February 2014
Vol. 5 Ed. 2

Bulletin

Global insight on official monetary and financial institutions

Sunnier times

Hope in southern Europe

Investing in West Africa
Growth glimmers in Greece
Portugal's road to recovery
Risk capital in Europe
Need for reform in Russia

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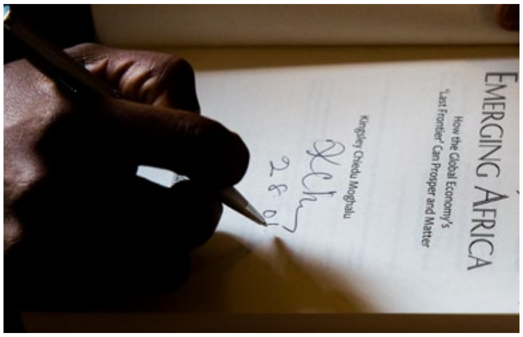
Cover story

After a wrenching five-year recession, Greece appears finally to be turning the corner with a modest growth revival this year – but at enormous social and political cost that could still upset Europe's most high-profile debtor and weaken further the cohesion of economic and monetary union (EMU). We look at the remaning points of fragility in southern Europe and assess hopes that, despite continuing uncertainty in the world economy, the malaise in the Old Continent could give way to steadier financial and business prospects in coming years. See p.16-19.

International monetary policy

Europe & the euro

Emerging markets



Nigerian deputy governor affirms 'African capitalism'

Speaking at the launch of his new book, *Emerging Africa*, Kingsley Chiedu Moghalu, deputy governor of Central Bank of Nigeria, said Africa must emulate the strategic thinking of the likes of China, Dubai and Singapore and develop its own distinctive form of 'African capitalism' if it wants finally to fulfil its potential. 'There is a big difference between growth and prosperity. There is a big difference between growth and economic transformation,' he said. Moghalu's grandiose vision would smack of hubris if he himself were not so forthright about the troubles of a continent that is held back by corruption, rickety infrastructure and poor governance. See p. 28-29.

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(See p.20-21 for full details)

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OMFIF

Promoting dialogue for world finance

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

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

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

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

Advisory Board

OMFIF's 150-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars and other OMFIF activities. See p.20-21.

Bulletin

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

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Diary dates – past and forthcoming

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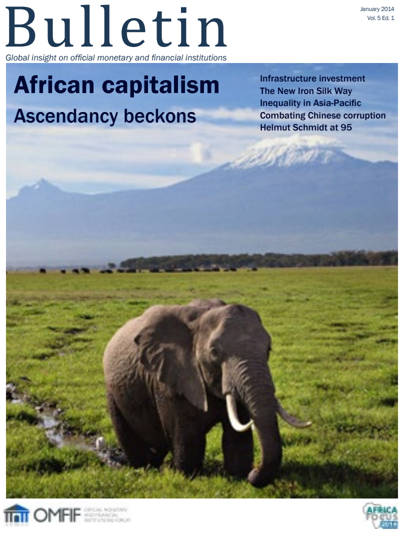


OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Southern adjustment

Pain and optimism side by side

David Marsh, Chairman

The need for adjustment in the southern periphery of Europe has occupied politicians and financial markets for five years and led to severe hardship through very large falls in output and high unemployment. The pain of the correction has not been alleviated by its unexpected nature.

When and before the euro was launched in 1999, many experts (including from the German Bundesbank) warned against the notion that countries in a monetary union with Germany that could no longer adjust their economies through exchange rate changes were entering the gates of paradise. They would either have to get their costs and productivity in line with those in countries with sounder economic structures – or see these changes thrust upon them by the brute force of low economic activity and lost jobs. This is exactly what has happened.

However, there are some bright spots. We record how economic reforms have spread into the south, with some reasons for optimism in Greece, Portugal, Spain and (even) Italy, where a new government under Matteo Renzi, the mayor of Florence, is preparing to take office and push forward the reforms that Italy knows it needs but has not so far achieved.

George A. Provopoulos, Governor of the Bank of Greece, and Carlos Moedas, Secretary of State to the Portuguese prime minister, both deliver upbeat messages on the state of their respective economies – although the view from Athens remains tinged with worries that politics could throw the improvements off track.

Lorenzo Codogno spells out the need for Europe to embrace risk capital to support the move out of crisis. Bob Bischof tells Britain to concentrate on emulating Germany, not overtaking it, and Holger Schmieding pours scorn on the apostles of euro gloom. Vicky Pryce gives a less optimistic assessment of Greece, while Kenneth Dyson outlines challenges facing Germany over European institutional reform. We illustrate, too, how at a time when Chancellor Angela Merkel's authority is coming under threat, her predecessor Gerhard Schröder – a former sceptic on the euro now turned supporter – is taking on a statesmanlike allure.

Gabriel Stein surveys the difficulties of interpreting data from the International Monetary Fund on reserve currency diversification. Darrell Delamaide analyses the outbreak of consensus on the Federal Open Market Committee over tapering the Fed's monthly asset purchases under new chairman Janet Yellen. Steve Hanke takes issue with prevailingly positive comments over the legacy of her predecessor Ben Bernanke. William Keegan expresses his worry about the rise of 'the politics of envy'.

In our emerging markets section, we provide coverage of the OMFIF launch of Kingsley Chiedu Moghalu's new book on the African economy. Angus Downie writes on risks in Middle Africa. Iikka Korhonen of the Bank of Finland recommends Russia should shift to pro-growth reforms. Pierre Van Hoeylandt says long-term thinking is needed for African investment.

In our reviews, we give space to an exemplary crop of books: by Roel Janssen, on looted Dutch war gold; by our new editor Alan Wheatley on reserve currencies; by François Heisbourg in a solution to the euro's travails; and (just for something different) Meghnad Desai on the origins of Hindu scripture. So this month's edition has something for everyone.▪

David Marsh

Coming to terms with low-yield environment

Reserve managers in both developed and emerging market economies face a proliferation of tasks and challenges as a result of a sizeable increase in official reserves of gold and foreign exchange and the enlarged complexity and interdependence of the markets in which they invest.

Reflecting these trends, central banks are in the vanguard of the gradual evolution of a multiple reserve currency system, as the world slowly moves away from excessive reliance on the dollar.

An OMFIF reserve management seminar, 'Foreign exchange and gold reserve asset management: Trends and best practice,' gathered a limited number of central bank and other sovereign reserve managers, sovereign issuers and experts in Hong Kong on 10 February.

Participants discussed implications of a low-yield environment and how to achieve secure returns. Other topics included Asian currency internationalisation, gold as a reserve asset, strategies for asset allocation, exiting unconventional monetary policy and effects on reserve management.



Seminar participants, pictured left to right: Francis Chu, Executive Director, Reserve Management, Hong Kong Monetary Authority; Julia Leung, former Under Secretary for Financial Services and the Treasury, Hong Kong; and Eli Remolona, Chief Representative, Asia, Bank for International Settlements.

ADVISORY BOARD

OMFIF welcomes three new members, François Heisbourg, Ludger Kühnhardt and Obindah Gershon nee Wagbara. Their appointments take the number of Advisory Board members to 150. For full list of members see p.20-21.

François Heisbourg is Chairman of the council of the Geneva Centre for Security Policy and the London-based International Institute for Strategic Studies. Heisbourg is Special Adviser of the Paris-based Fondation pour la Recherche Stratégique. He has held positions in government as member of the French mission to the UN and International Security Adviser to the Minister of Defence. He also served as Vice-President of Thomson-CSF, Senior Vice-President of Strategy at Matra Défense Espace, Professor at Sciences-Po Paris, and Director of the International Institute for Strategic Studies.

Ludger Kühnhardt is Director at the Center for European Integration Studies (ZEI) and Professor of Political Science at Bonn University. He has served as Professor of Political Science at Freiburg University, where he also served as Dean of his Faculty. Kühnhardt's political and academic consulting experience includes assignments for the Secretary General of the Council of Europe, the President of the European Parliament and the parliament of the Economic Community of West African States (ECOWAS).

Obindah Gershon nee Wagbara is Professor of energy and natural resource economics at Georgetown University, School of Foreign Service in Qatar. He previously worked in the United Kingdom at University of Dundee, and at the Gas Exporting Countries Forum (GECF). Gershon nee Wagbara is experienced in crude oil and natural gas trade, natural resource management, energy policy and markets.

EXPERT SEMINAR

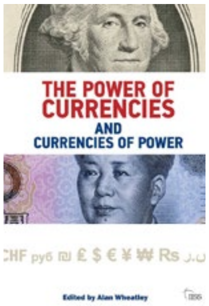
Challenges for reserve asset management in Africa

Lamido Yuguda, Head of Reserve Management at the Central Bank of Nigeria, spelled out challenges for reserve asset management in Nigeria, including the relatively new field of action of the Nigerian Sovereign Investment Authority. Nigeria, the biggest reserve holder in Africa, has been publicly backing the reserve asset use of the renminbi, for a mixture of economic and strategic reasons. He was speaking at a Policy Group meeting on 28 January, following the book launch of Kingsley Chiedu Moghalu earlier in the day (see below).

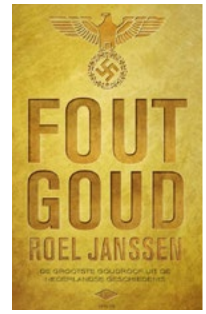
Pictured left to right, David Marsh, OMFIF; Edward Longhurst-Pierce, OMFIF; Razia Khan, Standard Chartered Bank; Kingsley Moghalu, Central Bank of Nigeria; Dina Patel, OMFIF; Pierre Van Hoeylandt, CDC; and Meghnad Desai, OMFIF.

BOOKS & THE ADVISORY BOARD

The power of currencies, the European dream and lost Nazi gold



This month's feature covers four publications. *The Power of Currencies and Currencies of Power* by Alan Wheatley provides a comprehensive analysis of the role and function of a reserve currency; the post-1945 rise of the dollar; the outlook for the system of reserve currencies and the move to a multi-currency world; and prospects for the renminbi. In his latest publication, *'Who wrote the Bahagavadgita'*, Meghand Desai embarks on a 'secular enquiry into a sacred text'. François Heisbourg's 'reflective politico-intellectual' book, *La fin du rêve européen (The end of the European Dream)*, concludes that the euro must be dismantled to save the European Union. In *Fout Goud (Guilty Gold)*, Roel Janssen uncovers the looting of Dutch war gold in a documentary thriller that incorporates the history of lost Nazi gold. See p.34-37.



ECONOMISTS MEETING

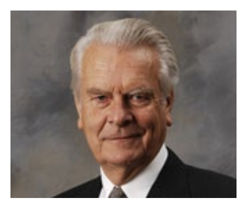
Economic outlook and banking union discussed at Bundesbank

Joachim Nagel, Member of the Executive Board, Deutsche Bundesbank, chaired the fourth Bundesbank-OMFIF Economist Group Meeting in Frankfurt on 15 January. The group of economists, fund managers and central banking officials from Europe and Asia, pictured right, discussed the 2014 economic outlook in the light of measures to stabilise the euro bloc, seen in the correction of current account and budgetary deficits in the crisis-hit countries. The group assessed progress in working towards banking union in Europe and risks that official balance sheet assessments could damp bank lending.

EXPERT SEMINARS

Taking stock of financial trends

Lord (David) Owen, former UK Foreign Secretary and a member of the OMFIF Advisory Board (pictured right), spelled out his perspectives for European developments in a wide-ranging speech at Commerzbank House in Berlin on 23 January. Held in association with the British Chamber of Commerce in Germany, the seminar included a panel with Jim O'Neill, former Chairman of Goldman Sachs Asset Management, among others, on developments and trends in financial markets in the UK and the EU.



UK, Portugal pledge on Lusophone Africa

The UK and Portugal have pledged to work together to forge new growth markets in the twin southern African Lusophone economies of Angola and Mozambique, dual gateways to a new era of sustainable African growth and development. The promise of joint action, especially in energy, infrastructure, transport and logistics, was made at an OMFIF seminar on trade and investment in Lusophone (Portuguese-speaking) Africa at the Armourer's Hall in London on 4 February. See p.19.

AFRICA FOCUS 2014

2013 YEAR OF THE LUSO-ECONOMY OMFIF

BRIEFING

The Spanish reform agenda

Jaime García-Legaz, Spanish Trade Secretary, (pictured right) discussed progress achieved by Spain under its reform and restructuring programme geared to overcoming the economic imbalances of the early years in economic and monetary union (EMU). At the briefing on 'Outlook for the Spanish economy and reform agenda 2014', held at the Reform Club in London on 31 January, García-Legaz extolled Spain's export performance as a force for stability.

Fed board in consensus to continue tapering

Rare absence of dissent as Bernanke ends tenure

Darrell Delamaide, US Editor

For the first time in more than two years, all the voting members of the Federal Open Market Committee showed consensus, hawks and doves alike, now that they have decided to start tapering the Fed's monthly asset purchases.

At the January meeting of the FOMC – the last for departing Federal Reserve Chairman Ben Bernanke – there were no dissents as the panel voted to trim another $10bn off the Fed's monthly bond purchases, bringing the sum down to $65bn from the original $85bn after a similar cut in December.

Nor does there seem to be much disagreement about continuing more or less at that pace as economic data continue to reassure policy-makers. The standardised statement issued after the meeting indicated that the signs of growth and improvement in the labour market that prompted the FOMC to act in December remain on track.

In her inaugural testimony to Congress as chairman, Janet Yellen promised continuity in monetary policy and said the Fed would not be blown off its tapering course by turmoil in emerging market economies (see below).

Richmond Fed chief **Jeffrey Lacker** dissented at every meeting in 2012 when he was a voting member, and the Kansas City Fed leaders – first Thomas Hoenig, then **Esther George** – objected at every meeting in 2013 until the last one with the decision to start tapering. Boston Fed chief **Eric Rosengren** lodged a dissent at that meeting, however, because he thought it was premature to withdraw monetary stimulus.

Rosengren has rotated out of a voting position and has not commented on the January decision. Lacker and George are not voting members this year but both expressed support for continuing the reduction in bond purchases.

Referring to the cuts in both December and January, Lacker told a Shenandoah University audience in Winchester, Virginia, 'I supported both decisions because they are consistent with the linkage the committee established between the asset purchase programme and the outlook for labour market conditions.'

The unemployment rate fell to 6.7% in December and to 6.6% in January. While Lacker expects tapering to continue through 2014, he is less bullish on growth than many of his colleagues, seeing GDP growth closer to 2% for the year instead of more optimistic forecasts of nearly 3%.

In a speech in Cape Town just after the FOMC meeting, George called the successive reductions in asset purchases 'a modest but positive step'.

Long-term costs

However, she continues to be concerned about potential long-term costs of the Fed's unconventional monetary policies, including the zero-bound interest rate and quantitative easing. 'The costs of accommodative policies, moreover, may not be confined to just the countries with expansive policies,' she said. 'Such policies can influence other countries by distorting their exchange rates and balance of payment positions, capital flows and rates of credit expansion.'

She also said at the meeting, which was focused on financial supervision, that these policies could have an impact on financial stability as banks faced compressed profit margins on traditional banking business and might be tempted to pursue higher-yielding and riskier activities.

Dallas Fed chief **Richard Fisher**, a longtime opponent of the bond purchases who is a voting member of the FOMC this year, expressed satisfaction with the rate of tapering.

'I'm happy with the pace that we're on and developments in the economy,' he told a community forum at Texas Christian University in Fort Worth. He said he'd like to see the asset purchases scaled back to zero 'as soon as practicable', which might be by year-end if the economy stays on track.

Fisher also drew attention to the unanimity of the voters at the January FOMC meeting. 'I don't feel lonely any more,' Fisher told the local paper in Forth Worth.

Philadelphia Fed chief **Charles Plosser (voter)**, another long-standing opponent of the central bank's bond-buying programme, said he wants it to be phased out at a faster pace. He is worried that the unemployment rate will hit the 6.5% mark the Fed has set for considering a rise in interest rates while it is still reducing asset purchases.

Highlights of Janet Yellen's first congressional testimony

Fed policy: 'I expect a great deal of continuity in the FOMC's approach to monetary policy. I served on the Committee as we formulated our current policy strategy and I strongly support that strategy.'

Job market: 'If incoming information broadly supports the Committee's expectation of ongoing improvement in labour market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings.'

Employment: 'The recovery in the labour market is far from complete. The unemployment rate is still well above levels that FOMC participants estimate is consistent with maximum sustainable employment.'

Economic outlook: 'We have been watching closely the recent volatility in global financial markets. Our sense is that at this stage these developments do not pose a substantial risk to the US economic outlook.'

Inflation: 'I am committed to achieving both parts of our dual mandate: helping the economy return to full employment and returning inflation to 2% while ensuring that it does not run persistently above or below that level.'▪

'Although the FOMC has indicated that it doesn't anticipate raising rates when the economy crosses that threshold, I do believe that we will have complicated our communications if we are still purchasing assets at that point,' Plosser said at an economic seminar in Rochester, New York.

'I would like to see purchases concluded before the unemployment rate reaches the threshold, which is likely during the first half of the year.'

Dennis Lockhart (non-voter), head of the Atlanta Fed, is more cautious regarding any eventual increase in interest rates.

'Notwithstanding the decision to taper asset purchases, the stance of policy remains very accommodative,' he told a business group in Birmingham, Alabama. 'Translation: short-term interest rates are quite low – and in my own outlook, they will remain low for quite some time. I expect the Fed's policy rate to stay put until well into 2015.'

Chicago Fed chief **Charles Evans (non-voter)** echoed this prognosis in a speech in Detroit. 'I currently expect that low inflation and still-high unemployment will mean that the short-term policy rate will remain near zero well into 2015,' he said.

Boston's Rosengren emphasised that the unemployment rate by itself does not give a full picture of the job market.

'While the traditional unemployment rate is an important measure, its decline does not capture the wider difficulties in the labour market that are being felt by so many Americans,' he told an audience in Sarasota, Florida, in early February. 'My sense is that evaluation of the labour market situation requires much more attention to these broader measures.'

He reminded his audience that the FOMC last month affirmed that interest rates are likely to remain unchanged well after the 6.5% unemployment threshold has been breached.

Rosengren urges patience

The statement was in fact quite explicit: 'The committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the committee's 2% longer-run goal.'

In view of the underutilisation of labour, Rosengren concluded, 'I firmly believe that monetary policy-makers should remain quite patient in removing accommodation.'

Janet Yellen was sworn in as the new chairman of the Fed at the beginning of this month in a quiet ceremony unattended by any prominent officials and not even captured by television cameras.

Daniel Tarullo, a 2009 appointment, performed the swearing in as the senior member of the Board of Governors, now shrunk essentially to four with Bernanke's departure and Susan Bloom Raskin not participating with her nomination to be deputy Treasury secretary pending.▪

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

Bernanke 'has been graded too generously' over role in financial crisis

Ben Bernanke has been graded too generously for his 12 years running the Federal Reserve, *writes Steve Hanke in Baltimore.* I would put him down as a fail. In the run-up to the bankruptcy of Lehman Brothers in September 2008, the Fed pumped up aggregate demand and spawned bubbles in housing, equities and commodities that burst so spectacularly during the panic of 2008-09.

The bubbles were inflated by Fed liquidity injections to fend off a false deflation scare in late 2002. That's when Bernanke, a mere Fed governor at the time, sounded the deflation alarm in a speech before the National Economists Club. Bernanke convinced his Fed colleagues that the danger of deflation was lurking.

As then-chairman Alan Greenspan put it, 'We face new challenges in maintaining price stability, specifically to prevent inflation from falling too low.'

By July 2003, the US central bank had cut the Fed funds rate to a then-record low of 1%, where it stayed for a year. This artificially low interest rate – the neutral rate at the time was 3-4% – set off a wild hunt for yield and what I call leveraging lunacy. Hot money poured into developing countries, causing more asset bubbles.

US housing prices, measured by the Case-Shiller index, surged by 45% between the first quarter of 2003 and their peak three years later. Share prices jumped 66% from the first quarter of 2003 until they peaked in the last quarter of 2007. The Commodity Research Bureau's spot index leapt 92% between the first quarter of 2003 and a peak in the second quarter of 2008.

Artificial credit-created investment booms sow the seeds of their own destruction. As night follows day, a bust was just around the corner.

Operating under a regime of inflation targeting and a floating exchange rate, Bernanke saw fit to ignore fluctuations in the dollar. Nobel laureate Robert Mundell has convincingly argued that exchange rate changes transmit inflation or deflation through the economy, and they can do so rapidly. This was the case during the financial crisis. But by ignoring currency signals, Bernanke was flying blind.

As a consequence, the Fed failed to stabilise the dollar/euro exchange rate, which gyrated dramatically after Lehman Brothers failed. This in turn created wild swings in the prices of gold and oil.

In addition, annual consumer price inflation plunged from 5.6% in July 2008 to -2.1% a year later. With the demand for dollars and safe-haven US Treasuries soaring, Fed policy was far too tight and Bernanke did not even know it.

Central bankers like to blame others for the world's economic and financial troubles. The Fed has pointed the finger at commercial banks for being too risky because they are under-capitalised and under-regulated. In response it has backed more stringent capital requirements and a forest of new regulations. This regulatory zeal has created a credit crunch in the middle of a sub-par recovery.

But how could this be? After all, central banks around the world have turned on the money taps. Indeed, in the US, high-powered base money created by central banks has more than quadrupled since August 2008. Keynes called this 'state money'. The problem is that 'bank money' – generated by commercial bank deposits – has shrunk by 12.1%. The result is an anaemic increase of only 4.5% in the total money supply (M4).

The public is right to be confused. The Fed has embraced contradictory monetary policies. The central bank has been ultra-loose with state money but tight with bank money, the largest component of the money supply.

Bernanke's days at the Fed have been marked by monetary misjudgements and malfeasance. Since the proof of the pudding should be in the eating, this chef deserves zero stars.▪

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

Recoveries still vulnerable to bubbles

Politics of envy returns as growth worries linger

William Keegan, Chairman, Editorial & Commentary Panel

Much has been made of the centenary of the outbreak of the first world war in 1914, and rightly so. Japanese Prime Minister Shinzo Abe has gone so far as to liken current tensions between China and Japan to those in Europe in the run-up to the outbreak of the Great War.

Writing in the Guardian, Frank-Walter Steinmeier, Germany's foreign minister, emphasised how the European Union had brought us peace and 'the prospect of war breaking out in the heart of Europe has become unimaginable'.

Nevertheless , in common with many other European politicians, Steinmeier is worried about the danger of outbreaks of nationalism associated with high unemployment and the lack of prospects for so many young Europeans.

I continue to believe that the main problem with the 'European Project' was, and is, that the formation of the euro was a step too far. Facing the worst financial crisis in living memory was bad enough; on top of this came having to cope with the strictures of a structurally faulty single currency.

Although financial market sentiment towards the euro improved after Mario Draghi's famous promise to do 'whatever it takes' in July 2012, such rescue action could be undertaken only within very restrictive rules.

This year has begun with better macroeconomic news in the US and UK but renewed concern about the euro and widespread consensus that the modern capitalist, or market, economy is by no means out of the woods.

There is a fear, expressed by such distinguished figures as Prof. Lawrence Summers in the US and Adair Turner, former head of the UK Financial Services Authority, that recoveries are too dependent on the creation of bubbles. And there is a general recognition that the banking system is far from repaired.

Indeed, the bankers, like the Bourbon kings, appear to have learned nothing and forgotten nothing. The bonus culture made a significant contribution to the way the banks got out of control. I personally find it laughable, but also outrageous, that these institutions that depend on being bailed out by the taxpayer should be paying bonuses at all.

It seems extraordinary that Bank of England Governor Mark Carney (pictured above) should profess to have no problem with the level of bonuses (remember his background is Goldman Sachs).

With real wages depressed in most advanced economies, it should not be surprising that we are experiencing a return to what the right wing calls 'the politics of envy' and the left merely an attempt to redress what is regarded as gross, indeed obscene, inequality.

Now, in addition to the anniversary of 1914, I have been thinking of another date. We are already thirty years beyond the year 1984. That date mesmerised members of my generation. Orwell's prophetic work was published in 1949, when my contemporaries and I were 11. We thought 1984 was so far in the distance that it would be remarkable if it were ever reached.

Now, here we are, 30 years beyond the unreachable year, and hardly a day goes by without reference to the way that, via all the surveillance revealed by Edward Snowden, Big Brother has emerged not from a Communist regime but from the governments of the world's leading democracies.

However, with regard to 'equality' and ' the politics of envy' it is not 1984 that rings a bell, but Orwell's other great work, *Animal Farm*, and that famous line : 'All animals are equal, but some animals are more equal than others.'

Left-wing and social democratic political parties have been struggling to come to terms with the implications of this throughout my career. They know that they can never achieve equality; the best they can hope for is to try to humanise the capitalist system and eliminate grosser inequality.

It is a thankless task. The British Labour Party lost the 1992 general election, at least in part, by promising higher taxes for the better off. More recently the SPD failed to win the German election at least in part for similar reasons.

But the SPD will probably have another go within the Coalition, and the Labour Party has recently caused a stir by promising to raise the top rate of tax from 45% to 50%.

At a time when so many people are so badly off, and British Chancellor of the Exchequer George Osborne is almost sadistically promising yet another attack on the 'welfare' budget, I do not find it at all unreasonable that Labour should want the better off to 'share the burden' of austerity.

Also 50% does not look nearly so unwise tactically as Francois Hollande's 75% top rate. However, I am reminded of the remark of an earlier British Labour chancellor, the late Roy Jenkins.

He agreed that 50% for high earners would not be unreasonable. But for presentational reasons he thought 48% would be less controversial.▪

William Keegan is Senior Economics Commentator at the Observer.

‘Germany’s dominant’, says former leader

Schröder displays wolfish charm on the euro and Tony Blair

David Marsh, Chairman

Former German chancellor Gerhard Schröder has broken with six decades of political correctness by declaring that Germany’s ‘dominance’ in the European Union is exactly the opposite of what was planned 15 years ago by the architects of economic and monetary union (EMU) – especially the French government.

In a new book *Klare Worte (Plain Speaking)* – bristling with swashbuckling self-confidence – Schröder, who celebrates his 70th birthday in April, explains how he has revised his formerly sceptical attitude on the European single currency on the grounds that Europe has moved towards better-coordinated financial and economic policy.

In fact, his much-proclaimed (and, in the light of subsequent events, completely correct) caution over the single currency during his Opposition years before end-1998 was always tactical rather than strategic.

Schröder was habitually cynical about unduly-engineered economic planning. Still more importantly, Schröder believed that he had automatically to contradict anything that Chancellor Helmut Kohl backed.

Beyond his undoubted entertainment value, Schröder possesses a cold, hard, relentless logic; an ability intelligently to change his mind (and to explain beguilingly why he does so); and a technique of delivering penetrating one-liners on other statesmen’s qualities.

Tony Blair, the former British prime minister, irritated him because of his ‘priestly’ demeanour – and because of his insistence on bringing his personal coach with him when they played tennis (Schröder still won).

He had a soft spot for George W. Bush in spite of their disagreement over the Iraq war. And Bill Clinton, otherwise a cult figure for the European Left, did not endear himself to Schröder because he habitually turned up to meetings one hour late.

Accolade for prescience

Schröder holds the supreme accolade for prescience. He predicted in early 1998 – a year before the euro was born – that Germany’s industrial and economic dominance in Europe would increase because Germany’s inflation rate would be lower than other European countries which would no longer be able to devalue because of their adherence to EMU, leading to a big improvement in German competiveness and industrial strength. That is exactly what has happened.

Schröder, who termed the euro ‘a premature sickly child’ before he became chancellor at the end of 1998, presided over the introduction of the single currency in 1999 as the successor of Helmut Kohl.

Eight years after he left office in 2005, Schröder writes in his book that Germany has a special obligation to strengthen the single currency because it has ‘reinforced Germany’s dominance – contrary to the intentions of [former French President François] Mitterrand.’

In his book, launched in a blaze of publicity last week in Berlin in front of a 500-strong audience, Schröder puts paid to habitual German self-deprecation by emphasising Germany’s European strength. There is vulnerability, too.

Strengthening single currency

He admits that the collapse of the single currency would be a ‘disaster’ for the Germans by exposing a new German currency to a ‘massive’ revaluation. He thereby puts his finger on the essential reason why the Germans are willing to expend great quantities of financial and political capital to maintain the project’s survival.

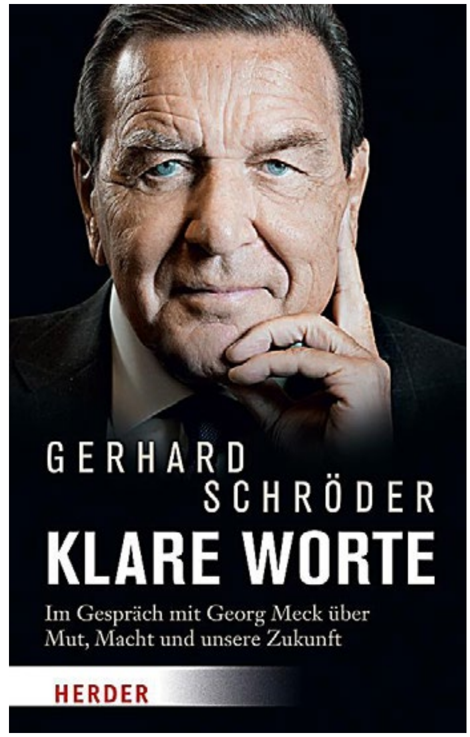
His appearance at the Alfred Herrhausen Foundation of the Deutsche Bank, where he was introduced by the bank’s joint chief executive Anshu Jain, gave Schröder ample opportunity to show off his particular brand of wolfish charm.

Rather like Germany’s senior Social Democrat elder statesman, Helmut Schmidt, who has just turned 95, Schröder has seen his popularity rise in direct proportion to the number of years elapsing since he held office.

He publishes his book at an intriguing time. Chancellor Angela Merkel (whom he barely mentions) is on the ropes, rocked by nascent instability in the Grand Coalition in which she was forced to govern after the inconclusive German elections in September.

The Social Democrats – having finished well-beaten in September – have manifestly risen in power and stature in recent weeks of coalition infighting.

Deutsche Bank has faced some criticism in Germany over having given Schröder and the Social Democrats a well-publicised platform ahead of the May European elections that are widely expected to bring a backlash against established European parties.



Schröder was heavily criticised in his own party for introducing in 2003-04 the Agenda 2010 package of reforms – supply-side and labour market measures now recognised worldwide as spurring Germany’s better economic performance during the past few troubled years.

ECB sovereignty

In his book he crosses another Rubicon by stating firmly that, because of political factors, the much-hyped independence of the European Central Bank (and of the Bundesbank) is in fact extremely constrained.

‘The sovereignty of the European Central Bank has existed no more than that of the Bundesbank,’ he writes. Asked at the book launch about the reasons for his authorship, Schröder gave as his answer the same mixture of chutzpah and cheerful and political incorrectness.

Whereas higher-minded German politicians would have said that they write books to improve the world, Schröder gave a typical snappy réplique: ‘It’s my birthday present to myself.’■

Secrets behind IMF reserve currency data

Renminbi key factor in information gaps on diversification

Gabriel Stein, Chief Economic Adviser

The secretiveness of developing economies is making it harder to analyse the all-important currency composition of the world's growing hoard of foreign exchange reserves. The proportion of reserves that is broken down by currency reached a third consecutive all-time low in the third quarter of 2013, according to the International Monetary Fund's quarterly Composition of Foreign Exchange Reserves (COFER) data.

IMF members are not required to disclose how they allocate their foreign exchange reserves, which totalled $11.43tn at the end of September, and they are increasingly choosing not to do so. In 1999, countries declared the currency breakdown of more than three-quarters of their reserves; by late 2013, the number was down to 54.1%.

The increased reticence is squarely due to developing economies, which divulged the composition of only 37.1% of their reserves in the latest IMF tally, down from 55.9% at the end of 1999. By contrast, advanced economies declared how 89% of their reserves were allocated.

This is broadly unchanged from 1999, when the figure was 90.6%. In other words, advanced economies are generally happy to go public, whereas developing ones tend to prefer greater opacity.

Incidentally, it should be kept in mind that 'unallocated' means exactly that: no distribution is given. It is probable that the breakdown of the $5.24tn in unallocated foreign exchange reserves is broadly similar to that of the $6.19tn in allocated reserves.

However, there are likely to be minor differences, as neighbouring countries that trade substantially with each other will tend to hold at least some reserves in each other's currencies.

Renminbi holdings

In addition, more countries are holding the renminbi as part of their reserves. This is in spite of the fact that the renminbi is still not convertible and – since its exchange rate is pegged to the dollar – is to all intents and purposes just a subdivision of the American currency.

The growing share of unallocated reserves mirrors the continued rise in the proportion of reserves held by developing economies. At the end of the 1990s, advanced economies held slightly more than 60% of total foreign exchange reserves, with developing countries accounting for just short of 40%. By late 2013, the positions had shifted dramatically: developing economies held close to 70% of total reserves. The two trends together mean that unallocated reserves are likely to represent more than half the total in the next few years.

Canadian and Australian dollars

If central banks and treasuries (the ownership of foreign exchange reserves varies from country to country) are becoming more secretive, the IMF is trying to cast further light on reserve management. Last year the IMF added the Canadian and Australian dollars to its breakdown of assets by currency. They joined the dollar, the euro, sterling, the yen and the Swiss franc.

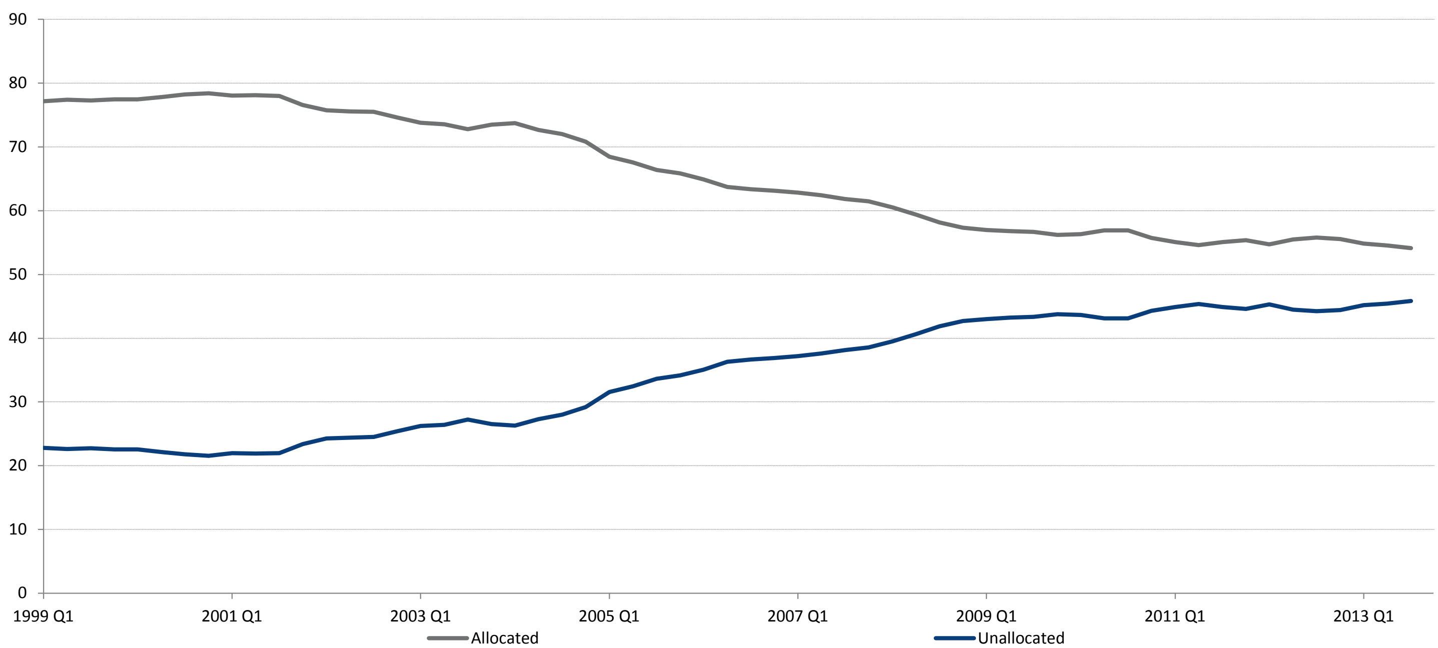
Because data go back only to the fourth quarter of 2012, it is impossible to say what the trend in holdings of the two newcomer currencies is.

On the one hand, the fact that they are being categorised separately implies that reserves in these two currencies have been rising. On the other hand, the governors of both the Bank of Canada and of the Reserve Bank of Australia are attempting to talk their currencies down, which could distort the pattern at least in the short term.

Diversification

However, foreign exchange reserves managers are clearly keen to diversify.

Chart 1: Allocated vs unallocated reserves, % of total



Source: IMF COFER

The IMF's data show the dollar retains its primacy, with 61.4% of allocated reserves still in greenbacks in the third quarter of 2013. But the US currency's share is slowly being eroded.

Contrary to the fond hopes of at least some euro area spokesmen, this is not because of an increased preference for euros. In fact, the euro's share of declared foreign exchange reserves is also falling.

Medium term

It is therefore likely that the Australian and Canadian dollars' share of foreign exchange reserves will edge up somewhat over the medium term.

The IMF data need to be treated with some caution; non-dollar currencies are converted into dollars at the end of the reporting period covered, which means that total reserves and each country's share are affected by exchange rate fluctuations.

It should also be noted that the IMF's decision to carve out the Canadian and Australian dollars explains the ostensible drop in 'other currencies' in the third quarter of 2012.

The renminbi, too, is almost certain to be categorised separately at some point, although probably not until the Chinese capital account has been freed up and the currency is convertible.

Whether any other country's money will join the select group of allocated currencies is difficult to say. There is certainly no natural candidate, either from the BRICs countries or from any other emerging market economy. That may change, but probably not over the next 10 years.

Since the mid-1990s, the value of total foreign exchange reserves has multiplied eightfold, from $1.4tn in 1995 to $11.4tn in late 2013. By way of comparison, nominal world GDP has gone up 2.4 times, while the volume of world trade has risen 2.6 times.

The surge in reserves partly reflects the determination of emerging market economies, primarily in Asia, to shore up their defences in the wake of the Asian financial crisis in 1997-98.

Although the current account surpluses needed for countries to accumulate reserves were a substantial cause of the Great Recession, a study by the National Bureau of Economic Research shows that the policy of self-insurance paid off: countries with high foreign exchange reserves relative to short-term debt suffered less than others from the crisis.

Shifts in current account

However, shifts in the current account balances of the world's leading economies suggest that the pace of reserve accumulation is set to moderate. China's surplus is narrowing, heading for 2% of GDP from a dizzying 10% in 2007. Japan, for a long time a big creditor nation, will probably become a debtor in the medium term.

On the other side of the ledger, the US current account deficit has narrowed from 5.7% of GDP in 2007 to 2.7% in 2013.

The shale oil and gas explosion and an increased propensity to save among Americans approaching retirement age, or working past it, means that this trend is likely to continue.

A sustained US surplus at some point over the next ten years is not a fanciful forecast. And the euro area has shifted from a roughly balanced current account to a sustained surplus of 2% of GDP and widening.

Reserve accumulation

A slowdown in reserve accumulation will come not a moment too soon. Whatever level of reserves is appropriate, the holdings of some Asian nations, notably China, are clearly excessive and a burden rather than a blessing.

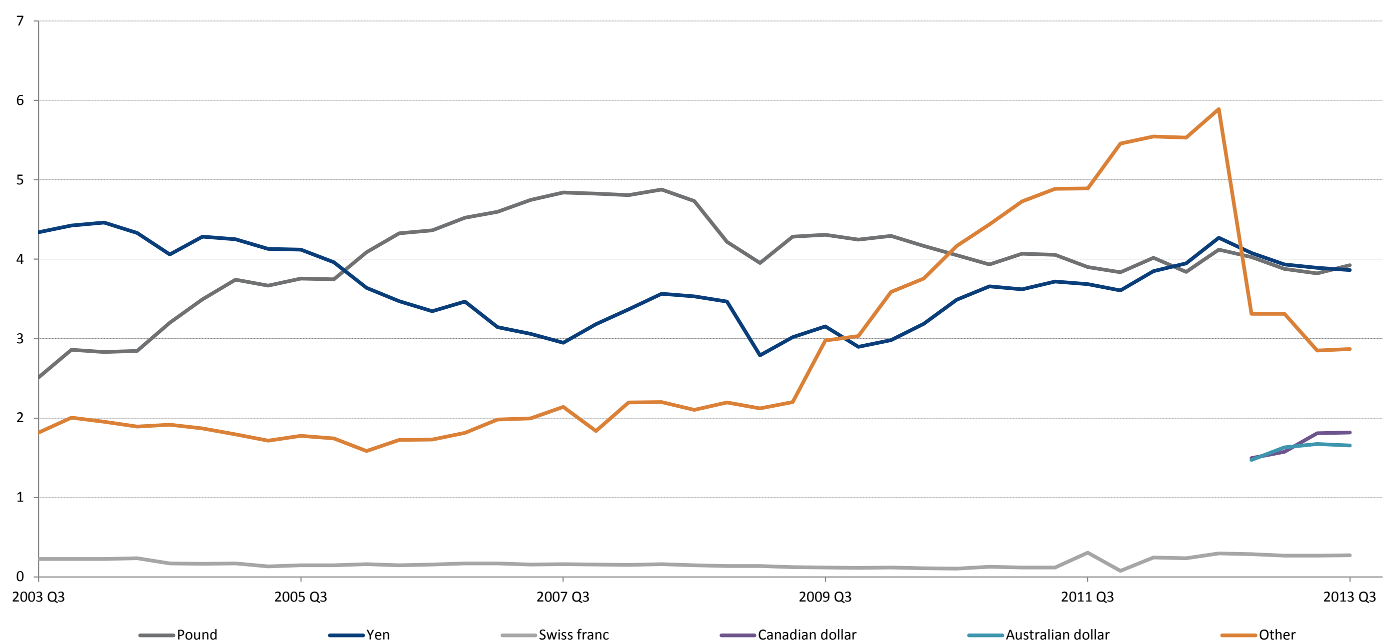
The adequate level of reserves has generally been measured relative to imports, with holdings equivalent to around six months of imports deemed a good rule of thumb. More recently, the focus has switched to reserves relative to total short-term debt or to short-term foreign debt.

Here there is less agreement, but holding reserves to cover 100% of short-term foreign debt plus three months' worth of imports should probably provide ample security for most countries.

Even on that basis, many countries hold far more foreign exchange reserves than necessary. This is another reason to expect the growth in reserves to diminish over time: for many countries the marginal benefit is simply no longer there.■

Prof. Gabriel Stein is Chief Economic Adviser at OMFIF. He is the main author of the fourth OMFIF report on Chinese economic developments during the Year of Renminbi Focus. *See p.36.*

Chart 2: Share of allocated foreign exchange reserves of currencies other than dollar and euro, %



Source: IMF COFER

Growth glimmers in Greece

European help on debt expected ahead of May elections

George A. Provopoulos, Bank of Greece

Five years ago the thought of a euro area crisis seemed counter-intuitive. After all, the purpose of European monetary union (EMU) was to make the kind of crisis that occurred impossible. However, when deciding on the architecture of the single currency, policy-makers settled on a bare-bones approach based on an independent, price-stability-orientated central bank and fiscal discipline on the part of member countries.

This architecture proved inadequate for several reasons. First, the fiscal rules were poorly designed and not enforced rigorously enough.

Second, instead of increasing pressure for the structural reforms and policy adjustments needed to strengthen competitiveness in the periphery, market forces acted in the opposite direction by mispricing risk.

Third, the founders of EMU underestimated the importance of financial stability in a monetary union – they made no provision to deal with private credit booms and busts or with the feedback loops between banking crises and fiscal crises.

A tale of two crises

Broadly speaking, the euro area has experienced not one but two separate crises – one sovereign-induced (mainly in the case of Greece) and the other banking-induced. What the affected countries – Cyprus, Greece, Ireland, Portugal and Spain – have in common is that they ran large current-account deficits prior to the crisis.

The initial tremors of the euro area crisis were felt in Greece in the autumn of 2009 following the disclosure that the country's fiscal deficit would be much higher than investors had expected. The outbreak of the Greek sovereign-debt crisis took the markets by surprise. It should not have.

Greece joined the euro area in 2001. From that year until 2009, large and growing fiscal and external imbalances should have sounded loud warnings in the financial markets. Those years were characterised by big budget deficits, driven mainly by expenditure, high and increasing government debt and a steady erosion of competitiveness.

Once the crisis started in late 2009, a self-reinforcing spiral kicked in, which led to a cumulative real GDP contraction of 25%.

In the remainder of the periphery – especially Ireland, Spain and Cyprus – it was the banking sector that generated a sovereign crisis.

The large size of those countries' banks relative to national GDP undermined confidence in the sovereigns, creating doom-loops between the two. The lesson from this experience was clear: an effective economic and monetary union needs to include a banking union.

A crisis-induced economic adjustment

Greece has made a remarkable adjustment in response to the sovereign crisis, both on the fiscal and external fronts. From 2009 to 2013, the fiscal deficit dropped by some 13 percentage points of GDP. The structural fiscal deficit has shrunk by 19 percentage points of GDP. The primary fiscal deficit has swung from 10.5% of GDP in 2009 into a small surplus.

What makes these achievements especially impressive is that they have taken place despite a contracting economy, which creates moving targets for fiscal consolidation. Greece's fiscal consolidation is one of the largest ever achieved under an IMF programme.

Greece's cost competitiveness against its major trading partners deteriorated by about 30% from 2001 to 2009.

Between 2010 and 2013 the entire loss was recouped As a result, the Greek economy is rebalancing. The share of exports of goods and services in GDP rose from 18% in 2009 to 28% last year. The current account, in deficit by 15% of GDP in 2008, moved into surplus last year.

Two aspects of the improvement in competitiveness stand out. First, it has been achieved without the benefit of nominal exchange-rate devaluation. Reflecting extensive labour-market reforms, it has been based on reductions in unit labour costs – an internal devaluation.

Second, it has been achieved against a backdrop of low inflation in the economies of Greece's trading partners, which makes it harder to regain competitiveness.

The restructuring of the Greek banking system has been extensive. With the deepening of the crisis, the Bank of Greece stepped in to preserve banking system stability. Ample liquidity was provided to the banks.

Viable lenders were fully recapitalised using a combination of state and private funds. Non-viable banks, which were unable to raise private capital, were resolved. Before the crisis, Greece had almost 20 banks. Today we have four well-capitalised pillar banks and a few smaller ones.

We are now implementing the second stage of our strategy, based on policies to allow banks to repay state aid and finance economic recovery. Banks are exploiting synergies and economies of scale, further eliminating excess capacity and becoming more efficient. They are refocusing on their core activities.

Late last year, we re-engaged BlackRock to update credit loss projections for banks' loan portfolios up to 2016 and to assess their procedures for managing non-performing loans.

The efficient use of backstop funds during recapitalisation and resolution has left a buffer of around €8-9bn, should additional capital needs arise. Moreover, the sale of non-core assets and the exploitation of synergies arising from mergers could add some €5bn to the buffer.

A 'code of conduct' for banks' dealings with distressed borrowers is being drawn up and will be implemented as of 2015. Improvements in non-performing loan management will lower capital requirements, freeing up resources that can be used to finance a new growth model for the Greek economy.

Initiatives at the EU level

Policy responses to the crisis have also included monetary policy initiatives by European Central Bank and changes to EMU's architecture.

The actions of the ECB have been decisive. The ECB has kept policy rates at historically low levels; it has satisfied the liquidity needs of banks and has expanded its collateral framework. The announcement of Outright Monetary Transactions has helped reduce tail risks of a euro break-up.

Furthermore, under its forward guidance the ECB has made it clear that it will keep policy rates at present or lower levels for an extended period of time.

Changes in the architecture include

improvements in macroeconomic surveillance (through the 'six-pack', the fiscal compact, and the 'two-pack') and efforts to establish a banking union.

Feedback loops

Banking union is being designed to sever the negative feedback loops between banks and the sovereign, as well as to create an integrated, stable and well-capitalised banking sector. The Single Supervisory Mechanism, which will become fully operational this November, will lead to the transfer of the supervision of almost 85% of total euro area bank assets to the ECB.

A necessary complement to the SSM is a resolution framework to deal with non-viable banks. The first decisions on the Single Resolution Mechanism have already been made. Finally, the harmonisation of deposit guarantee schemes, which will begin in January 2016, will help prevent the emigration of funds in search of a greater degree of protection.

For too long, the countries on the euro's periphery sacrificed long-term gains for short-term gratification. The policy reforms that the crisis countries are implementing follow an established recipe.

That formula stresses the need to improve competitiveness, ensure welfare spending is affordable, strengthen employment incentives, push through privatisation and streamline the public sector.

Some of these measures take time to work. The gains do not come overnight. Supported by the ECB's policies and the strengthening of the EU's architecture, that recipe is now working. The case of Greece illustrates the progress that has been achieved.

Since the peak of the crisis in mid-2012, Greek government bond spreads have fallen by around 1,800 basis points; the Athens stock exchange has risen by about 85%; bank deposits have increased by 9%; the reliance of banks on Eurosystem financing is down by about 50%; economic sentiment recently reached a five-year high; the twin deficits have been transformed into twin surpluses; and the January 2014 PMI for manufacturing points to expansion for the first time in 53 months.

Return to growth

It is generally expected that 2014 will be the year when the Greek economy returns to growth, supported by an improved export performance, the restoration of confidence and a considerably smaller fiscal drag than in the previous years.

Nevertheless, the storm clouds have not yet completely cleared. The economic and financial environment in Greece remains fragile. The very high unemployment rate has led to social and political polarisation. A surge in political uncertainty could undermine the recovery.

It is my hope that such an unfortunate scenario will not occur. Greek citizens have had to undergo tremendous sacrifices during the past few years. These sacrifices are bearing fruit. This progress, which is now visible, makes me confident that Grecovery is on the way.■

George A. Provopoulos is Governor of the Bank of Greece. This article is based on the speech he delivered at the OMFIF Golden Series lecture in London on 7 February.

On the web

See the full speech at www.omfif.org/media/563956/greece-speech.pdf

Left to right: George A. Provopoulos, Governor, Bank of Greece; David Marsh, Chairman, OMFIF; and Vicky Pryce, Member, OMFIF at the Golden Series lecture.

Why Greek debt is unsustainable

Europe's most troubled economy yet to turn a corner

Vicky Pryce, Advisory Board

Everyone connected with Greece – creditors, debtors and above all its long-suffering citizens – might have expected the European Union's most troubled economy to have turned the corner by now. It has not.

Consumer and business confidence in the euro area is edging up. Ireland has exited its bailout programme and Portugal hopes to follow suit. Spain's economic performance is improving. And the International Monetary Fund's rosier view of the global economy in 2014 should trickle through to European exports. But not much is changing in Greece.

Greece's international creditors are conducting yet another review of the government's finances as Athens struggles to meet the conditions imposed in return for loans to keep the economy afloat. Privatisation receipts in particular are falling short of target. The value of Greek assets has collapsed and, although various domestic and international investors are showing interest, anticipated sale prices are unlikely to be met.

Shortfall in finances

Greece must raise about an extra €4bn this year to plug a shortfall in its finances. A further bailout of €7-11bn is likely to be needed next year. For the Greeks living with 27% unemployment, this is a never-ending nightmare.

Neither fiscal consolidation nor internal devaluation appears to have worked so far. Although private sector wages fell 23% between 2009 and 2013, investment spending has nearly halved and exports have risen by just 6%. The country's public debt is still unsustainable and a fierce credit crunch is constraining growth.

Despite a big increase in taxes since 2009, revenues have lagged estimates as people have stopped spending or are unable to pay what is due.

Real estate tax

Property taxes illustrate the perverse effects of trying to extract more money from an unwilling and increasingly impoverished nation.

Higher taxes lower the value of the collateral used for loans, reduce the ability to raise further finance and add to non-performing loans on the books of already shaky banks. Consumers then retrench further as they see the value of their assets eroded with each tax increase.

Deflation

It is not surprising that Greece's economy has collapsed by 25% since 2008. As prices fell by 2% in the year to October and nearly 3% in November, deflation is now a real worry, sapping consumers' willingness to spend and increasing the real burden of household and government debt.

Despite recent optimistic forecasts based on the emergence of a primary budget surplus, some pick-up in exports and improved tourism receipts, the economy may well shrink further in 2014. That would be the seventh consecutive year of decline.

The handling of the Greek crisis has been the worst example of IMF and European Union ineptitude, though the Greek government has a lot to answer for as well. Instead of nipping the crisis in the bud and achieving an early debt restructuring, Greece was forced down the path of severe austerity as a condition for rescue packages that eventually grew to €240bn. That is an enormous sum for an economy that accounts for only 2% of Europe's GDP. Indeed, the bailout is the largest on record for any country.

Losses to private sector investors

The losses that private sector investors had to agree to in early 2012 have provided only temporary relief. The reduction in public debt was more or less offset by the cost of recapitalising Greek banks, which are major holders of the government's debt and had to take heavy losses on their bonds. Public debt has risen to more than 170% of GDP.

Greece cannot grow sufficiently under current conditions to reduce its debt to 124% of GDP by 2020, the level the IMF now deems to be 'sustainable'. The time has come, maybe after May's elections for the European parliament, to take a decisive step to prevent Greece from becoming a failed state. Greek debt is now mostly in the hands of the public sector.

Before the write-down in early 2012, which reduced private sector debt by forcing 50% nominal losses on banks and other private organisations, some 36% of Greek debt was in the hands of public institutions. (The European Central Bank held 15%, the IMF 6% and the euro area 15% through the European Financial Stability Facility.) That proportion is estimated to have risen to 85% as private investors have sold down their holdings and the official sector has continued to disburse bail-out funds. Greek banks still hold about 5% of the debt.

Greek Prime Minister Antonis Samaras – still struggling to meet creditors' conditions.

Role of public institutions

Now that that the private sector buffer has gone, the decision rests with public institutions. What is needed is an acceptance that the 'taxpayer' will have to shoulder some losses in the form of write-offs, a lengthening of maturities and a lowering of interest rates.

This forbearance should be accompanied by more aggressive monetary intervention to combat deflation across Europe, to allow funding to resume and to facilitate sustained capital inflows to Greece from the European Investment Bank. Greece should push for this during its current presidency of the EU. But the question is whether Germany would ever agree.▪

Vicky Pryce, member of the Advisory Board, is an economist and business consultant. She is author of 'Greekonomics' the Euro Crisis and Why Politicians Don't Get It, Biteback Publishing, 2013.

Portugal's road to recovery

Tough adjustment draws on lessons from history

Carlos Moedas, Secretary of State to the Prime Minister of Portugal

History teaches that prosperity built on debt is prosperity built on sand. Portugal has learnt that lesson afresh and is well on the way to putting its economy back on the road of sustainable growth and job creation. The economic imbalances that Portugal is correcting through extensive reforms are an echo of the country's experience as a pathfinder in international trade.

At the beginning of the 16th century, King Francis I of France dubbed King Manuel of Portugal 'le roi épicier', a reference to the extraordinary revenues accumulated from the spice trade.

Yet domestic expenditure was so high that, by the mid-16th century, the Portuguese monarchy was running, in the words of a historian, a 'bankrupt wholesale grocery business' that was 'completely mortgaged to the bankers'. Debt went hand-in-hand with the expansion of world trade.

Similarly, a build-up of debt and economic imbalances contributed to the end of the first wave of globalisation in the early 20th century, a period that John Maynard Keynes brilliantly captures in *The Economic Consequences of the Peace*. Financial crises became increasingly common. As Mark Twain said, 'History does not repeat itself, but it does rhyme.'

More recently, after joining the euro, Portugal embarked on a new cycle of debt accumulation. One of the many problems with high levels of debt is that they mask fragilities in the economy and postpone much-needed structural reforms that leave the potential of the economy unfulfilled.

Portugal has therefore addressed these latest imbalances with a very challenging adjustment programme initiated in 2011 and now nearing completion.

A new approach

Portugal learned from past mistakes and adopted a different approach. The country reduced its spending, improved its trade balance and developed a more flexible labour market.

At the same time, Portugal improved its business environment, sharpened its competitiveness and became more open to innovation. There is now a greater reliance on skills and on sustained productivity gains and less reliance on debt.

After a long period of recession and rising unemployment, the Portuguese economy is finally expanding again. GDP has grown for three consecutive quarters, while as of November 2013 unemployment had fallen continuously for nine months.

In the last 15 years, Portugal never ran a trade surplus. However, in the first three quarters of 2013, exports of goods and services exceeded imports. In the four years to December, exports rose by 24%, while imports contracted by 5%. This is a stronger performance than countries such as Spain Italy, France and Ireland.

This crucial achievement reflects gains in competitiveness, which are the fruit of efforts by Portuguese firms to carve out overseas markets as well as the demanding reform agenda that the government has been implementing.

Lessons from the past

The opportunities offered by trade and economic integration cannot be wasted once again because of excessive debt. That is why we are working hard to ensure that our public finances are permanently healthier and our economy becomes more competitive and flexible.

If we want to escape the fate of our spice-dealing ancestors, we have to balance economic growth with sustainable levels of borrowing. We need to be realistic about the sort of state that we can afford. That is why we have successfully privatised the postal service, our airport infrastructure company, our main energy company and the management of our electric network.

In promoting economic growth, we have cut red tape and made life easier for entrepreneurs. Portuguese and other EU investors can complete online all the formalities needed to do business in our country.

Likewise, we have simplified the legal processes for launching and managing a firm.

Our long-term strategy for growth involves close cooperation with our strategic partners, including the UK and the vast Portuguese-speaking world.

Portugal is deeply linked by historical and cultural ties both to the Lusophone countries and to the UK. Our economies have complementary needs and competitive advantages.

As trade opportunities multiply, we can collaborate to our mutual benefit by sharing technical expertise, natural resources and business experience.

Lusophone economies

One of the biggest changes in Portuguese trade in the last few years has been in the markets for our goods and services. Portuguese-speaking countries play a decisive role in our economy, both as investors in our country and as buyers of our products.

Portuguese exports to Angola increased more than 400% between 2002 and 2012, turning it into our fourth-biggest market. Our exports to Angola come to nearly €3bn, or 1.8% of Portuguese GDP. Our exports to Mozambique have increased at a similar pace.

Portuguese firms have also increased their presence in Angola, with the stock of direct investment jumping from about €700m to €2.6bn in four years.

It is often thought that a shared language is the main competitive advantage that Portuguese firms have in the Lusophone world. But there is much more to the story. Portuguese companies have been investing in Angola and Mozambique for many years, accumulating market know-how.

They are aware of major opportunities and challenges and are well-acquainted with the local business cultures. They do not try to export the Portuguese way of doing business; rather, they develop models tailored to the needs of those markets.

Keynes left an important message for post-war Europe. He wrote that 'the unveiling of illusion' must be the means to achieve sustainable economic growth. Portugal's government has done its part to correct past illusions by managing a difficult adjustment programme and putting the economy back on a more balanced footing.

Prosperity built with debt does not last. We are laying stronger foundations, with structural reforms, with a strong export sector and with initiatives to forge a more open and productive economy. ▪

Carlos Moedas is Secretary of State to the Prime Minister of Portugal. This article is based on the speech he delivered at the OMFIF Expert Seminar, 'The role of Portugal and the UK in Lusophone economies', in London on 4 February.

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The euro area's vulnerable paymaster

Shifting political sands put limits on German power

Kenneth Dyson, Cardiff University

The common view of Germany as an economic and political giant immune to the woes of the single currency is wrong. Germany is a semi-hegemonic power grappling with dilemmas over how to manage Europe's crisis and vulnerable to euro area contagion as well as domestic policy failures.

Faced with these challenges, Chancellor Angela Merkel has pursued two priorities: to protect the interests of German taxpayers and to safeguard both the competitiveness of German companies and the country's creditworthiness in financial markets.

Merkel was re-elected in September 2013 with her reputation enhanced. But the process of designing new euro area institutional arrangements could provoke a divisive debate about Germany's relationship with Europe.

The attendant risks will be all the greater if growth in southern Europe remains elusive. Pressure would mount on Germany to transfer more resources to countries on the euro area periphery and to stoke domestic demand. In such a context Germany would find itself increasingly isolated and exposed to the potentially uncontrollable unraveling of the single currency.

To its critics, Germany is a bully that exports deflation by imposing austerity on errant members of the euro area and is open to charges of hypocrisy for failing to reform its services sector and utilities.

Germany's rate of investment has fallen steadily since the 1990s, casting doubt on the economy's long-term growth potential. More generally, Berlin has been painted as lacking ambition and boldness in its management of the euro crisis, thereby imperilling the peace and prosperity that European integration has gifted to Europeans since 1945.

But Germany lacks the capacity to bail out other than a limited number of small euro members without inflicting both self-harm and collective harm, including huge costs to its taxpayers and loss of global competitiveness.

Given Germany's extensive trade and financial links to the rest of the euro area, its negotiators thus face the dilemma of what short- and long-term costs they are prepared to accept in abridging the no-bail-out principle to keep the single currency together.

Euroscepticism

Two factors make this balancing act particularly difficult. First, the new anti-euro Alternative für Deutschland party failed to break into the Bundestag in the 2013 elections. Nevertheless, a vote of 4.7% for a party only six months old showed how public opinion could mobilise behind a domestic challenge to the elite consensus of support for ever closer European union.

Second, successive rulings by the German constitutional court have limited the government's room for manoeuvre. The court's decision to ask the European Court of Justice to rule on the legality of the European Central Bank's Outright Monetary Transactions bond-buying plan risks undermining the effectiveness of the policy instrument, widely credited with dispelling fears of a break-up of the euro in 2012.

The court has underlined the democratic requirement that fiscal policy decisions must be rooted in parliamentary legitimacy. The effect has been to strengthen the role of the Bundestag in what were seen as essentially intergovernmental arrangements for collective financial assistance.

For Merkel, any institutional changes that would require treaty change would be fraught with political risks. Hence her decision to seek a more powerful role for the European Council, rather than the unelected European Commission, as the best means of securing a measure of democratic endorsement of reform.

Creditor state

Germany's approach to European economic integration is that of the creditor state, a stance it has held consistently since the 1950s. Creditor states' interests in limiting their liabilities are anchored by a set of principles: avoidance of moral hazard, with states taking individual responsibility for stability and sustainable growth; no rules providing for bailouts; and, if a bailout becomes unavoidable, then the debtor state must cede sovereign authority to its creditors as a quid pro quo for the liabilities they are assuming. This has been the template for managing the crisis in Greece.

Creditor states have powerful incentives to coordinate with each other. They have bargaining power. No system of international policy coordination and liquidity provision has credibility unless they participate.

Hence they can threaten to walk away from discussions on creating new institutional arrangements. This was evident in negotiations for the 1991 Maastricht Treaty and in bargaining over the 1997 Stability and Growth Pact.

Creditor-state power matters above all when that power is systemically significant, as with Germany both before and after the creation of the euro.

But Berlin must not take its dominance for granted: Germany faces the risk of

Bernd Lucke, leader of Alternative für Deutschland and the face of euroscepticism in Germany.

contagion from the euro area through trade and financial channels, and the danger that falling investment will undermine its growth potential.

What's more, the ranks of the informal club of creditor states at the heart of euro area crisis management are thinning.

For practical purposes, membership of the club was defined by a triple-A credit rating. Initially the group comprised Austria, Finland, France, Luxembourg and the Netherlands, as well as Germany, and accounted for 60.8% of euro area GDP.

However, by 2013 Austria and France had lost their top-notch credit rating and the four remaining member states represented only 36.4% of euro area GDP. Consequently, the political cover that the club gave German negotiators has been reduced. Moreover, domestic opposition to fiscal austerity has made both Finland and the Netherlands less reliable club members.

If Germany's creditor-state status were to erode, attitudes at home to the single currency would probably change rapidly. The fundamental debate about 'what kind of Germany, in what kind of Europe', foreshadowed by the emergence of the eurosceptic AfD, could no longer be postponed.

Avoiding isolation

The lesson of history for Germany's foreign policy community is that the country must avoid isolation in Europe. Another lesson of history, however, is that the power of creditor states is transient.

Germany has already undergone a transformation from being the reluctant hegemon at the time of EMU to being an acutely vulnerable semi-hegemon during the euro crisis. Debtor states are drumming up support for the argument that the export surpluses of Germany and other creditors reflect a damaging excess of output over spending, not merely superior competitiveness.

The US Treasury leveled this charge against Germany in November 2013 and the European Commission is investigating German surpluses.

Berlin bestrides the European stage. Little if anything happens in the euro area without its approval. But Germany may need to take out insurance against a post-creditor-state status, just as Britain may need to insure itself against a structurally imbalanced economy that is over-dependent on a highly volatile finance sector.▪

Kenneth Dyson is Research Professor at Cardiff University.

Supporting the British Mittelstand: UK should imitate Germany, not think of overtaking it

The prediction by a leading London research firm that the British economy could overtake Germany's within 20 years falls into the category of fantasy forecasting, ***writes Bob Bischof in London.*** **Indeed, the UK must redouble its efforts to make sure the gap with Europe's economic powerhouse does not widen further.**

To do that, it needs to ditch the short-term thinking that grips both the Government and the City of London.

The Centre for Economics and Business Research (CEBR) grabbed headlines with a report over Christmas that Britain will soon leapfrog France and stands a good chance of surpassing Germany to become Europe's largest economy by 2030.

As a German living in the UK, I do not find the CEBR's outlook credible.

Germany's output in 2013 was worth $3.65tn, followed by France on $2.65tn and the UK with $2.45tn. To catch up with France within the next four years, Britain would need around $50bn in additional output a year.

That would translate into a growth rate roughly 2 percentage points higher than France's. Given the woes of the French economy, that is not out of the question.

But narrowing the gap with Germany looks tougher. German GDP is 45% per cent greater than Britain's. Its workforce of 40m is 10m bigger and is more than 10% more productive.

The consultancy argues that a weak euro will make it harder for Germany to stay ahead, as sheer currency conversion (assuming sterling is strong) would give the UK an edge. But this challenges the consensus that a weak currency helps Germany's exports.

Even a chronically low birth rate is unlikely to have much of an impact. Germany in the past has relied on an influx of Gastarbeiter, or guest workers from abroad, to bolster the labour force.

It is doing so now, with migrants arriving in increasing numbers from eastern and southern Europe.

Instead of asking whether Britain can catch up with Germany, it makes more sense to examine how to stop the gap from widening. The danger with selling illusions about the future is that it can breed complacency among businessmen and politicians alike.

Britain could easily do better and should do so. But it has to be realistic. The UK needs a huge effort to turn around its balance of payments deficit, to increase business investment and to make sure its youngsters have the right education and skills.

Britain must improve its infrastructure, raise productivity and cease relying on rising house prices to fuel another consumption-led boom.

All these issues need to be addressed at a time when the government is still trying to get the deficit down. Germany, by contrast, will have a balanced budget this year.

Can the UK pull it off? I believe it can, but it needs a shift towards long-term strategies in business and government. Selling British businesses and assets to create short-term value for shareholders and calling it 'inward investment' is not the answer.

Mergers and acquisitions are no match for organic growth. Paying out more in dividends as a percentage of profits than any other developed economy is not a long-term strategy for success either.

The UK has an abundance of entrepreneurs but cannot emulate the Mittelstand – the small and medium-sized enterprises that are the backbone of the German economy.

Instead of the silly-sounding acronym SME, why don't we simply say we wish to support the British Miittelstand?

All too often starved of adequate bank finance, those British companies that make it over the first hurdles are soon driven into the arms of private equity or the stock market. Too many are swallowed up and disappear.

Lord Bamford, who chairs the excavator manufacturer JCB, his family firm, said to me not long ago: 'If my Dad or I had gone to the stock market for money, we would not be here any more.'

His words should haunt British politicians. If the UK wants to reduce its dependence on the City and succeed in international competitioniit should do something about developing more SMEs into JCBs. It's the real economy, stupid! ▪

Bob Bischof is Chairman of SCCO International.

Overcoming Europe's liabilities

Harnessing risk capital to spur innovation and growth

Lorenzo Codogno, Italian Ministry of Economy and Finance

As Europe claws its way out of crisis, policy-makers need to shift the burden of financing the economy from debt capital to risk capital to support innovation and stronger growth in a way that limits systemic financial threats.

Much attention has been devoted to the sustainability of public debt, but the global crisis has demonstrated that excessive household and company liabilities can be even more destabilising than heavy government debts alone.

Even the ECB, in an August 2013 report on 'Corporate finance and economic activity in the euro area', highlighted that corporate debt in Europe rose much faster in the run-up to the last crisis than in previous ones, with large differences among European countries and economic sectors.

Overleveraging was apparent before the crisis: from 2000-07, total liabilities in the euro area rose by about 40% to 590% of GDP. The ratio increased by 50% for financial corporations, 25% for households and 13% for non-financial corporations. By contrast, the public debt to GDP ratio over the same period declined by 6%.

From 2007-12 total leverage in the euro area economy increased by a further 30 percentage points to 622%, mainly led by financial corporations and governments.

Shockingly vulnerable

An overleveraged economy is inherently more vulnerable. Servicing large debt makes corporate balance sheets less flexible and exposes enterprises to higher insolvency risk. In turn, bad loans worsen the balance sheets of banks and financial institutions, causing even local and sectoral shocks to ripple through the entire economy.

It was apparent that the economy, and particularly the financial sector, was strongly under-capitalised before the crisis or, putting it differently, was over-indebted.

However, deleveraging is painful, protracted and costly, especially at the end of a deep recession. Reducing debt inevitably implies less investment and consumption in the short run and some degree of resource under-utilisation that can damage longer-term growth. Indeed, the current loss of output cannot be recouped by simply postponing the use of unexploited resources. In short, deleveraging risks causing permanent damage to the supply side of the economy.

Nevertheless, consolidating the financial position of both the private and public sectors is crucial to ensure sustainable growth in the future.

Negative impact

Basel II and III regulations have tried to rebalance the risks taken by banks. In the near term, the effects of the rule books will remain restrictive at a macroeconomic level unless more efficient alternative financing channels develop.

For instance, a recent research paper by the Organisation for Economic Cooperation and Development estimated a negative medium-term impact from the Basel regulations of up to 0.15 percentage points of GDP on OECD countries and 0.23 percentage points on the euro area.

Furthermore, achieving the minimal capital requirements prescribed by Basel III can have pro-cyclical macroeconomic effects, despite the newly introduced counter-cyclical capital buffer.

On the other hand, it is well known that the main driver of economic growth is innovation that is effectively embodied in investments in new machinery and companies. As investing in innovation is costly and risky, risk capital should be the preferred source for funding, not bonds and loans.

The economy is thus apparently trapped between the need to make financial institutions safer and less vulnerable and the need to spur more investment in innovation.

Escaping the trap

A European Investment Bank report on 'Investment and Investment Finance in Europe' provides some suggestions how to escape this trap.

First, some form of risk-sharing among lenders and investors is necessary to foster investment. Second, countries suffering persistently low investment returns should accelerate structural reforms that encourage a shift of resources to more productive sectors. Finally, policy-makers should facilitate bank lending and alternative financing sources.

The development of such sources is crucial to spur the economy, as regulatory demands are going to cause banks to funnel credit to safer and 'traditional' uses.

However, the evidence suggests no rebalancing from debt financing to risk capital is taking place. Since innovative projects are too uncertain to be funded through the established channels of equities, bonds and loans, only securitisation using special vehicles can provide the necessary financing.

Thus, the role of venture capitalists, credit funds and other specialised operators is essential to sustain innovation and make both companies and credit institutions less vulnerable.

In its 2013 'Global Shadow Banking Monitoring Report', the Financial Stability Board focuses on the advantages of further developing non-bank institutions that provide credit to firms.

Systemic risks

Nevertheless, the report warns against the systemic risks that arise when specialised operators perform bank-like functions, particularly those with close connections to the traditional banking system and with strong links to each other.

Appropriate monitoring and regulatory frameworks for the shadow banking system are therefore required. At the moment, only a few jurisdictions have bank-like prudential regulations and international standards are still lacking, allowing operators potentially to bypass national rules.

A patchwork of national standards raises compliance costs and creates regulatory uncertainty, further discouraging the growth of this important sector.

Moreover, shadow banking entities are outside the scope of the Basel regulatory framework. At the moment, discipline derives mainly from consumer protection legislation and so is not fully suitable to address the risks of providing credit to businesses.

To conclude, innovation holds the key to stronger potential economic growth, and the key to fostering innovation is to shift the financing burden from debt to risk capital in a way that limits systemic risks. That is the challenge for Europe.▪

Lorenzo Codogno is Director-General at the Ministry of Economy and Finance, Italy.

Apostles of euro gloom have it wrong again

Like Germany after 2005, euro area can reap rewards of reform

Holger Schmieding, Berenberg

Financial markets are, rightly, starting to give the euro area the benefit of the doubt. The systemic euro crisis is over for almost all practical purposes. Although the German constitutional court has made it more difficult for the European Central Bank (ECB) to activate its Outright Monetary Transactions (OMT) programme, the ECB has enough alternative options, including quantitative easing, to contain renewed tensions.

Generally, the outlook for the euro area is positive. As in 2012 and 2013, the apostles of doom and gloom are likely to be proven wrong again this year. Instead of collapsing, most of the erstwhile problem countries on the euro periphery are already starting to reap the rewards of their painful reforms.

As a multinational currency, the euro has encountered some unique problems. But contrary to widespread perceptions, the euro bloc has been quite successful.

Despite the setback during the euro crisis, the euro area's jobs performance over the 15 years of the euro's existence matches that of the US.

Peter Hartz, architect of the controversial Hartz reforms, shaking hands with Gerhard Schröder in 2002.

Euro area unemployment

The major reason why the euro unemployment rate of 12% is now much higher than the US rate of 6.6%, whereas it was previously lower, is simple: whereas some 7m discouraged US workers have withdrawn from the labour market, the participation rate has risen on trend in the euro area.

The US has an edge over the euro area in terms of total GDP growth. But the US paid a high price for that. During the 15 years of the euro, the ratio of public debt to GDP has risen by roughly 23 percentage points in the euro area, with the entire increase happening in the wake of the post-Lehman recession.

In the US, artificial life support for aggregate demand has boosted the debt ratio by around 43 points at the same time. According to the IMF, the US ratio of general government gross debt to GDP now exceeds that of the euro area by 10 points.

Being a euro member can be tough. The common currency denies its members the easy but ultimately futile escape route of devaluation. Instead, the euro forces its members to tackle problems the hard but lasting way, through sweeping structural reforms.

The 2004-05 reforms

With the social reforms brought in by Chancellor Gerhard Schröder in 2004-05, Germany turned itself from the sick man of Europe into the continent's growth engine, Spain, Portugal and Ireland are following suit.

Even recalcitrant France has finally started to embrace some reforms. Following waves of entitlement cuts, almost all national pension and welfare systems in the euro area are now more sustainable than the US Medicare and Medicaid programmes despite Europe's less favourable demographics.

Macroeconomic management

In addition, the euro area's macroeconomic management has been less disastrous than that of the US in the last 15 years.

When the US faced a financial crisis in September 2008, it mishandled matters so badly that it pushed the west into its worst recession in 80 years.

When the euro area faced financial problems in 2011, it caused only a mild recession in the region itself with limited repercussions for the rest of the world.

Initially, the euro area was slow to react to the panic triggered by difficulties in Greece. But since the ECB promised that it would behave like other major central banks and intervene with full force if needed to stop a market panic, the euro crisis has faded away.

Nine months after the ECB deterred rampant speculation against the future of the euro in mid-2012, the euro area economy returned to modest growth in spring 2013. Leading indicators project a gradual firming of growth towards its trend rate of around 1.7% by the second half of 2014.

With the exception of stagnant Greece, GDP is expanding again in all crisis countries on the euro periphery. With the usual lag, the labour market is turning the corner as well. Unemployment is already falling in Ireland, Portugal and Spain.

Credit crunch

The credit crunch for small enterprises in parts of the periphery remains a problem. But we have to put it into context.

Across most of the euro area, lending is falling mainly because cash-rich companies do not need to borrow.

Statistics show a clear drop in the rates charged by banks on company loans in Spain and Italy, the two major countries suffering to some degree from a genuine credit crunch.

The ECB's asset quality review and stress tests are likely to reveal some further capital shortfalls. Once these are dealt with, the credit crunch will probably be over for good.■

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Developed economies to lead the way

Germany will remain growth locomotive

Michael Holstein, DZ BANK

DZ BANK Economic Forecast Table

GDP change (%)

	2011	2012	2013	2014	2015
US	1.8	2.8	1.9	3.2	3.0
Japan	-0.4	1.5	1.8	1.7	1.6
China	9.3	7.7	7.7	7.9	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.4	2.3	2.6
France	2.0	0.0	0.2	0.8	1.3
Italy	0.6	-2.6	-1.8	0.4	1.3
Spain	0.1	-1.6	-1.2	0.6	1.5
UK	1.1	0.3	1.9	2.4	1.7

Addendum

	2011	2012	2013	2014	2015
Asia excl. Japan	7.6	5.8	5.8	6.5	6.3
World	3.8	2.9	2.7	3.6	3.7

Consumer prices (% y/y)

	2011	2012	2013	2014	2015
US	3.2	2.1	1.5	2.1	2.5
Japan	-0.3	0.0	0.3	1.9	1.6
China	5.4	2.7	2.6	3.2	3.8
Euro area	2.7	2.5	1.4	1.4	1.8
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	1.2	1.5
Italy	2.9	3.3	1.3	1.3	1.2
Spain	3.1	2.4	1.5	0.5	1.3
UK	4.5	2.8	2.6	2.2	2.8

Current account balance (% of GDP)

	2011	2012	2013	2014	2015
US	-2.9	-2.7	-2.5	-2.6	-2.8
Japan	2.0	1.1	0.9	1.1	1.5
China	1.9	2.3	2.1	2.2	1.7
Euro area	0.2	1.3	2.3	2.5	2.5
Germany	6.2	7.1	7.0	7.2	6.5
France	-2.5	-2.1	-1.7	-1.8	-1.5
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.1	1.0	2.0	2.3
UK	-1.5	-3.7	-3.8	-4.3	-4.0

Financial markets have become significantly more nervous of late, with most concern focusing on the difficulties of a number of emerging market economies. Argentina and Turkey are the centre of attention; investors are pulling out capital, putting currencies and bonds under pressure.

Other big emerging markets such as Brazil, India and Russia have been affected and several central banks have already felt the need to support their national currencies by raising interest rates or through intervention.

In contrast, economic data so far for the final quarter of 2013 show encouragingly robust growth.

The US has reported another strong period with GDP growth of 3.2%, even though state spending cuts continued to depress demand. The UK economy is up to speed again, and China's growth rate is holding at just under 8%.

The euro area beat expectations by growing 0.3% between the third and fourth quarters of 2013, consolidating a hesitant recovery that began last spring.

This year is expected to bring a perceptible economic improvement, especially in the industrialised countries. In the US, robust domestic demand and reduced pressure from the consolidation of public finances are the two main factors that should ensure that growth remains robust at around 3%.

The euro area has found its way out of recession, even if the upturn still lacks real momentum in many countries.

Germany will remain the bloc's growth locomotive. German companies' prospects for 2014 remain decidedly favourable. After two disappointing years, the German economy is expected to grow by more than 2% in 2014.

The economies of non-euro area countries such as the UK and Switzerland are showing a bit of pace again this year.

Despite the difficulties facing several emerging market economies, global growth is likely to remain resilient and will turn out to be 1 percentage point higher in 2014 than last year. ▪

Michael Holstein is Head of Macroeconomics at DZ BANK.

North-south rift over government bonds

A new fault line is opening up in the euro area over whether banks should be required to hold capital against bonds issued by southern governments with weakened credit ratings, ***writes Stefan Bielmeier in Frankfurt.***

The issue threatens to flare up into open political warfare between a creditors' club led by Germany and debtors led by Italy and Spain.

Banks currently apply a zero risk weighting to the government bonds of all euro area member states without exception. Critics of this approach argue that credit risk has increased on the euro area periphery since the crisis. And because of the close links between states and banks, fiscal troubles would lead directly to financial sector instability.

It is still standard practice for southern European banks in particular to borrow cheap money from the ECB and invest it higher-yielding sovereign bonds. If capital-adequacy regulations were rewritten or if the ECB were to call for new risk weightings, banks would have to raise more equity or reduce their bond holdings.

This would call into question the entire system for funding peripheral sovereigns as banks now hold more than 40% of some countries' debt. Bond spreads would widen and the euro area bond market would fragment further.

But creditor nations are determined to press their case, which both Madrid and Rome reject in principle.

Southern governments are likely to play for time until their economies and credit ratings have fully recovered, a tactic tantamount to demanding an indefinite postponement of any change in risk weightings. ▪

Stefan Bielmeier, member of the Advisory Board, is Divisional Head of Research & Economics at DZ BANK.

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Scramble for Africa in full swing

Nigeria a test for governance and growth model

Alan Wheatley, Editor

On the first visit to Africa by a Japanese prime minister in eight years, Shinzo Abe gave the keynote speech of his recent four-country tour at the African Union's headquarters in Addis Ababa. The irony that he spoke in a building constructed not by Africans but by China, the continent's most avid suitor, was lost on no one.

The scramble for Africa is still in full swing. Japan, which made new promises of aid, is not alone in trying to make up ground ceded to China. President Barack Obama plans to invite 47 African leaders to Washington in August to strengthen US trade and investment ties with the continent where he was born.

Africa desperately needs capital from any source. Already the fastest-growing continent, largely due to a boom in natural resources, its per capita GDP is projected to rise 6% a year in the coming decade. Yet all but one of the 25 countries that score lowest on the UN's Human Development Index are in Africa.

An obvious question thus arises: how can Africans capitalise on intense global interest in their economies and use it for their own ends, not just for the political benefit of foreign governments and the economic gain of multinational companies

This was the theme elaborated by Dr. Kingsley Chiedu Moghalu, deputy governor of the Central Bank of Nigeria, at a series of OMFIF meetings in London to launch his book *Emerging Africa*.

Moghalu said Africa must emulate the strategic thinking of the likes of China, Dubai and Singapore and develop its own distinctive form of 'African capitalism' if it wants finally to fulfil its potential. 'There is a big difference between growth and prosperity. There is a big difference between growth and economic transformation,' he said.

Thinking big

Moghalu's grandiose vision would smack of hubris if he himself were not so forthright about the troubles of a continent that is held back by corruption, rickety infrastructure and poor governance. Nigeria is a case in point. According to local media reports, its economy is poised to leapfrog South Africa's to become the largest in Africa when GDP is rebased to the year 2010. The country's statistics collectors have failed to keep pace with the economy's frantic development, especially in the services sector.

Nigeria, for instance, makes more movies than Hollywood. Nigeria has even received the blessing of the man who coined BRICs. Former Goldman Sachs economist Jim O'Neill has identified Mexico, Indonesia, Nigeria and Turkey – collectively the MINTs - as the next big engines of global growth.

Foreign investors are attracted to Nigeria's entrepreneurship and fast-growing consumer market as well as to its oil and gas. Yet they also see a litany of woes: corruption and cronyism, blatant theft of oil in the Niger delta, chronic power shortages and an intensifying insurgency in the north of the country by the murderous Boko Haram Islamist group.

An immediate risk for investors is that government spending spins out of control in the run-up to elections in 2015 as politicians siphon off the country's oil earnings, forcing the central bank to defend the naira by further tightening monetary policy.

The days when an African central bank governor was at the beck and call of his president to run the money-printing presses flat out were over, Moghalu reassured investors. Yet his own bank, though more independent than it was, is not immune to political pressure. Financial markets should expect no let-up in the tension between spendthrift politicians and a central bank determined to achieve macroeconomic stability.

Finance to the rescue

In his book, Moghalu says a combination of public sector and private capital is needed to transform Africa. The continent's financial sector is making great strides – mobile phone banking is the most striking example – but markets remain largely illiquid. Stock markets are underdeveloped and there is limited access to long-term financing and to venture capital for start-ups.

Finance must be harnessed not solely to create profit but also to generate wealth for nations; it must transform economies by financing not just consumption but also production.

Deputy Governor Kingsley Chiedu Moghalu discusses 'African Capitalism' at his book launch in London.

Viewed through this prism, globalisation was doing Africa few favours, Moghalu said. Inequality was rife. Foreign investors had flocked to Africa to extract its oil and commodities but had largely shunned light manufacturing despite rising costs in China. Nearly everyone in Africa now had a mobile phone; but no one in Africa made mobile phones.

This led Moghalu to ask, referring to the title of his book, whether Africa could truly be said to be emerging. To unlock the 'secrets of prosperity', Africa needed the sort of clear, long-term worldview that had powered economic growth in China for more than three decades.

Building institutions and rules-based systems will be critical to Africa's success. The number of wars in Africa has halved in the past decade and the peaceful democratic handover of power no longer raises eyebrows.

An optimistic interpretation is that powerful elites increasingly recognise that political instability is in their self-interest because it is making them rich. But the benefits are not trickling down to the poor. Transparency in public spending and the award of government contracts is a distant dream in many countries.

As Nigeria's missing oil revenues show, politicians are rarely held to account if money meant for schools and clinics is siphoned off. The European Union has blocked aid to Malawi since vast looting of public funds came to light.

The China connection

Moghalu stresses the need to develop human capital so that Africans have the skills to expand manufacturing. Nigeria's richest man, Aliko Dangote, is proving that Africa can develop an industrial base. He has built cement plants in 14 countries, including one in a remote part of Nigeria, rich in limestone, that will be one of the largest in the world when it is completed.

Dangote, whose empire includes sugar, salt, flour and other food-processing factories, is raising $9bn to build an oil refinery and petrochemical plant on the Atlantic coast. If he pulls it off, Nigeria's bill for imported oil products could be halved, boosting national self-confidence and relieving pressure on the naira. Yet the China irony reappears. According to a profile in the Financial Times, Dangote has relied largely on Chinese companies to build the factories that have made him a multi-billionaire.

Critics might accuse Chinese investors of plundering Africa's resources and employing far too few local workers. But Africa has to show that it can stand on its own feet and rely less on China – and Japan and the US.

That is why Moghalu said he welcomed a recent change in Britain's foreign aid priorities. The UK plans to spend more money on economic growth and jobs instead of programmes such as education and disease prevention.

Traditional aid had kept Africa dependent on an outstretched hand instead of seeking its own solutions. 'Foreign aid has held Africa down for too long,' Moghalu said. 'Only Africans can be Africa's salvation.' ▪

Alan Wheatley is Editor at OMFIF.

Left to right: Consuelo Brooke, OMFIF; Kingsley Chiedu Moghalu, CBN; Eugene Nxumalo, Morena Capital; Meghnad Desai, OMFIF; Razia Khan, Standard Chartered Bank.

Investing in Africa: Long term perspective required

Over the last few years, the 'Africa rising' story has dominated – however, this narrative is an incomplete one, *writes Pierre Van Hoeylandt in London*. In his new book, *Emerging Africa*, Kingsley Chiedu Moghalu highlights the importance of economic development, innovation and the development of human capital to enable Africa to reach its potential.

Africa may be the 'last frontier' but it is a continent of vast differences. So it is with the interest of investors, which varies widely from one country to another.

While the top four countries – Egypt, Nigeria, South Africa and Kenya – account for two-thirds of private equity investment into Africa, and the top 12 account for over 80%, the remaining 40-plus countries account for very little, despite representing a population of almost 500m and a GDP of approximately $700bn.

Recent McKinsey analysis suggests that capital tends to chase the larger private equity deals in Africa. With transactions of $50m and above, supply is likely to outstrip demand, but the opposite is true for deals of less than $15m.

Even in those countries that account for a greater proportion of private equity into Africa, there are regions that have attracted less capital but have the potential for growth. Northern Nigeria is one example – despite its population of 80m people and GDP the size of Angola, very little capital is being invested in the region.

A recent visit to northern Nigeria by the board of CDC, the UK's development finance institution, showed how hard it is to build businesses of value in this market, in particular given the lack of reliable infrastructure. But it also highlighted that there are businesses with growth potential, for example in the agricultural sector, that are succeeding.

CDC's assessment of its performance over the past 50 years points to the difficulties of investing successfully in such challenging markets. At the country level, the political environment is often unpredictable and the regulatory framework rudimentary. At the business level, there are limited investment opportunities and a lack of familiarity with growth investment sources such as private equity.

Despite these obstacles, there is cause for hope. For instance, larger strategic players are beginning to push into some of the frontier countries where resources are abundant and markets exist. CDC recently invested in Feronia, an agricultural production and processing business in the Democratic Republic of Congo.

Such frontier investments require a deep understanding of the local environment, a long-term perspective and the willingness to bring skills to those markets. Finance alone is inadequate.▪

Pierre Van Hoeylandt is Head of Frontier Investments at CDC.

Divergent outlook for Middle Africa

Six key risks investors should watch in 2014

Angus Downie, Ecobank Group

Economic growth in Middle Africa is expected to pick up in 2014 given the brighter global outlook, further investment in export-orientated activities and strong domestic demand. A pace of expansion of around 6% is likely this year, slightly higher than in 2013 and much faster than in developed economies.

There will be significant differences in growth, however, ranging from 15% in Sierra Leone to stagnation in Central African Republic. Equatorial Guinea's economy could contract 2%. Oil exporters are expected to post strong growth of nearly 8% due to rising output to meet increased global demand.

Middle Africa – the vast region between North Africa and the South African rand zone – continues to withstand most of the effects of the 2007-08 global crisis and is expected to remain largely insulated from adverse international economic developments in 2014 and beyond. Still, a number of major risks lie in store, most of them externally driven.

Spillover from euro area crisis

Currency pegs to the euro and/or strong trade links to Europe mean the problems of the single currency bloc could spill over and affect Middle Africa.

The euro area has a serious shortfall in nominal growth, which is likely to translate into weak demand for Middle Africa's exports for years to come.

The euro area never was, and probably never will be, an optimal currency area. This underlines concerns over the potential break-up of the monetary union, particularly for the Francophone countries in Middle Africa that benefit from the peg to the euro.

The euro area banking system is weak, so credit extended to Middle Africa is likely to remain insufficient. Finally, euro area institutions appear slow to recognise and deal with these shortcomings; the longer the delay in tackling them, the greater the impact on Middle Africa.

US monetary policy tightening

As with the euro area's woes, US fiscal problems and tightening monetary policy will affect Middle Africa via two channels: reduced capital inflows as US investments become more attractive and a stronger US dollar that will make Africa's imports more expensive.

US Treasury yields have been rising since late May 2013 when former Federal Reserve chairman Ben Bernanke first mentioned the possibility of monetary tightening.

Now that the Fed has reduced its monthly bond buying by $20bn to $65bn, the risk is that US yields rise further and draw investors out of Middle Africa and back to the US.

Ghana & Kenya

The two economies at greatest risk from the withdrawal of US monetary stimulus are Ghana and Kenya due to their large current account and fiscal deficits.

Currency weakness could become pronounced, particularly in Ghana, whose central bank raised interest rates in early February to 18% from 16% to counter capital outflows.

Real GDP growth in China has been slowing steadily due to tighter credit policies and weaker OECD demand for Chinese manufactures. The slowdown is having a significant impact on Middle Africa. Bilateral trade, which reached $150bn in 2013, is likely to grow more slowly this year, highlighting the risk of relying too heavily on a dominant trading partner.

Risks persist that politics could destabilise parts of Middle Africa. Mali, Niger, Guinea-Bissau and CAR have recently experienced political problems that have disrupted economic activity and depressed growth. These countries remain outliers due to long-simmering, low-level conflicts that have not been resolved.

Political instability

Political stability in Africa has improved steadily over the past decades, reflected in peaceful elections and changes of government in Ghana, Kenya and Senegal. Most of the episodes of instability that do occur are not difficult to anticipate. But assessing how they will unfold over the longer term, and what impact they will have, is a different proposition.

Countries facing challenges that could become more severe in 2014 include Nigeria (the insurgency by the Boko Haram Islamist group), Kenya (the International Criminal Court cases against President Uhuru Kenyatta and his deputy over post-election violence) and Côte d'Ivoire (the pending trial, also at the ICC, of former President Laurent Gbagbo).

External commodity price shocks

Oil has the perennial potential to impose the largest shock on most of Middle Africa. Most countries are oil importers and face a deterioration in their terms of trade from higher oil prices. A 5% increase in Brent oil prices in 2014 would add $1.5bn to the oil import bill of key economies.

Instability in Syria, Libya, and Egypt risks pushing oil prices up, perhaps to $110-115 per barrel, although rapprochement between the US and Iran could work in the other direction. Higher Iranian oil output would help drive down global prices in conjunction with increased supplies of US shale oil.

Financial instability

Given that the global crisis was largely caused by financial sector problems, it is important to continue to monitor the health of the industry. Further bank-related problems, particularly in Europe, would reduce capital flows into Africa.

However, most Middle African banking systems have been somewhat insulated from recent strains because they are not fully integrated into global financial markets. Pressure on African banks' asset quality and liquidity has mainly arisen indirectly via international trade developments.

The outlook for Middle Africa appears reasonably good: domestic demand continues to expand at pace, while the global economy seems to have turned the corner and is strengthening.

However, US and euro area problems are deep-seated and will take years to resolve. That is particularly true of the euro area, which will remain a concern for Middle African economies hoping to increase exports to help fund domestic development.

The six main risks facing Middle Africa each poses a serious economic threat. While it is unlikely that all the risks will be realised this year, they highlight the potential challenges that could derail growth and the somewhat fragile situation Middle Africa still finds itself in.■

Angus Downie is Head of Economic Research at Ecobank.

Moscow needs reforms to expand potential

Russia faces post-crisis slump in growth potential

Iikka Korhonen, Bank of Finland

Since the economic and financial crisis of 2008-09, Russia has been struggling to return to the fast growth rates it enjoyed in 2000-07. Several factors have contributed to the slowdown, but it is clear that potential output growth is now much lower than many analysts thought during the boom years (see Chart 1).

Between 2000 and 2007 Russia's GDP increased by more than 7% a year on average. Even though the global economy was enjoying a period of rapid growth, Russia's performance was impressive.

Partly this can be explained by ever-higher oil prices, as crude oil shot up from \$20 a barrel in 2000 to more than \$140 in the summer of 2008.

Export revenue

As energy products constitute some two-thirds of its exports, Russia enjoyed a financial windfall. Moscow pursued a conservative fiscal policy during this period, using much of the extra tax take to pay down old Soviet debts and then to build a sizeable sovereign wealth fund. But the additional export revenue still translated into increased investment and consumption.

Russia's growth did not come only from oil. Many other factors played a part. Russia was partly still a transition economy, shifting resources from old, non-productive uses to other, more market-orientated sectors.

This development, together with business-friendly reforms in the early 2000s, led to faster productivity growth.

Finally, in 2005-06 Russian companies and households started to borrow more, using the funds for both investment and consumption.

Productivity growth

Since the 2008-09 crisis, things look very different. Productivity growth had already decelerated markedly before the crisis and has not picked up. There are a number of explanations for this, but it is clear that the Russian government has not been too keen on reforms that would increase competition.

For example, accession to the WTO could have been an opportunity to foster competition and hence productivity in many Russian markets. Instead the authorities seem more concerned about finding ways to support incumbent companies and to stifle competition.

The stance of the authorities ties in with concerns about the business environment in Russia. Russia is still an emerging economy with a relatively low level of income.

Per capita GDP is about one third of the US level using exchange rates adjusted for purchasing power. So one would expect to find many excellent investment opportunities in the country.

However, Russia's investment is only 20% of GDP, trailing far behind countries such as India, not to mention China. In fact, Russia's relatively large current account surplus has usually been invested abroad. Potential investments in Russia often do not get off the drawing board.

Business environment

For many companies, Russia's business environment and regulations are difficult to navigate. This increases the cost of investing and operating. Complying with the authorities' requirements can be cumbersome, which opens the door to corruption.

This is a particular scourge for small and medium-sized companies, which find it difficult to grow beyond a certain size. Larger foreign and domestic firms have become more accustomed to operating in the present environment.

The current state of affairs reduces Russia's attraction as an investment destination. It probably also makes the country more vulnerable to external shocks.

For example, recent turmoil in emerging market economies has hit countries with large current account deficits the hardest. The rouble has fallen sharply in recent weeks, although Russia still has a sizeable current account surplus (see Chart 2). This reflects, among other things, investors' views of the Russian economy.

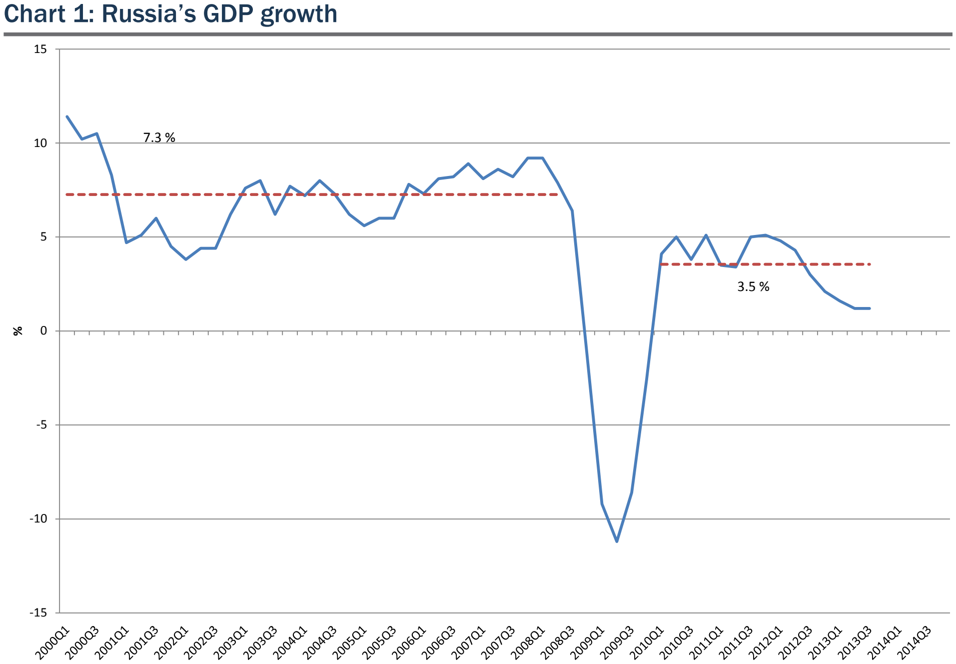
Demographic decline

Even if Russia's business environment were to improve as it did in the early 2000s, other factors would constrain growth in coming years. Demographic decline is one important cause. Although fertility rates have recently improved slightly and Russians live a bit longer, the working-age population peaked a few years ago at 103m and will continue to shrink for at least another 15 years.

Those who will come of working age during the next two decades have already been born, so we can say with confidence that in 2025 Russia's working-age population will be only slightly greater than 85m.

That would mark a fall of about 20% in less than three decades, a slump portending

Chart 1: Russia's GDP growth



Source: Rosstat

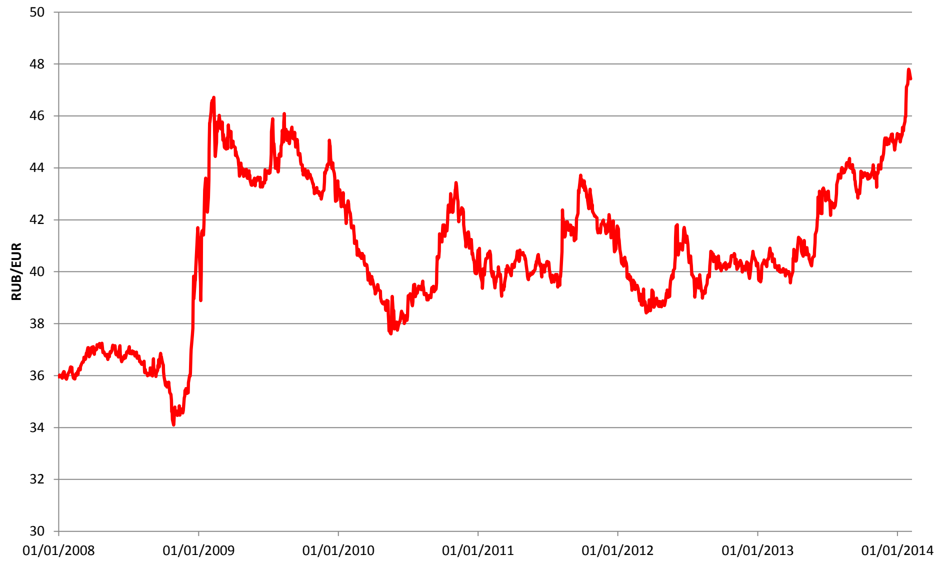
much slower GDP growth unless labour productivity shoots up.

Finally, much will depend on the global economy. If growth remains lacklustre and the price of oil stays at current levels, Russian growth will need to rely more on domestic demand.

However, if oil prices start to rise again, investment will get a boost, as will private and public consumption. Unfortunately, the futures markets are pointing to lower oil prices in coming years, a prospect that makes pro-growth reforms in Russia more urgent.▪

Iikka Korhonen is Head of the Institute for Economies in Transition (BOFIT) at the Bank of Finland. BOFIT conducts high-level research on transition economics, focusing on Russia and China.

Chart 2: Rouble/euro exchange rate



Source: Bloomberg

A sober outlook for growth in Finland in a still-volatile euro area

On 6 February, the Bank of Finland and OMFIF organised the first Economists Meeting in Helsinki. Officials from the central bank, including Deputy Governor Pentti Hakkarainen and Member of the Board Seppo Honkapohja, were joined by leading Finnish banking and financial experts alongside international economists and capital market specialists.

They discussed Finland's economic prospects, links with the country's Scandinavian neighbours as well as with Russia and China, and the situation in the euro area.

While the public debt outlook is rather benign in Scandinavia compared with the euro area average, private sector indebtedness is a cause for concern.

Finland is losing market share in Russia and China, but the fact that its exports go to a broad spectrum of countries is providing a cushion.

Participants exchanged views on whether Finland's negative growth in the last two years was structural or cyclical and how policy could build on support productivity and economic expansion following progress made in current account rebalancing and restraining wage growth.

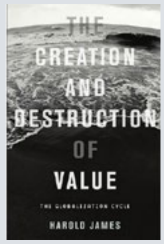
Hakkarainen in his lunch speech addressed banking union. Together with the outlook for financial stability in the euro area and how to break the bank-sovereign nexus, this was a recurring topic of the meeting.

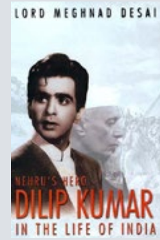
Alternative EU/euro system fiscal institutions for the future were discussed. These institutions are important for the success of the single currency.

Looking ahead to elections for the European Parliament in May, it seems that Europe faces a paradox: without an economic success story to tell, political integration will be difficult; yet political integration is a precondition of stronger economic growth.▪

Economists Meeting participants at the renovated Bank of Finland Museum

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





The makings of a reserve currency

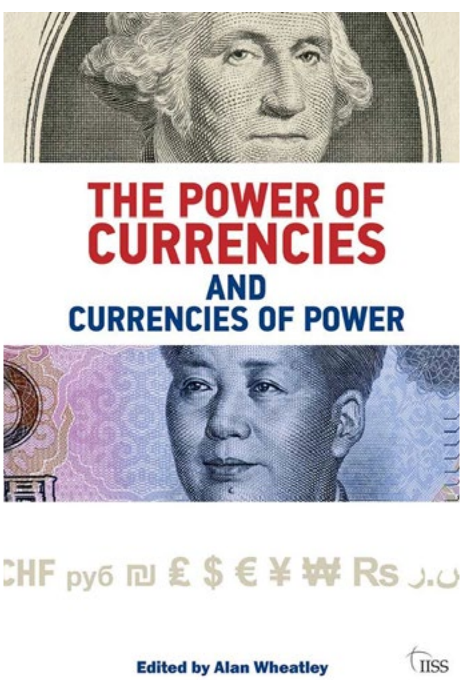
Renminbi sets sail on what could be a slow voyage

John Nugée, Senior Adviser to OMFIF

This is an ambitious book. In only just over 150 pages, the authors have tackled no fewer than four large and important subjects: the role and function of a reserve currency; the rise of the dollar to that position since the War and the use the Americans have made of their power; the outlook for the system of reserve currencies and the move to a multi-currency world; and finally the prospects for the renminbi.

Each of these four topics could easily sustain a book on its own, and inevitably the format of separate essays by different contributors means that the chapters adopt different styles and some areas are covered in more depth than others.

But Alan Wheatley, the book's editor, has been well served by his fellow writers, with some fascinating details on the use of American financial power in the intelligent sanctions imposed on Iran and a powerful chapter by Yuriko Koike, a former Japanese defence minister, observing the rise of China and the implications of an internationalised renminbi from Tokyo's viewpoint.



The discussion of these two topics is perhaps the high point of the book – interesting, relevant and, to this reviewer at least, offering new insights. Elsewhere, the need to concentrate the analysis to fit the space available may lead some students of the subject thirsting for deeper treatment of the many issues that are raised.

The question of how a currency actually becomes a reserve currency (and whether a state can actively promote its currency as such, or whether it just emerges into the role); the balance of advantages and disadvantages for the issuing country of having a reserve currency; the challenge of the Triffin Dilemma, which the US has never solved satisfactorily; the role of regional reserve currencies in an increasingly global world – all these are touched upon without quite enough space for detailed analysis or definitive answers.

This is important, because much of the forward-looking section of the book, where the writers consider what might follow the dollar-based world of today, makes the twin assumptions that, firstly, China, as the future largest economy in the world, will be able to achieve for its currency whatever it wants and, secondly, that what it will want is reserve currency status, either alongside the dollar or in its place.

While the first assumption is largely uncontroversial, the second is more interesting: not every country that has had the capacity to internationalise its currency has shown the desire to do so (West Germany and Japan both tried hard to avoid their currencies being internationalised in the 1970s and 1980s), and issuing the world's reserve currency is not an unalloyed positive for the country concerned.

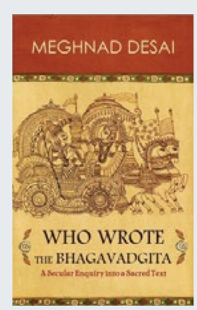
This is the challenge that faces China's leaders, and they are well aware of it; the answers are not obvious and by no means all point to a rapid move to reserve currency status for the renminbi.

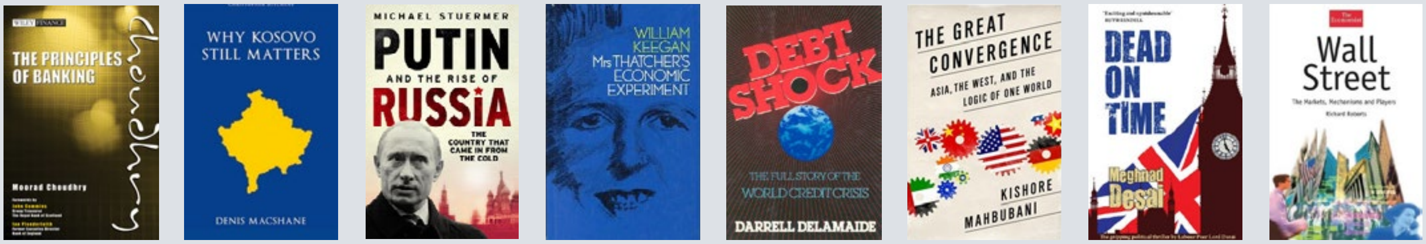
In suggesting some of the issues they will need to bear in mind as they address their strategic options, this book will be eagerly read in Beijing and elsewhere.▪

John Nugée is Senior Adviser to OMFIF and a member of the Advisory Board.

A secular enquiry into a sacred text

In his latest book, *Who Wrote the Bhagavadgita: A Secular Enquiry into a Sacred Text,* Lord (Meghnad) Desai, chairman of the OMFIF Advisory Board, adopts a more controversial approach to the Hindu scripture. Desai explores the Bhagavadgita – part of the Hindu epic, the Mahabharata – as a human creation, as well as its origins, considering multiple authors over several centuries. He further examines the scripture's negative and potentially destructive themes, such as social inequality and violence, and their implications. To obtain copies of the book, contact Element Books.▪





Of dreams and inconvenient dilemmas

A cry from the heart to save the EU

Willem van Hasselt, Ministry of Foreign Affairs, The Netherlands

François Heisbourg is a highly respected French intellectual with more behind-the-scenes knowledge of strategic and military thinking than most of us. He has written a book on the EU and the euro that is worth reading.

Most media attention has been on the author's conclusion that the euro must be dismantled to save the EU, an idea quickly rejected by many. You may find this 'shock therapy to save Europe' unsettling, but do read the book first before you judge.

Heisbourg – whose authority in the field of high politics gives depth to the analysis – interprets the European integration process since 1951 with a focus on roughly the last 25 years. What he calls the 'Kohl-Mitterrand Pact' laid the groundwork for post-Cold War Europe, German reunification in the context of the EU and EMU, and the opening of the union to countries in central and eastern Europe.

Yet referendums in France and the Netherlands in 2005 rejected a constitutional basis for the EU, and implicitly for the euro. EMU appeared unprepared for the shock of a financial crisis of American origin. In 2010 the Greek debt drama became an EMU-crisis to which the ECB could not respond in the way the Fed had. Youth unemployment spiked, risking a lost generation in some member states.

As to enlargement, fear of the 'Polish plumber' grew stronger than the constitutional patriotism of the German philosopher Juergen Habermas. Thus, two decades of EU and five years of crisis later, the European Dream – according to Heisbourg – has dissipated.

Our European dilemma, he writes, is that 'without the federalism that no one wants, EMU cannot survive'. A response might be that no 'pur sang' federalist has attended European Council meetings for many years and that EMU has been gradually strengthened, restoring market calm.

Yet this does not do justice to Heisbourg's message: will the right competences be transferred to the EMU core effectively and swiftly enough to save the euro at a time when electorates are sceptical? Monetary union has been built on inadequate economic, fiscal and political foundations. The huge effort to save an unbalanced EMU and euro puts the existence of the EU at risk.

Heisbourg observes that the EU and the euro have become like Siamese twins. Separating them is a complex surgical operation. If successful, only one survives. For Heisbourg it is the EU that has to be kept alive. It is because of the EU and its economies of scale that member states are able to face up to the challenges of globalisation.

La fin du rêve européen is a thought-provoking but tragic book, written by a prominent thinker from the country that was 'demandeur' of the euro. It is tragic because the proposed solution – an orderly dissolution of the single currency as part of a Franco-German initiative – looks politically unfeasible. Remember Angela Merkel's words: 'If the euro fails, then Europe fails.'

Is Heisbourg's proposed escape from our dilemma really convincing? Why, at least, did he not examine less radical options, for example a far more sophisticated European Monetary System orbiting a much smaller EMU core? Erik Holm, a Dane, set out the case for such an arrangement in the OMFIF Bulletin three years ago.

More fundamentally, the political reality behind Heisbourg's dilemma is that, from the euro's conception until this very day, France and Germany have never fully agreed either on the institutional underpinnings of the currency or on the E and M of Economic and Monetary Union.

Although the author touches upon the two countries' deep differences over economic governance, as a federalist he could have said more about their conflicting institutional views. 'Political union is the essential counterpart of economic and monetary union,' Chancellor Helmut Kohl told the Bundestag in November 1991. President Francois Mitterrand, protective of French political sovereignty, was having none of it.

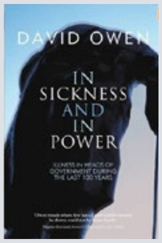
La fin du rêve européen is a sincere and deeply reflective politico-intellectual 'cri de coeur'. It will disappoint readers in search of easy answers to an inconvenient dilemma at the heart of our European project, but someone had to write this book to have us look in the mirror. ▪

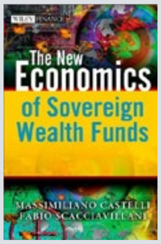
Willem van Hasselt is EU Strategy Advisor to the Ministry of Foreign Affairs, The Netherlands.

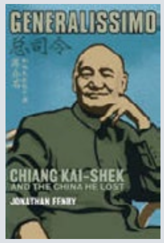
中国资本账户自由化
从全球各国汲取经验教训
Capital account liberalisation in China
Guidelines from global experience

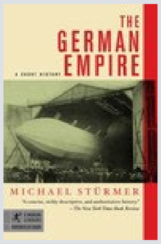
Capital account liberalisation in China: Guidelines from global experience is being published in cooperation with the Chongyang Institute for Financial Studies, Renmin University of China. A Chinese version of the report is being launched at a joint OMFIF-Chongyang Institute seminar in Beijing on 21 February 2014.

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









A tangled tale of bullion booty

Real-life Reichsbank thriller tracks looted Dutch war gold

Roel Janssen, Advisory Board

Nearly half of the gold looted by the Nazis from the Dutch central bank during the Second World War remains to this day in Switzerland, a reminder of the Alpine nation's controversial role as a financial conduit for Hitler's regime. About 61,000kg of Dutch war gold, currently valued at about €2bn, is believed to be still in Swiss possession.

During the Nazi occupation of the Netherlands, 145,650kg of monetary gold and gold coins that Dutch citizens were forced to hand over to the central bank were transported to the Reichsbank in Berlin. After the war, the Tripartite Gold Commission (TGC), set up in 1946 by the US, France and the UK to return gold stolen by Germany, handed back about 71,820kg of gold to the Netherlands – less than half of the total. In 1998, the TGC made its final share-out and was dissolved.

Looting of Dutch gold

The story of the looting of Dutch gold and how it ended up in Switzerland is told in my documentary thriller *Fout Goud (Guilty Gold)*. The book, which comes out in the Netherlands on 20 February, combines historical facts with a fictional plot.

The Reichsbank sold about 80% of the gold it stole from occupied countries to Switzerland to obtain convertible Swiss francs to pay for imports needed by Germany's war machine. Smaller amounts were sold to Sweden, Spain, Portugal and Turkey.

In December 1946, Switzerland and the US, acting on behalf of the TGC, signed the Washington Agreement. The Swiss, who denied any wrongdoing by buying gold from Germany during the war, agreed to hand over 52,000kg of gold (SFr250m) to the commission for the 'economic recovery of Europe'. The Agreement gave Switzerland a waiver for any future claims on gold it had bought from Nazi Germany.

A few years later it became clear that Switzerland had bought at least 336,300kg of gold from Germany during the war. Of the Dutch gold that was transported to Berlin, about 122,000kg ended up in Switzerland.

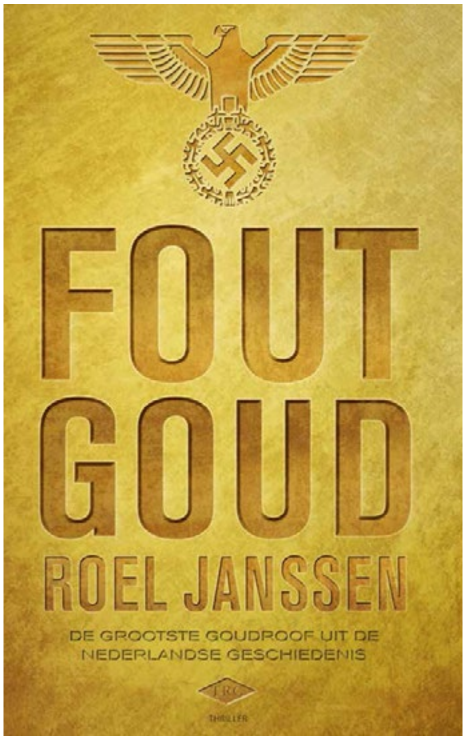
When the Dutch demanded their gold back, the Swiss refused to discuss the claim, citing the Washington Agreement. Despite arduous diplomatic and legal efforts in the 1950s and 1960s the Swiss were adamant: returning any more gold was out of the question. When the TGC was dissolved at a conference in London, the Netherlands stated that it maintained its claim against Switzerland. Two years later, the Dutch government endorsed the conclusions of a national war-gold commission that further efforts to recover the gold were futile.

Neither parliament nor Dutch society was told about the decision silently to shelve claims on the stolen war gold that remained in Swiss vaults.

In 1996, publications in the UK stirred up the question of Jewish gold and dormant Jewish bank accounts in Switzerland. In the end, Swiss banks were forced to repay $1.25bn to Jewish victims. The Swiss government added $500m to the settlement, though it denied any wrongdoing. The value of the Jewish gold was much smaller than the stolen monetary gold.

In my fictional retelling of the looted Dutch gold, the main protagonist inherits 15 gold coins from his grandmother. He decides to find out what happened to the gold during the war.

His search takes him to underground shelters and bunkers in Berlin and to the salt mine in Merkers, where the American Third Army discovered the remains of the Reichsbank's gold reserves in the final weeks of the war.



***Fout Goud (Guilty Gold)* will be published in Dutch on 20 February and launched at the Dutch central bank, De Nederlandsche Bank.**

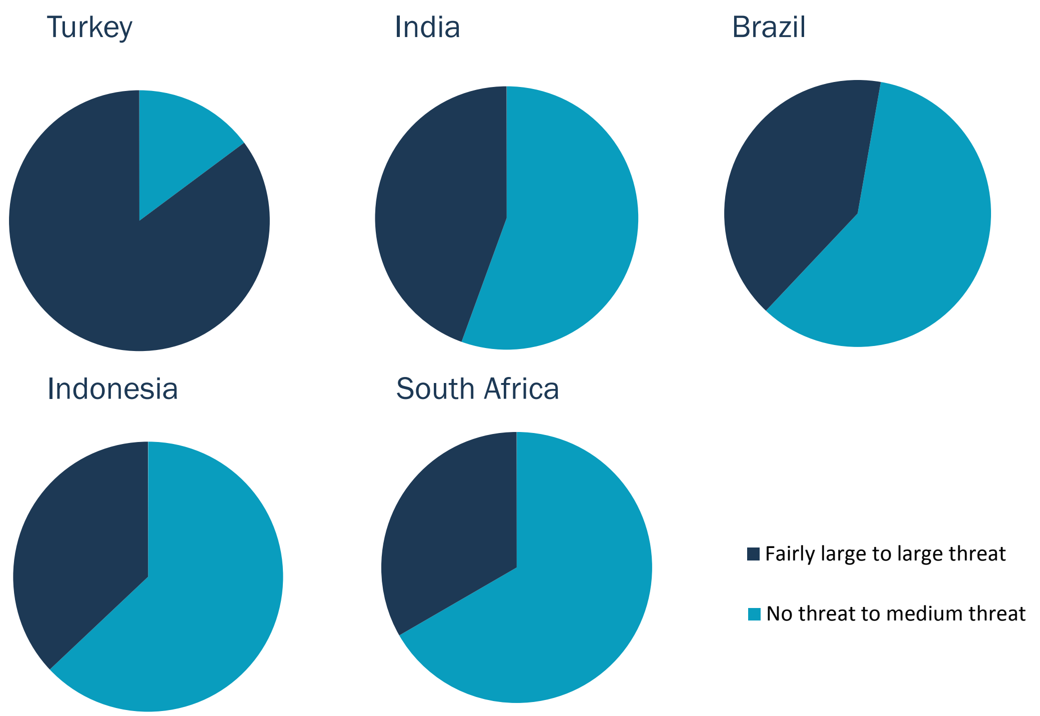
The Bundesbank's announcement in 2013 that it would ship its bullion reserves back to Frankfurt prompts the Swiss central bank to repatriate its gold too. The story ends with a spectacular attempt to recover a cache of gold in Switzerland.▪

Roel Janssen, member of the Advisory Board, is a financial journalist at the NRC Handelsblad.

On the web

To obtain copies of the book, visit www.uitgeverijcargo.nl or www.bol.com.

Five large emerging market economies which were hit by financial market fall-out last summer face important elections this year: Brazil, India, Indonesia, Turkey and South Africa. Members of the Advisory Board were asked whether political and economic developments in each country will pose a threat to international financial stability. Turkey and India were thought to present the gravest threats to stability, followed by Brazil, Indonesia and South Africa. The charts below show the percentage of Advisory Board members polled in January who favoured certain positions.



'This is largely based on both the likelihood that things will go wrong, and the likelihood that if they do, it will roil international markets. On the whole, Indonesia is not connected enough and international exposures to the country are not systemic, while South Africa is really much more difficult to destabilise than most people think (if Zuma hasn't been able to). But Turkey is both close to exploding and in an explosive part of the world.' **— John Nugée**

'Brazil: long term, structural problems; but short term, nothing that a little exchange rate flexibility can't cure. India: they'll be fine as long as Raghuram Rajan runs monetary/financial policy. Turkey: the political situation is worrisome and they need a sizeable adjustment.' **— Eduardo Borenszetin**

'Without exaggerating the exposure of these "Fragile Five" to the risks of tapering by the Fed, there appears to be considerable vulnerability stemming from the large current account deficits and fiscal deficits. But if the adjustment to tapering is not disorderly, the threat to international financial stability may not be that significant.' **— Hemraz Jankee**

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