January 2015
Vol. 6 Ed.1

The Bulletin

Official monetary and financial institutions • Asset management • Global money and credit

Search for guidance

Maze of monetary challenges

A year after Janet Yellen: the world of female central bankers
Kevin Anderson & George Hoguet on China's A-shares
Bronwyn Curtis's bittersweet 2015 predictions
Meghnad Desai on Greek elections and the euro
Jingdong Hua on emerging markets and reserve diversification
Julia Leung's *Tides of Capital* launches OMFIF Press
Karl Otto Pöhl and his legacy
David Smith & Darrell Delamaide on bringing Cuba in from the cold

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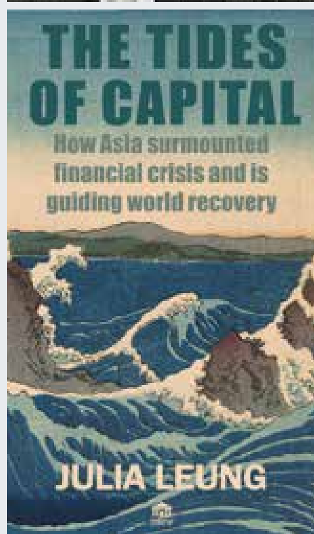
THE VALUE OF INVESTMENTS CAN FALL AS WELL AS RISE AND LOSSES MAY BE MADE. TELEPHONE CALLS MAY BE RECORDED FOR TRAINING AND QUALITY ASSURANCE PURPOSES. * Source: Investec Asset Management as at 30.09.14. Issued by Investec Asset Management, December 2014.

Cover story

The world enters 2015 in some disarray. The fall in the oil price, which in past decades would have been viewed as an unmixed blessing, is now a source of anxiety and perturbation – a product of deflation worries in Europe, souring worldwide energy investments and much-diminished revenues for oil-rich economies. The first 2015 edition of The Bulletin looks at the maze of monetary challenges confronting a world seeking guidance.



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Leung calls for coordination as Europe mulls go-it-alone bond purchases

Julia Leung's book, *The Tides of Capital*, contains a powerful plea for better coordination among major players in the world economy – but holds out only scant hope that this aim will be realised. With the US, Japan, Europe and China all lined up in diverse policy directions, the world is entering a period of probable economic turbulence with no semblance of an overall strategy. The disarray in Europe is especially piquant. Deep-seated divergences within the European Central Bank have now come fully into the open. The ECB is even considering sanctioning an extreme form of go-it-alone policy, under which constituent central banks would each buy government bonds on their own account, which some might say would strongly constrain euro area solidarity.

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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.

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OMFIF's 170-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, weekly Commentaries, seminars and other OMFIF activities.
See p.24-25.

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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.

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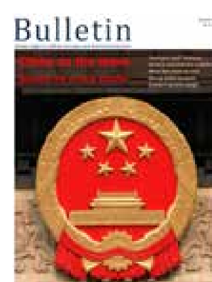
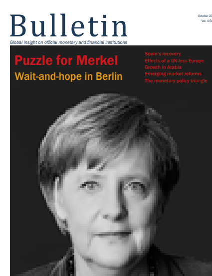




EDITORIAL

World economy searching for direction

A year after Janet Yellen took over at the Federal Reserve is an appropriate moment to survey the progress of women in central banking. This is not always the safest of jobs. Compared with our survey in November 2013, the roll call contains some absentees, with Gill Marcus from South Africa retiring, Mercedes Marcó del Pont from Argentina (like many predecessors as well as her immediate successor) forced out, and Yussur Abrar from Somalia leaving after just three weeks.

But, where previously there had been none, two females now sit on the 25-strong European Central Bank council, Chrystalla Georghadji of Cyprus (the first lady governor from a euro bloc country – albeit one with exchange controls) and Sabine Lautenschläger, on the ECB executive board. Overall, we demonstrate in the OMFIF Index of Female Central Bankers that gender equality in this field has shown a clear increase over the past 12 months. So this is work in progress. The same applies to the somewhat directionless state of the world economy. Bronwyn Curtis's New Year predictions make sobering reading. The one uniformly bright spot applies to the US. Darrell Delamaide delves into the Federal Reserve's code system and divines that interest rates are due to go up in mid-year. Trevor Greetham maintains the US as his favourite equity market. Dalin Hamilton takes a cautious line on Shinzo Abe's re-election in Japan.

In Europe, we are back in déjà-vu territory. Meghnad Desai says the snap Greek poll on 25 January adds up to the referendum he advocated in July 2011 and was briefly tabled (and then shelved) by George Papandreou, the Greek prime minister. Harald Benink, Wim Boonstra and David Marsh investigate easing options for the European Central Bank, where Mario Draghi remains committed to aggressive balance sheet expansion, opposed by Jens Weidmann, the Bundesbank president. John Plender examines the wider issues of possible debt restructuring. Ian Solliec says higher German inflation would be in Germany's best interests. Denis MacShane surveys a bevy of European electoral contests where populist anti-EU parties may gain the upper hand. Michael Lafferty gazes into the crystal ball for European banking and spots clouds on the horizon.

In our emerging markets section, David Smith outlines perspectives for Latin America. Jingdong Hua from International Finance Corporation explains IFC's MCPP instrument for giving official institutions access to syndicated loans for emerging market private sector companies. Kevin Anderson and George Hoguet from State Street Global Advisors submit the Hong Kong-Shanghai Connect programme to fresh scrutiny, with a particular focus on the international monetary ramifications. We review books by William Keegan, John Micklethwait and Adrian Wooldridge – a worthy crop of sages to accompany OMFIF into the New Year. ▪

Toning down the testosterone

Success comes late for the lady who doesn't yell

Bronwyn Curtis, Chief Economic Adviser

Janet Yellen is described as a brilliant thinker who focuses on the human side of economics – a dove rather than a hawk. To me, this is a just reflection of the greater affinity she has with people and the real economy. The greed of the macho culture of finance got the world into a mess; less testosterone, in the form of the first non-male head of the Federal Reserve, may get us out of it.

When I was looking for background material I searched for Yellen on the Financial Times website. It asked me if I meant 'Yelled' – so much for being the most important policy-maker in the world. Let's put that down to a computer blip, but it reminded me that Janet Yellen is probably the least likely person to yell at her colleagues. When I reviewed Sheryl Sandberg's *Lean In* I was struck by how much the barriers to successful women have been breached, especially in 'new' areas like technology. Getting to the top was certainly tougher and took longer for Yellen than Sandberg, who was 45 when she got the top post as Chief Operating Officer of Facebook. Aged 67 when she took over, Yellen is the oldest person to be elevated to the top of the Federal Reserve. Alan Greenspan was 61 and Ben Bernanke was only 53 when they got the job.

Yellen has one son, Robert, and may have had the usual issues around having children. One can only wonder whether she would have been appointed to the position much earlier if she had been a man. Yellen is known for her diplomacy and non-confrontational manner.

This doesn't mean she is submissive. Alan Blinder, a colleague at the Federal Reserve Board in the 1990s, remembers her approach to policy differences as being 'argumentative, but in a good way'. Sandberg says the path to success for women is to be 'relentlessly pleasant'. That style came as naturally to Yellen as academic success. Compare her approach with that of her ex-student Larry Summers, who was her main competitor for the job and President Obama's preferred candidate. Summers is known for his arrogant manner and had to resign as president of Harvard University after a series of conflicts. Both Sandberg and Yellen had outstanding academic careers and high-powered mentors. In the case of Sandberg, her relationship with Larry Summers kick-started her career. It is not clear that it was the same for Yellen, whose enthusiasm for economics was kindled by James Tobin, a future Nobel Prize winner.

Yellen was an over-achiever from an early age. When she graduated in 1963 she won all the major prizes, including for mathematics, science, and English. Her academic prowess far exceeds most people's but her career, while illustrious, wasn't the straight line upwards that Sandberg seems to have enjoyed. For many years she was better known as George Akerlof's wife – a fellow economist who shared the Nobel Prize for economics in 2001 – and, despite a stint as an assistant professor at Harvard, she wasn't offered tenure. It is worth noting that even as late as 2004 only four of 32 tenure offers made in Harvard's Faculty of Arts and Sciences went to women. Sandberg is a billionaire while Yellen earns just $201,700 a year as chair of the US Federal Reserve. But if I were asked whom I would want on my team, I'd take Janet Yellen any day. ▪

ADVISORY BOARD

With the latest appointment, the OMFIF Advisory Board has risen to 170 people, subdivided into six groups ranging from Capital Markets & Investments to Economics & Industry. For the full list of members see p.24-25.

OMFIF has appointed Franco Bassanini, chairman of Italy's largest development bank, Cassa Depositi e Prestiti, to the Advisory Board. Bassanini was a member of the Italian parliament from 1979 to 2006, and served as Italian Cabinet Minister for Public Administration and Regional Affairs (1996-98), Undersecretary of State to the Prime Minister's Office (1998-99), and Cabinet Minister for Public Administration (1999-2001).

He is president of the Long Term Investors Club, a grouping of 15 public sector financial organisations from around the world with a balance sheet total of $3.2tn, and of Astrid Foundation, an Italian think tank. He is the author of 18 books and numerous articles on law and political science.

ECONOMISTS MEETING

Macroeconomic outlook for Hungary

Participants at the Central Bank of Hungary-OMFIF Economists Meeting on 1 December in Budapest exchanged views on the economic outlook and banking situation in Hungary and the central, east and southeast European region.

Raising competitiveness and the consolidation of the Hungarian banking sector following the global financial crisis were at the centre of discussions.

Hungary needs to catch up lost ground. CESEE growth performance is stronger than the European Union average, but still mainly below pre-crisis levels. The economy is becoming more balanced and growth is projected to accelerate slightly in 2015.

There was some discussion on whether Hungary will join the euro area. The euro was very attractive to Hungarians before the crisis, but now support for membership has dropped below 50%.

Giving up its national currency would mean losing tools for monetary adjustments. Under present circumstances, a range of Hungarian speakers indicated it would be 'political suicide' to announce any plans to join.

OMFIF CITY LECTURE

Adair Turner on central banking since the crisis

Addressing a packed Armourers' Hall on 10 December, Lord Turner, former chairman of the FSA, outlined how central banking and economic theory have evolved since 2008.

Lord Turner explained that banks no longer do what the textbooks say they do. Rather than providing finance for industry to invest, as classical economics supposes, the great majority of bank lending in modern developed societies goes into existing assets – primarily real estate. The second biggest use of it is to maintain consumption.

Neither of these sets of activity responds in the orthodox way to monetary policy. He recommended that banks focus on the tasks outlined in the textbooks. Whereas borrowing to invest can be curtailed by a rise in interest rates, borrowing to consume and to buy real estate is largely unaffected. This had led central banks to develop new macroprudential tools such as targeted lending and even targeted institutions. For example, as an improvement, he suggested stripping out real estate from bank's lending operations.

CONFERENCE

Long-term investment in European infrastructure

Social infrastructure investment and long-term strategies were the topics of debate at the Investing in Long-Term Europe conference in Rome on 12-13 December.

Infrastructure investment is crucial to long-term economic growth. The euro area has stagnated for three years and investment levels have yet to return to pre-crisis levels. While there is high demand from the private sector for quality, viable infrastructure projects in Europe, suitable projects are lacking. Some investors complained that prices for highly sought after quality projects are being driven too high as too much money chases too few deals.

Jean-Claude Juncker, the new European Commission president, has created an ambitious €315bn European Fund for Strategic Investment to push private investment into European projects, initiated with €21bn from the EU and EIB.

The EU needs to create a pipeline of investment-grade projects and the right environment for private sector investment. Juncker's plan can be seen as a step in the right direction, but there is still a long way to go in implementing a long-term investment strategy for European infrastructure.

OMFIF IN HONG KONG

Internationalisation of the renminbi

The Fourth Asian Central Banks Watchers Group, hosted by OMFIF and the Hong Kong Institute for Monetary Research on 12 December, took stock of developments in renminbi internationalisation, its profound implications for world finance, and China's role in the global economic system. The country has advanced to become the world's second largest economy and the biggest trading nation with the largest foreign exchange reserves.

To make China less dependent on large holdings of official US debt, Beijing continues to drive greater diversification of currencies and asset classes. At the same time, the renminbi is becoming more important as an alternative reserve currency to the dollar, despite its formal lack of convertibility.

The seminar focused on the growing importance of renminbi internationalisation for the world economy, and the renminbi's role in international reserve management, capital markets, trade financing and investment.

Speakers included Lillian Cheung and Eddie Yue (HKIMR and HKMA); Frank Packer (Bank for International Settlements); Ben Knapen (European Investment Bank); Jean-Luc Schneider and William White (Organisation for Economic Co-operation and Development); Jukka Pihlman (Standard Chartered); Li-Gang Liu (ANZ) and Au King Lun (Bank of China).

Eddie Yue and David Marsh

Former BIS economist warns on world economy

William White, former economic adviser at the Bank for International Settlements, launched a strong warning of dangerous imbalances in the world economy at the close of the fourth annual meeting of the Asian Central Banks Watchers Group on 12 December. White, who is also chairman of the OECD economic development and review committee, was speaking in a panel discussion at the HKMA before an audience of financial sector practitioners.

Other speakers were Julia Leung (former Treasury undersecretary, Hong Kong), Gary Smith (Barings), William White (OECD), Satoru Yamadera (Asian Development Bank) and Lillian Cheung (HKIMR).

Moderated by David Marsh, the discussion covered the world significance of the renminbi, moves to make the Chinese currency more widely accepted, the liberalisation of China's capital account and the development of the Asian savings market. A particular theme was the outlook for financing Asian infrastructure.

HKMA

Julia Leung

Gary Smith

William White

Satoru Yamadera

David Marsh

It's lonely at the top for the US economy

America's strength may flag as rest of world weakens

Bronwyn Curtis, Chief Economic Adviser

The US in danger of becoming the only game in town for the world economy. If weakness continues nearly everywhere else, the dollar may become a little too strong for the good of its domestic base.

I am not optimistic about either Japan or Europe, but reasonably positive that China will remain on course. The oil price fall is basically good for the world economy and I see firmer prices over the course of the year. Despite the relief from lower oil prices, I worry about German growth being weaker than expected and the country descending into recession. I am not at all sanguine about the euro area, with speculation rising that Greece will decide to leave (or be forced out), despite the risk of disarray. Whatever happens to Athens and the euro, the Greeks will need a further debt restructuring. Ugly scenes will ensue as creditors jostle to be repaid. And there's a risk that Britain may decide earlier than expected to leave the EU – which I do not think would be a good outcome.

Will the US recovery stay on track and what are the forces that could disrupt it?

The falling oil price has raised US growth prospects for 2015 to close to 3%. More upside surprises are possible in the first half of the year as companies are flush with cash and price falls for many consumer goods have increased real spending. Some of the positive impact will be offset by a deceleration in oil and gas development. Perhaps the biggest threat to the US is that it has become the sole driver of global growth. When growth is fragile in the rest of the world, there are feedback effects. Weak growth elsewhere translates into an over-strong dollar. Exports will suffer, hurting GDP. Normally this wouldn't be so important, but with China slowing, much of the emerging world struggling and the euro area possibly heading into deflation, financial market participants may panic if the US economy starts to falter.

Where will US interest rates and the rate of the dollar against the euro and yen be at the end of 2015?

The deflationary impact of the stronger dollar and lower oil prices may delay the US interest rate increase expected around mid-year. There is a possibility that rate hikes are delayed until 2016. Declining inflation is an important factor in the Federal Open Market Committee's decision to be 'patient' about changing its policy stance. It will want to see inflation bottom out before hiking rates and will be watching wages closely to see if cost pressures are building. Look for US 10 year bond yields to trade as low as 1.5%. QE in Japan and, in the case of Europe, the threat of QE works at least as far as the currencies are concerned and there will be further falls in 2015. Against the dollar expect the euro to be closer to 1.10 than 1.20 by year end and the yen closer to 130 than 120.

Will we see firm evidence that Abenomics can bring Japan back from the path of deflation?

The current level of quantitative easing in Japan may not be enough to return inflation to a sustainable level. Yet another round of QE will be necessary as the slide in commodity prices could push core CPI rise below 0.5%. The yen fell 30-35% against most trading partners in 2014. It will fall further in 2015 and there is a chance that policy-makers' measures will cause the yen to collapse. The labour market is tight, but dislodging deflationary expectations takes a long time. There is an outside chance that a collapse in the yen would create an upward wage/price inflationary spiral. But it seems unlikely that inflation expectations can be turned around sufficiently quickly for the Bank of Japan to achieve its 2% inflation target. GDP growth in 2015 will be closer to 0.5% than 1.5% unless exports finally respond to the weak yen.

Will the Chinese economy suffer a hard or soft landing as it retreats further from fast-paced growth?

Soft landings are hard to achieve but so far Chinese policy-makers have shown themselves to be nimble and adept at keeping the economy growing, albeit at a slowing pace. Expect monetary and fiscal easing and a wide range of reforms to head off the growth headwinds and contain disinflation. I see a year of 'muddling through' but there are massive risks. If growth dips below 7% or the property market falls more sharply, the credit bubble in China could burst, particularly construction debt. Pump-priming may cease to work as marginal returns on capital fall even further and debt levels rise. If growth did slow dramatically, there wouldn't just be social strife to worry about. China is a global force. A real slowdown would reverberate around the global markets and commodities would take a further hit.

Will we find a cure for Ebola and will we be more or less pessimistic about Africa by the year's end?

Better drugs to contain Ebola will be developed, but they will be expensive and poor African countries like Sierra Leone will continue to struggle. There will be another medical crisis. Malaria kills 500,000 a year – 50 times more than Ebola last year – and is returning in Cambodia and Thailand. Drug resistance is part of the problem and a crisis due to antibiotic resistance can't be ruled out. Then there is Bird Flu. Tourism in Africa is already being affected and the slump in oil and other commodity prices will hit many countries, although Nigeria and Angola should have learnt the lessons from previous oil slumps. Continued conflicts, including active dissident groups in Nigeria and Kenya, will add to Africa's woes.

Will the world oil price continue to trend downwards or will we see a recovery?

A barrel of Brent crude fell from $115 in June to under $60 in December 2014. It was beyond anything that could be predicted from new sources of supply like US shale production or the effect of slowing economies. Oil prices may hit $40 but will bounce back in 2015, although not to the extent implied by the futures market. Increases in global spare capacity, rising inventories and the foreign exchange needs of Russia and Iraq should keep the market supplied in the first half of the year, unless Saudi Arabia cuts production. The IMF expects lower oil prices to add 0.3%-0.7% to world output in 2015 so a range around $60-80 per barrel seems most likely, unless the global economy responds more than anticipated to the price falls.

What influence will Russia and the Middle East have on oil and global economics and politics?

Both Russia and the Middle East are oil suppliers and initially they will export more to make up lost revenues. Russia is likely to strengthen its ties and influence in the region. Russian behaviour in the Middle East has been more constructive than it has been elsewhere and Russia will remain central to working with Iran. The dire state of the Russian economy will make President Putin more determined to show his strength elsewhere and he will test Nato and the west. The Baltics may be his next target. Ukraine will have another terrible year as the government struggles to contain the separatist movement. Putin may back the separatists to take territory from Ukraine to join up Russia with Crimea.

Will the euro crisis intensify, with more talk of a possible break-up, or will we see resolution?

The euro crisis will become more intensive. A deflationary nightmare compounds the dangers from political fragmentation and the rise of populist anti-EU parties. The euro area will continue to suffer from the depth of the Russian recession and the decline in demand, even if the US resumes its role as the consumer of last resort. The ECB will carry out QE, but it will be a case of 'buy on the rumour, sell on the fact' and it will have to take further measures through the year. And there is a good chance that 'Super Mario' Draghi will resign in June from the helm of the ECB to take up the Italian presidency. The debt-laden euro area will head down the path Japan trod 20 years ago. If Greece doesn't leave of its own accord, other members may force it out.

Will creditor nations in Europe and elsewhere be forced to prepare for debt restructuring for Greece and other hard-hit euro area countries?

Greece will need to restructure its debts. Thus was promised by European finance ministers more than a year ago, on condition that the Greeks register a primary budget surplus. This is one condition that Athens has achieved, even though the government has been reprimanded by the rest of Europe for failing to find all the budgetary cuts earlier called for. European finance ministers have been dragging their feet over Greek rescheduling – not surprising, given most of the debt is now owed to public sector lenders like the ECB which insist (like the IMF) on being preferred creditors. That's not a position everyone, clearly, can be in. We will witness ugly scenes as different groups of public sector creditors in Europe and elsewhere jostle to recover their money. Debtors in the rest of the euro area should pay up on time and avoid being sucked into the Greek morass.

What are the positive and negative news items about the world economy that are not yet factored into most pundits' predictions for the New Year?

Pessimism is pervasive, so all the bad news is priced in and we will see more upside than downside surprises. Germany may descend into recession and outright deflation, triggering a re-think about fiscal stimulus both at home and in the wider EU, which would lead to a euro area-wide infrastructure package. The UK might hold an earlier than expected vote and exit the EU. China could reverse its one-child policy and step up its economic reforms, causing economists to upgrade their outlook for China.

Climbing gradually up the gender ladder

Only 15 female central bank chiefs in 191 institutions

Female central bankers are building up influence across monetary authorities around the world, although they are still a long way from launching a full-scale assault on what has traditionally been an all-male domain.

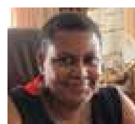
The OMFIF Index of Female Central Bankers nearly doubled last year, rising to 1.85 on 31 December (compared with a maximum score of 10) against 0.93 a year earlier, above all owing to Janet Yellen heading the US Federal Reserve. The index calculates the positions held by women, as governors and as members of policy-making boards, weighted by their nation's GDP and G20 positions.

The number of female governors remained unchanged at 15 out of 191 institutions surveyed. Incumbents in South Africa, Kyrgyz Republic, El Salvador and Belarus stepped down or were ousted. Women took over in the US, Cyprus, Maldives and Ukraine. Females were promoted to sub-gubernatorial board positions in several leading countries. Yet only five of the world's top 100 economies – the US, Russia, Malaysia, Israel and Ukraine – have non-male governors. Female governors are particularly scarce in Africa, Latin America and Australasia.

All G20 members increased or maintained female representation on central bank councils. In Australia and Russia, women make up one third of these bodies. The Bank of England and the European Central Bank each had two women on their monetary policy bodies at end-2014, against none previously. Four of the 15 Federal Open Market Committee members and alternates were women. The Bank of Canada increased its senior female contingent to three from one.

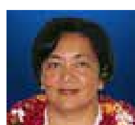
In 15 countries, led by the US, female governors are at the helm – but mainly in less developed nations

Janet Yellen, Chair, Federal Reserve (from Feb 2014)
Previously Federal Reserve vice chair (2008-14), president, Federal Reserve Bank of San Francisco (2004-10). She was chair of the White House Council of Economic Advisers under President Bill Clinton, and Professor Emeritus at the University of California, Berkeley, Haas School of Business.

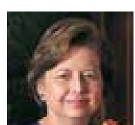


Caroline Abel
Central Bank of Seychelles (from March 2012)
Previously first female deputy governor (2010–12).

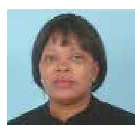
Azeema Adam
Maldives Monetary Authority (from April 2014)
Previously assistant governor and chief economist, monetary policy and statistics. Joined bank 1991.



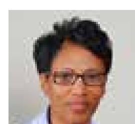
Maiava Atalina Emma Ainuu-Enari
Central Bank of Samoa (from August 2011)
Previously manager, financial markets department. Joined bank 1991.



Zeti Akhtar Aziz
Bank Negara Malaysia (from May 2000)
Previously acting governor (from 1998), senior positions including reserve management. Joined bank 1985.

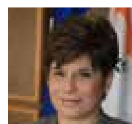


Maria do Carmo Silveira
Central Bank of São Tomé e Príncipe (from Mar 2011)
Previously prime minister (2005-06), governor (1999-2005).

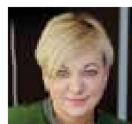


Wendy Craigg
Central Bank of The Bahamas (from June 2005)
Previously deputy governor and board member (1997-2005).

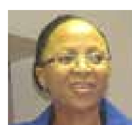
Karnit Flug
Bank of Israel (from November 2013)
Previously deputy governor (from 2011). First joined bank 1988, rejoined 1997.



Chrystalla Georghadji
Central Bank of Cyprus (from April 2014)
Member of ECB governing council. Previously Cyprus auditor general (1998-2014).



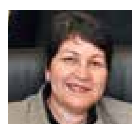
Valeriia Gontareva
National Bank of Ukraine (from June 2014)
Previously chairman, Investment Capital Ukraine (2007-14).



Rets'elisitsoe Adelaide Matlanyane
Central Bank of Lesotho (from January 2012)
Previously second deputy governor (2006-07), first deputy governor (2007-12).

Linah Kelebogile Mohohlo
Bank of Botswana (from October 1999)
At bank for over 30 years. Previously at International Monetary Fund.

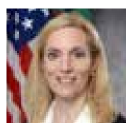
Elvira Nabiullina
Central Bank of the Russian Federation (from June 2013)
Previously minister of economic development (from 2008), aide to President Putin (2012-13).



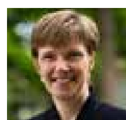
Jeanette Semeleer
Central Bank of Aruba (from September 2008)
Previously executive director (2000-2008) after working in research department. Joined bank 1990.

Jorgovanka Tabaković
National Bank of Serbia (from August 2012)
Previously minister of economic and ownership transformation (1998-2000).

Female central bankers have risen to decision-making positions in several industrialised countries



Lael Brainard, Board Member
US Federal Reserve (from June 2014)
Previously Treasury under secretary for international affairs.

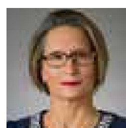


Claudia Buch, Deputy President
Deutsche Bundesbank (from May 2014)
Previously president, Halle Institute for Economic Research (2013-14).

Esther George, President
Federal Reserve Bank of Kansas City (from October 2011)
Previously executive vice president of supervision and risk management (2009-11).

Sabine Lautenschläger, Board Member
European Central Bank (from April 2014)
Previously deputy president, Deutsche Bundesbank (2011-14).

Anne Le Lorier, First Deputy Governor
Banque de France (from November 2011)
Previously at EDF group (2002-11) including responsibility for corporate finance and treasury management.



Andréa Maechler, Board Member
Swiss National Bank (from July 2015)
Currently deputy division chief , IMF monetary and capital markets department.

Loretta Mester, President
Federal Reserve Bank of Cleveland (from June 2014)
Previously executive vice president and director of research at Federal Reserve Bank of Philadelphia.

Marta Evelyn Rivera, Vice President
Central Reserve Bank of El Salvador (from June 2014)
Previously president of the bank (2013-14).

Nemat Shafik, Deputy Governor
Bank of England (from August 2014)
Previously IMF deputy managing director (2011-14).

Sayuri Shirai, Member of Policy Board
Bank of Japan (from April 2011)
Previously associate professor (1998-2006), then professor at Keio University (2006-11).

Nazneen Sultana, Deputy Governor
Bangladesh Bank (from January 2012)
Previously executive director. Joined bank 1980.

Carolyn Wilkins, Senior Deputy Governor
Bank of Canada (from May 2014)
Previously adviser to governor, secretary to governing council.

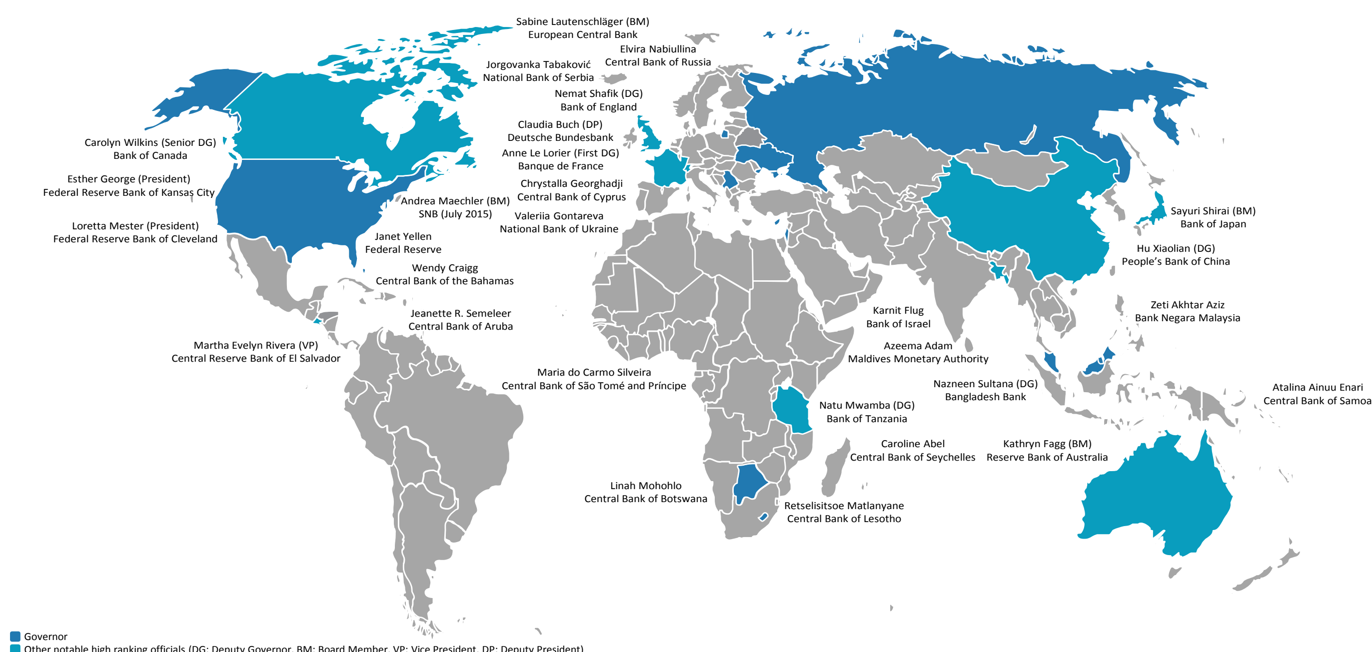
Hu Xiaolian, Deputy Governor
People's Bank of China (from July 2009)
Previously director, State Administration of Foreign Exchange (2007-09).

Ksenia Yudaeva, First Deputy Governor
Central Bank of the Russian Federation (from 2013)
Previously chief of experts directorate, presidential administration.

Notable female central bank governors who left office in 2013-14

Gill Marcus (South African Reserve Bank) and Zina Asankojoeva (National Bank of the Kyrgyz Republic) stepped down in 2014. Marta Evelyn Rivera (Central Reserve Bank of El Salvador) relinquished her role as governor to become deputy governor. Nadezhda Ermakova (National Bank of the Republic of Belarus) was ousted at end-December. In 2013 Mercedes Marcó del Pont (Central Bank of Argentina) was forced out. Yussur Abrar (Central Bank of Somalia) left after just three weeks in the job.

Female central bankers spread out across the world



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Ms Chow Pee Fun at CAMRI
Tel: (65) 6601 1047 | Email: bizcpf@nus.edu.sg

Mr Jai Arya at NUS Business School
Tel: (65) 6601 3843 | Email: jai.arya@nus.edu.sg

For more information, please visit www.bschool.nus.edu.sg/CAMRI/EE

Fed starts coded countdown on 'lift-off'

Shift in language indicates action in mid-year – or earlier

Darrell Delamaide, US Editor

Greater transparency at the US Federal Reserve does not rule out the use of code, it seems. The statement coming out of December's Federal Open Market Committee meeting characterised policy-makers as willing to be 'patient' about raising rates for the first time in six years, replacing the 'considerable time' phrase it had been using for a very considerable time.

Just to leave no doubt that this represented no immediate change in policy, the statement added that its declaration of patience is considered to be 'consistent' with its previous guidance.

The codebreakers at the Wall Street Journal ferreted out similar statements from 2004, when the FOMC stopped saying in January it would keep rates low for a 'considerable period' and said it would be 'patient.' It used that language again in March, the Journal reported, and dropped that in favour of 'measured pace' in May before actually raising rates in June.

Calming nerves

Fed chair **Janet Yellen (voter)** helped analysts out by specifying in the press conference that there would be no action in the first two meetings of the New Year, in January and March. So the earliest change would be in April, but presumably the world will get ample warning of an imminent move when 'patient' disappears from the statement.

Also, for good measure, Yellen cautioned people against assuming that change would come only at a meeting with a press conference following, which happens only four out of the eight times the committee meets. This would mean a decision could come at the April or July meetings, which have no press conference scheduled, and not just in June, which has a press conference.

She responded in this way to a concern expressed earlier by St. Louis Fed chief **James Bullard (non-voter)** that the market expected policy changes only when there would be a press conference to explain the action.

As always, Yellen left herself leeway by saying that policy moves are completely data dependent and timing could change as the data warrant. Nonetheless, the Fed seemed to be starting a countdown to 'lift-off,' as this initial hike in rates has come to be known. For the market, the affirmation that nothing would happen before April was enough to indulge in a little irrational exuberance as US stocks flirted with new highs. Some of the FOMC voters, however, seemed to be getting tired of this word game and the December statement brought an unusually high number of dissenters – three.

However, since all three were voting for the last time it may have just been their respective swan songs.

Positive data

Two of the dissenters, **Charles Plosser** of Philadelphia and **Richard Fisher** of Dallas, wanted to drop time references altogether and leave the committee free to respond to the increasingly positive economic data sooner rather than later. Both men have announced their retirement for March, and rotate out of voting positions in 2015.

Minneapolis Fed chief **Narayana Kocherlakota**, who also rotates out as voter and who announced his retirement for early 2016, dissented because he feels talk about raising rates undermines the Fed's credibility in keeping to its 2% target on inflation, given that inflation is running significantly below that target.

With only five of the seven positions on the Board of Governors currently filled and three of five regional bank voters dissenting, that made the tally on the statement seven to three – an unusually close vote.

Subsequent to the meeting, Kocherlakota explained his dissent by saying the statement 'creates an unacceptable downside risk to inflation and inflation expectations.' He noted that inflation has been below the 2% target for 30 months, the Fed staff expects it remain below target for the next few years, and a recent decline in market measures of longer-term inflation expectations no longer make it possible for the Fed to claim expectations are stable.

In his view, the FOMC should make it clear the Fed will not think about raising rates until there is a reasonable expectation that inflation will hit its target within a year or two, and should even be willing to resume asset purchases if it remains low. Kocherlakota remains an outlier, though, among the policy-makers, and most FOMC members still talk about mid-2015 as the likely date for lift-off.

San Francisco Fed chief **John Williams,** who rotates into a voting position in 2015, said in a radio interview, for instance, 'that June 2015 seems like a reasonable starting point for thinking about when lift-off could happen.'

Another new voter for 2015, **Jeffrey Lacker** of Richmond, said he agreed with the December statement, at least for the time being. 'I support the characterisation that we can be patient at this point and that characterisation could change from meeting to meeting for me,' he said during a panel discussion in Charlotte, North Carolina.

Lacker is considered the most hawkish of the regional bank heads rotating into voting positions. Williams is usually rated a dove, as is **Charles Evans** of Chicago, while Atlanta's **Dennis Lockhart** is considered middle of the road. On balance, the FOMC voters in 2015 will tilt in a more dovish direction, after the departure of Plosser and Fisher, two of the more outspoken hawks.

Lockhart had affirmed his position ahead of the December meeting that the Fed can start raising rates in the course of 2015, but only 'mid-year or later.' Anticipating the language of the December statement, Lockhart said in a speech in Atlanta that while current economic data makes for optimism, 'I think patience regarding timing lift-off and a cautious bias regarding the subsequent pace of rate moves is a sensible approach to policy.'

Measured pace

No one disputes that inflation is running below target but many policy-makers remain sanguine about it as long as the economy is improving. This was Yellen's point in the December press conference. She said that as long as inflation expectations remain 'well anchored' and employment continues to improve, an upward pressure on wages and prices will re-assert itself. Inflation, in those circumstances, 'will tend to move back toward 2%,' she concluded.

More immediately, however, the stream of positive economic indicators will have Fed watchers scrutinising the coded statement from the FOMC meeting at end-January to see if Yellen and cohorts are still 'patient' and on target for a June hike in interest rates or switch to a 'measured pace' indicating a possible initial hike in April. ▪

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

Look to 1990s for what to buy in 2015

Desynchronised economy provides many opportunities

Trevor Greetham, Fidelity Worldwide Investments

The US-led global recovery looks set to continue into 2015 with disinflationary pressure keeping monetary policy loose and supporting a bull market in equities that has already seen America's S&P 500 index triple from its March 2009 low.

The Federal Reserve will probably start normalising interest rates during the year but the inflation picture is unlikely to warrant the sort of aggressive action that would trigger a bear market.

If anything, problems elsewhere in the world could keep US policy looser for much longer. A lack of wage inflation points to the existence of slack in the developed economies while excess capacity and the structural slowdown in China are keeping commodity prices under downward pressure.

The environment recalls the 1990s, and I am following a strategy that would have worked well over that decade: bullish on US equities, cautious on the emerging markets and commodities and sceptical about Europe.

The 1990s saw a prolonged period of disinflationary recovery with Japan playing the role of China today – a large industrial economy going ex-growth. Meanwhile, the fall of the Berlin Wall brought excess commodity-producing capacity from the Soviet bloc onto global markets.

Against expectations at the time US growth remained robust, the dollar was strong and Alan Greenspan's Fed provided enough liquidity to drive Wall Street to stratospheric levels. Those who think equities are too expensive today should note that the darlings of the 1990s, technology and healthcare stocks, are once again leading the US market higher and the fundamentals in both sectors are good enough to encourage a further increase in valuation multiples if the bull market continues.

US economy

The US has been my favourite equity market for the last four years. A strengthening housing market and an end to fiscal tightening are underpinning a solid expansion. The trend in corporate earnings has been consistently strong relative to other regions, particularly Europe.

The Federal Reserve is likely to be the first of the major central banks to raise interest rates and this could trigger a period of volatility but, as long as the inflation picture remains benign, the equity markets will come to understand that the Fed will be easing off on the accelerator pedal and not slamming on the brakes. And a tighter Fed means dollar strength is likely to continue adding to returns for unhedged investors.

The picture elsewhere is mixed. The desynchronised nature of the global recovery will create opportunities.

With China slowing, commodity-reliant emerging markets and developed markets like Canada and Australia with large resource sectors are likely to see poor equity returns and currency weakness.

UK equities in a global context merit caution. The resource sector has a large weight and political uncertainty ahead of the general election is undermining the housing-led recovery.

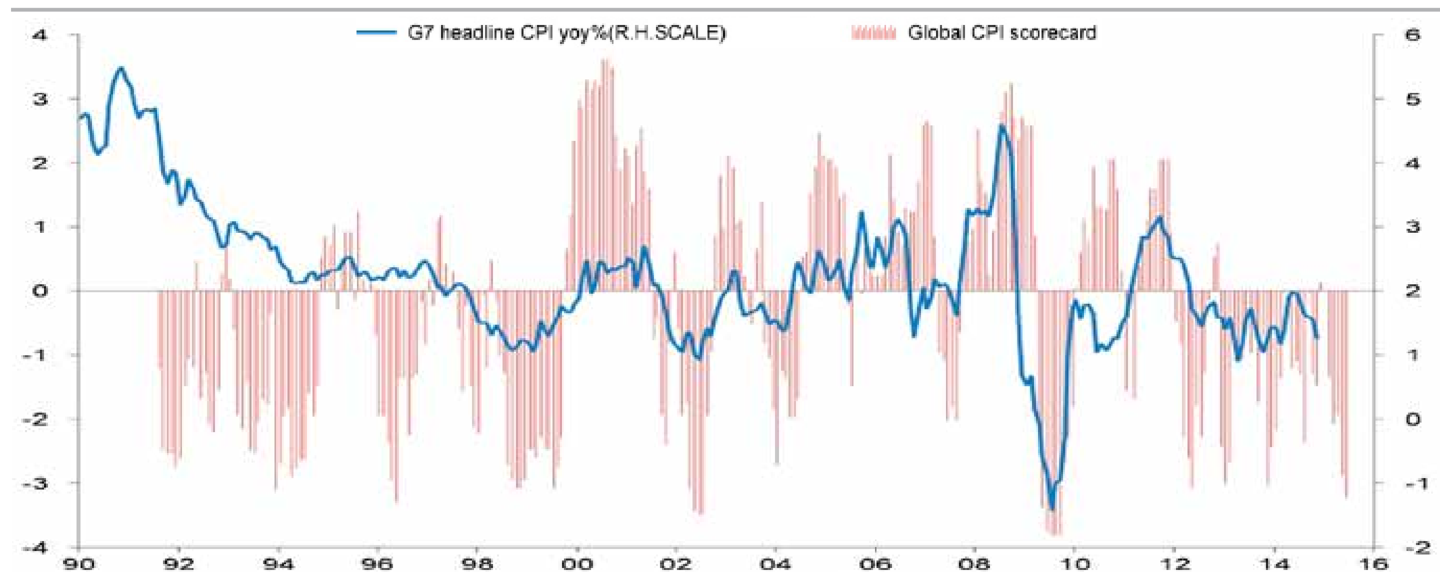
A resumption of public spending cuts early in the next parliament could herald a period of renewed economic weakness.

Europe is in a bit of a muddle. Growth momentum has peaked and several countries have moved into outright deflation, and prices fell 0.2% across the euro area in December.

Since the unconventional measures do not seem to be effective, European Central Bank President Mario Draghi will push the ECB towards a decision to buy sovereign bonds, but many in Germany would see quantitative easing as a bail-out for profligate governments.

A period of market stress may be necessary before policy-makers overcome their reluctance. With eurosceptic political parties on the rise, time is not on Europe's side. I am underweight European equities and short the euro. Outright money printing would make me less negative on the equity market if and when it begins.

Inflation lead indicators point consistently downwards as they did in the 1990s



Source: Thomson Reuters Datastream

Japan is the one place that feels very different compared to the 1990s and the stock market is a top pick. As a commodity importer, Japan benefits from China's slowdown and its export sector is well placed for a US-led upturn.

Nominal growth

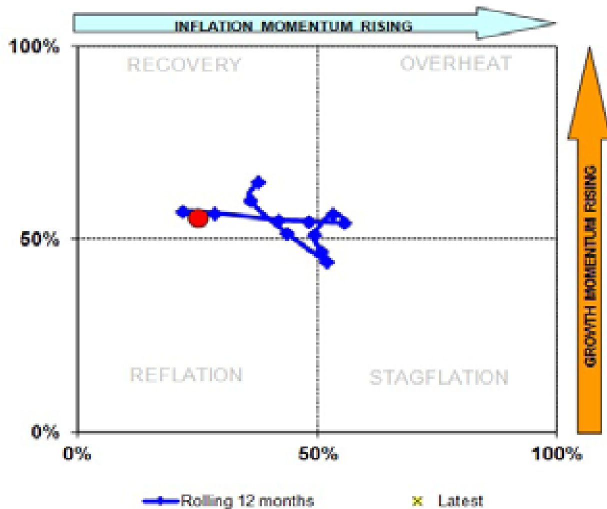
The domestic economy is patchy but the authorities are set on doing whatever it takes to deliver strong and sustainable nominal growth in order to allow the economy to grow out of debt. To this end, the Bank of Japan has stepped up its money printing programme and Prime Minister Shinzo Abe has sensibly postponed the October 2015 sales tax rise. Progress on structural reforms is slow but calling snap elections gave him four more years.

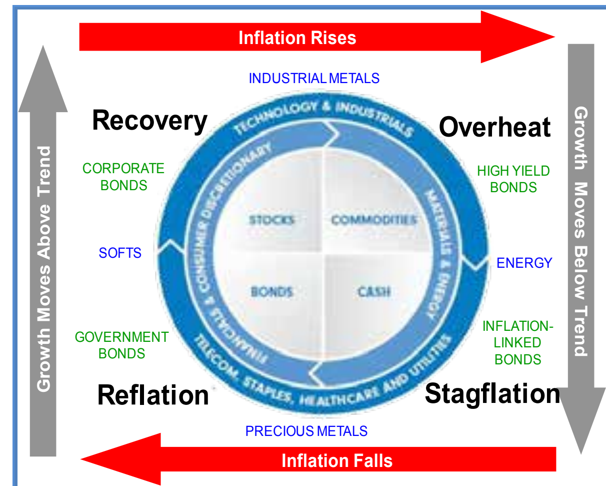
Currency weakness is part of the plan, so a short yen position makes sense. I see equities continuing to offer the best opportunities for investors but that doesn't mean to say there won't be some tricky moments.

Hardly a year went by in the 1990s without a crisis somewhere in the world, most often in the emerging markets. Deflationary shocks from Europe or China have the power to unsettle the markets in 2015 but the Fed would adjust policy accordingly and the US recovery would rumble on. Ultimately it is inflation not deflation that will end this bull market and there are few signs of it today. ▪

Trevor Greetham, a member of the Advisory Board, is Director of Asset Allocation of Fidelity Worldwide Investment.

The Fidelity diagrams of world economic and financial conditions





Source: Fidelity. This represents the opinion of Fidelity Solutions. For illustrative purposes only.

Abe wins a new mandate but has much still to prove on economic reform

Shinzo Abe, the Japanese prime minister, won his gamble of calling a snap election on 14 December, maintaining his two thirds 'supermajority' in the lower house of parliament and opening up a new opportunity – his third – of securing his goal of a 'strong Japan'.

The global economy, as well as the Japanese people, would benefit if he succeeds, *writes Dalin Hamilton in Tokyo.* However, to use an analogy that would ring home in baseball-mad Japan, the odds of a swing strike (when the batter swings at the ball and misses) are much greater when the batter is at two strikes, the position he now is in, rather than when first stepping to the plate.

Far from being upbeat, as I had expected, Japanese officials and market participants after the election showed no great flurry of optimism. Instead, the overall mood is hesitant, as observers wait to see the pace and scope of Abe's actions. The stock market's performance has raised 1.7% since the election with many investors and commentators expecting further growth throughout this year.

The question is whether Abe will use his new political capital to invest in his 'third arrow' of structural reform – or whether he will channel his energy into constitutional reform and strengthening Japan's defensive capacity (which may be politically necessary in some quarters because of sporadic sabre-rattling with China, but is fundamentally much less pressing).

I fear that Abe will squander the win on the latter course of action, tantamount, in baseball, to chasing a pitch out of the strike zone and striking out. The danger is that Abe will announce economic reforms amounting to a 'swing for a single' but will have no chance of hitting the much-needed home run.

Similar to his tactics in announcing a watered-down version of his growth strategy during his administration after 2012, Abe may be tempted to put political expediency, above all his desire to maintain popularity in his Liberal Democratic Party above the longer-term needs of the nation. Abe now stands a good chance of staying in office until late 2018 and becoming one of Japan's longest-serving prime minister in half a century. Unfortunately, though, Abe has not shown the true leadership necessary to pass required economic reforms thus far.

This can change but I doubt that it will. Abe is president of a political party enjoying dominance because it is supported by regional areas that have disproportionately large political representation, as well as by the ever-increasing numbers of older voters.

The Japanese Supreme Court has ruled the rigged electoral system for regional areas is unconstitutional, but the LDP owes its supermajority to these constituencies.

Much-needed liberalisation of Japan's agricultural and medical sectors, to name just two necessary reforms, will directly hit two pillars of the LDP's voting support. I cannot see Abe choosing a path that counters the economic interest of his party's core constituencies.

Abe wishes to leave a legacy of permanent reform. But, at the beginning of his new mandate, the odds on him achieving this goal are still fairly high. ▪

Dalin Hamilton, Coordinator for International Affairs, City of Miyakonojo, Japan.

Politics will supply shock, but not awe

On Greece, we may now get a referendum

Meghnad Desai, Chairman

The Greek general election on 25 January looks like a referendum on Greece's membership of the euro. If the Greeks vote for radical left-wing Syriza and its leader Alexis Tsipras, a new anti-austerity government could eventually take Greece out of economic and monetary union. Alternatively, it could catalyse a series of anti-creditor steps that may lead to Germany and the main creditor countries leaving.

The Greek people don't like the idea of further cuts in living standards but are equally against being treated as international pariahs.

Expect protestations from international creditors that, if the Greeks vote for Syriza, they will be 'committing suicide', cutting themselves off from foreign loans, sacrificing all previous reform efforts, and so on.

Tsipras himself will do his best to sound some diplomatic notes as a man with whom Angela Merkel and others can do business.

The Greek electorate may pull back from the brink and water down support for Syriza.

We can expect another coalition. The outcome will be messy. Whatever happens, we face much debate and hand-wringing, a lot of it self-serving and hypocritical, about whether the Germans should live up to their historical pro-European sympathies, relax insistence on orthodoxy and allow a further rescheduling of Greek debts in another deal to keep the euro intact. The Germans don't appear too keen to throw good money after bad.

So far, there's been little 'contagion effect'. Yields on Greek debt have shot up, yet the spreads between long-term interest rates in Germany and in the main debtor countries Spain, Italy and France remain very low. I do not expect that to last. There will be a lot of talk about Greece being a 'special case'. Sure, Greece is special. We all are, some more than others. I anticipate other weaker countries, led by Italy, will sooner or later get sucked in.

Greece could split itself off from the rest of the euro area with fewer repercussions than three years ago – as the German government now seems to admit.

Private bondholders and foreign banks have largely got their money out of Greece. Greek government debt (more than 170% of GDP) is now overwhelmingly in the hands of European public sector lenders, whether the European Central Bank, individual governments or the myriad European rescue funds.

'Grexit' would lead to political turbulence, exchange controls and a concerted effort by the creditors to make life difficult for the Greeks ('pour décourager les autres'). But it would not bring a run on the banks and a financial crisis. Let's be clear. Whether Greece is in or out, the Germans and the other big creditors within EMU, led by the Netherlands, will not get their money back.

In a financial restructuring, which is what the euro area requires, everyone feels the pain – debtors and creditors. Everyone feels sorry for the debtors. No one is too worried about the creditors, especially if the largest one is Germany, generally believed to be a country big and able enough to look after itself that it should not have lent the Greeks all that money in the first place.

It's slightly depressing that we have been here before. In July 2011, I suggested that Greece should hold a referendum on whether its citizens were willing to pay back the debt.

'That should concentrate minds,' I wrote then in the OMFIF Bulletin.

Meghnad Desai's call for a Greek referendum in OMFIF Bulletin, July 2011

How Greece can learn from Iceland

Concentrate creditors' minds: hold a referendum

Meghnad Desai, Chairman, Advisory Board

There is a lesson for the euro area here. Not every creditor deserves a break. They should have known it was risky to lend to Greece. Let them bear the cost. I believe Greece should hold a referendum on whether its citizens are willing to pay back the debt. That should concentrate minds – both in Greece and among the creditor countries – and might make a contribution to resolving the issue.

At end-October that year, George Papandreou, then prime minster, seemingly took my advice and called a referendum, which was to take place on 4 December.

He (and the rest of the European Union, led by German Chancellor Angela Merkel) then got cold feet. Papandreou scrapped the idea just a few days later and stood down in favour of a government of national unity that knuckled down to austerity and reforms in exchange for debt relief.

This was agreed in February 2012 and involved rescheduling of €206bn worth of Greek bonds owed to largely private bondholders. Taking into account the total amounts, this was five times bigger than the previous largest sovereign restructuring in history (for Argentina in December 2003).

The restructuring was supposed to reduce government debt to an allegedly sustainable 120% of GDP by 2020. Instead, it's gone the other way. Observers predicting a favourable outcome forgot about the 'snowball effect' under which the relative size of a country's debt automatically rises when the interest rate is higher than the annual increase in nominal GDP (which in Greece's case has been contracting).

This time round, there will be less alarm about Greece leaving. The European Central Bank and (especially) the ever-alert Bundesbank will be dusting down emergency plans that were held in place during all the ups-and-downs of recent years.

Angela Merkel is older, wiser, more tired and more cynical. She will be advised by Jens Weidmann, the Bundesbank president, who now has come of age, with nearly four years of ECB crisis management under his belt. Weidmann is only 46 but looks like a man more willing to suffer a bust-up rather than submit to blackmail.

Ahead of the Greek vote, and with Tsipras speaking openly about debt write-offs, the last steps the ECB wishes to take is to wade into the market and buy government bonds in anything except token amounts.

If anyone is to supply 'shock and awe', then it must come from the politicians, not the central bank. I'm sorry to say that I expect more shock than awe. ▪

Prof. Lord Meghnad Desai, Emeritus Professor of Economics at the London School of Economics, is chairman of the OMFIF Advisory Board.

Moral hazard worries to the fore

Trans-Atlantic divergences over debt and deleveraging

John Plender, Chairman

The Greek election on 25 January is an uncomfortable reminder that the existential problems of the euro area, while not as acute as in 2011-12, remain unresolved.

It also underlines the marked difference in the approaches adopted by the US and the continental Europeans to debt adjustment.

The US saw a more effective post-crisis strengthening of bank balance sheets along with timely recognition of losses on subprime loans. Quantitative easing provided both devaluation and monetary stimulus. At the same time the budget deficit incurred to avoid an economic slump after the collapse of Lehman Brothers has already been substantially cut.

The US has thus achieved both public and private sector deleveraging. Gross domestic product is higher relative to pre-crisis peaks than in the other big developed world economies. In the euro area, by contrast, the hardest hit countries were, by definition, unable to devalue.

While Greece defaulted on its debt, other peripheral economies were obliged by France and Germany to soldier on to protect undercapitalised euro area banks.

The clean-up of the banking sector has been conspicuously less rigorous than on the other side of the Atlantic and the burden of debt adjustment has fallen mainly on demand deflation, with the result that euro area GDP remains below its pre-crisis peak and outstanding debt is higher than before the crisis. Unemployment, especially youth unemployment, in the periphery has reached horrendous levels while extremist political parties are everywhere on the rise.

The Greek election ought to be an opportunity for a more strategic approach to the problems of those countries where questions remain about solvency. For the smaller peripheral economies that would point to debt reconstruction.

For Italy, where the public sector is very heavily indebted but the private sector is not, the obvious solution is a wealth tax, together with the stretching of maturities on government debt. Yet this is unlikely to happen. In northern Europe an exaggerated worry about moral hazard takes priority over economic growth.

There is a lack of concern at the growing political discontent over austerity and unemployment. Bond markets encourage the complacency: yields on peripheral sovereign debt other than that of Greece have fallen since Antonis Samaras, the Greek prime minister, decided to take his electoral gamble, which is probably an accurate assessment of the low risk of contagion on a further Greek default. Nor is there much that the US and UK, both growing more strongly than the big euro area economies, can do to influence an approach to economic management to which Germany's Angela Merkel is firmly wedded.

The prognosis in the euro area is not wholly gloomy in the short run. Conviction in the markets that the European Central Bank will provide more palliative care by moving to full scale quantitative easing in the face of incipient deflation has brought about a more competitive euro, while the halving of the oil price since last June will provide some stimulus to consumption.

Yet against a debt deflationary background and excessive reliance on monetary policy to stimulate growth, the euro area economy will be lucky to grow by one per cent this year with or without a move to full QE.

As so often, the muddle-through scenario looks the most plausible in 2015, but the longer term problems in the euro area will continue to accumulate as an atavistic approach to debt adjustment increases the odds on disorderly rather than orderly default in the periphery in due course. ▪

John Plender is chairman of the OMFIF Board of Directors.

Antonis Samaras, New Democracy leader and current prime minister (left), discusses political options with Alexis Tsipras, the Syriza leader, in May 2012.

The ECB's bond-buying dilemma

Polarised EMU in store ahead of Greek elections

David Marsh, Managing Director

The spectre of a still more polarised and fragmented single currency bloc is haunting European policy-makers as a result of controversy over possible quantitative easing ahead of the Greek elections on 25 January.

The European Central Bank is considering forms of QE that would stop well short of full-scale across-the-board purchases of member countries' government bonds and would end up further dividing economic and monetary union between creditor and debtor states.

The calling of a snap Greek election on 25 January appears to rule out an unconditional decision on comprehensive QE, defined as purchases of sovereign bonds of all of EMU's now-19 member states, at the European Central Bank's next monetary policy meeting on 22 January.

The ECB cannot be seen to be interfering in the Greek election by purchasing Greek bonds ahead of the poll, where the issue of Greece's continuing EMU membership will play a major role. Central banks rarely take monetary policy action immediately ahead of an important election or other significant international milestone such as a summit meeting.

The political and emotional nature of the ECB QE debate provides one more reason why the ECB on 22 January may prefer to limit itself to slightly more detailed statements of intent, with other details to be decided later. This is in spite of fresh worries about low inflation throughout the euro area, signalled by a negative annual inflation rate of 0.2% for December.

Any QE involving purchases of Greek bonds that may fall dramatically post-poll would expose the ECB to unacceptable losses. Yet, equally, the ECB would find it very difficult to launch QE involving purchases of all EMU members' government bonds apart from those of Greece.

This would stigmatise Athens, and precipitate the very Greek bond sell-off that the ECB wishes to avoid. Alexis Tsipras, leader of the left-wing Syriza party which opinion polls indicate may emerge in the lead on 25 January, has condemned any ECB move to exclude Greece from a QE package.

Other countries with lower credit ratings, including those still recovering from the EMU debt crisis such as Portugal, Ireland and Spain, would view as discriminatory any ECB action confined only to the better-rated bonds.

They would see this as widening interest rate spreads between the EMU periphery and core members, undoing some of the remedial action the former countries have taken in recent years.

Minimising risks

Peter Praet, ECB board member responsible for economics, confirmed in a New Year interview, where he stressed he was speaking 'theoretically', that the ECB could minimise risks by deciding to buy only triple A-rated bonds, or by allowing each central bank to carry out its purchases at its own risk. Both ideas have been floated as possible conditions by Jens Weidmann, the Bundesbank president.

However, such structures would undermine the guiding principle of solidarity among member states that has been a bedrock of EMU's working practices since it started in 1999.

As Praet has admitted, if the ECB decided to limit purchases to triple A-rated securities, that would substantially increase the amounts required to be purchased, which would run into further German objections.

It would open up a debate on whether France should be seen as a triple A-rated borrower along with Germany and the Netherlands. And it would place the ECB in the supremely illogical, if not untemable, position of lowering interest rates in core countries where economic prospects are already quite strong, and raising them in the struggling periphery – a technical, legal and political minefield from which no country would emerge unscathed.

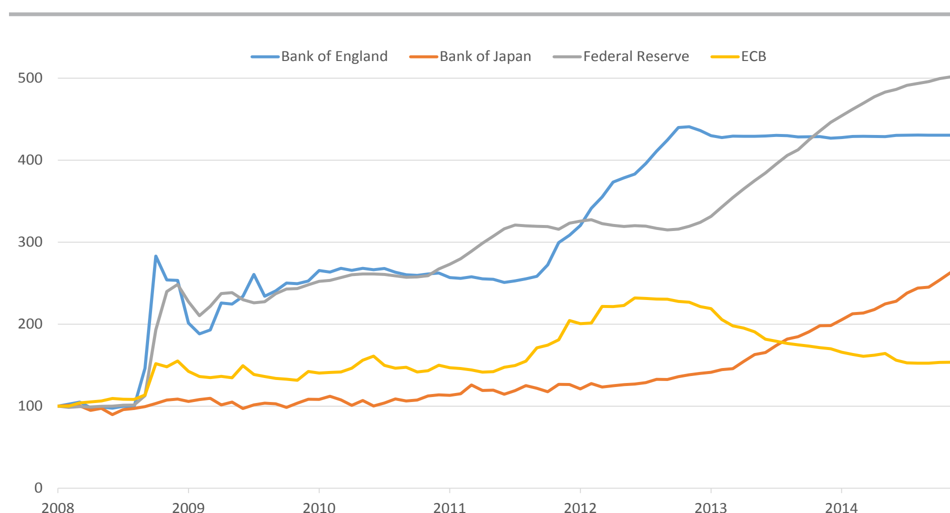
If the ECB went further to meet German conditions and allowed countries to invest in government securities at their own risk, and on their own conditions, then that could result in the Bundesbank participating in the exercise in only token amounts. This would add up to a striking symbolic defeat for Mario Draghi, the ECB president.

Paradoxically, it could end up increasing rather than diminishing demand for top-rated German government bonds, as large foreign holders of, say, French euro issues could take advantage of Banque de France purchases of these bonds and switch to less expensive German issues. There are good reasons for thinking that Draghi would rather avoid such an outcome.

The position of ECB governing council members taking a 'wait and see' line over QE will have been strengthened by the view broadcast by leading ECB officials over the New Year that there is no imminent danger of deflation in the euro area. Draghi told the German daily Handelsblatt. 'The risk [of deflation] cannot be ruled out completely, but it is limited,' although he said inflation expectations had been falling since June.

Whatever happens, as the campaign for the Greek election picks up steam, the chances of fresh tussling among EMU members over blame and responsibility for the euro malaise are likely to rise. In this highly-charged atmosphere, the ECB will wish to remain as neutral as possible – a high-wire balancing act. ■

Balance bank assets 2008-2014, 1 January 2008 = 100



Source: Bank of England, Bank of Japan, Federal Reserve and European Central Bank

How Europe could escape deflation

ECB and EIB should reflate Europe's economy

Harald Benink, Advisory Board and Wim Boonstra, Rabobank Nederland

Mario Draghi, president of the European Central Bank, says policy-makers 'without delay' should bring euro area inflation, now 0.3%, back to the target of below but close to 2%. We agree. However we think that Draghi has not yet embraced the most optimal solution.

The ECB should not start buying existing government bonds as part of a classical quantitative easing programme which may lead to financial bubbles without creating substantially higher economic growth.

Instead, it should buy new bonds to be issued by the European Investment Bank to finance infrastructure projects of up to €1tn.

European outlook

Europe is on the brink of deflation. Euro area growth is insufficient to bring about substantially lower unemployment in the periphery. Inflation is dangerously low, and inflation expectations are declining.

Most international institutions, including the IMF, recommend a substantial increase in investment in Europe's infrastructure, including bridges, roads, sustainable energy, electricity power grids, and research and education.

However, given the deplorable state of government finances, there is little room for extra fiscal spending. Germany could do more but seems reluctant to do so. The plan by Jean-Claude Juncker, president of the European Commission, to create a €21bn fund under the aegis of the EIB is an important first step. By using public money as a capital base, the plan could finance a total of €315bn of infrastructure projects.

Yet this is too modest to reverse the deflation risk. For this, a substantially larger impulse is required, organised by the EIB, to be financed by ECB monetary expansion.

Mitigating risk

In our proposal, €21bn of European taxpayers' money could be made available as a capital base to mitigate the risk to the ECB of its investments in the infrastructure fund. There are three clear benefits from our proposal.

First, an investment impulse of up to €1tn would stimulate demand and reduce unemployment. The announcement itself would have a positive impact on confidence.

Second, higher investment in infrastructure would strengthen the supply side of the economy, enhancing Europe's competitiveness and longer-term growth potential.

Third, the announcement of such a substantial monetary expansion, raising the ECB's balance sheet from €2tn to €3tn, would have a significant upward effect on long-term inflation expectations, anchoring them at higher levels and reducing the risk of deflation.

This is not a call for monetary financing of government spending. But it takes account of the ECB's track record of going to the limits of its mandate to rescue the euro.

Concerns are sometimes voiced about the potential inflationary nature of monetary expansion. However, these voices pay insufficient attention to euro countries' experience of moving perilously close to deflation. Although the situation in southern European countries is gradually improving, the prospects for many of Europe's unemployed remain dismal. There is only one remedy: a strong growth impetus.

Our proposal is designed as part of a 'grand deal' where countries like France and Italy commit to detailed structural reforms, especially in labour and services markets and pension systems. Without such a commitment, the EIB should not be willing to make infrastructure investments in these countries.

At the same time the EIB's willingness to make substantial investments in France and Italy should help their politicians to convince electorates to endorse economic reforms.

Without such a deal the euro area may face a long period of stagnation. ▪

Harald Benink is professor of banking and finance at Tilburg University and a member of the OMFIF Advisory Board. Wim Boonstra is chief economist of Rabobank Nederland and professor of economic policy at VU University Amsterdam.

Germans' euro rhetoric toughens – but the markets still bet they will say Yes

In the perennial trials over who gives in on the euro, the Germans always say No to bailing out debtors, stretching out payment terms, and watering down orthodoxy - until they end up saying Yes. This time, they may mean it.

However, the capital markets are still betting that, whatever happens after the 25 January Greek elections, there will be some kind of compromise to keep the euro intact. As Barry Eichengreen, the Berkeley professor, has put it, the fear of a catastrophically disruptive outcome equivalent to 'Lehman Brothers squared', will lead to creditor compliance.

There are several flaws to this argument. First, the euro area is manifestly more capable of dealing with a Greek exit without undue 'contagion' to the other debtor countries than it was three years ago.

Second, the nerves of the Germans and other creditors have been stretched by the inability of the Greek private bondholder restructuring of February 2012 to make any difference to the relentless upward progression of the Greek public debt ratio – even though (given the fall in Greek GDP) this was eminently foreseeable.

Third, three years ago there was not even a glimmer of a German anti-euro party capable of winning parliamentary representation. Today the AfD has won seats in the European parliament and three state legislatures – and would gain a foothold in the Bundestag if a vote took place now.

Fourth, partly reflecting the three other factors, the German Social Democratic party, coalition partners with Chancellor Angela Merkel's Christian Democrats, is itself taking a more antagonistic line. Sigmar Gabriel, the SPD leader and deputy chancellor, has said Germany will not be 'blackmailed' by Greece. This time, the words may have real meaning. ▪

Three-way tussle in store

Election battleground in 2015 over Europe's future

Denis MacShane, Advisory Board

Greece is in the eye of the euro storm. Germany's decision, backed by other euro member states, against extending or softening Greek financial support may end with the election of the first national government fully opposed to the single currency bloc's austerity politics.

As the prelude to a year of important polls across Europe, on 29 December Greece's left-wing Syriza party joined with the neo-Nazi Golden Dawn and other members of parliament to refuse to vote for the coalition's presidential candidate, triggering an election on 25 January.

Turn-around

Greece has suffered a 25% drop in GDP over the past six years and massive cuts in jobs, pay and pensions. The result has been an impressive turnaround in the country's national budget and international accounts.

But Greece remains in crisis. And this month's poll is just one of a series of elections, including Finland, Estonia, Spain, Poland, Denmark and Britain, where voters have to decide whether to endorse existing governments, be tempted by populist anti-EU parties or just stay at home and abstain.

The 20th-century model of political contests, when voting for standard parties appeared to make a difference, is giving way to cynicism and apathy. Many voters believe financial markets and the media have more power than elected ministers.

Sweden has managed to put off its election as the Swedish conservative and liberal parties agreed to allow the Social Democrats to govern on limited terms until 2018 rather than risk an election which would have boosted right-wing populists.

Britain's election in May is vital for the EU's future. If David Cameron stays in Downing Street, the prime minister has promised to hold an in-out referendum in two years on whether the UK will stay in the European Union.

The latest polls show a majority ready to vote No. Nine ministers briefed the press over the Christmas holidays that they demanded the right to campaign to leave Europe whatever token concession a re-elected Cameron can obtain from Brussels in any renegotiation.

Political euroscepticism has moved beyond irritation with Brussels. It has now fused with resentment over immigration, annoyance about European Court of Human Rights rulings, and a sense that the no-growth, high unemployment euro area is no longer part of Britain's future.

If the Labour Party wins in May, leader Ed Miliband has made clear there will be no Brexit referendum. This will not remove the populist clamour against all things European but at least buys time to allow the politics of European membership to change in favour of continuing membership.

21st-century model

Elections in Spain, Switzerland, Denmark and Finland will test the kind of political system to which Europe appears to be evolving.

There looks likely to be a hybrid between the 21st-century model of a three-way split between populist identity parties, and the binary 20th-century political choice between a democratic left and democratic right party formation with a modest reserved space for liberal parties. In Denmark, no party has won an outright majority since 1909.

Helle Thorning-Schmidt, the Social Democratic prime minister, is faltering in the polls but any replacement government is unlikely to challenge Denmark's EU membership.

Even if the Danish currency is de facto part of the euro, and Danish central bank policy mirrors that of the ECB, the Danes like the Swedes and Finns seem to know how to avoid dramatic polarising politics.

The Swiss election is another example of a system where the 'winner takes all' model does not exist. There may have to be some re-jigging of the 'magic formula' of 1959 which allows all main Swiss parties a seat or seats in the seven-strong Federal Council or government cabinet.

The populist and strongly anti-EU Swiss Peoples Party has 30% of the vote but is under-represented in the Federal Council and may demand an extra seat.

Switzerland too has an EU problem after its referendum decision 11 months ago to impose quotas on EU citizens entering the country.

As Cameron found out, this is an issue where Chancellor Angela Merkel, Donald Tusk, president of the European Council, as well as Jean-Claude Juncker, the Commission president, are not prepared to give way.

Negotiating a way out of the EU-Swiss impasse ahead of the October election will test the finest diplomatic skills in Brussels and Berne.

The contests in 2015 will be three-way. They pit voters against the established Brussels view of what should be done. They involve skirmishes between populist and anti-EU political movements on the one hand, and on the other, the classical parties that won elections and usually took turns in government in the long period of post-1945 European political settlement.

And they provide a battleground for the debate on whether the state should be the ultimate arbiter and provider of national wellbeing, or whether markets and supranational forces are now in the driving seat. ▪

Denis MacShane is a former Europe minister, a member of the OMFIF Advisory Board and author of *Brexit: How Britain Will Leave Europe* to be published early in 2015 by I.B. Tauris.

Why Germany needs higher inflation

Europe's biggest economy should act in enlightened self-interest

Ian Solliec

The challenges facing the euro area are complex and daunting. It urgently needs to bring inflation back on a normal path, a route that would be in Germany's enlightened self-interest. If Germany cannot agree to reflate its economy, the only reasonable alternative is to leave the single currency bloc.

At root, the euro area's problems are not primarily fiscal in nature. They reflect instead a balance of payments crisis, arising from dramatic divergences in competitiveness between the core and the periphery in the early years of the euro.

So the answer lies in restoring the competitiveness of periphery countries to avoid them becoming further mired in the vicious cycles of low growth and budget deficits leading to depression and unrest.

Inflation headroom

The official German position is that structural reforms are the way forward to regain competitiveness. However, expected increases in productivity are uncertain, and at best will happen in the long run. In the short run, the only way to boost competitiveness within the currency union is via internal devaluation, with nominal wage reductions.

This policy has clearly shown its limits. The example of wage moderation successfully implemented by Germany in the 2000s is irrelevant, since higher inflation in the periphery allowed Germany to gain competitiveness simply by suppressing wage growth. It never had to tackle deflation.

Since, in a currency union, competitiveness can be adjusted only by acting on inflation differentials, Germany's ultra-low inflation is a fundamental problem. Above-average inflation in Germany is the only answer. Appeals for solidarity have shown their limits.

Yet once the possibility of a euro area break-up is considered, the case for promoting German reflation becomes stronger.

Germany's economy suffers from potentially risky imbalances, which would worse in the case of break-up. The current account surplus, at 7% of GDP, is the most evident sign of this disequilibrium.

If Germany had its own currency, it would be a lot higher as a result of Germany's relatively low production costs.

If the euro were to split between stronger and weaker members, German exporters would suffer a considerable revaluation, with highly negative consequences for the German economy. Compared with this, the benign effects of moderately higher German inflation would be a boon.

Excess capital

Currently, with so much excess capital to invest abroad, Germany is bound to make costly mistakes. With its ageing infrastructure, Germany has no shortage of investment opportunities at home.

Rather than suffer the adjustment of a euro break-up, German industry should welcome a steady real appreciation brought about by moderately higher inflation, which would give it plenty of time to adapt to a stronger currency.

With their own currencies much-devalued, on the other hand, the Italian, French, and Spanish economies – in the event of a break-up – would roar back to life. Inflation would, it is true, erode the real value of Germany's roughly €1tn of net claims on Europe and the rest of the world.

However, gradual erosion would be much preferable to the dramatic loss that would follow a break-up, caused by the ensuing hole in the balance sheet of the Bundesbank that would cost German taxpayers dearly.

So the choice for Germany is to decide between releasing some of the pressure that has built up in the system, or risk a catastrophic upheaval. This is a matter of self-interest as much as of solidarity.

Certainly, inflation may be difficult to rekindle. And French and Italian reforms are badly needed. Yet as long as Germany obstructs the European Central Bank's actions to inject more liquidity into the financial system, inflation has no chance of returning to the path set down by the ECB's mandate, and structural reforms will never bear fruit.

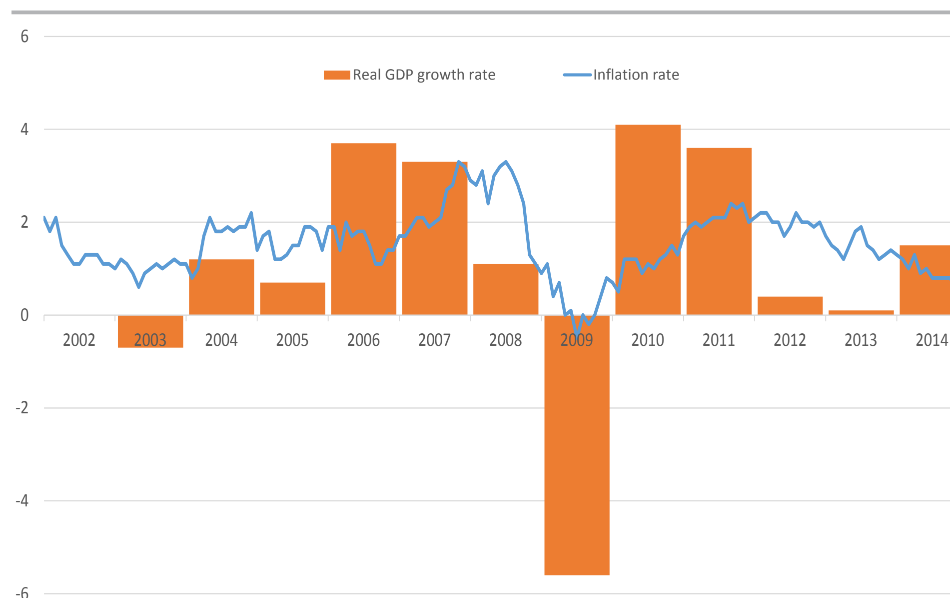
Indeed, a clear nod of approval from German authorities could be enough to shift inflation expectations in the right direction.

Ideally, Germany would take more forceful fiscal action, launching infrastructure projects at home and responding to Jean-Claude Juncker's appeal for European countries to join his investment programme.

The time has come for Germany to make up its mind and act, quickly and decisively. Unfortunately, history provides no great assurance that this will actually be the case. ▪

Ian Solliec previously worked for BNP Paribas, corporate and investment banking department, focusing on quantitative research.

Real GDP growth and inflation rate, Germany, 2002-14



Source: Federal Statistics Office (Germany), Eurostat. Real GDP growth rate is percentage change on previous year (volume). Inflation is percentage change of consumer price index on previous year. 2014 figure is seasonally adjusted growth rate from Q3 2013 – Q3 2014.

Capital backing still in fragile state

Message for European banks: handle with caution

Michael Lafferty, Lafferty Group

Neither the euro area not the UK's banking system is materially short of capital, says the European Central Bank and the Bank of England, in separate assessments. Both claims need to be treated with caution. Europe's banks are still in a very fragile state

According to the ECB, only €9.5bn of additional capital needs to be raised by 13 mainly smaller banks among the 130 largest in the euro area to bring them into line with the 2014 stress requirements. This is the message from the ECB before it took a new supervisory role for euro area banks in November.

The starting point for the ECB assessment was an asset quality review, which showed an overvaluation of bank assets of €47.5bn at 31 December 2013 – hardly significant for an exercise covering €22tn of assets. The most significant adjustments were required in Italy, Greece, Germany, Austria, Netherlands, France and Spain – many of the 'usual suspects' when it comes to accounting waywardness.

The AQR required the banks to have a minimum so-called CET1 equity capital ratio of 8% at end-2013. This was then stress-tested against two hypothetical scenarios. Under the baseline scenario, banks were required to maintain a minimum CET1 ratio of 8%. Under the highly-demanding adverse scenario, they were required to maintain a minimum CET1 ratio of 5.5%.

Under the adverse scenario the ECB found that the 130 banks' aggregate available capital would be depleted by €215.5bn (22% of capital held by participating banks) and risk-weighted assets (RWA) increased by about €860bn by 2016. Including this as a capital requirement at the threshold level brings the total capital impact to €262.7bn in the adverse scenario.

Startling as a 22% capital depletion may seem, the big euro area banks still have a median capital ratio of over 8% in the adverse scenario – and each bank needs a capital ratio of only 5.5% to pass. (By way of comparison, the UK adverse stress tests found that the capital ratio of the eight banks concerned would be reduced from 10% in 2013 to 7.3% in 2015, or 7.5% if certain management actions were implemented.)

This is how the ECB's comprehensive assessment identified a capital shortfall of only €24.6bn across 25 participating banks after comparing these projected solvency ratios against the thresholds defined for the exercise – 8% for 2014 and 5.5% in 2016. Thanks to various capital-raising and other initiatives only 13 banks need to raise an additional €9.5bn to become compliant. On past experience such a capital-raising will not be a problem. Between the financial crisis in 2008 and 31 December 2013, capital in excess of €200bn has been raised by 130 banks that were stress-tested. Since 1 January 2014, a further €57.1bn has been raised. This helps explain why the capital shortfall identified by the stress test is only €9.5bn.

Mark Carney, governor of the Bank of England

The second part of the 2014 European bank stress tests came in mid-December, when the Bank of England reported that all but one of the eight banks tested – the hapless Co-operative Bank – had passed, though two others would also have failed if they had not taken or committed to corrective action before the exercise was complete. For both banks, this action included raising or exchanging several billions of debt that automatically converts to common equity in the event that a bank falls below a minimum capital ratio.

Lloyds, which currently claims a Tier 1 ratio of 12%, would achieve only 5% on the adverse stress test – and a mere 5.3% even if it took further strategic management actions. It attained 5% partly by exchanging certain Tier 2 capital instruments into £5.3bn of AT1 'high-trigger' securities in April 2014. RBS, currently claiming a 10.8% capital ratio, achieves only 4.6% on the adverse test and a slightly better 5.2% if it implements certain strategic actions in the future.

The Bank of England points out that there is a substantial variation in the eight banks' leverage ratios, which fall from 3.6% at end-2013 to a low point of 3.4%.

While the ECB and Bank of England stress test methodologies have much in common, they do differ in their definitions of what counts as capital. The UK has used fully-implemented Basel III, the ECB has not, preferring phased-in numbers. This has an enormous effect – and according to one commentator means that many euro area banks will have to find additional equity to add a further 2% to their aggregate capital ratios even before the regulator introduces further buffer requirements.

This shows that the stress tests are an approximate exercise, just one of the tools for assessing the health of Europe's banks.

Inevitably, there are concerns about the adequacy of the bad debt provisioning of many European banks – from Italy's Monte de Paschi to the UK banks, and Barclays in particular. Despite economic growth since 2008, which has outstripped that of France, loan quality in the U.K. is worse and the coverage ratios even at the largest banks are not impressive.

The 29% bad debt coverage ratio at Barclays at end-2013 compares with almost 70% at RBS, a level which would wipe an additional £10bn off the £64bn of shareholders' funds at Barclays at the end of 2013 – and reduce its capital ratio dramatically.

There can be little doubt that Europe's banks remain in a fragile state – one from which it will take them many years to recover. Some will not survive in anything like their current structure. Others will simply be absorbed by stronger banks, or liquidated.

Far too many European banks have shattered business models, are poorly managed or run for the benefit of management and operate in protected home markets where all too often they end up delivering poor customer service and little or no profit to shareholders.

The worst excesses revealed so far have been in Britain but there is evidence that similar levels of misconduct such as misselling of products (often manufactured in the investment bank) have been taking place in countries like Germany and Italy too. ▪

Michael Lafferty is chairman of the Lafferty Group.

The 12 months ahead will see further attrition for investment banks, with some of the biggest headaches expected in Europe, ***writes Michael Lafferty.*** Most European banks like to claim that they are universal banks – though closer questioning will reveal that they have many different definitions. In Britain, universal banking has the same meaning as it has in the US – combining (since 'Big Bang' in London and the collapse of the Glass-Steagall Act in the US) what used to be called commercial and investment banking. Too-big-to-fail banks like Deutsche Bank, UBS, Credit Suisse, BNP and Société Générale nowadays like to operate under Anglo-Saxon colours. The route that Germany's Deutsche Bank decides to take will be a milestone for both European and global banking. By all accounts it is considering the sale of Postbank, the largest retail bank in Germany – something co-chairman Jürgen Fitchen implied in a pre-Christmas interview where (incredibly) he called for further consolidation in European retail banking. Here are 20 predictions for trends that will become visible in 2015.

1	The retail banking and securities industries will be re-separated within five to 10 years. The UK has set the pace with 'ring-fencing the retail bank' and Europe and the US will follow suit.
2	As Barclays CEO Anthony Jenkins said, 'Universal banking is dead'. Expect a similar announcement soon from HSBC.
3	Citi will be broken up into a US (mainly retail) commercial bank, an international (mainly) retail bank and an international corporate and investment bank.
4	Canadian, Nordic, Spanish, Australian and South African banks will continue to be the most focused retail banks in the world – but there will be exceptions in each market.
5	Revolutionary change is inevitable at Deutsche Bank. It is neither a credible global investment bank nor the powerful retail bank it could be if set free from investment banking influence.
6	The newly-separated UK retail banks will gradually succeed in turning retail banking into a profession, like accountancy and law.
7	The community bank model will catch on in Europe. The US has over 6,000 such 'small town' retail banks that are often owned by the same families for decades. They are a great deal more in favour with consumers than too-big-to-fail (TBTF) institutions like Citi and B of A.
8	TBTF banks will be broken up across Europe and North America – and much of this will happen ahead of legislation, which is inevitable.
9	The new CEOs of Britain's big retail banks will need to have unblemished CVs. Possibilities include Canadians, Americans, South Africans and Nordics.
10	The big Japanese banks will remain 'lost in the wilderness' for another decade.
11	Slick Madison Avenue-type annual reports notwithstanding, at least one of the 'Big Five' state-owned Chinese banks will suffer a world-record fraud loss. Weaknesses in both accounting practices and financial controls make this almost inevitable.
12	African banking will boom for the next 50 years or more.
13	International banking standards will follow UK banking standards before long. The putative International Banking Standards Council will be headquartered in London.
14	Britain's new Banking Standards Review Council will require retail bankers and corporate bankers to be professionally qualified in their own disciplines – and the world will eventually follow.
15	Germany's banking system will go through major changes over the next decade. There will be many more shareholder-owned banks, while numerous Sparkassen and co-operative banks will be privatised or demutualised.
16	Small, mainly consumer/SME banks will proliferate across the world.
17	Credit unions and non-bank financial institutions will play a key role in growing the financial services market.
18	A slew of technology upstarts will force banks to make drastic changes in their operating models.
19	Shadow banking will continue to dominate the minds of regulators, but will not threaten the banking system in any way.
20	Banks will continue to face more advanced forms of cyber threats and other such sophisticated risks.

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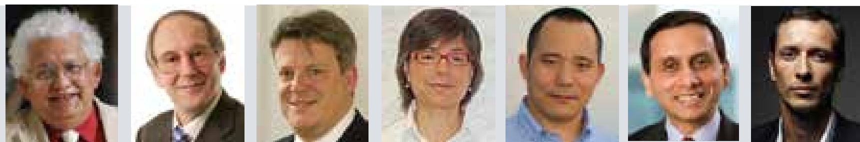

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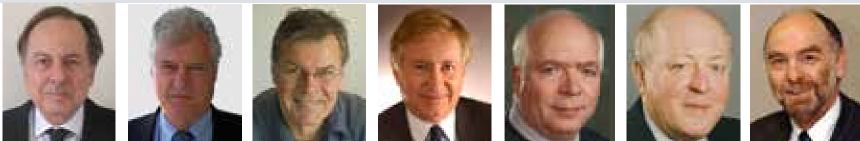

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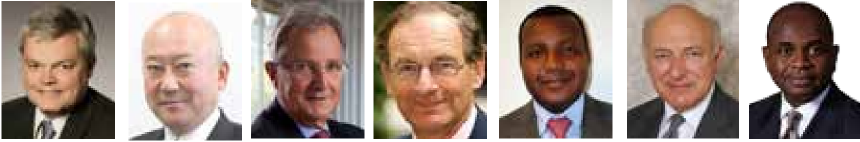

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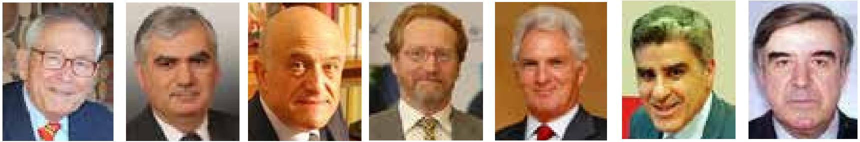

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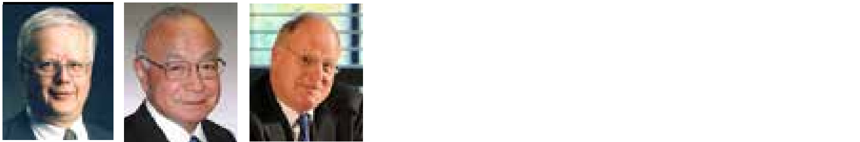

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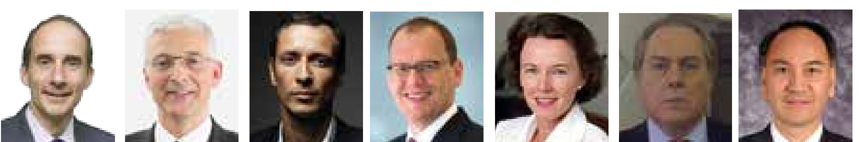

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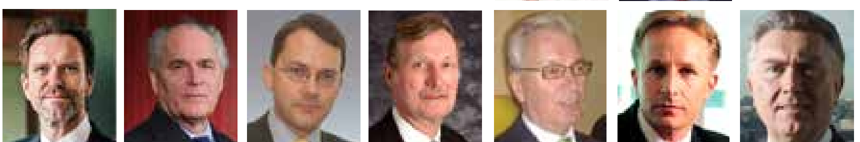

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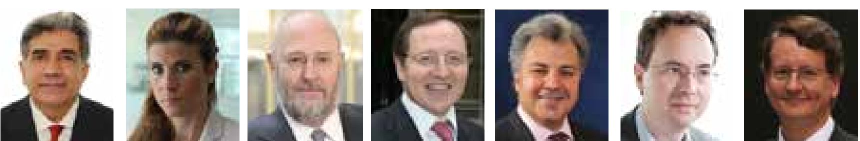

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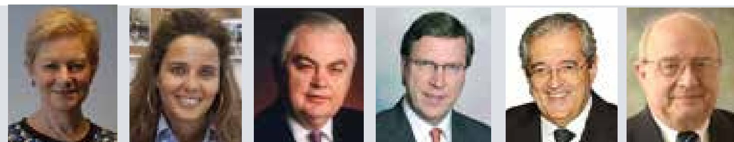

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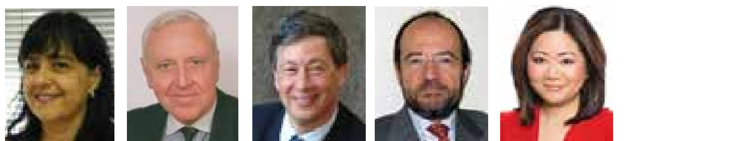

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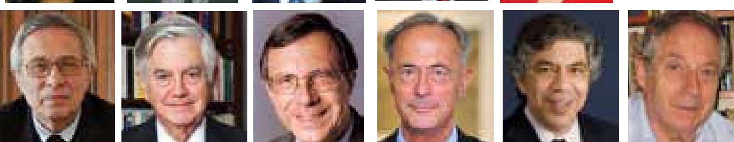

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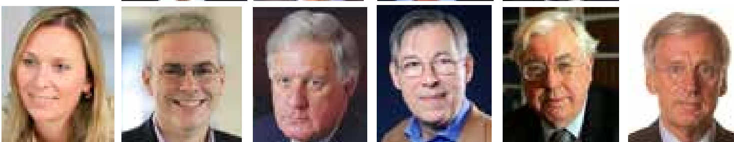

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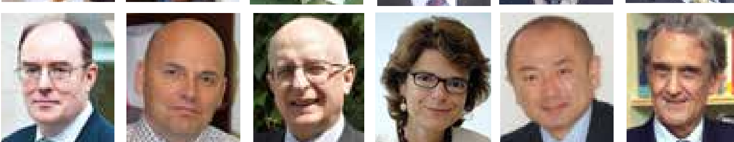

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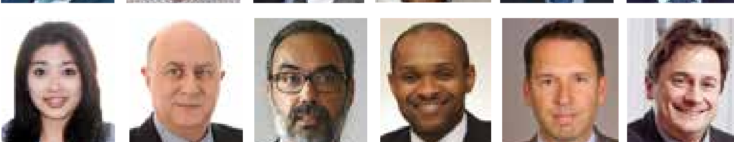

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US-Cuban thaw signals regional change

Across Latin America, reality is breaking through

David Smith, Advisory Board

Almost everywhere in Latin America, the stunning drop in oil prices has created fall-out across the economic and political landscape. Hence the relief at a piece of positive news connected to changing fortunes in the energy market: the dramatic normalisation of relations between Cuba and the US a week before Christmas.

The deal between US President Barack Obama, Cuban President Raúl Castro and his predecessor Fidel signals a new era in Washington's diplomacy with Latin America.

Just as important, it opens up room for fresh dialogue within the region at large, offering the prospect of greater north-south trade and investment that has been stymied for decades because of the Cuban impasse.

Boost for leaders

The cold war has at last ended in the Americas. That represents a much-needed boost for leaders in the region who have cast 2015 as the year to launch reforms in the eye of the storm created by the plunging oil price.

The winners and losers in this cycle face the political imperative of having to face reality, rather than rely on dogma. If the wake-up call is heeded, the net effect may be positive for the region. Mexico provides a good example. Enrique Peña Nieto, the reform-minded president, had opened up the bastion of the national oil company Pemex to foreign investment. He insists that reforms of the state-owned oil industry will lead a broader agenda for change aimed at making his country an Asian tiger, Latino-style.

Pressure for change is rising, too, in Brazil. A massive corruption scandal involving state oil giant Petrobras had cast a shadow over the attempts of newly-reelected President Dilma Roussef to change economic course to return the country to growth.

Venezuela and Ecuador, the two Latin American members of Opec, face still more fundamental pressure. They have used their oil wealth to subsidise supporters at home and bail-out allies abroad like the Castros.

Venezuela's President Nicolás Maduro went to Havana in mid-December to assure the island's leaders that Caracas would keep sending them cut-price oil, even as his debts mounted catastrophically.

His Cuban hosts wondered aloud if Maduro had a grip on reality. A few days later, they re-established relations with Washington.

The oil price decline has produced another kind of effect in Argentina, where prospects for recovery from recession, high inflation and default hinge on the exploration of the so-called Vaca Muerta ('Dead Cow'), the world's second-largest deposit of shale oil and gas, in Patagonian province of Neuquén. If oil stays at $50-60 a barrell, that remarkable Argentine resource could look too expensive to mine. A nightmare for a government already in technical default, and loathe to consider reforms.

Reform agendas

So the question is whether Latin American reformers stick to their agenda before the oil price fall, and whether the US-Cuba rapprochement acts as welcome boost to their prospects. Mexico, Brazil, Chile, even Bolivia had been suggesting that the moment has come for the region to take a long hard look at itself and deal with its pressing underlying issues of badly lagging education, employment and infrastructure.

Their leaders had called it a wind of change blowing through the region, and forecast that the coming year would see them address some of the deep-seated structural issues that have hampered growth and development for decades. And that was before Obama and Raúl Castro gave this strategy further impetus by through the normalisation move.

It's not hard to diagnose the reasons behind the change of mood. Latin America ended 2014 with growth of just 1.1%, the lowest in years, revealing a slowdown deeper than in 2009, the

US shift on Cuba with geopolitical impact across Latin America and the world

President Obama's landmark decision to normalise relations with Cuba will stand out as one of his most significant, *writes Darrell Delamaide in Washington*. Reversing more than a half-century of US foreign policy and implementing the end of the US embargo will require an act of Congress. But in the meantime the two countries will exchange ambassadors, ease travel restrictions, and reduce the obstacles to trade as much as possible.

'Neither the American nor the Cuban people are well served by a rigid policy that is rooted in events that took place before most of us were born,' said Obama, who was born in 1961, two years after Fidel Castro took power. 'These 50 years have shown that isolation has not worked. It's time for a new approach.'

The most immediate effect will be to improve relations between the US and other Latin American countries. US policy toward Cuba has been a festering sore, poisoning bilateral relations and impeding hemispheric collaboration. The shift aims to 'begin a new chapter among the nations of the Americas,' Obama said.

The announcement came ahead of Obama's early January trip to Mexico for a meeting with President Nieto and the Summit of the Americas in April in Panama. Brazil's President Rousseff announced at the New Year that she will use 2015 to make a Brazilian president's first state visit to the US in two decades.

There is also a wider international geopolitical context. The shift exploited the vulnerability of Cuba's erstwhile patrons, Russia and Venezuela, as plummeting oil prices weakened these energy exporters. In an effect that will be noted across Europe, Obama managed to score further points against Russian President Vladimir Putin over his incursion into Ukraine.

Republican lawmakers catering to the Cuban exiles who are an important voting bloc in Florida will fight a rearguard action against Obama. But polls show most Americans – especially Latinos and even second-generation Cuban-Americans – are in favour of the change. ▪

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

year after the global collapse. The dogmatists fared especially badly. The Argentine and Venezuelan economies contracted. Others did little better. Brazil reported an anaemic 0.2% growth. Chile, for so long Latin America's leading light, managed a mere 1.8%.

Revitalising economies

No wonder some major countries, and some of the smaller ones, want to embark on ambitious programmes to revitalise their economies, create jobs, attract investment, and return to the growth cycle that had made Latin America such a dynamic emerging market at the start of the millennium. Remember when Latin America was set to be the next Asia, back in 2010?

In Mexico, President Nieto has unveiled a new, 'open for business' chapter in the life of Pemex, the state oil consortium that has driven the Mexican economy since its 1930s nationalisation. And he has promised a multi-billion dollar growth-boosting investment programme, specifically to attract foreign investment to a country that boasts a cheap, increasingly skilled labour force.

His domestic crisis, over the disappearance of 43 students apparently murdered in Guerrero, has rightly drawn international headlines. But the still bigger question is whether Nieto stays the course on the economic agenda.

Mexico must be a standard-bearer of change rather than guardian of the status quo. Whether he lives up to this goal will be a critical indicator of the entire region's future wellbeing and performance.

Reviving the economy

Reflecting its size and population, Brazil is the natural agenda-setter for the region. Freshly re-elected President Rousseff has signalled that there is no option but to scale back government, control inflation, and bring back investors who have fled in the face of her first-term penchant for micromanagement of everything from the central bank and the currency to the oil industry. 'We have to start growing again,' she has proclaimed, 'because that is the only route to high, full employment. You will see us induce economic activity, revival.'

In Chile, for example, for so long the favourite of Wall Street and the World Bank, President Michelle Bachelet has surprised many on her return to power by boosting government budgets, raising corporate taxes substantially, and putting the government back in the business of national health care, state pension plans and job protection.

'Development for all Chileans comes first,' she has said. 'Our reforms will create divergent opinions, but I prefer to assume and confront that rather than lose this historic opportunity for development.' Bolivia, home of the left-wing President Evo Morales, the country's first head of state from the indigenous community, has been a rare success story.

In the past few years Morales has presided over a country growing at an annual 5%, largely due to natural gas sales to its large neighbours Brazil and Argentina. His focus is on development, on education, health, infrastructure, financed by high taxes on foreign companies and by dollar reserves that are the envy of others in the region.

That, perhaps, is the true message in the last few months' cycle of crisis, dominated by cascading oil prices. The key word now for many in Latin America is Development, with a capital D.

Key challenges

Back in 2010, amid those projections of the region as the new Asia, some saw the decade ahead as Latin America's moment. 'Latin America is poised to join Asia in leading a global economic recovery,' declared Luis Alberto Moreno, head of the Inter-American Development Bank, that year. 'If the region's leaders rise to the challenge, this decade to come could be the decade of Latin America.'

What Moreno identified then as the key challenges – education, health, jobs, infrastructure – lie at the heart of the agenda that reformist leaders know they have to tackle.

I saw Moreno recently discussing the region's need to embrace new technology and make it widely available, harnessing innovation to development. Referring to Brazil's soccer superstar Neymar, he remarked, 'What we cry out for is a Neymar for technology and innovation.'

Indeed, technological links with the likes of Silicon Valley could make an enormous difference. Latin America needs a new relationship with the US with dialogue based on common interest across the Americas, rather than a north-south stand-off over Cuba.

The diplomatic shift between Washington and Havana does not by itself add up to a revolution. There is a long way to go before the required spirit of positive dynamic change is successfully instilled across the region.

But the US-Cuban accord signals hope that the region is on the mend. The Americas may be on the way to realising the continent's full potential, diplomatically, politically and economically. ▪

David Smith, a member of the OMFIF Advisory Board, is a writer, professor and adviser to NGOs based in Buenos Aires.

CURRENCY NEWS

With all eyes on the rouble as 2014 drew to a close, it seems that following an initial period of market differentiation, its troubles eventually spread to become contagious among its emerging market peers. In December the Turkish lira fell 5.1% against the dollar as Brazil's real fell to its weakest in 10 years.

The Indonesian rupiah – seemingly Asia's biggest victim – recorded early-December losses of 4.3%, while even those we might expect to benefit from an oil price slump weren't immune, with the South African rand down 5.1% for December.

Even the Indian rupee, the best-performing emerging market currency of 2014 versus the dollar, slipped to its weakest in a year during December.

This wider sell-off was attributed to an aversion to emerging market risk on the part of nervy investors, with some seeking solace in other 'safe haven' asset markets such as German, US and Japanese government debt.

The situation was not helped by the decision of Standard & Poor's, the ratings agency, to downgrade Bulgaria to non-investment grade, raising fears over other countries at risk of a similar fate.

This all compounded what had anyway been a miserable year for emerging market currencies. With the rouble ending the year roughly 40% down against the dollar, the Brazilian real was 11.3% down for the year, while the Mexican peso – widely considered to be one of the most stable emerging market currencies – fell by around 11%.

Along with the Indian rupee and the Turkish lira, the Chilean peso and Thai baht also experienced a turbulent but ultimately disappointing year, as emerging market currencies fell on average between 5-15% over the course of the 12 months.

To blame for this wider trend over the course of 2014 were plummeting oil prices and weak global growth, but crucially also the strength of the dollar.

Emerging market investors will be hoping clarity on the direction of US monetary policy in 2015, as well as the oil price eventually finding a bottom, will produce more cheer as we proceed further into the New Year ▪

Jamie Bulgin is Deputy Director, Markets and Institutions.

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How to diversify in emerging markets

IFC's programme for official investors

Jingdong Hua, International Finance Corporation

Emerging market bonds have been in great demand, with sovereign issues by countries like Ethiopia and Rwanda meeting heavy oversubscription. Yet corporate bond markets have lagged behind sovereign issuance. In many emerging markets loan finance is still the main form of debt available to the private sector.

Loans are usually syndicated on a project by-project basis. In view of the cost and effort in terms of origination, credit analysis and supervision, most official institutional investors have hitherto regarded this route as uneconomic.

However an initiative by the International Finance Corporation, a member of the WorldBank Group, has changed this state of affairs. IFC's innovative loan syndication platform, the Managed Co-lending Portfolio Program (MCPP), launched in late 2013, allows investors to participate in IFC's future portfolio of emerging market senior debt. IFC creates and manages a portfolio of emerging market loans on behalf of third party investors, which pledge capital for co-investment.

The first investor was the People's Bank of China through the State Administration for Foreign Exchange (SAFE), with a $3bn allocation to create a global emerging market loan book. In just 14 months IFC has deployed over $700m in 19deals for SAFE and built a $1.4bn pipeline in 31 additional deals.

MCPP allows investors to build on IFC's experience in making profitable investments in emerging market private sector companies for more than 50 years, offering diversification in asset class, geography and industrial sector.

IFC has a robust credit culture and assesses each loan on its individual merits, pricing commercially to ensure an appropriate return. In infrastructure project finance, for example, for decades IFC has been a market leader in originating and structuring complex transactions in countries ranging from Argentina to Zambia. While IFC prices its loans consistently with local market levels, IFC's track record, as the Chart shows, suggests a loan book with the credit characteristics of developed market infrastructure lending.

There are good reasons for investing in emerging market senior debt. Financing needs are tremendous. Emerging market corporate debt has tripled since 2009. Growing economies continue to look for additional credit. In infrastructure alone emerging markets need over $1tn of investment annually.

Senior secured debt ranks higher in the capital structure than bonds, leading to greater post-default recoveries. Floating rate loans have minimal duration and have historically outperformed bond assets when interest rates rise. Additionally, returns on loans have historically been uncorrelated with other assets, providing diversification benefits across a fixed income portfolio.

All this explains why some commercial banks and international financial institutions have built up long-term lending to emerging markets. IFC is already actively engaged with many commercial banks through its 'B loan' and parallel loan programmes. Over the last 50 years IFC has syndicated over 1,000 senior loans worth $48bn to around 750 co-investors. Under these programmes while IFC originates each loan investors make credit decisions, independently and on a deal-by-deal basis.

The MCPP takes a different approach. Under this programme, IFC and each investor pre-agree loan eligibility criteria. IFC then commits investors' funds in every transaction that meets these requirements. Multiple loans are committed to create a diversified portfolio. IFC lends for its own account in every transaction, and is the lender of record for each loan on behalf of the MCPP investor, resulting in the same risk/return profile for IFC and the MCPP investor.

The program follows a 'blind pool' approach with investors committing funds for an unknown set of future IFC loans. Similar to a tracker fund, the MCPP investor's portfolio will be constructed to mimic IFC's own account future loan portfolio. MCPP investors' exposure is a set percentage of the amount IFC invests for its own account in each transaction. These investors benefit from delegating to IFC all decision-making, including project appraisal and approval as well as supervision.

The structure aligns incentives, ensuring that MCPP investors benefit from the same care and attention that IFC takes in managing capital for its own account. This is particularly important during times of distress.

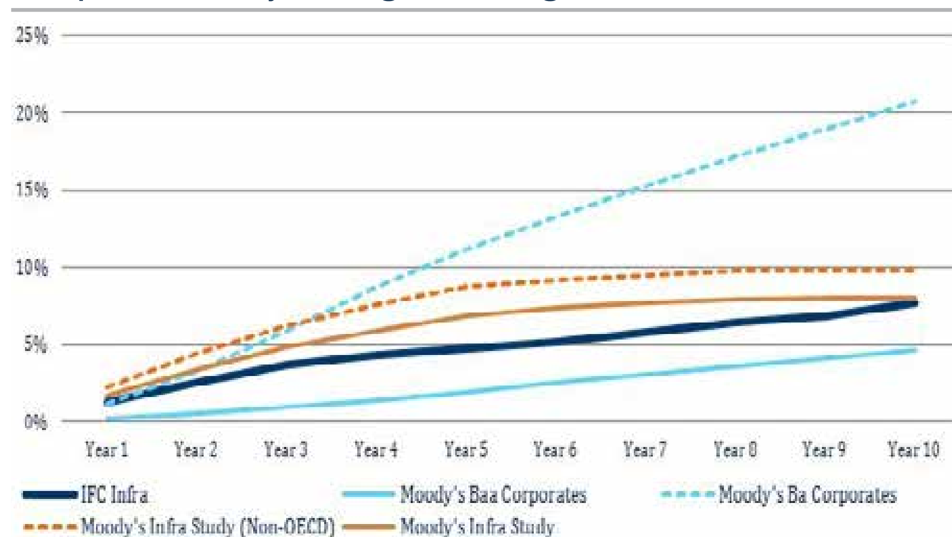
Through geographical diversification and multi-sector exposure, IFC is able to create a loan portfolio with a distinct risk profile that can complement other investments within a fixed income allocation. This diversification helps to reduce volatility across the loan book, with annual default rates exhibiting only modest standard deviations.

Given the scale and breadth of IFC's lending, MCPP can be customised to each investor's specific requirements. Programmes can be designed to follow IFC's global portfolio or can be tailored to replicate a subset of IFC's loan book.

Having demonstrated proof of concept with SAFE, IFC is now looking to expand the MCPP initiative. Official institutional investors, can benefit from IFC's expertise in building a diversified, commercially attractive loan portfolio with a stable, short duration asset class. At the same time, they can help address some of the world's most pressing development challenges. ▪

Jingdong Hua is Vice President and Treasurer of IFC.

Comparison of 10 year weighted average cumulative default rate



Source: International Finance Corporation

Broader access to China market

Wider monetary effects of Connect programme

Kevin Anderson and George Hoguet, State Street Global Advisors

The Hong Kong-Shanghai Connect programme is a major development and paves the way for further gradual capital account liberalisation in China. Launched on 17 November, it allows Chinese investors to buy Hong Kong stocks, and foreign investors to buy Chinese A-shares.

Northbound flows are limited to a $2.1bn daily quota, while southbound flows are subject to a $1.7bn daily quota. These amounts are likely to increase over time as investors' familiarity with the market structures grows.

By definition, this programme does not include securities listed on the Shenzhen stock exchange, although this would seem a natural next step. There was significant investment in infrastructure to enable the connect programme. The 60-page information book for market participants posted on the website of the Hong Kong stock exchange outlines the technical details of the programme.

Structural challenges

Despite the significant amount of technical undertaking between Shanghai and Hong Kong, there are still some structural challenges which overseas institutional investors face which may be one reason for their more muted adoption in the short term. Capital gains tax for overseas investors was only clarified only on 14 November.

Concerns around beneficial ownership of securities and pre-delivery requirements are still obstacles for some institutional investors, in particular where mutual or pooled fund investments are involved. Clarification is welcome, as long as these uncertainties remain, it is likely some overseas investors are still evaluating the Connect programme and their entry point.

Broadening access

Longer term, however, the programme is important for many reasons. For global investors, it broadens access to the Chinese A-share market and expands the roughly $100bn in combined qualified foreign institutional investor (QFII) and renminbi qualified foreign institutional investors (RQFFI) quotas.

For domestic Chinese investors, it provides an opportunity to gradually diversify their portfolios. And for the international monetary system, it is additional evidence of China's desire to promote the renminbi as a reserve currency. For global investors, reasons to consider investing in China include the prospect of return enhancement, diversification, and a broader investment opportunity set.

Even after adjusting for controls on ownership, the Chinese A-share market is capitalised at roughly $1.2tn, making it about the size of the German or Swiss stock markets.

Over the past 10 years the correlation of the A-share index with the MSCI World index is just 0.56. And there are more than 989 companies listed in Shanghai, of which 568 will be available under the programme.

Capital controls

Finance theory suggests, and experience confirms, that when capital controls are removed, domestic shares should rally. Why? Global investors, unlike domestic investors, are already broadly diversified, and require less of a return than domestic investors. (In technical parlance, global investors price securities off their covariance, whereas local investors, who have fewer alternatives, price them off their variance.)

When controls are first removed and foreign money flows in, equity markets often rally. Such was the case in Taiwan in 1991 and in Korea in 1992.

From the announcement of the programme until 10 December, the Shanghai market rallied 15%. Of course other factors, such as the recent People's Bank of China rate cut and a weakening property market, may have influenced investor perceptions.

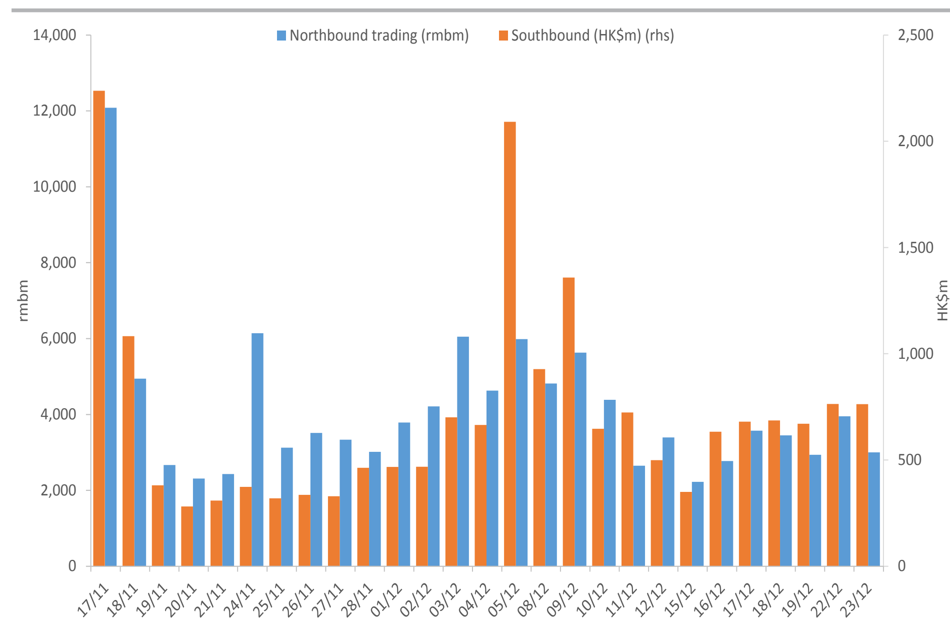
Another desirable longer-term outcome of the Connect programme is that it will introduce a greater overseas institutional ownership in the Chinese stock market, thus diluting the very high retail involvement and likely contributing to higher demands on transparency and longer holding periods.

The programme will contribute to gradual full integration of the domestic Chinese and Hong Kong markets. Valuation differences between H-shares (Hong Kong listed shares of Chinese companies) and A-shares will disappear over time.

Yet another implication of the programme is that it increases the likelihood that major index providers such as FTSE and MSCI will accelerate the inclusion of A-shares in their mainstream emerging market indices.

In terms of southbound flows, the programme offers Chinese investors the opportunity to diversify their portfolios. Currently, Chinese investors hold just 6% of their assets in common stocks. By investing in Hong Kong companies, they will be able to

Buy-trade value, 17 Nov – 23 Dec 2014



Source: Hong Kong Exchange

access certain sectors, such as Macau gaming, and upstream oil and gas producers.

Retail investors account for the majority of the A-share market and often favour 'glamour' stocks, including small- and mid-cap stocks as witnessed by the southbound investor behaviour thus far.

In terms of the international monetary system, the programme should be viewed in the context of the panoply of measures announced at the third and fourth party plenums to rebalance the economy and to promote a more sustainable growth trajectory.

Arguably, the Chinese economy was built on an undervalued exchange rate, subsidies, and financial repression. Each of these is gradually coming to an end.

More opportunities for Chinese investors to invest overseas provide outlets for savers and over time can help reduce excesses in the property market. And greater inflows can facilitate the policy formulation process.

It is a mistake to believe that the increased use of the renminbi as a vehicle currency, capital account liberalisation, and reserve currency status will all proceed at the same pace. The percentage of world trade settled in renminbi is still quite modest, but it continues to grow. And the number of central banks investing a portion of their reserves in renminbi deposits and fixed income investments is increasing. Foreign participation in the A-share market is still quite small – just 5.5%.

Foreign participation

Increased foreign participation in the A-share market can facilitate the dialogue with corporate managements and, at the margin, improve corporate governance. But investors should be realistic in their assessments.

The Chinese stock market is still very immature and very volatile (annualised volatility is roughly 30% per annum). And the securities market infrastructure is still underdeveloped.

For example, in all of China, a country of 1.2bn people, there are just 2,900 chartered financial analysts, versus 55,000 in New York alone.

Both the global investment and policy communities wonder whether China can successfully reorient the economy without a recession and/or a property market/excess capacity-induced financial crisis.

These developments would exacerbate deflationary pressures in the world; in fact, the producer price index of inflation in China is negative.

At this juncture, however, there is insufficient evidence to reject the consensus view that the Chinese economy will grow by at least 7% in 2015.

China's leaders appear acutely aware of the challenges facing the country. And, unlike many western countries, China benefits from both fiscal and monetary policy flexibility.

The Connect programme is a small step in the transformation of the Chinese economy, but it is a step in the right direction.

Lao-tzu's (604-531 BC) observation is well known: 'A journey of a thousand miles begins with a single step.' ▪

Kevin Anderson is Head of Investments Asia-Pacific and George Hoguet, CFA is Global Investment Strategist in the Investment Solutions Group at State Street Global Advisors.

Sovereign investors and markets

Global Public Investors (GPIs) have a total $30tn under management, amounting to 40% of world GDP. They have the potential to use their influence as shareholders to make a difference to the quality and performance of companies in which they invest. This could have wider repercussions on the monetary system, by integrating sovereign investors from emerging market economies more closely with international capital markets and allowing them to function as shock-absorbers in times of stress.

Some large-scale public sector investors such as Norges Bank Investment Management (NBIM), the Australian Future Fund and California Public Employees' Retirement System (Calpers) have made well-publicised efforts to set more formal rules and procedures for their interactions with investee companies. Yet such episodes remain exceptional *writes Liisa Vainio.*

Relatively little is known about the decision-making processes on corporate governance structures of other large public funds especially from the Middle East and Asia – apart from the fact that many of these entities are somewhat shy about disclosing their views in public.

However, the financial crisis and increased public scrutiny of global heavyweight companies have brought changes to the governance behaviour of many private sector investors, so it is expected that this would have repercussions on GPIs too. Many sovereign funds are increasingly benchmarking themselves against North American municipal and state fund managers which often have clear corporate governance guidelines.

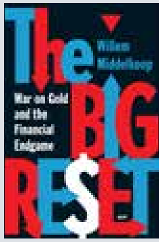
As demarcation lines become blurred in many cases among different categories of public investors, there will be pressure from both the investor and investee sides for GPIs as a group to tighten up and make more transparent their corporate governance procedures. This applies both to more simple structural questions relating to companies in which they invest, for example, over separating the positions of chairman and chief executive, and to more complex issues of performance, planning and strategy.

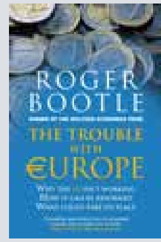
As an example, the Swiss National Bank, now ranked 10th among GPIs according to assets under management, with large equity holdings of $70bn to $80bn in companies around the world, is investigating how it can best fulfil corporate governance guidelines to maintain standards as a responsible investor able to use wisely its undoubted shareholder power.

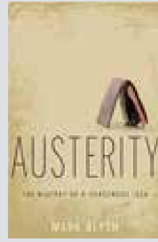
GPIs which have become trailblazers in this field remain a small minority, but the numbers taking these initiatives seriously can be expected to increase. Proactive corporate governance guidelines have the ability to produce higher quality performance in investee companies, improve staff retention, add to purposeful strategic direction and increase overall returns for investors. These benefits should give ample incentive for public investors worldwide to heighten their interest in applying best-practice corporate governance principles, turning to advantage these investors' growing influence.

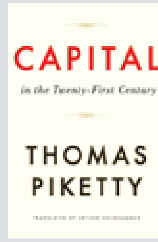
A good starting point is the Santiago principles consisting of the 24 Generally Accepted Principles and Practices (GAPP) aimed at improving transparency, governance structures and accountability for the world's biggest sovereign funds. It is in these institutions' own interest to invest in appropriate governance structures, both for themselves and for investee companies. This is a long-term trend where institutions which help set appropriate international standards can reap lasting advantages. ▪

Liisa Vainio is Head of Projects.









A voice for the voiceless

Battle over state's role in UK public services

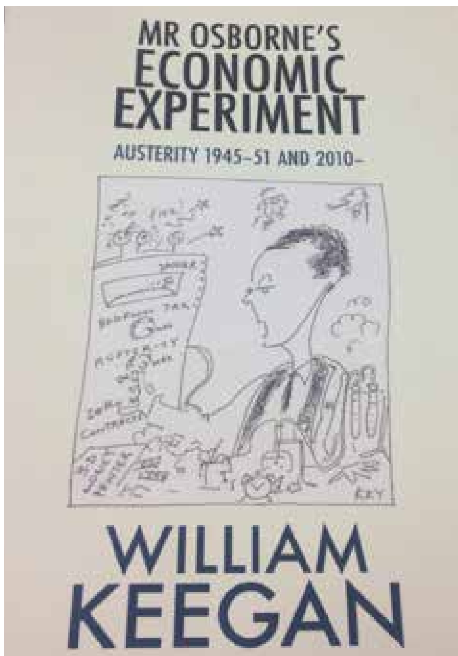
Trevor Greetham, Advisory Board

In *Mr Osborne's Economic Experiment,* Bill Keegan uses the contrast with the unavoidable austerity of the post-war period to make a clear and simple case against the more ideological cutbacks of today.

He tackles what could be dry and sterile subject matter in a way that is both entertaining and highly readable, cementing his reputation as a J.K. Galbraith for our age.

A veteran commentator and author, Keegan explains that the 1945-51 Labour administrations of Clement Atlee had no choice but to squeeze the economy to keep a lid on inflation and reduce imports.

Britain had a chronic balance of payments problem laid bare after America stopped the Lend Lease arrangement that had financed a fifth of the wartime economy. As someone who was there at the time, Keegan is quick to point out that most people today would seem unrecognisably wealthy and well-fed to a time traveller from that straitened age.



Keegan wants to whisk us on to modern times but it is 30 years since he wrote *Mrs Thatcher's Economic Experiment* and the similarity in titles means the reader will inevitably stop off on the way. Famously, 364 economists signed an open letter opposing the new Conservative government's swingeing 1981 budget cuts. They were proved wrong.

The economy grew a solid 3% a year over the subsequent decade. A dramatic fall in inflation saw base rates drop from 17% to just over 7% by 1988, boosting real incomes and house prices and spawning the 'yuppie' generation.

This goes to show how, in normal circumstances monetary policy trumps fiscal policy. The last six years have been anything but normal, however, Keegan repeatedly reminds us that the great financial crisis was not caused by excessive government debt.

Despite dire warnings, gilt yields never once looked as if they might spike higher as they did in Greece where, stripped of the right to print its own currency by the formation of the euro, sovereign default was a risk that was ultimately realised.

By 2010, interest rates in the UK were if anything too low, leaving no room for the Bank of England to reduce the cost of borrowing to cushion the impact of spending cuts. An unnecessarily tight fiscal stance counter-intuitively delayed recovery, derailed tax receipts and raised government debt levels.

With banks calling in loans and the private sector trying to pay down debt Keegan argues that the government's top priority should have been to support growth.

In these circumstances you don't have to be a Keynesian to oppose austerity. But, while there are important differences in degree, both Labour and the Conservatives planned aggressive public spending cuts in 2010 and all parties seem to believe the budget deficit is public enemy number one even today.

In his call for increased government spending, this seems to put Keegan to the left of left. And yet, searching for the counter-factual to show that an alternative path was, and still is, possible, he seizes upon America, hardly a beacon of socialist thinking.

Ben Bernanke, a world authority on the Great Depression, miraculously found himself at the helm of the world's largest central bank 75 years later when the next crisis of a similar magnitude came along. Conscious of mistakes made in the late 1930s, he implored Congress not to remove stimulus too soon.

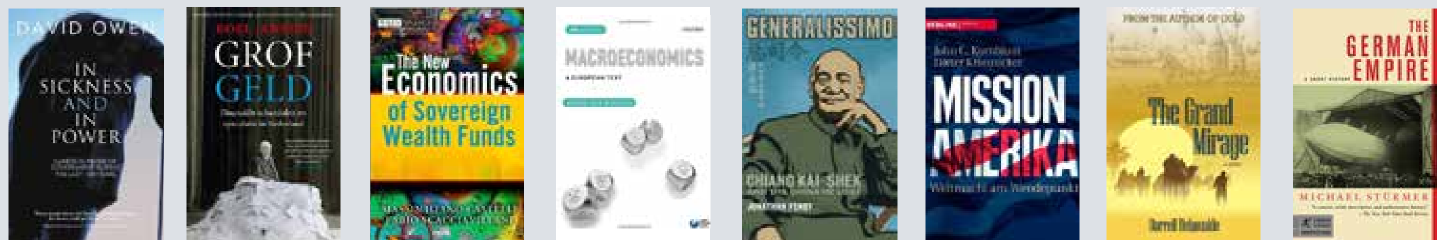
The economy rapidly exceeded its 2007 peak, tax revenues expanded and the deficit is no longer a matter of public concern. The best way to pay down national debt as a share of the economy is to grow the economy. America, not Greece, shows what could have been had looser policy been sustained.

Keegan finishes by chronicling the gradual shift in George Osborne's rhetoric away from cuts intended to prevent a crisis to what has become a rolling five year austerity plan with the explicit aim of shrinking the state.

Whether you agree with the economics or not, the question now is what sort of role you think the state should play in the provision of public services. Keegan's concern for what he calls the voiceless in society bearing the brunt of the cut backs makes his opposition to this approach clear.

There is remarkably little George Osborne in this book and the author never resorts to personal attacks. It is a battle of ideas and required reading for those on both sides of the political debate. In Keegan, the voiceless have found a voice. ▪

Trevor Greetham, a member of the Advisory Board, is Director of Asset Allocation of Fidelity Worldwide Investment.



Recipes for improving democracy

Round-the-world guide to learning from clever ideas

William Keegan, Advisory Board

***The Fourth Revolution – The Global Race To Reinvent The State* is the sixth joint book by The Economist team of John Micklethwait and Adrian Wooldridge (Micklethwait is currently the editor but will soon be joining Bloomberg News). As befits that highly successful magazine with its worldwide reach, the range covered is enormous.**

I confess that, given what I would regard as the right-wing leanings of The Economist, which the authors would describe as 'liberal' – classically liberal, not the bastard version used as a term of abuse in the US – I was expecting a somewhat less nuanced work than they have managed to produce.

History of democracy

Their essential interest is in establishing where democracy went wrong and what can be done about it. We are given a beautifully written refresher course on political history, the emphasis being on how democracy, founded in ancient Athens, abolished by the Roman Emperor Augustus, was gradually revived in Europe and the US about 1500 years later.

What they end up advocating, at a time when there is so much dissatisfaction with democratically elected politicians around the world, is less a revolution than a recipe for further evolution, in order to repair the damage.

They take us from Hobbes's great insight that a state is necessary for the peaceable conduct of all human affairs (Revolution One) through John Stuart Mill and the Liberal State (Revolution Two) to Beatrice Webb and the Welfare State (Revolution Three) to the present state of democracy and its discontents.

In the process there are many excursions around the world, with plenty about the state capitalism of China – whose economic achievements they admire up to a point – and, of course, the efficiency of autocratic and meritocratic Singapore, modernised by Lee Kuan Yew.

They flirt with an 'Asian Alternative', which they regard as 'the most substantial challenge that the western model has ever faced: far more substantial than the old Soviet Union'.

What the authors are looking for around the world is not some kind of authoritarian model, but techniques for improving the way government works: efficiency without the nasty aspects of certain regimes. Their central concern is that, while there was, and is, much that is good in western democracy, the welfare state has become too bloated. Too many demands are placed upon it.

And governments become captured by interest groups and lobbyists, so that for all the authors' concern about welfare spending, much government money is diverted to those who are already well enough off, such as the agricultural lobbies of various countries.

They argue that there is far more scope for governments to learn from business and find 'clever ideas from every corner of the world' as well as to make more use of the information technology revolution to cut costs and provide better services.

At heart their Fourth Revolution is about 'reviving the power of two great liberal ideas… putting more emphasis on individual rights and less on social rights' and 'lightening the burden of the state'.

They come up with what I would regard as one of The Economist's wackier ideas: A system whereby each law expired after 10 years. And, for those of us who are more sympathetic towards the welfare state, for all its faults, the authors provide us with a wonderful paradox.

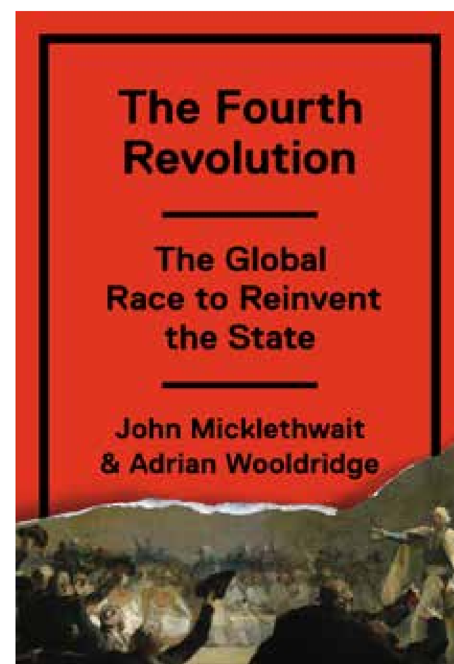
However, notwithstanding what I have referred to as their nuanced approach, the authors come down in the end in favour of a much smaller state. This, to my mind, is absurdly impractical in the complex modern world.

Surprise, surprise, their view is shared by Chancellor Osborne – a man once turned down for a job at The Economist – whose plans for cutting back the state if the Conservatives are re-elected send shivers down my spine.

They record that voters might have been happy to accept Milton Friedman's 'small government revolution' when it meant lower taxes and less red tape but not when it meant fewer services or unsafe meat.

But they add, 'it is notable that Friedman spent his golden years living in liberal San Francisco rather than Friedmanite Laredo in Texas'. ▪

William Keegan, member of the Advisory Board, is Senior Economics Commentator at the Observer.



GLOBAL PUBLIC INVESTOR 2015

DRIVING WORLD ECONOMIC GROWTH

Global Public Investor (GPI) 2015 advances understanding of the underlying investment behaviour and performance of different categories of public entities owning assets equivalent to 40% of world output.

The second edition of the report, GPI 2015, goes into greater detail on big investment themes by highlighting how institutions handle the wide variety of asset classes in which they invest. Additionally, it provides macroeconomic data on countries' net foreign investment positions and the precise role of official institutions in each case.

A centrepiece of the publication is the GPI Top 400 ranking, an extended and more comprehensive ranking of the world's largest 400 public investors based on assets under management.

Release date: Spring 2015

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A pivotal figure on the monetary stage

Pöhl, impatient, prescient Bundesbank president, dies aged 85

Karl Otto Pöhl, who died on 9 December aged 85, was the most prescient, erudite, eclectic, international and impatient president of an institution that, more than any other, shaped post-war Germany.

For a dozen action-packed years, between 1980 and 1991, he headed the Deutsche Bundesbank, the central bank that presided over the D-Mark and now, 15 years after the birth of monetary union, is leading a rearguard action to preserve its legacy.

Born into poverty in 1929, just four months before the man who became his nemesis during the 1980s, Chancellor Helmut Kohl, Pöhl strode to prominence on the monetary scene in the febrile atmosphere of Bonn, the provisional capital of a provisional state: pre-unification West Germany.

Up to his resignation in 1991, for complex personal and political reasons including disagreement with Kohl over the financial tactics of German unification and preparations for economic and monetary union, he spent 20 years at the helm of global finance.

Pöhl, nearly always ready for opinionated discussion and sometimes waspish dialogue, was celebrated for plain speaking but was ultimately impaled politically by inability to cut deals with Germany's elected rulers.

A one-time sportswriter and economic journalist, he became a pivotal figure on the international monetary stage in his 40s as an adviser to Helmut Schmidt, finance minister and then chancellor.

This continued after the took over at the Bundesbank in 1980. Although unknown to the wider public, no other contemporary official played such an important behind-the-scenes role in economic brinkmanship with successive British prime ministers.

Margaret Thatcher, famously, admired him more than any other German alive or dead.

He participated, somewhat reluctantly, in preparations for EMU in the 1988-89 committee under European Commission president Jacques Delors, with whom he had an antipathetic relationship. Pöhl forecast, ominously, in June 1989, considerable resistance' from the German people once they understood that monetary union 'centres on their money.'

Pöhl provides a prime example of the 'Becket effect', named after English King Henry II's chancellor Thomas à Becket, who opposed the King after he was appointed, and was murdered for his pains. Outsiders brought into the Bundesbank end up far more wedded than expected to stubborn-minded independence.

As a member of the Social Democratic Party, Pöhl was flattered when Christian Democrat Kohl reappointed him for a second eight-year term from January 1988. But Pöhl was irritated when Kohl telephoned him in December 1987 to encourage him to cut interest rates, part of an international stimulus plan that Pöhl later regretted as helping stoke economic overheating.

Earlier, he had lost Schmidt's favour over higher interest rates in 1980-81. Pöhl finished with the hard-worn distinction of falling out with the two German chancellors who appointed him – a bittersweet badge of central banking honour.

His quick wit, rapport with journalists, and readiness to forge personal contacts with financial leaders ranging from Paul Volcker of the US Treasury and Federal Reserve and Robin Leigh-Pemberton of the Bank of England to Dutchman Wim Duisenberg and Frenchman Jacques de Larosière gave him cult-like status abroad – but at the cost of diminishing political support at home.

He attained a reputation for not suffering fools gladly. An other-worldliness that could border on recklessness ultimately led to his departure from a central bank over which he presided with relish and esteem but which he never truly regarded as his home.

After the Bundesbank he built up considerable commercial expertise heading the German private bank Oppenheim before – in the aftermath of his own retirement – he became himself a victim of the managing partners' own mismanagement when the bank fell upon hard times, and folded in the early years of the new millennium.

One of the reasons why Pöhl sought to escape the Bundesbank's shackles was his aversion to being bound by the voting power of the querulous provincial central bank presidents on the Bundesbank's policy-making council.

In a curious reworking of history, Mario Draghi, presiding 30 years later over the European Central Bank in Frankfurt, is facing similar opposition to his policies from the ECB's decision-making council.

This time the resistance is led by none other but Pöhl's eventual successor, another former chancellors adviser-turned-central bank governor, the Bundesbank's chief Jens Weidmann – with results that could lead to more convulsions down the road. ▪

Karl Otto Pöhl (1929 - 2014)

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