The Bulletin

February 2016
Vol. 7 Ed. 2

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

China in transition
A struggle for modernisation

John Adams on renminbi policy
Rubén Calderón on transatlantic capital
John Kornblum on why Merkel will stay
Frédéric Samama on green bonds
Ben Shenglin on Chinese banks

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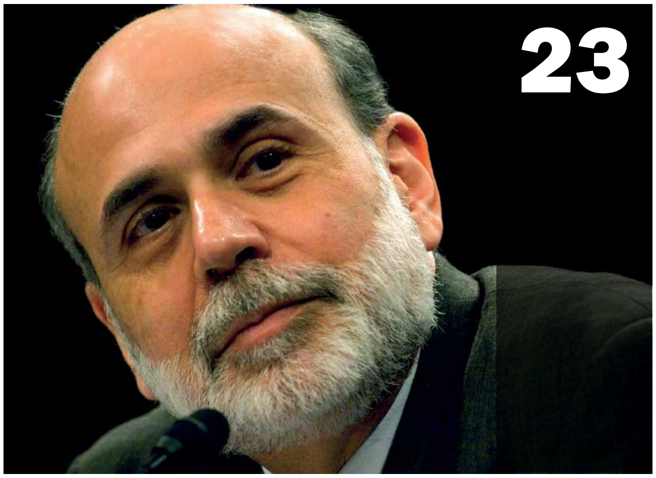

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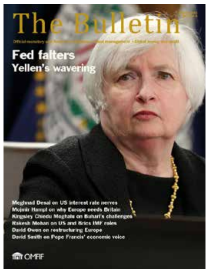
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EDITORIAL

China's tremors from triple transition

China is weathering a series of tremors as the world's second-largest economy traverses three separate transitions. These uncomfortable – possibly insurmountable – tasks provide the kernel of the February Bulletin, illustrated on the cover by Finance Minister Lou Jiwei, Premier Li Keqiang and Zhou Xiaochuan, governor of the People's Bank of China.

Shift No. 1 is the well-documented move away from an investment-led, export-orientated command economy towards one that is far more market-driven and guided by internal consumption – an evolution inevitably accompanied by a growth slowdown. The second concerns the currency: as a result of the renminbi's entry into the International Monetary Fund's special drawing right, China has to open its capital markets and operate an international money, even though it is still a developing country facing titanic internal challenges. The third switch is potentially the most difficult: the Communist party's struggle for modernisation to maintain its hold over a populace that is becoming increasingly wealthy, internationally mobile and politically and socially astute.

These trends are dissected by Jonathan Fenby, Ben Robinson, John Adams, Ben Shenglin, Marcello Minenna, Edoardo Reviglio and Willem Middelkoop. The renminbi's contortions – and the efforts by the PBoC to resist a substantial devaluation, reflected in falling Chinese foreign exchange reserves, down $420bn in six months to $3.2tn at end-January – have overshadowed New Year financial markets worldwide. For the time being, at least, the Chinese authorities, mindful of the sensitivities of the country's political-economic balancing act, are resisting any widespread shift to competitive devaluation.

In this context, the most significant news over the past month has been the relative weakness of the dollar against the euro, in spite of the general 2016 expectation of US monetary tightening and European easing. This partial about-turn reflects the widening perception that the US Federal Reserve will mitigate its planned interest rate increases in the face of global economic uncertainties.

Arguments over easing by the European Central Bank on 10 March are finely balanced. The Bank of Japan's surprise promulgation of negative interest rates on 29 January makes action more likely, but hawks on the ECB council are fighting a rearguard action, highlighting failure so far in boosting inflation and the sapping effect on budgetary reforms of rising volumes of ECB-held government debt.

Darrell Delamaide displays sanguinity in predicting that the US can avoid a recession, partly because the Fed has now turned more dovish on interest rates, while John Kornblum believes that Germany, and particularly Chancellor Angela Merkel, will overcome its tests on migration and the euro. Rubén Calderón extols underlying stability in capital flows between the US and Europe. Frédéric Samama explains the virtues of green bonds. Brian Reading, Denis MacShane and Jacques Lafitte unravel the intrigues surrounding the forthcoming UK EU membership referendum.

The outlook for emerging markets is murky, too. But, amid general gloom over Brazil, David Smith spots signs of hope in Argentina. We end with two book reviews, by William Keegan and George Hoguet, praising a scholarly work on British prime ministers and the memoirs of former Fed Chairman Ben Bernanke – providing intellectual guidance that may be needed as 2016 progresses.

Poland 'shock' over credit downgrade

Tests may be looming over central bank independence

A special correspondent in Warsaw

A climate of disbelief was palpable in Warsaw in January when rating agency Standard & Poor's announced it was downgrading Poland's long-term foreign currency sovereign rating from A- to BBB+, and changing its outlook to negative. While experts have hailed Poland's efforts to reform its economy, many in Warsaw believe agencies are not sufficiently objective in assessing the country's performance.

The S&P statement emphasised a significant erosion of institutional checks and balances – an allusion to the continuing row over the appointment of constitutional court judges and government moves to curb media independence. A more judicious decision by S&P would have been to impose a negative downgrade on the outlook, rather than cutting the rating by an entire notch.

Many observers, including S&P, believe that the ruling Law and Justice party – elected in October – could start to test the National Bank of Poland's independence.

There has already been talk of moves to replicate the Bank of England's Funding for Lending Scheme (aimed at encouraging banks and building societies to increase lending to the real economy), though the central bank has rejected these plans.

The banking system is swamped by liquidity stemming from the conversion of EU funds into domestic currency, and the central bank is regularly withdrawing excess liquidity. Under such circumstances, there would appear little justification for an FLS-like programme. But Marek Belka, president of the central bank, whose tenure ends on 10 June, has offered the government his support. Such co-operation will be essential.

Much has been achieved over the past 26 years. However, Poland's per capita GDP remains lower than that of Greece, while the fruits of economic reform have not been evenly shared. That is why the new government, aware of the social discontent that brought it to power, is focusing on social issues.

The government has pledged to increase both spending and revenues, including a controversial tax on banks. Other measures being considered include a plan to lower the retirement age – new President Andrzej Duda's key pledge. The debate over the issue suggests that many Poles are simply unaware of the challenges that globalisation poses. But it would similarly be unfair to characterise a desire to retire earlier as a uniquely Polish phenomenon.

Political parties traditionally moderate their positions when moving from opposition into government, and the ruling party already appears to be distancing itself from some of its election pledges.

The ministerial team in charge of public finances is making a reasonably good impression. The new government appears willing to co-operate with the central bank.

Any far-reaching changes to constrain the bank's independence would certainly be badly received by financial markets. Poland's future remains finely balanced. ■

Advisory Board

OMFIF has appointed Yaseen Anwar and Brian Reading to the Advisory Board. For the full list of members, please see p. 20-21.

Yaseen Anwar is senior adviser to the Industrial and Commercial Bank of China, Singapore, and on the advisory board of the International Monetary Institute, Beijing. In 2014 he retired as governor of the State Bank of Pakistan, where he spent seven years. As governor, he signed currency swap agreements with China and Turkey, and Pakistan became the seventh country to sign an agency agreement with the People's Bank of China to invest in local government bonds. Prior to the central bank, he worked for more than 30 years in New York, Paris, London, and Egypt with JPMorgan Chase, Bank of America and Merrill Lynch.

Brian Reading is a veteran British economist with a career spanning more than five decades. Initially an Oxford academic, he was successively a Bank of England adviser, a temporary civil servant, economic advisor to Prime Minister Edward Heath (1970-72) and economics editor at The Economist. From 1989-91 he was visiting professor at Strathclyde University. Thereafter he became an international consultant, latterly with Lombard Street Research, which he helped to found. He is the author of *Japan: the coming collapse* in 1992 and *The Fourth Reich* in 1995.

Monetary tools 'cannot resolve crisis'

Europe resistant to integration, vulnerable to shock

Monetary policy is unable to solve the crisis in the euro area – instead, fiscal reforms and a strengthening of European capital markets are needed to boost growth, demand and competitiveness. These were among the conclusions of the Economists Meeting on 4 February in Frankfurt, which focused on establishing a favourable policy mix and regulatory environment in Europe.

Participants highlighted the need for investment to raise the potential growth rate, but suggested political risk and regulatory uncertainty were hindering this. Inability to define adequately the nature of the crisis or the appropriate response has reduced the effectiveness of post-crisis policy-making, and created tensions between the member states of the EU.

Britain's potential exit from the EU highlights these challenges, but a consensus on how best to reform Europe and encourage Britain to stay in was lacking. Reforming the banking sector, the labour market, and the tax system remain unfinished tasks, but the need for closer policy coordination is hindered by declining political support for European integration. Participants concluded that Europe is vulnerable to a future shock precipitated by tightening liquidity conditions.

Wrestling with impact of lower oil prices

Migrant measures buoy activity through public spending

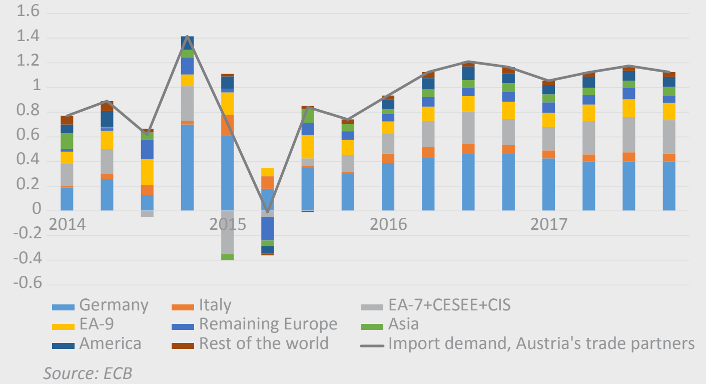
The contradictory implications of lower oil prices on the European economy were high on the agenda at the Economists Meeting at the Österreichische Nationalbank in Vienna on 25 January, attended by bankers and asset managers from central and eastern Europe and around the world.

Hosted by Ewald Nowotny, OeNB president, the meeting heard that cheaper oil had exerted downward pressure on wage growth, reflected in the lower inflation rate that was keeping interest rates low as the European Central Bank struggled to increase prices through cuts in negative deposit rates and expanded quantitative easing.

Measures to deal with migrants were positive for economic activity because they acted as a 'public spending programme'. As the Chart shows, foreign trade influences on Austria's economy are becoming more internationally balanced as a result of a fall in the relative growth rate of central and eastern Europe, reflected in more substantial flows of exports to other parts of the world.

Austrian export growth becomes more balanced

Regional contributions to quarterly growth (%)



Source: ECB

Briefings

Nakao shares plans for investment

Takehiko Nakao, president of the Asian Development Bank, outlined the bank's wide-ranging plans to boost infrastructure investment in Asia at a discussion with OMFIF in London on 26 January. Spelling out ADB's operational principles for loans and grants of $14bn a year, Nakao was sanguine on co-operation with the Asian Infrastructure Investment Bank, set up under Chinese leadership last year, saying the two institutions could work in a complementary manner.

Obstfeld dwells on China

Prof. Maurice Obstfeld, chief economist at the International Monetary Fund, addressed the impact on the world economy of the slowdown in Chinese growth in a discussion with OMFIF members in London on 20 January. The exchanges included issues connected to capital controls in emerging market economies to offset the impact of dollar fluctuations, as well as the outlook for the world economy in what has started out as a stormy and volatile year.

Adonis outlines infrastructure finance

Lord Andrew Adonis, chairman of the UK government's National Infrastructure Commission and a member of the OMFIF advisory board, outlined the criteria behind a more integrated approach to infrastructure planning in a London discussion meeting on 12 January. The exchange of views included attracting finance from official institutions and sovereign funds from around the world, as well as the impact on infrastructure investment of efforts to withstand climate change.

Frieden's currency briefing

Prof. Jeffry Frieden, professor of government at Harvard University, and a member of the OMFIF advisory board, discussed the regulatory and monetary policy roles of central banks at a London breakfast with the advisory board on 20 January. Frieden expanded on some tenets of his most recent book, *Currency Politics: The Political Economy of Exchange Rate Policy,* regarding the factors behind monetary decision-making in view of fluctuations in advanced and emerging market currencies.

Iceland's lessons

Guðmundsson on recovery

Már Guðmundsson, governor of the Central Bank of Iceland, discussed the country's post-crisis recovery and the role of unconventional policy in reigniting growth at a City Lecture in London on 28 January.

He explained that Iceland's position as a small, open, financially integrated economy with an independent monetary policy allowed it to pursue capital controls and a flexible exchange rate which stabilised the economy. However unwinding these policies and liberalising capital controls present challenges in the year ahead.

Guðmundsson drew three main conclusions from Iceland's crisis. First, small countries hosting headquarters of large multinational banks face unacceptable risks without a multilateral financial safety net. Second, cross-border banking in the EU, without a full banking union, is dangerous. Third, capital controls and flexible exchange rates can lessen the effects of the crisis and help with post-crisis readjustments, but can be difficult to unwind afterwards.

Dollar pre-eminent

Caruana unravels world money

Jaime Caruana, general manager of the Bank for International Settlements and former governor of the Banco de Espana, dwelled on aspects of the multicurrency system at a meeting in London on 4 February.

Among the subjects under discussion was the difference between a multicurrency system, with several international reserve currencies, and a multipolar one, with several important reserve currencies.

Caruana concluded that while the world has several reserve currencies, the dollar is still pre-eminent.

Another issue was the propensity for central banks to manage their monetary and exchange rate policies entirely on domestic concerns, with very low coordination. Questions were asked about whether policy-makers were paying enough attention to cross-border factors.

2016 YEAR OF THE MULTICURRENCY SYSTEM

‘Glass half-full’ mentality prevails

Overcoming adversity in US and Germany

The outlook for Germany is positive despite the problems besetting Chancellor Angela Merkel. The refugee crisis and rumblings within her own party create an unpropitious background, but few believe Germany would be better off if Merkel was replaced as chancellor. In the US, the economy is expected to bounce back following weak fourth-quarter growth. Consumer spending is reassuring. If the Fed backs away from raising rates and consumer demand remains relatively strong, most economists predict the US will avoid a downturn.

Reaping the lessons of Sigmund Freud

John Kornblum, Advisory Board

The question for Germany in 2016 is whether it will remain the pillar of stability in Europe, or whether multiple crises will tear away at its internal equilibrium – as they have in so many other members of the European Union.

Germans themselves often point out that they do better in hard times than in good. It is almost as if they cannot psychologically handle the absence of impending doom. This probably means that the difficult days ahead are just what the father of psychoanalysis Sigmund Freud would have ordered – get out there and head off disaster.

Reading the tea leaves in Germany can be fraught with difficulty. One way to be led astray is to pay too much attention to daily political chatter. In the more than 50 years since I first came to Germany, I have learned some important lessons.

First, a society so scarred by the past desperately yearns for stability and predictability. What passes for political debate is really mutual hand-wringing about impending risks.

Catastrophe is always just around the corner – hence Chancellor Angela Merkel’s argument that the euro is needed to prevent a third world war. There is even an untranslatable term for this syndrome: *Problembewusstsein*, which can be roughly rendered as acute awareness of the existence of problems.

This is one reason why there is little public discussion of alternative courses of action. German politicians have learned never to be caught proposing meaningful policy changes. Despite helping return Germany to economic prominence, at the time he was chancellor Gerhard Schröder was voted out of office in 2005 for doing so with his new economic agenda. Instead of direct alternatives, politicians have learned to describe new ideas as strengthening the status quo. Taking aim at politicians is one way of pretending to be seeking change. Circular talk show debates create an impression of immobility and conflict that do not really exist.

Last year was eventful for Germany. Just as its role as the centre of European political and economic life was solidifying, the full import of the migration crisis came crashing through.

Most current debate revolves around the future of Merkel, whose charitable approach to refugees has stimulated what some have described as a full-scale revolt within her own Christian Democratic Union party. Finance Minister Wolfgang Schäuble has clearly taken some soundings, and appears to be positioning himself to step in if ‘asked’ to do so.

But caution is in order. Despite the sexual assaults in Cologne on New Year’s Eve – for which refugees were widely blamed – Germany is far from in crisis. In fact, the papers are filled with reports of creativity and charity in making life better for refugees.

For all the grumbling in her party, Merkel has become an international superstar. Few believe Germany would be better off if she were replaced as chancellor. She is likely to be around for a long time. ■

John Kornblum is senior councillor at Noerr and a former US Ambassador to Germany.

US ‘unlikely to slip into recession’

Darrell Delamaide, US Editor

Economist surveys in late January put the odds of the US slipping into recession this year at only 20%. This is up from 15% in December. But if the Fed backs away from raising rates and consumer demand remains relatively strong, most economists think the US will avoid a downturn.

The US economy, on latest International Monetary Fund figures, is forecast to grow by 2.6% in both 2016 and 2017, compared with an estimated 2.5% in 2015 and 2.4% in 2014.

These projections take account of lower forecasts for global growth by the World Bank and the IMF, as well as of weak fourth-quarter US expansion. In early January the World Bank said that in the US this should pick up to 2.7% in 2016 from 2.5% in 2015, the strongest since before the financial crisis.

The IMF has cut its forecast, but its predictions do not offer any grounds for substantial worries. Following the late-January announcement of weak fourth-quarter growth – 0.7% compared with 2% in the third quarter – economists stuck to their view that the US economy was a case of a glass half-full rather than half-empty.

While exports and domestic investment drifted into negative territory, consumer spending was reassuring for most, even though this declined for a second quarter in a row. There was confidence the economy would bounce back, possibly as early as the first quarter of this year, with growth returning to 2% and above.

An inventory glut and the dampening effect of warm weather on purchases of winter items and utility spending prompted some economists to see the low fourth-quarter figure as a ‘speed bump’ representing only a temporary slowdown.

A solid housing sector, steady job gains and low energy prices contributed to this optimism. Foreign trade, given the weak economies in most other countries, is likely to remain a drag and the pain experienced in the oil and gas industry offsets much of the gains from lower energy prices.

The Federal Reserve has already signalled it is ready to back off its plan to raise interest rates a full percentage point over the year. The policy-makers of the Federal Open Market Committee will return to a wait-and-see stance as they try to read the mixed economic data. ■

Darrell Delamaide is a writer and editor based in Washington, DC.

Growth travails for Beijing and Brazil

Regional differences trouble China, Latin America

Beijing's ability to manage declining growth and introduce structural reforms will be the essential challenge facing China in 2016. A stormy year will see the Shanghai stock market fluctuate amid swirling expectations of official intervention. In Latin America, Brazil and Argentina are likely to experience a markedly different 2016. While Brazil remains mired in the worst economic crisis in a generation and a political scandal comes ever closer to the country's leadership, there is a palpable change of direction in Argentina.

Chinese leaders face stormy 2016

Jonathan Fenby, Advisory Board

Chinese growth will slow further in 2016 to around 6.4%, according to official data. The actual number is widely believed to be 1-1.5 points lower.

The gap underlines how China's outlook is full of uncertainties and hazards, as a result of multiple conflicts between politics and economic policy-making. The essential question will be the leadership's ability to manage declining growth, as well as its readiness to introduce structural reforms that will inevitably initially slow expansion.

Expected volatility may be over-interpreted by markets, which are finding it hard to accept that the world's second-largest economy is experiencing a long-term transition in which monthly data have limited meaning. Disparate – and occasionally contradictory – factors are at work. For example, services will continue to grow while heavy industry declines. The administration of President Xi Jinping will speak of reform, but this essentially means strengthening the state sector rather than privatisation or opening up protected sectors to significant competition.

Important regional differences will test Beijing's ability to implement decisions across the country. Some provinces – notably the industrial north-east, coal-mining Shanxi and steel-producing Hebei – will be in or near recession. Others, such as Chongqing, which reported 10% expansion in 2015, will maintain strong growth. The anti-corruption campaign will continue, aiming to make state-owned enterprises more efficient but curbing entrepreneurial initiative. Increased Communist party control will introduce a political factor into the bid to build 'national champions'.

China's international presence will grow further with projects under the 'One Belt One Road' programme, including a big effort to expand in Iran. Tensions in east Asia will not abate. Beijing will find dealing with the newly-elected administration in Taiwan tricky.

The debt mountain of around 250% of GDP remains a major problem. Debt service costs become more important as growth declines. Municipal bonds will be issued to finance non-performing local government loans from state banks. But the banks will buy most of the bonds, making this a balance-sheet transfer. If the new five year plan in March sets too high a growth target (6.5% or more), increased leverage will be the only way of meeting targets, with dangerous implications for corporates facing falling profitability.

China has not significantly reduced excess capacity, and in some cases has increased it. So China will export deflation to the world. The distorted Shanghai stock market will continue to fluctuate on expectations of official intervention, undermining valuations. The most important factor is the currency. If capital flight continues at a high level, the renminbi will depreciate against the dollar and exchange controls will tighten. The experience of 2015 – above all the mishandling of foreign exchange fixing and the stock market, as well as increasingly politicised decision-making – points to a stormy 2016. ■

Jonathan Fenby is Director of Trusted Sources.

Brazil plummets, Argentina secures foreign investment

David Smith, Advisory Board

Latin America's heavyweight economies are heading in different directions. The outcomes in Brazil and Argentina will significantly affect the region.

Numbers from Brazil show the worst economic crisis in a generation. The real has sunk against the dollar, devaluing 50% in a year, while inflation recently broke through the 10% barrier – a level deemed unacceptable just a few months ago. Unemployment figures underline the dire economic position. More than 1.5m jobs were lost last year – 600,000 in December – with virtually every sector reporting contraction. GDP shrank by 3.8% and a similar outcome appears likely this year – the first time the regional giant will have suffered consecutive years of economic contraction since the 1930s.

President Dilma Rousseff, facing impeachment as the Petrobras bribery investigation moves ever closer to the leadership of her Workers' party, blames Brazil's woes on the global economy, the slowdown in China, and rising US interest rates. But one banker in Sao Paulo says that Rousseff is 'in denial of the real problem... Brazil can't afford her government and Brazil can no longer lead the region.'

By contrast, Argentina's new leadership has made a good start. President Mauricio Macri took his pro-market, pro-business message to the World Economic Forum in Davos, and won guarantees of billions of dollars of foreign investment from major multinationals. His inheritance is daunting – 25% inflation, a fiscal deficit of 6% of GDP, and the peso swinging between 9 to the dollar (the official rate) and 16 and higher (unofficial). The currency is floating freely, government spending is being cut, taxes on exporters have been slashed, and Argentina is returning to world markets with a conviction not seen in a decade.

The government has to make tough decisions, not least how best to curb wage rises in the face of high inflation. But the change of direction is palpable. According to a long-term investor in Argentina and Brazil, 'The government in Argentina seems to understand you can't avoid the fork in the road. Brazil just looks the other way.'

Other countries are watching. In Colombia, Peru, Mexico and Chile, where change has been the mantra in recent years, there is a belief that Argentina's new direction will be the litmus test for an agenda based on pragmatism rather than ideology. The hope is that Brazil's crisis will be the catalyst for fresh thinking throughout Latin America, rather than dragging the region towards further recession. ■

David Smith represented the UN Secretary-General in the Americas, 2004-14.

Investors see ‘Eumerica’ benefits

US-Europe alliance strengthens capital flows

Rubén Calderón, Fidelity Investments

The strategic importance of the alliance between the US and western European nations rose out of the ashes of the second world war. This alliance, or ‘Eumerica’, is not accidental, nor is the fact that it has fostered the highest levels of capital flows in the form of investment and financial capital.

With the standing of the EU – and the euro area – likely to preoccupy investors, it is worth reviewing what sustains ‘Eumerica’ from the point of view of capital flows.

Foreign investment

US foreign direct investment flows to the EU in the fourth quarter of 2014 were roughly equivalent to those the US received from the rest of the world, at around $190bn – of these, the EU accounted for more than 50% ($100bn). EU FDI flows to the US have remained stable since 2009, albeit at 50% of previous levels.

By comparison, FDI flows from the US to China were $6bn, or 3% of US FDI flows to Europe, while China’s share of outgoing European FDI to the US was 4%. Japan was the largest source of FDI for the US, at more than $32bn. US FDI flows to the UK amounted to $47bn.

These levels of investment bolster the claim that the transatlantic economy employs 15m workers in mutually ‘onshored’ jobs on both sides of the Atlantic – this at a time when long and arduous negotiations over the Transatlantic Trade and Investment Partnership remain in doubt. The power the deal’s eventual conclusion is likely to unleash will increase the potential for investment in productive capital and job creation.

Trade figures underline the vitality of the transatlantic trade route. According to data compiled by Johns Hopkins University’s Center for Transatlantic Relations, total foreign affiliate sales are the most significant commercial route in the world, with an estimated value of $5.5tn. Total foreign affiliate sales of multinationals between the US and Asia Pacific stand at $3tn. Total trade within NAFTA is roughly the same as that within the transatlantic economy ($1.3tn and $1.2tn respectively).

Portfolio assets

Portfolio assets offer further evidence of Eumerica’s significance. From just over $1tn in 2001, international portfolio assets grew to around $4.5tn by the end of 2014. The US, Luxembourg, the UK, Japan, Germany, and France were the leading recipients of portfolio flows.

Flows into mutual funds and exchange-traded funds on US exchanges contribute to financial flows on behalf of US investors. Assets under management for Europe-focused funds and ETFs stood at $1.5tn, 12% of the equity total, as of last January, higher than the level for emerging markets (9%).

Equity funds account for the lion’s share of US mutual funds and ETFs, with $12.5tn of assets under management. Bond funds account for less than half that amount. Flows into these asset classes can occasionally be volatile, as they respond to shifts in public perceptions of the stability of political or monetary regimes.

Benefits of global diversification

Europe’s sovereign crisis soured the mood of investors and tested their patience, and Europe-focused funds experienced outflows. But these were 44% of the outflows seen during the 2008-09 global financial crisis. Net flows into Europe-focused funds since 2013 have been higher than outflows during the global financial crisis or the euro crisis.

To the extent that earnings per share are a primary driving factor behind equities’ performance, the evidence supports the diverging performance of European and US stock markets since 2009. While US earnings rebounded from post-crisis lows in 2009 and saw a continuous run-up until recently, European earnings per share have failed to keep pace with their US peers.

Earnings and market trends aside, a dividend yield differential between Europe’s 3.2 and the US 2.0 is connected to flows into Europe-focused investments over the past two years, further evidence to counter predictions that Europe is ‘unravelling’.

Although a return of market jitters remains possible, the decoupling in stock market trends, along with persistent capital flows within the transatlantic economy, suggests that US investors recognise the benefits of global diversification. ■

Rubén Calderón is Portfolio Manager, Global Asset Allocation, at Fidelity Investments.

Southern Europe losing export market share

Despite substantial cost-cutting efforts, southern European countries have failed to significantly increase export market share since the financial crisis, according to data collated by the Österreichische Nationalbank for 2008-14.

According to the statistics, discussed at the OMFIF Economists Meeting at the OeNB headquarters in Vienna on 25 January, Cyprus and Greece have fared the worst, losing market share of 3% and 11% respectively despite cutting unit labour costs by 5%.

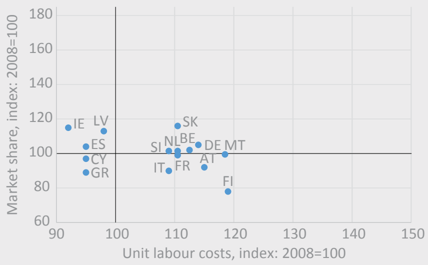
Most euro area countries have increased unit labour costs, with a 12% rise across the euro area after the financial crisis. But necessary economic rebalancing has failed to spark a substantial increase in activity.

The data may support those who argue that the euro area is suffering from inadequate overall demand and requires additional fiscal stimulus. Many countries’ post-crisis strategy of cutting costs through internal devaluations has depressed domestic demand while failing to increase exports.

But the figures also display some surprising conclusions. Slovenia, the Netherlands and Belgium registered relatively large increases in labour costs but marginally increased market share. Somewhat less unexpectedly, rising unit labour costs have come at the expense of market share in France, Italy, Malta, Austria and Finland.

Unit labour costs, export market share

Developments since onset of crisis, 2008-14



Sources: Eurostat, ECB

Sectoral differences are important. Manufacturing labour costs in Finland are below the euro area average, but the country has lost the largest total market share. This is largely due to declining export demand as a result of low euro area growth and a sharp contraction in exports to Russia. ■

Market turmoil turns Fed dovish

America brakes journey to credit normalisation

Darrell Delamaide, US editor

Close readers of the Federal Open Market Committee statement from the panel's late January meeting detected a note of caution bordering on uneasiness. Federal Reserve Vice-Chair Stanley Fischer (voter) sounded the same themes in a major speech at the start of this month.

Speaking at the Council on Foreign Relations in Washington, Fischer affirmed that the slowing economy – visible in the data after the Fed raised rates in December – had prompted the FOMC to keep rates unchanged in January and plan only a very gradual trajectory of increases in the coming months.

For one thing, Fischer said, 'Further declines in oil prices and increases in the foreign exchange value of the dollar suggested that inflation would likely remain low for somewhat longer than had been previously expected before moving back to 2%.'

> ***"The committee would be willing to see unemployment fall below what it considers a level that might carry inflation risks. This is because policy-makers feel there is still considerable slack in the labour market.***

Structural adjustments in China and the impact of low prices for oil and other commodities in emerging markets have engendered considerable volatility in asset markets.

'At this point, it is difficult to judge the likely implications of this volatility,' Fischer said. 'If these developments lead to a persistent tightening of financial conditions, they could signal a slowing in the global economy that could affect growth and inflation in the US.'

He quickly added, however, that 'we have seen similar periods of volatility in recent years that have left little permanent imprint on the economy'.

Fischer highlighted the Fed's overall accommodative stance in keeping its balance sheet at historically high levels by reinvesting principal payments from its securities portfolio: 'Doing so should help support accommodative financial conditions and so reduce the downside risks to the economic outlook in the event of a future adverse shock to the economy.'

Slack in the labour market

The vice-chair clarified that the committee would be willing to see unemployment fall below what it considers a level that might carry inflation risks.

This is because policy-makers feel there is still considerable slack in the labour market – people working part-time who would prefer full-time jobs, and those staying out of the labour market altogether but who would like to work.

In a similar vein the new head of the Dallas Fed Robert Kaplan (non-voter), who argued in favour of the rate hike in December, turned somewhat more dovish in January.

In remarks to reporters in Dallas earlier in the month, he said that FOMC participants' median expectation of four rate hikes in 2016 was 'not baked in the cake'.

But he added that there could be enough positive information to hike the federal funds rate by another quarter point by the committee's second meeting in March.

Kaplan grew more cautious in interviews in late January, noting that the committee's most recent statement had omitted the word 'balanced' to describe the risks facing the US economy.

'It should be saying to people (that) we are going to take some time here to understand what is going on,' Kaplan told Reuters.

Fumbles in China and plunging oil prices were among the concerns causing policy-makers to pause, he indicated.

'When you put all that together, I think there is good reason to be patient (and) take more time to assess the impact on the US economy.'

A need for more information

Kaplan, who took over the Dallas Fed in September after a career that included a long period with Goldman Sachs, sounded the same tone in a separate interview with Bloomberg.

'There is no predetermined path, we are going to be agnostic about this, we are going to be data-dependent and I need to see more information,' he told Bloomberg on a visit to New York. 'I wouldn't even speculate on what the next move is.'

San Francisco Fed chief John Williams (non-voter) also changed his tune from December, when he said the four rate hikes forecast for 2016 were in line with his own expectations.

Stanley Fischer, Federal Reserve vice-chair

'Standard monetary policy strategy says a little less inflation, maybe a little less growth, and argues for just a smidgen slower process of normalising rates,' he told reporters in late January.

Dennis Lockhart (non-voter), the head of the Atlanta Fed, was openly sceptical in mid-January that the Fed panel would have enough new information to proceed with a rate hike at the March meeting.

'How much will we know about inflation trends or inflation developments going into the mid-March meeting?' he told reporters following a speech in Atlanta. 'We will have some data but not a great deal more.'

Very few economists now expect the Fed to follow through with four rate increases this year and predictions – guesses – range from none to three.

Fewer go as far as Nobel economist Paul Krugman, who posted a blog just before the January meeting to the effect that the Fed had erred over the December rate hike.

Given the market volatility in January, Krugman said, 'Surely everyone would be feeling more comfortable if the Fed had waited, and probably decided not to hike for a while.' ■

Darrell Delamaide is a writer and editor based in Washington, DC.

Impasse of competitive devaluation

Renminbi depreciation would harm China's reforms

Ben Robinson, OMFIF Economist

Fears of a competitive devaluation of the renminbi and an impending currency war are overstated. Such fears rest on the assumption that China may pursue devaluation to boost exports and support its flagging economy, which in 2015 slowed to its lowest growth for 25 years.

China devalued 2% in August and substantially lowered the renmimbi's reference rate in January. The delinking of its currency peg to a basket of other currencies has been naturally reflected in a depreciation against the dollar. Despite all this, a committed policy of devaluation would harm the Chinese economy.

Part of last year's GDP slowdown stemmed from declining growth in both fixed-asset investment and manufacturing output – these fell by around 2% and 18% respectively compared with the previous year. Reinvigorating these sectors through devaluation would not put China back on the path to faster growth.

Large-scale investment has shown diminishing returns over the last few years as a result of growing overcapacity. High borrowing to fund infrastructure and other investment projects is weighing on the country's fiscal balance, with total debt now standing at around 250% of GDP.

China's future growth depends on rebalancing away from investment as a proportion of GDP. Currency depreciation and looser monetary policy to reduce domestic borrowing costs would hinder efforts in this direction.

Nor would currency depreciation unambiguously help China's manufacturing export competitiveness, given that China imports around 35% of the components for the goods it then exports.

Value-added goods

Much of the imported content of China's exports is the high value-added, research and design-intensive element of the goods, which China predominantly imports from the US, Japan, Taiwan and South Korea. Depreciation would make these imports more expensive and increase the production costs of its higher-value exports.

While goods with a high domestic content would become more competitive on export markets, China's high domestic-content exports are still relatively low-value. Boosting these sectors through devaluation would set back attempts to rebalance its economy away from lower-value manufacturing and towards higher-value services and consumption.

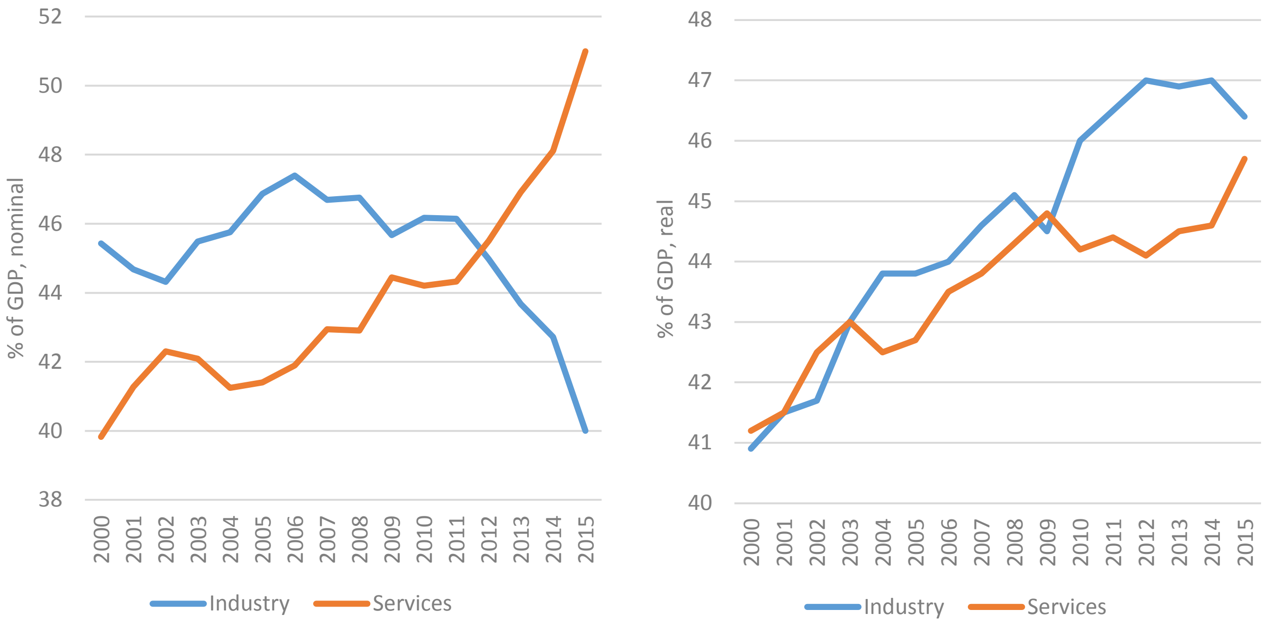
The limited extent of China's rebalancing is illustrated by Chart 1. Although services appear to be taking over from manufacturing, this is largely the effect of a decline in the nominal value of manufactured goods due to falling input costs.

> ***"China's future growth depends on rebalancing away from investment as a proportion of GDP. Currency depreciation and looser monetary policy to reduce domestic borrowing costs would hinder efforts in this direction.***

Adjusting for inflation, manufacturing as a share of output has fallen only slightly in recent years. Meanwhile, the associated producer-price deflation has harmed cashflow and increased the real value of debt for China's manufacturers, raising the pressure on these highly leveraged firms.

Chart 1: China's limited rebalancing – manufacturing to services shift less in real terms than nominal

Contributions to GDP growth, nominal and real (left and right), 2000-15



Sources: World Bank, China National Bureau of Statistics

The lack of progress on China's economic rebalancing in real terms, and the growing strain on China's traditional producer firms, bring important consequences. The results are twofold. A currency depreciation aimed at increasing the manufacturing industry's competitiveness by reducing total costs would further harm the profitability and cashflow of Chinese producers.

Additionally it would pose a threat to China's economic reforms and attempted move towards a more sustainable growth model.

Capital outflows

Much of the current downward pressure on the Chinese currency comes from the size of capital outflows, which totalled a net $676bn last year (Chart 2).

The strain on domestic producers is one reason for this outflow, with local firms desperately seeking growth outside of China. This led to a $32bn outflow of capital in the form of increased outward direct investment during the third quarter of 2015.

Foreign firms have rapidly limited their direct investment into China, which fell $32bn over the same period.

As US interest rates begin to rise, many Chinese companies have been paying down their foreign debts. Some capital outflows have therefore been beneficial, since they have effectively financed corporations' action in paying off foreign debts.

As a result many Chinese companies have healthier balance sheets and fewer liabilities. However further depreciation would be counterproductive, creating a less beneficial environment for national companies and foreign investors. Rather than encouraging economic activity, this could spur faster capital flight.

> ***"Much of the current downward pressure on the Chinese currency comes from the size of capital outflows… Depreciation would impose restrictions on China's monetary policy options and reduce the policy tools available to deal with these issues.***

Depreciation would impose restrictions on China's monetary policy options and reduce the policy tools available to deal with these issues. Stemming outflows resulting from depreciation may require the imposition of severe capital controls, a move suggested by Bank of Japan Governor Haruhiko Kuroda. Though this would create room for the central bank to expand monetary policy, it would severely limit inward foreign investment.

Moreover, the government could take advantage of cheap central bank money to finance an expanded fiscal stimulus in an attempt to boost domestic demand. The combination of loose monetary policy and fiscal expansion would risk returning the country to unsustainable borrowing and a dependence on fixed investment. This could lead to further overcapacity and the risk of exporting deflation, creating a negative feedback loop – consequences underlined by recent analysis from the International Monetary Fund.

China is aware of these risks, spending a record $108bn in December and almost $100bn in January to help maintain the value of the currency, while aggressively targeting the spread on the offshore renminbi rate. This suggests a renminbi devaluation of up to 10%, anticipated by some market commentators, is not desired by the government.

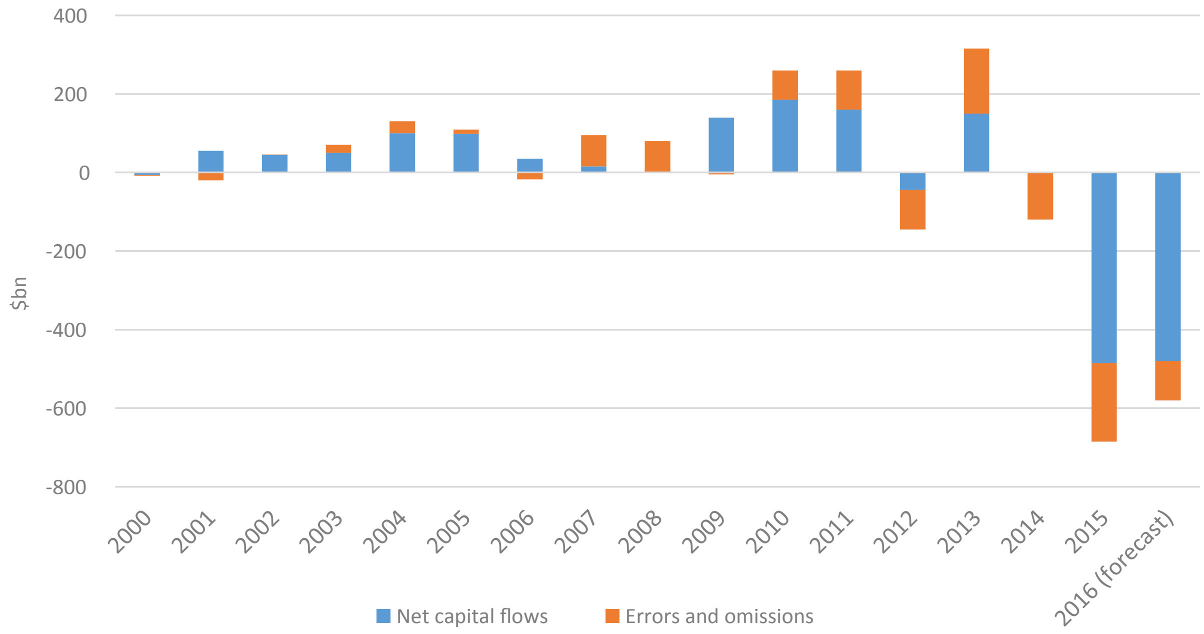
Smaller reductions in the reference rate are likely, but these are primarily to manage the effects of a rising dollar. Policy-makers recognise the dangers that depreciation presents to the health and long-term prospects of the Chinese economy and its attempts at rebalancing.

The real challenge for China is maintaining the value of its currency while fixing the weaknesses in its capital account position that are contributing to the downward pressure on the exchange rate. This is where capital controls can play a part.

A rise in the dollar will heap further pressure on China's official reserves, while further capital outflows will reduce already shaky confidence in China's economy. Depreciation would not help this predicament. ■

Chart 2: Chinese capital outflows increasing

Total net flows, including errors and omissions, 2000-16



Source: Institute of International Finance

Beijing’s currency contradictions

Chinese weigh benefits and costs of seigniorage

John Adams, Advisory Board

China’s renminbi policy is running into contradictions. With worldwide monetary policy in flux as the main industrial countries adopt competing monetary approaches, various aspects of the renminbi’s internationalisation are running into each other. This is creating inevitable complications and conflicts.

The current phase of economic weakening requires an export stimulus by depreciation. But national policy considerations demand monetary soundness, making centralised Chinese-style currency management fraught with difficulty.

Outsourcing currency policy to the foreign exchange departments of large companies, which would use appropriate derivatives and hedging instruments to handle risks, might be the answer – but that would imply a loss of control that Beijing might find unacceptable.

Internationalisation of the renminbi

China has been pushing ahead with the internationalisation of the renminbi as a currency for trade, and this is set to go further. Despite big increases in renminbi invoicing, the overall amount as a proportion of world trade remains extremely low.

According to the People’s Bank of China’s 2015 internationalisation report, the renminbi was the world’s fifth most used payment currency, the second most used trade finance currency, and the sixth most traded currency in 2014.

Renminbi trade use naturally accompanies a build-up of reserves of the Chinese currency in central banks around the world, particularly in countries (like Nigeria and Australia) with considerable commodity and raw materials exports to China.

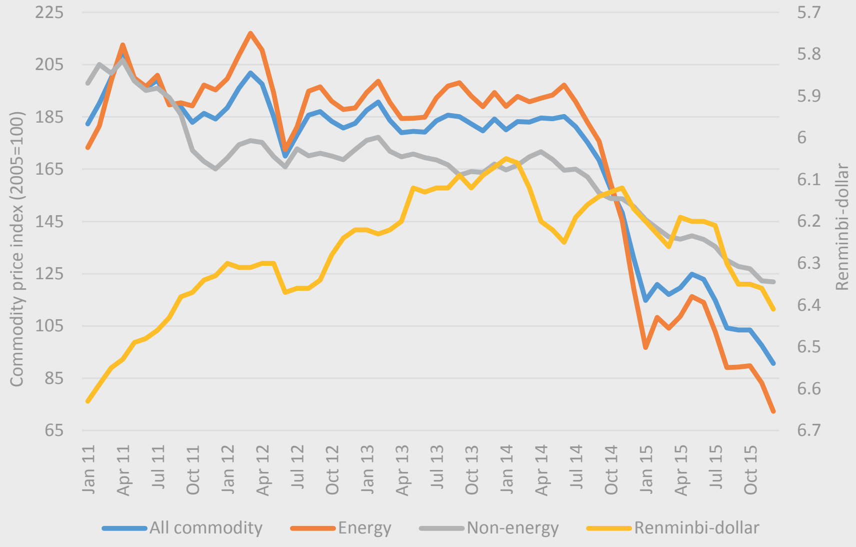
These official holdings were relatively non-controversial when renminbi appreciation was seen as a one-way bet against the dollar. But this policy is more difficult for central banks and reserve funds to explain to their political masters when the renminbi and national reserves are falling. This is particularly galling if the depreciation of the renminbi is seen as possibly engineered by China for export promotion purposes.

China’s response is that the renminbi has not moved much in trade-weighted terms against a basket of 15 currencies. The trade-weighted index of the Shanghai-based China Foreign Exchange Trading System shows a trade-weighted renminbi appreciation of around 3% last year, similar to the index computed by the Bank for International Settlements.

Although the renminbi’s depreciation against the dollar in the past few months has caused an underlying increase in import prices, this has been more than offset by the much larger collapse in world commodity prices, as the Chart shows.

Decline in renminbi offset by fall in commodity prices

Renminbi-dollar exchange rate against commodity price index, 2011-15



Sources: IMF, Bloomberg

But Chinese car drivers are being asked to pick up some of the bill for the falling renminbi: any further fall in world oil prices below $40 per barrel is not being passed on in the form of lower prices at the Chinese pumps. This will keep transport costs high in the vastness of China.

> **“Although the renminbi’s depreciation against the dollar in the past few months has caused an underlying increase in import prices, this has been more than offset by the much larger collapse in world commodity prices.**

The move is of course a rather blunt but effective way of keeping air pollution from rising even further in Chinese cities. It comes at a time when China’s government is importing record volumes of cheap oil at low prices to replenish its strategic reserve stocks.

The seigniorage effect

Chinese officials, academics and think-tanks have been examining the benefits and costs of a drift towards some sort of ‘seigniorage’ effect for the renminbi, and comparing it to the dollar experience.

As in the case of the US, China would benefit from the issue of renminbi to non-Chinese entities. Greater volumes of Chinese debt held by foreign asset managers would reduce debt service costs.

The seigniorage effect could enable China, as is the case in the US, to run a looser fiscal and monetary policy – a useful adjunct to policy during the current Chinese push to keep the budget deficit down.

On the other hand, an appreciating currency harms exports, and higher demand for Chinese assets could reduce returns to Chinese savers by depressing domestic interest rates.

Weighing up the pros and cons of currency internationalisation is a central task of Beijing’s financial management. ■

John Adams is Chief Executive of China Financial Services.

Global ambition unfulfilled

Chinese Big Five banks target developed markets

Ben Shenglin, Chairman, OMFIF Economists Network

Since China opened up to the rest of world nearly 40 years ago, Chinese financial institutions have been attempting to explore overseas markets and expand their business abroad. They have had some success, but need to do more before they can be considered truly global institutions.

The Chinese Banks Internationalisation Index, devised by the Academy of Internet Finance, aims to measure the progress of Chinese banks' internationalisation over time. It reflects criteria including offshore assets, operating results of overseas businesses, banks' overseas offices and the number of cross-border mergers and acquisitions transactions undertaken.

The index indicates that Bank of China is the most internationalised of China's Big Five state-owned banks, with an index value 2.5 times the five-bank average for 2007-14. Agricultural Bank of China is accelerating the pace of its internationalisation but still largely falling behind.

As of 2014, CBII values for BOC, ICBC, Bank of Communications, China Construction Bank and Agricultural Bank of China – on a scale of 0 to 100 – were 21, 8.2, 7.1, 4.1 and 2.7 respectively.

China CITIC Bank leads the way among joint-stock banks, and is more internationalised than both China Merchants Bank and Guangdong Development Bank. However, growth has moderated over the past five years, and Guangdong Development Bank is quickly catching up.

At the end of 2014, CBII values for China CITIC Bank, China Merchants Bank and Guangdong Development Bank were 4.4, 2.3 and 1.2 respectively.

Reflecting continuing low levels of internationalisation, contributions from overseas business to Chinese banks' overall results remain low. For the Big Five banks, the percentages of assets, revenue and net profits generated outside the Chinese mainland between 2007 and 2014 were just 8.1%, 6.1% and 6.3% of the total respectively, significantly behind global banks such as Citibank (60.3%, 50.6%, 50.3%) and HSBC (48.4%, 62.4%, 69.1%).

> *“As they look to expand, Chinese banks will need to be prudent when developing global strategies, which should reflect their own capabilities and priorities. Copying others will be fraught with risk.*

Overseas business

Chinese banks' overseas business is growing rapidly. Excluding the impact of the 2008 financial crisis and the Chinese government's Rmb4tn ($586bn) stimulus package, which generated lending opportunities for onshore businesses, overseas operations have expanded at a much quicker rate over the past eight years. Growth at the Big Five banks has averaged 28.6%.

Almost half of the overseas branches of Big Five banks are in Asia. There are more branches in more developed regions such as Europe and North America than in less developed regions such as Africa, showing that developed markets remain a major focus. Among the Big Five banks, Bank of China and ICBC have the widest international branch network, accounting for almost three-quarters of the total.

Developing global strategies

As they look to expand, Chinese banks will need to be prudent when developing global strategies, which should reflect their own capabilities and business priorities. Simply copying others will be fraught with risk.

They would also benefit from following government policies and strategic priorities more closely, and paying greater attention to financial regulations in different countries. For countries with lower regulatory barriers, establishing local branches and acquiring local banks may represent a possible entry route. ■

Ben Shenglin is Professor of Banking & Finance, Dean of Academy of Internet Finance, Zhejiang University and Executive Director, International Monetary Institute, Renmin University of China.

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Shadow of falling reserves

Banking defaults could precipitate chaos

Marcello Minenna and Edoardo Reviglio in Rome

There are no signs that the shadows over Beijing and Shanghai are lightening. Chinese stock markets have fallen 22% this year, with few signals of stabilisation.

The so-called circuit breakers have failed. Risks have grown through massive stock market support from government funds (the 'China plunge protection team') and Chinese banks' loans of over $200bn to institutional investors, all under the benign eye of the People's Bank of China.

The PBoC faces serious difficulties in managing the renminbi, under pressure from the US interest rate hike. The central bank has run down its foreign exchange reserves from $4tn in mid-2014 to $3.2tn in January in a bid to stem the currency's decline.

On offshore markets the Chinese currency is trading much lower than on the official one, raising speculation that the PBoC is managing the official exchange rate down towards the offshore value.

This detachment could be dangerous since it encourages a 'dollar black market' from operators defending themselves against devaluation risks.

Offshore renminbi markets are still in their infancy (only 3% of the official market) but are gaining weight rapidly after the November 2015 decision to bring the currency into the International Monetary Fund's special drawing right.

In a foretaste of possible Argentina-like troubles, in recent weeks Shanghai's foreign exchange booths have attracted sizeable queues of dollar-seeking Chinese citizens.

> *“On offshore markets the Chinese currency is trading much lower than on the official one, raising speculation that the PBoC is managing the official exchange rate down towards the offshore value.*

To mitigate renminbi short-selling, the PBoC has raised the overnight bank lending rate up to 80%. In the short term, the PBoC can win these battles, but falling foreign exchange reserves cast doubt on its ability to surmount a full-scale currency war.

The biggest risks lie within the Chinese banking system. In the last decade, credit to China's real economy has grown 10% a year, with corporate debt now surpassing 147% of GDP. Last year's economic growth decline to a 'meagre' 6.9% has raised registered bad debts to $700bn.

This is 2.3% of total banking assets, tiny compared with 40% in Greece and 16% in Italy, causing some independent analysts to doubt whether this adequately reflects Chinese banks' hidden risks – especially since the dollar's rise is exacerbating the problem of hard currency loan repayments.

A dangerous accounting malpractice – transforming standard loans into 'investments' supporting non-financial intermediaries (the shadow banks) – appears to be spreading. This reclassification allows banks to boost profits by circumventing regulatory standards imposing reserves against bad loans.

Lack of adequate reserves could trigger uncontrolled defaults of some of these shadow loans, precipitating chaos faster than anyone can imagine. The New Year has started badly in China. We may not yet have seen the worst. ■

Marcello Minenna is Ph.D. Lecturer at the London Graduate School of Mathematical Finance. Edoardo Reviglio is Chief Economist of CDP Group and Lecturer at the Department of Business and Management, LUISS Guido Carli, Rome.

Beijing's growing global role

Need for balancing domestic and international tasks

Willem Middelkoop, Advisory Board

For the first time since the end of the second world war, the US is no longer in the driving seat at the most significant global institutions. This could bring major changes to the global financial system over the coming decade. Assuming Beijing can overcome its shorter-term economic and political challenges, China should gain a much larger seat at the world monetary table.

Meetings have already been held to discuss China's role in a 'new global financial order'. At the 2014 Chinese International Finance Forum Jean-Claude Trichet, the former president of the ECB, told the audience, 'New rules have been discussed, not only inside the advanced economies, but with all emerging economies, like China.'

Other observers have called for China to assume a more central role in the global financial system. Speaking at last year's annual meeting of the Bretton Woods Committee George Soros, chairman of Soros Fund Management, argued that, 'The system we now have has broken down, only we haven't quite recognised it... You need a new world order where China has to be part of the process of creating it.' Soros added that the IMF and World Bank had 'lost their monopoly'.

China, still with the largest foreign currency reserves in the world, has increased pressure for reform of global financial institutions since President Xi Jinping took office in 2012. A stream of economic initiatives has followed, including the launch of the Asian Infrastructure Investment Bank, as well as further renminbi internationalisation.

The UK's March 2015 decision to be among the AIIB's 57 founding members prompted former US Treasury Secretary Larry Summers to declare that the date 'could be remembered as the moment the US lost its role as the underwriter of the global economic system'.

Beijing is serious in its demands for reform of dollar-centred institutions. In the IMF, for example, the most important decisions require a special majority of 85% of votes, giving the US – which controls more than 16% – an effective veto.

But China is on a path of co-operation rather than confrontation, as Xi noted in the US and UK last year. Beijing wants to be a force for predictability and stability in Asia and further afield. Undue monetary fluctuations need to be avoided. China will be happy to share a leading global role with the US in the coming decades. The question is whether this can be balanced with its array of domestic policy tasks. ■

Willem Middelkoop is author of The Big Reset and a co-founder of the Commodity Discovery Fund.

The greening of green investments

High-profile moves towards low-carbon activities

Frédéric Samama, Amundi Asset Management

Until recently, large institutional investors did not pay much attention to climate change. Environmentally friendly financial products were something of a niche market, and only a few investors seriously considered climate change issues within their broader risk management frameworks. But there is now growing awareness of the potential impact of such issues on the value of financial assets.

As part of their fiduciary responsibilities, long-term institutional investors are increasingly seeking to reduce transition risks stemming from an effective international response to climate change, and to take advantage of investment opportunities using new financial products. One result has been that low-carbon indices have enjoyed rapid growth. Investors are seeking products that can help reduce climate change risks over the long term without affecting short-term returns.

Many investors are seeking opportunities to directly invest in companies and projects that can help reduce climate change. Increasing interest from investors in green bonds and recent initiatives in China and India to mobilise private capital could have profound implications for this development.

Moving towards a low-carbon world

To motivate investors and send a clear message to policy-makers, the Portfolio Decarbonization Coalition was established in September 2014 with the UN's support. The organisation aims to gather investor pioneers in decarbonisation strategies.

The PDC has had high-level support from the outset, as well as ambitious targets. UN Secretary General Ban Ki-moon said, 'Some of the biggest – and potentially transformational – announcements at my climate summit came from the private sector. A coalition of institutional investors has committed to decarbonise $100bn in institutional equity investments.'

One of the direct consequences of decarbonisation is that asset owners start adjusting their investment strategies. They do so by withdrawing capital from carbon-intensive companies, projects and technologies, and re-investing in more carbon-efficient areas of the economy.

The PDC understands that, when large institutional investors begin to re-allocate capital on the basis of companies' carbon impact, this provides those companies with a strong incentive to change the focus of their investments to low-carbon activities, assets and technologies.

Investors in the spotlight

The PDC set out to assemble a coalition of institutional investors committed to decarbonising substantial investments across asset classes before December's climate change conference in Paris.

The initial $100bn target was surpassed within 15 months, finally reaching $600bn. This sends a strong signal that institutional investors are committed to tackling climate change risks on a significant scale.

This level and speed of commitment shows how mainstream investors are taking climate change more seriously. For example, the most recent asset managers to join the PDC — Caisse des Dépôts et Consignations in France, Stichting Pensioenfonds ABP in the Netherlands and Allianz in Germany — have committed to moving investments out of coal-intensive industries and into clean energy to 'decarbonise' large equity portfolios.

In Paris, the PDC was recognised as one of the key initiatives for addressing climate change in the private investment community. Following the conference, it published its first annual report setting out members' decarbonisation strategies.

> ***“When large investors begin to re-allocate capital on the basis of companies' carbon impact, this provides a strong incentive to change the focus of their investments to low-carbon activities, assets and technologies.***

Portfolio
Decarbonization
Coalition

Spreading a clear message

The Paris conference sent a clear message to investors. By coming together to adopt the most ambitious climate change agreement in history, countries showed investors that the global economy is moving towards a low-carbon future. But targeted regulations can further strengthen their mobilisation.

For example, the mandatory disclosure of climate change-related risk exposures for all asset managers, including state-owned vehicles such as pension funds and sovereign wealth funds, should be straightforward to implement, and support the emergence of a consensus on ways to reduce carbon emissions.

Institutional investors

France took the lead with the Energy and Green Growth Law in 2015, which included a provision concerning institutional investors.

The law extends the voluntary arrangement of the Montreal carbon pledge – under which investors commit to measure and publicly disclose the carbon footprint of their investment portfolios annually.

French President François Hollande said, 'In France, as well as in other European countries, we ask investors to report on the climate risk exposure of their portfolios.'

To maintain momentum, in 2016 the PDC intends to promote best practice across the investment community by engaging new investors. It will also engage governments and other stakeholders on how and where policy and regulations can support the adoption of best practice by institutional investors.

It is supported by other initiatives, such as the UN Environment Programme's inquiry into the design of a sustainable financial system. This acts as a secretariat for the green finance track, which China has established as part of this year's G20 presidency.

With the new G20 green finance track, the Financial Stability Board's task force on climate-related financial disclosures and national initiatives to mobilise investors in London, Paris, Beijing and Delhi, 2016 is set to be a pivotal year for investors.

This is an opportunity to take the PDC's proposals forward, and scale market and policy innovation to make the Paris agreements a reality. ■

Frédéric Samama is Deputy Global Head of Institutional & Sovereign Clients at Amundi Asset Management. For more information on low-carbon indices see Andersson, Bolton, Samama (2016), Hedging Climate Risk.

Yearning for Britain's global punch

UK independence referendum and the great divide

Brian Reading, Advisory Board

The divide between those for and against the UK leaving the EU – 'Brexit' – knows no conventional boundaries. UK political parties differ horizontally, left to right on the x-axis. Brexit splits parties vertically, top to bottom on the y-axis. Economists, corporate executives, trades unionists, the establishment, lower, middle, upper classes, media, young and old, public servants and private sector workers: all are divided.

Multinationals tend towards a self-interested stance against Brexit. But even here there are differences. Japanese car manufacturer Toyota says it will stay in Britain whatever the outcome.

Few voters will be persuaded to change sides during the debate. Many undecided may get bored and decide to remain undecided – not voting. 'Don't know' is not only a respectable position but also intellectually the most respectable. Nobody knows the future.

Numbers will be bandied about – the benefits of EU membership to date, the future costs and benefits of staying in or leaving. Measured in billions of pounds, they will be spuriously precise and utterly unfounded. Past, present and future costs and benefits cannot be known. All depend on counterfactual constructs, 'guesstimates' of what would otherwise have happened or will happen.

One analyst published his estimate of the benefits of being in. When asked about the costs of Brexit, he replied he did not know as that depended on the counterfactual. This is a bogus debate. The Scottish National Party pre-referendum independence arithmetic showed massive benefits for Scotland from North Sea oil. These vanished when oil prices plunged from $100 to $30 a barrel.

Logical arguments

There are, however, some issues that depend on logic. The establishment remains mesmerised by Britain's imperial legacy and yearns for the country to punch globally at its former weight. The ins argue that EU membership helps it do so. Not so. Although membership increases the EU's punch, it reduces the UK's. When the UK agrees, it is as strong in or out. When the UK differs, it is stronger out and the EU weaker.

EU members regularly disagree, and do so publically. There is often no EU position, so no voice. This is not to argue that the UK position, when it differs, is always right. But it is better to be seen as supporting or opposing, rather than submerged by indecision.

UK Prime Minister David Cameron and German Chancellor Angela Merkel

Another fallacy is to suppose foreign direct investment into an advanced economy is undeniably beneficial. Balance of payments current and capital accounts (now renamed financial accounts) are opposite and equal – the larger the capital inflow, the worse the current balance.

Freely floating exchange rates balance capital inflows with current outflows through currency appreciation. Foreign exchange intervention artificially increases capital outflows, boosting domestic demand for imports by its monetary consequences.

> ***"When the UK agrees, it is as strong in or out. When the UK differs, it is stronger out and the EU weaker.***

FDI creates identifiable and quantifiable employment gains. The consequent job losses are unidentifiable and unquantifiable. Domestic savings and technological improvements are crowded out. Advanced economies need not import management expertise.

A third fallacy is to argue that the UK is too small to go it alone. In an uncharacteristic non sequitur, Martin Wolf, an economics commentator, argued on 7 January in the Financial Times, 'The big justification for leaving is that the UK has long been able to sustain democratic self-government and no other arrangement could be as legitimate. The big argument against this is that the UK, with less than 1% of the world's population and less than 3% of its output, can achieve what it wants more effectively from within the European club.'

This must be based on an unstated premise. Britain is the world's ninth largest economy (PPP GDP) and 21st by population. In the EU Britain must take rules it fails to change. Out, it makes its own rules and can choose which EU rules to take. It may or may not be in its interests to do so. But it is a democratic choice.

The issues are complex. Scottish independence, a possible consequence of Brexit, has been dealt a blow by the oil price collapse. It is a microcosm of the arguments. Equally, ever closer union has been torpedoed by the euro debacle.

Sadly, the immigration crisis has also demonstrated the inability of EU members to work together to address a humanitarian tragedy.

Personally I am biased in favour of Brexit from an unreformed EU. I am sceptical that negotiation can agree reforms. But at the same time events are capable of enforcing them.

Independence is never absolute. But interdependence consequences, accepted democratically, are surely preferable to those enforced and obligatory – especially for a large economy that differs structurally and historically from its neighbours. ■

Brian Reading is an independent economist.

Preparing for a UK-less Europe

If Hollande gives in, opponents will gain

Denis MacShane and Jacques Lafitte

To read the British press, 99% of the discussion over the deal that British Prime Minister David Cameron hopes will avoid Brexit has focused on supplements for low-pay European workers with children.

But this focus on EU migrant workers has obscured a much bigger issue – particularly in France, and maybe not just there. In Paris, the issue is not what the UK does on immigration, but rather London's bid for oversight of the euro area's development.

As French pro-business commentator Nicolas Baverez of Le Point writes, 'The UK did not want to join the euro and cannot now demand a *droit de regard* on the single currency. France should actively prepare for Brexit, shaping an attractive offer to the talent, firms and capital that will leave Britain to operate in the single market.'

Latest opinion polls showing a trend towards Brexit are forcing French politicians and business leaders to begin drawing up contingency plans for a UK-less EU. Cameron's claim that he has altered the terms of British membership so that they are 'different to what other countries have' has been noted.

Euro secures partnerships

Most British politicians and pundits view the euro as a failure. But that is not the case across the Channel. The euro is now well into its second decade.

No one on the continent wants to return to the old Europe of competing currencies. Reverting to Balkanised national currencies and other economic and populist nationalisms is viewed as a much greater threat than Brexit.

For France in particular, the euro is the 'Ark of the Covenant' securing peace and partnership with Germany. No French politician can offer London concessions suggesting that it has the right to stop or even slow decisions about the euro area.

> ***"Reverting to Balkanised national currencies and other economic and populist nationalisms is viewed as a much greater threat than Brexit.***

President François Hollande's opponents in the 2017 presidential election will be merciless if he makes any concessions appearing to privilege London over the euro area. In the eyes of virtually all French, the trade is all one way and *l'Albion perfide* is up to its old tricks.

A return to the euro area

The EU will return to the unfinished business of the euro area soon after the UK referendum. As Baverez writes, 'The EU must speed up the consolidation of the euro area, relaunch the single market in services, and invest massively in the security of its territory and its population.'

This line was echoed earlier this month by the governors of the German and French central banks, Jens Weidmann and François Villeroy de Galhau, in a joint article in Le Monde and Süddeutsche Zeitung.

The two argued that the EU needed a finance ministry under political control and that 'greater integration seems to be the obvious way to restore confidence in the Euro area.'

As the rest of Europe ponders Brexit, can the British come to terms with the euro's existence? The currency is not going to go away and – Brexit or no Brexit – the euro area will not take much notice of what the UK says, however reasonable and justified London may believe it is. ■

Denis MacShane is a former Minister of Europe and a Senior Adviser at Avisa Partners. He is author of Brexit: How Britain Will Leave Europe. Jacques Lafitte is the CEO of Avisa Partners in Brussels and was seconded from the French finance ministry to the EU Commission in the 1990s as the official responsible for introducing the euro.

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Banca d'Italia hosts OMFIF's Seventh Main Meeting in Europe and focuses on European economic governance, construction of capital markets union, policy divergence among central banks and investment in the low yield environment.

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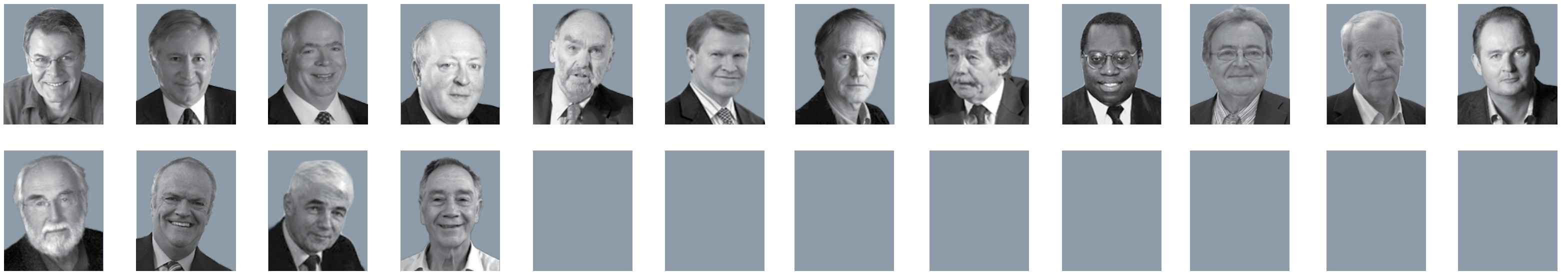

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Premiers, politics and pecadillos

A broad canvas from Walpole to Cameron

William Keegan, Advisory Board

In the monumental work *A History of British Prime Ministers, Walpole to Cameron*, former Labour MP and political journalist Dick Leonard has tried 'to judge the characters involved by the success or otherwise with which they have pursued their declared objectives, rather than whether I personally approve of these objectives.'

The more historical chapters are brilliantly researched and likely to be a boon to anyone's reference library. This is a great volume to dip into and be reminded of the peccadillos of Robert Walpole, Lloyd George and many 19th century premiers.

But Leonard's assessment of prime ministers from Churchill and Attlee onwards is likely to attract the greatest interest. He got to know many of them during his long career working for The Economist, the BBC and The Observer.

Churchill and Thatcher

Winston Churchill and Margaret Thatcher were probably the most widely known British prime ministers abroad during the period covered by the book. They are also the two who have made the biggest mark on British history in the past 75 years.

As Leonard concludes, Churchill, once a highly controversial figure, by the time he died in 1964 had been 'almost universally recognised as "the greatest living Englishman, if not of all time"'. Indeed, 'without him it is open to doubt whether hundreds of millions of Britons and other Europeans would be living in liberty today'.

Thatcher, by contrast, 'was – by a wide margin – the most divisive prime minister in the period covered by this book… and the division survived her death'. As Leonard notes, to her admirers she was 'the greatest premier since Churchill', to her critics something altogether different. But 'what both sides might agree on is that she was effective…'.

But what a political minefield she left in her trail. After she fell out with colleagues over the ill-judged poll tax and her visceral hostility towards 'Europe', she first lobbied Conservative MPs to vote for John Major as her successor, then decided that he was 'not one of us' and spent the rest of his premiership undermining him. In her own words, she was the 'backseat driver' of the eurosceptic wing of the Conservative party, and indeed the cabinet.

A wide-ranging history

A history of all 53 prime ministers covers a very broad canvas – the rise and fall of the British Empire, the Industrial Revolution, Britain as the workshop of the world, and two world wars and their aftermath.

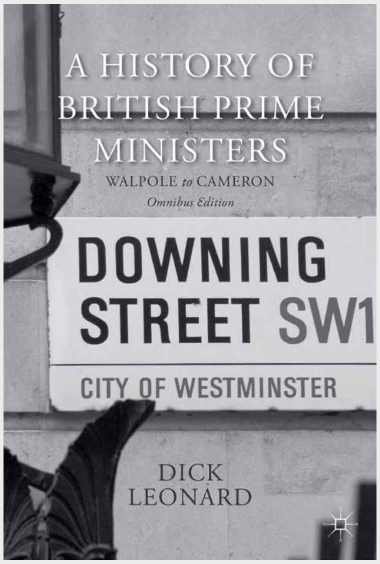
The economic horrors of the inter-war period were sufficiently remembered in 1945 for the electorate to reject a Conservative party led by Churchill. But the latter, after fulminating at many of the Attlee government's much-needed 'socialist' reforms, not least establishing the National Health Service, did not seek to undo the welfare state on returning to office in 1951.

A series of subsequent prime ministers struggled, in former US Secretary of State Dean Acheson's famous words, 'to find a role' for Britain after the loss of empire, beginning with Anthony Eden's disastrous Suez venture in 1956. Macmillan – a prime minister I warm to more than Leonard does – and who was certainly a 'One Nation' Tory, tried unsuccessfully to join what was then known as the Common Market.

Harold Wilson also received a definitive 'non' from President Charles de Gaulle. Edward Heath, prime minister between 1970 and 1974, was derailed by several 'events', but took us into the European Community in 1973. It was Wilson's task in 1975 to use a referendum about continued EC membership when his party was split, just as David Cameron is doing now when the Conservatives are split.

Failures in office

Some chancellors become prime minister, while some do not. Some heirs to the office are kept waiting too long. Leonard praises Tony Blair's government for improving public services but, after Iraq, feels it necessary to head his chapter 'Tony Blair – Fallen Idol'; to my mind a fair judgement.

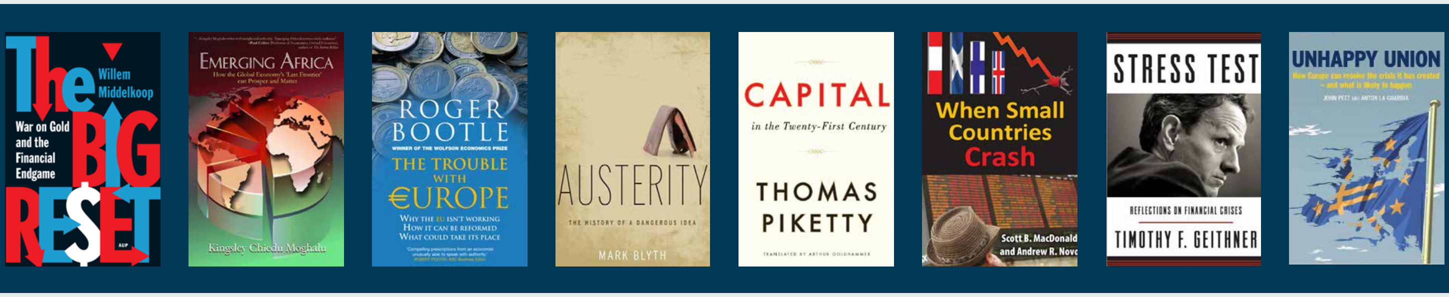


Leonard records, without challenging it, the general view that Gordon Brown's premiership was 'a total failure' on the domestic front. But he gives due credit to Brown's crucial role in what the latter, in a celebrated slip of the tongue, called 'saving the world'.

It is too early for definitive judgements on the Cameron premiership. Leonard notes that he 'now faces three great challenges – keeping the UK together in the face of the Scottish National party challenge, keeping Britain in the EU, and – perhaps the least difficult of the three – eliminating the deficit by the new target date of 2017-18'.

Leonard is nevertheless a reluctant admirer: 'Behind his bland exterior, David Cameron is a single-minded and ruthless operator.' The way he turned on his hitherto coalition partners in the election of 2015 'was a triumph of professionalism, which left both his Liberal and Labour opponents looking like a bunch of amateurs'. But he has also been 'over-dependent on his chancellor… for a sense of direction to his government'. ■

William Keegan is Senior Economics Commentator at The Observer.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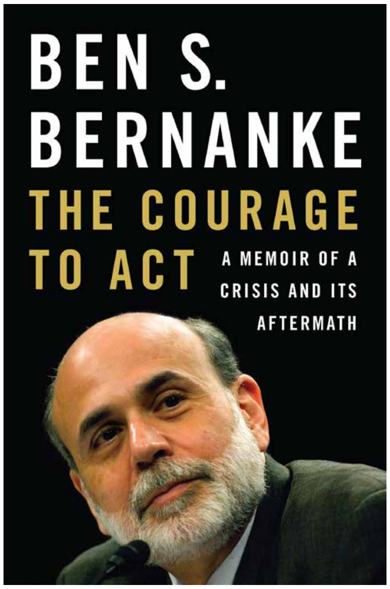

BEN S. BERNANKE
THE COURAGE TO ACT
A MEMOIR OF A CRISIS AND ITS AFTERMATH

'Courage is grace under pressure.' So wrote Ernest Hemingway, author of *Death in the Afternoon*, a book about the ceremony and traditions of Spanish bullfighting.

The most interesting sections in former Federal Reserve Chairman Ben Bernanke's memoir, *The Courage to Act – A Memoir of the Crisis and Its Aftermath*, are not those describing the formulation and execution of policies designed to save the American financial system and avoid another Great Depression – though these are gripping.

Rather, they are his reflections on the structure and weaknesses of the US financial and regulatory system, the relevance of history, the American political system, and the discipline of economics. For example, 'Sound monetary policy, I knew, can support a healthy economy – but it cannot create one. In the long run, the economy's ability to produce a rising standard of living for future generations depends on people having opportunities to acquire both economically valuable skills and the perspective that comes from a broad education. Nothing else matters as much.'

This book is a riveting, moving memoir, and a testament not just to Bernanke's analytical and leadership skills, but also the efforts of countless nameless Federal Reserve, US Treasury and other government agency officials who laboured under frightening and chaotic conditions both tirelessly and frenetically to prevent a global financial meltdown.

Hard work and determination

It is also a testament to the plasticity of the American system. Bernanke, who grew up in small town South Carolina and attended Harvard College almost by accident, rose to the second most powerful office in the land on the basis of analytical insight, hard work and determination, and civic engagement (he was elected twice to a local school board). Anyone wanting to know how and why US decisions were made during the global financial crisis should read this book.

Bernanke divides the book into three sections – Prelude, The Crisis, Aftermath. The first describes Bernanke's personal history, intellectual evolution and research on the 'financial accelerator' and Great Depression. His research impressed on him the need to forcefully deploy monetary policy during recessions, to act decisively to preserve financial stability, and to think 'outside the box' when confronted with extraordinary circumstances. For Bernanke, excessive reliance on wholesale funding by banks and a 'shadow banking system' that had become too large and complex were important causes of the crisis.

This section also covers Bernanke's tenure as a governor of the Federal Reserve and as chairman of the Council of Economic Advisors. For Bernanke, Greenspan's thinking 'was idiosyncratic and less conceptual than I was used to'. Bernanke argues throughout for the institutionalisation of policy formulation and for an explicit inflation target.

Multiple financial crises

Bernanke devotes large chunks of the second section to multiple crises: Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, AIG, Washington Mutual, Citibank, Wachovia, passage of the Troubled Asset Relief Program, and a severe recession that led to 10% unemployment.

In this cauldron, Bernanke and his colleagues executed a strategy with four main elements: lower interest rates; emergency lending aimed at stabilising the financial system; rescues (coordinated when possible with the Treasury and Federal Deposit Insurance Corporation) to prevent disorderly failure of major financial institutions; and stress-test disclosures of banks' condition.

Lest we forget, US government interventions were massive: $182bn in support for AIG; $350bn in commercial paper purchases; $700bn in TARP funds; $600bn in swap lines, $3.5tn in quantitative easing – for openers!

Bernanke's discussion of the decision to let Lehman Brothers fail is one of the most striking in the book. The author is at pains to suggest that there was no other alternative, arguing that there was no buyer for Lehman, and that it had insufficient collateral to qualify for an emergency loan under Section 13 (3) of the Federal Reserve Act. He then suggests Congress would never have acted to recapitalise major financial firms absent the failure of some large firm and the associated damage to the system. In this sense, 'a Lehman-type episode was probably inevitable'.

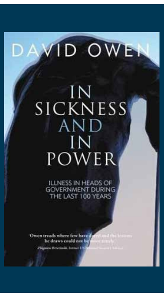
Under a microscope

The third section discusses macroprudential regulation, QE, Dodd-Frank, Federal Reserve communications policy, and countless other topical debates. It also describes what it's like to be relentlessly pilloried by political opponents and to have one's every utterance put under a microscope.

Bernanke was against nationalising the banks, feels that the Obama stimulus was too small, argues that Dodd-Frank 'does much good and stands as a remarkable achievement', and laments the evolution of his chosen political party.

Throughout the book there are reflections on the many personalities and institutions Bernanke dealt with throughout the crisis. One may not agree with all the decisions that were taken (such as the failure to impose losses on some senior debtholders of financial institutions). But this is an important book, of interest to future historians, and written by an exceptionally able, thoughtful, and courageous public servant. ■

George Hoguet is Global Investment Strategist in the Investment Solutions Group of State Street Global Advisors.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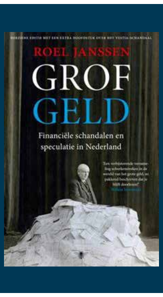
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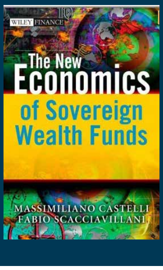
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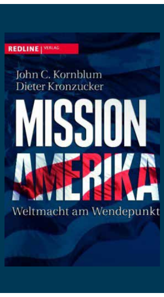
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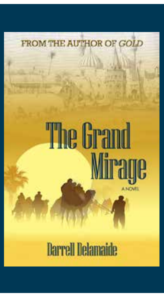
FROM THE AUTHOR OF GOLD
The Grand Mirage
A NOVEL
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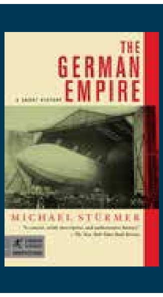
THE GERMAN EMPIRE
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