Bulletin

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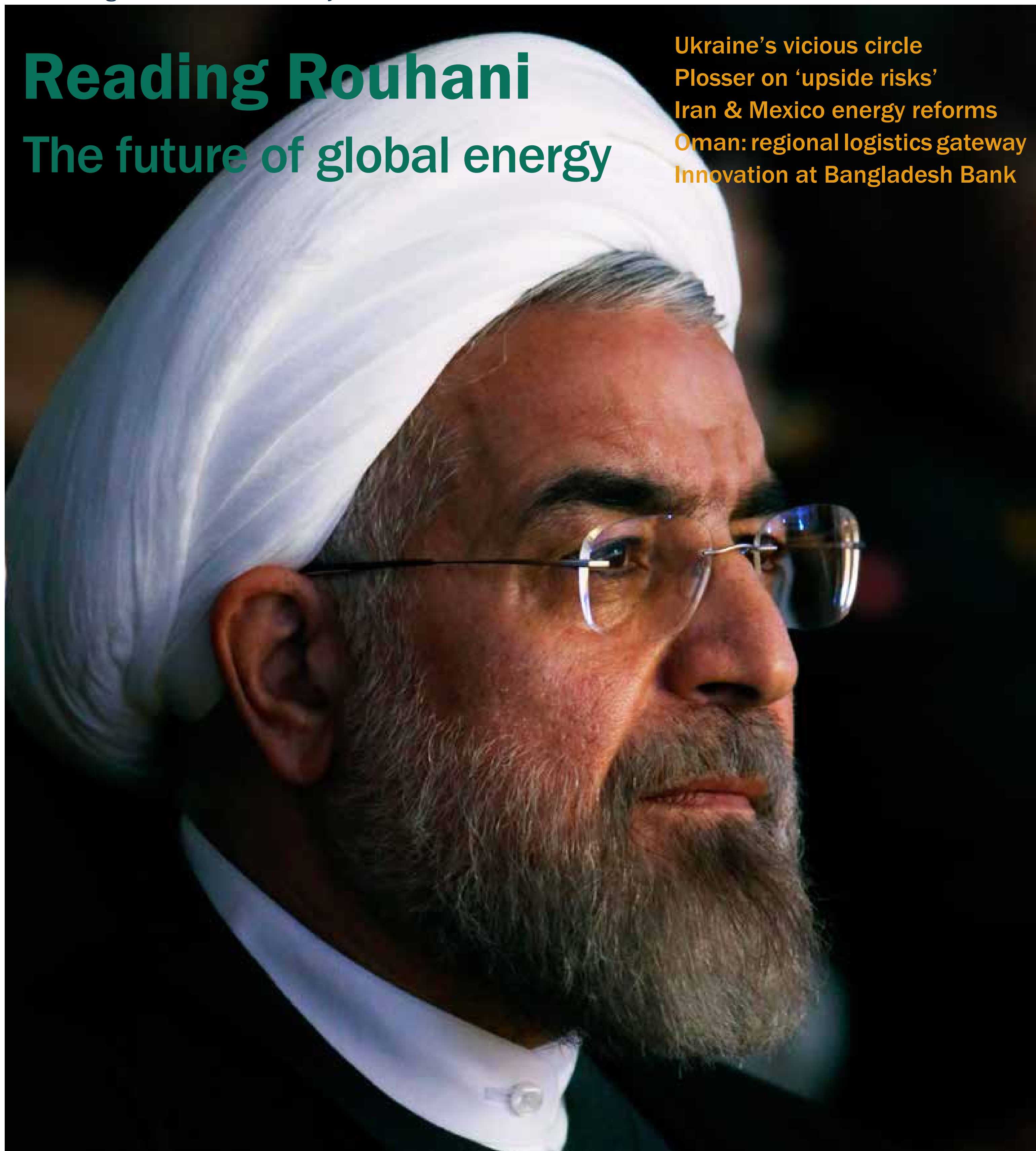
Global insight on official monetary and financial institutions



Reading Rouhani

The future of global energy

Ukraine's vicious circle
Plosser on 'upside risks'
Iran & Mexico energy reforms
Oman: regional logistics gateway
Innovation at Bangladesh Bank

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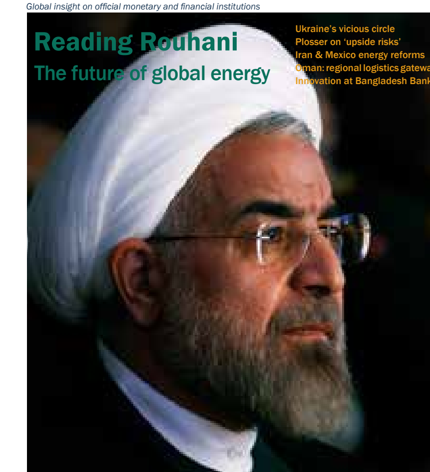
Cover story

Iranian President Hassan Rouhani has forged the beginnings of a rapprochement with the US and the west at an intriguing time. Russian sabre-rattling over Ukraine and abiding tensions in Iraq and Libya would normally be expected to raise world energy prices. In fact the oil price has been steady, demonstrating a shift in the industry balance with the importance of Middle East producers declining. In this Bulletin, we take an in-depth look at the world energy picture, with the aid of articles focusing on Russia, the Middle East, Iran, Mexico and Africa. See p.27-33.



We look at *Inclusive Finance and Sustainable Development* by Atiur Rahman, Bangladesh Bank governor and development economist. For the review by Moorad Choudhry, see p.34-35.

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Plosser says Fed must consider upside risks

A wind of change is blowing through American monetary policy. OMFIF and our guests gained insights into this when Philadelphia Federal Reserve Bank President Charles I. Plosser gave his Golden Series Lecture in London on 6 March. 'For the first time in years, I see the potential for more upside risk to the economic outlook. We need to consider this possibility as we calibrate monetary policy,' he said. 'Even after the Fed has stopped buying assets, monetary policy will still be highly accommodative. As the expansion gains traction, the challenge will be to reduce the degree of ease and to normalise policy in a way that ensures that inflation remains close to our target, that the economy continues to grow.' See p. 8-11.

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OMFIF

Promoting dialogue for world finance

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

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

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

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

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

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

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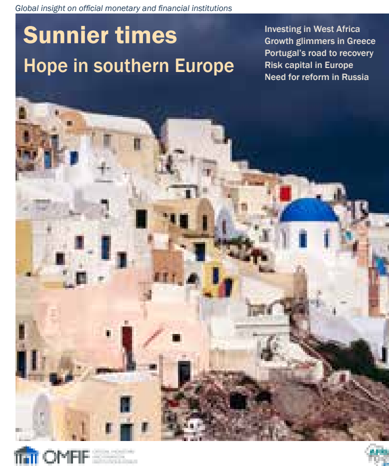


Shifting sands of world energy

Pessimism over Ukrainian tussle gains ground

David Marsh, Chairman

OMFIF ranges widely over the shifting sands of world energy this month. Two big themes are at the forefront of attention: developments in Iran following the entry of a reformist president, Hassan Rouhani, and the stand-off between Ukraine and Russia. The positive effects, both geopolitical and from the viewpoint of energy markets, of the rapprochement between Iran and the west seem balanced by the repercussions of the worsening of US-Russian relations over the Ukrainian crisis.

So far, world financial markets have reacted to the first process with optimism and opportunism, demonstrated by the stream of hopeful visitors to Tehran from deal-hunting financiers and business enterprises from east and west. Undue pessimism over the latter circumstances has been shrugged aside, but has been on the ascendancy in recent days – and the potential repercussions of the Crimea referendum on 16 March may well act as a further dampener. The positive start to the year for equity markets in the US and Europe, bringing valuations once again to levels that seem far ahead of trends in the real economy, could quickly be thrown off course.

Dwelling on a tide of influences on international energy, from China and the US through to the Middle East and North Africa, Nick Butler believes that oil and gas prices are headed downwards – a trend that Saudi Arabia as the key producer will be unable to avert. Vicky Pryce, too, says that the American shale gas boom will change the shape of energy markets. Fabio Scacciavillani of the Oman Investment Fund disagrees, playing down talk of a shale gas bonanza in the US. He says the promise of American energy self-sufficiency is exaggerated. Winston Moore looks at the impact of an expected increase in international investment in the Iranian oil sector on expenditures in Mexico and other parts of Latin American, making unfavourable comparisons with the state oil concern Pemex. Efraim Chalamish surveys the effects of increasing disputes over energy in developing countries.

Examining Ukraine, meanwhile, Pooma Kimis spots portents of a potential reverse for President Vladimir Putin, while Michael Kaimakliotis berates lack of Europe's leadership and foresight over the squabbling to the east of a rather unconvincing European Union. It's a paradox that Putin's pugilism has cruelly exposed European vacillation, and yet the euro has risen in recent weeks, partly because of flows of funds into the currency area, termed by Mario Draghi, the European Central bank president, as 'an island of stability'. Draghi has made clear in recent days that a further rise in the euro is far from helpful.

Jaime García-Legaz, the Spanish trade secretary, explains why his country's reform efforts are bearing fruit with an improved economic performance. Colin Robertson ponders gloomily the raft of uncertainties likely to come to a head over Scottish independence, on which a referendum is being held in September.

Gabriel Stein investigates different reasons on both sides of the Atlantic for fluctuations in the volume of reserves held at central banks by the banking systems in the US and Europe. Philip Turner of the Bank for International Settlements (BIS) outlines the dilemma for emerging market central banks as US interest rates start to rise. Moorad Choudhry explains why regulators' efforts to force banks to hold more capital could reduce the availability of deposits – effecting a significant change in many banks' business models.

Charles I. Plosser, president of the Philadelphia Fed, spells out the looming end of accommodative monetary policy in the US, while Darrell Delamaide gives his monthly survey of opinions across the Federal Reserve. Steve Hanke produces an acerbic view of Janet Yellen's monetary stance. William Keegan salutes a visit to London on 24 February by William White, former head of the BIS monetary and economic department, when White blamed 'human nature' for the economic collapse in 2008-09. Human nature is very much on display, too, in Putin's Russia – and, after the Crimea referendum, a great many issues, political and economic, remain at stake.▪

David Marsh

Bank of Mauritius-OMFIF education programme launched in Port Louis

Working in cooperation with the Bank of Mauritius, OMFIF carried out a six-day set of training seminars for a total 150 participants from the central bank, the country's commercial banks and a number of other Mauritius financial service companies on 3-8 March 2014. A total of 45 banks and other entities took part, with 10 OMFIF personnel and associates.

'It has been a great week partnering with OMFIF to offer this Executive Development Programme to the banking community in Mauritius,' said Bank of Mauritius Second Deputy Governor Mohamad Issa Soormally.

He added, 'The training sessions have been enriching in terms of the quality of the presentations by the experts and the deliberations that ensued on corporate governance, leadership skills and foreign exchange dealings. The response of the participants has been very positive and the exchange of ideas, fruitful. We look forward to undertaking further collaborative work with OMFIF.'▪

Leadership trainer Steve Radcliffe addresses Mauritius bankers at the OMFIF training course in Bank of Mauritius

ADVISORY BOARD

OMFIF welcomes Julia Leung as Senior Adviser. Leung joins the Advisory Board following a previous position as Undersecretary for Financial Services and the Treasury in Hong Kong. She will work to further OMFIF's cooperation with Asian central banks and other official institutions. One of her principal responsibilities will be to write a report for OMFIF on how Asian governments have coped with the global financial crisis and the lessons drawn from this and the 1997-98 Asian financial crisis.

POLICY GROUP

Lubbers in London focuses on ECB and green growth

Ruud Lubbers, former Dutch prime minister, took part in two sessions of discussions on 18 and 19 February in London on developments in economic and monetary union and on the outlook for sustainable 'green growth' as a new force for the world economy. Lubbers, who presided over the Maastricht summit in the Netherlands in December 1991 that launched Europe on the road to the single currency, voiced his hope that European leaders would allow the European Central Bank to take on fully-fledged powers similar to institutions in the US, Japan and the UK.

BMW, the world car industry and Europe

Ian Robertson, member of the BMW Management Board, spoke about structural changes in the world car industry and the influence of new technologies for materials and environmental protection at an OMFIF lunch on 26 February in London. The discussion, from a representative of one of the most globalised European companies with a large base in the UK, encompassed a wide-ranging debate on the economic and political environment in Britain, Europe and the world.

GOLDEN SERIES

Nowotny praises Europe's steady recovery, says OMT not needed

Ewald Nowotny, governor of the Austrian National Bank, praised Europe's steady recovery from recession and said the European Central Bank's Outright Monetary Transactions (OMT) bond-buying programme was effectively in abeyance as it had achieved its purpose. Speaking at an OMFIF lecture in London on 17 February, he played down any question of the ECB cutting interest rates further to spur economic growth. On the bank's OMT programme, Nowotny made clear the importance of the German constitutional court's ruling on the illegality of the programme under German law, but said that euro break-up fears had now dissipated, so the OMT was not needed. Nowotny explained Austria's structural features and policies that had allowed a relatively quick post-2009 recovery from recession.

Oman puts development focus on Indian Ocean trade

Oman is well-placed to become a trade and logistics hub between Europe, the Middle East and Africa, according to Salim bin Nasser Al-Ismaily, chairman of the Omani Public Authority for Investment Promotion and Export Development, at an OMFIF lecture in London on 27 February. The lecture, part of a day-long discussion on trade and investment opportunities between senior Omani officials and members of the London business and financial community, was accompanied by briefings with key representatives of the Oman Investment Fund: Hassan bin Ahmed, chief executive, and Fabio Scacciavillani, chief economist and member of the OMFIF Advisory Board, who spoke about investment in ports and logistics as well as the Gulf states' position on regional integration. See p.32-33.

Left to right: Hassan bin Ahmed Al Nabhani, Oman Investment Fund; Salim bin Nasser Al-Ismaily, Public Authority for Investment Promotion and Export Development Oman; David Marsh, OMFIF; Lee Chee Khian, Duqm SEZ; and Jamal Aziz, Sohar Free Zone.

BOOKS & THE ADVISORY BOARD

Reflections on unorthodox central banking and financial crises

This month's feature covers two publications. *Inclusive Finance and Sustainable Development*, by Bangladesh Bank Governor Atiur Rahman, encompasses a range of thinking in fields of central banking and economic development. Moorad Choudhry reviews his collection of speeches and lectures on issues from capital adequacy to microfinance and sustainable development. John Nugée, whose recent book, *Reflections on Global Finance*, was reviewed in the December 2013 Bulletin, describes *When Small Countries Crash*, by Scott MacDonald and Andrew Novo. The book focuses on the impact of financial disaster on small countries, including the collapses of Iceland, Ireland and Cyprus. See p. 34-37.

EXPERT SEMINARS

Central bankers ponder beating low yields to raise reserve returns

A day-long OMFIF reserve asset seminar at the Innholders' Hall in London on 24 February, grouping 20 central banks, discussed how to generate higher returns while controlling risks at a time of low interest rates. The meeting followed a similar session at the Mandarin Hotel in Hong Kong on 10 February, bringing together eight central banks. Major preoccupations at both seminars were how to keeping assets safe at time when sovereign risk has grown, and methods of diversification, including into the renminbi. On 24 February, William White, former head of the monetary and economic department at the Bank for International Settlements (pictured right), gave a strong warning of risks ahead for the world economy.

ECONOMISTS MEETINGS

Bank of Finland meeting discusses euro and Russian outlook

The OMFIF-Bank of Finland roundtable discussion, chaired by Deputy Governor Pentti Hakkarainen (pictured right) on 6 February in Helsinki, dealt with Finland's economic prospects, the overall outlook for the euro area and coming developments in Russia, China and Baltic region. A further series of discussions took place on the preparations for European banking union. The day in Helsinki included exchanges with the Finnish finance ministry and Treasury on economic developments, debt management issues and cooperation in the euro area.

BRIEFINGS

Africa's year of ambition: outlook for 2014

A telephone briefing on 3 February – 'Africa's year of ambition' – encompassed an exchange of views on the African outlook between Albert Bressand, special adviser to the European Commissioner of Development, and Minesh Mashru, vice president, equity and infrastructure, Quantum Global. They concluded that more needed to be done to encourage private capital, for instance from pension funds, to enter Africa.

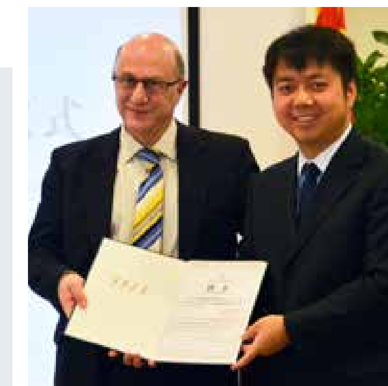
Updating fund managers on 'third arrow' of Abenomics

Toshio Oya, counsellor at the Japanese finance ministry, and Masao Uno, the ministry's London chief representative, took part in a roundtable discussion with London fund managers at the Japanese embassy in London on 13 February. Oya provided an update on the domestic reforms which spearhead the so-called 'third arrow' of the economic measures promulgated by Shinzo Abe, the Japanese prime minister.

INTELLIGENCE

Challenges of Chinese liberalisation

A joint OMFIF-Chongyang Institute report on Chinese capital account liberalisation, launched on 21 February in Beijing, warned that China needs to be prepared for the unexpected. Previous cases of exchange control relaxation around the world have led to a great variety of outcomes, from asset price bubbles to currency crises. The report, 'Capital account liberalisation in China', which was presented at the Chongyang Institute for Financial Studies at Renmin University in Beijing, is available in both English and Chinese (for more details, contact sales@omfif.org). The report contains lessons from case studies comprising countries that have liberalised capital controls in recent decades: Israel, Malaysia, Mauritius, Mexico, South Africa, Sweden and the UK. Gabriel Stein, Chief Economic Adviser at OMFIF, is pictured right with Wang Wen, Executive Dean at the Chongyang Institute, at the report launch in Beijing.



Forward guidance and monetary policy

The Fed's stance must become more systematic

Charles I. Plosser, Federal Reserve Bank of Philadelphia

The Federal Reserve has taken extraordinary policy actions to support the economic recovery. The Fed has lowered its policy rate – the federal funds rate – to essentially zero, where it has been for more than five years.

Since the policy rate cannot go any lower, the Fed has attempted to provide additional accommodation through large-scale asset purchases. We are now in our third round of this quantitative easing.

Since September 2012, the Federal Open Market Committee (FOMC) has added about $1.3tn in long-term Treasuries and mortgage-backed securities to its balance sheet through this programme, buying at a pace of $85bn a month in 2013. This programme, known as QE3, is already twice the size of the last round of asset purchases initiated in November 2010, known as QE2.

Measured reductions

In December 2013, the Committee announced that it would reduce the pace of purchases from $85bn to $75bn per month. In January, it announced a further reduction to $65bn. The FOMC is now on a path of measured reductions, which, if continued, will end the purchase programme later this year.

If the economy continues to improve, we could find ourselves still trying to increase accommodation in an environment in which history suggests that policy should perhaps be moving in the opposite direction.

In addition to asset purchases, the Fed is using forward guidance as a policy tool, which is intended to inform the public about the way monetary policy is likely to evolve in the future.

The FOMC has indicated that it intends to leave the policy rate near zero well past the time that the unemployment rate falls below the 6.5% threshold, especially if projected inflation continues to run below the Committee's 2% target.

Communications challenge

Even though the FOMC has said that it doesn't anticipate raising rates when the economy crosses that threshold, I believe that with the economy so close to the unemployment threshold, we face a communications challenge. In particular, it has not been described how policy will be conducted after the unemployment rate falls below 6.5%.

But further forward guidance is offered, it is important to be clear about what this forward guidance is supposed to accomplish. As that famous American baseball player Yogi Berra is reported to have said, 'You have to be careful if you don't know where you're going because you might end up somewhere else.'

Reaction function

One way to think of forward guidance is that it is just another step toward increased transparency and effective communication of monetary policy. This approach seeks to clarify how policy-makers will alter policy as economic conditions change – that is, to describe a reaction function.

By being more transparent about how policy will evolve as a function of economic conditions, this approach can help the public form more accurate expectations about the future path of monetary policy.

Economists have learned that expectations play an important role in determining economic outcomes. When businesses and households have a better understanding of how monetary policy is likely to evolve, they can make more informed spending and financial decisions. If policy-makers can reduce uncertainty about the course of monetary policy, the economy is likely to perform more efficiently.

Of course, in order to communicate something about the reaction function, you have to have one. That means in order to succeed with this approach to forward guidance, policy-makers must be able to agree on how they will systematically respond to changes in economic conditions. To be useful, however, the reaction function need not be mechanistic.

Qualitative information about such a function and how it will be implemented can also be useful and meaningful.

Nevertheless, some degree of commitment to abide by the specified reaction function is necessary if the communication is to achieve the desired result of reducing policy uncertainty and providing meaningful forward guidance.

A somewhat different rationale or view of forward guidance is that it is a way of increasing accommodation when the policy rate is at or near the zero lower bound.

Some models suggest that when you are at the zero lower bound, it can be desirable, or optimal, to indicate that future policy rates will be kept 'lower for longer' than might otherwise be the case.

Thus, policy-makers may want to deliberately commit to deviating from what they would otherwise choose to do under normal conditions, such as following a Taylor-like rule. In these models, such a commitment would tend to raise inflation expectations and lower long-term nominal rates, thereby inducing households and businesses to spend more today.

Credibility and commitment

This approach asks more of forward guidance than just articulating a reaction function. It takes more credibility and commitment because it requires policy-makers to directly influence and manage the public's beliefs about the future policy path that differs from how policy-makers behaved in the past. This approach to forward guidance can backfire if the policy is misunderstood.

For example, if the public hears that the policy rate will be lower for longer, it may interpret this news as policy-makers saying that they expect the economy to be weaker for longer. If that is the interpretation of the message, then the forward guidance will not succeed and may even weaken current spending.

Lack of clarity

The FOMC has not been clear about the purpose of its forward guidance. Is it purely a transparency device, or is it a way to commit to a more accommodative future policy stance to add more accommodation today?

This lack of clarity makes it difficult to communicate the stance of policy and the conditionality of policy on the state of the economy.

I believe there is another – perhaps more fundamental – tension underlying forward guidance and communication. Forward guidance in either of the two approaches I have discussed requires a degree of commitment to conduct future policy in some particular manner. Commitment is central to the success of either approach.

'Rules versus discretion'

Yet, I would suggest that the old 'rules versus discretion' debate is alive and well. This, of course, is not a new tension within the FOMC, nor is it one that is likely to go away in the near term. But the heightened weight and prominence given to forward guidance as a policy tool has certainly shined a spotlight on this longstanding debate.

The desire to maintain flexibility to respond to 'events on the ground' is a strong one. One can make the case that discretion is deeply ingrained in most policy institutions, particularly the Fed.

Yet, the desire to maintain discretion is anathema to the commitment required for successful forward guidance. Policy-makers cannot maintain discretion and simultaneously commit to forward guidance and expect that guidance to be effective.

Over the past five years, the Fed and, dare I say, many other central banks have become much more interventionist. This is not a particularly healthy state of affairs for the central banks or our economies.

The crisis in the US has long passed. With a growing economy and the Fed's long-term asset purchases coming to an end, now is the time to contemplate restoring some semblance of normalcy to monetary policy.

Changed role of central banks

In my view, the proper role for monetary policy is to work behind the scenes in limited and systematic ways to promote long-term growth and price stability.

But since the onset of the financial crisis, central banks have become highly interventionist in their efforts to manipulate asset prices and financial markets in general as they attempt to fine-tune economic outcomes.

This approach has continued well past the end of the financial crisis. While the motivations may be noble, we have created an environment where 'it is all about the Fed.'

Symbiotic relationship

Market participants focus entirely too much on how the central bank may tweak its policy, and central bankers have become too sensitive and desirous of managing prices in the financial world. I do not see this as a healthy symbiotic relationship for the long term. If financial market participants believe that their success depends primarily on the next decisions of monetary policy-makers rather than economic fundamentals, our capital markets will cease to deliver the economic benefits they are capable of providing.

And if central banks do not limit their interventionist strategies and focus on returning to more normal policy-making aimed at promoting price stability and long-term growth, then they will simply encourage the financial markets to ignore fundamentals and to focus, instead, on the next actions of the central bank.

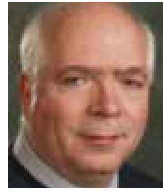
I hope we can find a way to normalise the role of monetary policy to one that is less interventionist, less discretionary, and more systematic. I believe our longer-term economic health will be the beneficiary.▪

This is an edited and abridged version of the speech delivered at the Golden Series Lecture in London on 6 March 2014. Charles I. Plosser is President and Chief Executive Officer of the Federal Reserve Bank of Philadelphia.

On the web

See Charles I. Plosser's full speech at www.omfif.org/media/596400/plosser-speech.pdf

Left to right: Neil Williams, Hermes Fund Managers; Charles I. Plosser, Federal Reserve Bank of Philadelphia, Lord (Meghnad) Desai, OMFIF; and John Plender, OMFIF.



Fed debate turns to interest rates

Hawks, doves dispute timing and guidance over next monetary moves

Darrell Delamaide, US Editor

After reaching a consensus of sorts on tapering, which is likely to continue on its present course barring any dramatic developments, policy-makers at the US Federal Reserve are now openly debating the timing of interest rate increases, with options ranging from this year to mid-2016.

Members of the Federal Open Market Committee (FOMC) have long insisted that tapering does not represent a tightening of monetary policy, but rather a reduction in monetary stimulus. The US central bank is still buying bonds and still maintaining a very accommodative balance sheet.

To calm any market jitters about the reduction in monthly asset purchases, the Fed has provided 'forward guidance' to the effect that interest rates will stay at their present level near zero for some time yet. But some of the more hawkish FOMC members are making the case for boosting rates sooner, even suggesting they should already have gone up.

'Note that most formulations of standard, simple policy rules suggest that the federal funds rate should rise very soon – if not already,' Philadelphia Fed Chief **Charles I. Plosser (voter)** told a conference in New York.

At the very least, the Fed's measured timetable for phasing out monetary stimulus by the end of the year risks being overtaken by events. The Fed has reduced asset purchases by $10bn a month at each of the last two FOMC meetings but is still buying $65bn worth of bonds a month.

'If the economy continues to improve, we could find ourselves still trying to increase accommodation in an environment in which history suggests that policy should perhaps be moving in the opposite direction,' Plosser said in an OMFIF Golden Series Lecture in London on 6 March.

Philadelphia Federal Reserve Bank President Charles I. Plosser

Communications challenge

He was critical of the way the Fed is deploying forward guidance to tell the public how monetary policy is likely to evolve. The FOMC has said it expects to leave interest rates near zero well past the time that the unemployment rate falls below 6.5% – the committee's now-abandoned trigger point for considering a rate increase.

The jobless rate ticked up to 6.7% in February from 6.6% in January, but Plosser said he expected the rate to drop to 6.2% or lower by the end of 2014 on the back of full-year economic growth of around 3%. With the unemployment rate already close to the FOMC's 6.5% marker, the Fed faces a communications challenge, Plosser said.

'The FOMC has not been clear about the purpose of its forward guidance. Is it purely a transparency device, or is it a way to commit to a more accommodative future policy stance to add more accommodation today? This lack of clarity makes it difficult to communicate the stance of policy and the conditionality of policy on the state of the economy,' he said (see p.8-9).

Unemployment

On the dovish side, Boston Fed President **Eric Rosengren (non-voter)** says the 6.5% target was set 'conservatively' and that the FOMC has made it clear that it is only a threshold to start considering interest rate increases, not an automatic trigger for them.

Full employment, in his view, is really only achieved at a level more like 5.25%, which he doesn't expect before mid-2016. 'When we reach 6.5% unemployment, the economy will still be characterised by significant labour market slack,' Rosengren said.

Born-again dove **Narayana Kocherlakota (voter)**, head of the Minneapolis Fed, suggested an equally long time at the same New York event Plosser attended. He said that Fed policy-makers have 'two to three years' to grapple with the problem of how raising rates might contribute to financial instability.

Long-time dove **Charles Evans (non-voter)** of the Chicago Fed agreed with Plosser about the need for clarity in communications, but he wants policy-makers to make it clear that the central bank is willing to let inflation rise beyond its 2% target in order to bring unemployment down.

'The Fed has demonstrated that it will act aggressively to reduce resource slack when it is well away from its objective,' Evans said at the same New York forum. 'It is less clear the public understands that we should be willing to overshoot our objectives in order to more speedily re-attain our goals.'

To minimise the risks from adverse shocks, the Fed should act swiftly to reach its goals, Evans said. 'The surest and quickest way to get to the objective is to be willing to overshoot in a manageable fashion,' he said. 'With regard to our inflation objective, we need to repeatedly state clearly that our 2% objective is not a ceiling for inflation.'

Fed Governor **Daniel Tarullo (voter)** took a middle-of-the-road approach, saying there was no need to tighten monetary policy now, even to head off asset bubbles, which he thinks should be handled first by supervisory measures.

He acknowledged nonetheless that the Fed's current monetary policy may indeed prompt investors to reach for yield by taking on excessive risk or increasing leverage.

'Here, then, is the potential quandary,' Tarullo told a conference of the National Association of Business Economics. 'The very accommodative monetary policy that contributed to the restoration of financial stability could, if maintained long enough in the face of slow recovery in the real economy, eventually sow the seeds of renewed financial instability. Yet removal of accommodation could choke off the recovery just as it seems poised to gain at least a bit more momentum.'

'Winners' and 'losers'

The fresh debate between hawks and doves is taking place against the backdrop of the transcripts from the 2008 FOMC meetings, which were released last month. The verbatim account with names attached showed how the committee coped with the financial crisis that unfolded over the year.

The Wall Street Journal compiled a list of 'winners' and 'losers' looking at members' comments with the benefit of hindsight. In general, the paper found, doves got it more right than hawks.

The newspaper had high praise for Boston's Rosengren: 'At almost every point in the crisis, he put his fingers on real problems,' the Journal said. The paper also singled out William Dudley, then markets chief at the New York Fed and now president there, and current Fed Chairman Janet Yellen, who was head of the San Francisco Fed at the time, for their clarity and prescience.

Topping the list of 'losers' was Timothy Geithner, then president of the New York Fed and later Treasury secretary. The Journal said his comments lacked the 'precision' of Dudley's and were far too optimistic about the resilience of the Wall Street banks.

But the hawks as a group were also branded losers. 'It turns out they were focused on the wrong problem for much of 2008,' the Journal said. 'While they worried about inflation, the foundations of the financial system and the broader economy were cracking.'

Cleveland Fed Chief **Sandra Pianalto (voter)**, who is stepping down in June, put the debate between hawks and doves in perspective as she looked back on her time on the committee. She was happy to have been considered a 'centrist', but said the debate was generally constructive.

'Hearing the diversity of views and interacting in this way around the table helps us reach better decisions,' she told an audience at Wooster College.

'The media is fond of classifying FOMC participants as the 'hawks' who want to tighten policy and the 'doves' who want more accommodation. I myself have been called a 'centrist,' and it has been said that watching the center tends to give you a good sense of which way the committee is leaning.'

Pianalto's successor, who will take her seat as a voting member on the FOMC, will be Loretta Mester, currently the director of research at the Philadelphia Fed. Given her provenance as chief adviser to the arch-hawk Plosser, Mester is widely expected to at least lean hawkish.

Mester, who has regularly attended FOMC meetings in her current capacity, has had little to say in public on monetary policy, though she has suggested that in the past the Fed has been too slow to raise interest rates.■

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

Fed's approach to US economy 'fuels hot money flows'

Karl Schiller, West Germany's economics minister from 1966-72, pithily pronounced that: 'Stability is not everything, but without stability, everything is nothing.' I agree. The world's great destabiliser is the US, *writes Steve H. Hanke in Baltimore.*

In the post-1945 era, the world has been on a dollar standard. Accordingly, the Federal Reserve is the de facto central banker for the world. But you would never know it by looking at its statements and actions. For the most part, the Fed functions as if it is operating in a closed economy. Its disregard for the rest of the world results in policies that send huge hot money flows to and fro, creating enormous instability.

Ronald McKinnon captured this picture in his recent book *The Unloved Dollar Standard: From Bretton Woods to the Rise of China.* As well as identifying the US as the great destabiliser, McKinnon shows how China has injected stability into the international monetary system by linking the renminbi more or less tightly to the dollar since 1995. China has coupled this currency link with a successful counter-cyclical financial policy. Whenever there has been a bump in the road, China has expanded bank money and the economy has enjoyed the greatest boom in world history.

There has been a change of guard at the Fed. In her initial testimony to congress, Janet Yellen, the new chairman (pictured right), reaffirmed the Fed's unspoken closed-economy mantra. No doubt she will not change the dashboard operated by the previous incumbent Ben Bernanke to include what is arguably the world's most important price: the dollar/euro exchange rate.

The Fed will stay lashed to an unrealistic model and continue to ignore the obvious: that by manipulating interest rates it fuels great hot money flows that create boom-bust cycles across the globe. It appears that Yellen will further tighten the regulatory vice on the banking system. Yellen has indicated that she favours higher capital and liquidity ratios, which will force banks to continue to deleverage. Since about 80% of the nation's money supply (M4) is produced by banks, this means money will remain tight.

Recall that the Divisia M4 measure of money, which is computed by the Center for Financial Stability, is growing at a paltry year-on-year rate of 2% (December 2013). Such a tight monetary stance in the face of economic weakness amounts to a wrong-headed pro-cyclical approach.

Yellen was clear that the central bank bore no responsibility for the boom-bust cycles in

emerging markets. Indeed, she didn't venture into the debate about 'currency wars', which erupted when the Fed drove interest rates artificially low and pushed hot money flows to higher-risk, higher-yield markets. This tends to strengthen local currencies relative to the dollar, boosting the foreign exchange reserves of recipient countries and their domestic money supplies. Asset booms and inflationary pressures follow.

Countries that embrace sound economic policies mitigate the damage. The best protection is a combination of balanced budgets, low debt and free-market institutions.■

Steve Hanke, member of the Advisory Board, is Professor at The Johns Hopkins University.

Raising equity could lower deposit availability

Implementing Basel III hampers banks' maturity transformation

Moorad Choudhry, Advisory Board

The higher regulatory capital and liquidity buffer requirements of Basel III and its European Union equivalent, Capital Requirements Directive IV (CRDIV), have reignited the debate on how much capital is enough.

The former deputy governor of the Bank of England was one of those who remarked that, under the right stressed conditions, no amount of capital would be sufficient and bank failures would always result.

This discussion is essentially an academic one because of the almost infinite range of scenarios. What might be enough capital under nine different sets of circumstances may prove insufficient under the 10th.

A prudent approach to bank capital management recognises that levels allowable under Basel I and II were clearly insufficient and so the stiffer requirements being enforced by legislative fiat, together with the leverage ratio limit, are good for the stability of the industry.

That said, greater leverage and falling levels of bank capital have accompanied economic development in almost every country in the world, as Chart 1 illustrates.

The demand for bank products, both assets and liabilities, has been as much a driving force behind the growth of bank balance sheets as the desire of lenders to maximise profit. Rather than assessing what the 'right' level of capital is, it is more pertinent to consider how higher levels will affect the business model.

This article considers two areas of banking, one very simple and the other more complex, where bankers will need to undertake a fundamental review of their operating model as a result of changes brought about by Basel III.

Maturity transformation

In the wake of the financial crisis, it is worth reminding ourselves of the value of deposits and the way banks undertake maturity transformation. This function is vital to continued economic development. Implementing Basel III capital and liquidity requirements will have an impact on the ability of banks to undertake maturity transformation.

Banks take in small sums of cash from a large number of customers who wish to have instant access to funds and pool them into loans for other customers who wish to borrow money for longer periods of time. No other type of institution offers this maturity transformation service.

The instant access bank deposit is one of the unsung heroes of economic development, due to its liquidity, function as a reasonable store of value and usefulness in settling transactions. Issuing debt in this form is what makes banks so important to world commerce.

Deposit account

The value of the deposit account is reflected in the demand for it in every sector of the economy. It is what enables banks to operate with a high degree of leverage compared with other industries.

The instant access deposit is a highly sought-after form of corporate debt and banks meet a genuine customer demand when they offer it as a product.

Basel III requires a much larger share of bank balance sheet liabilities to be in equity rather than debt, with higher tier 1 capital ratios and an explicit 3% leverage limit.

The more capital a bank has, the safer it is because it is better able to absorb losses from loan defaults. But a higher percentage of equity in the balance sheet means a lower percentage of debt.

By definition, requiring banks to reduce leverage will affect the supply of deposits. If a bank previously funded itself to the tune of 90% with deposits and 10% with equity, an increase in the required equity proportion to 20% reduces – all else being equal – the availability of deposits to customers by 10 percentage points.

At the macro level, banks would require customers to hold fewer bank deposits and more bank equity. This is a riskier investment with the potential to harm the economy.

The impact on deposit account supply has not attracted much attention in the academic or business media. The effect on derivatives market-making, on the other hand, has generated considerable debate.

Cost of funds

As well as higher capital levels, Basel III requires banks to hold a greater percentage of lower-returning liquid assets as part of a liquidity reserve (the liquidity coverage requirement) and a greater share of genuine long-term liabilities (the net stable funding ratio, NSFR).

Both of these add to the net cost of funds of every bank, some more so than others. This has strengthened the case, always strong, for derivatives market-makers to incorporate term cost of funds into their customer pricing – the so-called funding value adjustment.

Chart 2 shows the change in the Libor-OIS spread either side of the 2008 bank crash. As banks no longer fund at Libor-flat, their term cost of funds has increased significantly.

Whereas corporate bankers always took the cost of funds into account in setting a price for a customer, derivatives traders did not.

This reflected the no-arbitrage 'risk-neutral' pricing methodology for derivatives, with Libor-flat used as a proxy for the risk-free interest rate parameter in the Black-Scholes-Merton framework.

That orthodoxy has now changed as a result of higher term cost of funds and, significantly, the need to meet Basel III liquidity rules.

As long as banks actually funded at Libor-flat, not incorporating funding value adjustment was not a problem. But Basel III has forced the issue.

To meet the NSFR requirement, market-making banks will have to raise some contractual term liabilities, with an accompanying rise in term cost of funds. Not to pass this on via the funding value adjustment would be akin to lending money below Libor while funding these loans at Libor-plus.

Of course, introducing funding value adjustment will have an impact on customer pricing and bank competitiveness. Banks with a higher cost of funds will be at a disadvantage. The resulting changes to operating models could be significant: on a pure profit-making basis, one would expect less-competitive banks to pull out of this business.

As the industry works towards higher regulatory requirements, it is worth bearing in mind the role of banks and their essential function of maturity transformation. Raising capital levels is by no means bad for customer lending. Far from it. But it may have an unintended consequence in reducing the availability of deposits.

If this happens, customers will have a smaller home for their savings and will hold a larger share of riskier bank equity. At the other end of the spectrum, the liquidity requirements of Basel III will prompt some banks to withdraw from making markets in derivatives, narrowing customer choice.

Ultimately we need to be mindful of the impact of higher regulatory capital and liquidity requirements on the overall funding mix and the resulting effect on clients.

Neither regulators nor banks would wish customers to turn to the 'shadow' banking system to meet their deposit and hedging needs. The supply of both simple and complex, but essential, bank products remains a global imperative.▪

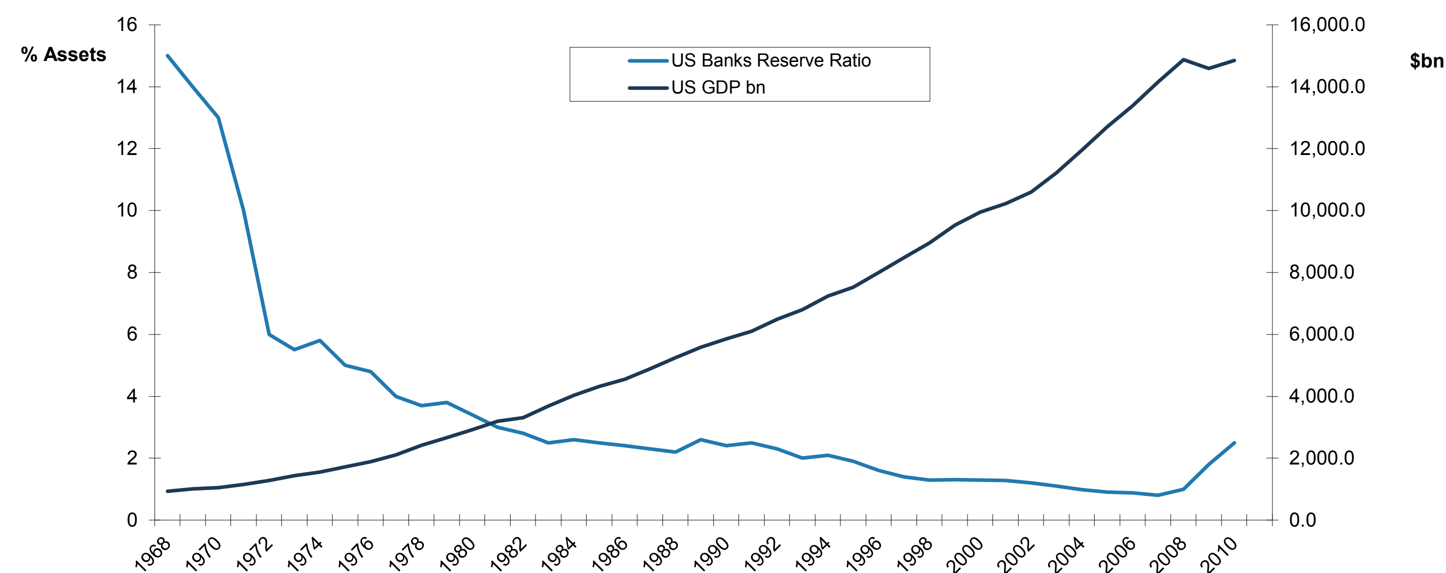
Moorad Choudhry is Professor at the Department of Mathematical Sciences at Brunel University and author of The Principles of Banking.

Bank for International Settlements – the centrepiece of Basel III regulations

On the web

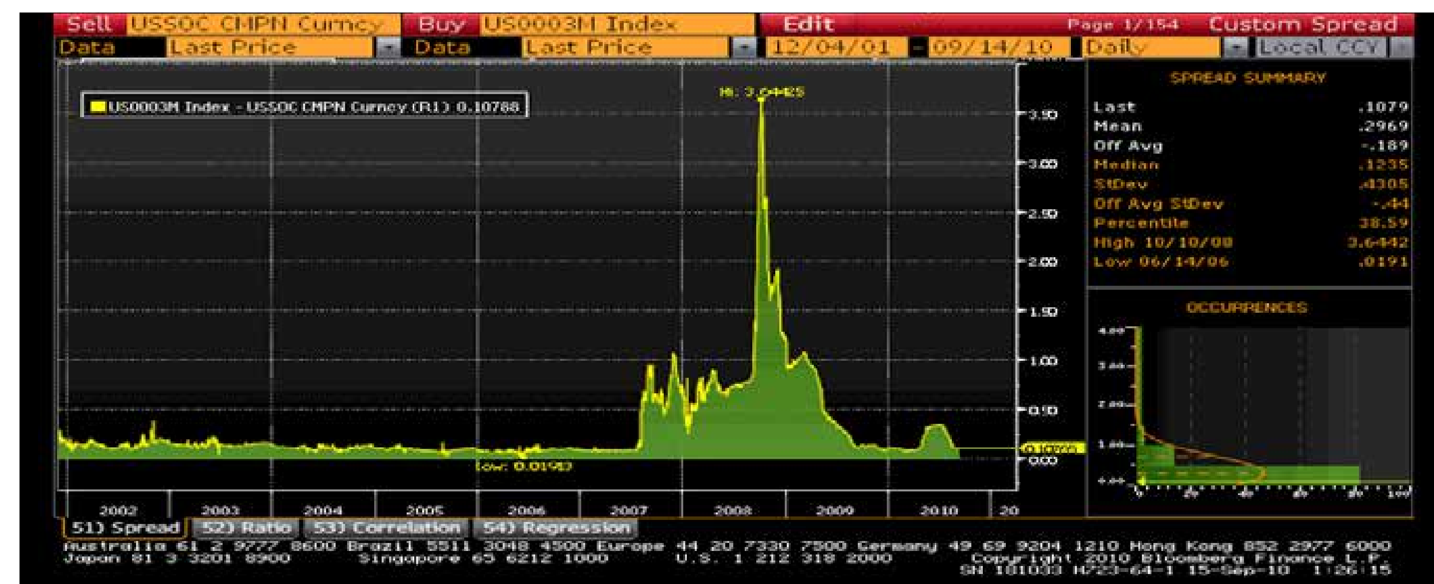
See related article by Choudhry, 'The real special thing about banks,' at www.cnbc.com/id/101169511

Chart 1: US GDP and bank capital levels history



Source: US Federal Reserve

Chart 2: $ Libor-OIS spread 2002-10



Source: © Bloomberg LP

Unpalatable choices for emerging markets

Central banks risk losing policy independence

Philip Turner, Bank for International Settlements

An extraordinary drop in global long-term interest rates has lured international investors to the bond markets of emerging market economies and led to a surge in overseas bond issuance by firms in developing countries. As the long period of ultra-low yields draws to a close, the monetary and financial-stability policy choices facing central banks in these countries can only become tougher.

During the 2000s, many emerging market governments became able to issue – and to sell abroad – long-term debt denominated in their own currency rather than in dollars. In doing so, they avoided the currency mismatch risks created by heavy dollar borrowing that was the root cause of the Asian financial crisis among others.

But one potential vulnerability has given way to another: emerging market corporations – many of which could not easily issue in their home markets – have increasingly replaced their sovereigns in international bond markets.

Massive debt issuance since the financial crisis has increased firms' foreign exchange exposure and means that gross external debt is a better indicator of financial system risks than international bank lending data. Emerging market borrowers raised about $990bn on international bond markets from 2010 to the first half of 2013.

Non-banks accounted for more than $700bn of this sum. They now raise twice as much by selling bonds as they do by borrowing from foreign banks.

What's more, 48% of net debt raised by emerging market firms – defined according to the nationality of the issuer – was through overseas subsidiaries. Such capital inflows do not show up directly in balance of payments or external debt data, which capture residence-based transactions.

Large-scale bond issuance

Large-scale bond issuance could affect the banking systems of emerging market economies through various channels. For example, companies lodge cash borrowed cheaply abroad with local banks.

But these deposits are flighty, raising wholesale funding risks for the banks if external financing conditions tighten. To address any resulting money market instability, central banks may be forced to take radical measures that could undermine their credibility.

Local currency debt

Local currency debt markets in emerging market economies have also been transformed. Governments now borrow much more in local currency than in foreign currency.

The World Bank estimates that local currency debt in the emerging markets totalled $9.1tn at the end of 2012, nearly double the $4.9tn figure at the end of 2008.

Crucially, local currency debt markets are now closely integrated with global markets. The World Bank estimates that foreigners now hold 26.6% or more of local currency bonds, up from 12.7% in 2008. What's more, statistical evidence shows clearly that since 2005 yields on those bonds have moved closely with US yields.

This was not the case earlier. Because of an extraordinary drop in the term premium on US Treasuries over that period, the average nominal long-term yield for major emerging market countries fell from about 8% in early 2005 to around 5% by May 2013.

This amounted to a real long-term interest rate of just 1%. Real rates have been low enough for long enough to have had a pervasive impact on fixed investment and on financing decisions in emerging markets.

Policy rate

The development of local currency bond markets has made the domestic long-term interest rate an important variable in monetary conditions for developing-country central banks, supplementing changes in the short-term policy rate and the exchange rate.

The consequence for monetary policy is that the impact of a higher policy rate may on occasions be outweighed by a lower long-term interest rate driven by foreign, not domestic, conditions.

This may well mean that the monetary stance in many emerging market economies has been much looser than the policy rate alone would suggest, because of the substantial fall in real long-term rates.

The second implication is that the stance of monetary policy becomes more uncertain. The central bank cannot precisely determine either the long-term rate or the exchange rate. Sharp market-driven movements in either may be regarded as transitory so the central bank might prefer to wait.

Or it may wish to react pre-emptively to get ahead of the market. Adding to the headache for policy-makers, expectations about the exchange rate and the long-term interest rate are often jointly determined – particularly after financial shocks, either foreign or domestic.

Monetary policy independence

The third implication is that monetary policy independence is weakened: developments in dollar bond markets heavily influence long-term local currency rates in countries without capital controls, irrespective of the choice of exchange rate regime.

This conclusion is not new. In the 1980s and early 1990s, it was short-term dollar rates – the funding and usually lending rate of international banks – that dominated because international bank lending was a key component of capital flows. Since the recent crisis, however, capital flows via bond markets have become more important, making long-term dollar rates crucial.

In 2009, a BIS Working Group agreed that capital controls could, 'at least in the short-run, help monetary policy by moderating the size or the volatility of inflows and by modifying their composition in favour of more stable flows.'

But what is entirely new in the current environment is that global long-term rates have been driven very low for a prolonged period of time. How controls would work in practice in the face of such a long-sustained anomaly is quite another story.

The long-term interest rate is fundamental for financial stability. It is the foundation stone of the financial system and must be a focus of macroprudential policy.

It provides the basic discount rate and is thus central to the pricing of all long-term assets. When the long-term rate is 'too low', long-term asset prices can rise 'too high'. In particular, it influences the market value of assets that potential borrowers have as collateral for getting new loans.

A negative term premium can become a systemic concern if sustained for very long. Households may decide not to commit their savings to longer-term instruments. They may calculate that they can earn more by investing in short-dated paper.

But prudent borrowers will want to finance long-term fixed investment with long-term debt. Hence the financial system will be called upon to effect maturity transformation and so bridge the gap between the differing preferences of savers and borrowers.

Word of warning

A word of warning for emerging market economies is that the severity of the recent financial crisis in the rich world owed much to excessive but largely hidden maturity transformation by firms that were ill-equipped for such a function. Many investors sensed an almost-assured profit and borrowed short to buy long-term assets.

Central banks in emerging market economies will therefore have to think very carefully about the size of the term premium in the yield curve for their own government bonds, about the desirable degree of volatility in these markets and about how maturity transformation in their financial system is changing.

In recent months, many emerging market economies have grappled with a slump in both their currency and their government bonds. Debt market volatility has increased since the Federal Reserve flagged in May 2013 its intention to start reducing its monthly asset purchases.

Foreign investors in emerging market bonds have been painfully exposed to changes in global financial conditions, while some corporate borrowers in developing countries have struggled to cope with currency mismatches and rising bond financing costs.

Movements in long-term US interest rates, the global benchmark, can have major implications for both monetary policy and financial stability in emerging market economies. The long period of declining global bond yields is over.

At some point, central banks in the advanced economies will both increase short-term interest rates and reduce their bond holdings. Uncertainty about the policy path could unsettle global bond markets and increase pressure on some emerging market currencies, raising the local currency cost of servicing dollar debt.

Higher long-term rates, currency depreciation and more volatile markets could make the choices facing emerging market central banks even more difficult.■

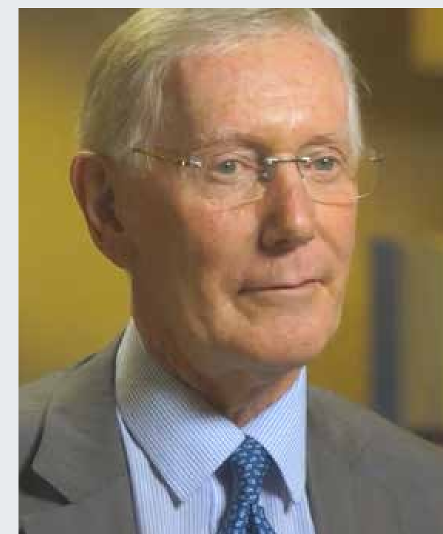
Philip Turner is Director of Policy, Coordination and Administration and Deputy Head of the Department Monetary and Economic Department at Bank for International Settlements.

The view from a monetary Cassandra: Why 'human nature' led to the financial crisis

In 1992, after the fall of the Berlin Wall and the collapse of the Soviet Union, your correspondent had a bright idea. Having mixed during my journalistic career with many a well-heeled banker and industrialist, I decided to try to write a bestseller and become financially independent, *writes William Keegan in London.*

I hit upon the title *The Spectre of Capitalism – The future of the world economy after the fall of Communism*, an obvious play upon Marx's famous phrase. I was quite pleased with the title and did my best to warn about the dangers of 'bourgeois triumphalism' and unfettered markets.

However, I was soon put in my place: nowhere near the bestseller lists, and the only famous leader reported to have read it was General Augusto Pinochet, ex-leader of Chile, when in captivity in London. True, there was a Chinese translation. But, funny that, no Chinese royalties.



William White – a voice of warning

So I did not laugh all the way to the bank. And, although there were warnings about reckless lending and borrowing in the financial system, I had no idea that we would end up with the kind of financial crisis from which, in my opinion, we are still suffering.

Let us face it: my generation took a functioning banking system for granted. I was reminded of this when hearing William 'Bill' White, former head of the monetary and economic department at the Bank for International Settlements (BIS), on excellent form, at a recent OMFIF roundtable discussion in London.

The Queen famously asked, at the London School of Economics (she chose the right location), why nobody had warned her about the financial crisis. In fact White had come pretty close to it, but it is just conceivable that Buckingham Palace was not on the BIS mailing list.

One of Bill's problems was that his main shareholders did not want to hear. Such eminent persons as Alan Greenspan and Jean-Claude Trichet insisted that things were going well.

As Bill reflected last month: 'The banks made money, the politicians wanted to spend, [policy-makers] wanted to make people happy. They had achieved price stability.'

For a man whose percipience was brushed aside, Bill is remarkably generous to those who ignored him. They were not stupid people. It was 'human nature' to hope the 'great moderation' would continue.

Bill tells a wonderful anecdote about the time a German translator said to him that the toughest thing she ever had to translate was a 16-page text of his. He had been consciously obscure because he was 'criticising [his] main shareholders'.

Well, we are where we are, and many people worry about the degree to which such an economic recovery as we have had in the industrialised countries has partly depended on a recrudescence of the kind of asset price inflation which contributed to the crisis in the first place.

Bill is pretty pessimistic. 'Recovery after a financial crisis normally takes a decade, and this crisis could be worse.' 'Why', he asks, 'should demand suddenly strengthen?'

Yet 'debts in the G20 are still above pre-crisis levels' while the exposed financial sector is 'still trying to deleverage'. Despite all the monetary easing, Bill White seems concerned these days as much about the dangers of deflation as about the BIS's traditional bogy, inflation.

The upshot is: 'Recovery poses risks. But no recovery poses even greater risks.'■

William Keegan, Chairman of the Editorial & Commentary Panel, is Senior Economics Commentator at the Observer.

A tale of fluctuating balances

The reasons behind changing reserve patterns at central banks

Gabriel Stein, Chief Economic Adviser

Since central banks began their various forms of asset purchases and quantitative easing, much ink has been spilt on the subject of banks' reserves with central banks. These are seen variously as a problem and a danger. In truth, they are neither. Central banks created them and can destroy them at will.

The main near-term risk facing the euro area is that of possible deflation in 2014. What happens to banks' reserves with the European Central Bank (ECB) is wholly irrelevant to this.

Banks' reserves have increased sharply in the wake of the 2009 recession and central banks' recourse to 'unconventional' monetary policies.

In truth, the policies are not that unconventional at all; quantitative easing is merely a new name for debt market operations, which used to be standard practice for central banks until the 1980s.

In the euro area, reserves rose from just under 15% of the ECB's balance sheet in early 2007, before the financial crisis began, and eventually peaked at 38% in March 2012.

In absolute terms, reserves rose from €169bn in January 2007 to €1.15tn at their highest point.

In the US, reserves started out at just 0.2% of the Fed's balance sheet in January 2007, but they crested at 62.9% in December 2013 and have barely budged so far this year. In absolute terms they rose from $1.6bn to more than $2.4tn over the period.

One caveat needs to be mentioned: the figure for the euro area refers to all deposits by banks relating to monetary policy operations, while the Fed data refer to excess reserves, i.e. over and above all reserve requirements. However, required reserves are fairly small, and what matters here is as much the trend as the level.

Reserve management concerns

The explosion of banks' reserves led to concerns among central banks as well as among some commentators. There are two principal issues.

First, why were banks building up reserves with the central bank, and how could they be made to lend out the funds instead to kick-start credit growth?

Second, what could central banks do if banks did not lend out the reserves at the time but saved them for later, when policy-makers might not wish them to be used for fear of the economy overheating?

Even such a seasoned observer as Richard Fisher, president of the Federal Reserve Bank of Dallas, falls into this trap. In a speech to Financial Executives International in February, he commented, 'The store of bank reserves awaiting discharge into the economy through our banking system is vast, yet it lies fallow.'

Erroneous assumptions

As it happens, these concerns are entirely misguided and based on a set of erroneous assumptions. The first is that banks first need to have money to lend it out. Therefore, reserves parked with central banks could instead be lent to the non-bank private sector.

But banks do not need to have any money in order to lend. Banks create money by the very act of lending, since a loan creates an asset on the banking system balance sheet (claim against the borrower) and, by definition, a corresponding liability (deposit of the borrower, now credited with the amount lent).

Size of bank reserves

The overwhelming majority of money in any advanced economy consists of bank deposits. The size of banks' reserves with the central bank is, broadly speaking, irrelevant to the issue of credit growth.

If the size of the reserves were inversely related to credit growth, the data would give the impression that the ECB and the euro area have dealt much better with the financial crisis than the Fed.

Euro area banks' reserves are back below 20% of the ECB's balance sheet, while in absolute terms they have fallen from a peak of €1.15tn to about €430bn.

By contrast, excess reserves held by US banks with the Fed remain elevated, both relative to the Fed's total balance sheet and in dollar terms.

In fact, whereas credit to the non-bank private sector is growing in the US, albeit weakly, in the euro area it continues to contract. Euro area banks' reserves with the ECB are falling because the banks are busy repaying funds they borrowed in the pair of three-year refinancing operations conducted in 2011 and 2012.

Long-term refinancing operations

The second error has to do with how the reserves arose. They are not the result of action by the banks – 'we have this huge amount of money, let's park it with the central bank' – but of action by the central bank, specifically its quantitative easing or asset purchase programme; or, in the case of the ECB, its long-term refinancing operations (LTROs).

The central bank buys assets from the banks and credits their accounts at the central bank, thereby creating reserves.

The second point shows that the concern about banks potentially lending out their reserves at a time when a central bank might wish to dampen activity is misguided. Central banks created the reserves; they can destroy them at will, most easily by selling assets to the banking system.

This issue is important because it affects ECB and Fed policy. The ECB is concerned about a perceived lack of liquidity in the euro area, as well as about the danger of deflation. With its policy interest rate at 0.25%, the ECB's options are limited.

Two that have been discussed are a further LTRO to boost liquidity and introducing negative interest rates on banks' reserves to mobilise them for lending.

It is difficult to see what good another LTRO would do. If banks are busy repaying previous LTROs early, it is a sign they do not need extra liquidity.

The ECB is in any case providing all the liquidity banks are asking for in its regular monetary policy operations. Moreover, the ECB has indicated that in the forthcoming Asset Quality Review it would not look kindly on any banks availing themselves of a potential LTRO.

This all but ensures that only banks desperate for liquidity and unable to raise it elsewhere would make use of a new LTRO. It also virtually rules out linking the provision of liquidity to mandatory on-lending of the funds provided.

Negative interest rates

Negative interest rates on banks' reserves might have an impact on output growth – but not in the way that many observers and practitioners would expect. It would not cause banks to shift their assets from deposits with the central bank to claims on the non-bank private sector (i.e. lending). This link does not exist.

Negative interest rates might work if they cause banks to adjust their portfolio from deposits with the central bank to other assets – most likely short- and long-term government paper. If bought on the secondary market and from the non-bank private sector, this would boost money supply.

If bought directly from the issuing government, it would amount to 'underfunding', i.e. banks funding the government deficit, and would leave money supply higher than if the bonds are bought by the non-bank private sector. Both developments would be good news.

However, negative interest rates could throw up other problems. Banks could decide to shrink their reserves faster by repaying more of the LTROs.

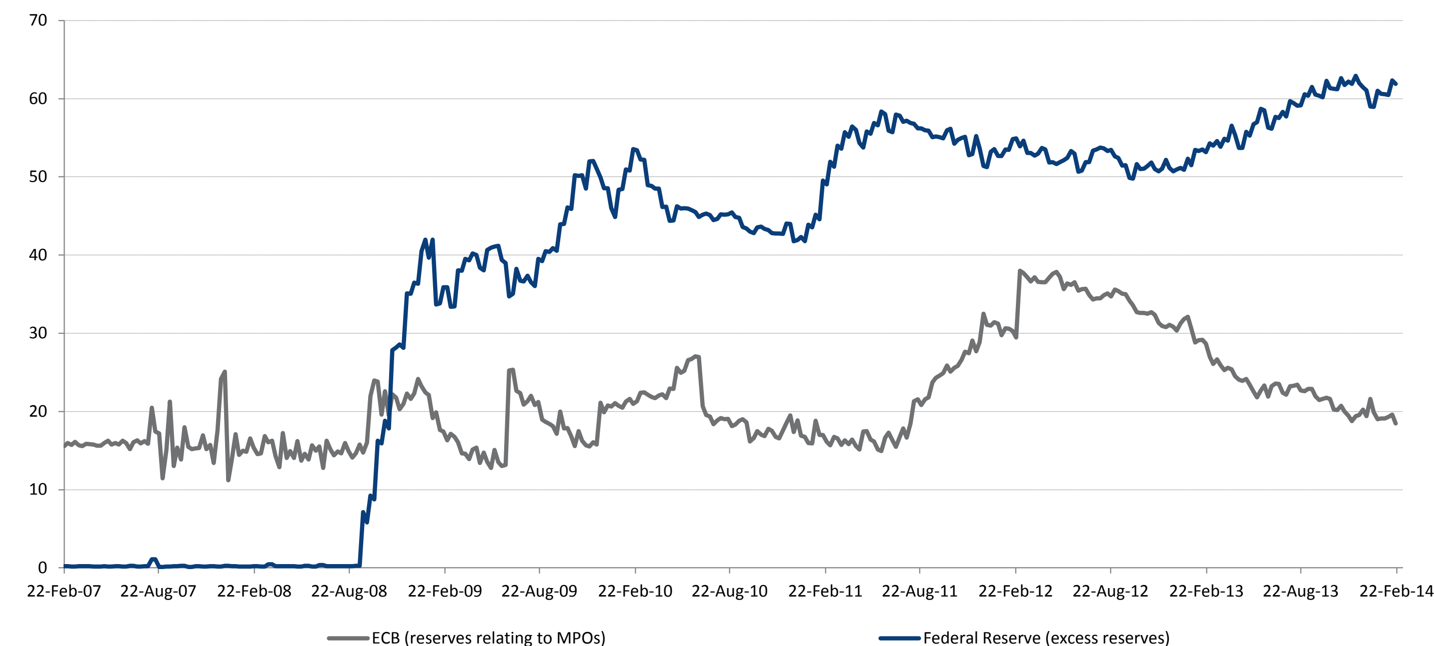
They could decide to raise interest rates on lending to recoup losses on their reserves. Or they might decide to switch to holding physical cash, on which there would be no loss.

But the truth is that banks' reserves with central banks are a non-issue. They are not part of the stock of broad money. They are not a latent inflation threat.

They are not the result of a choice between lending out funds and storing them. The main near-term danger facing the euro area is that of possible deflation. Banks' reserves are wholly irrelevant to this.▪

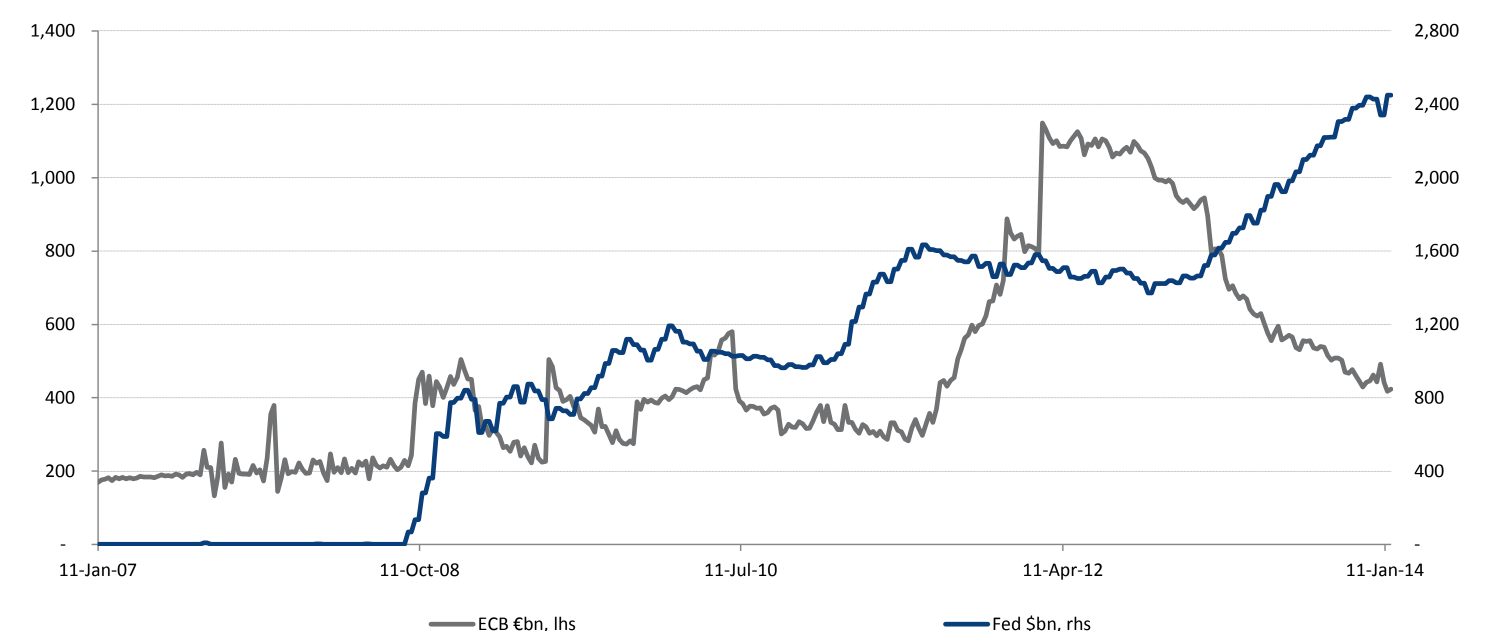
Prof. Gabriel Stein is Chief Economic Adviser at OMFIF. He is the main author of the fourth OMFIF report on Chinese economic developments during the Year of Renminbi Focus. *See p.36.*

Chart 1: Banks' reserves with central banks, % of total central bank balance sheet



Source: ECB, Federal Reserve

Chart 2: Euro area & US, banks' reserves with central banks



Source: ECB, Federal Reserve

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Why Abe needs to unleash structural reform

Healing of US economy could be Abenomics real third arrow

Shumpei Takemori, Advisory Board

A surge in the Bank of Japan's bond buying is the simplest of the three arrows of 'Abenomics' to fire. Massive monetary stimulus has already had a positive impact on growth. But now Prime Minister Shinzo Abe must take the trickiest arrow out of his policy quiver – structural reform – and hit the bull's eye to sustain the revival of the world's third-largest economy.

A wide range of possible reforms are under discussion. But the way Abe's government is handling the matter, by forming a committee of experts, is underwhelming. It is more important to answer some key questions. First, how is the political system obstructing economic growth? Second, does Abe's reform plan really have the potential to solve these systemic problems?

Political representation

The major obstacle to growth is Japan's skewed electoral system. One vote in densely populated areas carries, at worst, one-fifth of the weight of a vote in rural parts of the country where few people live. This political imbalance has created at least two big economic difficulties.

Public investment and other resources are diverted from big cities such as Tokyo, Yokohama and Nagoya and used unproductively in scarcely populated corners of Japan (see Chart). Furthermore, the electoral distortions show that the agricultural lobby, whose power is rooted in depopulated rural area, has a major influence on trade policies.

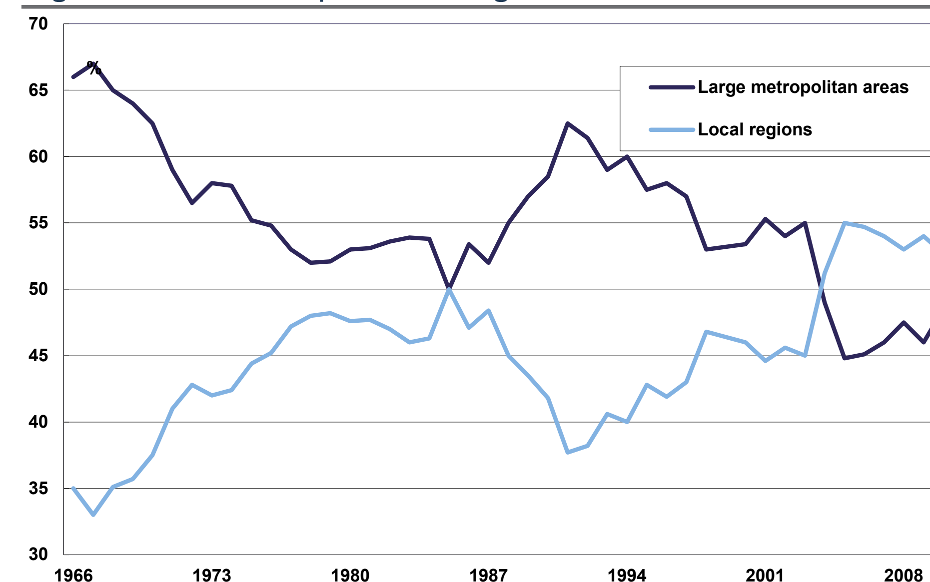
To some extent, Abenomics offers an opportunity to put resources to more productive use in urban areas. For example, Abe can use the 2020 Tokyo Olympic Games as a pretext to funnel more public investment to the capital. And the Bank of Japan's monetary easing translates into low mortgage interest rates, which will encourage house-building in cities.

At the heart of Abenomics is a strategy for export-driven growth similar to that pursued by Prime Minister Junichiro Koizumi, whom Abe served as chief of staff.

Japan's exports as a share of GDP almost doubled under Koizumi due to stronger US consumption and epic currency intervention by the Ministry of Finance to weaken the yen.

The currency initiative was led by then-vice minister Haruhiko Kuroda, whom Abe chose to be the governor of the Bank of Japan.

Regional distribution of Japanese central government investment



Source: Ministry of Internal Affairs and Communications

It is common for a country in crisis to recover through export growth. The puzzle is why Japan has taken so long to pursue this course. It was the curious movement of the yen-dollar exchange rate that inhibited an export-led recovery.

When the Asian financial crisis engulfed Korea in 1997, the economy achieved a swift recovery on the back of exports thanks to a sharp fall in the won against the dollar. By contrast, the yen kept rising throughout the 1990s.

Indeed, the yen appreciates when there is a crisis because Japanese companies react by repatriating their overseas assets, which entails heavy dollar selling and yen buying. The Japanese currency scaled a record high immediately after the 2011 earthquake and tsunami. Unfortunately, the Koizumi/Kuroda strategy ended in tears due to the eruption of the US sub-prime crisis in 2007. But this was not the two men's fault.

This time around, not least through its impact in weakening the yen, the Abe/Kuroda strategy may propel the economy on to a higher, export-led growth path as long as the US recovery is sustained. That is why the healing of the US economy, rather than any witches' brew of structural reform, is likely to be the real third arrow of Abenomics.

Many observers believe that a further weakening of the yen, possibly toward the Y110 to the dollar level, will be the single most propitious method of bringing the economy on to a sounder long-term path – especially since the inflationary effects of such a decline would be, as long as they did not go too far, in line with the government's and Bank of Japan's strategy.

True puzzle

Critics argue that Japanese firms have little scope to increase investment, despite near-zero interest rates, because their profitability is low. I disagree.

The true puzzle for me is that Japanese firms are increasingly relying on equity finance (which is more expensive) rather than debt, even though borrowing costs are falling thanks to the Bank of Japan.

Leveraged buy-outs

If Abenomics is to succeed, Japanese firms must realise that switching to debt financing will boost profits. A simple way to trigger the shift is via leveraged buy-outs

With the yen weak, interest rates low, stock prices rising and companies stockpiling cash, the conditions for leveraged buy-outs are ideal. I urge European investors to start considering leveraged buy-outs of Japanese firms.■

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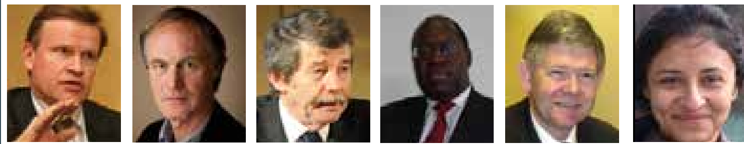

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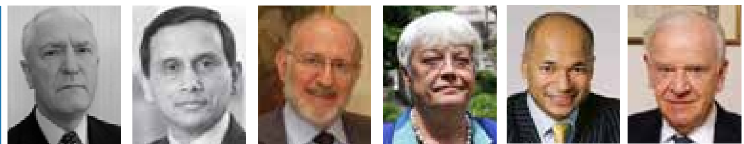

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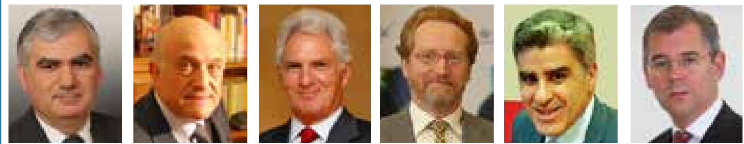

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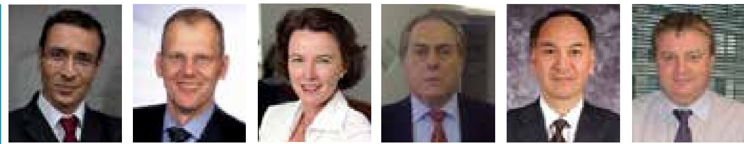

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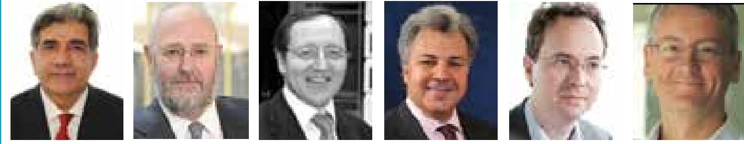

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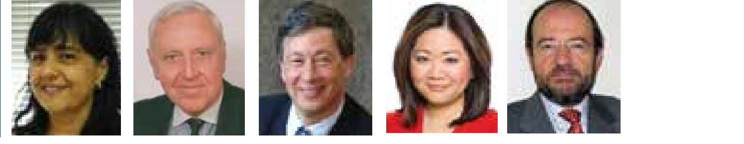

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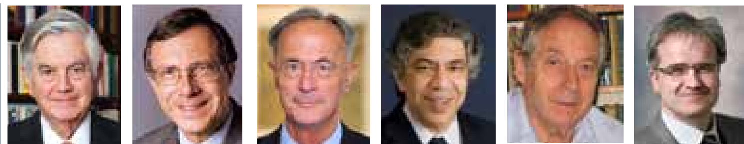

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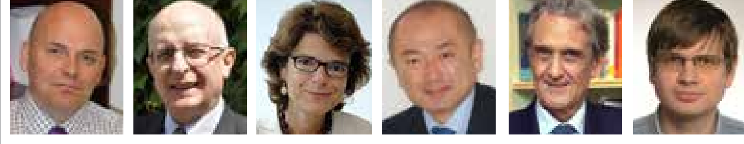

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Reform success spurs Spanish rebound

Time to reap rewards from shift to exports

Jaime García-Legaz, Spanish Trade Secretary

Spain has begun the New Year on a sounder footing for the first time since the crisis started. The European Commission has just doubled its growth forecast for Spain and analysts have become more optimistic about the outlook for growth and unemployment.

Spain is shifting away from domestic sources of growth towards an export-led economy. Spain's new economic model greatly reduces the risk of boom-bust cycles because credit-fuelled housing and consumer booms are less likely to materialise.

The recovery and new pattern of growth rest on three economic policy pillars: structural reforms to boost competitiveness and productivity; a clear commitment to the sustainability of public finances; and the clean-up and recapitalisation of banks to strengthen the financial system.

Reforms to increase competitiveness, together with declining labour costs, help explain the strong performance of Spain's external sector in recent years.

In 2013 exports rose 5.2% to €234bn (5.4% when adjusted for inflation) and imports fell 1.3%. The overall trade deficit was roughly half that of 2012, while non-energy trade recorded a €25bn surplus.

Exports have proved more resilient to the economic cycle thanks to two factors – diversification and product quality. First, non-EU economies account for almost 40% of Spain's exports. Sales to these markets rose 6.1% in 2013, led by a 24.9% increase in exports to the Middle East. Shipments to Asia and Africa rose 10.3% and 8.4% respectively.

The main contributors to Spain's improved export performance include Portugal (which accounted for one percentage point of the 5.2% increase in nominal terms), the UK (0.9 percentage points) and France (0.7 percentage points). These three countries still make up a large chunk of Spain's export basket. Brazil accounted for 0.4 percentage points.

Second, Spain has broadened its range of exports, particularly of high value-added goods and services. In 2013 the main contributors to export growth included capital goods (such as transport and industrial equipment), vehicles, chemicals and consumer goods.

Exports of non-tourism services, mainly professional services and services to firms, have outpaced exports of goods and tourism since 2005.

As a result, Spain's performance has been among the best of the world's large economies. In contrast to Spain's 5.2% increase in exports in 2013, France recorded a drop of 1.6%. Germany's exports dipped 0.2% and Italy's 0.1%. UK exports increased by 1%, the same as the European Union. But euro area exports declined by 0.1%. Japan outpaced Spain with 9.5% export growth, but the US trailed with an increase of 2.1%.

In 2014, Spain's exports are likely to reach a record 35% of GDP. While the external sector will keep spurring growth, domestic demand will stabilise further. Spain continues to strengthen its position as a net lender to the rest of the world and the private sector is deleveraging rapidly.

Since 2007 the current account relative to GDP has adjusted by almost 12 percentage points. The current account has been in surplus since the second half of 2012, which is enabling Spain to reduce its net external indebtedness. This improvement is of a structural nature and is due to competiveness gains stemming from an internal devaluation.

On top of export growth, Spanish products are increasingly substituting for imports, according to analysts. This trend is significant and makes Spain's current adjustment much more sustainable than the one achieved by exchange rate devaluation in the 1990s.

As the 2014 European Commission's economic forecast recently concluded, Spain's incipient recovery is likely to strengthen in coming quarters on the back of improving confidence and some easing of financing conditions.

The momentum of the economic rebound is well established. It is now time to reap the rewards of the work that has been accomplished to reinforce the foundations of a new growth model.▪

Jaime García-Legaz is Spanish Trade Secretary at the Ministry of Economy and Competitiveness.

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China clouds growth optimism

German good news offset by emerging market doubt

Michael Holstein, DZ BANK

DZ BANK Economic Forecast Table

GDP change (%)	2011	2012	2013	2014	2015
US	1.8	2.8	1.9	3.2	3.0
Japan	-0.4	1.5	1.6	1.4	1.5
China	9.3	7.7	7.7	7.5	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.4	2.3	2.6
France	2.0	0.0	0.3	0.8	1.3
Italy	0.6	-2.6	-1.9	0.4	1.3
Spain	0.1	-1.6	-1.2	0.8	1.5
UK	1.1	0.3	1.8	2.4	1.7
Addendum					
Asia excl. Japan	7.6	5.8	5.9	6.2	6.2
World	3.8	2.9	2.7	3.4	3.7
Consumer prices (% y/y)					
US	3.2	2.1	1.5	2.1	2.5
Japan	-0.3	0.0	0.4	1.9	1.6
China	5.4	2.7	2.6	3.2	3.8
Euro area	2.7	2.5	1.4	1.1	1.8
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	0.7	1.5
Italy	2.9	3.3	1.3	0.6	1.4
Spain	3.1	2.4	1.5	0.4	1.3
UK	4.5	2.8	2.6	2.2	2.8
Current account balance (% of GDP)					
US	-2.9	-2.7	-2.5	-2.6	-2.8
Japan	2.0	1.1	1.0	0.8	1.2
China	1.9	2.3	2.0	2.0	1.6
Euro area	0.2	1.3	2.3	2.5	2.5
Germany	6.2	7.1	7.0	7.2	6.5
France	-2.5	-2.1	-1.7	-1.8	-1.9
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.2	1.0	2.0	2.3
UK	-1.5	-3.7	-3.8	-4.3	-4.0

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Concerns over growth in several struggling emerging market economies have persisted in the last four weeks. Uncertainty over the outlook for China has added to the anxiety.

Sentiment indicators are signalling that weakness in other emerging market economies is undermining business confidence in China, where reform and anti-corruption campaigns could further damage growth.

Environmental problems, notably smog alerts, are also causing temporary production shutdowns. Accordingly we have nudged down our forecast for growth in the first quarter and think GDP for the full year will expand at most by around 7.5%.

This is the Chinese government's target, reaffirmed by Premier Li Keqiang in his annual work report to the National People's Congress on 5 March.

Weather-related constraints on companies and consumers are evident in the US too. Severe winter weather over much of the country is hampering the economy, as reflected in the weakness of several indicators.

First-quarter growth is expected to be slightly lower than in the fourth quarter of 2013. But the forecast is still optimistic and, at present, there is no need to revise down the full-year GDP forecast.

The delicate economic recovery in the euro area continues, as confirmed by GDP data for the fourth quarter of 2013. The most encouraging development is a distinct pick-up in Spain and Portugal, two countries hit hard by the crisis. Persistent weakness in Italy remains a cause for concern, with hope as well as trepidation attached to the new government under Matteo Renzi, who was given his mandate on 17 February.

It is hoped that the new government is serious about its reform programme. The consistently positive trend of euro area sentiment indicators suggests that the economic upturn still has legs.

Strong business climate indicators imply that Germany is on the brink of an economic acceleration. Not only exports but also investment – finally – contributed positively to growth in the closing quarter.

A strong drawdown of inventories capped growth at 0.4%. As shops refill their shelves, the impact will be reversed.

This restocking, together with robust private consumption, should ensure that the economy picks up in the first quarter and that annual growth climbs back above 2% in 2014.▪

Michael Holstein is Head of Macroeconomics at DZ BANK.

Scots' uncertainties could weigh on markets

Edinburgh independence tussles expose fiscal doubts

Colin Robertson, Advisory Board

As the debate on Scottish independence heats up, questions about the use of sterling, the Bank of England and EU membership are in the headlines. It is assumed that much of the uncertainty will be cleared up ahead of September's referendum.

However, the underlying issues are fiscal and the referendum agreement provides for extensive negotiations in the event of a vote to split from the UK.

In his January briefing, John Nugée bemoaned the lack of emotion in the debate. That has all changed. Chancellor George Osborne has rejected currency union for an independent Scotland, while the president of the European Commission, José Manuel Barroso, has stated that it would be 'difficult, if not impossible' for Scotland to be in the EU if it became independent. Several prominent businessmen have also voiced concerns.

Seeking a fairer society

Unlike other countries seeking independence, the issues in Scotland are not ethnic. Nor, given the maturity of North Sea oil, is independence realistically a grab for natural resources.

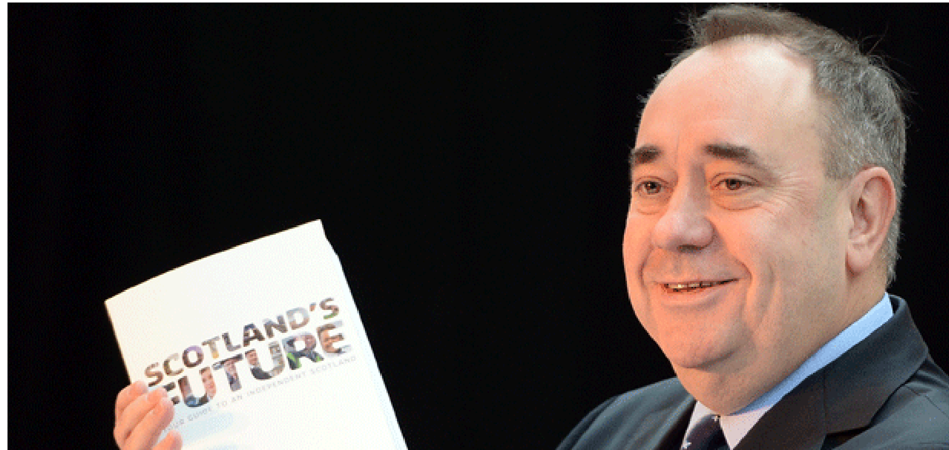
In *Scotland's Future*, the Scottish government sets out the case for independence. It argues for 'closing the gap between the rich and the poor' and for a 'more prosperous and a fairer society'. It puts forward the need to determine employment law and business regulation locally, not in Westminster. There is a snipe against privatisation.

The white paper refers enviously to the Scandinavian economies, their ability to make their own decisions and their higher quality of life. The issue of a more equal society is raised once more.

Power has already been devolved

Scotland has its own legal and education systems, quite distinct from those elsewhere in the UK. The Scottish government is already responsible for health and it has no desire to change the structure of local government.

While Scotland's future is to be nuclear-free, Scotland's security is to be guaranteed as a member of Nato. Scotland will contribute a 7,500-strong regular armed force, presumably much as it does to the British deterrent at present. Therefore, much will remain unaltered.



Scottish First Minister Alex Salmond holds up *Scotland's Future* at its launch on 26 November 2013

To a large extent, independence is about fiscal policy. There is no enthusiasm for a separate currency or an independent monetary policy. Of course, that might change if interest rates were to be jacked up, sterling to soar and Scotland to plunge into recession, but that is not on the radar in the foreseeable future.

The plight of the peripheral euro area countries has made it clear to everyone, including Scotland's first minister, Alex Salmond, that the use of sterling would entail externally imposed restraints on fiscal policy. His point is that Scotland should have more freedom as to how it raises taxes and spends government revenues, even if the total sums will not be at Scotland's discretion.

However, there will still have to be considerable constraints to deter businesses from moving south to England and to prevent the flight of higher earners.

In reality, the scope for manoeuvre is limited and it is not clear that the final outcome in the event of a Yes vote would differ greatly from what has been termed 'devolution max' – much greater autonomy for Scotland while remaining part of the UK.

A lengthy process

Scotland would not become independent the day after a Yes vote, but rather after a process of negotiation. At the optimistic end of the scale, the Scottish government envisages the talks being completed by March 2016. However, the UK general election is likely in May 2015, delaying serious negotiations.

Salmond is threatening that Scotland would not assume its share of UK liabilities unless it received its share of UK assets, including those of the Bank of England. However, Scotland is hardly going to make a Unilateral Declaration of Independence and be perceived as defaulting on its debts.

Likewise, bold statements from George Osborne that an independent Scotland will be unable to use sterling ring hollow. Scotland will be unable to build up a credible level of foreign exchange reserves for it not to be part of a currency bloc and the UK ex-Scotland needs to avoid an unseemly break-up of the Union. Witness Financial Times reports of the US fretting over a weakened UK. In short, negotiations are liable to be problematic and carry on for a number of years.

Prolonged uncertainty

A Yes vote is likely to lead to a lengthy period of uncertainty. Will mortgages to Scottish homeowners made by English banks end up being repayable in sterling or in Scottish pounds? Will English banks reduce lending to Scottish homeowners in the interim? Is NatWest, as a part of RBS, Scottish or English?

Ahead of the referendum, the pro-union faction will highlight these sorts of issues in an attempt to sway the vote. This will not make resolution of the problems any easier if it loses the vote.

The implications for UK financial markets are not good and could make for a precarious summer. In the event of a Yes vote, sterling and gilts could suffer for years.

UK equities would do better as the UK quoted corporate sector has a relatively low exposure to the UK economy.▪

Colin Robertson is former Global Head of Asset Allocation at Aon Hewitt.

Ukraine tussle exposes European weakness

Putin's parade unlikely to end in glory

Pooma Kimis, Director of Markets and Institutions

A curious and destructive European symmetry appears to be at work. The tussle over Ukraine, and the smaller, inter-related but potentially no less violent tug-of-war over multi-ethnic, multilingual Crimea, have sparked off destabilising ructions in an entity supposedly reflecting the continent's centuries-old craving for unity: the European Union.

Russian President Vladimir Putin has drawn up his parade of political and military power in front of a house of Europe that appears pitifully weak and divided.

European leaders have been exposed not as a collective body united for action but as heads of an assortment of sovereign states nervously protecting their own interests. Domestic political constraints undoubtedly play a role.

Arguing in favour of maintaining French warship supply contracts for Russia, French President François Hollande has wielded the defence of respecting contractual law and upholding France's business reputation. In view of his poor political standing and worries over job losses in key industries, a more relevant consideration may be his fears that scuppered arms deals would further lower his poll ratings. The spectre of unemployment, not the spectacle of Russia holding Ukraine to ransom, may be what worries the French public.

The Germans, too, are reluctant to take a stand. Post-Cold War Germany no longer confronts the Soviet empire across its eastern border, but Chancellor Angela Merkel is weighed down still by the legacy of German atrocities in the East during the Second World War. She prefers to focus on internal economic and social problems, rather than putting Germany out on a limb by, for example, backing away from oil and gas supply contracts vital for supporting an economy that is already vulnerable to higher energy prices.

William Hague, Britain's foreign secretary, has huffed and puffed about turning off the Russian gas tap and doing what the British always do in a crisis: turn to the US, in this case to secure shale gas supplies.

But Europe's dependence on Russian natural gas and good pipeline links weaken Europeans' ability to take a strong 'our way, or the highway' stand. As ever, the European political stakes are streaked with grey.

The financial markets have shrugged off the dangers for the moment, but this could be premature. Some local banks in Ukraine could go under, with a material impact on European banks with Ukrainian exposures. The hryvnia's decline and the deteriorating macroeconomic environment east of the EU could send disruptive ripples across Europe's heartlands.

President Putin wishes to emerge from a period of Russian passivity in the wake of what he sees as the catastrophe of the Soviet Union's dissolution.

For Russia's tortured soul, he offers not revolution but resurrection. It is a high-risk route that could bring Europe to the brink. Whatever happens, the Russian president has embarked on a journey that can hardly be expected to end in glory.▪

Pooma Kimis is Director of Markets and Institutions at OMFIF.

Europe trapped in vicious circle over Crimea and Ukraine

Europe's policies over Ukraine appear to have been fatally flawed from the start. By seeking to draw Kiev more closely to the European Union, the Europeans issued a warning signal to Moscow that President Vladimir Putin was unlikely to ignore, *writes Michael Kaimakliotis in Zurich.*

Strategic minds in Brussels should have reflected on this and been ready for the hostile reaction that inevitably emanated from Russia's fears of a westwards drift by a key neighbour. Not surprisingly, the Russian leadership noted Europe's weak and divided state – and decided that the answer lay not in backing down but in a show of strength. Russia reasoned it could act aggressively in Ukraine without fear of a strong and united Europe.

So far, Europe's miscalculation has exposed it to a double setback. On the one hand, as events in Crimea have demonstrated, Russia has been empowered to take aggressive action. On the other, Europe has presented, to its citizens and to the world, an unnerving display of prevarication and indecisiveness.

In courting Ukraine, Europe's leaders made overtures to a country that is well known to be divided between support for Russia and for the west. Ukraine's deep economic difficulties require significant financial support that Europe is unwilling to provide. Russia supports Ukraine through sales of natural gas at discounted prices.

The odds were stacked against Europe. Had Ukraine accepted Europe's offer, Russia could have taken steps to worsen Ukraine's economic plight. Even if the Europeans had tried harder, it was extremely unlikely that they could have succeeded in wooing Ukraine on a sustainable basis.

Ukraine's strategic importance to Russia is enormous. Russia could not be expected to allow Ukraine to fall into what it regards as unfriendly hands. It provides Russia with access to the Black Sea and the Mediterranean. Ukraine is the route for the lion's share of Russian gas exports to Europe, the basis of much of Russia's economic power. Ukraine is the lynchpin of the Eurasian Economic Community, Russia's instrument for regaining or enhancing control over former Soviet states.

Europe's weakness and American hesitations over involvement in overseas conflicts have made the Russian decision rather straightforward. Moscow can brush off sanctions, which would be far less devastating to Russia's geopolitical position and Putin's standing than losing Ukraine. Game theorists would say that Ukraine has great salience for Russia but far less for Europe.

For Europe, a successful Ukraine strategy would require economic strength, political leadership and support from electorates. None of this is evident. Euro policies and politics still risk undermining Europe, even if the near-term outlook has improved.

A vicious circle is apparent. Lack of European cohesiveness over Ukraine further weakens support among Europe's citizens for the reinforced political and economic structures that would best serve the continent's long-term interests.▪

Michael Kaimakliotis is an adviser to Quantum Global in Zurich.

New era for Middle East as energy status fades

Probable fall in oil prices will cut revenue in key countries

Nick Butler, Advisory Board

The world economy displays uncertainties that, in other comparable periods in the last three or four decades, would have put upward pressure on oil prices. Yet prices have remained steady, despite the risks of confrontation over Ukraine, renewed violence in Iraq, minimal exports from Libya and lack of progress in talk between Iran and pivotal countries (the US, Russia, China, the UK and France) over Tehran's nuclear ambitions. This shows how the oil supply-demand balance has tilted, with short term supplies running ahead of demand.

President Hassan Rouhani's promise of 'constructive interaction' with the rest of the world has not yet been translated into concrete reality, but rapprochement with the west would be a major factor calming the energy market.

For a combination of political and economic reasons, even the world's 'swing' oil producer, Saudi Arabia, will not be able to prevent some fall in prices over the short to medium term. The pattern is part of developments under which Middle East is gradually losing its 100-year old pivotal status in the international oil market.

In different ways oil, followed by gas, has shaped every economy across the region. But things are changing. The Middle East producers remain important in the international market but, with the critical exception of the Saudis, they are no longer indispensable.

Middle East oil exports now make up only 35% of the global total, against 50% in the 1980s. Exports of 19m barrels per day (of which 8.5m bpd comes from Saudi Arabia) are still substantial but the trend is clear and will continue. The world has found other sources of oil and gas. The region is now one supplier among many.

The availability of alternative production is one cause of the shift. The other is the steady decline in the amounts available for export. Domestic consumption, often heavily subsidised (the price of a gallon of petrol in Saudi Arabia is just $0.50), has been increasing steadily.

Regional demand has increased fourfold in the last 30 years. According to the International Energy Agency, it will rise a further 20% by 2020 as one baby-boomer generation succeeds another. Rising consumption is a challenge across the whole of OPEC but a particular problem in the Middle East because of continued high population growth.

The trigger for a probable fall in oil prices could be anything from a mild downturn in Chinese growth to the lifting of sanctions on Iran in the wake of the Tehran-Washington nuclear deal. In a delicately balanced market, any suggestion that supply will exceed demand will trigger nervous trading. The international gas market has witnessed a similar picture, where shale gas developments in the US have reduced local prices.

This could lead to a worldwide reduction once exports start to flow. Those exports are likely to head for Asia where they will soften the high prices in the region following the accident at Fukushima and the suspension of Japan's nuclear power production.

In an increasingly interconnected market, Asian ripples will spread across the world. This will add to pressure on prices in Europe where competition from different sources of gas supply is already starting to intensify.

All this will have an impact on Middle East economies. Since few oil-producing states have managed to diversify their economies, there will be a risk of declining net revenues which fund growing populations and crucial spending on security and regional aid.

Even a limited downturn in the global price would leave a number of the oil exporting states seriously in deficit. A price of $110 a barrel is generally considered to be the break-even number, with some countries needing more.

The consensus across the oil industry now is that prices are more likely to fall than to increase. The extent of the fall depends on the willingness of the Saudis to absorb the pain of cutting back supply.

Production from Iraq and Iran which has been constrained by political instability and sanctions looks certain to rise. Both countries have the potential to double their current production. Investment in Iraq is already growing while innumerable international companies are waiting for the signal that some form of deal over nuclear power has been agreed with Iran. Some are not even waiting for that formality.

Despite supply-side problems in Iraq, Iran and Libya, oil prices have actually fallen in the last two years. The prospect of a sustained increase in output will turn the spotlight on Riyadh where the room for manoeuvre is limited. Current production is over 11m bpd of crude and natural gas liquids but over 3m bpd of that is used internally.

Iranian President Hassan Rouhani

The reality is that the Middle East cannot rely on ever rising prices of oil and gas to meet its economic needs. Many countries face falling revenues. The region as a whole will have to follow countries like Oman and Qatar, which have recognised the need for a broader spread of activity providing productive employment and new sources of revenue. Supplies of exportable oil and gas will have to be conserved.

This will require developing new, indigenous energy production from renewables such as solar power, or perhaps in some cases from nuclear. Some countries will have to advance development of petrochemicals and similar energy-intensive products, adding value to natural resource production.

Education, science and technology will become necessary priorities, available to everyone rather than limited to a privileged few. Progress on all these fronts has been sporadic.

There are now signs across the region of a much-needed sense of urgency. The transition will not be simple or easy. A long period in which every Middle East problem could be buried under a carpet of oil and gas revenue is coming to an end.▪

Nick Butler is Visiting Fellow and Chair of the King's Policy Institute at King's College London.

Geopolitics and the energy market

New pipelines hold comfort for the future

Vicky Pryce, Advisory Board

Oil prices have failed so far to rise as much as markets first feared as a result of the deepening crisis in Ukraine. And estimates suggest that there is enough gas in storage to cover Europe for any disruption of Russian gas supplies. But the crisis is sharpening the focus on energy security.

There are three comforting factors. Pipelines are being built that will eventually bypass Russia and Ukraine altogether. Closer to home, fracking may come to be seen as a more attractive option. And most significantly of all, changing geopolitics may well lead to greater imports of cheaper US shale gas.

These developments would be welcome. However they would not hide the mess that is European Union energy policy at present.

EU Emissions Trading Scheme

Carbon prices through the EU's Emissions Trading Scheme have been at very low levels, partly reflecting the impact of years of weak economic and industrial growth. This has removed the incentive to shift to more energy-efficient patterns of production.

At the same time, attempts to meet EU renewable energy targets have led to increases in taxes and levies to finance the production of cleaner energy and to cover associated network costs. The result is that the end customer is paying higher prices.

Coal is still an important source of cheap electricity. But coal-fired power stations will be forced to close due to the EU's directive on large combustion plants.

Europe's energy prices

The upshot is that energy prices in Europe are, by some estimates, up to four times those in the US. European electricity prices for household and industrial users rose on average by some 40% from 2008 to 2012, even though wholesale electricity prices fell by 35% over the same period and wholesale gas prices were on balance unchanged.

The UK has tried to balance low EU Emissions Trading Scheme carbon prices through an escalating carbon price floor imposed on carbon-emitting electricity generators. Industry organisations are now calling for a carbon price freeze to maintain UK competitiveness.

Russian President Vladimir Putin

Electricity prices vary significantly across Europe. Taxes in Denmark, for example, account for more than 50% of the final price to households – vastly more than in many other countries. Industrial users pay most in Cyprus, Italy and Malta, according to Eurostat figures.

Price trends have varied hugely. For instance, over the second quarter of 2012 electricity prices rose sharply in Bulgaria and Italy but fell by 12% in Sweden and 10% in Norway.

Cacophony of prices and policies

In other words, EU energy prices are a cacophony in the absence of an over-arching European framework that everyone can understand. So much for the power of Brussels.

Policies differ markedly. Germany is phasing out nuclear energy and is heavily subsiding solar power.

The UK has just agreed to an effective subsidy for the nuclear sector by fixing long-term prices for the power it generates. At the same time, the UK has slashed subsidies to solar power and is reducing support to wind power.

Brown coal is still very much in the energy mix of Poland and Germany. Other countries are agitating as they are forced under EU rules to move to energy sources they either cannot afford or must import. And yet the Commission wants more.

It acknowledges that, although the EU as a whole will easily meet the target to reduce greenhouse gas emissions by 20% by 2020, some countries are struggling. That is especially the case of some of the new EU entrants.

Tougher targets

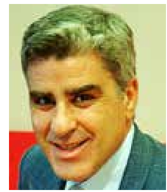
Nevertheless, the Commission proposes not only to keep a reformed Emissions Trading Scheme as the central tool to reduce carbon emissions but also to impose tougher targets.

By 2030 it wants cuts of 40% in EU domestic emissions over 1990 levels and wants 40% of energy to come from renewable sources.

How can that happen while keeping energy prices low? The Commission puts its faith in internal measures – restructuring, greater energy efficiency, better inter-connectivity and greater competition. But the evidence so far is stacked against Brussels.

The high infrastructure costs needed to meet EU climate change targets, along with differences in the priorities and preparedness of European countries, suggest that the aim of a single, integrated and efficient EU energy market delivering affordable and competitive prices is still over the horizon of even wishful thinking.▪

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



US shale bonanza may be exaggerated

Cluster of competing influences on energy prices

Fabio Scacciavillani, Advisory Board

Energy prices tend to spur the bitterest disputes. Lately, however, the remarkable stability of oil prices has silenced the purveyors of doom and, at the same time, dampened excited talk of a new energy era.

Over the past three years, Dubai Fateh crude has rarely traded outside a range of $100-110 a barrel, and then only briefly. The price has marked time despite the world economy's struggle to recover from the 2009 recession. Numerous policy and security shocks have also failed to jolt prices. These include the Arab Spring, the war in Libya, sanctions against Iran, an earthquake in Japan and political unrest in Turkey, Thailand and Ukraine.

Affordable clean power largely remains a dream. Investing in solar, wind or other green-energy sources means investing in government benevolence and hefty subsidies, rather than in profitable ventures.

The energy sector has witnessed a technological revolution, but in conventional hydrocarbons, namely shale gas, and primarily in the US. Horizontal drilling and fracking techniques have changed the energy equation so much that, after a long period in which companies moved production overseas, manufacturing in the US is reviving thanks in part to abundant supplies of cheap gas.

This is a striking illustration of the inertia that characterises global energy markets. The first industrial revolution was based on coal, which is still the primary source of electricity despite environmental concerns. Coal generates 40% of global electricity production, according to the International Energy Agency.

Coal still ranks second on the list of the world's primary energy sources after oil. Indeed, since the beginning of this century it has been the fastest-growing source, propelled by growth in China and other emerging market economies.

As for environmental worries, critics of coal neglect the promise of technologies such as carbon capture and storage (CCS) greatly to reduce carbon dioxide emissions.

Against this backdrop, world oil production remains resilient with annual deliveries of 86-88m barrels per day (bpd). Expectations point towards a moderate decline until the end of this decade as result of the shift towards natural gas. It was not usually profitable to extract, liquefy and transport natural gas when oil prices were below $30 a barrel, which translates as $5 per million British Thermal Units (MMBTU) energy equivalent. But with oil at $100 a barrel – $17 per MMBTU energy equivalent – liquefied natural gas is a much more attractive proposition. Even Gulf Cooperation Council countries are struggling to produce and transport enough gas to meet domestic demand.

For oil demand to drop substantially, however, at least one of three conditions must materialise: new and cleaner affordable energy sources become readily available; alternative technologies are rapidly adopted and deployed on a large scale; or energy efficiency improves greatly.

In the absence of major innovations, forecasts up to 2030 show that oil and gas will still account for roughly one-third of energy consumption. That means the volume of extracted fossil fuels will keep rising. In the medium term, supply from Iraq, folded back into the OPEC quota system, will have a major influence on oil prices. The suspension of sanctions on Iran (which had reduced exports by more than 1m bpd) will further increase supply.

On the other hand, production from newly discovered fields in countries such as Brazil remains a distant prospect and output from Libya lags badly behind schedule. Even the much-touted shale bonanza in the US, with its promise of energy self-sufficiency, might be exaggerated – as the analysis of data from older wells is starting to show.

These developments have significant implications for GCC countries. Based on a rough update to a study I co-authored with Nasser Saidi and Aathira Prasad in 2009 at the Dubai International Financial Center, the present value of the hydrocarbon reserves of GCC countries amounts to more than $25tn.

This is a conservative estimate that assumes a 3% real rate of return and discount rate, together with an oil price of $90 a barrel at 2014 constant prices.■

Fabio Scacciavillani is Chief Economist at the Oman Investment Fund.

Diversification and small business growth underway in Middle East

Diversification away from oil and gas will play an increasing role in the Middle East's economic development. That was one of the main messages to emerge from OMFIF's Second Main Meeting in the Middle East, which took place in Qatar on 27-28 November.

Participants from a total of 40 institutions heard that expansion of manufacturing and services as well as travel, hospitality and tourism would all become increasingly more important.

Greater emphasis was being given to small and medium-sized businesses, while staging Expo 2020 in Dubai was a landmark.

Opening the meeting, Sheikh Abdullah Saoud Al-Thani, governor of the Qatar Central Bank, spelled out the favourable impact of regulatory changes on the country's development as a financial centre. In instituting centralised supervision under the aegis of the central bank. Qatar could be a template for other countries in the region, he said.

The meeting focused on the outlook for energy prices and supply in light of increased US output of shale oil and gas. Given a likely increase in US production costs, and relatively low costs in Qatar, Doha could decide to stretch out oil and gas development.

The difficulties of the euro seem to have provided an excuse for Gulf states to relax their already slow long-term plans for monetary union.

The UAE and Oman have already pulled out of the project, and European and Arab participants drew up a list of conditions for successful development of Gulf monetary union.

One senior Gulf official said the political will was in place, but another four to five years would be needed to set the date for the establishment of a central bank and the fixing of exchange rates.■

Oman set to become regional logistics gateway

Investment Fund development focus on Indian Ocean trade

OMFIF Report on Golden Series Lecture with Oman Investment Fund

With an eye to future growth and boosting employment, Oman is fostering policies to move away from reliance on energy and towards logistics, according to Jamal Aziz, chief operating officer of Sohar Freezone. Aziz was one of several senior Omani officials who spoke at an OMFIF meeting in London in February.

He said the zone, adjacent to a deep-sea port and positioned as a gateway to the Indian Ocean, offered opportunities for investors in sectors including information and communications technology, health care, clean technology and waste management as well as energy.

Oman is not creating enough jobs for its growing population and so is placing great emphasis on maintaining a steady flow of investment, unobstructed by bureaucracy. To that end, Oman is working towards greater predictability in its fiscal and financial policies, Aziz said. The goal is to create some 40,000 new jobs.

Oman has developed rapidly over the last 30 years and per capita income has climbed to $30,000. Life expectancy is now 76.5 years and Oman ranks as the 24th freest economy in the world.

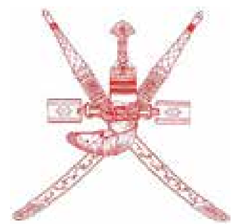
The priority for the country now is to ensure a sustainable rate of growth. According to Salim bin Nasser Al-Ismaily, chairman of the Public Authority for Investment Promotion and Export Development Oman, education and gender equality hold the key to attaining this goal.

'The ink of a scholar is holier than the blood of a martyr,' he said, referring to the importance of education as a means of promoting gender equality. 'If you invest in a woman, it means you are investing in society.' Investment in scientific research and technology were also important to fuel sustainable growth.

Hassan Bin Ahmed Al Nabhani, chief operating officer of the Oman Investment Fund, discussed the role of the sovereign wealth fund, which was founded in 2006. The purpose of the fund was to diversify Oman's wealth by investing abroad while encouraging the domestic private sector by investing in large-scale projects alongside foreign partners. Promoting the private sector, particularly SMEs, was crucial given the dearth of venture in Oman.

As a long-term investor, the fund's focus was on larger projects in high technology, high-value manufacturing, mining and fishing, and logistics.

Al Nabhani said transparency is an important aspect of the strategy of Oman Investment Fund, which is ranked fourth among the top 10 more transparent sovereign funds.■



Left to right: Abdulaziz Abdullah Al Hinai, Embassy of the Sultanate of Oman; Hassan bin Ahmed Al Nabhani, Oman Investment Fund; Salim bin Nasser Al-Ismaily, Public Authority for Investment Promotion and Export Development Oman; David Marsh, OMFIF; Lee Chee Khian, Duqm SEZ; and Jamal Aziz, Sohar Free Zone.

Iran changes pose challenge for Mexico

Tehran shake-up sends ripples to Latin America

Winston Moore, Advisory Board

Mexico and Iran face similar challenges modernising their hydrocarbon sectors at a time of a major geopolitical shift in energy markets. The US is positioned to become a major oil producer and exporter, a standing it has not enjoyed since before the Second World War when it supplied over half the oil in the world.

This shift coincides with the much-publicised visit by Iranian President Hassan Rouhani to the World Economic Forum in Davos to talk to international oil majors as well as national oil companies including Mexico's Pemex and Brazil's Petrobras.

Iran faces a similar predicament to Mexico. Both countries lack modern technology for hydrocarbon exploration and development. They must boost their refining capacity, attract foreign investment partners and increase their know-how.

Rouhani's courting of Mexico follows concern that Iran's energy sector reforms could double its crude output, adding 2.5m barrels per day (bpd) to global supplies. That would create a glut that could reduce the price of Brent crude to $88 a barrel. This prospect will no doubt worry Mexico if its proposed energy sector reforms do not translate into increased output and revenue.

Iran is an OPEC member holding the fourth-largest proven oil reserves in the world at 157.3bn barrels.

The effects of US and EU sanctions against Iran's nuclear programme since 2011 reduced its oil output from 4.2m bpd in 2011 to 2.7m bpd in 2013. Oil exports halved to 1.5m bpd, a situation made worse by rising gasoline and diesel imports due to a lack of refining capacity.

Attracting investment

Iran now needs to attract investment from oil majors to modernise its obsolete hydrocarbons sector. To this end, Rouhani declared a willingness to use Iran's oil and gas reserves to contribute to global energy security.

The president wants Iran to double oil output to 5m bpd by 2015. This hinges on $35bn in oil and gas upstream investment from foreign investors – a challenging programme to implement even without sanctions.

The situation in Mexico is no different, perhaps worse. Mexico is the sixth largest oil and gas producer and the third largest in the western hemisphere after Canada and the US.

But its proven oil reserves are 10bn barrels of oil equivalent (boe), down from 56bn in 1990, while oil output has dropped to 2.5m bpd from a peak of 3.4m bpd in 2004.

Mexico is in trouble due to the depletion of its giant Cantarell oil field. It needs to reform its hydrocarbons sector. Pemex, the state oil company, has been the sole operator in Mexico since it was founded in 1938 after the sector was nationalised.

Mexican domestic oil consumption stands at 2.1m bpd, leaving little for export; net oil exports could fall to zero by 2019.

Mexico must also address a rising dependence on foreign imports. Natural gas imports have increased by 30%. The petrochemical industry sources 66% of its inputs overseas. Mexico imports 40% of the petrol it uses, showing the need for an increase in domestic refining capacity.

Reliance on foreign know-how

The US remains Mexico's most important trading partner for crude and gas exports and refined imports, but Pemex lacks the financial resources and technical expertise to develop deep-water offshore prospects in the Gulf of Mexico, currently estimated to hold 30bn boe.

The expected lifting of sanctions and opening up of Iran's oil industry to investment are likely to have a negative impact on Mexico and its capacity to attract investors. This will especially be the case if the price of oil falls when additional output from fracking and shale oil and gas extraction in the US and Canada comes on stream.

By 2016 the US is expected to produce 9.6m bpd, close to its peak production of crude oil in 1970.

North America as a whole will cease to be an energy customer for Middle Eastern countries, whose principal buyers will be China, Japan, India, Europe and the Far East.

These developments explain Rouhani's attempts to position Iran as a global oil supplier by getting sanctions lifted and modernising its hydrocarbons sector.

Iran will benefit from the removal of sanctions as it has a greater capacity to sell more oil on the international market and thereby reduce domestic fuel costs and inflation. Mexico does not. Pemex needs to be recapitalised and re-engineered.

To boost oil output and reduce fuel and energy costs, Pemex must focus not only on upstream but on the entire hydrocarbons value chain, including refining, petrochemicals production, transport, storage and distribution.

Among Mexico's neighbours, Venezuela produces only 2.4m bpd despite holding 298bn barrels, the largest proven oil reserves in the world. Most of their producing fields have matured and operating conditions for international oil companies include a prohibitive share by the state oil company PDVSA.

Venezuela is facing a serious economic crisis with falling oil output and revenues, inflation, rising crime, and constraints arising from the forward sale of oil production to China.

Emerging Brazil

Elsewhere in Latin America, Colombia (Ecopetrol) and Brazil (Petrobras) are expected to produce more oil. Brazil's influence as an exporter will be felt as offshore developments mature in 2015.

It can become a global player by 2025 and the International Energy Agency reckons Brazil will become the sixth largest global oil producer by 2035. The Libra field, Brazil's largest deep-water prospect, holds an estimated 8-12bn boe.

Mexico faces a similar challenge to extract oil from ultra-deep locations such as the Chicontepec field. Sceptics ask whether the country will be able to exploit the resources it has found in the Gulf of Mexico.

However, Petrobras has deep-water exploration expertise that Pemex could tap. Mexico has reported no significant discovery of reserves since 1970s. Cantarell was found in 1976 and Ku-Maloob-Zaap (KMZ) in 1979.

Added to this, oil majors active with Pemex since the 1980s through service contracts have not reported major discoveries. Furthermore, it will take Mexico time to implement its energy reforms.

A big increase in yields is improbable before 2020. Mexico faces a greater challenge than Iran, which has the infrastructure in place to double its oil output.▪

Dr. Winston Moore is Director of Moore Asociados.

Energy disputes on the rise

Repercussions for western companies from Africa-China moves

Efraim Chalamish, Advisory Board

Energy investment disputes between global investors and foreign governments are on the rise. According to a World Bank report last year, 37% of all the disputes it manages are in the energy and energy-related sectors. The cases cover all aspects of the energy sectors.

For example, in December 2013 a Hungarian company sued Croatia at the World Bank's International Centre for Settlement of Investment Disputes (ICSID) over the ownership of an oil and gas company. The same month, two Moldovan investors and their companies won a $500m award against Kazakhstan resulting from the seizure of assets and the loss of oil contracts.

Africa serves as a case in point. Energy has become a critical component of Africa's growth story. In the last five years oil production rose 30% and natural gas production doubled.

Yet this good news brings significant challenges, one of which is the risk of 'resource nationalism' that triggers energy investment disputes. Such nationalism is on the rise in the oil and gas industry around the world, for several reasons. The potential growth of the energy sector represents a disincentive for governments to invest in other industries, impeding development of the rest of the economy. This lack of diversification could lead to more nationalism and the 'resource curse' of over-dependence on oil, seen, for example, in Angola and Nigeria. Both countries are stepping up efforts at diversification, with mixed results.

The Arab Spring underlined the vulnerability of the energy sector in north Africa, reducing oil and gas production and confronting consumers with shortages. So far, the upheaval has not led to a big increase in arbitration cases between foreign investors and governments, but this could change later on.

Significant oil and gas discoveries in Africa could tempt governments to increase taxes and royalties unilaterally. The relative lightness of state intervention in the energy sector has hitherto been a spur to multinational investment in the region. But this will change if governments fill the regulatory vacuum with nationalistic policies.

Additionally, the growth of the African middle class and increased energy consumption may increase tension with foreign investors. Only 28% of the continent's oil production is now consumed in Africa. The rest is exported. These proportions will change and, as the financial stakes rise, governments may come under pressure to protect local interests at the expense of foreign companies.

At the same time, China's extensive interests in Africa must be re-examined. Chinese investment presents numerous challenges to governments across the continent. But China has sometimes been a victim of expropriation. China National Petroleum Corporation workers were kidnapped in Nigeria and anti-government militants attacked Sinopec's construction site in Ethiopia.

The history of colonialism has traditionally fuelled resource nationalism in Africa. Chinese companies are sensitive to what is an emotional issue. They acknowledge that natural resources belong to Africans and that they must make a significant contribution to local development. A move from traditional direct investment to 'loans-for-oil' deals would reduce the exposure of Chinese businesses to shifts in governments' policies and so might lower the number of disputes. Western companies could follow that lead.▪

Dr. Efraim Chalamish is a law and economics professor and adviser.

France fuses earth, gold and state in quest for mineral riches

A classical Gallic triumvirate of earth, gold and state has been fused into a global fighting force by France's new publicly-owned mining company set up to secure mineral wealth around the world, *writes David Marsh in London.*

The Socialist administration of President François Hollande plans to invest up to €400m over the next five to seven years in a state-owned mining company Compagnie Nationale des Mines de France (CMF).

Contrasting with Hollande's recent tilt to supply-side economics for dealing with France's problems, the new policy confirms an abiding hallmark of successive French presidents: ambiguity in picking a way between state intervention and private sector orientation in industrial policy.

The founding of CMF, France's first state industrial start-up for 20 years, marks a throwback to France's historical successes 200 years ago in mining coal and iron ore. From that bygone age, only metals group Eramet and the uranium business of state-owned nuclear firm Areva have survived.

France's self-confident foray into the state mining sector contrasts with Germany's more low-key approach. Like the French, the Germans are concerned about the potential securing of world-wide mineral wealth by countries like Russia, China and Brazil – but they are relying on a private sector 'raw material alliance' linking large industrial groups such as BASF, BMW, Volkswagen and Thyssen-Krupp.

CMF will prospect for resources – including gold, lithium, germanium and rare earths – in France, French overseas territories and elsewhere around the world, including Africa, Central Asia and South America.

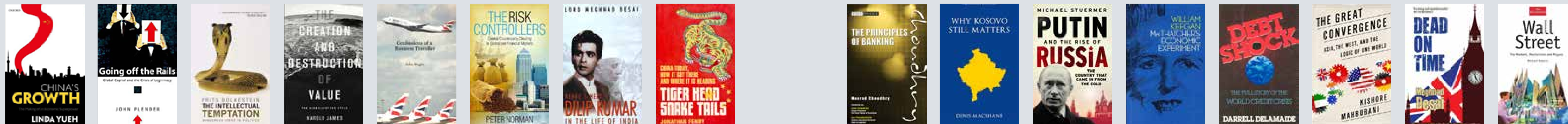
French industry minister Arnaud Montebourg says the government considers the state as an intelligent economic actor serving the interests of the nation.

'Francophone African countries, notably, would like to work with us …. Colbertism is coming back and that is good,' he proclaimed last week, referring to Jean-Baptiste Colbert, 17th-century finance minister under Louis XIV and the pioneer of French dirigisme.

The French announcement seemingly confirms a reputation for vacillation between different policy options that Hollande had been struggling to throw off. In February, Paris agreed to invest €800m to acquire a 14% stake in struggling carmaker PSA Peugeot Citroen, alongside China's Dongfeng.

Although Hollande's recent signals of embracing business orthodoxy have been welcomed as a sign of realism by French industrial leaders, Montebourg has continued loudly to champion the merits of state intervention in industry. This seems to be just one more area where President Hollande has not yet made up his mind.▪

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



The need for social and financial inclusion

Innovation and finance: how Bangladesh way improves society

Moorad Choudhry, Advisory Board

I have at least one thing in common with the author of this most worthwhile work, and that is that we were both born in Bangladesh. At that time the country was known as East Pakistan, becoming independent only in 1971. It faces the myriad social and development issues associated with youth everywhere.

The country's economic problems go beyond mere young age. Extreme poverty, scarce natural resources, a high birth rate and high population density combine to make Bangladesh the ultimate development challenge, one that exercises both domestic authorities and international agencies.

Fortunately for the nation and his countrymen, Atiur Rahman possesses the background and expertise, together with a position of influence as governor of Bangladesh Bank, the central bank, to be able to make a genuine impact on the economy and people's well-being.

Innovative and pragmatic

His book, *Inclusive Finance and Sustainable Development*, is testament to his innovative thinking and practical application in the fields of both central banking and economic development.

It is a collection of speeches and lectures the author gave in 2009-13 on issues from capital adequacy to microfinance and sustainable development.

The lectures on the latter topics contain some gems of practical value, which make this book an essential read for both development economists and central bankers everywhere.

Everywhere? Yes, indeed. The UK payday loan and small-size, high-cost credit company Wonga.com has generated so much profit in the last five years that it can afford to sponsor the shirts of a Premiership football club, Newcastle United.

According to Wikipedia, Wonga pays £7.5m a year for this privilege. Many of Wonga's customers are non-banked and demand a product – small, short-term loans – that conventional banks in the West do not offer. The price the non-banked pay for access to this credit is what many consider to be an exorbitant interest rate.

Financial inclusion

But as Rahman illustrates, microfinance should be a mainstream financial product. In his country, it is. There is no reason it could not be a conventional bank product in developed, as well as developing, economies. I am sure many of Wonga's customers are viable mainstream bank clients, but the UK banking sector does not offer the services they need.

Before he joined Bangladesh Bank, Rahman had worked closely with the Nobel-prizewinning founder of Grameen Bank, Mohammed Yunus, to implement microfinance.

The Grameen business model has since spread worldwide. This was a genuine value-added innovation, but one that no Harvard-educated management consultant would ever have dreamt up.

The book contains numerous examples of the social benefit and inclusivity of Rahman's policy guidance. The '10-taka' bank account for villagers is one (10 taka is about eight pence).

SME programmes

Bangladesh Bank's programme for small and medium-sized enterprises (SMEs) is another, a comprehensive suite of initiatives ranging from loan target-setting to liberal refinancing facilities aimed at funnelling credit to small firms in rural Bangladesh. At the time of writing, 22 banks and 24 non-bank financial institutions had signed up for the scheme. This is a triumph.

Bringing women into the financial mainstream and empowering them to become entrepreneurs was another success for development economics in Bangladesh. Here again microfinance and Bangladesh Bank played their part.

As a number of speeches reproduced in this book illustrate, the Bank adopted various innovative approaches to benefit women. These included a loan quota for women borrowers and a reduced interest rate on loans under the women-only scheme.

Other initiatives targeted the origination of small loans without collateral to individuals and to SMEs where 51% or more of the shareholders were women.

All these and more policy directives, and the direct beneficial impact they had on villagers, are described eloquently in this landmark anthology.

These collected lectures contain so many worthwhile policy lessons that readers can choose those applicable to their own countries. Green banking, corporate social responsibility, physical infrastructure, e-banking – it's all here.

My one criticism is that the wide range of topics and the length of each piece make it a difficult book to use as a reference. A short abstract at the start of each speech, perhaps supplied by an editor, would have been useful.

But that is a minor gripe about a book whose title says it all – social and financial inclusivity is essential if an economy is to develop to the benefit of every layer of society. This is true of every country, not just emerging economies.

Unorthodox central banking

As noted by Toufic Choudhury in the preface, this book is 'a treasure-chest for economists, for those associated with macroeconomic management, practising bankers and researchers'. I endorse absolutely this sentiment.

The US Federal Reserve has always had a growth as well as an inflation target in its remit. Rahman makes a robust, coherent and analytically sound case for central banks to have an even wider social and development objective in addition to their orthodox monetary policy responsibilities, one that emphasises genuine inclusion for all segments of society.

He shows how a country's banks, taking their cue from their central bank's guidance, can incorporate these objectives into their business models.

Alongside Rahman, I believe that banks and the financial sector are a force for good in society, at least when operating under a set of basic ideals. This conviction is amply exemplified in this splendid, readable book.■

Prof. Moorad Choudhry is IPO Treasurer at RBS Group Treasury.

Bangladesh Bank Governor Atiur Rahman

中国资本账户自由化

从全球各国汲取经验教训

Capital account liberalisation in China

Guidelines from global experience

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

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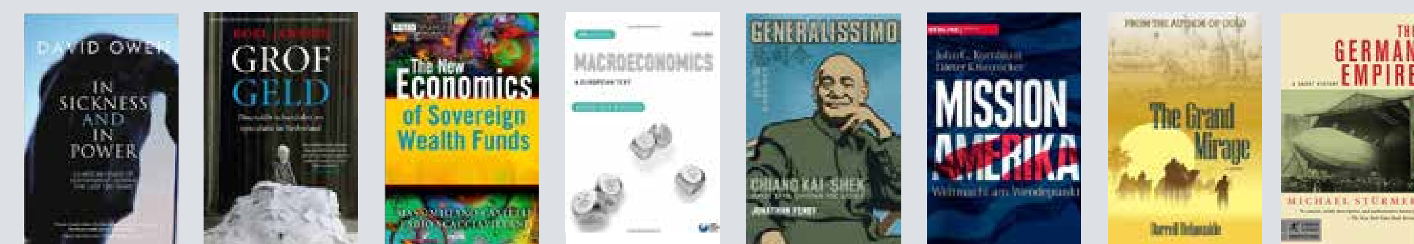


The lessons of small country breakdowns

States that stumble on road to aggrandisement

John Nugée, Senior Adviser

This is a book about financial crises. With the global financial turmoil still fresh in everyone's mind, this is by no means the only recent book to consider past crises and try to draw lessons from them.

But where the authors of *When small countries crash*, Scott MacDonald and Andrew Novo, differ is in their focus on the impact of financial disaster on small countries. This is a fascinating subject.

Whereas financial crashes in large countries can be extremely complex and confusing, in small countries the tragedies are on a more human scale and so are easier to grasp. As a result, the subject matter of this book is both attractive and approachable for the general reader; and, with the collapses of Iceland, Ireland and Cyprus still recent, it is also very topical.

Episodes of financial crashes

The authors spot the main connection among all the episodes of financial collapse they examine, which is the dangers that arise when a small country's ambition outruns its capacity to control events or survive a financial storm.

There have been a number of cases around the world, not just in finance but in geopolitics, where apparently minor developments in areas of tension around the world have drawn the international community into drama, danger and worse.

The book reminds us that global interconnectedness has been accelerating and now, because of the interweaving nature of world financial markets, is a day-to-day reality.

In almost every case in the book, a small country sought to succeed in the financial world and was undone when its risk management failed to protect it against adverse international events.

Scotland's collapse

For readers in the UK, the book's opening chapter is particularly relevant as it tells the tale of Scotland's collapse into bankruptcy in the early years of the 18th century, a bankruptcy which led directly to the Act of Union with England in 1707.

As September's referendum on Scottish independence draws near, it is valuable to see how that 300-year union came about. Having said that, for this reviewer the book falls a little short of its ambition.

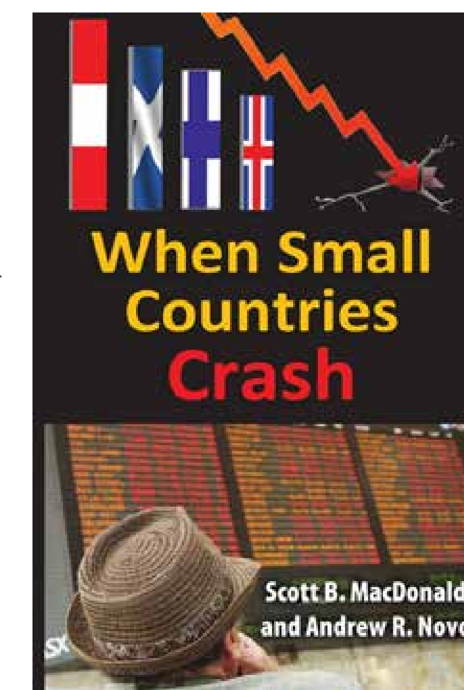
The main problem is that the authors do not go into enough detail: every crisis is introduced with the basic historical facts, but the book's format (a short chapter on each) is too brief to allow the human dramas to unfold and the themes behind the bare facts to be explored.

One is left unsure if countries were unwise or just unlucky, and why some countries collapse but other small nations with oversized banking systems, such as Switzerland and Luxembourg, survive and prosper.

Luxembourg & Iceland

Indeed, the book does not really explain why Luxembourg remains very rich and successful, while Iceland failed. Both have similar populations. Is Luxembourg the cleverer of the two or merely luckier?

Similar structural questions could be posed regarding other pairs of apparently similar countries. And, with Iceland's example in mind, it is worthwhile looking at how smaller countries recover from failure as well as how they get into trouble in the first place.



Stylistically, the book is somewhat staccato – no links between chapters, no overriding themes brought out – and there is a surprisingly large number of misprints, spelling mistakes and so on.

These multiply in the later chapters dealing with current events. The impression is that the book was a labour of love in the earlier chapters but rather rushed to market at the end.

Despite these drawbacks, the book's unusual focus on smaller countries and extensive historical research makes it worthy of consideration for anyone interested in the longer history of financial crises.■

John Nugée is Senior Adviser to OMFIF and a member of the Advisory Board. He is the author of the book, Reflections on Global Finance: selected essays 2002-2013.

ADVISORY BOARD POLL

'In making its decisions on 'tapering' money stimulus under quantitative easing, should the Federal Reserve ...

... be overwhelmingly guided solely by the requirements of the US economy, *53%*

or

... take other countries' needs and wishes more overtly into account?' *47%*

'Since the prospects for the US economy are not independent of what happens elsewhere, developments in emerging markets are clearly important for the Fed. The lack of comment on emerging markets in the latest set of Fed minutes does not indicate a conflict between what is best for emerging markets and what is best for the domestic economy, but it does suggest that the Fed's interest in the former is no greater than its perceived impact on the latter.' **— Colin Robertson**

'The answer has to be first point, as the Fed's legal remit – it is not permitted by law to do the second. It may take global trends into account in undertaking this, but it cannot "overtly" consider the welfare of other countries.' **— Philip Middleton**

'The US has, nominally at least, focused on the interests of the US economy – that is its mandate. At the same time, the US monetary response to the global crisis – its actions e.g. swap arrangements with other central banks and ongoing policy coordination – reflect its awareness of the increasing interconnectedness of global financial markets. Given the extreme sensitivity, and with an emerging markets crisis snapping at the heels of the global economy, the US should of course take into account the needs and the wishes of other countries in forming and executing policy.' **— Ray Kinsella**

'The Federal Reserve must follow its mandate and focus on the US economy. Only when the G20 and their central bankers forge a consensus on the management of the global international monetary non-system (for none exists today) would it be possible to coordinate monetary policies of diverse states. Today each country and central bank defends their own model of growth, monetary policy goals, and economic paths and there is no realistic prospect of this changing despite the complaints of those being adversely impacted today.' **— Stuart Mackintosh**

'Taking "other countries' needs and wishes" into account, especially "overtly", is not something any central bank should do. This is because (1) a central bank's policy should be as clear, simple and comprehensible as possible; (2) a central bank cannot afford to become entangled in the messy politics of preferring one country over another; and (3) a country needs at least as many policy tools as policy goals, monetary policy is already overburdened with the two targets of exchange rates and domestic prices.' **— Sahoko Kaji**

'Any attempt to take other countries' needs and wishes more overtly into account runs the danger of the Fed presenting a confused message. As markets like clarity the clearer the Fed is about its policies the better.' **— Paul Newton**

'Raghuram Rajan, governor of the Reserve Bank of India, has been a frontrunner in underlining this lack of global monetary cooperation. While the emerging markets should be prepared for a 'normal' world without quantitative easing, there is a need for better communication. Nevertheless, emerging markets must pursue their efforts at structural reforms. Greater coordination efforts are needed and advanced economies need not view the conduct of monetary policy purely from the perspective of their domestic mandate. Emerging markets have played their role in pulling along the global economy at a time when the developed countries slowed down.' **— Hemraz Jankee**

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