The Bulletin

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

Staying afloat

Greece's euro

Bronwyn Curtis & **William Baunton** on gold
Meghnad Desai on options for Alexis Tsipras
George Hoguet on renminbi and SDR politics
José Manuel González-Páramo on banking union
Anthony Robinson on shifting power in Ukraine
Niels Thygesen & **William White** on Asia

OMFIF

Greece's euro

In the aftermath of Greece's election on 25 January, creditors and debtors in Europe have been engaged in a tactical and strategic battle about stabilising the European single currency. For the time being, it has become Greece's euro. Prime Minister Alexis Tsipras and his Finance Minister Yanis Varoufakis are in the eye of the storm. But the bigger question marks hang over how Germany will come to terms with deep-seated expectations of changes in euro area policies.

Leung's new role

OMFIF author Julia Leung will become executive director of the Investment Products Division of the Securities and Futures Commission in Hong Kong.

Leung was executive director of the Hong Kong Monetary Authority and Hong Kong Treasury undersecretary. She is author of *The Tides of Capital*, published by OMFIF Press and available on Amazon.

International monetary policy

Europe and the euro

Emerging markets

Review

Testing euro fire-wall may require a fire

One reason for a certain equanimity about a possible Greek euro exit is that, during the past three years, Europe has constructed significant fire-walls separating the Greeks from the rest of the single currency bloc. The day is fast approaching when Europe may examine how strong they are. No one wishes to test a fire-wall by starting a fire, but that is what may happen. The logical extension of the growing confrontation between Greece and its creditors is that Alexis Tsipras, the new Greek prime minister, will get ready to break from the euro, perhaps by issuing stocks of parallel domestic currency (or stamping current euro banknotes with a Greek emblem).

One of the reasons why policy-makers are digging in is because the issues are so complex and intertwined that resolution is well-nigh impossible. Almost any theoretical agreement is bedeviled by fresh dilemmas. So politicians seek refuge in established positions. See p.12-14.

New ECB building in Frankfurt

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Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent research and advisory group and a platform for 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.

Advisory Board

OMFIF's 169-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, weekly Commentaries, seminars and other OMFIF activities.
See p.16-17.

The Bulletin

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

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

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Letters provide opinions from our readers with points of view on the subject matter in our Bulletins and Commentaries.

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OMFIF Meetings take place within central banks and other official institutions. The frank and confidential nature of meetings provides for a deep-seated exchange of views and best practice.

A full list of past and forthcoming meetings is available on www.omfif.org/meetings

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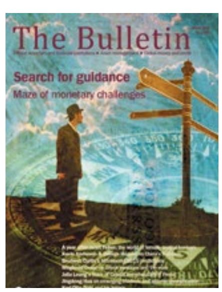
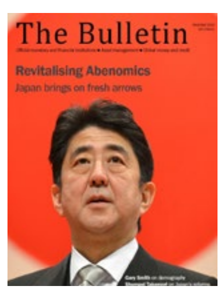




EDITORIAL

Brinkmanship and potential breakdown over Greece

The new government in Greece led by far-left Syriza has introduced a note of brinkmanship and potential breakdown into dealings on European money, with reverberations that could spread around the world. For the first time, a government has taken office in a euro member country that is implacably opposed to the programme of economic structuring, spending cuts and revenue enhancement prescribed by the European Union as the recipe to heal the single currency's malaise.

The worry about Alexis Tsipras, the Greek prime minister, and Yanis Varoufakis, his composed, tough-talking finance minister, is that their policies could lead to Greece's ejection from the euro (or, possibly, Germany's departure). Room for compromise exists – but it is rather narrow. Whatever the outcome of negotiations on Greece's fate, policies applied to Athens will set a template for other euro area debtors. For all these reasons, we devote considerable space to a decisive chapter on the euro's 15-year history.

Vicky Pryce surveys the options facing the Tsipras government, which have diminished further after the European Central Bank's decision to stop accepting Greek government paper as collateral for loans to banks. Meghnad Desai says the Athens government, now that it has won voters' confidence, has little choice but to maintain the resistance to austerity that brought Syriza to power. On the international monetary scene, George Hoguet delivers a double bill: an essay on China's chances of bringing the renminbi into the Special Drawing Right, and a review of former Treasury official David Mulford's book on world monetary affairs. Darrell Delamaide explains why the Federal Reserve is now adopting patience over the long-expected tightening of monetary policy. Anthony Robinson ranges over Russia's confrontation course in Ukraine and explores the special role played by Kazakhstan in efforts to find a solution. José Manuel González-Páramo looks at the unfinished business of European banking union.

In our emerging market round-up, coinciding with renewed interest in gold as a result of negative yields in many prime bond markets, Bronwyn Curtis and William Baunton delve into the role of developing nations' central banks in purchases of the yellow metal. Steve Hanke investigates the parallels between today's problems in Russia and the dilemmas that Indonesia faced in 1997-98. Philip Saunders, John Stopford, Max King and Aniket Shah say emerging market investors have to pay attention to the quality rather than simply the quantity of growth. One country where this adage needs to be put into effect, Winston Moore opines, is Bolivia. We round off with two reviews, by Niels Thygesen and William White, of Julia Leung's book from the OMFIF Press, *The Tides of Capital*, containing Asian precepts for a more stable and sustainable monetary future. ▪

ECB rules do not rule out risk-sharing

National central banks cannot avoid QE exposure

Frank Westermann, Advisory Board

An important element in the European Central Bank quantitative easing programme starting next month is the limit on risk-sharing, with risks from asset purchases residing largely with national central banks carrying out the operations.

Individual euro members, or the euro system as a whole, really cannot avoid being exposed to risks from individual national central bank's (NCB) bond purchases. But the technical practices and accounting rules of the euro system have been framed in such a way that the issue of possible central bank losses arising from purchase of government securities can be successfully hidden for many years. The timing of the crystallisation of losses, and the definition of who will bear them, will remain extremely opaque.

Through NCB asset purchases, new money can flow freely across borders, reshaping frameworks of assets and liabilities in a way that renders ineffective the ECB's risk-limitation arrangements. Consider the position of a euro area government that anticipates imminent difficulty repaying bond issues purchased by a NCB under the QE programme. As long as these bonds are eligible collateral, and the ECB maintains its full allotment policy, the government concerned should be able to find a private bank that will buy newly issued bonds. The private bank can use these bonds as collateral to obtain refinancing loans from the central bank. And the government can use the revenues to repay the maturing bonds held by the NCB.

From the central banks' perspective, collateralised loans would replace the purchases of the now-maturing bonds – but unlike bonds, these loans are subject to loss sharing. Also, the government does not need to default, as – indirectly, via the private banks – it will continue to have access to central bank financing. Furthermore, a fall in prices will not immediately lead to losses; there is no 'fair value' accounting for bonds purchased under QE, as they are classified as 'held to maturity'.

The International Accounting Standards Board has recently introduced the IFRS9, which ensures a more conservative approach by applying the 'expected loss model'. As long as the euro area does not implement this, however, and countries do not explicitly default, sudden write-offs of losses – individual or shared – are unlikely to happen in the near future. The issue of central bank losses from QE will preoccupy us for many years. But, if and when they are crystallised, the losses are likely to be borne by the euro system as a whole. ▪

ADVISORY BOARD

OMFIF has appointed Bahar Alsharif to the Advisory Board, which has risen to 169 people, subdivided into six groups ranging from Capital Markets & Investments to Economics & Industry. For the full list of members see p.16-17.

Bahar Alsharif has over 25 years' experience in treasury operations and portfolio management. She is Deputy Treasurer at International Finance Corporation, overseeing global expansion to Europe and Asia. She was previously in charge of the Cash Management Desk, managing IFC's short-term fixed income portfolio, foreign exchange and banking relationships. She oversaw the setting up of investment portfolios in local currencies and emerging markets and the launch of a first-in-kind offshore Chinese renminbi discount note programme in 2012. Alsharif holds a BA in Economics and a Masters in Business Administration and joined the World Bank Group in 1985. She joins the Capital Markets & Investment panel.

BRIEFING

Greek finance minister outlines reform and debt measures

Yanis Varoufakis, the Greek finance minister, set out his plans for reform, growth and debt alleviation at an OMFIF meeting in London on 2 February. Varoufakis outlined a plan for debt relief through exchanging parts of Greece's €320bn public sector debt into low coupon perpetual bonds. Greece's Syriza-led government strategy of ending obfuscation over the country's effective bankruptcy was laid out to OMFIF members including (left to right) Filippo Cartiglia, David Marsh, Philip Middleton and Lord Norman Lamont. Varoufakis made clear that Greece wants to end its long period of submission to the 'troika' of international creditors and adjust its economic programme to allow growth. He sees an eventual compromise as paving the way for similar treatment of other euro bloc debtors.

OMFIF CITY LECTURE

Masaaki Shirakawa cautious on quantitative easing

Masaaki Shirakawa, former governor of the Bank of Japan (left), voiced caution about the overall impact of quantitative easing in remarks at the OMFIF City Lecture on 27 January at Armourers' Hall in London.

Shirakawa listed parallels between QE in Japan and Europe, not hiding his scepticism about whether the policy would achieve its intended goals of boosting inflation and growth. Among the points of convergence, Shirakawa said, was the widespread perception that the central banks in both jurisdictions were 'the only game in town', and that exchange rate considerations – bringing down the value of the euro and the yen – were predominant. He outlined the challenges for Japan in coming years, from boosting growth and labour force participation to increasing productivity. Lord Meghnad Desai (right) suggested that Japan might have reached an ideal state of being: great wealth, a shrinking population, and little expectation of paying debts.

BILATERAL

China and City of London collaborate on banking regulation

Cross-border supervision and China's recovery and resolution plan were the themes of a dinner with members of the China Banking Regulatory Commission at the London Capital Club on 27 January. Following meetings with the City of London and the Bank of England's Prudential Regulation Authority, the CBRC hopes to learn from UK banking regulators' experience, and to improve bilateral banking co-operation. The CBRC visit is part of intensive exchanges with London, aiming to strengthen the city's role as a renminbi hub in enhanced world use of the Chinese currency.

ECONOMISTS MEETING

Central banks 'risk becoming agents of fiscal policy'

Against the backdrop of the Greek election and the Swiss National Bank's decision to end its peg to the euro, participants at the Economists Meeting at the Deutsche Bundesbank in Frankfurt on 28 January discussed the uncertainties ahead for the euro area.

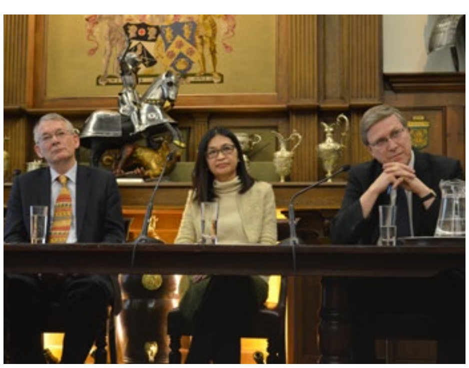
The ECB's QE programme will have implications for Germany and Europe. Delegates voiced the view that central banks risk becoming agents of fiscal policy. This could mean that governments become used to their 'lender of last resort' role. QE will not work if governments do not take the opportunity to implement reforms. Regulatory and liquidity requirements force many banks to hold sovereign assets. One delegate asked why commercial banks should trade the one asset they were told would increase in value.

Another widespread opinion centred on the lack of incentives for banks to contribute to volume. The effects of QE on the real economy are difficult to foresee. It was suggested that the reason QE worked in the US is that, when the Fed embarked on the programme, the Treasury simultaneously issued more debt. In Europe, this path is blocked by the stability and growth pact.

BOOK LAUNCH

Asian policy-maker recounts currency tussles

The west should beware of sparking negative reactions from Asia by refusing to adapt rules of international monetary behaviour to world economic realities, said Julia Leung, former Hong Kong Treasury undersecretary, subsequently appointed to a key Hong Kong regulatory role. Speaking at the launch of *The Tides of Capital* at Armourers' Hall on 27 January, Leung defended measures taken by Asian countries to protect their economies from the damaging effects of swirling international capital flows sparked by unorthodox western monetary policies. In *The Tides of Capital*, Leung recounts behind the scenes tussles during the 1997-98 Asian financial crisis and the global turbulence a decade later. She calls for greater coordination on world economic polices between the US and Asia, including a more important role for China. The book is available at a discount to OMFIF members. Please contact editorial@omfif.org.



Clockwise from top left: Meghnad Desai, Julia Leung and Masaaki Shirakawa at the London launch; Julia Leung; Peter Taylor, Peter Montagnon, John Nugée and Masaaki Shirakawa; Julia Leung and David Marsh at the Frankfurt launch; Pooma Kimis and Koichi Katakawa; David Marsh, Julia Leung and John Nugée

Fed panel grows 'patient' with new voters

Low inflation may delay action on interest rates

Darrell Delamaide, US editor

The Federal Open Market Committee this year may not only be more dovish after four new regional bank presidents rotated into voting positions, but, tellingly, also more 'patient.'

Patient is the new code word for Federal Reserve officials to signal to the market that lift-off – the first move off zero-bound rates in more than six years – may be three months away.

The FOMC statement from the late January meeting contained the magic word, indicating that June is now the earliest meeting one should expect an interest rate hike.

In fact, the market now seems more inclined in its pricing of Treasuries to think that September will be the target date for action. For one thing, Fed watchers note, bad winter weather could distort economic data too much for policy-makers to feel comfortable removing 'patient' from the statement in March.

The January statement was unanimously approved by the 10 voting members of the panel, after the three members who dissented in December rotated out of voting positions.

In the meantime, the only FOMC members talking up early action are non-voters. Voting members are either keeping mum – none of the five governors of the Federal Reserve board made any public comments about monetary policy – or affirming that they are patient for the time being.

Atlanta Fed chief Dennis Lockhart (voter), a centrist on the panel, reiterated ahead of the January meeting that no hike was likely before summer. 'If the early months of this year bring mixed news on the economy,' Lockhart continued in a speech in Atlanta, 'the risk manager in me will lean to preferring a later date for the first policy move to an earlier one.'

Inflation moving at 'deliberate speed'

Lockhart indicated that inflation, which continues well below the committee's 2% target, would be the key to timing.

Referring to the Fed's dual mandate of stable prices and maximum employment, he said 'the biggest factor influencing the actual timing of a liftoff decision should be the Committee's confidence that these objectives will be achieved in an acceptable timeframe and, especially, that inflation will move at deliberate speed toward the target of 2% per annum.' Jeffrey Lacker (voter), head of the Richmond Fed, was notably cautious even though he tends to be hawkish. Although the Fed focuses on 'core inflation' stripping out the impact of volatile energy and food prices, he worried that plunging oil prices could impact core price stability.

'In past episodes of large energy price movements, we have seen some bleed through into core inflation, and that seems to be happening again,' Lacker told a business group in Virginia. 'As a result, inflation trends may be a bit more difficult to discern in coming months.'

He said he nonetheless expected inflation to move in the direction of 2% target after the fall in energy prices 'has played out.'

But, he concluded, 'there is no pre-set timetable for raising rates. The FOMC's actions genuinely will depend on the economic data available at the time.'

Lift-off approaches

Other voting members were expressing even more dovish sentiments. Given that inflation is still well below the Fed's target, Chicago Fed President Charles Evans (voter) told CNBC-TV he is 'in favour of being patient' on raising rates.

'We shouldn't be raising rates before 2016 if things transpire as I'm expecting,' Evans said.

San Francisco Fed President John Williams (voter) told reporters at an economist meeting in Boston that improving employment and a growing economy was bringing the moment of liftoff closer. But, he added, 'I see no reason whatsoever to rush to tightening. I don't see any upside risks to inflation.'

Boston Fed chief Eric Rosengren (non-voter) echoed this sentiment in an interview with The Wall Street Journal. He worried that if the Fed systematically missed its 2% target, inflation expectations would not remain anchored.

'It is too early to make that assessment, but it is certainly something that we need to be aware of,' Rosengren told the Journal, 'and is a reason to be patient until we start seeing some evidence in wages or prices that the kind of inflation dynamics we're expecting in our model is actually going to happen. The evidence to date is pretty sparse on that.'

Other non-voters, however, are less patient, and think it's time for the Fed to begin 'normalising' monetary policy.

Charles Plosser (non-voter), head of the Philadelphia Fed, is not concerned about inflation and is already sufficiently confident it is moving toward 2%. Plosser, who will retire in March, has consistently urged the FOMC to get ahead of the curve on inflation and raise rates sooner rather than later.

Federal Reserve governors in discussion

'I believe the economy has returned to a more normal footing, and as such, I believe that monetary policy should follow suit,' he told a business audience in Philadelphia.

Time to 'get going'

A return to normalcy is what St. Louis Fed chief James Bullard (non-voter), would also like to see with the economy and employment clearly on a growth trajectory.

'I think it is important to get started and to start normalising policy,' he said in an interview with The Wall Street Journal.

For one thing, he noted, rates would remain extremely low even if the Fed were to raise them. 'We're talking about levels of 50 basis points or 75 basis points,' he said. 'That is still extremely low and that would still be putting upward pressure on inflation even if we did that. So I'd like to get going. I don't think we can any longer rationalise a zero interest rate policy.'

Newcomer Loretta Mester (non-voter), who took over as head of the Cleveland Fed last year, made the same point in urging a rate hike in the first half of the year.

'Even after we raise interest rates for the first time, the so-called lift-off, the monetary policy is going to remain very accommodative,' Mester said in an interview with Fox Business Network.▪

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

Why criteria matter on the SDR

China's renminbi initiative and dollar 'hegemony'

George Hoguet, State Street Global Advisors

China's suggestion that the renminbi be included in the Special Drawing Right – the IMF reserve asset made up of a basket of currencies – raises important issues for China and the world.

Market participants may view it as containing some internal contradictions. Does China seek to promote greater use of the renminbi as a reserve currency, greater use of the SDR as a reserve currency and private unit of account, or both? And when?

Criteria matter

To the extent that the renminbi is perceived *not* to meet the current criteria for SDR inclusion, its inclusion could lessen the already non-existent interest among market participants in the SDR as a currency of bond issuance and investment. On the other hand, to the extent that the renminbi *does* meet the criteria, and means are developed to provide liquidity for SDR-denominated bonds, inclusion could, over the next 25 years, enhance both the official and private use of the SDR. The point is that, for the SDR even to begin to rival the dollar as a reserve asset, a private SDR market must develop. Liquidity of SDR instruments and the SDR's constituent currencies is vital. In this context, we need to look carefully at the criteria the IMF uses to establish SDR eligibility.

China's SDR initiative is part of a series of measures to reduce dollar 'hegemony' and to promote the renminbi as a reserve currency. Full renminbi liberalisation will take a long time and is designed to facilitate the restructuring of the Chinese economy.

Over the past 18 months China's foreign economic policy initiatives have included participation in the Brics Bank and Contingent Reserve Fund; the Asia Infrastructure Investment Bank and 'Silk Road' projects; and continued expansion of central bank swap lines, with facilities now established with 29 central banks. China has also added further Qualified Foreign Institutional Investor quotas and established the Hong-Kong Shanghai Connect programme. Development of the 'Dim Sum' bond market has continued.

In October 2015, as part of its five year review, the IMF Board will determine the constituent currencies of the SDR, which will take effect on 1 January 2016. SDRs currently account for less than 4% of global reserves. And despite a nascent SDR-denominated Certificate of Deposit market in the late 1970s (when inflation was high and the dollar was weak), the SDR as a private medium of exchange or unit of account has never taken hold. (A few airlines denominate lost baggage claims in SDRs, and some international organisations in addition to the IMF denominate their accounts in SDR.)

The Fund's 2010 paper 'Review of the Method of Valuation of the SDR' outlines the broad principles and specific metrics to be used to include a currency in the SDR. These include the currency's relative importance in the world trading and financial system; the stability of the composition of the SDR currency basket; and continuity in the method of SDR valuation.

In 2005 the IMF Board reaffirmed its 2000 decision which mandated that the SDR basket 'comprises the four currencies that are issued by Fund members... whose exports of goods and services during the five year period ending 12 months before the effective date of the revision had the largest value, and that have been determined by the Fund to be freely usable currencies in accordance with Article 30(f) of the Articles of Agreement.' Article 30(f) states that 'A freely usable currency means a member's currency that the Fund determines (i) is, in fact, widely used to make payments for international transactions and (ii) widely traded in the principal exchange markets.'

Usable currency

China, now the world's largest exporter, meets the first criterion for SDR inclusion. But is its currency 'freely usable?' In 2010 the Fund concluded that the renminbi was not widely used to make payments for international transactions, or widely traded in principal exchange markets. Criteria included percentage turnover in daily foreign exchange trading; percentage of international bank liabilities denominated in the currency; and international debt securities in the currency in question.

While use of the renminbi as a settlement currency has grown rapidly in recent years, it is still relatively narrow. According to Society for World Wide Interbank Telecommunication data, as of October 2014, the renminbi was the seventh-ranked payments currency in the world, with a 1.6% market share. This places it behind the Australian dollar (2%) and Canadian dollar (1.8%), neither of which is in the SDR.

Despite the enlargement of QFII and Renminbi Qualified Institutional Investor Quotas, China's capital account is still closed, and its legal system, as emphasised in the recent Fourth Party Plenum, is not yet fully developed.

It is understandable that some IMF Board members may take the view that the renminbi still does not meet current criteria for inclusion in the SDR and that the issue should be revisited only in the 2020 reconstitution. (The Fund could also review SDR composition 'off-cycle', or before 2020.)

Revamping criteria

The Board could revamp the criteria by which currencies are selected and weighted in the SDR. A study by Agnes Benassy-Quere and Damien Capelle of the Centre d'Etudes Prospectives et d'Informations Internationales argues that the 'free usability' criterion should be reviewed. Central banks can designate which currency of the constituent SDR currencies it would like in exchange for the SDR.

The study argues that, in the case of China, the 'freely usable' criterion is less relevant, as central banks will want access to a currency likely to appreciate. Market participants may not be convinced, as the ability to hedge inexpensively underlying investments is key. And there are no 'one way bets' in the currency market. If the renminbi were added to the SDR basket in 2016, its weight would be roughly 10.5%.

Several institutional gaps need to be met for a private SDR market to develop, including multiple market makers; continuous and transparent pricing; repurchase mechanisms; derivatives; technology infrastructure, and a 'lender of last resort'. To the extent that a non 'freely usable' currency is added to the SDR, the private use of the SDR may be further frustrated.

The renminbi's share of world reserves will gradually rise, and the renminbi will one day be a constituent currency of the SDR. As part of its broader SDR initiative (first advanced by Zhou Xiaochuan, governor of the People's Bank of China, in March 2009), China may wish to consider promoting the private use of the SDR.

This initiative could begin by either borrowing in SDR, or investing in SDR instruments. ▪

George Hoguet is Global Investment Strategist in the Investment Solutions Group at State Street Global Advisors.

Ukraine's role in the Eurasian balance

Germany and Kazakhstan have no illusions about Russia

Anthony Robinson, Advisory Board

As attitudes harden on both sides of an unprecedented challenge to the post-war territorial settlement in eastern Europe, attempts at mediation on Ukraine are being replaced by military reinforcement. A joint Franco-German mission to win compromise from President Vladimir Putin runs the risk of simply postponing a further deterioration.

When the Ukrainian crisis began a year ago President Barack Obama declared that the US had no intention of reacting militarily. Moscow interpreted this as a green light to send thousands of unmarked troops and military advisers into the peninsula, followed by a rigged referendum and annexation.

Shrugging aside unexpectedly tough western sanctions, the Kremlin repeated the exercise in eastern Ukraine. There, Russian-backed separatist forces continued fighting Ukrainian troops through several cease-fires, nullifying the Minsk protocol signed in September when all signatories agreed to withdraw forces.

To the intense frustration of German Chancellor Angela Merkel, who has been leading the west's rejection of Russian expansionism, and of Kazakh President Nursultan Nazarbayev, Putin's ultimate goal remains obscure.

Russian expansion

Invading Crimea proved easier than providing regular supplies to the 2.7m inhabitants of the peninsula. It is connected by road, rail and utilities to the Ukrainian mainland but is only reachable by boat across the narrow Kerch strait from Russian territory. This is fuelling fears that the 100,000 strong army of 'volunteers' which separatists say they intend to recruit will be used not only to consolidate their hold on Lugansk and Donetsk but to secure a land bridge between Russia and Crimea.

This prospect has obliged the US to go beyond its original reluctance to consider military assistance to the out-gunned and relatively poorly-equipped Ukrainian forces and is forcing Nato to react. But the risk of an extended civil war in eastern Ukraine takes place against a new background.

Putin appears to have retained a high degree of domestic support despite the shooting down of a Malaysian airliner, the inflationary effects of the oil and sanctions-induced collapse of the rouble, and the downgrading of Russian debt and future growth prospects. But Ukrainians' unexpected willingness to fight back in a conflict which has already cost over 5,000 lives has led to growing Russian military casualties. The body bags do not go unnoticed, despite efforts to repatriate casualties clandestinely. Putin's decision to drop the price of vodka by 16%, when food and other prices are rising, reveals a certain nervousness about the public mood.

Putin still appears to believe, however, that the groundswell of Russian great power chauvinism which he has tapped into gives him a much stronger capacity to last the course. In particular, he seems to feel in a stronger position than policy-makers in western Europe, led by a German chancellor facing a challenge to financial orthodoxy and wider questions over the long term survivability of the euro area.

Potential back-sliding

Thus far the chancellor has been able to discourage back-sliding by potential 'doves', such as Italy, France and the powerful German exporter lobby, which Putin had counted on to split the western camp. Germany has finally assumed a leading political role commensurate with its economic power and influence. But Germany is as reluctant as any other EU state to fund the $15-$20bn refinancing urgently needed by a near bankrupt Ukraine, or to increase the military spending needed to rebuild Nato's military forces.

A credible degree of Nato strengthening is also required in other frontline areas, such as the Baltic states and Poland, and in Romania, with its proximity to Moldova and the 'frozen conflict' microstate of Transnistria.

Nato members are naturally most preoccupied with the implications of Moscow's apparent determination to tear up the post-war European settlement, even though, ironically, this was drafted mainly by Stalin himself at the Teheran, Yalta and Potsdam conferences. But similar fears are replicated beyond the Nato limits in former Soviet central Asia, and especially in Kazakhstan.

Chancellor Merkel and President Nazarbayev share a conviction that a weak compromise, which froze the Ukrainian conflict without verifiably securing Ukrainian sovereignty, would give Moscow a permanent veto over Ukraine's foreign and domestic policy. It would be a model for restoring Russian hegemony over the Baltic states and central Asia.

Six months ago Nazarbayev was shocked when Putin told a Moscow audience that Kazakhstan had never really been a state and was essentially the creation of Nazarbayev himself. The implication was that once 74 year old Nazarbayev left the scene, Kazakhstan was just as vulnerable to subversion as the Crimea or eastern Ukraine.

Lesson of history

In Czarist times the newly conquered central Asian khanates were grouped together as Turkestan. But Stalin divided Turkestan into five separate Soviet states on the divide and rule principle. He tacked onto Soviet Kazakhstan a large chunk of ethnic-Russian Siberia, formerly governed from Omsk, making Kazakhs a powerless minority in their own state. During collectivisation 1m Kazakhs died, to be replaced by Crimean Tartars, Poles, Volga Germans, Chechens and others sent to the Kazakh gulags.

At independence, the Kazakh economy was an integral part of the Soviet military-industrial complex. But today only 7% of Kazakh exports go to Russia across the 7,000km shared border while Russia supplies 35% of imports. While retaining close ties to Moscow, Nazarbayev has quietly forged new financial and trade links with the EU, US, China, Turkey and dynamic Asian states such as Singapore, South Korea and Japan.

Unlike Putin, who squandered the historic opportunity offered by high commodity prices to diversify the Russian economy, Nazarbayev attracted over $120bn of foreign investment. This has transformed the economy and made Kazakhstan a key link in an upgraded China-Europe rail, road and logistics corridor.

A newly built 1,000km-long railway line across the Kazakh steppe comes into operation this year. It will cut transit times by 36 hours and offer an alternative southern route to Europe from China via the Caspian and Black Seas – which does not pass through Russia.

Investment-starved Russian railways, by contrast, are struggling to modernise the country's rail route to China and the east. This is a classic example of Putin's failure to diversify the Russian economy – opting instead to try to prevent Ukraine and others from following a Kazakh- or EU-style reformist path. ▪

Anthony Robinson, a former Financial Times Moscow correspondent and east European Editor, is a member of the OMFIF Advisory Board.

America the pivot

David Mulford's message

George Hoguet, State Street Global Advisors

The health of the US economy and US global economic leadership are vital for world prosperity. That may appear a truism, but it is worth restating. The message resonates strongly in David Mulford's memoir *Packing for India: A Life of Action in Global Finance and Diplomacy*. Mulford, 77, chronicles his career from Rockford Illinois, to Oxford, to Africa as a research scholar, to the White House as a Fellow, to the investment bank White Weld, to the US Treasury, to the Saudi Arabian Monetary Agency, back to Wall Street and finally to India.

A persistent theme of the book is the necessity for policy-makers to drink the 'truth serum'. This means boiling a problem down to its essentials, thinking clearly, 'looking reality in the face', and recognising the power of markets. It will be of interest to economic historians and to policy analysts interested in international economic cooperation.

Historic transformations

Mulford served as assistant secretary and subsequently undersecretary of the US Treasury for international affairs from 1984-92, and was US Ambassador to India from 2003-09. In these positions he was present at historic transformations, including the gradual liberalisation of Japan's capital account, the Plaza and Louvre Accords, the Baker and Brady Plans, the creation of the European Bank for Reconstruction and Development and the US-India Civil-Nuclear Agreement.

Mulford's discussion of the early days of the Eurobond market and his experiences at SAMA (where Mulford served from 1975-82 as a senior investment advisor) should be particularly instructive for the current generation of investors. Imagine having to invest $500m a day with a small staff, no computer, no Bloomberg and no internet.

It was in this crucible (and earlier on the football fields of the Mid-West) that Mulford refined the skills that at times left investment bankers selling placements to SAMA 'without warm feelings of gratitude'.

In a masterful stoke, Mulford personally negotiated a permanent seat for Saudi Arabia on the board of the International Monetary Fund. He outlines techniques that current policy-makers may benefit from. The about-face of the Reagan administration in terms of its willingness to intervene to weaken the dollar represented a profound policy transformation.

Mulford acknowledges the ability of markets to overshoot and create excesses. Mulford's initiative, the dramatic Plaza Accord of 25 September 1985, led to an eventual 40% decline in the value of the dollar. Not only did it remedy a fundamental price misalignment; it also demonstrated that a small group of policy-makers, the G-5, could collaborate.

Similar creativity was shown in launching the Brady Plan. The Treasury's initial strategy in dealing with the Latin American debt crisis of 1982-89 was to buy time. The countries needed to adjust; the commercial banks had to continue to lend; regulators needed to avoid forcing precipitous write-downs; the IMF and other international financial institutions needed to provide bridge finance; and the world economy needed to grow.

When it became apparent by 1987 that debt burdens were unsustainable and secondary debt markets had emerged, the Brady Plan, which offered the banks both a carrot and a stick, emerged. The cost to the US taxpayer was minimal.

India's evolution

Mulford's final chapters deal with US-India relations and the long and complex negotiations leading to President Bush signing the US-India Nuclear Cooperation Approval and Non-Proliferation Enhancement Act.

This agreement allows India to be a state with nuclear weapons that is permitted full access to the world of civil nuclear commerce without signing the 1974 Nuclear Non-Prolifileration Treaty or giving up its nuclear weapons. This act was contentious in both India and the US. A key breakthrough, facilitated by Mulford's diplomacy, came when Prime Minister Manmohan Singh asked the International Atomic Energy Agency to approve the IAEA-India Nuclear Safeguards Agreement.

There are sure to be those who disagree with Mulford's interpretation of events. But this book is important because it informs readers of the evolution of global capital markets and argues that US leadership is critical to global prosperity. ▪

George Hoguet is Global Investment Strategist in the Investment Solutions Group at State Street Global Advisors.

SOVEREIGN NOTES

Fluctuations of the US economy as well as euro area tension provide many lessons for African Global Public Investors. These sovereign institutions are building up instruments to assess in more timely fashion the influence of international developments on their own policies.

The first lesson is that further diversification in a time of volatility brings benefits. Three of the top 10 African GPIs, Government Employers Pension Fund ($120bn), Public Investment Corporation (GEPF's main investment manager, with $132bn under management), and the South African Reserve Bank ($50bn) all have sizeable exposure to their domestic market. This has become a major source of discomfort following debilitating party politics and commodities instability.

Second, politics matters. Forthcoming elections in South Africa could bring unexpected shifts. Weeks of power cuts and 'load shedding' by Eskom, the national electricity provider, ANC party bickering and presidential scandals have been destabilising but not life-threatening. GEPF has asked PIC to start funding companies throughout South Africa investing in clean-energy infrastructure through 'green bond' issues, an important landmark in GEPF's investment policy.

Third, GPIs must monitor exogenous factors. South African GPIs are harnessing internal market intelligence units to improve returns and build a stronger team within their respective institutions for effective peer benchmarking.

Infrastructure investment benefits greatly from south-south flows too. China has committed over $20bn so far, and this is expected to double in 2015. Relationships between Chinese and South African GPIs have benefited from strong inter-governmental ties, with regular co-investment roundtables taking place in London, Johannesburg and Beijing.

All this means that South African GPIs may shine out as brighter investment stars in 2015 than previously anticipated. The rand is stabilising, low oil prices are benefiting the domestic economy and the country had a trade surplus in December. South Africa could deliver positive surprises in 2015. ▪

Pooma Kimis is Director, Markets and Institutions.

Greece may provide salutary shock

After the stage management, compromise is in the air

Vicky Pryce, Advisory Board

These are dangerous times for Europe. Everyone is watching Greek developments. The question is whether and when policy-makers will realise that Greece is not an exception in the euro area which has to be treated in a certain way because of its problems. It is much more a symptom of what is wrong with the euro project as a whole.

The flaws are well known: no central transfers of funds, no mutualisation of debt, and no lender of last resort – until the president of the European Central Bank famously announced in 2012 that he would do whatever it takes to save the euro.

Mario Draghi has shown that he means business. Despite German opposition, the ECB will embark on a €1.1tn quantitative easing programme from next month. But there is much work to be done to remodel the rest of the euro structure to tackle the crisis that has been created. A serious rethink is needed.

Pain for Greece

The heart of the problem is that, in the absence of a fiscal union and adequate and timely support to head off crisis, national governments have been given no choice but to cut back sharply to achieve fiscal consolidation and reduce debt. The pain for Greek citizens has been enormous. In Greece GDP has fallen by 25% in five years.

Against this backdrop came the rise of Syriza, a collection of ex-communists and disaffected MPs and voters from the centre-left Pasok and other smaller parties. In the 25 January election, the party increased its vote to 36% from just over 4% 10 years ago and 27% in 2012. It narrowly failed to get a majority despite being allocated the 50 seats which automatically go to the largest party under the peculiar Greek electoral system.

Charismatic head

Alexis Tsipras, Syriza's charismatic head and now prime minister, swiftly formed a coalition with a small populist right-wing party, the Independent Greeks, and was sworn in the next day. The Independent Greeks, whose leader has made unpleasant remarks about Jews and Muslims, may seem a strange bedfellow for a radical left-wing party, but they are united by extreme dislike of the austerity package and how it has been forced on Greece. The Independent Greeks provide another useful benefit: they stave off attacks from the far right that Greece is becoming communist.

Financial markets have been nervous, especially after the ECB announced on 4 February it was no longer accepting Greek government bonds as collateral for Greek banks' funding. The Athens stock market has been weak and 10 year Greek bond yields have risen to above 10%. The market will remain volatile as long as negotiations are not concluded about the future of the bail-out programme.

The bail-out programme has so far extended to the end of February, but no one knows how and if it will continue. At stake are austerity conditions imposed on Greece including details of the 2015 budget and Greeks' demands for debt restructuring – a potential stumbling block.

Effect on Podemos

The shouting match has started. Both sides ask for all and hope to get something in return. The Europeans, led by German Chancellor Angela Merkel and her Finance Minister Wolfgang Schäuble are playing tough. The Finns and the Dutch are just behind. The Spaniards, who are also creditors to the Greeks, are voicing concerns about any deal that may be struck. The Spanish government is particularly mindful of the effect on Podemos, Spain's own anti-austerity party which is riding high in the polls in advance of elections at the end of 2015.

Negotiations need to be concluded quickly for three reasons. First, Greece will be running out of money to pay back some €10bn of loans falling due over the next six months.

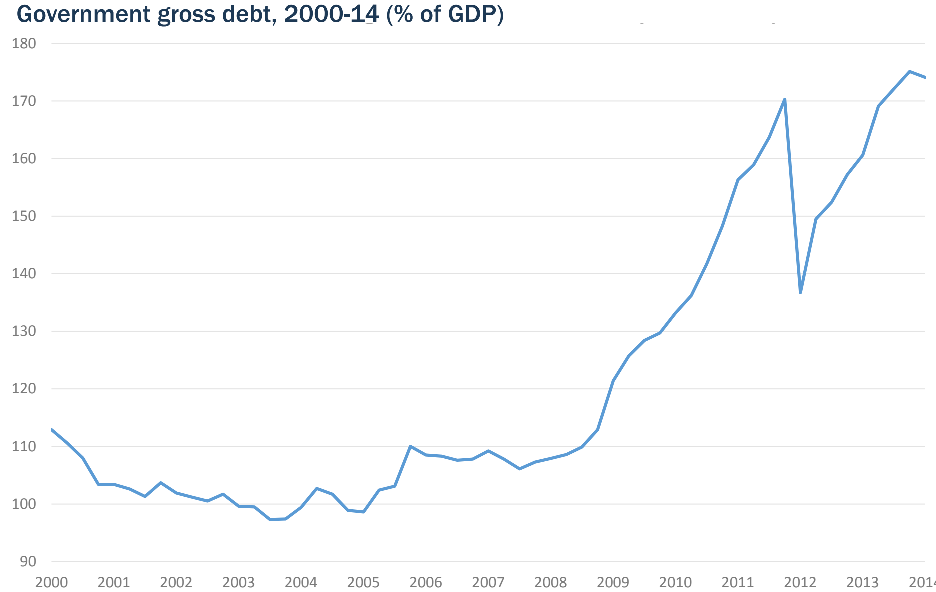
Second, its banking system is already drained of funds and will not be able to rely on ECB support if Greece unilaterally exits the bail-out programme after the extended deadline of 28 February. Emergency liquidity assistance (ELA) from the Bank of Greece is continuing up to a ceiling of €60bn, but is subject to ECB approval.

Third, the collateral that banks offer for funding is coming under pressure, as the 4 February ECB decision showed. The banks' holdings of bonds and Treasury bills issued by the Greek government are dropping in value, and the same is true for the potential bad loans on their books. With the Greek economy likely to fall back as businesses hesitate to invest or hire workers this will lead to an increase in non-performing loans which already represent about one-third the four main Greek banks' loans.

Some red lines have become clear. The main element of Greek government policy is that the country has to turn a new page beyond austerity. It is now clear that prescription advanced by the 'troika' (the IMF, the ECB and the European Commission) has not worked. The IMF itself has accepted that, and Mark Carney, the governor of the Bank of England, criticised the euro area in late January for over-restrictive fiscal policies

Debt to GDP ratio now above 170%

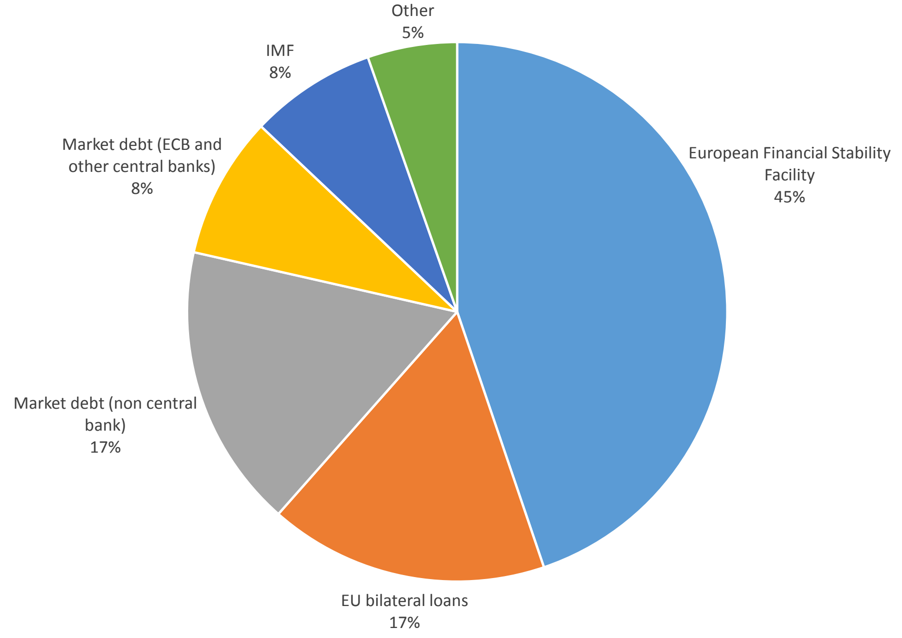
Government gross debt, 2000-14 (% of GDP)



Source: Eurostat, Cebr analysis

Greece's €320bn government debt is mostly owed to the troika

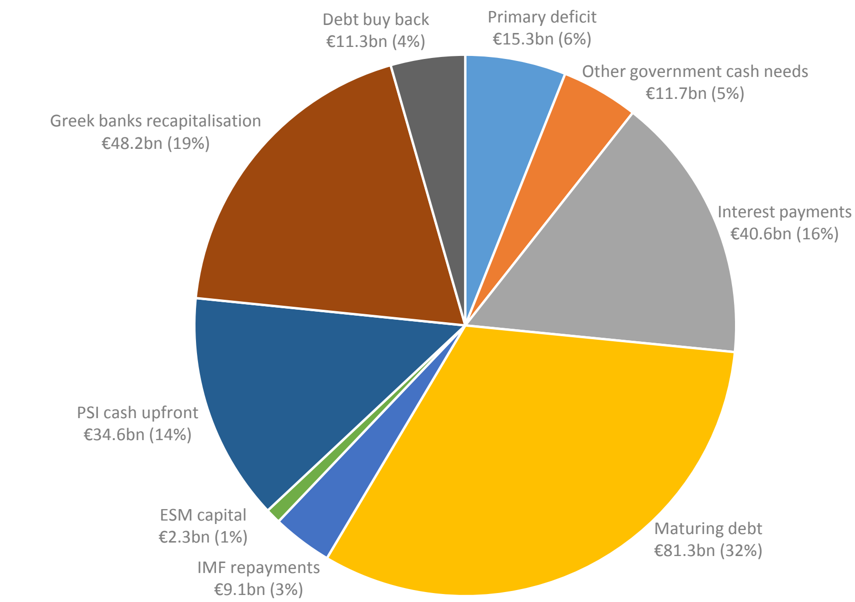
Composition of government debt, 2014



Source: FT, European Commission

Half of new 2012 funds went on debt service

Proceeds of the bail-out loan



Source: Macropolis

and lack of fiscal union in the form of transfers from rich to poor countries.

Important support is coming, too, from the US. In an interview after the Greek elections, President Barack Obama said, 'You cannot keep on squeezing countries in the midst of depression.' He added, 'The best way to reduce deficits and restore fiscal soundness is you must grow'. This statement has been much replayed in Greek media.

The Greeks, above all Tsipras and Yanis Varoufakis, finance minister, have made clear that the troika is dead. They do not recognise the authority of what they believe is an undemocratic body. In this they appear to have won. Commission officials and political representatives seem to accept that a different dialogue needs to be found.

This creates its own problems. Dealing separately with each member of the European Union, the Commission, the ECB and the IMF is not easy, especially with the aim of reducing Greece's unsustainable debt burden of 175% of GDP. But it needs to be done, and quickly.

Compromise on debt

Syriza won the most votes on a promise to end austerity but also to reduce the burden of debt, with some of its pre-election pledges suggesting that they wanted to write off half of it.

Germany and others have made it clear that no such deal can be done. Varoufakis, who has spent a week on a tour of European capitals, has bluntly disagreed with both Schäuble and Jeroen Dijsselbloem, the Dutch finance minsiter and Eurogroup president. There will be bluff and counter-bluff.

There is an element of stage management here. Varoufakis, a steely economist, has practised in public a threatening and somewhat confrontational tone, while Tsipras has appeared to be more conciliatory. In private, however, the two men are adopting a similar attitude, assuring bankers and other creditors that Greece will honour its obligations, particularly to the ECB and the IMF, and will eschew unilateral action.

The truth is that the average Greek is not expecting miracles but would be pleased if some of the austerity burden were lifted. Compromise is in the air. Greece does not want to leave the euro; nor does Europe want this to happen, which would presumably lead to Greece leaving the EU as well, with enormous repercussions.

The Greeks will no doubt win some concessions. These may come in the form of longer maturities on debt, lower rates and possibly a further loan agreement to see them through until they are once again able to tap the financial markets. But the negotiations will be tough. In the spirit of compromise, Varoufakis has already dropped immediate write-off demands. He has suggested instead converting current loans owed to European countries into 'growth' bonds with payments linked to the health of the economy, and ECB borrowings into 'perpetual' bonds that pay interest but have no maturity. The response so far from Greece's creditors has been muted.

Greece will fight, too, for a less exacting primary surplus requirement, or even simply a balanced budget, well below the 4.5% of GDP demanded by the troika in 2015 and 2016.

At some point, Greece will want to be accepted in the ECB's bond-buying programme. But write-downs will be necessary if the euro area is to return to growth. QE alone will not suffice. That would mean revisiting the debt sustainability targets of Portugal, Ireland, Spain and Italy, and rethinking fiscal policy across the euro area. The Greek election result may give Europe the salutary shock it needs to show determination to make the euro work. ▪

Vicky Pryce is a former head of the UK government economic service and author of *Greekonomics*.

What Tsipras should say to the creditors

Greece needs a debt service holiday

Meghnad Desai, Chairman, Advisory Board

Alexis Tsipras, the Greek prime minister, is in a tight corner. After the high-profile, low-results tour of Europe by Yanis Varoufakis, his finance minister, Tsipras faces a possible backlash in Athens if his government retreats from its ambitions for toning down Greek austerity and negotiating widespread debt relief.

Any radical party coming to power almost always disappoints. Tsipras is discovering an essential truth. Whatever a leader may say in opposition, once in office, your adversaries close in on you. Particularly if your government has built up €320bn in debt, most of which is owed to official creditors who have an annoying desire to be paid back for fear of provoking their own negative reaction in their home capitals.

Charting a path

Yet Tsipras has to stay firm to his purpose. If his Syriza party ends up forming a conservative government, anarchy will result. So the Greek prime minister has to chart a path as close to the brink as possible. He has to wield the nuclear option of Greek exit from the euro so he can meet the demands of his voters waiting for a chance to regain an element of self-respect.

The European Central Bank is rightly trying to tone down its role. Vaurofakis' suggestion of swapping the ECB's holdings of €27bn of Greek government bonds purchased under its securities market programme of 2010 will not fly.

IMF role

Decisions on Greece's future have to be taken by politicians, not unelected central bankers. The only route for Tsipras and Varoufakis to obtain significant concessions will be through the International Monetary Fund. It will come at a considerable cost. The US will have to get involved. Rolling over or further softening loans to Greece will not be popular on the IMF's board. The IMF already has its hands full with Ukraine and, perhaps, other emerging market economies waiting in the wings.

The arithmetic of the Greek debt is inexorable. It is unpayable in any reasonable time frame without subjecting the Greek population to a generation of misery.

Alexis Tsipras, now Greek prime minister, promoting his manifesto at Piazza Maggiore in May 2014

Tsipras has two choices. One is drastic. The other is only mildly catastrophic. The drastic choice is to renege on all debt, or at least a large portion of it. Greece has done this before in its modern past as Carmen Reinhart and Ken Rogoff recounted in their book *This Time is Different*. Since independence in the 1830s, Greece has been in a state of default about 50% of the time. Refusing to pay debts would cut Greece off from international markets for a while, although creditors show a remarkable appetite to come back to lend more money. But there is a caveat.

Between 80% and 90% of Greece's public sector debt of €320bn is held by the IMF, European governments and the European Central Bank – the so-called troika. Tsipras could say that, if other euro members wish Greece to stay in the single currency, they have to let Greece renege on perhaps 50% of the debt. That would be solidarity, Greek-style. Some countries may agree but I doubt the Germans would.

Debt options

The other, more feasible choice is to ask for a holiday from servicing the debt for the next five years. Antonis Samaras, the former prime minister, managed to produce a primary budget surplus. So if Greece was forgiven debt servicing, it would be in a better position to manage its public finances – although it would still have to roll over maturing debt. Because of the exit of most private lenders, the average interest rate on Greek debt is down to 2.5%. Interest costs make up around 4% of GDP. The amounts saved would be around €7bn, enough to make a difference, but not so large to cause a wholesale creditor revolt among the creditors.

I believe the best option would be for Greece to renege on all debt, but that is probably unachievable. My more moderate proposal is second best, but it is workable. After the ritual amount of bickering and confrontation, there will be a compromise it. The euro bloc's de facto leader Angela Merkel would be well advised to start working towards it. ▪

Lord Meghnad Desai, Emeritus Professor of Economics at the London School of Economics, is chairman of the OMFIF Advisory Board.
Photo credit: Lorenzo Gaudenzi

An end to fragmentation

Banking union as pathway to deeper integration

José Manuel González-Páramo, BBVA

Banking union marks the departure point of a long journey towards genuine EU integration, but it is not the final destination. The existing banking union decided since 2012 embodies the most important EU reform since the creation of the euro. It has been pivotal in underpinning the single currency and reversing European fragmentation.

However, the euro area remains unduly divided, so action is required to put integration back on track. In a nutshell: banking union is unfinished. The first thing to do is to bring banking union to its full capacity. This requires a lot of work from the technical and the management sides to run successfully the new institutional framework. The new set-up needs to be put into the position, as an urgent priority, of producing beneficial uniformity, efficiency and equal treatment of all participants.

In parallel, EU leaders will have to find a way to complete the banking union with a common deposit guarantee scheme and a public backstop. This will require high doses of political will. In the medium term, further integration is needed, including capital market union, fiscal union and economic union, all of them underpinned by due democratic legitimacy.

Bank recapitalisation

The adaptation to the culture and modus operandi of the new authorities, both single supervisory mechanism and single resolution mechanism, will be a tectonic change for most entities. This process will require a big effort for new authorities and the banks.

The first test took place with the Asset Quality Review and the associated stress test. The European Central Bank and the European Banking Authority performed well. The exercise was sufficiently sound and transparent, making its results credible and robust.

Stress tests are here to stay. They are a key part of the new Supervisory Review and Evaluation Process methodology. The AQR exercise is a one-off procedure that is not meant to be repeated at banking union level every year unless there is fresh severe turbulence. This point is important: having a comprehensive assessment as the benchmark for future exercises can create unnecessary confusion.

Another source of confusion has to do with the recapitalisation of banks that failed the exercise. Some analysts have shown concern about the SRM not being able to guide the process. Again, this is misleading. The SRM was never meant to deal with that. By law it will not have full resolution powers until 2016. The very essence of this recapitalisation process is that it must help draw a line between past problems and the future. In coming years, we will be able to envisage mutualisation of costs in the context of the SRM.

All banks involved in the recapitalisation process should be able to cover the capital gap from the markets. If that is not possible, an 8% bail-in will apply. If that is not sufficient, there will be public support, from the national sovereign in the first instance and ultimately from the ESM.

When the results of the AQR stress test were released, the direct recapitalisation tool was not yet approved. Now it is there, which is good news. That should dispel any doubts about a negative financial spiral in the unlikely event that a bank needed public support to bridge its capital gap.

Single resolution mechanism

The single resolution board will be in charge of all resolution tasks starting in January 2016. During 2015, one SRB priority will be to develop the first resolvability assessment with special focus on the biggest European institutions. It will also be preparing the single resolution fund (SRF) which will start functioning by early 2016. And it will develop coordination guidelines with national resolution authorities, supervisory authorities and third country authorities.

In general terms the financial power of the SRF is adequate. However, the lack of a public backstop is a clear weakness especially in a systemic crisis. The €55bn overall capacity of the fund has been criticised for being too low. But the fund would be used as a private backstop, only after losses equivalent to 8% of total liabilities have been absorbed internally through a bail-in. This threshold is quite high, and would have been sufficient to cover losses in most of the recent banking crises in Europe.

A 5% cap will apply in the use of the fund, making a premature depletion extremely unlikely. In addition, the fund will be able to raise ex-post contributions and borrow money from third parties on an ex-post basis in case of need. In this sense, the inclusion of a private loan facility is an important step forward.

Nevertheless, a credible common backstop should be put in place as soon as possible to keep intact the credibility of the SRM and the SSM. Having access to liquidity (just as the Federal Deposit Insurance Corporation has a credit line with the US Treasury) will be essential, especially during the transition. A transitory solution lies with the ESM direct recapitalisation tool but in the medium term a more consistent mechanism would be necessary.

Certainly, the SRB involves a complex decision-making process. But it is the best design available, given the political constraints.

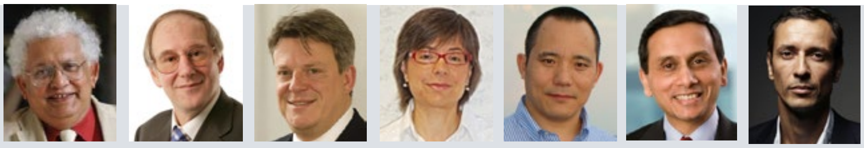
Completing banking union

Banking union needs to be completed with a single deposit guarantee scheme (DGS). This was rightly removed from the agenda in late 2013 to avoid a fatal deadlock in banking union negotiations. But banking union will be neither credible nor stable if it lacks a strong common safety net. The existing safety net is extremely fragile. It operates with the DGS component on a national basis, and with a SRF that will be 100% European only in 2024. Political agreement will be challenging. This necessary completion requires elements of a fiscal union and hence reform of the European treaties.

This requirement underlines that the future of Europe must be met through a deepening of European institutions. During the crisis, Europe often acted with urgency, signing intergovernmental agreements such as on the European Stability Mechanism, the fiscal compact or the SRF. The next step should be a change in the treaties to integrate these regulations under a European legislative framework. Many people see this as a long-term issue. But steps need to be taken as quickly as possible to enhance European governance.

Banking union by itself cannot guarantee total financial integration. The completion of banking union must be accompanied by deeper economic, fiscal and political union. This is the only way to end persistent fragmentation. This will involve changes in the treaties when political conditions are right: a demanding but necessary challenge to overcome. ▪

Prof. José Manuel González-Páramo is executive director of BBVA. This is an abridged version of a speech delivered at the OMFIF Economists Meeting at the Deutsche Bundesbank on 28 January 2015.



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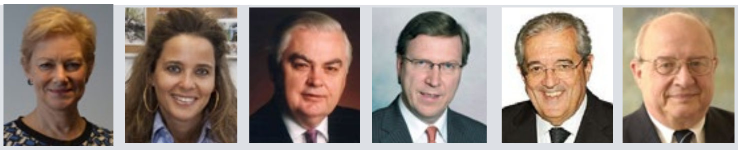

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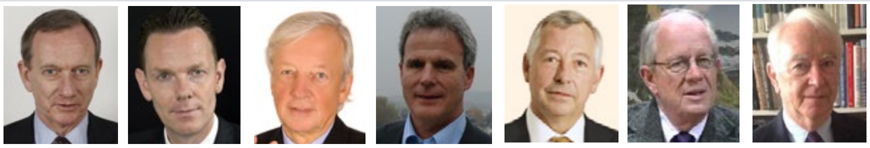

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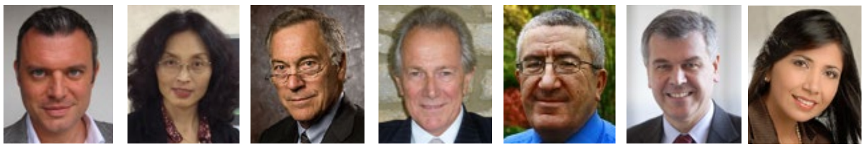

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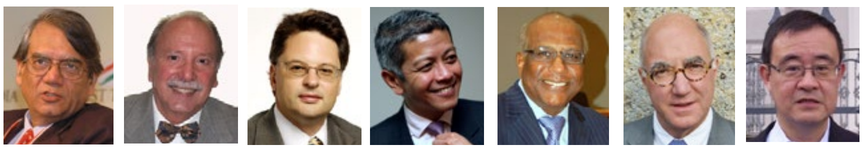

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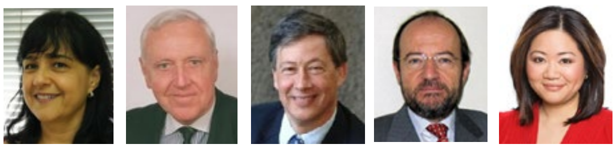

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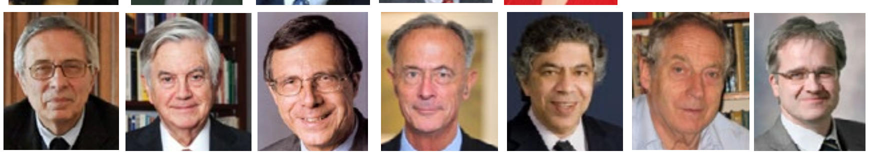

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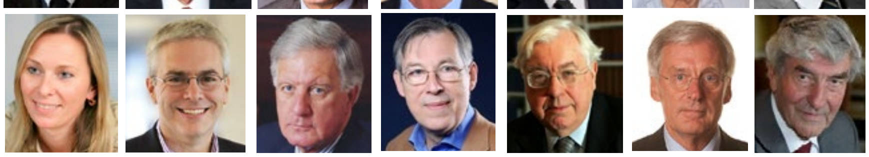
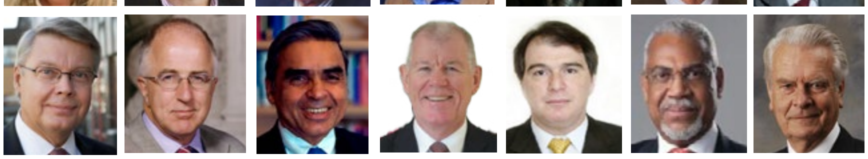
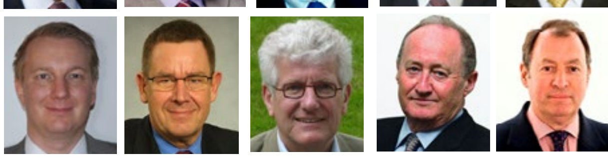


Natalie Dempster, World Gold Council
Jonathan Grant, Policy Institute at King's
Peter Heap, former UK Ambassador to Brazil
François Heisbourg, Fondation pour la Recherche Stratégique
John Kornblum, former US Ambassador to Germany
Ben Knapen, European Investment Bank
Ruud Lubbers, former Dutch Prime Minister

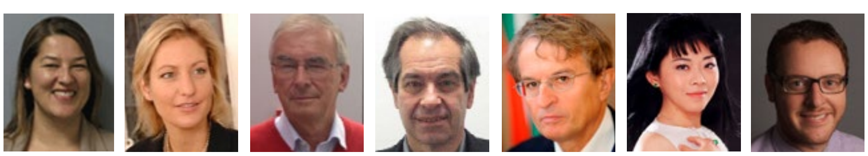


Bo Lundgren, formerly Swedish National Debt Office
Denis MacShane, former British Minister for Europe
Kishore Mahbubani, Lee Kuan Yew School of Public Policy
Boyd McCleary, former HM Diplomatic Service
Luiz Eduardo Melin, Brazilian Development Bank
Murade Miguigy Murargy, CPLP
David Owen, House of Lords

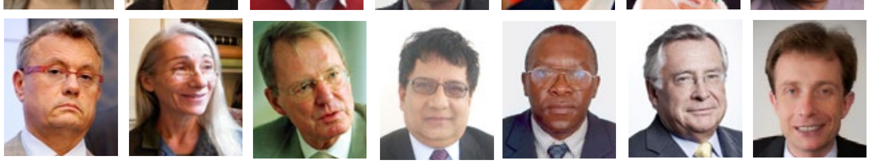


Jukka Pihlman, Standard Chartered Bank
Poul Nyrup Rasmussen, former Danish Prime Minister
Paul van Seters, Tilburg University
Christopher Tugendhat, House of Lords
Paul Wilson, De La Rue

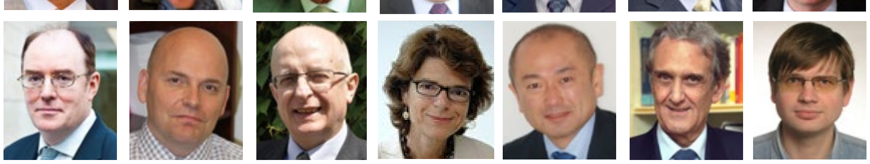
ECONOMICS & INDUSTRY



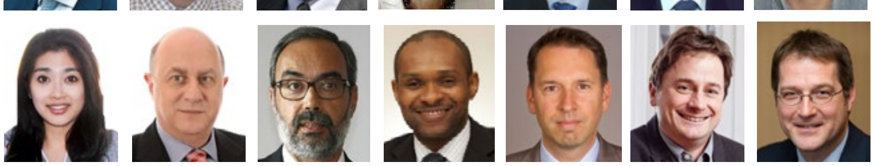
Irena Asmundson, California Department of Finance
Katinka Barysch, Allianz
Robert Bischof, German-British Chamber of Industry & Commerce
Eduardo Borensztein, Inter-American Development Bank
Albert Bressand, European Commission
Shiyin Cai, Dialogue in the Dark
Efraim Chalamish, New York University



Vladimir Dlouhy, former Czech Industry Minister
Brigitte Granville, Queen Mary, University of London
Hans-Olaf Henkel, University of Mannheim
Hemraz Jankee, formerly Central Bank of Mauritius
David Kihangire, formerly Bank of Uganda
Robert Koehler, formerly SGL Carbon
Pawel Kowalewski, Deutsche Bundesbank



Gerard Lyons, Greater London Authority
Stuart Mackintosh, Group of Thirty
Winston Moore, Moore Asociados
Vicky Pryce, formerly UK Department for Business
Takuji Tanaka, Innovation Network Corporation of Japan
Pedro Schwartz, CEU San Pablo University
Vilem Semerak, Charles University, Prague



Song Shanshan, SDIC CGOG Futures
Gabriel Stein, Oxford Economics
Jorge Vasconcelos, New Energy Solutions
Obindah Gershon nee Wagbara, Georgetown University
Frank Westermann, Osnabrück University
Philip Whyte, Centre for European Reform
Volker Wieland, German Council of Economic Experts

Bright spots amid the setbacks

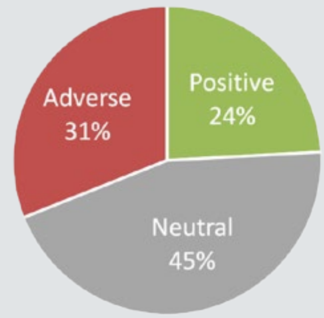
Mixed views on Africa's top four economies

Amid considerable uncertainty across much of the world economy, Africa stands out as a relatively bright spot, with abundant signs of sustained growth in spite of setbacks over Ebola, governance and sometimes endemic conflicts. OMFIF has surveyed the four largest African economies, Algeria, Egypt, Nigeria and South Africa, all open to the vicissitudes of the global economy and in particular the decline in the oil price. In a poll of the OMFIF Advisory Board in January, 36% of respondents said they had a positive view of Africa in the next two to three years, with 11% holding an adverse opinion and 53% saying they were neutral. South Africa fared well with only 3% of respondents holding negative views, compared to 55% for Nigeria. Opinion was more broadly split on Egypt, with 38% voicing positive opinions and 52% negative. The salient points of these four countries' economic performance, together with the individual findings for the Advisory Board poll, are set out below.

Algeria

	2012	2013	2014	2015	2016
GDP growth (% change)	3.3	2.8	3.8	4.0	3.8
Inflation (% change)	8.9	3.3	3.2	4.0	4.0
Government deficit/surplus (% of GDP)	-4.1	-0.9	-4.5	-4.6	-3.5
Current account balance (% of GDP)	5.9	0.4	-3.0	-2.9	-3.6

Advisory Board view



GDP is estimated to have grown 3.8% in 2014, up from 2.8% in 2013, driven by domestic demand and investment, with help from relative political stability. Oil and gas provide more than a third of GDP, putting the International Monetary Fund's 2015 projection of 4% growth in doubt. Although inflation is projected to rise this year, the government has been successful in lowering inflation from its high of 8.9% in 2012 to 3.3% and 3.2% in 2013 and 2014.

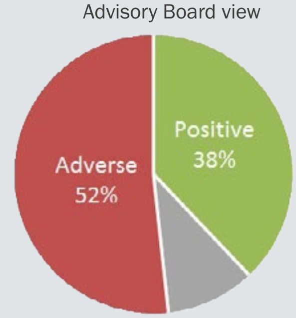
Algeria's current account balance moved from surplus to deficit. After a surplus of 5.9% of GDP in 2012, 2014 saw a 3% deficit which is expected to continue into 2015. This is due to declining exports (comprising almost solely oil and gas) and rising imports. With oil prices below $50 and low prices set to continue, the country's current account position will only worsen.

The sustainability of OPEC members' public finances is called into question as a significant portion relies on oil and gas revenue, which is declining both in volume and price. Algeria exports 1.2m barrels a day, 1.4% of total world production, from its 12.2bn barrels of reserves. In order to balance the 2015 budget, an oil price of $130.50 is needed, according to the IMF. Algeria urgently needs to diversify its economy away from oil and gas, perhaps utilising its $80bn sovereign wealth fund, the Revenue Regulation Fund. The Bank of Algeria maintains foreign reserves of more than $200bn, considerably more than any African central bank, public pension fund or sovereign wealth fund.

Egypt

	2012	2013	2014	2015	2016
GDP growth (% change)	2.2	2.1	2.2	3.5	3.8
Inflation (% change)	8.7	6.9	10.1	13.5	12.0
Government deficit/surplus (% of GDP)	-10.5	-14.1	-12.2	-11.5	-12.1
Current account balance (% of GDP)	-3.9	-2.7	-0.4	-4.0	-4.5

Advisory Board view



The economic outlook remains fragile. GDP is forecast to rise 3.5% in 2015 and 3.9% in 2016, with much dependent on political stability and reforms. Political unrest has been disrupting the economy since 2011 and particularly since the ousting of President Mohamed Morsi in 2013. The new constitution signed in 2014 was a positive step, but persistent violent protests continue to hold back manufacturing, trade and tourism. Inflation was relatively low at 6.9% in 2013, but prices rose by 6.9% 2014 and are forecast to rise by 13.5% in 2015.

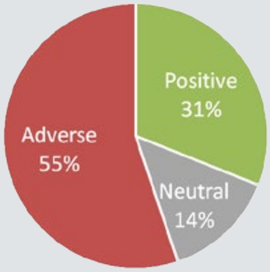
The weakening Egyptian pound has increased food prices despite measures to rein in inflation. The Central Bank of Egypt has been targeting weak economic growth with loose monetary policy, lowering interest rates and increasing money supply. It has used its foreign exchange reserves to manage the exchange rate since 2004, with Gulf States helping to bolster Egypt's foreign reserves in the past few years.

Egypt's budget deficit reached a dangerous level of 14.1% in 2013. It has improved in 2014 to 12.2%, but still needs to come down. The IMF forecasts that it will remain around this level in 2015 and 2016. The current account balance has improved since 2012, mainly due to financial aid inflows from Gulf states, with the IMF forecasting it to increase above 2012 levels in 2015 and 2016.

Nigeria

	2012	2013	2014	2015	2016
GDP growth (% change)	4.3	5.4	7.0	7.3	7.2
Inflation (% change)	12.2	8.5	8.3	8.7	8.2
Government deficit/surplus (% of GDP)	0.4	-2.3	-1.7	-2.2	-1.9
Current account balance (% of GDP)	4.4	4.0	3.7	2.2	1.7

Advisory Board view



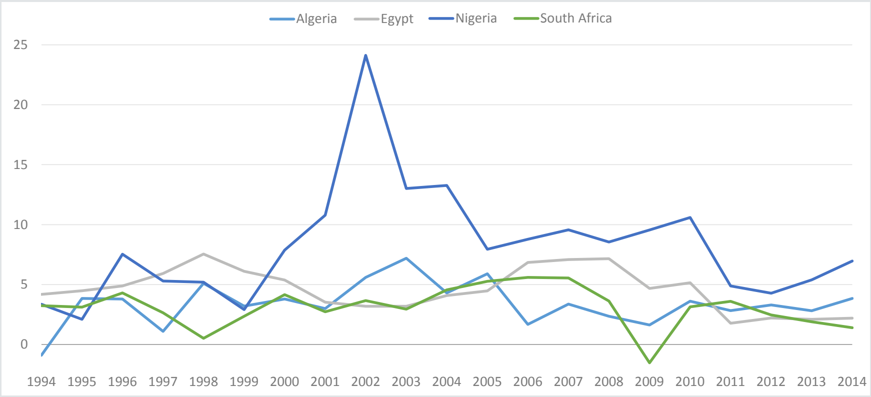
Nigeria has rebased its GDP from 1990 to 2010, increasing the estimated size of the economy by 89%, comfortably surpassing South Africa as the continent's largest economy. GDP is forecast to grow 7.3% in 2015 and 7.2% in 2016, according to the IMF. Nigeria's impressive growth performance is due to its highly diversified economy, especially compared to other African OPEC members. The performance of key non-oil sectors, namely agriculture, technology, trade and services improved greatly, while the oil sector continues to be affected.

Supply problems and weak investment are hampering the Nigerian oil sector, with prices below $50 per barrel reducing revenue. Oil reserves currently stand at 37bn barrels, three times as many as fellow OPEC member Algeria. Production is 1.8m barrels a day, or 2.1% of world production. Nigeria needs an oil price of $122.7 per barrel in 2015 to balance the fiscal budget, according to a Deutsche Bank report, with 70% of its revenue coming from petroleum exports. This contributed to a budget deficit of 1.7% in 2014. It is forecast to rise to 2.2% in 2015.

The drop in oil prices comes as increased spending is needed to fight a war against Boko Haram in the northeast. Finance Minister Ngozi Okonjo-Iweala plans to double VAT to 10% and cancel projects if oil prices remain low. The benchmark interest rate was raised to 13% last year after three years at 12%. Inflation was estimated to be 8.3% in 2014 and is expected to remain around that level. The naira continues to fall. It lost 18% of its value since the middle of 2014 despite the central bank spending over $5bn of reserves trying to defend it.

Nigeria leads the way on growth

GDP growth rate of leading African economies, 1994-2014

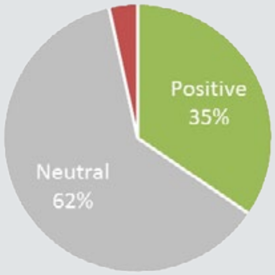


Source: IMF

South Africa

	2012	2013	2014	2015	2016
GDP growth (% change)	2.6	1.9	1.4	2.3	2.8
Inflation (% change)	5.7	5.8	6.3	5.8	5.5
Government deficit/surplus (% of GDP)	-4.3	-4.4	-4.9	-5.1	-5.0
Current account balance (% of GDP)	-5.2	-5.8	-5.7	-5.6	-5.4

Advisory Board view



South Africa is not performing well and is not expected to improve dramatically in the next few years. In 2014, growth declined to 1.4%, lagging far behind Nigeria and other leading economies. The IMF's prediction of the country's outlook is more positive than the Advisory Board's, with growth predicted to rise to 2.3% in 2015 and 2.8% in 2016.

Labour disputes, sometimes violent, have been a problem since 2012, contributing to the dire labour market. Unemployment reached 25% in 2014 and will remain at bout 24% until 2019, according to the IMF. Unemployment for 15-24 year olds sits at around 65%. Debt is rising and investment spending is slowing.

The South African Reserve Bank has been raising interest rates since the end of 2013, with the repo rate now at 5.8%, in an attempt to keep inflation within the 3-6% target range. Inflation had been within this range but rose to 6.3% in 2014. The IMF forecasts inflation will decrease to 5.8% in 2015 and 5.5% the year after. The government deficit is rising year-on-year, reaching 4.9% in 2014. It is projected to rise further in 2015. The rand has been depreciating throughout 2014, and is nearing record lows. A dollar is worth nearly 12 rand, putting pressure on food prices and retailers.

Indonesia crisis lesson for Russia

Putin should peg rouble to dollar

Steve Hanke, Advisory Board

The Russian rouble ended 2014 in bad shape, and the problems are continuing. For most of last year, Russia faced the ratcheting up of economic sanctions. The latest stand-off over Ukraine, with the US and Russia appearing to move closer to a proxy battle backing protagonists in the disputed region of east Ukraine, sets the stage for further economic attrition.

Already in 2014, we saw a number of factors that combined to push the rouble into a free fall. The collapse of oil prices, the announcement on 10 November that the rouble would float, as well as confrontation in Ukraine created the conditions for the rouble to fall like a stone.

The rouble's purchasing power was severely depleted while its volatility increased dramatically. It is not a pretty picture, but one that can be brought into focus by reflecting on the Indonesian financial crisis of 1997-98.

The story of the Indonesian crisis, in which I played a role as President Suharto's unpaid special counsellor, serves some useful lessons.

Much of this experience is relevant to Russia today. If Russia wants to avoid further rouble turmoil, further impoverishment of its citizens, and potential political upheavals, it should tether the rouble tightly to the dollar. That's what I counselled Suharto to do in 1997, through the creation of an orthodox currency board in which the rupiah would be fully convertible into the dollar at a fixed exchange rate. This currency board system corresponds to the stance taken by the big oil producers in the Gulf. Despite the evident differences in geopolitics, Russia would be advised to consider a similar line.

Indonesia parallels

There are clear parallels between Indonesia in 1997-98 and Russia in 2014-15. On 14 August 1997, shortly after the Thai baht collapsed on 2 July, Indonesia floated the rupiah. This prompted Stanley Fischer, deputy managing director of the International Monetary Fund, to proclaim that 'the management of the IMF welcomes the timely decision of the Indonesian authorities. The floating of the rupiah, in combination with Indonesia's strong fundamentals, supported by prudent fiscal and monetary policies, will allow its economy to continue its impressive economic performance of the last several years.'

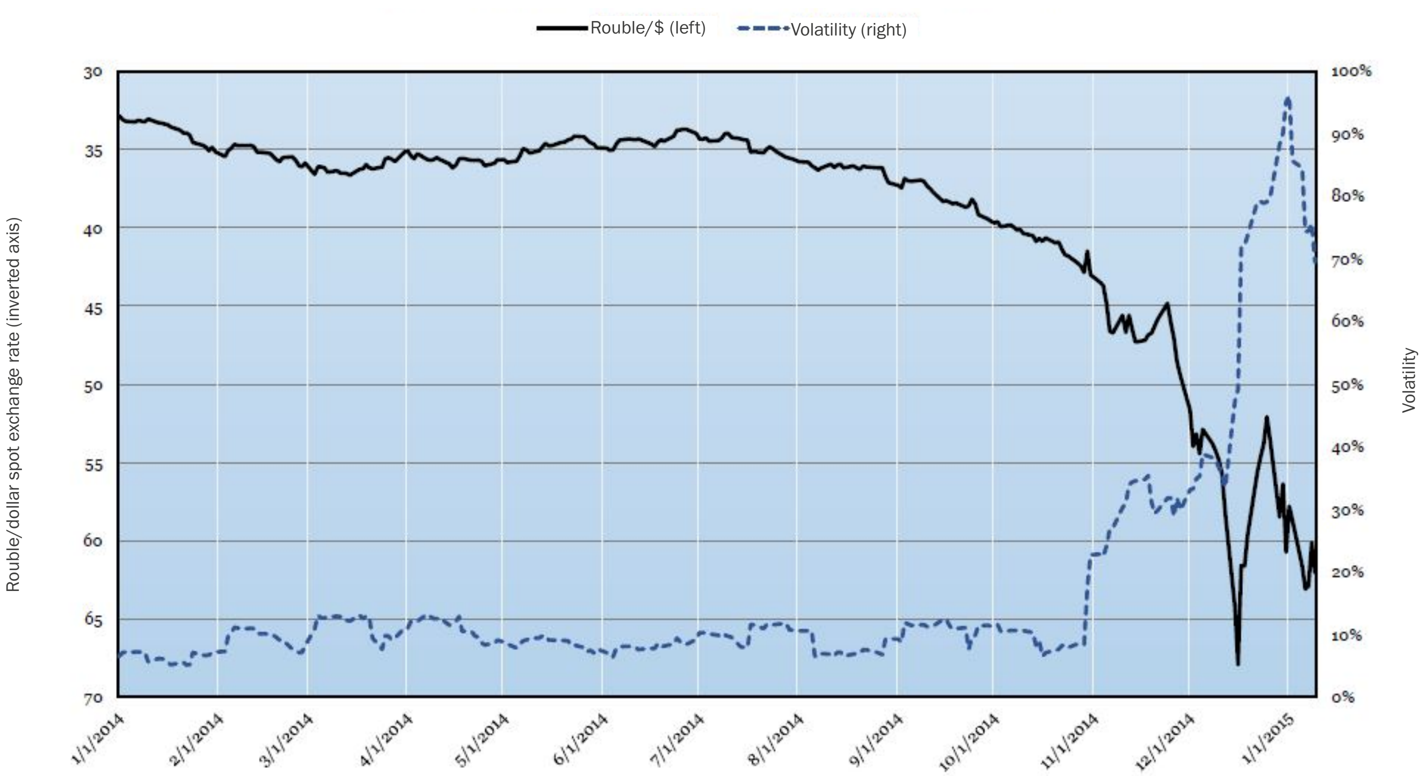
IMF expectations

Contrary to the IMF's expectations, the rupiah did not float on a sea of tranquility. It plunged from 2,700 rupiahs to the dollar to nearly 16,000 in 1998. By late January 1998, Suharto realised that the IMF medicine was not working and sought a second opinion, which I was invited to give, in the form of the currency board proposal. On the day that news hit the street, the rupiah soared by 28% against the dollar. These developments seemed to infuriate the US government and the IMF.

Ruthless attacks on the currency board idea and on myself ensued. Suharto was told in no uncertain terms – by both US president Bill Clinton and the managing director of the IMF, Michel Camdessus – that he would have to drop

How the rouble has plummeted

Exchange rate to the dollar and daily volatility ratio



Sources: Bloomberg calculations by Prof. Steve H. Hanke and Mazin Al-Rayes, The John Hopkins University.
Note: Volatility is calculated as the standard deviation of continuously compounded daily returns over a 14 day period. The left axis has been inverted to show the declining value of the Russian rouble against the dollar.

President Suharto signing the IMF agreement in 1998 overlooked by Michel Camdessus, managing director.

the currency board plan or forego $43bn in foreign assistance. He was aware that his days as president would be numbered if the rupiah was not stabilised. (Unfortunately for Suharto, he was forced to abandon the currency board idea, and, indeed, his days were numbered.)

Economists on bandwagon

Economists jumped on the bandwagon too. Every half-truth and non-truth imaginable was trotted out against the currency board idea. Those oft-repeated canards were outweighed by the support for an Indonesian currency board by four Nobel laureates: Gary Becker, Milton Friedman, Merton Miller and Robert Mundell.

Merton Miller understood the great game immediately. In his words, the Clinton administration's objection to the currency board was 'not that it wouldn't work but that it would, and if it worked, they would be stuck with Suharto.' Much the same argument was articulated by Australia's prime minister Paul Keating: 'The US Treasury quite deliberately used the economic collapse as a means of bringing about the ouster of President Suharto.'

Even Michel Camdessus could not find fault with these views. Upon his retirement, he proclaimed: 'We created the conditions that obliged President Suharto to leave his job.'

To depose Suharto, the IMF had to forge a public position of open hostility to currency boards. This deception was required to convince Suharto that he was acting heretically and that, if he continued, it would be costly. The IMF's hostility required a quick about-turn. Less than a year before the Indonesian uproar, Bulgaria (where I was President Stoyanov's advisor) had installed a currency board with the endorsement of the IMF, and Bosnia and Herzegovina (where I advised the government on currency board implementation) had followed suit under the mandate of the Dayton Peace Agreement, and with IMF support, in August 1997.

Suharto campaign

One element of IMF manipulation regarding the Indonesian episode involved the widely-circulated story asserting that I had proposed to set the rupiah's exchange rate at an overvalued level so that Suharto and his cronies could loot the central bank's reserves.

This take-the-money-and-run scenario was the lynchpin of the Clinton administration's campaign against Suharto. It was intended to rally international political support against the currency board idea and in favour of ousting Suharto.

The overvaluation story was enshrined in the Wall Street Journal in February 1998, a piece of misinformation that was repeated in magazines and newspapers as well as in so-called scholarly books and journals.

This convoluted story is worth telling because it shows that Russia, if it is wise, can handle its own travails in more effective ways than Indonesia nearly two decades ago. ▪

Steve Hanke is professor of Applied Economics at Johns Hopkins University.

CURRENCY NEWS

The first major exchange rate policy move of 2015 – the Swiss National Bank's decision to abandon the cap on the currency's value against the euro – had immediate ramifications for many emerging market currencies.

In the subsequent 48 hours in Europe, the Hungarian forint, the Polish zloty and the Czech koruna all fell to 52-week lows, sinking more than 18% each to 280.35, 3.77 and 24.31 respectively against the dollar. In Latin America the Chilean peso lead the decline.

This all seemed to be precipitated by the problem that traditionally dogs emerging market currencies: investors' risk aversion. And it was not helped by the SNB's hint that it expects sluggish growth in Europe will further weaken the euro.

Many investors turned to the dollar or yen as demand for riskier assets dampened. Meanwhile the assumed continuing weakness of the euro suggests a challenging export environment for developing countries which trade with Europe, particularly Turkey.

Emerging markets were already expected to face a challenging 2015, with commodities set to be a key theme. In the face of the plummeting oil price, Russia's woes are expected to continue whilst oil-exporters Nigeria and Venezuela are anticipated to struggle. Other commodities too, notably copper, have experienced recent volatility.

Many predict that a further factor for declining commodity prices will be a surging dollar, with QE exit strategy in the US and subsequent interest rate increases leading to weaknesses in emerging markets and a depreciation of domestic currencies.

A feature of 2015 could be the threat of 'currency wars' as emerging markets engage in a battle of competitive devaluation. The value of the renminbi will be under particular scrutiny, given the Chinese currency's sensitivity to the downward move of the euro against the dollar. So it's been a rocky start to 2015 for many emerging market currencies. And it could prove to be another stormy year ahead. ▪

Jamie Bulgin is Deputy Director, Markets and Institutions.

Why quality of growth matters

Importance of sustainable investment

Philip Saunders, John Stopford, Max King and Aniket Shah

The evolution of emerging market economies should be a key point of focus for global asset allocators today. Charting their development is not a simple task, given the diversity of economies, companies and asset classes that all fall within the broader emerging market umbrella.

Yet the recent volatility and underperformance of many emerging market assets have made investors question not just their long-term investments, but also the way in which they think about the evolution of the opportunity presented to them.

The process of development in emerging economies is likely to be enduring, driven by the expectation of rising living standards. The path of development will be neither smooth nor universal but, in most countries, any faltering or reversal of momentum should result in renewed pressure to accelerate market-based reforms. This will come not just from the international community but, more importantly, from populations increasingly able to compare their fortunes with progress in similar countries.

With risk and volatility, perceived or real, being the price of the opportunity for excess returns, investors will need discipline. This means country by country, sector by sector and company by company analysis.

Emerging market economies are highly differentiated, with diverse drivers of development, growth and returns. In each, there are some key development components that will drive investability and returns.

Collapse of communism

The dismantling of the Iron Curtain and the collapse of communism in eastern Europe towards the end of the 20th century was not just a major political event, but an economic one too. Economic growth, which averaged 2.5% in emerging economies in the 1970s and 1980s, compared to 3.3% for developed economies, has risen to an average of 5.9% since 2000, compared with 1.9% for developed economies. Emerging economies accounted for just 16.8% of the global economy in 1990, but now account for over 50%.

Investors have benefited. The compound total return for the MSCI Emerging Markets Index from the start of 1990 to the end of May 2014 has been an annualised 7.9%, comfortably ahead of the 3.2% annualised compound return of the MSCI World Index. Similarly, from 1994 (when the data series started) to the end of May 2014, the J.P. Morgan Emerging Markets Bond Index returned an annualised 9.8%, well ahead of the Citigroup World Government Bond Index, which returned 5.5%.

The outperformance has been far from steady, with both indices displaying considerable volatility and sustained periods of underperformance.

Emerging economies are still at the early stages of a multi-generational 'catch-up' with the developed world. This process is being driven by a variety of factors – most notably the diffusion of technology, broad improvements in political governance and stability and greater reliance on market mechanisms.

Emerging market growth

The next phase of emerging market growth, however, will bring a different set of challenges for these economies: namely, how to ensure broad-based development of institutions, political structures and corporate governance in an environment where economic growth is shared by a larger portion of the population.

Investors should adjust their attitude in the light of these challenges. They should be thinking more about the quality of economic growth and development as opposed simply to the quantity of growth.

Over the past 10 years, the investment community has focused on the level of economic growth in emerging markets – namely GDP growth – as the main reason for the attractiveness of these markets.

However, not much interest has been given to the sustainability of this growth or its distribution within society – both of which are key components for the long-term development of an economy.

Over the short term, aggregate economic growth is not a sufficient driver of investment performance, both on the equity as well as fixed income side. This point has been proven by various academic studies and brokerage houses over the years, but needs to be emphasised.

The reasons for this are many. First, GDP growth is a backward-looking figure, whereas equity markets are the present-value of future growth and earnings.

Second, GDP measures a nation's economic output, whereas in our globalised world, stock market indices – in emerging as well as developed markets – reflect earnings occurring around the world. Third, GDP is more closely associated with top-line figures and equity returns with bottom-line figures. Many emerging markets have not been able to translate top-line growth into bottom-line growth.

Finally, GDP gives very little sense about the distribution of economic growth within a society, and, therefore, little sense of who may be benefiting from a country's total increase in output.

Over a longer time frame, though, there is likely to be a stronger connection between these two concepts, but investors should be wary of equating the two.

To move beyond GDP, investors should be charting the development of emerging economies using a series of different metrics, including diversification of an economy, the diverse components of economic growth, improvements in governance (both corporate and political), the development of local capital markets and investor bases, and continued improvements in human capital.

Long-term investors

These five metrics will become an important gauge of whether an economy is developing the fundamental characteristics of an attractive and sustainable investment destination. With the post-millennial period of high across-the-board returns unlikely to be repeated, optimising returns will require a change of gear in emerging market investing and a more active approach.

The new environment requires intensive desk research, analysis and due diligence combined with flexible asset allocation. The additional quantity of preparation may deter investors hoping for the utopian world of easily earned premium returns: low risk, low cost, low volatility and high liquidity.

For long-term investors who understand the changing global opportunity, returns will flow to those who combine careful preparation with the necessary quantum of boldness. ▪

Philip Saunders (pictured), Max King and John Stopford, Investec Multi-Asset team; Aniket Shah is Programme Leader, Financing for Sustainable Development Initiative, United Nations.

Downturn in Bolivia

Challenge for economic model

Winston Moore, Advisory Board

For a decade, Bolivia under left-leaning President Evo Morales stood out as a model of sustained economic growth in Latin America. Booming commodity prices trebled government revenues, stimulated internal demand and boosted GDP. Inequality and poverty were reduced and record foreign currency reserves, low inflation, and fiscal and trade surpluses were achieved. But falling commodity prices jeopardise these advances.

Morales is Bolivia's first president of indigenous origin and will this year become its longest continuously serving head of state. He was re-elected for a third term with 60% of the vote in October 2014, and may seek a fourth term to forge ahead with his populist vision. International investors are hoping that this will be tempered by sound economic management. Bolivia provides a case study on how investors must concentrate on quality and sustainability of emerging market growth.

Driven by heavy public expenditure, the economy grew 6.8% in 2013, the highest rate in 38 years and up 21% compared to 2012. There followed a slow-down in 2014 with GDP growth of 5.2%. Growth was achieved on the back of a $12bn export revenue windfall, amounting to 50% of GDP and providing liquidity for increased public spending. Bolivia earned $6bn from hydrocarbon exports to Brazil and Argentina and nearly $3bn from lead, zinc, silver, gold and tin exports. The resulting $2.6bn trade surplus was equivalent to 7.3% of GDP, one of the highest rates in South America.

The decline in commodity and oil prices will result in a sharp fiscal reduction. Bolivia's international reserves of $15bn, nearly half the country's $32bn GDP and the highest such ratio in Latin America, will help ensure stability. Morales may look to support growth through increased indebtedness for public investments. Unfortunately, Bolivia is losing competitiveness since the boliviano has been pegged against the appreciating dollar.

The decline in export revenues will make it difficult for companies operating in Bolivia to recover costs. Yacimientos Petrolíferos Fiscales Bolivianos, the state oil company, might have to shoulder urgently-needed exploration work, a high-risk venture reliant on its own profits, as it may no longer be able to seek funding from the central bank.

President Evo Morales

Investors have shied away from Bolivia given the absence of laws to guarantee juridical security, and regulations to protect investment are still missing. Soon after coming to power in 2006, Morales nationalised the shares and operations of international companies in key state assets including oil, electricity, telecommunications, water, railways, and national airline companies which had been privatised or partially privatised in the 1990s. The majority of companies affected by nationalisation received compensation, albeit well below the amount demanded.

Bolivia withdrew from the International Centre for Settlement of Investment Disputes in May 2007, and wants all contracts in mining, hydrocarbons and the energy sector to be resolved in Bolivian courts.

Despite the country's relatively good macroeconomic performance, the Morales approach is building up trouble for the future. The economic model of placing undue priority on mineral extraction is running out of steam. Bolivia has not adapted an overall economic structure that is too reliant on mining and natural gas exports.

Morales' state extraction sector has no place, for example, for small and medium-sized companies. There has been little or no integration between different economic sectors. No less than 90% of companies in Bolivia are isolated and backward with limited options for development. 70% of state companies are not profitable and unduly laden with debt. The National Industry Chamber laments how the state has moved inexorably into economic activities previously carried out by the industrial sector. All this adds up to a formidable battery of problems for Morales as he ponders his political future. ▪

Winston Moore is managing director of Moore Associados. Photo credit Alain Bachellier.

ON GOVERNANCE

Investing in corporate governance structures would benefit many emerging market companies. Change is underway. There has been a slew of initiatives in Latin America and Africa to contribute to and learn from the global dialogue on corporate governance.

International Finance Corporation's Latin American programme includes the 'Companies Circle'. Founded in 2005, it enables members to showcase how companies in the region can implement good corporate governance and the benefits to be gained from transparency and accountability.

There has been a shift, too, in Africa. There is the New Partnership for Africa's Development – an African Union strategic framework which includes a corporate governance branch; the Pan African Consultative Forum on Corporate Governance; the AU's African Peer Review Mechanism to promote high standards; and the African Corporate Governance Network, launched in 2013.

To add to the mix, international agencies including the International Finance Corporation are taking an interest in improving corporate governance in Sub-Saharan Africa.

In addition to the larger-scale African initiatives, individual countries are working on renewing their corporate governance codes and improving compliance in general. The Institute of Directors in Southern Africa introduced the King Code of Governance Principles and the King Report on Governance in 2009. The Securities and Exchange Commission of Nigeria launched a new code in 2011 and Mauritius is reviewing its code with completion expected this spring.

All these platforms aim to develop best practice standards, raise awareness of the importance of corporate governance and develop action plans for its implementation.

With these networks and peer review mechanisms, Latin American and sub-Saharan countries are rapidly grasping the potential of effective corporate governance codes. Making companies more accountable and transparent can only be beneficial to emerging market economic growth. ▪

Liisa Vainio is Head of Projects

China's gold may back currency

Emerging markets increase gold holdings

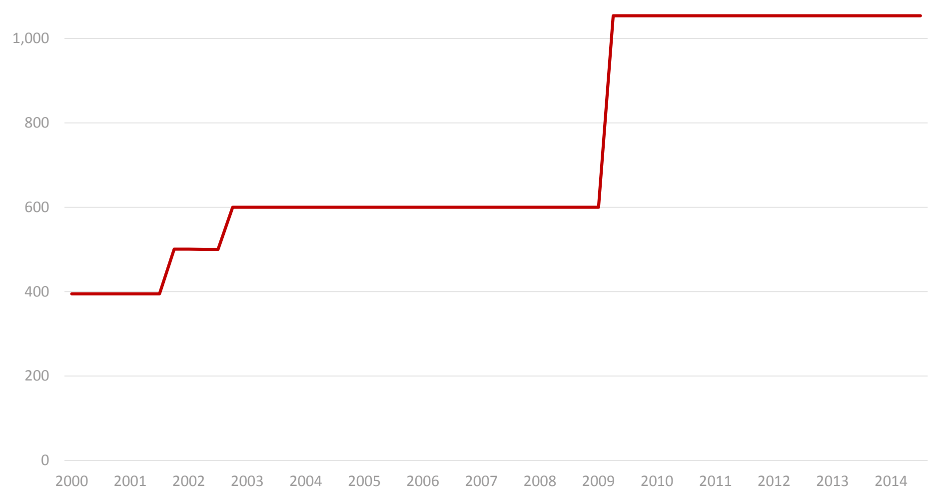
Bronwyn Curtis and William Baunton

Gold's central position in the global financial system disappeared after the collapse of the gold exchange standard and the Bretton Woods system in 1971-73. But now change seems to be underway. As the financial influence of emerging markets in the global economy has risen, so has their interest in diversifying away from US assets in their foreign exchange reserves. Another factor is the widespread move to negative interest rates on some top-rated bonds, making non-yielding gold holdings more attractive.

Gold is a natural beneficiary. In these intriguing changes to the world financial system, China is playing a pivotal role. We have already seen recent examples of Chinese diversification in the form of financial largesse for financially stressed countries such as Argentina, Venezuela and Russia. An accelerated move into development finance has been greeted with unease by the International Monetary Fund, the World Bank and the Asian Development Bank as Beijing reinforces political links with countries supplying China with oil and food.

The official version of China's gold reserves

Publicly declared gold holdings of China, 2000-14 (tonnes)



Sources: World Gold Council, IMF

The gold price has fallen a third from its financial crisis peak

London gold fixing price, 1968-2015 ($ per troy ounce)

Sources: London Bullion Market/FRED

Most of China's $4tn foreign exchange reserves is invested in relatively low-yielding US Treasury bonds. Chinese diversification into more productive 'real assets' has been apparent for some years, seen, for example, in purchases of equities and real estate by investment arms of the Chinese state. China has a long-term interest in building up assets that will provide tangible returns to the Chinese economy as well as political clout.

Chinese diversification

In foreign exchange, diversification of Chinese investments, too, is a fact of life, with the euro a beneficiary early on, as well as Asian currencies. (One of the reasons for China's interest in propping up the euro is to prevent too steep a decline in the value of the euro-denominated assets it keeps in its reserves).

This is where gold plays a role. Gold has been on China's 'buy list' for some time. It is an ill-kept secret in Beijing that gold producers in China – now the world's biggest producer of the yellow metal – have been selling some of their output to the state reserves. This could be several hundred tonnes a year.

In 2013, China produced 440 tonnes of gold from mining and another 120 from recycling while net imports were 1,200 tonnes. Total consumption for the country, however, was measured to be only 1,200 tonnes, leaving at least 500 tonnes unaccounted.

China has given no updates on its gold reserves, officially remaining at 1,054 tonnes since 2009, during a period in which several other leading emerging market economies – including Brazil and Russia – have been overtly building up their gold stocks.

Gold's decline

Gold has been largely out of fashion since the ebbing of the financial crisis in the past two years, especially since the dollar started to rise in mid-2014. European central banks made heavy sales in the 1990s.

Gold had something of a comeback during the peak of tension over the euro, but the 'normal' fundamentals driving the bullion price have been negative for some time.

In the past gold has been used as a hedge against a falling dollar and/or rising inflation. With the dollar heading higher and deflation rather than inflation the biggest concern especially in Europe, investors have spent the last two years liquidating gold exchange traded funds and other gold holdings.

One reason why the gold price has not been even lower is that, as the historical record shows, the metal has traditionally been a hedge against deflation (as demonstrated in the OMFIF report in January 2013 'Gold, the renminbi and the multi-currency reserve system'). In periods of deleveraging and deflationary pressures, gold becomes attractive and returns to fulfilling its traditional role as a store of value.

Central bank holdings

The rise in political tensions in the Middle East and the Ukraine has triggered some safe haven buying but the biggest marginal new buyers have been central banks in emerging markets.

Most central banks hold some gold but as a percentage of total reserves these holdings are tiny in emerging market countries compared with western central banks.

OECD countries have over 50% of their reserves in gold. Germany holds 67% of its total reserves in gold. Holdings in emerging market central banks are generally below 5% and for many they are just 1-2%. Malaysia holds just 1.1% in gold and Brazil a mere 0.7%. China's officially declared gold holdings are a mere 1% of reserves.

Central banks have been net buyers in gold since 2010. This contrasts with the large sales made by many developed countries in the early part of the century – selling that has now stopped. In 2014 central banks, led by Russia, bought 461 tonnes of gold, 13% higher than 2013 and the second highest level since 2010.

China is already the biggest player in the gold market, overtaking South Africa as the world's biggest producer in 2010 and India as the world's biggest consumer in 2013. China has an incentive to increase the amount of gold it has in its reserves, as part of generally demonstrating financial solidity, and especially as it aims to establish the renminbi as a viable alternative to the dominance of the dollar.

The latest data from Swift, the international currency clearing system, shows that the renminbi has overtaken the Canadian and Australian dollars and is now the fifth most used global payment currency behind the yen, pound, euro and dollar.

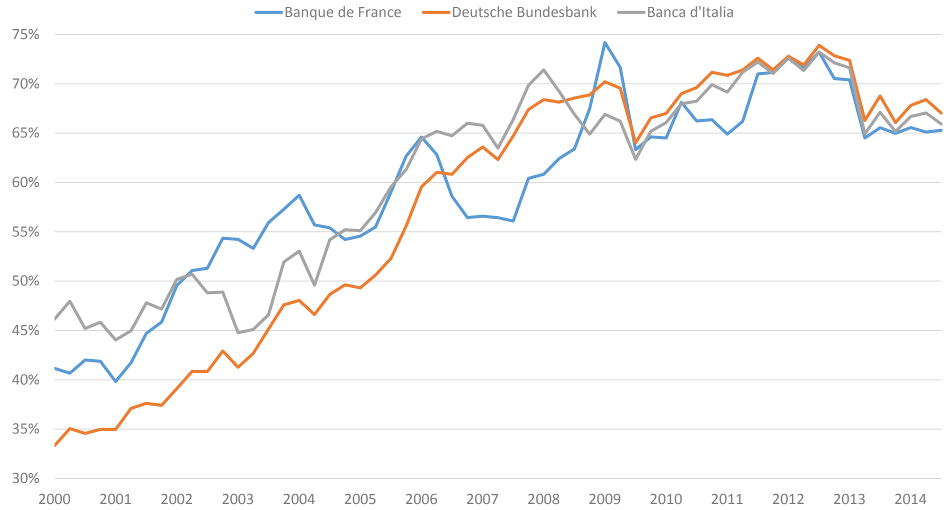
International payments are still dominated in dollars, which account for more than 44% of total total. But the march of the renminbi, albeit from a low level of just 2.2%, will continue as multinational companies, banks and investors step up use of the currency. The renminbi is still some way from full convertibility, but China is actively boosting its global use with an increasing number of reforms.

IMF reform

At the end of 2015, the International Monetary Fund will carry out a review of the Special Drawing Right, the reserve asset based on a basket of currencies. The renminbi could be included alongside the dollar, euro, yen and sterling. Gold would represent important backing, so it makes sense for China to boost the metal's share in its reserves as the renminbi moves further towards a more important role. ▪

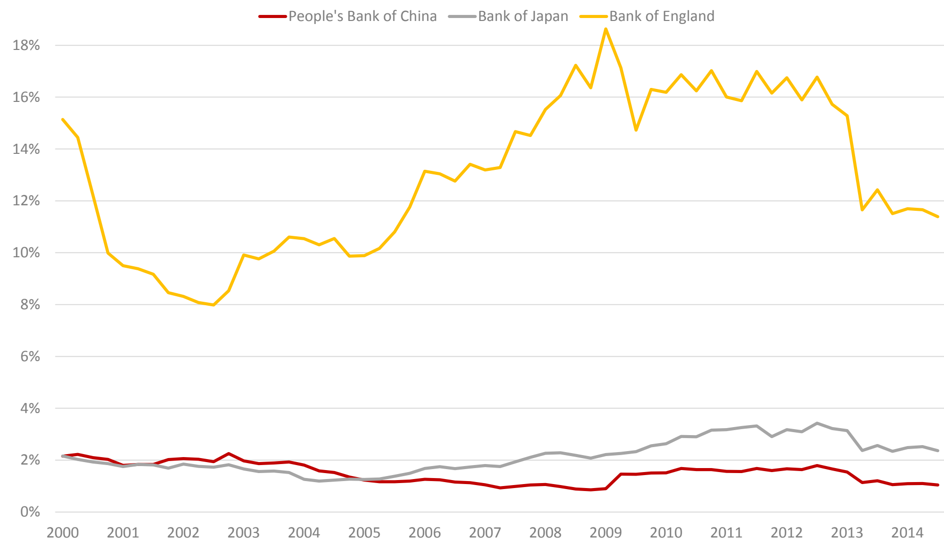
Bronwyn Curtis is Chief Economic Adviser and William Baunton is Economist, OMFIF.

European central banks' gold reserves stabilise around 65%
Total gold holdings, 2000-14 (% of total reserves)



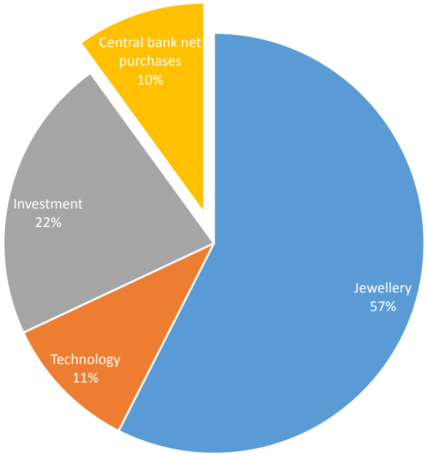
Sources: World Gold Council, IMF

Gold makes up only 1% of China's reserves
Total gold holdings, 2000-14 (% of total reserves)

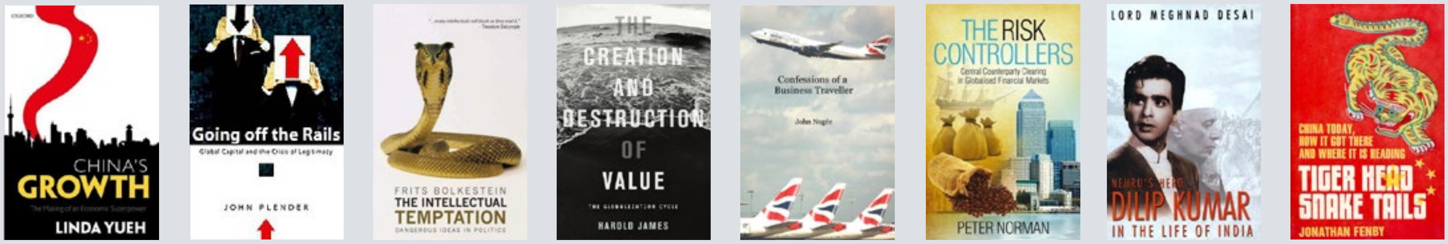


Sources: World Gold Council, IMF

Where the gold went
World gold demand Q3 2014



Sources: World Gold Council, IMF



Market failures warrant policy responses

Asia's experience is ripe for study

William White

***The Tides of Capital* is a must read for policy-makers. It is short, and they have little time. But more importantly, it punches above its weight in identifying the sources of problems faced by governments and central banks and the terrible trade-offs they are commonly confronted with.**

This brutal realism is not surprising since Julia Leung was a policy-maker in Hong Kong for over 20 years and has been tempered in the fire of successive crises. She puts that practical experience, and the insights revealed in the book's earlier chapters, to particularly good use in a remarkable final chapter. There, she suggests a framework for monetary and financial stability in Asia as well as improvements in international co-operation in the monetary and financial spheres. There is a great deal to learn in this book.

It is also essential reading for academics, and those influenced by them, particularly in the west. For many, it will not be pleasant reading. Leung reviews, chapter by chapter, a number of Asian economies, with her observations on China particularly absorbing and rather frightening when one looks to the future. Economies are not self-stabilising as many academic models assume. Moreover financial markets are not only extremely important for the real economy; they are also far from efficient, being subject to many forms of market failure. In particular, capital inflows and outflows are 'flighty' and momentum trading can violate the law of uncovered interest parity for long periods of time. Exchange rates might then go anywhere.

Francesco Papadia, Julia Leung and David Marsh at book launch in Frankfurt, 28 January

Policy advice

Policy advice based on academic assumptions that bear little relation to reality is useless. Indeed, Leung suggests it can be worse than useless. There is an 'edge' to her prose that reveals the lingering, bitter heritage of the Asian crisis and the policies forced upon many Asian governments at the time. The fact that western policy-makers, including the International Monetary Fund, have now embraced an Asian perspective seems actually to have worsened the distrust.

In addition, the IMF has been slow to enact governance reform through 'chairs and shares' to recognise the increasing importance of emerging market countries.

Asians resent their 'excess saving' being blamed for the current global crisis. Rather, they think it had more to do with the US and others 'living beyond their means'. The lesson must be that it is crucially important to find ways to put this distrust aside if we are ever to make progress in reforming the dysfunctional international monetary system.

As her title suggests, Leung is mostly concerned with the disruptive role played by international capital flows in Asia and elsewhere. They were at the heart of the Asian crisis. Volatile inflows and outflows from western countries have proved troublesome since the beginning of the global crisis. They bring inflation and 'imbalances' (not least elevated asset prices) on the way in, which implies a real vulnerability when the subsequent outflow begins. 'Spillovers' from easy monetary policies in advanced countries to emerging markets are real and important. Letting one's currency float more freely might well be desirable but it is no panacea.

I agree with all of the above, and with the broad thrust of Leung's suggestions concerning policies that might work to deal with this problem: capital controls, domestic macroprudential instruments and foreign exchange intervention to amass buffers against outflows. Market failures warrant, even demand, administrative responses.

Where I tend to disagree is with the degree of confidence she has in the efficacy of these measures, both past and presumed. We are still on a journey of intellectual discovery, albeit with the Asian experience being an important way station.

Leung's suggestion that macroprudential policies have been 'effective in limiting growth in household credit and cooling house prices' seems to me to go too far. In her own words, house prices in Hong Kong rose an 'astonishing 90%' between 2009 and 2013. This is not to deny that the use of instruments like loan to value ratios might have made the banking system more stable. Recall too the vigorous use of 'dynamic provisioning' in Spain which, while helpful, failed to avert the crisis and problems of bank insolvency.

To repeat, this book is well worth reading. If its exposure of policy shortcomings, both intellectual and practical, makes us all feel a little more humble that is no bad thing. ▪

William White is chairman of the Economic and Development Review Committee, OECD.

A challenge for the regional club

Asia may not have all the answers, but the west can learn

Niels Thygesen, Advisory Board

In *The Tides of Capital*, Julia Leung raises three important themes. Have the challenges in international economic policy-making become financial more than economic in origin? What lessons did Asia learn from its crisis in the late 1990s – and were they remembered in the recent more global crisis? And finally, did Asia receive counterproductive advice from the IMF and other orthodox sources two decades ago?

All three are vividly presented in the book, based on the author's extensive experience and interviews with policy-makers.

International crises

The events triggering international crises do appear to have become increasingly financial, in the form of sudden reversals of capital flows into a country. If these are largely inspired by events in the countries from which capital flows originate, rather than by policy mistakes in the receiving countries, that has obvious implications for international policy. The west must be tolerant of efforts to stem 'excessive' inflows, and provide compensating financing of the sudden reversal of flows. Tighter domestic policies and structural reforms have lower priority.

Many Asian countries faced massive ingoing and outgoing tides of capital in 1997, and more recently after actual or perceived changes in US monetary policy since 2010.

The Asians have learned to be more self-reliant, illustrated by their accumulation of international reserves. They have downplayed policies of pegging their currencies to the dollar, and built up national bond markets in their own currencies, reducing exposure to currency mismatches. And they have gained confidence in using policy instruments, out of favour or simply unused in industrial countries, such as capital controls – or 'management', in the current terminology.

In this sense Julia Leung's claim in the subtitle that 'Asia [has] surmounted financial crisis and is guiding world recovery' is well justified. The high tide in her text is her sense of vindication, understandable for an official subjected to strictures from international colleagues when Hong Kong intervened in its stock market in 1997. The Asians showed a capacity to innovate at such moments, and a talent for crisis prevention which served them well when the global crisis hit in 2008.

A major theme of the book – the allegedly poor quality of policy advice during the Asian crisis – seems to me questionable. The economic policies of the countries most affected were unsustainable. Thailand, Indonesia and Korea all needed major reductions of their current account deficits, justifying, at least initially, international policy recommendations of fiscal and monetary contraction with structural reforms. The IMF quickly relaxed the fiscal targets as recession developed, allowing automatic stabilisers to operate, but interest rates had to remain high longer to avoid excessive depreciation. Some structural reforms may only have been weakly related to rapid adjustment of imbalances, but seem, in retrospect, well justified.

Disaffection with the IMF persists, particularly among those who believe that international policy advice has been applied less harshly in industrial than in developing countries. There was, indeed, more emphasis on monetary accommodation and recapitalisation of banks in the 2008 crisis, particularly in the US.

A closer recent parallel to the handling of the Asian crisis is that of Europe after 2010 when financing of imbalances after a massive reversal of capital flows from stronger to weaker economies was not enough. Major fiscal consolidation and structural reforms in labour and product markets were required. The results are so far incomplete – and the medicine has proved as unpopular as it was in Asia. Emphasis on adjustment is usually inescapable, and remains on the IMF agenda.

Further questions

Leung's account raises further questions. If Asians are so unhappy with the IMF, could they have done more to provide an alternative? The reality seems to be that, when the going gets tough, a regional club is too narrow and mutually friendly. This makes a neutral outside arbiter advisable – assuming that it does not base recommendations on questionable empirical evidence, as may have been the case with IMF advice on capital flows. My belief is that the IMF was never as categorical, almost ideological, as Leung claims. The Fund has become considerably more pragmatic in recent years. ▪

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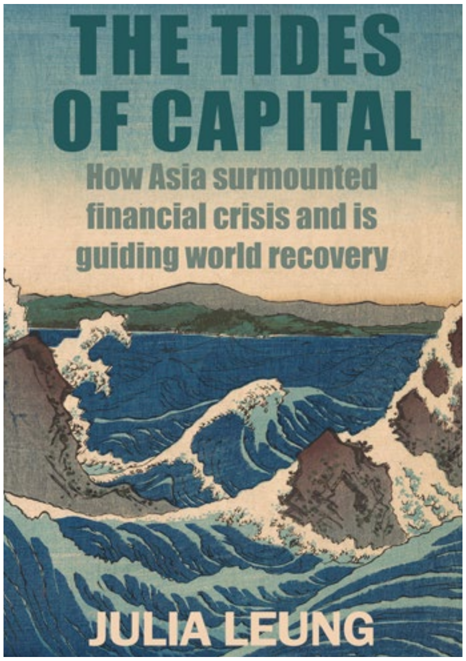

GLOBAL PUBLIC INVESTOR 2015

DRIVING WORLD ECONOMIC GROWTH

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

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

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

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