The Bulletin

January 2017
Vol. 8 Ed. 1

Growth, risk, vulnerability
World shocks and emerging markets

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Etsuro Honda on Abenomics challenges
John Mourmouras on central bank independence
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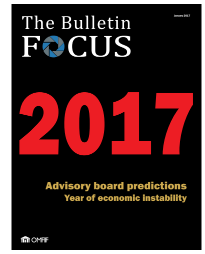

Predictions

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The Official Monetary and Financial Institutions Forum is an independent platform for dialogue and research. It serves as a non-lobbying network for worldwide public-private sector interaction in finance and economics. Members are private and public sector institutions globally. The aim is to promote exchanges of information and best practice in an atmosphere of mutual trust. OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries.

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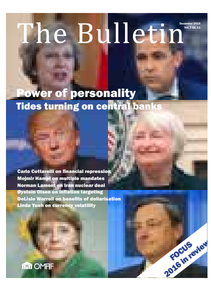
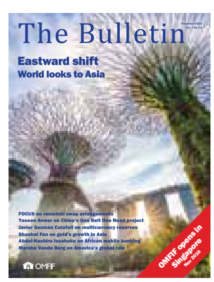
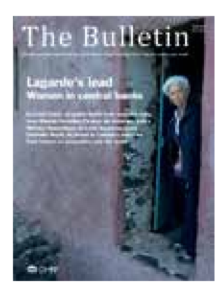
The 172-strong OMFIF Advisers, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors: Monetary Policy; Political Economy; Capital Markets; Industry and Investment. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership changes anually owing to rotation.







EDITORIAL

World shocks, emerging markets: growth, risk, vulnerability

Last year marked the dress rehearsal for major political and economic shifts. In 2017 the curtain goes up for the real show. The UK vote to leave the European Union, the election of Donald Trump, and Italy's rejection of constitutional reform proposals were serious disturbances; the first two were genuine shocks. This year the electorates' decisions take effect. As our new year forecasts show, advanced economies will remain strong sources of potential instability. However, we devote the cover story of the first Bulletin for 2017 to emerging market economies, which could be heavily affected by the developed economies' problems, but still represent a valuable opportunity for investors to diversify risk and profit from the world's best growth opportunities.

In the debt-fuelled booms and busts that started with the US-driven financial crisis and continued with Europe's debt upsets, emerging markets could be hit next. Years of ultra-low rates in advanced economies motivated huge capital inflows into emerging markets. But the Fed is changing course and will raise rates at least three times this year, predicts Darrell Delamaide. This creates vulnerabilities in emerging markets both directly, in terms of capital outflows, and indirectly, through dollar appreciation. China's slowdown and debt problems bring more uncertainty.

Exposure varies widely by region and country. David Mann emphasises the important trade and financial linkages between Asia and the US and suggests that the adjustment to higher US rates will come mainly through exchange rates. Phyllis Papadavid highlights how tighter Fed policy poses difficulties for financing infrastructure projects in Africa. The longer-term outlook for the continent is mixed. Mthuli Ncube points to the huge potential of digital financial services, while Danae Kyriakopoulou explains constraints from Africa's productivity puzzle.

In the monthly Focus containing the Advisory Board's predictions, we opine that many of the biggest shock waves will originate in the US as Trump enters the White House. Tensions in global geopolitics, particularly in Asia and the Middle East, create substantial risks. A shift in the economic mix from monetary to fiscal policy threatens global bond markets and could also be suboptimal for the US economy, notes Steve Hanke.

Despite rising inflation, US-style tightening is unlikely elsewhere. As John Mourmouras argues, central banks are independent but they are also interdependent with other areas of policy and may be obliged to overreact to shocks when decisions elsewhere move in different directions. Excessively loose policies bring some negative side-effects. But the Bank of England and the European Central Bank are expected to maintain their accommodative monetary stance.

The main risks for Europe will be political. The Greek crisis might be back on the agenda as questions remain over debt relief, warn Vicky Pryce and Danae Kyriakopoulou. Marcello Minenna and Edoardo Reviglio argue that Italy could prove resilient, but this would require flexibility in Europe's goals for the structural deficit. In Japan, all policy levers are moving in the same direction but have created a huge overhang of government debt. The most promising way out is monetising it, argues Etsuro Honda.

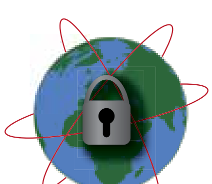
Another way to boost the effectiveness of unconventional monetary policy would be to abolish cash. Danae Kyriakopoulou reviews Kenneth Rogoff's proposal in *The Curse of Cash*. We mark the passing of Hans Tietmeyer, the former Bundesbank chief, a political technocrat who negotiated and presided over the D-mark's demise. Obiturist David Marsh knew him for 30 years. Tietmeyer was a friend of OMFIF who spoke at several meetings in Frankfurt and gave a City Lecture in London in April 2011. Europe needs people of his calibre, in 2017 and beyond.

Central banks' cybersecurity role

OMFIF to focus on financial resilience in 2017

Ben Robinson and Oliver Thew

Cybersecurity is key to financial stability and economic security, as global finance, payments systems and currency markets become increasingly dependent on digital technologies. Cybersecurity is a significant focus for OMFIF in 2017, with a series of meetings and workshops with central banks, regulatory agencies and global payment infrastructure providers planned for the year. This reflects a broader focus on the issue of fintech, which will feature as a new section in *Global Public Investor 2017*, to be published in June, bringing together public and private sector participants to discuss the impact of this fast-developing sector on global finance.



OMFIF YEAR OF CYBERSECURITY

Central banks must take a proactive approach to technological and digital innovations by developing governance and management standards for introducing new technologies and monitoring associated risk. A spate of attacks on central banks in South Korea, Indonesia, Bangladesh, Saudi Arabia and Russia underlines the hazards. Clear rules are needed on registering actual and attempted cyber attacks and hacks, otherwise unreported cases are likely to become more frequent. The potential impact of a successful cyber attack is growing in view of the proliferation of digital financial systems. The alleged cyber attacks and interference by Russia in the US elections underline the geopolitical significance of such activities. This is a significant area of vulnerability for the public sector. Philip Hammond, the UK chancellor of the exchequer, is one of a series of national politicians who has pointed out the security implications.

Private sector groups have taken the initiative in tackling cybersecurity issues, but central banks have a clear role to play in developing and implementing guidelines. They are key to strengthening national payments systems and to coordinating supervisors, regulators and market participants. More work needs to be done in increasing central bank resilience to cybercrime, training central bank personnel on emerging risks, educating board members about best practice, and implementing contingency plans for successful attacks.

There are signs of progress. These include creation of a specialist unit within The Bangko Sentral ng Pilipinas to boost its cybersecurity, and the Bank of Thailand joining forces with the telecoms regulator to increase its resilience capabilities. The European Central Bank has created an alert system for cyber attacks, the Bank of England is recruiting fintech firms to strengthen its security drive. Federal Reserve banks in the US have teamed up with the Financial Services Information Sharing and Analysis Centre – the industry body for cyber intelligence. Closer central bank co-operation and information-sharing could yield significant benefits for financial resilience. Failure to do so could prove disastrous.

OMFIF Advisers and Board

OMFIF has appointed Mthuli Ncube to the board of directors, Lutfey Siddiqi to the advisory board, and announced a restructuring of the advisory board. For the full list of members, see p.20-21.

Mthuli Ncube, professor of public policy at the Blavatnik School of Government, University of Oxford, and head of research at global investment firm Quantum Global Group, is joining the OMFIF board with immediate effect. Ncube was chief economist and vice president of the African Development Bank before becoming head of the Quantum Global Research Lab earlier this year. He holds a PhD in economics from Selwyn College, Cambridge University, and was dean and professor of finance at Wits Business School, Witwatersrand University in South Africa where he founded the Centre for Entrepreneurship.

Lutfey Siddiqi is adjunct professor at the National University of Singapore (Risk Management Institute). He is a governor and visiting professor-in-practice at the London School of Economics and Political Science, a member of the World Economic Forum global future council focusing on infrastructure investing and capital markets development. He was previously global head of emerging markets for foreign exchange, rates and credit at UBS Investment bank and a board member of CFA Singapore.

OMFIF is restructuring its 172-strong Advisory Board into three complementary groups. The Advisory Council is a representative group contributing to OMFIF's overall strategy. The Advisory Board is organised into four panels reflecting key areas of focus: Monetary Policy; Political Economy; Capital Markets; Industry and Investment. OMFIF Friends represent a broader affiliation of supporters of and contributors to OMFIF's work.

1976 sterling crisis: 'a pivotal moment'

Speakers at a joint presentation at the UK Treasury on 8 December marked the 40th anniversary of the 1976 sterling crisis that resulted in the UK government submitting to International Monetary Fund conditions as the price of a record $3.9bn stand-by credit.

Clockwise from top left: Lord (David) Owen; Lord (Bernard) Donoughue; Gerard Lyons; Richard Roberts

Tom Scholar, permanent secretary to the UK Treasury, which organised the seminar with OMFIF, said, '1976 was a pivotal moment in British modern economic history, and marked a significant change in course.' The meeting coincided with the launch of Richard Roberts' book, *When Britain Went Bust – The 1976 IMF Crisis*, published by OMFIF Press.

Johannnes Witteveen, 95, IMF managing director in 1976, who played a pivotal part in the episode, took part in the Treasury-OMFIF seminar. As Witteveen put it in a wry introduction to his speech, inviting back a former managing director to commemorate a stand-by credit in fraught political circumstances four decades ago is not an everyday occurrence. In London, as in his home country, Witteveen – Dutch finance minister during two spells in the 1960s – is not loath to step into the contemporary political fray. He castigated European nations (including the Netherlands) for an overdose of austerity that 'was turning voters away from European ideals'.

Roberts, professor of contemporary financial history at King's College London, reiterated the gravity of the 1976 episode and highlighted the lessons for Britain in 2016. Between the end of the first world war and 1976, the UK had experienced six currency depreciations. There have been four more after 1976, including the most recent collapse of sterling in the immediate aftermath of Britain's vote to leave the European Union. The decline in June-July 2016 was of roughly the same magnitude as in 1976.

Lord (Bernard) Donoughue, a senior policy adviser to then Prime Minister James Callaghan, said governments 'only work' if the prime minister and the chancellor of the exchequer work together, and that they 'must go into Cabinet united on every decision'. Donoughue pointed out that, rather than going bust, the real economic problem of the 1970s for Britain had been inflation.

Returning the conversation to today's political scene in Europe, Lord (David) Owen, former foreign secretary, said, 'There is a great danger in getting ourselves too excited about making projections about what's going to happen until we see out this coming year in Europe.' Right-wing political movements are gaining traction in key economies. 'We are making much too rapid an assumption.'

To buy When Britain Went Bust *please visit www.omfif.org/shop.*

Witteveen's warnings for policy-makers

Johannes Witteveen, former IMF managing director, made a symbolic journey to 10 Downing Street on 9 December, reliving a clandestine visit to the home of the British prime minister in December 1976. Among the lessons of the 1976 crisis, one stands out: when international confidence in a nation's economy starts to plummet, for whatever reason, it takes a mighty effort to win it back again. Countries around the world might be reliving this effect as the dollar's ascent gains further momentum in the wake of Federal Reserve tightening.

Witteveen, who helped contribute to Roberts' book by drawing on contemporaneous notes from the period, discussed several aspects of the crisis during his London visit. Paying tribute to Witteveen as a 'man of integrity and courage', Lord (David) Owen, who was a junior minister in the Callaghan government in 1976 and became foreign secretary the following year, said the former Dutch finance minister paved the way for a 'restoration of confidence' in the UK.

Prudent debt management

Maturity extension reduces the US Treasury's 'potential volatility in debt service costs that it pays over time' said Daleep Singh, US Treasury acting assistant secretary for financial markets, on 6 December at an OMFIF City Lecture at Columbia University's School of International and Public Affairs in New York.

Singh added that this maturity extension also lowers the Treasury's exposure to higher interest rate environments as it refinances its debt portfolio. Singh is responsible for advising the Treasury secretary on a broad range of policies in the areas of global finance, financial markets, debt management, and financial regulation.

Career of the 'gun-shy chairman'

Sebastian Mallaby, author of *The Man Who Knew: The Life and Times of Alan Greenspan*, said that Alan Greenspan 'spent four decades at or near the helm of financial power' in the US.

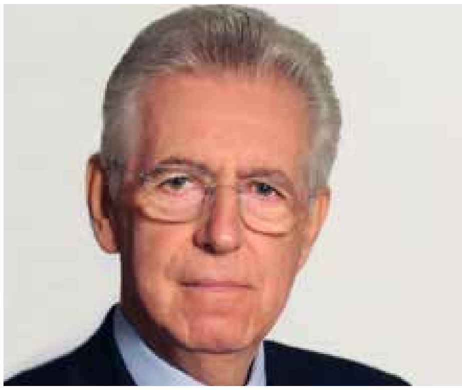
Mallaby spoke at an OMFIF discussion to discuss the book and the changing role of central banking through history, on 29 November in London. He said that the title of his book was taken from Greenspan's knowledge that finance is fragile. Greenspan's inability to act on this knowledge in the face of the financial crisis earned him the name the 'gun-shy chairman'. The conversation was moderated by David Marsh, managing director of OMFIF, and attended by past and present policy-makers.

Monti: Italy in no election hurry

Italy is unlikely to hurry into early general elections after the 4 December referendum, said Mario Monti, the former Italian prime minister, in an OMFIF telephone conference on 20 December.

Monti, who headed the Italian administration in 2011-13, emphasised that the country needed time to harmonise two inconsistent electoral laws before the next vote. He also talked about the European Central Bank's monetary policies, the wave of populism in Europe and the effects of Donald Trump's election on European policies.

The discussion, moderated by David Marsh, covered the parliamentary and presidential elections in the Netherlands, France and Germany, and Britain's roadmap to leaving the European Union.



Forthcoming meetings

America on the edge

Contributors to the OMFIF Press book *Trump – Curse or Cure?* discuss the political economy of the Trump administration one day prior to the inauguration in an OMFIF telephone briefing. Lord (Meghnad) Desai and Desmond Lachman participate in a discussion moderated by David Marsh.

19 January

Risk and yield management in a multicurrency system

A roundtable for public sector asset managers, covering political, financial and macroeconomic developments and implications for public sector asset managers, including divergence in currencies and yields, and balancing risk and return.

24 January, London

Transparency and regulation: A German perspective

City Lecture with Felix Hufeld, president of BaFin, Germany's financial regulatory authority, focusing on financial supervision, stability, and cross-border co-operation, as well as wider regulatory challenges throughout Europe.

1 February, London

For details visit www.omfif.org/meetings.

Yen 'set to plummet' against dollar

The yen is set to weaken as low as 130 against the dollar, said Shumpei Takemori, OMFIF advisory board member and professor of economics at Keio University in Tokyo, in an OMFIF telephone briefing on 1 December. John Plender, chairman of OMFIF and author of the report 'At the edge of a shock – Japan's problematic monetary future', introduced a briefing on the report and potential scenarios under which Japan could emerge from its debt trap. Speakers included Jun Saito of the Japan Centre for Economic Research, and Sahoko Kaji and Shumpei Takemori of Keio University.

US economy in 'firm and strong recovery'

Once the 'supertanker of the US economy gets going in the direction of recovery, it is very hard to stop', said Stewart Fleming, former US editor at the Financial Times, in an OMFIF telephone briefing on 13 December. The briefing covered the following day's Federal Open Market Committee meeting, which marked the first US rate rise in a year. Speakers included Ernst Welteke, former president of Deutsche Bundesbank, and Sarah Hewin, chief economist, Europe, at Standard Chartered Bank. The briefing also discussed the 8 December ECB governing council decision on QE and other developments in monetary policy.

Africa's productivity puzzle

Demographic question marks over economic expansion

Danae Kyriakopoulou

Sub-Saharan Africa has been one of the fastest-growing regions since the turn of the millennium. Average GDP growth between 2000 and 2015 was 4.9% – second only to the Association of Southeast Asian Nations and well above that seen in the Middle East, Latin America, and advanced economies in Europe and North America.

While this is positive news for the world's least economically developed region, delving deeper into the data presents a rather different, less encouraging picture. Among the factors behind GDP growth, favourable demographics have accounted for most of Africa's economic acceleration.

Average population growth in the continent between 2000 and 2015 stood at 2.5%, more than double the 1.2% world average. The working age population (those aged 15-64) rose by 50% over the same period, according to data from the United Nations Population Prospects.

The move from informal to formal economy

Accounting for this, Africa's economic miracle appears less impressive (see Chart). While Africa still performs well above many other regions, two things should be noted. First, African economies saw a bigger increase in labour force participation compared with the world average, as workers moved from the informal into the formal economy. By contrast, many advanced economies saw labour force participation decline as workers were discouraged from searching for employment following the 2009 recession. Labour force participation in the US, for example, stands at a 39-year low.

> ***"Cross-sectional evidence from African economies reveals a weak link between investment and productivity growth over the past decade.***

Productivity and commodities

Second, Africa's economic growth has been boosted by low-base effects. The same can be said of productivity growth. Slow productivity growth to an extent is a global phenomenon worrying central bankers in many advanced economies from the UK to Canada. Various hypotheses have been put forward to explain why this is happening in developed countries too. These range from challenges in the way productivity is measured, given the elusive nature of technological improvements, to the type of post-2009 recovery and trends in these economies' labour-capital-resources relationships.

In Africa, on the other hand, the roots of slow productivity growth are much more obscure and worrying. Starting from a low base, Africa has important room for improvement when it comes to output per worker. Moreover, the average figure for productivity growth on the continent as a whole is likely to be overstated owing to the commodities boom of the new millennium.

Countries with a high share of resource rents in the economy tend to see high levels of output per worker, given the capital-intensive nature of these sectors. This means that rising prices cause substantial improvements in output-per-worker (as labour stays constant while output improves), even when labour productivity has seen little change.

Africa needs new sources of growth

Slow productivity growth in Africa is both puzzling and worrying. The UN's projections show Africa's fertility rate is likely to slow gradually over the next decades, from 2.6 children per woman of child-bearing age in 2010-15 to 2.1 in 2030-35.

While this is still above the 2.0 threshold required to keep the level of population steady, and well above the rate of growth seen in other regions (Oceania is the second-highest with a rate of 1.1), it will be insufficient to continue to support accelerating African growth. So the continent will need to find new generators of economic expansion.

Increased capital spending, particularly investments in infrastructure, is often hailed as the key in helping to improve productivity. But cross-sectional evidence from African economies reveals a weak link between investment and productivity growth over the past decade.

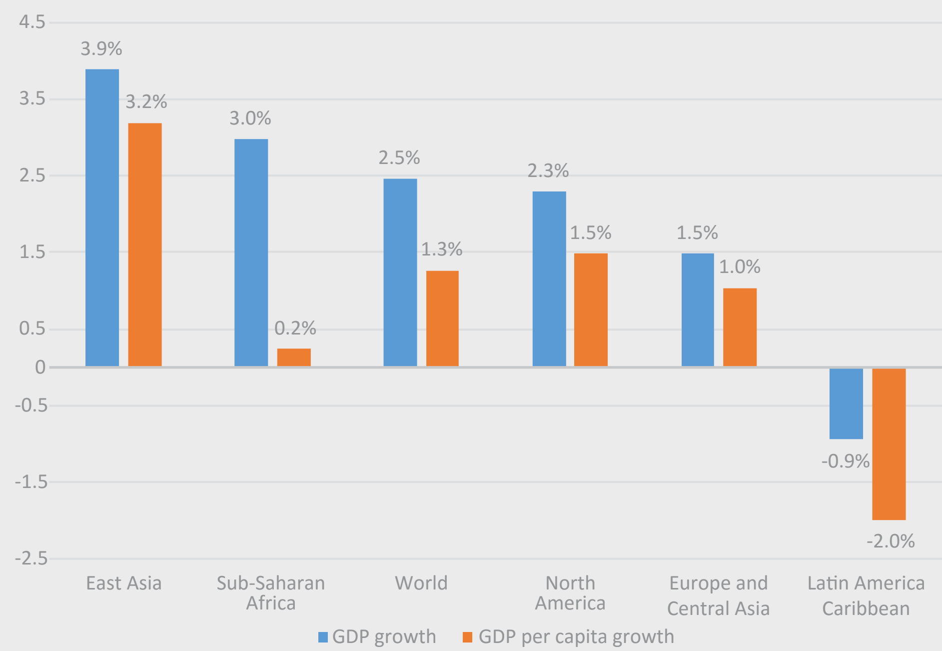
Lack of data hinders further examination. But one explanation could be that capital spending has focused on agricultural and resource-intensive activities, where the potential for rapid productivity improvements is low. This would imply a need to target capital spending on higher value-added sectors such as services.

Another, more optimistic possibility is that the lag required for these investments to show results and lead to improvements has not yet been completed. If this more sanguine assessment is correct, Africa's productivity revolution may already be underway. ■

Danae Kyriakopoulou is Head of Research at OMFIF.

Africa shows world's biggest demographic contribution to growth

Annual GDP growth, %, and annual GDP per capita growth, %, 2015



Source: World Bank, OECD Accounts, OMFIF analysis

US rate hikes' cost to Africa

Trump-Fed relations may aggravate global volatility

Phyllis Papadavid, Overseas Development Institute

Higher US interest rates will be bad news for Africa. If sustained, Fed rate hikes could be channelled through to sub-Saharan African economies in multiple ways, raising financing costs and reducing growth.

Open economies' long-term rates are often influenced by global risk premia, which could rise with the re-allocation of capital away from emerging economies to the US.

A steeper US yield curve, or a rise in long-term versus short-term rates, might reflect monetary normalisation in America, but it would bring negative repercussions to vulnerable African economies. In some instances, the US yield curve is a better predictor than emerging countries' own domestic interest rates in influencing economic outcomes.

Strains on creditworthiness

Growth trajectories have diverged within sub-Saharan Africa. Economies suffering from slower growth from weak commodity prices and reduced government revenues face strains on their creditworthiness. Those with depreciating currencies are especially vulnerable, as higher rates and a stronger dollar compound the cost of servicing sovereign and corporate dollar debt.

Nigeria, Zambia and Mozambique reflect this risk. Their currencies have depreciated by around 73%, 54% and 40% respectively since the start of 2015.

A steeper US yield curve, or a rise in long-term versus short-term rates, might reflect monetary normalisation in America, but it would bring negative repercussions to vulnerable African economies.

Sub-Saharan African debt issuance has helped countries use global financial markets to facilitate domestic investment. Higher US interest rates could narrow the scope for this financing, including for infrastructure, and could also hinder development of domestic sovereign bond markets. Interest rates have already started to increase in the larger sub-Saharan economies with more developed financial sectors, such as Kenya's.

In the wake of Donald Trump's presidential election victory, longer-dated US bond yields have risen significantly, on expectations that Trump's investment spending plans will boost US growth and debt. This has led to a sharp decline in global bond prices.

The expected rise in spending and tax cuts is estimated to increase US federal debt by $7.2tn over the next decade. If carried out, the magnitude of fiscal easing could lead to further increases in long-term US interest rates. To the extent that Trump's policies are considered pro-growth, they could have inflationary consequences.

Fed rate hikes in 2017

Following the 25 basis point rise in the fed funds rate after the 13-14 December US Federal Open Market Committee meeting, attention has now turned to the prospect of further increases in 2017. If the FOMC delayed raising interest rates amid potential fiscal easing, it would face the risk of abruptly increasing interest rates later on to keep the economy from overshooting its employment and inflation objectives.

Sub-Saharan African debt issuance has helped countries use global financial markets to facilitate domestic investment. Higher US interest rates could narrow the scope for this financing.

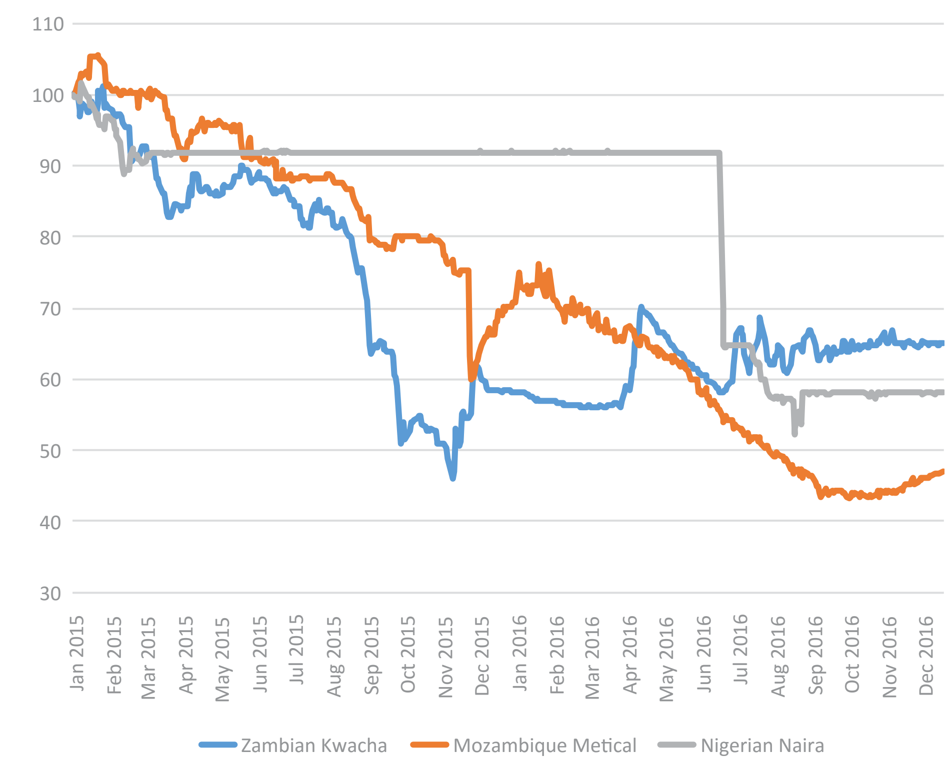
There could also be institutional risk. Janet Yellen has stated she will remain as Fed chair until her term ends in February 2018. Trump will have the opportunity thereafter to appoint a chair who is more sympathetic to his inward-looking policy inclinations.

Developments elsewhere in the world (and financial volatility stemming from the FOMC's actions) may therefore have less bearing on the Fed's deliberations than hitherto. This could present African countries with an unpleasant combination of international economic policies. ■

Phyllis Papadavid is Team Leader in International Macroeconomics at the Overseas Development Institute.

Significant depreciation of African currencies since January 2015

US dollar per African currency, index 1 Jan 2015 = 100



Source: Thomson Reuters, OMFIF analysis

Rush for Africa's digital financial services

Regulators must foster strong partnership ecosystem

Mthuli Ncube, Quantum Global Group

There are roughly 2.5bn people around the globe in lower- and middle-income countries who have no access to banking services. The potential for the expansion of digital financial services, which includes mobile banking and all electronic means of providing financial services, is clear. Africa, with a population of more than 1bn, of whom around 735m are mobile phone subscribers, is one of the key international markets for digital financial services.

There are around 203m registered non-bank mobile money accounts in the world, almost half of which are in sub-Saharan Africa, with East Africa accounting for the highest share. At least 19 African countries from across the continent have more registered mobile money accounts than bank accounts.

A number of factors such as mobile phone penetration, financial and conventional infrastructure development, population density, regulation, and the appetite of private players to pursue new initiatives have driven variation in mobile financial services.

The growth of mobile financial services

The high proportion of the African population that has no access to formal financial services has fuelled demand for mobile phones and mobile financial services. In most African countries, mobile banking is taking services to remote areas where conventional banks have been physically absent or too expensive to operate. Subscribers can now open accounts, check balances, pay bills, transfer money, and buy everyday essentials through their mobile phones.

Mobile financial services offer more opportunities for partnerships between banks and non-bank financial institutions. In many African countries, banks and multinationals are also competing to tap the market of the unbanked population. A necessary condition for the expansion of mobile banking is for regulators, especially central banks, to implement supportive regulatory regimes.

Successful development of digital financial services depends upon their ability to add value for all parties in the 'partnership ecosystem'.

The depth of financial inclusion across Africa varies considerably. Nigeria, the most populous country and largest economy in sub-Saharan Africa, has one of the highest rates of financial inclusion, with a 60% share of the adult population using formal financial services. However, Nigeria's regulator does not allow for multinationals to offer services directly to consumers. This is likely to be hindering market growth.

In Cameroon, only banks can offer digital financial services directly. There are 2.7m registered users, and the financial inclusion rate is 47%. However, 80% of banks' loan portfolio is comprised of large companies rather than retail customers. These figures reveal that there is a lack of willingness on the part of banks to pursue a mass market strategy through either digital financial services or traditional means. Multinationals are now partnering with banks to offer digital services in the country.

Mobile banking supports financial inclusion

Kenya's high rate of financial inclusion (67%) is supported by having the highest percentage (nearly 60%) of people over 15 years old who own a mobile banking account. The regulatory environment played a key role in 2007 when Safaricom, a telecommunications company, launched its M-Pesa initiative for mobile money transfers. The regulator offered Safaricom a 'no objection' letter that allowed the company to innovate and pilot test its service without the confines of strict regulation.

The political violence that struck Kenya in 2008 may have also contributed to the expansion of the M-Pesa service. The disruption to transport networks and shut down of formal financial services, such as ATMs, meant that M-Pesa was the only way customers could transfer money. To date M-Pesa has over 30m subscribers, making it the most successful digital financial services initiative globally.

Kenyans receive nearly 90% of their remittances through mobile phones, followed by Ugandans at nearly 70%, and Ivorians at 50%. This again is well above the average for sub-Saharan Africa (around 30%), and comparable markets including South Asia and Latin America (around 5%).

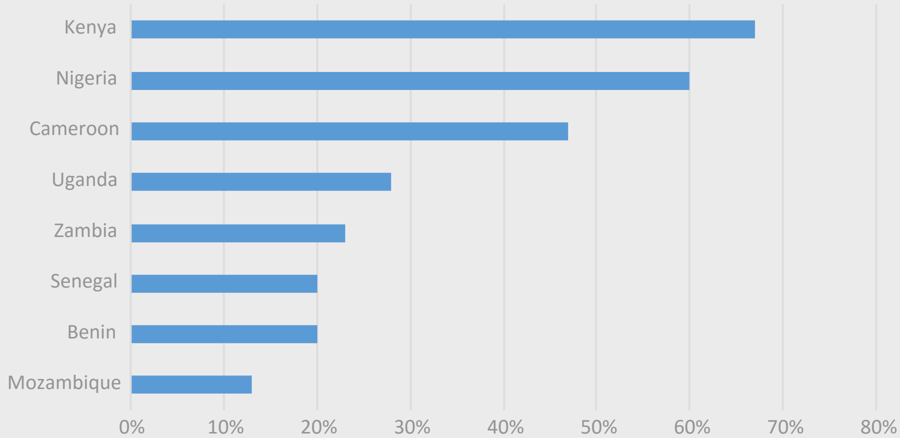
Successful development of digital financial services depends upon their ability to add value for all parties in the 'partnership ecosystem'. Tangible value must be delivered to customers, multinationals, banks, agents, financial institutions and other companies, such as retailers or dealers.

Finding technology and business models that work for all parties is challenging, as different actors have distinct business objectives. If there is failure to add value to any partner in this system, it may result in the collapse of the digital financial services business model. However, if the right models can be found, then Africa will lead the way in the world in pioneering digital financial services. ■

Mthuli Ncube is head of research at global investment firm Quantum Global Group and professor of public policy at the Blavatnik School of Government, University of Oxford.

Kenya has the highest level of financial inclusion in Africa

FInancial inclusion in selected African countries, %



Source: World Bank, OMFIF analysis

January 2017

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2017

Advisory board predictions
Year of economic instability

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A year of action and upheaval

Lines of risk across an unstable world

The world should prepare for another year of action and upheaval, according to the OMFIF advisory board 2017 forecasts. Many lines of political and economic risk intersect the US, China and Donald Trump's incoming administration. John Plender sees a spike in US bond market yields and heightened financial volatility disturbing global markets, while Trump's 'wayward behaviour and rhetoric' will exacerbate the damage in geopolitics and economics.

There are similar warnings of a worsening climate and wavering stability, particularly over China, from Meghnad Desai, Reginald Dale and Colin Robertson. Tension between Washington and Beijing could take various forms, ranging from disagreement in the UN Security Council to trade tariffs, and even to an armed conflict.

The advisory board expects Trump's economic policies will spur major reform in the US tax code (George Hoguet) and more Federal Reserve tightening (Marsha Vande Berg). They could also provoke a trade war with China (Steve Hanke). The Pacific Rim will be a prime field of geopolitical instability, predict Desai and Kishore Mahbubani.

The new administration faces important challenges over the Middle East, Russia and Europe. Boyd McCleary cautions on the potential fall-out over the nuclear deal with Iran. John Kornblum speculates that a possible Yalta-like deal between Trump and President Vladimir Putin could increase Russian influence in Syria and eastern Europe, a worry echoed by Miroslav Singer.

Domestic forces, too, could cause instability in Europe. Elections are due in Germany, France and the Netherlands, as well as possibly in Italy – four of the biggest euro area economies and founding members of the European Community. They will confirm global political influences already visible in Britain's decision to leave the European Union as well as the Trump victory: above all voters' (probably futile) search for safety and security in a world that appears to be becoming inherently more unstable.

Immigration will be a key issue and populism will rise, warns Akinari Horii. Mainstream parties will probably stay in power in the former three countries, predict Michael Stürmer, Jacques Lafitte, and Roel Janssen. Even though Angela Merkel is likely to remain chancellor after the autumn poll, Stürmer believes no politician in Germany will be the winner and German leadership will once again be in short supply.

> ***"Tension between Washington and Beijing could take various forms, ranging from disagreement in the UN Security Council to trade tariffs, and even to an armed conflict.***

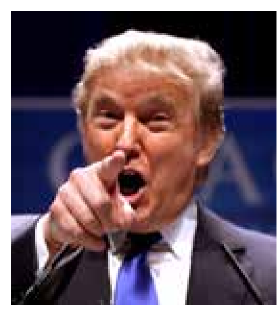
Other elections could enter the narrative. Greece's prime minister may gamble on a new poll, even though he may lose, notes Vicky Pryce. The success of Italy's new government is far from secured but the economy is fundamentally resilient, argues Antonio Armellini.

In the face of these political risks, Stefan Bielmeier expects that the European Central Bank will be a source of stability, with policy remaining expansive. Brexit will add to the continent's headaches, with Theresa May unlikely to reveal her negotiating strategy, warns Denis MacShane. In the UK, a key risk will be the housing market. Stewart Fleming foresees weaker price increases, rather than a bust.

In commodities and emerging markets. Nick Butler forecasts continued low oil prices due to high stock levels and lack of price-setting power by the Organisation of the Petrolem Exporting Countries. Commodity exporters will see sluggish growth. Kingsley Moghalu expects no improvement in recession-hit Nigeria, while Mthuli Ncube forecasts the spectre of hyperinflation will persist in Zimbabwe.

There are some bright spots. Gary Smith predicts that, despite the poor global environment, emerging market currencies will have a good year. Otaviano Canuto expects the Brazilian economy to stabilise in 2017, while Mark Burgess forecasts continued record growth for Australia.

What will be the greatest source of international macroeconomic instability?



The greatest threat in both economic and geopolitical terms is President-elect Donald Trump. Under his tenure market observers expect a combination of loose fiscal and tight monetary policy, as with Ronald Reagan's administration in the 1980s. While this comparison is broadly justified there are crucial differences, notably a much higher level of government debt today and much less slack in the US economy. The Fed will tighten more in response to inflationary pressure than markets expect, there will be a spike in bond market yields, and heightened volatility will disturb global markets. Trump's wayward behaviour and rhetoric will exacerbate the damage.

John Plender, Chairman, OMFIF

What is the greatest global geopolitical risk?

The greatest global geopolitical risk for the next five years is an armed conflict between the US and China, with India playing on the side of US. The conflict could flare up either on the disputed China-India border in the Himalayas, or in the South China Sea. Donald Trump's opening up to Taiwan shows his determination to irritate China one way or another. This issue is also connected with a potential Japan-China conflict. Shinzo Abe visiting Trump in New York was a sign that Japan feels it needs to get Trump on side for that eventuality.

Meghnad Desai, London School of Economics and Political Science

What is the greatest risk facing financial markets?

The greatest risk for financial markets in 2017 is the transition from monetary to fiscal stimulus. Monetary policy has led to strong performance in almost all financial markets. Excess liquidity has not been soaked up by the real economy and quantitative easing has directly manipulated bond yields downwards. However, fiscal stimulus is not typically kind to bond markets, especially when yields are exceptionally low, and higher bond yields could harm equities by raising the cost of share buy-backs. Policy-makers will need to persuade investors that fiscal stimulus will be effective within an acceptable time frame while maintaining confidence in central bankers.

Colin Robertson, SW1 Consulting

Will President Trump look back at 2017 as a good or bad year?

In one way, Donald Trump is bound to look back on 2017 as a good year, because he believes everything he does is great. He will make progress on deregulation and tax reform, but not as much as he would like on immigration and healthcare. Congress will be more difficult than he expects. Public dissatisfaction will rise. Abroad, like his two predecessors, he will be provocatively manipulated by Vladimir Putin; trade tensions will rise sharply; terrorism will continue, as will strife in the Middle East and with Iran; and he will run into serious economic, diplomatic, and perhaps even military conflicts with China.

Reginald Dale, Center for Strategic and International Studies

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Which initiative introduced by Trump will have the greatest immediate impact in 2017?

In 2017 Donald Trump will sign into law a major revision of the US tax code. The bill will dramatically simplify the tax system, reduce tax preferences, and promote investment. Owing to pressure from Republicans in the House of Representatives, the law will be revenue-neutral, with spending cuts on entitlement programmes. Tax simplification and reform will be a major achievement of the Trump administration. The world will grow more turbulent; his critics will blame him, but his ego will not allow him to admit fault.

George Hoguet, CFA Research Foundation

What will be the fed funds rate at end-2017?

Following the tightening course set in December's 25bp rate hike, US interest rates will increase by an additional 75 bps in 2017, to be spaced out in three hikes over the course of the year. This will add a full 1% to the November 2016 rate of 0.4%, and so the year will finish with a rate of 1.4%. Trump is expected to adopt an activist fiscal programme in 2017. Starting with corporate tax relief and financial sector deregulation, this programme will further accelerate the economy and provide fodder for continuing tightening. This is a plausible scenario, with or without the possibility of full-blooded Trump supporters filling two long-standing vacancies on the Fed's board of governors.

Marsha Vande Berg, Stanford University

Will 2017 see a rise in interest rates across the board?

The world economy is strengthening after another year of loose policy, while a rising oil price is pushing inflation higher from very low levels. This is the 'overheat' phase in Royal London Asset Management's Investment Clock framework, during which government bond yields tend to rise. It is unusual that, of the large central banks, only the Federal Reserve is likely to raise rates in 2017. This should keep the dollar strong. Political risk will keep policy loose in the UK and Europe, limiting the rise in long-term rates. Bank of Japan intervention will keep Japanese government bond yields close to zero.

Trevor Greetham, Royal London Asset Management

How will the US trade deficit change in 2017?

Hardly a day goes by without Donald Trump railing against China, accusing it of unfair trade practices and currency manipulation. Threats to impose punitive tariffs on the Chinese, and the spat over Trump's phone call with Taiwanese President Tsai Ing-wen, which broke decades of diplomatic protocol, offer uncomfortable harbingers of further squalls ahead. Trump's spending and tax promises will widen the gap between US spending and savings. This will cause America's trade deficit to balloon. When that happens, in view of China's high contribution to the deficit, Trump will undoubtedly point an accusatory finger at China. A trade war between the world's top two economies is increasingly probable.

Steve Hanke, Johns Hopkins University

What will President Donald Trump's rhetoric towards China mean for geopolitical relations in the Pacific Rim?

Trump has given confusing signals regarding relations with China. He spoke with President Tsai Ing-wen of Taiwan, yet his choice for ambassador to Beijing could not be more accommodating. Governor Terry Branstad has been a personal friend of President Xi Jinping since 1985. China is likely to exercise patience for six months or so. Even though Chinese leaders may be seething, especially in reaction to Trump's questioning of the One-China policy, they will not react hastily. But if Trump continues with his reckless criticism, China will pick a few areas to retaliate. The US needs co-operation from Beijing in the UN Security Council – the first signs of retaliation could surface there.

Kishore Mahbubani, Lee Kuan Yew School of Public Policy

Will there be a rapprochement between Russia and the West?

If Donald Trump acts like the deal-maker he claims to be, one could easily imagine a rapprochement similar to the Yalta Conference. The US agrees that Russia should control its part of the world, and in return Russia agrees no longer to contest the enlargment of Nato and the European Union. But this would be a fool's peace, forcing the West to accept Bashar al-Assad in Syria and consign Ukraine, Georgia and other states to Russia's influence. It could open the door for further Russian meddling in the West. Since we know little about the real aims of Vladimir Putin or Trump, the rest must be speculation.

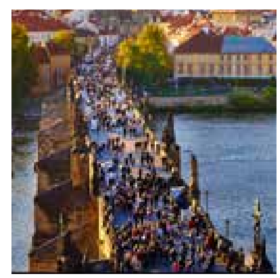
John Kornblum, Noerr

How will the change of administration in the US impact the war on Syria?

By the start of 2017 the Bashar al-Assad regime will have had significant success in Syria's civil war. Aleppo will be totally in government hands. This is one area where reality on the ground could pave the way for Donald Trump to do a deal with Vladimir Putin. However the downside is that Trump will cause real problems with Iran. He will not renege on the nuclear deal, but his arrival in the White House will make it more difficult for Europeans to do commercial deals with Iran, because of fears of repercussions in the US. This could in turn create domestic problems for Iranian President Hassan Rouhani, who faces an election in May.

Boyd McCleary, 39 Essex Chambers

What are the major economic risks for the 'new' Europe in 2017?



Central and Eastern Europe, the most dynamic part of the EU should be doing fine. The negative effects of oil and gas price increases should be offset by rising demand from Russia. Frictions between China and the US will cause little harm to either; America is rather dependent on Chinese imports. Still, Sino-US tension remains the major economic risk for the 'new' Europe. As for changes in investor sentiment, many investors sharply increased their reserves in recent years. Barring political risks, stemming chiefly from Russia's increased assertiveness and the widening divide between the Visegrad group and some 'old' EU countries, the new year should be a good one.

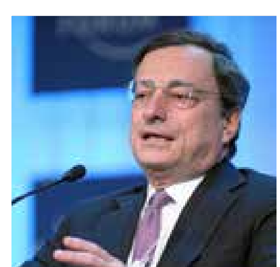
Miroslav Singer, formerly Czech National Bank

Will Europe repair its banks in 2017?

European banking instability will be the most significant downside risk for the global economy in 2017. The European people's understanding of this is somewhere between denial and anger, in the typical process of grief. It will take some time before they confront reality with respect to the scale of the problem. This is an election year for important EU countries and the problem is likely to get worse before the required public support is given to any plan of fundamental reform. Rising populism would make this process thornier and bloodier, leaving an uncertain economic outlook and putting downward pressure on economic growth.

Akinari Horii, Canon Institute for Global Studies

What will be the path of the European Central Bank's monetary policy?'



In 2017, the ECB will be challenged by low Inflation, sluggish growth, political uncertainty and a potential shortage in the bond market. Its decision to extend quantitative easing until the end of 2017 is a reaction to continued low inflation. Bond buying will be necessary in an election-rich year to temper political risks threatening the monetary union via the credit channel. Any decision to start true tapering – an uninterrupted reduction in purchases – will be data-dependent; the ECB knows that the positive effect of QE is rapidly declining. Throughout 2017 policy will remain expansive and has sufficient flexibility thanks to recent adjustments to the purchase programme rules. The topic of a possible shortage of bonds to buy, a feature of 2016, will not play a role in 2017.

Stefan Bielmeier, DZ BANK

Who will win the German parliamentary election?

The outcome will neither be victory nor catastrophe, but it will not produce the leadership Europe needs to weather Putin, Brexit and Trump. Angela Merkel's Christian Democratic Union (assuming, as I do, its continued alliance with the Christian Social Union) will come out on top, but no one will be able to claim a real victory. The right-wing Alternative for Germany will enter parliament, reducing the conservatives' coalition leeway. The CDU/CSU will need to link with the liberal Free Democratic party, but this will not be enough for a stable coalition – hence the need for courting the Greens and the Social Democratic party.

Michael Stürmer, WELT-Gruppe

Who will win the French presidential election and how will the results impact Europe?

After Brexit and Trump, some believe the next catastrophe could be Marine Le Pen becoming French president. History and polls suggest otherwise. French politics does not correlate with Britain and, if anything, is opposite from America. Le Pen has fallen almost 10 points in polls in 2016. François Fillon, the leader of the mainstream conservatives, does not need say anything to take traditional conservative-catholic votes away from her. Le Pen faces serious internal revolt. Yet, while informed money stays on Fillon, a surprise cannot be totally excluded.

Jacques Lafitte, Avisa Partners

What will be the result of the Dutch general election and what will be the effect on France and Germany?

Geert Wilders' Party for Freedom (PVV) will not become the largest party in the Dutch parliament – though his party will make gains, the election will be a disappointment for Wilders. Mark Rutte will continue as prime minister and his People's Party for Freedom and Democracy (VVD) will be the winner of the elections. The Labour Party (PvdA), the junior coalition partner, will do poorly. The Netherlands are always ruled by coalition governments and all parties but the VVD have stated that they will not co-operate with the PVV to form a government, so there will be a broad coalition of four, possibly five, parties in the next government.

Roel Janssen, NRC Handelsblad

How much of a risk will Italy's political instability and banking troubles pose to euro area stability?

Italy is more resilient than many believe. Matteo Renzi's loss in the 4 December constitutional referendum has forced him to the sidelines, but the new government is perceived to be still under his indirect control. Prime Minister Paolo Gentiloni will address the banking crisis and take on the associated political flak, but the main priority is introducing proportional legal changes to prevent a runaway victory for Beppe Grillo's Five Star Movement (M5S) in the impending general election. The success of the government's limited lifespan will depend on this strategy, though divisions remain with both President Sergio Mattarella and within Renzi's Democratic Party.

Antonio Armellini, former Ambassador, OSCE

Will Alexis Tsipras survive 2017 as Greek prime minister?

Many have predicted an early general election in Greece, though the next one is not due until October 2019. But there is no real desire to call an early poll among any of the major parties. Prime Minister Alexis Tsipras, leader of Syriza, would lose, since his popularity has dropped. New Democracy's new leader Kyriakos Mitsotakis, leading in the polls, would inherit an economy still in trouble with a hard negotiating period ahead. However, the European Commission may allow Tsipras more breathing room to avoid political upheaval in Greece. Talks with the IMF on longer-term debt relief seem to be stalling. Tsipras may decide that losing a snap election is worth the gamble if he can return as saviour in the future after New Democracy government fails to move Greece forward.

Vicky Pryce, Centre for Economics & Business Research

What kind of Brexit will Theresa May's government opt for as she triggers Article 50?

Theresa May would be well advised to play her Brexit cards close to her chest. There are options for different forms of Brexit – including political Brexit, with no more UK members of the European parliament; and economic Brexit, where Britain withdraws from the single market and customs union, driving much City and banking business out of London. Then there is Brexit against European citizens. If the UK wants to discriminate against Europeans by imposing visas and work permits, there will be no access to the single market. We won't know the EU line until after September's German elections. So the less May reveals about her position, the better.

Denis Macshane, Social Europe

What is the outlook for the UK housing market?

By the end of 2017 the British housing market will be facing its most difficult conditions since the aftermath of the global financial crisis. There will be pockets of relative strength, particularly in the north of England. In the south, low interest rates coupled with caution on the part of builders will prevent a bust. However, prices are already so inflated that house price increases are slowing. The year will be more subdued as Brexit uncertainties mount. Whether social housing will find the funds to ease a severe national shortage must be doubted.

Stewart Fleming, St Antony's College, Oxford

What will be the main factors affecting oil price in 2017?

This year will continue to see low oil prices, confirming that the current downturn is structural rather than a temporary cyclical shift. The Organisation of the Petroleum Exporting Countries' attempts to cut production will be met by increases elsewhere, especially in the US. This, in addition to high stock levels, sets a ceiling on prices. Demand growth worldwide is still being outstripped by production, and Opec does not seem strong enough to make the necessary dramatic cuts to raise prices.

Nick Butler, King's College, London

How will emerging market currencies perform in 2017?

Emerging market currencies look cheap, as they did in December 2015. The Barings emerging market debt team's proprietary valuation model suggests that they are close to maximum attractiveness. The fall-out of the US election has hit currency valuations, as have expectations of a series of hikes by the Fed in 2017. Yet fundamentals for many emerging market economies look sound, and commodity prices have remained relatively stable. This should provide support for the currencies of commodity producing nations. As was seen in 2016, a nimble strategy is optimal. An emerging market currency rally in the beginning of 2017 may not last the entire year.

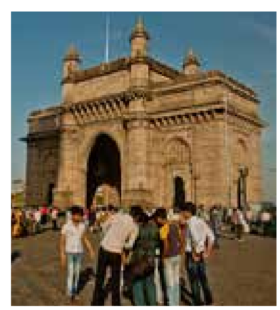
Gary Smith, Barings

Will China's debt cause financial instability in 2017?

Renminbi depreciation will be the authorities' preferred pressure-release as they grapple with slower growth, capital outflows, external headwinds, and the new currency basket. The dilemma will be how to support growth while curbing a housing market where affordability has deteriorated sharply. US trade tariffs pose a serious risk. Retaliation could be sought by a large devaluation, but that also risks the implosion of China's corporate and banks' balance sheets that are most exposed to dollar debt. The People's Bank of China may have to delve into its $3.1tn reserves to cushion the blow. Hopefully, given China's sizeable holdings of US government bonds, these will provide a mutual deterrent.

Neil Williams, Hermes Investment Management

Which economy will perform better in 2017, China or India?



Indian banks opened 2017 with a cut in lending rates, as they are flush with cash deposited since 9 November, when the government implemented its surprising demonetisation policy. Regardless, India is expected to continue its healthy growth of around 7.5%. The annual budget promises to continue the downward path of deficits and arrive at a timetable for the implementation of the radical Goods and Services Tax. China is sending mixed signals. There is a slowdown in the old economy, but the consumer sector is thriving. The debt situation is disturbing, but there is no danger of a rude shock given that it is renminbi-denominated. There is some alarm about capital outflows, but reserves are healthy. The chief concern is preventing the renminbi from depreciating too much.

Meghnad Desai, London School of Economics and Political Science

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Will the disruption from Modi's demonetisation experiment make way for benefits in terms of defeating corruption?

Prime Minister Narendra Modi's bold demonetisation experiment will not succeed in reducing corruption unless it is followed by a major campaign to modernise India's taxation system, increase digital transactions, and introduce other measures to curb the generation of unaccounted money. The introduction of the nationwide Goods and Services Tax must be used to catch an increasing number of transactions in the tax net, and simultaneously link them with the direct tax mechanism. All these measures could have been taken without the ill-advised demonetisation move, which has severely disrupted the country.

Rakesh Mohan, Yale University

Will there be any progress with the third arrow of Japan's Abenomics in 2017?

It is incorrect to regard Shinzo Abe's third arrow as a policy failure. Japanese structural reforms will begin to take effect, and progress on remaining reforms will continue. By their nature, structural reforms will have a positive impact but only with a lag. Some are much harder to implement than others. Japan may surprise in 2017 with stronger growth than anticipated, forecast between 0.5% and 1.4%. This is partly because domestic austerity has been abandoned. Moreover, the US will grow more strongly in the short term under Trump, and rising US interest rates may ease yen pressure.

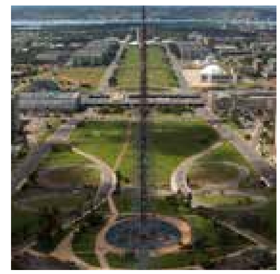
Jennifer Corbett, Australia National University

What trajectory will the Australian economy follow in 2017?

Australia will continue on its record growth path in 2017, though internal adjustments belie structural and cyclical challenges. The downturn in commodities has stabilised, while investment remains moderate. Residential investment is peaking as oversupply in apartments becomes apparent. High levels of household debt, weak wages growth and labour market bias to part-time work also indicate possible weakness. This suggests a hold for interest rates while imbalances are corrected, particularly as Philip Lowe, the new Reserve Bank governor, has focused on the impact of monetary policy on worsening financial imbalances in house prices and household debt.

Mark Burgess, Jamieson Coote Bonds

Will the Brazilian economy stabilise in 2017?



After two years of GDP contraction, rising unemployment and credit crunch, the Brazilian economy will stabilise in 2017. Business confidence levels have improved, particularly following the national congress' approval of a constitutional amendment for a public spending cap and the government's pension reform proposals. The political crisis has not impeded the economic reform agenda, and the central bank has hinted at lowering interest rates as inflation rates have systematically receded. However, given the fragility of balance sheets that have kept the economy in recession for two years, the recovery will be gradual. GDP growth is likely to remain between zero and 1% in 2017.

Otaviano Canuto, World Bank Group

Will Nigeria emerge from recession in 2017?

In response to a biting recession, Nigerian President Muhammadu Buhari has proposed a Ngn7.3tn ($23bn) expansionary budget for 2017 while his government seeks approval for foreign borrowing worth $30bn. Despite optimistic rhetoric, the country's economic fortunes are unlikely to improve significantly in 2017. This is because the solution to Nigeria's recession lies in fundamental policy adjustments, which the government is unwilling to make. Chief among the factors impeding productivity and driving inflation is the Central Bank of Nigeria's misaligned policy of seeking to maintain an artificial exchange rate for the naira. Foreign currency scarcity has hit the exchange market, hindering manufacturers' access to foreign exchange and fuelling a huge black market.

Kingsley Moghalu, Fletcher School, Tufts University

Will Jacob Zuma still be President of South Africa at the end of 2017?

Under political pressure, from deep inside his own party to leave office, let alone wider society, Zuma is putting up a fight. But there are limits. He needs to secure his own succession in the African National Congress leadership election in December. He wants the successor to be his former wife, Nkosazana Dlamini-Zuma, outgoing African Union Commission chair. His bet is that she will protect him from prosecution on more than 700 counts of fraud dropped in 2009 so he could stand in that year's election. The competition is unionist-turned-tycoon and now Deputy President Cyril Ramaphosa. Zuma faces fierce legal battles in 2017. If he calculates that leaving office early will enhance his ex-wife's chances, he will depart. But he can't be sure, so he may hang on into 2018.

Peter Bruce, Business Day

Will Zimbabwe's bond notes lead to hyperinflation in 2017?

Faced with liquidity constraints due to the adoption of the dollar, Zimbabwe introduced a domestic currency, in the form of bond notes, backed by an external loan of $200m. The exchange rate is set at one-to-one with the dollar, but the spectre of hyperinflation still looms. Given the demand for dollars in currency markets, the notes may begin to depreciate. If this happens, inflation will climb. The extent of the increase will be driven by the quantity of bond notes that are printed, and the degree of their depreciation. The Zimbabwean authorities must watch out for this.

Mthuli Ncube, Quantum Global Group

The man who knew about the euro

Fundamentalist who defended and buried the D-mark

David Marsh

Hans Tietmeyer, the German finance ministry and Bundesbank veteran who died in December aged 85, foresaw the economic and political strains befalling Europe's monetary union – but was unable to implement the safety mechanisms to prevent them happening.

His passing comes at a poignant time for Germany and Europe. In 2017, as vital elections loom and political solidarity appears to recede across the continent, make-or-break decisions are due on support for troubled members of the euro, above all Italy and Greece. Yet the far-reaching political union Tietmeyer always said was needed to underpin Europe's money seems as far away as ever.

Tietmeyer, Bundesbank president between 1993 and 1999, including the run-up to and introduction of the euro, was Germany's most political central bank chief. He goes down in history, too, as the most active. His career encompassed scores of international monetary negotiations and decisions over a crucial 30-year period.

An active Christian Democrat and confidant of Chancellor Helmut Kohl who survived a terrorist assassination attempt in the 1980s, Tietmeyer brought a steely, orthodox mind to the helm of German finance. But he was aware that politics would have the final say over the D-mark's replacement by the new European currency.

A younger, permanent rival

Like his immediate predecessor Helmut Schlesinger, a still-sprightly 92, with whom Tietmeyer worked as deputy president in the controversial 1991-93 currency period, Tietmeyer could always count on Kohl's support at fraught moments. This was in marked contrast to Karl Otto Pöhl, Bundesbank president in the 1980s, a Social Democrat and former protégé of Chancellor Helmut Schmidt. Pöhl, who could be as frivolously sardonic as Tietmeyer was earnest, regarded the younger man as a permanent rival, and resigned in 1991 after deep disagreement with Kohl over German reunification. He died in December 2014, also aged 85.

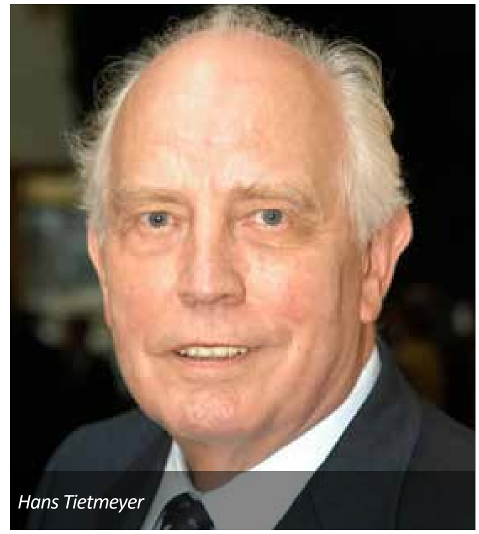
A decade earlier, as a hard line economic functionary in pre-unification West German governments in Bonn, Tietmeyer played an important role in Schmidt's political demise. He drafted a free market-leaning text by Otto Lambsdorff, then economics minister, which paved the way for the liberal Free Democrats' coalition switch away from Schmidt's SPD, bringing Kohl to power after years in the opposition wilderness. Tietmeyer was at the centre of successive economic flash-points. They ranged from 1980s currency accords with President Ronald Reagan's administration and the D-mark's 1990 introduction into East Germany, to European bargaining with British Prime Minister Margaret Thatcher and heated exchanges with France in the 1992-93 monetary squalls.

Tietmeyer had a sensitive side often concealed by grinding rhetoric and battering ram-style diplomacy. His self-depiction as an unyielding Westphalian oak became a central banking cliché. In 1996 Schmidt testily but inaccurately labelled Tietmeyer as the euro's most powerful adversary. Behind the habitual blunderbuss, Tietmeyer could be a patient and sympathetic interlocutor. And his instincts over monetary rapprochement with France – an essential but frequently troublesome ally over the single currency project – were more attuned with European Realpolitik than those of Pöhl or Schlesinger. Jean-Claude Trichet, the long-time French Treasury director, Banque de France governor and European Central Bank president, saw in Tietmeyer a friend, supporter and role model. Trichet's signals of affection were not always fully reciprocated.

> ***"Tietmeyer saw no reason to speed up European monetary union as a result of German unification.***

Tietmeyer grew up in the 1930s in a large catholic family near mainly protestant Münster. He once aspired to become a priest like two of his brothers. He brought theological fervour to defending the D-mark's sanctity. But, by presiding over its incorporation into the euro, he ended up burying Germany's quintessentially hard currency. In a wistful 1991 speech, Tietmeyer said he saw no reason to speed up European monetary union as a result of German unification, since Germany risked giving up 'one of the world's most successful and best monetary constitutions'.

In ceaseless 1990s European jousting, Tietmeyer stubbornly insisted that the independent Bundesbank should become the model for the future European central bank. As Tietmeyer's close relationship with Kohl demonstrated, independence was never as absolute as the Germans often depicted. Kohl could use Tietmeyer's fundamentalism as a crucial lever to win European partners' acceptance for Germany's euro policies. But neither man's efforts were sufficient to protect the new currency from inborn contradictions.


Hans Tietmeyer

Tietmeyer believed, in the best German economic tradition, that monetary union should eventually 'crown' a long journey of economic harmonisation and political integration. From the 1970s onwards, he held to the credo, most recently in a video interview with me released by the Bundesbank in August last year to coincide with his 85th birthday.

In countless warning speeches in the 1990s, Tietmeyer pointed to the dangers confronting monetary union unless it encapsulated political union, durable economic convergence and sufficient flexibility to weather unalterably fixed exchange rates. None of these three conditions was fully satisfied. Yet Tietmeyer and the Bundesbank – propelled by the overriding need to keep faith with France – had no option but to acquiesce, in a landmark decision in March 1998, in the D-mark's liquidation.

Tietmeyer was unflinching in portraying monetary union's inherent problems. He knew, equally, that his inability to repair them would form an imperishable and unsatisfactory part of an otherwise well-burnished legacy. ■

David Marsh is Manging Director of OMFIF.

Italian resilience to hardship

ECB and EU must be flexibile to Rome's crises

Marcello Minenna and Edoardo Reviglio

The good news for Italy is that a systemic solution to the banking crisis may soon be implemented. The bad news is that, despite a relatively good start to 2017 in terms of GDP growth, further clouds will overshadow the economy in the second half of the year.

A substantial recapitalisation of troubled banks is underway, with the burden to be shared by a combination of retail and institutional investors. This is in addition to a government contribution of €20bn of capital injections, plus €80bn of state guarantees.

The state-backed recapitalisation includes a €6.5bn injection into Monte dei Paschi di Siena, the country's third-largest lender. The bank was given liquidity guarantees and a capital injection under a cabinet decision just before Christmas, and was subsequently revealed to have a larger capital shortfall than expected. The 'precautionary recapitalisation' will force losses on MPS's junior bondholders under new EU bail-in laws. MPS failed to raise enough funds in a last-ditch attempt to bring in private capital, but is planning to issue €15bn of debt this year to restore liquidity and boost investor confidence.

Restrictive fiscal stance

The second half of 2017 seems more ominous. GDP grew at a faster than expected rate of 0.3% in the third quarter of 2016. But the economy could be compromised by the combination of a restrictive fiscal stance and continued monetary tightening due to the European Central Bank's decision to trim its asset purchase programme to €60bn a month from €80bn.

According to the European 'fiscal compact', the successor to the stability and growth pact, Italy should reach a primary surplus of 3.2% of GDP by 2019, starting from 1.5% in 2016, to comply with the medium-term objective of a zero structural deficit.

These objectives are set every three years for each euro country in line with the public debt level and demographic change in each state. The European Commission will classify Italy as a state undergoing 'very bad times' economically and with high public debt. Accordingly, the structural adjustment will be lowered to 0.25% of GDP.

The October earthquake and immigration emergency add to the reasons for further flexibility. As additional government reforms are set to have a positive impact on the budget, the EU can either set Italy a longer period of compliance with the fiscal compact objectives or authorise a temporary deviation from them. However, the method for measuring the cyclically adjusted budget balance is seriously flawed, given that the indicator is dependent on the volatile and often biased estimate of the output gap. Such estimates have shown very poor predictive power.

Key international institutions such as the Commission, International Monetary Fund and Organisation for Economic Co-operation and Development often provide diverging estimates of the size of the output gap. Significant changes in the estimated structural balance for the same year therefore can occur between different forecasting periods, leading to confusion.

No radical modification

In 2017 the European parliament will start integrating the fiscal compact into secondary EU law and an overall assessment of its implementation. This should be an important opportunity to discuss and define more flexible rules on debt and deficits.

Public sector investment or spending forced by exceptional events such as natural disasters may benefit from special treatment. However, it is difficult to imagine radical modification of the fiscal compact, in view of the policies on enforcing budgetary discipline by Germany and other core EU countries.

The fiscal stance was reconfigured by the government of former Prime Minister Matteo Renzi through a deactivation of safeguard clauses. This would automatically increase VAT rates and other taxes to comply with fiscal thresholds. Now, stricter consolidation appears unavoidable. These measures will probably begin to be felt in early April 2017 with the need for a budget correction worth at least €2bn. In 2018 fiscal adjustment could reach over €20bn, limited to €4bn in 2019. At the moment the major contribution would come from a VAT increase from 22% to 25%.

Upward pressure on rates

Later in 2017 Italy will face higher interest rates on its public debt. The ECB will begin to reduce the pace of its asset purchases from April until December, when the quantitative easing is bound to stop. ECB demand for Italian government bonds (up to €2bn monthly), which allowed over €20bn of saving on interest expenses between 2014-2016, will end and markets will expect higher yields.

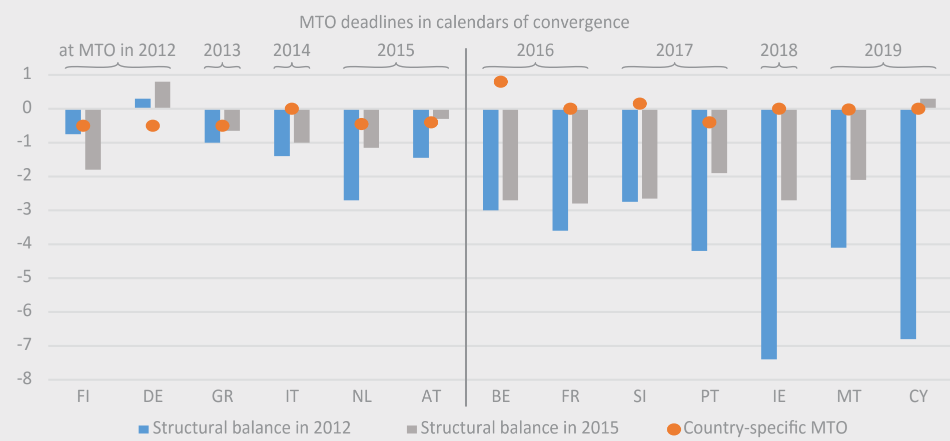
The end of QE will put upward pressure on rates in 2018, increasing the refinancing cost of the Italian debt. This will also weigh on the banking system, which will be forced to transfer higher interest rates to the manufacturing sector through increasing financing costs.

The Italian economy appears to be entering another phase of austerity and hardship. However, observers should not forget that, since 1992, Italy has been the most fiscally virtuous country in the EU, with 14 years of near-constant primary surplus (excluding 2014), despite its exceptionally high public debt. Italy will probably continue to show fiscal resilience. But the country's prime requirement is for higher growth, and it is difficult to see where this will come from. ■

Marcello Minenna is a Ph.D. Lecturer at the London Graduate School of Mathematical Finance, based in Rome. Edoardo Reviglio is Chief Economist at Cassa Depositi e Prestiti and Professor of economics at LUISS Guido Carli in Rome.

Limited convergence towards medium-term objective targets

Structural balance and medium term budgetary objectives, % of GDP, by country



Source: European Commission and European Central Bank calculations

No recovery without debt relief

Greece: too much politics, not enough economics

Vicky Pryce and Danae Kyriakopoulou

Grexit was never truly taken off the table. It was merely filed away in some euro drawer back in the summer of 2015, when the troika of creditor institutions – the International Monetary Fund, European Central Bank, and European Commission – and the Greek government settled on a third bail-out assistance programme following arduous negotiations.

Since that time, Greece has been largely absent from the headlines. Attention has shifted to Italy's banking problems and nationalist threats in France. Even to Germany, where Roland Berger, founder of the country's top consultancy firm, has suggested that to save the currency union Germany, not Greece, needs to depart. But after a tumultuous December, 2017 looks to be a decisive year for Greece.

IMF objections to fiscal surplus targets

There is a question mark over the IMF's participation in the bail-out programme. While the Fund interpreted its own rules flexibly to allow itself to be part of the troika of lenders to Greece since 2010, it did not sign up to the current programme because of objections to the fiscal surplus targets involved.

The European creditors, led by Germany, want to see Greece achieve a primary surplus of 3.5% by 2018, and sustain this over the medium term. The IMF's economists deem this impossible within the current framework of reforms. To achieve this target, Greece would require much further-reaching pension and tax reforms, which nearly all parties involved agree is politically impossible. The alternative proposed by the IMF is to lower the target to 1.5% and offer Greece some debt relief to cover the difference in terms of repayment.

Reaching a compromise will be arduous, with Europe facing a difficult choice between yielding to the IMF's debt relief demands or sacrificing the Fund's participation. Neither is attractive to EU lenders.

The first would be politically damaging in Germany given the toxicity of the debt relief issue with taxpayers. In a German election year, this will be an important consideration. The second would be unwelcome by European parliaments, especially in Germany and the Netherlands, which see the IMF as a provider of economic expertise and credibility.

> ***"Europe faces a difficult choice between yielding to the IMF's debt relief demands or sacrificing the Fund's participation.***

Squeezing Athens further to satisfy IMF demands would be counterproductive. In the light of other pan-European problems such as Brexit, unrest over refugees and continued banking crisis, further Greek political turmoil is unwelcome. However, without the IMF the whole programme could be threatened, as national parliaments need to approve the various tranches of bail-out aid for Greece until 2018. Signs so far suggest that Europe will contrive a half-way solution. Short-term debt relief measures were approved in December, though they are still to be fully implemented. The IMF meanwhile remains focused on its demands for further medium- and long-term reforms which it considers essential for debt sustainability.

A possible snap election

This places the Greek government, which is already grappling with very poor approval ratings, in a damning position. A decision in December to announce several fiscal giveaways to pensioners and north Aegean islands dealing with the refugee crisis – which greatly antagonised creditors – suggests that Prime Minister Alexis Tsipras might be preparing for snap elections.

This would not be his first choice. The latest polls give the lead to New Democracy, the centre-right party that was in government before Tsipras's Syriza. ND's new leader, the similarly youthful Kyriakos Mitsotakis, has focused his rhetoric on the need for reform and modernisation. But his shadow cabinet choices, revealed in November, imply that his priority might be achieving consensus among competing factions in the Greek centre-right.

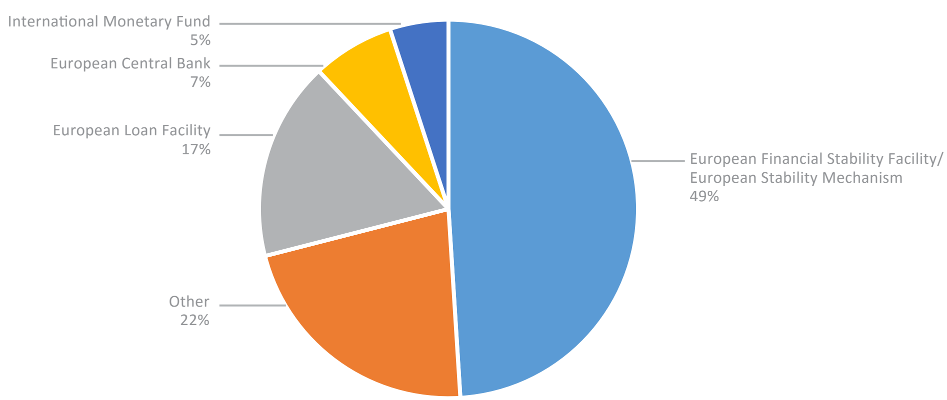
Further debt relief needed for recovery

While international negotiations and domestic political battles are expected to take centre stage this year, the Greek economy will be quietly suffering in the background. The IMF's analysis is sound: a recovery without further debt relief is a fantasy. There is plenty of room for reforms that might yield important economic benefits in the long term, but the short-term political cost is unpalatable. Mitsotakis, if elected, will be the seventh Greek prime minister that Angela Merkel will have faced during her tenure as German chancellor, with two being part of emergency caretaker governments. Political fluctuations are no surprise given the failure of successive programmes which have paid no attention to the feasibility of implementation.

The problem with efforts to address the Greek crisis so far is that there has been too much politics, not enough economics. All the agreements to date have effected little change on the root economic problems. This strategy is unsustainable. Now, more attention needs to be paid to the politics again. If no permanent solution which encourages a return to stable long-term growth is found, Greek politics may implode. ■

EFSF and ESM own half of Greek government debt

Composition of Greek general government debt, %, end-2015



Source: Greek Public Debt Management Agency, IMF staff estimates

Vicky Pryce is a Board Member at the Centre for Economics and Business Research, a former joint Head of the UK Government Economic Service and a Member of the OMFIF advisory board. Danae Kyriakopoulou is Head of Research at OMFIF.

Hawkish views define 2017 Fed agenda

Three hikes predicted but Trump brings uncertainty

Darrell Delamaide, US editor

After the stock market boom following Donald Trump's election, investors concluded that the Federal Reserve would go ahead with its long-awaited follow-up to last year's quarter-point interest rate hike. At its meeting in December, the Federal Open Market Committee duly approved – by unanimous vote – an increase in the fed funds rate to a range from 0.50% to 0.75%.

Policy-makers have revised their expectations for 2017. The dot-plot graph displaying the expectations of individual members indicated the likelihood of at least three further quarter-point hikes in the new year, as opposed to just two forecast for 2017 in the September graph.

Trump uncertainty: 'wait and see' mode

'Our decision to raise rates should certainly be understood as a reflection of the confidence we have in the progress the economy has made and our judgement that that progress will continue,' Fed Chair Janet Yellen said following the FOMC meeting.

When asked about the election results and Trump's economic plans, Yellen's attitude was one of 'wait and see'. Policy-makers' forecasts for growth over the coming three years hovered around 2% a year, and did not buy into Trump's prediction of much stronger growth.

'We are operating under a cloud of uncertainty at the moment, and we have time to wait to see what changes occur and to factor those into our decision-making as we gain greater clarity,' Yellen said.

Need for targeted fiscal spending stimulus

Overall, however, Yellen seemed relatively calm about the need for a fiscal stimulus implicit in Trump's plans. She said that unemployment has fallen to 4.6% and that slack in the labour market has diminished.

'Fiscal policy is not obviously needed [at this point] to provide stimulus to help us get back to full employment,' she said. But she added quickly, 'I am not trying to provide advice to the new administration or to Congress as to what is the appropriate stance of policy.'

When reminded that earlier this year she had called for fiscal policy to stimulate lagging US productivity, Yellen acknowledged that tax policy could be effective in that regard.

'Policies that would improve productivity growth would include policy changes that enhance education training, workforce development, policies that spur either private or public investment to enhance the quality of capital in the US that workers have to work with, and policies that spur innovation or competition or the formation of new firms,' Yellen said.

James Bullard, chief of the St. Louis Fed, also emphasised the impact of administration policy on productivity and on his view that the US is currently in a 'regime' of low natural interest rates.

'New policies brewing in Washington may have some impact on the low-safe-real-rate regime if they are directed towards improving medium-term US productivity growth,' he said.

> ***"Policy-makers have revised their expectations for 2017. The dot-plot graph indicated the likelihood of at least three further quarter-point hikes in the new year.***

But he cautioned that 'these policies should not be viewed as countercyclical measures', because 'the economy is not in recession today'.

Fiscal buffers for next downturn

Charles Evans, president of the Chicago Fed, echoed this warning. The country doesn't need infrastructure spending as a fiscal stimulus, since 'we are very near full employment', he said.

However, he added that building necessary infrastructure would be a 'terrific' idea. 'You don't need stimulus,' he said. 'You do need a plan for roads and bridges.'

Evans also supported some of Trump's tax plans, remarking that 'corporate tax rationalisation would be a huge improvement'.

William Dudley, president of the New York Fed, preferred to focus on the role of fiscal policy in the next downturn. Citing the limits on how far monetary accommodation can go in a low interest rate environment, he said, 'These limits suggest that fiscal policy may need to play a greater role in stabilising the economy than has been the case in past decades.'

Dudley suggested using 'fiscal stabilisers' – such as an extension of unemployment benefits or cuts in payroll taxes – that kick in automatically in a downturn to reduce fluctuations in disposable incomes.

Janet Yellen, Chair, Federal Reserve

Future Fed vacancies

Inevitably, there was speculation about how the president-elect would seek to steer monetary policy with his appointments to the Fed.

There are two long-standing vacancies on the Fed board of governors after senate Republicans obstructed President Barack Obama's two nominees for more than a year. The Trump transition team indicated that he would fill them quickly.

After the 13-14 December FOMC meeting, Yellen reaffirmed her intention to fulfil her four-year term as Fed chair, which expires on 3 February 2018.

'The term of the Fed chair was not meant to coincide with that of the president,' she noted. 'It is part of ensuring the independence of the Fed.'

Though her term on the board itself extends to 2024 even if she is not reappointed as chair, Yellen said that was 'a decision for another day'. Outgoing chairs almost never stay on the board.

The rotation of the regional bank presidents in the new year will bring several recent appointees into voting positions on the FOMC for the first time. It remains to be seen how the new voters line up on the hawk-dove scale but, given the relatively hawkish consensus that has developed, it may not make much difference. ■

Darrell Delamaide is a writer and editor based in Washington.

Public infrastructure full of hot air

Welcome to the world of waste, fraud, and abuse

Steve Hanke, Advisory Board

Economic policy is subject to fads and fashions, and the latest trend is public infrastructure. Its advocates include progressives on the left of the political spectrum, like Barack Obama, Hillary Clinton and Bernie Sanders, and populists on the right, including President-elect Donald Trump. They tell us to remove the chains of fiscal austerity and spend on public works, and that this elixir will cure all economic ills.

Globally, economic growth remains muted, and the US provides an important example. It has been over eight years since the 2009 recession, and the US has failed to bounce back. The economy may be growing, but the pace of expansion is below its trend rate. US aggregate demand, which is best represented by final domestic sales, is growing at a nominal rate of 2.8%, well below the trend rate of 4.7%.

The secular stagnation argument

Many argue that fiscal austerity has been responsible for keeping growth down. They advocate fiscal stimulus instead, through spending on public works. Another line of argument used to support increased spending on public works is based on 'secular stagnation'. Its leading advocate is Larry Summers, Harvard economist and former US Treasury secretary. He argues that private enterprise is failing to invest and that the government must step in and spend on public works.

Summers points to anaemic private domestic capital expenditure as evidence for his thesis. The Chart shows that net private domestic business investment is relatively weak and has been on a downward course for decades.

Investment fuels productivity. So, with little fuel, one should expect weak US productivity numbers. Productivity growth is indeed weak and has been trending downward. The US is in the grips of the longest slide in productivity growth since the late 1970s. Advocates of the secular stagnation theory assert that the deficiency in net private investment and the resulting productivity slump can be made up by public works spending.

Escaping fiscal austerity

This argument has been put forward many times in the past, but seems to be gaining ground as a means of escaping fiscal austerity. If proposed public works proceed as projected, the government financing magnitudes would be stunning. The McKinsey Global Institute estimated that annual spending of $3.7tn per year between 2013-30 was 'required' worldwide.

Trump has jumped on this infrastructure bandwagon by proposing a $1tn public works programme. But the alleged benefits of infrastructure spending are often wildly inflated, with cost estimates downplayed or distorted.

Analysis of the economic multiplier of infrastructure spending – around 1.6 by some estimates – is often flawed due to incorrect assumptions, and can be subject to misuse in the artificial inflation of benefits.

Once public works are installed, the hot air comes out of their alleged benefits. These projects are poorly maintained, and users are often not charged for what they use, or they are charged prices set well below the relevant costs incurred. Water is a classic case – on average 34% of the water delivered to water systems is either stolen or leaks out of distribution systems. It is hard to take seriously claims that billions of dollars are required to develop more water resource capacity when much of the water produced in existing systems leaks away. Adjusting for leaks and thefts, the alleged benefits for many new projects, which have been inflated by 'multipliers', wither away to almost nothing.

> ***"Trump has jumped on the infrastructure bandwagon by proposing a $1tn public works programme. The alleged benefits of infrastructure spending are often inflated, with the cost estimates downplayed or distorted.***

The reality of infrastructure funding

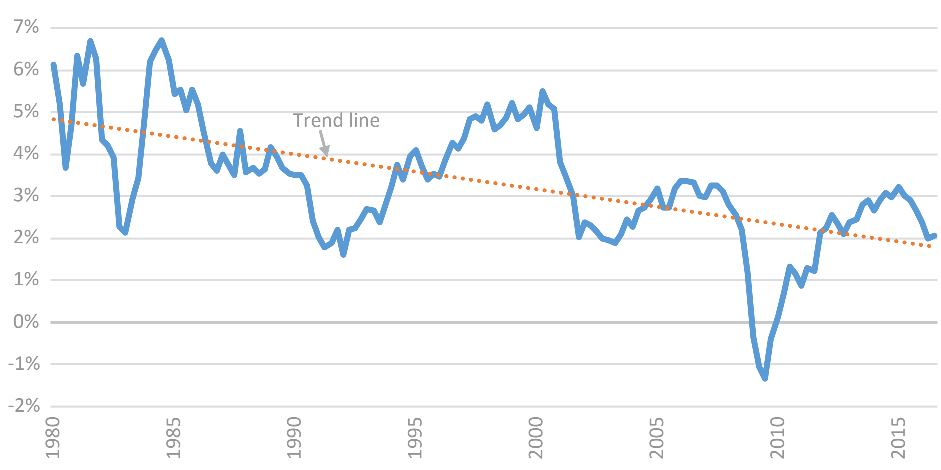
Infrastructure projects are always subject to cost overruns. While the projects might look good on paper, the reality is very different. Detailed studies show that the average ratios of actual costs to estimated costs for public works projects in the US typically range from 1.25 to over 2.

In addition to cost overruns, the financing of infrastructure requires the imposition of taxes, and taxes impose costs beyond the amount of revenue raised. The excess burdens of taxation include 'deadweight' distortions, enforcement and compliance costs. In short, it costs more than a dollar to finance a dollar in government spending. The best estimates indicate that, on average, it costs between $1.50 to $1.60 to raise a dollar in tax revenue.

Taking proper account of cost overruns and the costs of collecting taxes, one wonders if there are any public works projects that could justify federal financing, let alone financing to the tune of $1tn. This is the wonderful world of infrastructure waste, fraud, and abuse. ■

Private capital expenditure in US continues downward trend

Net private business investment, % of GDP



Source: US Bureau of Economic Analysis, author's calculations

Steve Hanke is Professor of Applied Economics at The Johns Hopkins University, Baltimore.

Central banks in an unconventional era

Monetary independence supports global economy

John Mourmouras, Bank of Greece

The intellectual roots of central bank independence can be traced back to the rational expectations revolution. This put forward the idea that people base choices on their rational outlook, past experiences and available information. Rational expectations played a pivotal role in breaking the intellectual deadlock with addressing the 'stagflation' phenomenon of the 1970s, when high inflation was combined with high unemployment and slow growth.

Under discretionary monetary policy in a rational expectations framework, the interaction of private agents with the government generates an inflation bias, without any sustainable output gains. This bias increases with governments' displeasure at the size of the output gap. As a result of this perceived bias, governments and central banks around the world moved to conduct monetary policy with a credible commitment to low inflation, anchoring inflation expectations to equally low levels.

Monetary policy in the post-crisis period

The financial crisis of 2008 and the ensuing European sovereign debt crisis have fundamentally changed the operational framework of independent central banks. Central banks have been given new macroprudential tasks, such as the supervision of systemic banks in economic and monetary union, conducted by the European Central Bank since 2014.

Another important change is that in the post-crisis era price stability is about preventing deflation, rather than halting excessive inflation. As a result, all major central banks have employed unconventional monetary policy tools in recent years. These include the provision of emergency liquidity and credit support to banks and extending the definition of assets accepted as eligible collateral when providing loans on a short- or medium-term basis.

To help raise inflation to targeted levels, central banks have turned to negative base rates and quantitative easing, considerably expanding central bank balance sheets. Since 2008 the Fed's balance sheet has more than doubled, while the Bank of England's has tripled. The ECB's balance sheet has grown 66% since its QE programme started in 2015.

Central bank challenges for independence

The legacy of the 2008 crisis and subsequent low inflation have brought challenges for central bank independence. First, external parties have questioned the independence of central bank policy instruments. Second, even if these policies are not formally challenged, they may be less likely to achieve their objectives because of the altered conditions. Such questioning is arguably aimed at the wrong target. I believe criticism should not be directed against the very concept of independence, but rather against the current economic mix of ultra-loose monetary policy with tight fiscal policy.

Monetary policy naturally interacts with fiscal, structural and financial policies. The separate authorities that conduct these policies may be formally independent, but they are also interdependent. The risk of such interdependence is that, if one independent policy authority does not take appropriate action to meet its mandated objectives, the other authorities may be obliged to overreact to persistent shocks to meet their own objectives. This may result in a regime of 'weak dominance' of other policies over monetary policy, effectively destabilising the regime of monetary dominance that central bank independence is meant to establish.

When interest rates are kept negative for too long, both the redistribution effects of monetary policy and the perceived degree of success of meeting the mandated objectives become more pronounced. This leads to greater demands for scrutiny of central bank independence. Concerns naturally arise about whether a monetary authority with an extended mandate of objectives can operate transparently and with appropriate accountability in a democratic political and economic system.

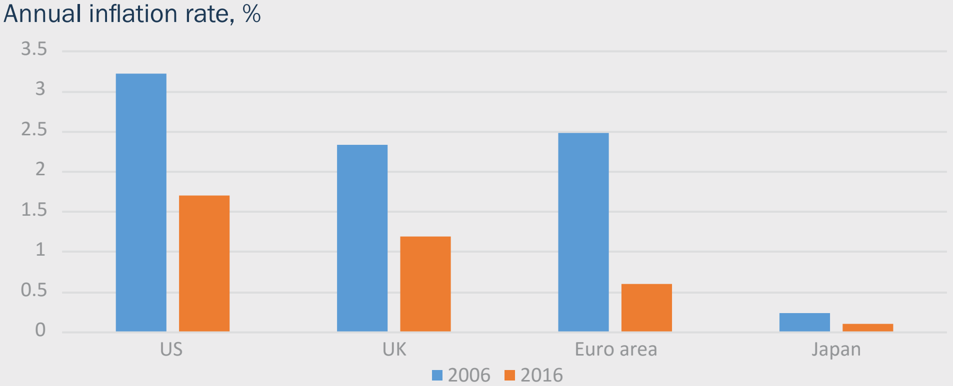
> ***"The independence of central banks may be scrutinised due to concerns about whether a monetary authority with an extended mandate can operate transparently and with an appropriate degree of accountability.***

An independent central bank subject to checks and balances and democratic accountability needs public backing. When negative rates persist, central banks almost inevitably lose major parts of the necessary broad constituency of support.

There is still a strong overriding need for Independent central banks focused on price stability, capable of creating policy room for necessary structural adjustments, appropriate fiscal policies and macroprudential stability. All the theoretical and empirical arguments point in this direction: this approach offers the most promising path for the ultimate objective of restoring normal growth conditions and creating jobs. Controversy about the means and goals of central banking independence is no reason why the world should water down a concept that has served the global economy well over 40 years. ■

Inflation has slowed in the past 10 years in major economies

Annual inflation rate, %



Source: Bureau of Labour Statistics, Office for National Statistics, Japanese Ministry of Internal Affairs and Communications, Eurostat, OMFIF analysis. 2016 inflation is latest year-on-year monthly inflation.

Prof. John (Iannis) Mourmouras is Deputy Governor of the Bank of Greece and a former Deputy Finance Minister. This is an abridged version of two speeches made in Tokyo at the JCER seminar and in Kuala Lumpur at the SEACEN Policy Summit, jointly organised with OMFIF, in November 2016.

Gold boost to Islamic finance

Shari'ah standard opens up market for long-term value

Shaokai Fan, World Gold Council

The arrival of the Shari'ah Standard on Gold, a definitive guide to Shari'ah-compliant investment in gold products, will enable investors to access gold's unique attributes as a long-term store of value, diversification tool and risk-mitigating asset through Shari'ah-compliant products. The World Gold Council launched the standard with the Accounting and Auditing Organisation of Islamic Finance Institutions on 5 December.

The industry will see the addition of a large and liquid gold market. The introduction of the standard opens up an entire asset class to Islamic finance, potentially sparking an influx of new products, innovations and ideas.

Complex link between Islam and gold

Gold has a deep historical connection with Islamic civilisations as both a currency and artistic medium. However, the complex treatment of gold in Islamic tradition has limited its development as an investable asset class.

Gold is a 'ribawi' item: a staple, everyday commodity that necessitated stringent transaction rules to prevent inequity between transacting parties. Ribawi items must be exchanged immediately, which results in the modern requirement that gold financial products must be exchanged within the same day or trading session. The complexity of Islamic rules led to a lack of Shari'ah guidance, which hindered the development of financial products despite an underlying demand for gold. Creating harmonised and authoritative Shari'ah guidance for gold was therefore imperative to open the asset class to Islamic investors.

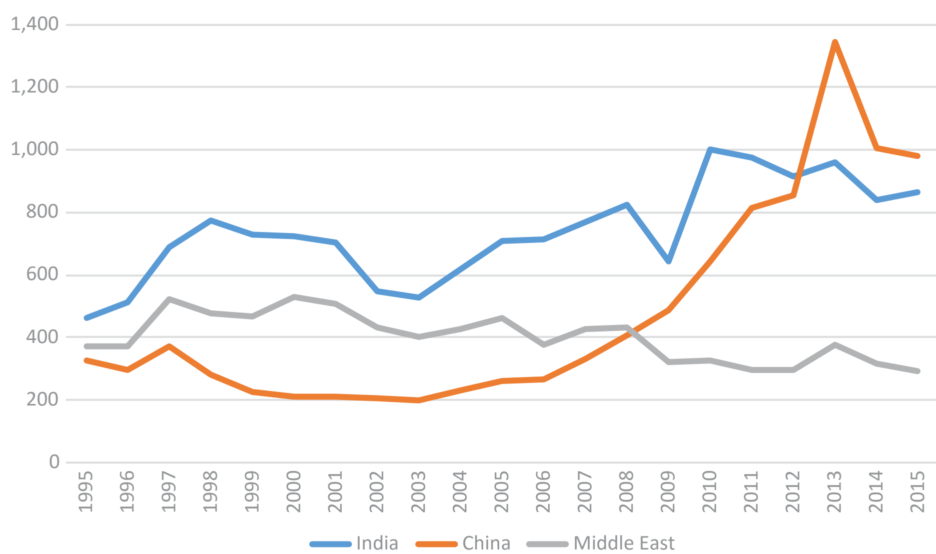
Gold's investment qualities as a diversifier, risk mitigator and long-term store of wealth resonate well with Islamic investors. Moreover, gold can fill critical gaps in the array of product offerings available in the Shari'ah-compliant market.

> ***"Creating harmonised Shari'ah guidance for gold was imperative to open the asset class to Islamic investors.***

Islamic investors cannot typically access derivatives-based risk management instruments or traditional interest-bearing safe haven assets like US government bonds. Since gold can function as a hedge against foreign exchange risk, tail risk and other market fluctuations, its inclusion as a Shari'ah-compliant asset can give Islamic investors a potent new tool.

Middle East gold demand currently below potential

Consumer demand for gold, tonnes



Source: Metals Focus; GFMS, Thomson Reuters; World Gold Council. Note: Consumer demand comprises jewellery and total bar and coin demand. Middle East comprises Saudi Arabia, United Arab Emirates, Kuwait, Egypt, Iran and other Middle East.

The gold market is 24 times larger than the volume of issued sukuk (Islamic bonds), affording multitudinous opportunities to investors. The World Gold Council is working with banks and financial services providers to help them develop their first gold products in accordance with the standard, giving easier access to Shari'ah-compliant gold for both retail and institutional investors.

Benefits for industry and policy-makers

The launch of the standard comes at a time when Islamic finance is at a crossroads. After years of rapid expansion, growth of the industry has slowed owing to weaker economic conditions, lower hydrocarbon prices and heightened geopolitical risk.

The sluggish global environment and prolonged decline in oil prices have prompted many policy-makers in Islamic countries to seek diversification, with Islamic finance championed as a driver for innovation.

Embedding gold as a Shari'ah-compliant asset class could propel Islamic finance into the next stage of development by expanding the size and depth of its investment sphere. Shari'ah-compliant institutional investors, pension funds, Hajj funds and individuals are all seeking ways to improve returns and diversification amid the current low yield environment.

Furthermore, gold can act as a primary safe haven asset for Islamic finance. Although the sukuk market has made significant strides in recent years, high credit quality sukuk remain scarce. Gold carries no credit risk and is no one's liability, and serves as a large and liquid market which is highly accessible to Islamic investors. This can reduce systemic risk in Islamic finance, making the market safer for investors.

The introduction of the standard could signal the beginning of a new relationship between financial products linked to gold and Islamic finance. Gold will now be more accessible to Islamic investors, while the industry overall will benefit from innovation sparked by the inclusion of a new asset class.

Given the long and rich history of gold in Islamic cultures, it is perhaps fitting that this most ancient of elements is now able to help power the future of Islamic finance. ■

Shaokai Fan is Director, Central Banks and Public Policy, at the World Gold Council. This article is for information only and does not constitute investment advice. The World Gold Council is not responsible for any losses.

Asia to contribute 60% of global growth

Policy loosening via weaker exchange rates

David Mann, Standard Chartered

Asia has reduced its economic exposure to the West, but financial linkages remain. The region has achieved relatively strong growth since the 2008-09 financial crisis, in contrast to persistently weak growth in the US and Europe.

Domestic demand from both consumers and investment is supporting the resilience, cushioning the region against its high exposure to external trade. All this should continue in 2017, helping Asia account for around 60% of global growth, according to Standard Chartered calculations.

Economic outlook

Markets are wary of the uncertain outlook for private sector investment and trade in the light of Donald Trump's election. Asia's economic linkages to the US are much weaker compared with a decade ago, yet remaining linkages may prevent Asian central banks from easing policy in the short term. It will be difficult to diverge from US monetary policy, especially if exchange rates remain as vulnerable as they have been since the 8 November election.

On external trade, there is room for positive surprises in Asia's 2017 export data because of base and price effects. Last year's low base should flatter year-on-year export growth in 2017. In addition, a partial recovery in export prices is likely to boost exports in nominal terms. Even with no further price rises, export values are likely to return to growth in 2017. These factors should start to materialise by the second quarter. This is also when emerging market Asian currencies are expected to be at their weakest in response to US reflation, further boosting exports.

China's growth will remain steady in the run-up to the National Party Congress in late 2017. Many longer-term challenges remain, including excess leverage, overcapacity and the demographic drag that will become more problematic in the 2020s. However, these issues are not expected to reduce growth below the current rate of above 6% ahead of such a politically important event for the Chinese Communist party. This, however, may mean more pain later.

Monetary easing has run its course

Monetary easing is over across Asia, mainly because of higher inflation and pressure to avoid divergence with the US. Standard Chartered forecasts project still-sluggish external demand in 2017, and tighter financial conditions due to upward pressure on dollar funding costs and dollar strength. While inflation is likely to rise, it is expected to remain below longer-term averages.

Exchange rates have typically been Asia's main mechanism of adjustment to higher US rates, and this is expected to be repeated in 2017. The loosening of monetary conditions may therefore happen via the exchange rate channel, rather than policy rate cuts.

India is a significant exception. The shock announcement in early November that it will eliminate 85% of currency in circulation to crack down on the informal economy is causing a cash crunch and hindering economic activity. Expectations for India's policy rate and GDP growth over the next two years have been adjusted down to reflect the consequences.

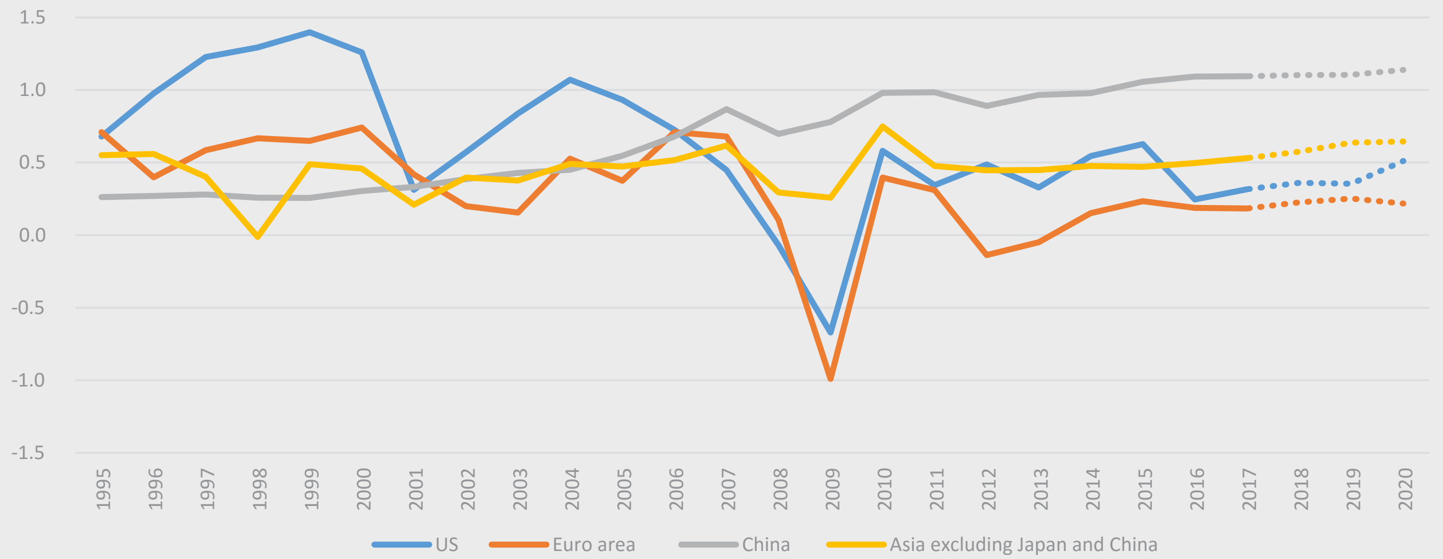
> ***"Many longer-term challenges remain, including excess leverage, overcapacity and the demographic drag that will kick in more aggressively in the 2020s.***

Assuming a large portion of the cash in the untaxed economy simply vanishes, this could be worth as much as 2-3% of GDP – a major shock to the system. In this context, the recent public sector salary rise and good monsoon rains are unlikely to be as supportive of growth as originally anticipated. Markets are on the lookout for more surprise announcements. ■

David Mann is Chief Economist for Asia at Standard Chartered.

Asia excluding Japan is likely to contribute 60% of global growth in 2017

Contributions to global growth by region, percentage points



Source: International Monetary Fund, Standard Chartered

Why Japan needs debt monetisation

Abenomics can succeed through fiscal expansion

Etsuro Honda, Japanese Ambassador to Switzerland

Shinzo Abe, the Japanese prime minister, has achieved one notable success in lowering the budget deficit. His economic policies – Abenomics – have resulted in improved tax revenues and reduced spending, and this budgetary regime change is set to be maintained.

Now, four years after Abe was elected to his second term in office in December 2012, it is time for a further change in applying Abenomics. When he took office, Abe and his officials believed that only monetary policy could effectively tackle deflation, although it was by no means a panacea. The stage is now set for developing policy further, and using fiscal means to play a significant role.

I favour continued fiscal expansion through the issuance of new Japanese government bonds worth ¥35tn-¥40tn, which will be purchased by the Bank of Japan.

This process of debt monetisation could prove to be the most effective means of overcoming the deflation trap which has beset Japan for the past 20 years.

Monetary easing is already in place and the BoJ has achieved strong results in many fields. The transmission of monetary policy has been particularly successful, and banks are adopting increasingly accommodative lending policies for both large and small enterprises. Unlike in other large economies, there has been no 'credit crunch' in Japan.

There is a consensus among government officials and monetary policy-makers that Japan requires further bold measures to escape its deflation trap. The priority must be improving macroeconomic strength. This feeds through to increased tax revenue, which is preferable to raising domestic tax rates.

Abenomics has set the economy on course for steady recovery. For the company sector, this recovery has already been demonstrated through increased profitability, in part because of a depreciating yen which is boosting exports. Corporate strength is improving employment conditions. Unemployment has fallen substantially. The output gap has narrowed and is close to zero, according to BoJ estimates.

> *When he took office, Abe believed that only monetary policy could effectively tackle deflation. The stage is now set for developing policy further, and using fiscal means to play a significant role.*

Shinzo Abe, Prime Minister, Japan

More robust fiscal stance

In line with the 2% inflation target, and with the shift to tightening in the US, a more robust fiscal stance through monetary financing would allow the BoJ to redraw monetary policy, especially in adjusting monthly government bond purchases.

However, the BoJ should start tapering only once the inflation rate looks likely to stabilise above 2%. It is important to show investors that the rate will be maintained and sustained in the long term. When tapering occurs it will, by necessity, be a very careful process.

Redistribution policies

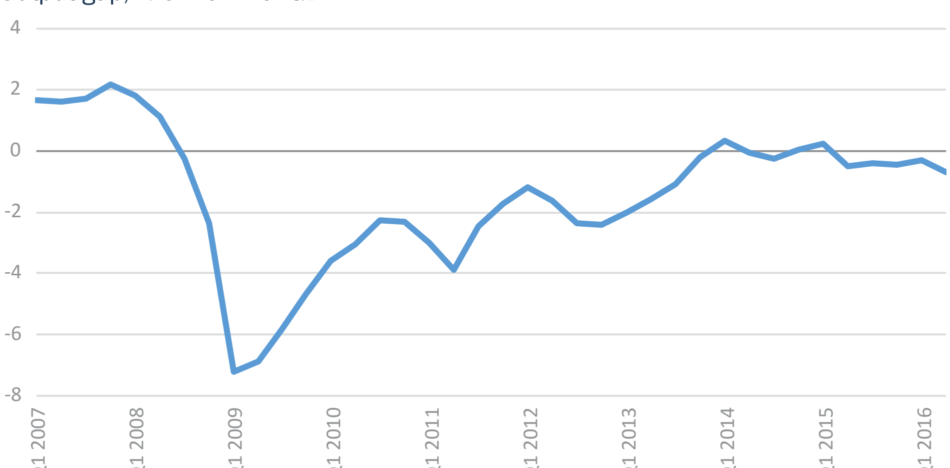
Sustainability of growth remains the most important factor for Japan, and a new operational framework will provide room for fine-tuning. To achieve sustainability, however, the real issue is how to change the mindset of corporate investors and managers.

Better coordination is needed between the government and the BoJ in terms of Japan's balance sheet. This arrangement has been far from perfect so far, taking as one example the increase in Japan's consumption tax in April 2014. The adoption of this measure was premature, and at the time worked against monetary easing.

Eventually the consumption tax will need to be raised to bring Japan in line with other advanced economies, particularly as it becomes an increasingly cashless society. Overall, however, a real estate or inheritance tax might prove more beneficial than a consumption tax. This is especially true given the backdrop of rising economic inequality, as real estate and inheritance taxes can act as a means of redistributing wealth among elderly people and help support middle-income household growth. ■

Japan's output gap has narrowed since 2009 trough

Output gap, % of nominal GDP



Source: Bank of Japan

Etsuro Honda is Japanese Ambassador to Switzerland, Ambassador for Economic and Financial Affairs in Europe, and a former economic adviser to Prime Minister Shinzo Abe.

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Blueprint for a timely idea

The economic and social benefits of less cash

Danae Kyriakopoulou

Indian Prime Minister Narendra Modi and Venezuelan President Nicolás Maduro would have benefited from reading Kenneth Rogoff's book *The Curse of Cash* before embarking on their demonetisation efforts at the end of 2016.

Their ill-planned actions have caused chaos, ranging from queues at ATMs and protests, to deaths from heart attacks and suicides. Worryingly for economists, they also risk putting a black mark against an idea which is fundamentally good and – as Rogoff convincingly argues – whose time has come.

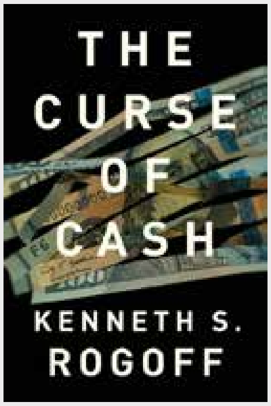
The dark side of cash

Rogoff, Harvard's pre-eminent monetary economist and former chief economist of the International Monetary Fund, devotes a large part of his book to introducing readers to 'the dark side of paper currency'. The examples he analyses range from the obvious, like its use in the black economy and facilitation of illegal activities, to the more sophisticated, such as monetary policy effectiveness at the zero lower bound, to the more obscure such as the public health risk of bacteria living on banknotes.

The statistics are impressive. Surveys reveal individuals in the US carry around $46 of cash on their person and just over $200 at home, yet an average of $4,200 per capita circulates in the economy. Of the $1.3tn floating outside banks, 80% is in $100 bills, yet the fraction of consumers who report having a $100 bill in their possession is close to zero. This hints at the huge role of the underground economy.

It would be easy to get carried away by these statistics. Commendably, Rogoff's response is measured, and his policy recommendations are soundly based on the empirical evidence he uncovers. Though the title might suggest otherwise, he is not inciting a witch-hunt against cash. As he makes clear from the introduction, he advocates a 'less cash' society, not a 'cashless' one.

He recognises that cash is a necessary medium of exchange for the unbanked population, a sizeable demographic factor in developing economies. His proposal for phasing out cash includes a clause on financial inclusion: governments should provide free debit or smartphone-linked accounts. Timing is important, and implementing one without the other could damage the economy in the short run, as the experience of India will probably show. Another key benefit is privacy. Fyodor Dostoyevsky called money 'coined liberty', nodding to the freedom, security, and simplicity it offers. But while it is not cash itself that is cursed, some of its users are. Thankfully, data reveal which sorts of cash are cursed.



> ***"While it is not cash itself that is cursed, some of its users are.***

Large-denomination bills dominate cash, but hardly feature in the average person's wallet. Based on this diagnosis, Rogoff's proposed treatment is to start with these, allowing access to lower-denominations and to limited private accounts indefinitely.

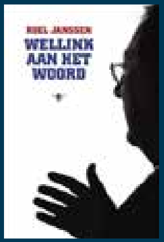
Cash and the zero bound

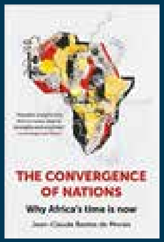
It is not just individuals who benefit from cash. Governments also gain from paper currency, or, more precisely, from their monopoly over its issuance. Seigniorage revenue, linked to governments' ability to monetise debts, is constrained in economies with independent central banks and is less relevant in a low-rate environment. But it is not trivial, generally ranging between 0 and 1% of GDP. This would be given up along with paper currency, but higher tax revenues raised through increased compliance and a weakened underground economy would more than make up for this foregone benefit. Central banks would also benefit from escaping the zero bound constraint on interest rates, given that cash allows individuals to escape negative rates by storing savings in cash.

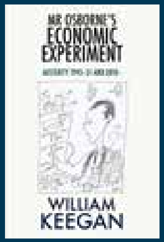
The key question is where to draw the line. Rogoff's proposal to allow only small bills and surrender more privacy to the government will make some readers uncomfortable. And phasing out cash is not the only alternative. One example is lottery prizes for consumers who send in sales tax receipts, an idea introduced in Greece and later practised in Portugal and Slovakia, resulting in increased tax compliance. Legalising some drugs would constrain the underground economy and increase the government's tax coffers, but these measures would only go a small way. Legalisation may work with marijuana, but it is unlikely to be extended to hard drugs or other illicit activities such as human trafficking. The beauty of Rogoff's proposal is that it can achieve multiple goals with a single action.

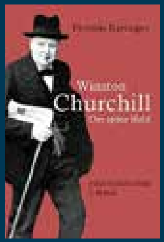
The book ends with a postscript: as it went to press, the European Central Bank announced its decision to phase out the €500 note. An analysis of Google trends suggests that this measure attracted far less attention than India and Venezuela's demonetisations. But it is probably the most relevant and tangible test of ideas explored in *The Curse of Cash*. The implementation and subsequent medium-term impact on corruption, crime and tax evasion may demonstrate the merits of Rogoff's policy proposals. ■

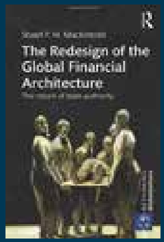
Danae Kyriakopoulou is Head of Research at OMFIF.

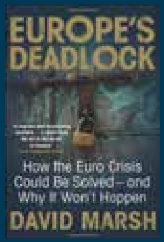












Trump's policies not as radical as voters hoped

Advisory Board expects greatest discrepancy with Fed, immigration

This month's advisory board poll focused on Donald Trump's imminent move to the White House, exploring his ability and willingness to fulfil his campaign pledges once inaugurated on 20 January. Members of the advisory board were asked, 'How far will Trump's policies veer away from his election promises on key issues?' These included trade, infrastructure investment, immigration, central bank independence, the environment, taxation, social policy and healthcare. Respondents rated each policy area on a scale from one to five, where one represented no discrepancy between Trump's campaign pledges and the post-inauguration reality, and five the greatest discrepancy. Responses were averaged to evaluate the overall stance of advisory board members.

Taxation, social policy and the environment are the areas where Trump is expected to stay closest to his election promises, with a discrepancy rate of 2.2 and 2.4 respectively out of 5. This effectively translates to a commitment to lower taxes and a sceptical attitude towards climate change. Conversely, Trump's rhetoric against the Federal Reserve's independence is not expected to translate into action, with the highest discrepancy rate of 3.1 out of 5. Immigration came a close second with 3.0 out of 5: Trump may not quite build the wall, but other forms of checks and visa restrictions could be delivered.

'I fear that history does not portend well for businessmen or CEO-style leaders in politics. The great risk lies in Trump's temperament and decision-making style: rash, self-interested, and lacking a willingness to listen and learn. Note that he has not received any briefings on international policy or security to date, even when offered. Let us hope he does not need to take any Cuban missile crisis-esque decisions during his term.'
Consuelo Brooke, C. Brooke Investment Partners

'Donald Trump seems to be going ahead with his policies, just like he announced in his campaign. There may be some discrepancies, but very few. Keep your fingers crossed that this will not end in the abyss.'
Roel Janssen, financial journalist

'Plenty of reality checks will be necessary to avoid the worst excesses of Donald Trump's campaign promises, but there will nevertheless be some severe shocks. Although Trump means what he says about the Trans-Pacific Partnership, it could take years to put new bilateral deals in place. Infrastructure investment will be the easiest way for him to create jobs. We've already seen some rowing back on healthcare following Trump's meeting with the sitting president. There could be significant trimming of his promises.'
Boyd McCleary, 39 Essex Chambers

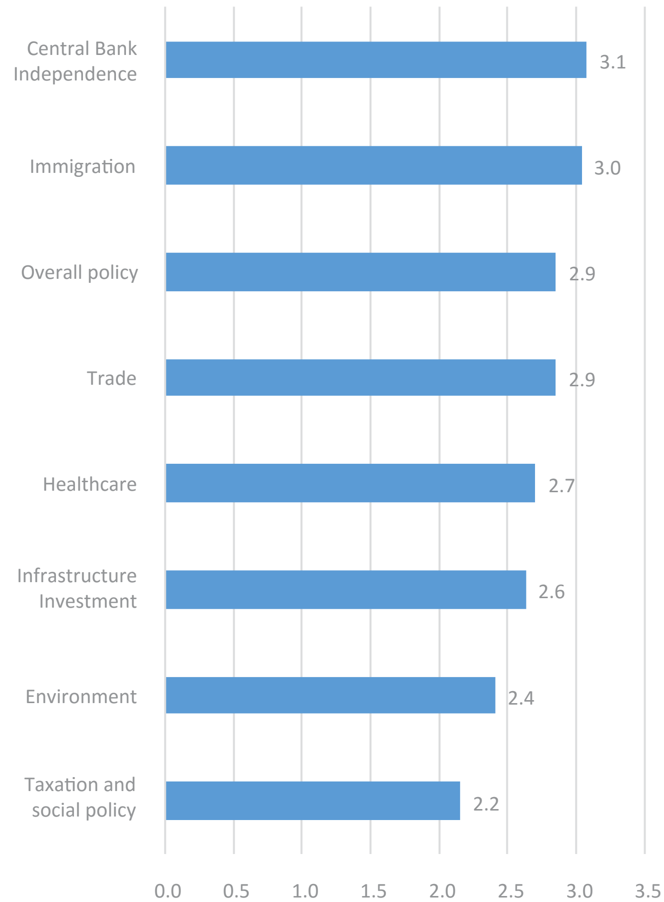
'I believe the president-elect means change and will deliver it. He may be less radical than most of his voters hoped, but change will be quite visible.'
Miroslav Singer, former Governor, Czech National Bank

'Trump's most dramatic impact will be the adjustment of climate and energy policy, as well as changes in foreign policy, including relations with China, Russia and the Islamic world. He won't accept the relentless rise of China's military in the Pacific, and will form temporary alliances based on the principle 'the enemy of my enemy is my friend'. Common interests with Russia should help to shape a relatively good, if wary, relationship in the short term.'
Jürgen Krönig, Die Zeit

These additional statements were received as part of the December poll, conducted between 7 and 20 December. The results were calculated as an average of total responses from 26 advisory board members.

Trump to break immigration policy promise

Average of responses to the question: as Donald Trump enters office, how far will his policies veer away from his election promises on the following issues? Please rate from 1 to 5 for each area, where 1 means no discrepancy and 5 means great discrepancy.



February's question

As a Chinese president heads to Davos for the first time ever, will 2017 be the year when America retreats from the international stage and China takes over as de facto world leader?

- **Yes**
- **No**