Infrastructure project life-cycle periods of up to 20 years or more require a long-term commitment and relative stability of policies.

The funding challenges due to the relatively large nature of investments are exaggerated by budgetary constraints for African governments. This has impacted the ability for the estimated funding gap to be met fully from the public sector. Therefore, greater private sector involvement is being sought within Africa, which at this time has been held back by several factors.

First, regulatory and legal frameworks are still developing in a number of sub-Saharan African countries. Investors require long-term certainty of the regulatory framework, including on setting of prices, and a legal framework that is robust and protects ownership rights including from risks such as expropriation.

Second, infrastructure investment is long-term by nature and therefore requires a financing structure that matches this risk profile. Availability of long-term financing in sub-Saharan African remains in a nascent stage compared to other developing regions, with lack of liquidity amongst local banks and challenges to obtain from international lenders or multi-lateral institutions due to the number of competing projects and limited liquidity. Bond markets remain underdeveloped to support access to different investors.

Third, public-private partnerships (PPP) have proven to be an effective approach to develop private infrastructure investment in both developed and emerging markets. However, the market for PPPs is undeveloped across Africa as PPP frameworks are not fully in place. This results in extensive negotiations for projects, often on a case by case basis, as opposed to generally accepted models which can be applied to various projects outlining both the role of the private sector and that of the government.

Environment for private investment

Private equity in infrastructure remains a minimal source of financing in sub-Saharan Africa. Despite this, return expectations from private equity investors is considered highest in sub-Saharan Africa at present due to the high economic growth expectations in the medium and long-term, as well as perceptions that risks are higher here than in many other markets.

Infrastructure is seen as a sector that will grow at rates beyond most other sectors to 2020. Hence, although these factors highlight the motivation of the private sector to invest in African infrastructure, improvements in the business eco-system in Africa is needed to help drive this investment.

Investors need transparency that investments can operate as planned over the long-term and will retain full government support. This requires the development of legal frameworks which protect investors in the long-term and aligns incentives between governments and private investors, including governments signing up to international arbitration agreements and double taxation agreements. As transparency improves, the likelihood is that private equity will grow and debt liquidity will rise to support growing levels of private investment. The growth potential is there to be seen, but the catalyst must come from within. A great deal more needs to be done.▪

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New monetary approach needed

Why sovereign funds in Africa could make a difference

Zeph Nhleko, South African Reserve Bank

Only less than a dozen countries in Africa have sovereign wealth funds, mostly created on the back of oil and gas reserves. South Africa, one of the important economies in the continent, is not among these countries. At face value this low participation rate may be surprising given the vast natural resource endowment in the continent.

However, a closer look at the conventional reasons for establishing sovereign wealth funds suggests very clearly the lack of imagination in the continent.

There is a requirement to bring in innovative thinking to reformulate the overall direction of monetary policy.

Generally, unconventional monetary policy focuses on the buying of financial assets. While this works miracles in the financial sector, it is not helpful in dealing with real economy issues in the same manner.

Infrastructure financing gap

The African continent, in broad terms, faces widespread poverty, inequality, unemployment, weak socio-economic systems such as health and education as well as less developed infrastructure. It has been estimated in various forums that Africa will require close to $100bn per annum for the next decade to maintain and overhaul infrastructure.

Despite what appear to be relatively sound growth levels, the continent continues to be plagued by a range of issues that signal that the level of economic growth is in fact insufficient.

Emphasis on the real economy

There is perhaps a case for an alternative unconventional monetary policy in Africa. This means that, unlike in advanced market economies where quantitative easing focuses on financial assets, an alternative unconventional monetary policy in Africa should put more emphasis on the real economy.

The room for real economy growth in Africa is so vast that an obsession with the financial sector from an economic policy point of view is not completely logical.

Unconventional monetary policy is aimed at smoothing short-to-medium term economic cycles, just like conventional policy does. However, this type of policy action does not do much to enhance the size of the real economy. Perhaps further research here is in order. But judging from what we have seen over the past six years, we can guess what the research answer will be.

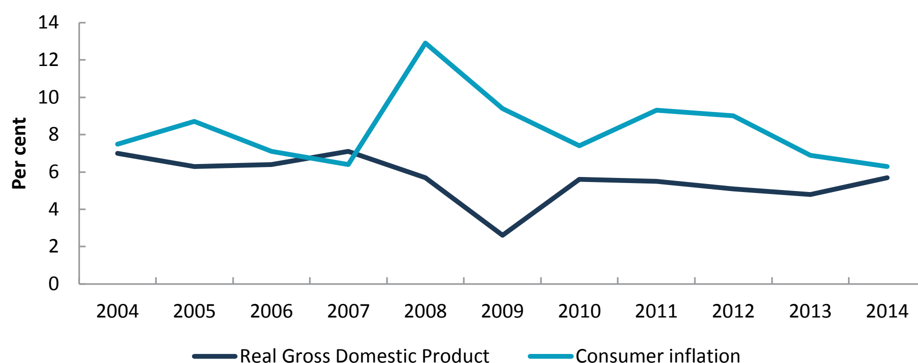
So in the case of sub-Saharan Africa – why continue to focus on smoothing economic cycles even though the overall level of economic growth has remained insufficient post-crisis? Is there perhaps a case for alternative unconventional policy?

Insufficient real GDP

As the chart shows, inflation has not been a major concern post the 2007-08 financial crisis. Although mild upward inflation fluctuations can be expected in the medium term, this does not detract from the fact that real gross domestic product has been insufficient over the past couple of years.

This should provide compelling justification for the continent to adjust economic policy towards issues that predominantly reduce unemployment.

Real GDP, consumer inflation in sub-Saharan Africa



Supervision

Sovereign wealth funds or other types of funds which can have, as part of their mandate, infrastructure investment, should be set up and preferably overseen by central banks so as to avoid economic policy mismatches.

For example, it would make sense in South Africa for the fund created to be overseen by the central bank to ensure that its operations do not impede the implementation of price and financial stability policies. This would allow the direct implementation of alternative unconventional monetary policy.

State ownership

The discussion around the state ownership of entities should perhaps be held along this forward-looking and long term view. The establishment of such a fund should be based on natural or public pension resources. Property development (including public property), rail and roads are just some of the many infrastructural needs that the country has and in which a fund of this nature can participate.

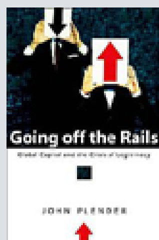
Diversification of the fund investment is paramount. Setting up such a fund should prioritise the reduction of unemployment levels from the current levels of around 25%. That will in turn have a dent on poverty and inequality levels.

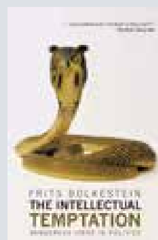
A logical question is: does this not hamper the functioning of other institutions in the economy such as development finance institutions? The straightforward answer is that if these institutions were carrying out their mandate, then perhaps unemployment and infrastructure in Africa would not be at these levels.

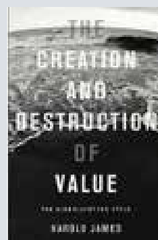
The feasibility of setting up a sovereign wealth fund, which may take multiple or varying mandates and may influence various policy spheres, should be weighed against taking a narrow approach such as setting up an infrastructure development fund. Alternative unconventional monetary policy should be flexible enough to deal with pertinent economic issues.■

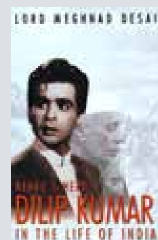
Zeph Nhleko is Senior Economist at South African Reserve Bank.

Books & the Advisory Board section features books written by members of the OMFIF Advisory Board, across finance, economics, history, arts and culture.









A plea for putting economics first

Searching for a worldview to push Africa ahead

Africa is in the news – for good and for ill, *writes David Marsh*. For all its resources, land, diversity, exuberance and people, the continent has lagged the other developing regions of the world in terms of economic growth and prosperity.

As a result of a variety of factors – the retreat of violence, better governance, more benign geopolitics, the march of Chinese investment, the final ebbing of colonialism – the continent seems poised, at last, to ascend the league table of world trade and investment.

For investors and onlookers, as much as its inhabitants, Africa has frequently frustrated and disappointed more than it inspires and excites. This time it may be different. An elegant and thoughtful book – Emerging Africa – by Kingsley Chiedu Moghalu, deputy governor of the Central Bank of Nigeria, provides fulsome ideas and insights on Africa's past, present and future. Many but by no means all of these are positive.

It is rare indeed, if not unprecedented, for such a well-written and realistic book to be produced by a serving central banking official, not just in Africa, but anywhere. Moghalu, in charge of the fraught field of Nigerian banking supervision, was educated at the London School of Economics and Tufts University as well as the University of Nigeria. He set up a consulting company in in Switzerland and worked for the United Nations for 17 years.

He is an unusually experienced and wide-ranging expert. But, as a result of Africa's modernisation and rejuvenation, he is – thankfully – a not entirely untypical example of a new breed of innovative and open-minded official now occupying Africa's central banking parlours.

Moghalu is deputy to Lamido Sanusi, the fiercely independent central bank president, who has been embroiled in a row with the Nigerian president over a leaked letter from the central bank alleging a $50bn hole in the government's oil accounts. The president says he has exaggerated oil theft, and called upon Sanusi to step down early from his five-year term that ends on 2 June.

Though latest indications are that the dispute has been resolved, the matters that have led to it have not. While setting down many reasons for optimism, Moghalu looks at his continent through 'a somewhat different lens – one not of hagiography but of interrogation, not of looking at what's on the surface but what's beneath, and not of political correctness but of recourse to the philosophical and strategic underpinnings of wealth and poverty.' Africa's much-mooted emergence has not happened, he says, because 'the factors that will drive the continent's renaissance' are not in place.

Weak governance

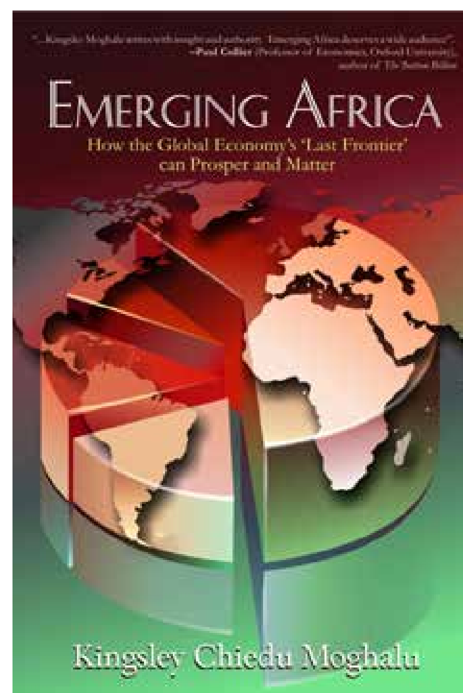
Although he does not exaggerate the issue, Moghalu tilts at 'raging corruption' as a signal of weak governance. Paying bribes to obtain a permit or secure a government contract 'distorts the business environment by creating an unfair advantage…Corruption is preventing the real take-off, let alone the development, of free markets in several African countries…Governments in African countries must combine building strong regulatory capacity with supervising their own exit from several areas of the economy, especially in the extractive industries.'

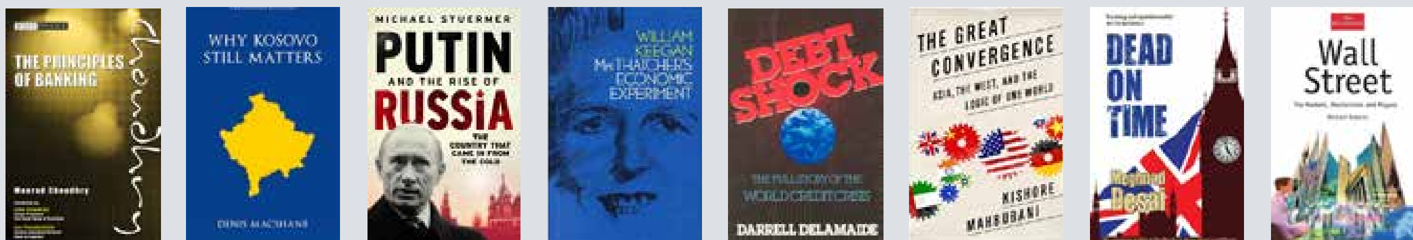
Among his precepts for strengthening a market-based economy, Moghalu calls for emancipation from foreign aid culture, espousal of 'entrepreneurial capitalism 'and better frameworks for financial market innovation and foreign trade and investment. He makes it clear that his model is neither American laissez-faire nor the centrally-run state capitalism of China, which, he says. 'favours China's interest more at this time than it favours Africa's.'

Effective leadership

Instead, Moghalu leans towards the 'effective leadership' displayed by the smaller, Asian states of Singapore and Malaysia whose archetypal leaders Lee Kuan Yew and Mahathir Mohamed have propagated successful 'Asian values' as response to those propagated by the west.

Africa's post-colonial 'worldview', seeing the world through the prism of political freedoms, was too narrow, Moghalu says, because it failed to espouse economics. Get the economics right: everything else then has a better chance of succeeding. Easier said than done – but it's the right approach to take.▪





European macroeconomics: A current and comprehensive analysis

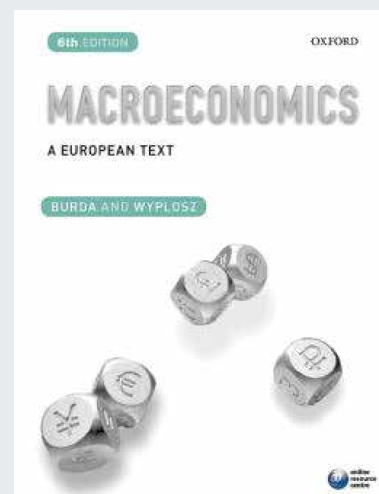
Macroeconomics: A European Text, sixth edition, provides a comprehensive analysis of contemporary macroeconomics from a European perspective, allowing students to relate the concepts to their own economic environment.

Written by Michael Burda and Charles Wyplosz, the textbook uses up-to-date European and global monetary policy examples to demonstrate the relevance of macroeconomic theory, including coverage of the global financial crisis and challenges faced by the euro area.

For instance, material on real exchange rates is linked to the public debt crisis in southern Europe; lessons on money and monetary policy include a discussion of central bank policies during the financial crisis; the importance and limitations of fiscal measures is illustrated by responses to the Great Recession; and the relevance of economic growth theory is highlighted by the current explosion of public debt and challenges of supply-side policies.

Burda and Wyplosz provide a modern approach to macroeconomics with both simplicity and rigour, while retaining the focus on particular features of the European economy.▪

Michael Burda is Professor of Economics at Humboldt University, Berlin.



Curbing rising inequality in Asia-Pacific

Edited by Ravi Kanbur, Changyong Rhee and Juzhong Zhuang, this book highlights four sets of policy responses to rising inequality in Asia and the Pacific.

These include: (i) efficient fiscal policies to reduce inequality in human capital with a view to addressing the rising skill premium; (ii) interventions to reduce spatial inequality; (iii) policies to make growth more employment-friendly with a view to increasing labour demand and hence labour's share in national income; and (iv) measures to promote equal opportunities through strengthening governance and institutions.

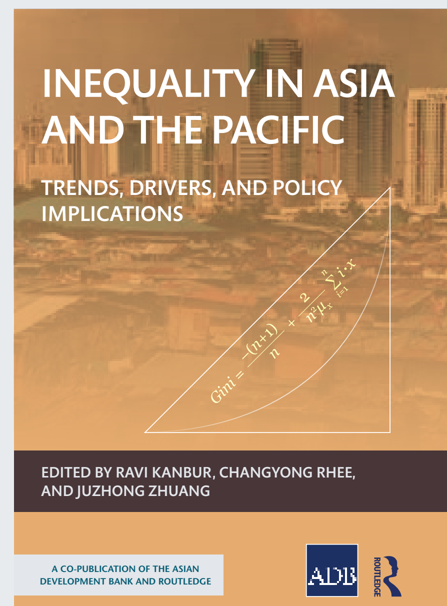
The book argues that Asia and the Pacific has enjoyed a remarkable period of growth and poverty reduction, but the new global realities of technological progress, more globally integrated markets, and greater market orientation are magnifying the effects of inequalities in physical and human capital.

Asian policy-makers need to redouble their efforts to equalise opportunities in employment, education and health to make growth more inclusive. Without such policies of job creation and efficient fiscal measures to enhance growth, Asia may be pulled into inefficient populist policies, which would help neither growth nor equity.

Part I presents a region-wide overview and synthesis of recent trends of inequality in Asia, their key factors (technological change, globalisation, market-oriented reform, and inequality of opportunity), and policy options to address rising inequality.

Part II contains 12 background papers, each providing an in-depth analysis of a particular issue related to inequality and income distribution, including gender inequality, structural transformation, the role of institutions, fiscal policy and redistribution, and inequalities in Southeast Asia, China, India, and Pakistan.

Inequality in Asia and the Pacific is published by Routledge and Asian Development Bank. ▪



Ravi Kanbur is Professor at Cornell University and Changyong Rhee and Juzhong Zhuang are Chief Economist and Deputy Chief Economist at the Asian Development Bank.

'Books & the Advisory Board' is being expanded to include a wider category of publications by OMFIF's financial and business contacts around the world. For further information please contact Harry Tsang at harry.tsang@omfif.org.

Oil price key to Maduro future

Balancing act breaks down as hyperinflation takes hold

Steve Hanke, Advisory Board

Bad economic news is rife in Venezuela: a collapsing bolivar, inflation and resulting empty shelves in shops and stores, and now massive blackouts. President Nicolas Maduro appears to be introducing a Latin American form of Marxism on the oil-rich but increasingly impoverished country.

Venezuela's downward economic spiral began in earnest with former president Hugo Chavez's unique brand of socialism. For years, the country sustained a massive social spending programme, combined with costly price and labour market controls, as well as an aggressive foreign aid strategy. This fiscal house of cards was supported – barely – by oil revenues.

As the regime's costs grew, it had to dip ever more into the coffers of state-owned oil company, PDVSA. It relied, too, on the central bank to fill the fiscal gap. This resulted in a steady decline in the bolivar. The decline accelerated as news emerged of Chavez's failing health, resulting in his death in March 2013. In the months since Maduro, his hand-picked successor, took the reins, the balancing act has become still more unstable.

On the black market, the bolivar's exchange rate against the dollar has fallen 64.5% since Chavez's death, bringing in triple digit inflation, currently 297%. This rate is over five times higher than the most recent official annual inflation rate of 54% reported by the government and echoed by the international financial press. The Venezuelan censors are effective. The Caracas-based reporters I speak to regularly tell me that the news organisations practise self-censorship to avoid having their reporters dismissed.

The government has responded to its economic woes by imposing ever-tougher price controls. For years, the government has set the price for key goods. Premium gasoline is fixed at only $0.58 per gallon, cheaper than a gallon of potable water in Caracas.

While these controls keep prices low on official markets low, they have led to empty shelves. About 22% of goods are simply not available in Venezuelan stores. In addition to scarcity, price controls can lead to unintended political consequences. Once price controls are implemented, it is very difficult to remove them without generating popular unrest. This was demonstrated by the 1989 Venezuela riots when President Carlos Perez attempted to remove price controls.

Recently, in a panic-struck and misguided response to the problems, Maduro sought, and was granted, emergency powers over the economy. His first move was to cap corporate profits. This was a diversionary tactic, since inflation eats away at corporate profits and return on investment.

Maduro has taken aim at the automobile industry, signing a decree to regulate car production 'from the factory door to the place of sale'. In consequence, the government has begun to fix prices for cars and crack down on those who sell at market prices. It will be interesting to see who Maduro blames when this results in a shortage of new cars.

This choice between 'fair' prices and arrest is now the norm for business owners in Venezuela. Despite frequent references to Chavez's 'Bolivarian' revolution, the Maduro playbook is nothing more than a rehashing of Marx and Engels' 10 point plan, as laid out in the Communist Manifesto: a road map that included measures such as abolition of property rights and centralisation of credit, communciations and transportation.

The results of these Manifesto-like policies are clear. The World Bank ranked Venezuela 181 out of 189 in its 2014 'Doing Business' rankings, behind such war-torn nations as Syria, Iraq, and Afghanistan. However, the Madurio regime enjoys continued popular support. In 337 mayoral elections in early December, Maduro's ruling socialist party trounced the opposition.

The president stated that his 'economic offensive' against private businesses would continue. 'We're going in with guns blazing, so watch out.'

Maduro's rule may be long-lived, as seen by past and present examples of hyperinflation under economically incompetent but politically resilient leaders in states such as Yugoslavia with Slobodan Milosevic or Zimbabwe under Robert Mugabe. An oil price below $50 per barrel, which seems unlikely, would scupper Madero. Otherwise, his regime looks likely to stumble on.▪

Steve Hanke is Professor at The Johns Hopkins University and Director of the Troubled Currencies Project at the Cato Institute.

Free trade boost from Pacific Alliance (...continued from page 31)

tariffs and non-tariff barriers, but transport costs determined by a combination of distance and the quality of roads, are currently the main obstacle to trade according to a recent Inter-American Development Bank (IADB) report.

Transport and service improvements

Pacific Alliance members are launching programmes to attract foreign investment to reduce costs and ensure a few prosperous locations are not the sole beneficiaries – avoiding the risk of further accentuating regional disparities and locking out potential exporters.

There is much room for improvement and diversification of transport in the road-haulage based Pacific Alliance member countries, with added scope for the development of rail and waterway freight.

Colombia is best positioned to gain from transport and service improvements. A 1% reduction in transport costs can translate into an 8% increase in agriculture and manufacturing exports, and a 6% increase in mining exports.

In Peru, a 1% reduction in transport costs can, according to the IADB, translate into a 4.3% increase in exports with a greater impact on primary goods rather than manufactures. The paving and construction of new all-weather roads will enable less export-developed regions to grow by as much as 16%.

A 1% reduction in transport costs in Chile would result in just over a 4% increase in agricultural, manufacturing and mining exports.

In Mexico a similar reduction would translate into increases of 4% in agricultural exports, 2.6% in manufacturing and 2.4% in mining exports, according to the IADB.

The Pacific Alliance agenda on development and transport costs reduction may well thus focus on economic de-concentration away from big cities through investment in transport, energy and infrastructure in peripheral locations.▪

Dr. Winston Moore is Director of Moore Asociados.

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