# The Bulletin

March 2015
Vol. 6 Ed.3

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

## The rolling oil price

### How easy money could end

**Simon Derrick** on dollar strength
**Duncan Goodwin** on oil price volatility
**Canuto Otaviano** on emerging markets
**Anthony Robinson** on Russia's commodity reliance
**Fabio Scacciavillani** on the US energy non-revolution
**Holger Schmieding** and **Michael Burda** on Greece

OMFIF

# African beginnings Global opportunities

With more than $112bn* under management, Investec Asset Management has transformed over more than twenty years from strong roots in Africa to become a truly global asset manager. We offer a diverse range of investment strategies from global equities, fixed income and multi-asset investment to specialist capabilities in emerging and frontier markets, commodities and resources. While our perspective and presence are global, it is our distinctive African heritage that sets us apart.

Call us on **+44 (0)20 7597 1999,** or visit **www.investecassetmanagement.com/international**

THE VALUE OF INVESTMENTS CAN FALL AS WELL AS RISE AND LOSSES MAY BE MADE. TELEPHONE CALLS MAY BE RECORDED FOR TRAINING AND QUALITY ASSURANCE PURPOSES. * Source: Investec Asset Management as at 31.12.14. Issued by Investec Asset Management, January 2015.

## The rolling oil price

The halving of the oil price in the second half of 2014, followed by a one-third rise since early January, has become a dominant factor in the world economy. A substantial part of the price fall has reflected excess US-generated supply. Another big influence is the stronger dollar as US expansion takes hold. The big questions are how far and fast the oil price correction will extend – and what will be the impact on inflation and central banks' eventual move away from easy money.

## Book reviews

George Hoguet reviews Jeffry Frieden's *Currency Politics*, exploring exchange rate determination in the US, Europe and Latin America. Graham Hacche evaluates Barry Eichengreen's *Hall of Mirrors*, presenting the parallels between the financial upheaval of 2008 and the 1930s Great Depression. Sophie Lewisohn examines Richard Sakwa's *Frontline Ukraine*, analysing the conflict from both sides.

## Oil and the international economy


| | | |
|---|---|---|
| Overcoming oil price fluctuations | Duncan Goodwin | 9 |
| Middle East producers hold trump cards | Fabio Scacciavillani | 10 |
| How GPIs can respond to oil fluctuations | Pooma Kimis | 11 |
| Brics divided on oil price impact | Canuto Otaviano | 12 |
| Achieving security through diversification | Donald G. Mbaka | 13 |
| Putin defies economic imperatives | Anthony Robinson | 14 |
| Oil price decline and banks' margins | Moorad Choudhry | 15 |
| Oil price impact on currencies | Simon Derrick | 17 |
| Mercantilists on the warpath | Steve Hanke | 18 |
| Currency News | Jamie Bulgin | 19 |
| Cheaper oil and slowing China | John Adams | 20 |


## International monetary policy


| | | |
|---|---|---|
| US central bank patience has its limits | Darrell Delamaide | 24 |
| Greece's last chance | Michael Burda and Holger Schmieding | 25 |
| Institutions react to changing landscape | Henry Quek | 26 |


## Review


| | | |
|---|---|---|
| Currency winners and losers | George R. Hoguet | 28 |
| A tale of two crises | Graham Hacche | 29 |
| Russia's reaction to western encroachment | Sophie Lewisohn | 30 |
| Oil price expected to rise steadily | OMFIF Advisory Board | 31 |


## Great Monetary Polarisation and euro borrowing

Six years after equivalent action in the US and UK, the European Central Bank has started quantitative easing in the form of a €60bn a month programme of asset purchases. The main impact, at a time when the world's largest monetary blocs are running diametrically opposing interest rate policies, looks likely to be a further spur towards a weaker euro as an important side-effect of the Great Monetary Polarisation.

Other effects will be less clear-cut. Currency weakness, low interest rates and the burgeoning US recovery are propelling the European economy towards higher growth, led by Germany where the lower euro will promote further export stimulus and enhance the country's already unnaturally large current account surplus. If these trends continue, and especially if inflationary pressures start to rise again as the oil price rebounds, there are bound to be calls from Germany and other creditor countries for Mario Draghi, the ECB president, to end the QE stimulus before the planned cut-off of September 2016.

The woes of Greece and other debtor nations will restrain any European euphoria. But the ECB's accommodative stance and higher interest rates elsewhere are likely to make the euro, once again, the world's favourite borrowing currency – a trend seen already in the euro's initial weak years after it was launched in January 1999.

**Official Monetary and Financial Institutions Forum**

**30 Crown Place**
**London**
**EC2A 4EB**
**United Kingdom**

**T: +44 (0)20 3008 5262**
**F: +44 (0)20 7965 4489**

**www.omfif.org**

**Board**

**John Plender (Chairman), Jai Arya, Jean-Claude Bastos de Morais, Pooma Kimis, Edward Longhurst-Pierce, David Marsh, John Nugée, Pete Wilkin**

**Advisory Board**

**Meghnad Desai**, Chairman
**Phil Middleton**, Deputy Chairman
**Frank Scheidig**, Deputy Chairman
**Paola Subacchi**, Deputy Chairman
**Songzuo Xiang**, Deputy Chairman

**Bronwyn Curtis,** Chief Economic Adviser
**Aslihan Gedik**, Senior Adviser
**Norman Lamont**, Senior Adviser
**John Nugée,** Senior Adviser & Director
**Fabrizio Saccomanni**, Senior Adviser
**Ted Truman**, Senior Adviser

**Management**

**David Marsh**, Managing Director
**Edward Longhurst-Pierce**, Director of Strategy and Planning
**Pooma Kimis**, Director of Markets and Institutions
**Oliver Lowe**, Head of Meetings and Operations
**Sunita Vaswani,** Head of Finance and Administration

**Editorial Team**

**William Baunton**, Economist
**Darrell Delamaide**, US Editor
**Sophie Lewisohn**, Editorial Manager
**Sacha Moreira**, Publishing Manager

**Subscription**

**For subscription details, contact the sales team at:**

**sales@omfif.org**

**T: +44 (0)20 3008 5262**

*Strictly no photocopying is permitted. It is illegal to reproduce, store in a central retrieval system or transmit, electronically or otherwise, any of the content of this publication without the prior consent of the publisher.*

*While every care is taken to provide accurate information, the publisher cannot accept liability for any errors or omissions. No responsibility will be accepted for any loss occurred by any individual due to acting or not acting as a result of any content in this publication. On any specific matter reference should be made to an appropriate adviser.*

*Company Number: 7032533*

# OMFIF

## Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent research and advisory group and a platform for exchanges of views between official institutions and private sector counterparties.

Our overriding aim is to enable the private and public sector to learn from each other in different ways, promoting better understanding of the world economy and higher across-the-board standards.

OMFIF's main areas of focus are economic and monetary policy, asset management and financial supervision and regulation. OMFIF co-operates with central banks, sovereign funds, regulators, debt managers and other public and private sector institutions around the world.

# Advisory Board

OMFIF's 174-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities.

# The Bulletin

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

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

## Submissions

Contact the editorial team for details on article submissions at editorial@omfif.org.

## Advertising & subscriptions

Contact: membership@omfif.org.

## Letters

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

## Diary dates

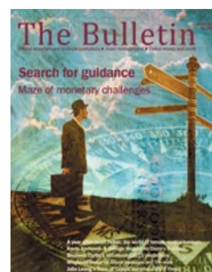
OMFIF Meetings take place within central banks and other official institutions. The frank and confidential nature of meetings provides for a deep-seated exchange of views and best practice.

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

## General information

See www.omfif.org for member access to more OMFIF intelligence, including commentaries, reports, summaries of discussions and bulletin archives.

For queries on the website, contact the editorial team at: editorial@omfif.org



# EDITORIAL

## Rolling oil price and an eventual end to easy money

**The rolling oil price and the disinflationary (but hardly deflationary) forces in its wake have spurred the European Central Bank into quantitative easing action – but also sowed the seeds for a pick-up in economic activity that sooner or later will cause central banks all over the world to back away from excessively easy money. We are living through the Great Monetary Polarisation – whether between larger countries and regional blocs, as seen between the US, China, Japan and the euro area, or within these blocs themselves, demonstrated by the tension between Greece and the leading creditor nations in the European single currency.**

OMFIF is devoting the March Bulletin to a thorough study of the supply and demand factors behind oil fluctuations, and their repercussions for international monetary policies and financial markets. Duncan Goodwin of Baring Asset Management and Fabio Scacciavillani of the Oman Investment Fund investigate the reasons for excess supply and how quickly this will fall away. Canuto Otaviano, Donald G. Mbaka, John Adams and Anthony Robinson range over the impact on the main emerging market economies, notably China, Russia, Brazil and Nigeria. Simon Derrick of Bank of New York Mellon examines the influence on the oil price of the dollar's worldwide rally, postulating a circle of causality in which one factor spurs on the other. Steve Hanke looks at moves afoot by political mercantilists in Washington to take export-inhibiting action against countries with currencies that have fallen against the strong dollar. Moorad Choudhry says the fall in inflation and interest rates engendered by the lower oil price adds up to a much bigger challenge for banks than the post-crisis response of tightened regulation.

Darrell Delamaide produces an update on latest Fed thinking on the timing of an interest rates rise, where the odds on an early hike have narrowed after February jobs data showed US unemployment fell to 5.5%, a 6½ year low. As the saga rolls on over Greece's near-impossible task of reconciling its need for a reduction in debts and austerity with desire to stay in the euro, Michael Burda and Holger Schmieding say the Athens process of muddling through with its creditors represents the country's last chance for salvation. A post-default Greece would have to earn its imports in a period of turmoil with little hope for international credit for many years, they say – and a devaluation might help exports, but ordinary Greeks would suffer a large hit in real wages, much worse than austerity.

Turning to the institutional investment landscape, Henry Quek of State Street analyses a series of surveys recording how international investors are reacting to changes in the macroeconomic and regulatory environment. In our book review section we highlight three topical volumes: *Currency Politics* by Jeffrey Frieden, *Hall of Mirrors* by Barry Eichengreen and *Frontline Ukraine* by Richard Sakwa. Each sheds light on fluctuations in currencies, economics and geopolitics besetting markets, all of which find expression in the ups and downs in the oil price. ▪

GLOBAL INVESTMENT SEMINAR

## Official institutions mull investment challenges

The second Annual Seminar on Asset and Risk Management for Central Banks and Sovereign Funds, held at Innholders' Hall in London on 20 February and attended by representatives of 16 countries, focused on investment challenges faced by official institutions. A key question was how their large pools of long-term capital can be channeled into investments offering appropriate risk-adjusted returns, especially in the prevailing environment of increasingly negative interest rates on prime-rated bonds . The gathering, chaired by John Nugée, Senior Adviser to OMFIF, heard that the world economy has mainly recovered from the global financial crisis but is still struggling to find a new equilibrium.

Extreme policy actions by monetary policy authorities had prevented a worse economic outcome, but there have been unexpected consequences and many chronic issues and imbalances remain. Speakers mentioned the weakness of private sector demand in much of the G7, stagnant productivity, the fragility of the financial system, high debt for many governments and unstable politics. These challenges have created an environment where authorities have had to apply ever more experimental policies to maintain economic activity. This has reduced clarity and understanding about the consequences of policy actions, and increased the risk of policy mistakes.

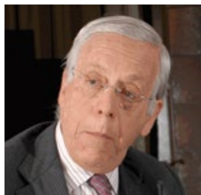
James Whitelaw, Bahar Alsharif, Imène Rahmouni-Rousseau and Tatiana Fic; Bronwyn Curtis and Bahar Alsharif; John Nugée and Emilio Rodriguez

## ADVISORY BOARD

OMFIF has appointed Célestin Monga, Mark Crosby, Antonio Armellini, José Manuel González-Páramo and Philippe Sachs to the Advisory Board, which has risen to 174 people, subdivided into six groups ranging from Capital Markets & Investment to Economics & Industry. For the full list of members see p.22-23.

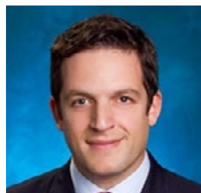
Célestin Monga is managing director of the Programme Support and General Management Division (PSM) at the United Nations Industrial Development Organistion. He has wide-ranging experience as an economist, author and academic, and has written several books on the challenges of African modernity which have been translated into several languages. Before joining UNIDO, Monga was senior adviser for Structural Economic Transformation at the World Bank. He joins the Public Policy panel.

Prof. Mark Crosby is associate professor of economics at Melbourne Business School. He has acted as a consultant to the Hong Kong Monetary Authority and to the Monetary Authority of Singapore on a number of projects since 1998, and has a research fellowship at the HKMA. He consults widely to business and government in Australia and overseas. Recent projects have included research into diversifying Brunei's economy and policy issues related to South Africa's increasing current account deficit. He joins the Education & Research panel.



Antonio Armellini, a professional diplomat and writer, was roving ambassador to the Conference on Security and Co-operation in Europe. His has held ambassadorial posts in London, Algeria, Iraq, India, Nepal, Paris, Warsaw, Addis Ababa, Vienna and Helsinki. A specialist on international security and European integration, his interests include the geopolitics of the Asian region and multilateral economic co-operation, on which he has written and lectured extensively. He joins the Public Policy panel.

José Manuel González-Páramo is executive director of BBVA. He has more than 30 years' experience in the academic and financial spheres in public and private institutions. From 2004-12 he was a member of the executive board of the European Central Bank, and from 19944-2004 was a member of the governing council and the executive commission of the Bank of Spain. He is professor of economics at the Universidad Complutense in Madrid and a lecturer at IESE Business School. He joins the Banking panel.



Philippe Sachs is Global Head of Standard Chartered Bank's public sector client coverage group. He previously headed Goldman Sachs' Asia Pacific sovereign ratings advisory and country risk management group. Prior to joining Goldman Sachs, he was a sovereign ratings advisor at JPMorgan Chase and a sovereign ratings analyst at Standard & Poor's. Sachs has a Masters from the Georgetown School of Foreign Service in international political economy. He joins the Banking panel.

## OMFIF CITY LECTURE

# Asmussen says euro area reforms must be implemented by all

Jörg Asmussen, state secretary at the German Labour Ministry and former member of the European Central Bank executive board, examined the outlook for the euro area at an OMFIF City Lecture at Armourers' Hall in London on 17 February. He said that understanding the euro's future depends on grasping its beginnings. There were two theories: the euro as a crown for already-integrated economies ('coronation principle') versus the euro as a cornerstone for integration, in which the currency is introduced first and policy-makers hope economic and political integration will follow. Europe adopted the latter path, to its cost. However, since the crisis, missing links in Europe's institutional framework have been put in place, including the European Stability Mechanism. Asmussen stressed that all euro members have obligations and should implement structural reforms, including countries running current account surpluses. He spent some time discussing the political and economic outlook for Greece.

# Gurría urges governments to focus on green growth

OECD Secretary General Ángel Gurría (pictured with Bronwyn Curtis, chief economic adviser, OMFIF) told an audience in London on 23 February he was more optimistic about the European and world economy on account of low interest rates, quantitative easing and the weak oil price. However, there are problems to be addressed. Chief among them are low growth and lack of productive investment. Obstacles to world economic dynamism include counter-productive tax regimes and stringent financial regulations, which have been tightened since the financial crisis, producing negative results in some areas. According to Gurría, harmonisation of regulation across Europe could increase foreign direct investment by 25%. He urged governments to work on cross-border reforms and put emphasis on 'productivity, productivity, productivity'.

**EXPERT SEMINAR**

# IFC offers investors access to emerging market debt

International Finance Corporation, the largest global development institution focused on the private sector in emerging markets, outlined its Managed Co-Lending Portfolio Programme at a breakfast briefing at Innholders' Hall in London on 20 February. As bond markets are still developing in many emerging markets, loans are companies' primary source of debt financing. MCPP is IFC's syndicated loan platform, giving access to emerging market loans meeting its legal, social, environmental and governance standards.

**ECONOMISTS MEETING**

# Portugal gathering discusses improved financing for enterprises

The second Banco de Portugal-OMFIF Economists Meeting was held in Lisbon on 26 February. Attended by senior public and private sector market participants from Europe and further afield, and chaired by Governor Carlos da Silva Costa of the Banco de Portugal, the roundtable discussion focused on economic conditions in the EU and the investment outlook for Portugal and Europe.

Subjects covered included the macroeconomic and monetary stance in Europe and different forms of liquidity provision in the euro area following the financial crisis. Delegates discussed the need to increase productivity in Portugal and other euro area countries, and the process of deleveraging in the Portuguese banking sector. The discussion moved on to a consideration of how to finance the real economy in view of weaknesses in financial markets. Of particular concern was how to find a balance between improving companies' access to market financing, particularly for smaller enterprises, and strengthening banking sector supervision and regulation.

Clockwise from top left: Roundtable discussion at Banco de Portugal; Jorge Mourato and Carlos Branco; joint chairmen David Marsh and Governor Carlos da Silva Costa; discussants; Governor da Silva Costa, David Marsh, Rui Albuquerque and Antonio Antunes; Pedro Duarte Neves and Carlos Branco

# Generating growth for generations

250 years of open minds
and uncommon perspectives.

Since our foundation in 1762, we have been helping clients benefit from changing global markets. Today, we are a leading global asset management firm that provides asset management services in developed and emerging equity and bond markets and asset allocation.

With a unique world-view, our sole focus is on fulfilling our clients' investment objectives by providing top quality investment management and superior service.

www.barings.com

twitter.com/Barings

**For Professional Investors/Advisers Only. It should not be distributed to or relied on by Retail Investors. Investment involves risk.** The value of investments and any income generated may go down as well as up and is not guaranteed. You may not get back the full amount invested. **Past performance is not a guide to future performance.**

Issued and approved by Baring Asset Management Limited (authorised and regulated by the Financial Conduct Authority).

# Overcoming oil price fluctuations

## Balanced investment strategy vital to offset volatility

Duncan Goodwin, Baring Asset Management

**The global oil market is at a turning point. The precipitous fall in the oil price has ended a golden era for many producers.**

The era was relatively short-lived, coming only a few years after the oil market crash brought on by the global financial crisis. Unlike the previous correction, the current slump is not the result of faltering demand, but structural oversupply.

This originates from the vast expansion in the US onshore sector. Fuelled by historically high oil prices, the availability of inexpensive credit and the rapid advance of shale drilling technologies, the past few years have been pivotal for the US onshore industry.

Oil prices above $100 per barrel for most of the past three years made costly capital projects suddenly viable.

Data from oil field services firm Baker Hughes show the active onshore oil rig count grew nearly ninefold from 179 in June 2009 to a peak of 1,609 in October 2014 with a new breed of small operators.

In contrast to Opec and larger strategic suppliers, these producers are more likely to act in isolation, take shorter term views and increase output in the face of falling prices. According to the US Energy Information Administration, shale drillers have increased output even amid the price decline.

In two of the most developed production regions, Eagle Ford in Texas and the Bakken formation located mainly in North Dakota, annual output was up more than 20% in December. Opec's decision not to cut supply at its November meeting will further increase pressure on smaller higher-cost producers.

This may lead to higher-cost projects being curtailed, affecting many US onshore operators. M&A-driven consolidation is expected, with growing interest from larger integrated oil companies, which will need to reassess investments in multiple higher-cost projects outside the US, such as deep water drilling.

### Tightening supply

Prices are already starting to move up beyond $60pb. Opec will have to take this into consideration at its next meeting in June. If prices stay under pressure, there will be a significant supply reaction in the US. As many as 800 rigs (roughly 50% of the record October 2014 level) could become non-operating over the next six to 12 months.

On this basis, supply is likely to tighten later this year with prices rising to an average $60pb in 2015 and $70-$80pb in 2016. According to research from Chevron, that price band is within the break-even production range of US shale drillers. If prices bounce back toward $100pb, this could incentivise capital spending in the US onshore sector, possibly leading to another vicious cycle of overproduction and collapsing prices. In such a scenario, Opec would take an active role in managing supply quotas to maintain market stability.

In an environment of dramatic change, investors need to maintain a balanced strategy. While an underweight stance is recommended in the global resources equity market, there are ample opportunities elsewhere. This includes energy-intensive areas where producers may benefit from lower input costs.

Profiting from such circumstances are, for example, speciality chemical companies, such as coatings producers. Other sub-sectors that may see derivative benefits include businesses benefiting from rising consumer demand, such as some food processors and companies with exposure to the US automotive sector.

Within the resources equity market, recent share price falls give rise to some attractive valuations.

A diversified approach offers protection from volatility in the near term as well as potentially positive returns over a longer period. ▪

Duncan Goodwin is Head of Global Resources, Global Resources Equity Team at Baring Asset Management.

### Opec president at odds with Gulf states on production strategy

**Opec's mandate is to 'coordinate and unify petroleum policies'. Its main tool is setting production targets for member nations in response to global oil prices. The recent drop was divisive,** *writes William Baunton in London*. Opec president Diezani Alison-Madueke is also oil minister for Nigeria, a country squeezed hard by the oil price slump since mid-June. As 80% of Nigeria's government revenues depend on oil, it has had to slash spending, raise taxes and postpone elections until 28 March, all while fighting Boko Haram insurgents.

Iran and Venezuela, too, are struggling. Alison-Madueke has pushed for Opec to return to the normal model of cutting production to raise prices. She will not get her way, as the powerful Gulf states want to maintain production at 30m bpd to challenge high-cost producers, particularly the US, and defend market share. Other non-Gulf states in Opec cannot so easily endure low oil prices. Alson-Madueke's calls to confront the issue in an emergency meeting, which requires unilateral consent, is unlikely to succeed. Her earlier belief was that the price floor had not been reached – a view now overtaken by events. On the right is a comparison of Opec nations' production and reserves, shedding light on members' policy preferences. ▪

| Country | Population (m) | Crude oil reserves, barrels (bn) | Crude oil production bpd (m) | Percentage of world production |
|---|---|---|---|---|
| Algeria | 38.7 | 12.2 | 1.2 | 1.4 |
| Angola | 21.4 | 9.0 | 1.7 | 2.0 |
| Ecuador | 16.0 | 8.8 | 0.5 | 0.6 |
| Iran | 78.0 | 157.0 | 2.7 | 3.2 |
| Iraq | 35.9 | 144.0 | 2.9 | 3.4 |
| Kuwait | 4.0 | 101.0 | 2.9 | 3.4 |
| Libya | 6.5 | 48.0 | 0.9 | 1.1 |
| Nigeria | 174.0 | 37.0 | 1.8 | 2.1 |
| Qatar | 2.2 | 25.0 | 0.7 | 0.8 |
| Saudi Arabia | 30.6 | 265.0 | 9.6 | 11.4 |
| UAE | 9.3 | 97.0 | 2.8 | 3.3 |
| Venezuela | 30.5 | 298.0 | 2.8 | 3.3 |

Source: Opec, Deutsche Bank, IMF, national sources

See p.31 for Advisory Board forecasts on oil prices and additional oil market data.

# Middle East producers hold trump cards

## In declining US sector, shale output vastly overestimated

Fabio Scacciavillani, Advisory Board

**A great deal of worldwide commentary about the US-led shale 'revolution' driving down the cost of oil is nothing more than exaggerated wishful thinking. Once markets settle down after the last year's fluctuations, long-term market forces will drive the oil price towards equilibrium, substantially above the recent trough below $50 per barrel.**

The marginal price of oil to sustain the upward trend in world demand is around $80 per barrel, so – irrespective of the volatility during the adjustment period – a price rebound is simply a matter of time.

Oil and gas producers in the Middle East, where extraction costs are among the lowest in the world, hold the trump cards. They can withstand the shock thanks to considerable financial reserves accumulated during the last decade and are waiting patiently for circumstances to normalise.

There has been much nonsensical talk of shale oil and gas opening a new era of cheap energy. In fact, there is incontrovertible evidence that the opposite is true.

### Inexorable decline

The world has reached the limit of inexpensive and abundant hydrocarbons energy. The oil and gas industry in the US, despite a venerable history of remarkable successes, is gliding towards an inexorable decline. Most fossil fuels produced in the future will be increasingly expensive, short in quality and long in risk.

We have heard a jubilant narrative by media pundits, consultancies, think tanks, Wall Street analysts and government officials about the marvel of the technological prowess that supposedly allowed the US to regain the role of energy superpower. But this overdone account of the state of the energy market turns reality on its head.

Ground-breaking leaps in extraction belong to the past. The production cost of a barrel of oil in the US over the last decade or so has tripled, despite technology improvements. What has been touted as the dawn of a new age of hydrocarbon bounty in reality marks the end of a chapter of cheaper energy extraction in the US.

Fracking and horizontal drilling constitute a desperate struggle to scrape the last remnants from the poorest deposit. This is an arduous and wasteful operation, barely yielding more energy content than required for extraction and transport.

The orders of magnitude reveal the true extent of the 'revolution'. In the US, shale production has been responsible for less than two years of gas supply and less than one year of oil supply. According to the latest data published by the Department of Energy, the US can expect about three years of future oil supply and eight years of future gas supply from shale.

As a consequence, expectations of sizeable US oil and gas exports are plainly absurd. They belong to the realm of propaganda trumpeted during geopolitical crises, such as that unfolding in Ukraine.

### Depletion

Even before the last price oscillations, critical voices and serious studies had tried to instill a dose of scepticism. A team at the Bureau of Economic Geology at the University of Texas, perhaps the most authoritative source on the subject, published in January 2014 a series of papers showing that the rate of depletion of shale gas is faster than previously estimated.

These studies, conducted jointly by geologists, economists and engineers, provided a bottom-up scrutiny based on output data from individual wells and production forecasts to 2030 under different energy price scenarios.

In marked contrast to the models used to attract capital to finance shale gas plays, the BEG studies uncovered a pattern of exponential decline: after a steep ascent in the first few months, production sharply declines, rather than plateauing, as originally posited.

The painstakingly collected data underscored that the 'sweet spots' – patches that are easier and cheaper to exploit – were tapped first, distorting investors' forecasts and inducing them to reckon that future attempts would be equally lucrative. On the contrary, given the rapid decline in the production rate, a large number of wells must be drilled to compensate.

Technology must be constantly upgraded, pushing up fixed and variable costs. Hefty capital expenditures required to acquire and retain positions in the unconventional projects explains the high debt accumulated by many producers.

In essence, the BEG researchers sounded the alarm about the risk of considerable overspending and over-borrowing in unconventional hydrocarbons.

Shell's drastic write-down last year of $2.1bn from its exposure to the Eagle Ford

**Oil begins to rebound after steep fall**

Europe Brent crude spot price 2009-15 ($ per barrel)

Source: US Energy Information Administration

shale venture corroborated those warnings, but, as typical in every bubble episode, did not dent the prevailing irrational enthusiasm, inflated by misleading figures.

Bloomberg has collected evidence on the exaggerated claims that most oil companies made to investors about their reserves. Predicting how much oil can be pumped out of shale (or for that matter from conventional deposits) is not an exact science and has often prompted raucous controversy. The figures that drillers pitch in public presentations are sometimes dubbed 'resource potential'.

**Reporting requirements**

However, the Securities and Exchange Commission requires listed oil companies to provide an annual assessment on their oil and gas potential output, a measurement called 'proved reserves', which company executives must certify to guarantee their accuracy and hence are more realistic.

Energy companies lobbied the SEC to let them disclose more speculative estimates to the public. Regulators caved in to the pressure and reporting requirements were loosened in 2010. Estimates in public presentations then tended to include wells that would lose money, fields that had never been drilled, and projects whose likelihood of success was less than 10%, according to Bloomberg data.

Not all presentations reminded investors that publicly announced estimates were more speculative than the numbers filed with the SEC, often with little explanation of what the number included, how long it would take to drill, or how much it would cost.

The data compiled by Bloomberg show that the average estimate of resource potential was 6.6 times higher than the proved reserves reported to the SEC. Moreover, 62 of 73 US shale drillers reported one estimate in mandatory filings with the SEC, but cited higher potential figures to the public.

The bottom line is that production of oil and gas from shale has added a few years, not decades, to US supply, and those meager resources have been tapped in haste, flooding the market and affecting world prices. It was an easy decision for Saudi Arabia to call the bluff by refusing to cut Opec production and prick the bubble.

**Shale industry**

Some of the frackers remain in business just because they sold their production on the futures market, while others are not shutting operations immediately because even the current depressed prices are higher than operation costs. But they will not be in a financial position sound enough to repay capital outlays.

Indeed, the shale industry is highly indebted and highly leveraged and the drastic drop in rig counts in the five months to mid-February shows that the situation is unravelling.

Geological consultant Art Berman compared the drop in rig counts from late 2014 to the drop following the financial crisis in 2008-09, then applied those decline rates to rig counts and production in the four major tight oil plays: the Bakken, D-J Niobrara, Eagle Ford and Permian basin.

In 2008-09, the US rig count plunged from 2,031 to 876 over 283 days. As of 13 February 2015, the rig count has fallen from 1,931 to 1,358 over 151 days (see Chart 2). Production for these four tight oil plays alone may fall between 536,000 and 665,000 bpd by June 2015.

Production will decline too in conventional US production and presumably elsewhere, for example in Canada and Russia, where extraction costs are highest.

The world liquids production surplus for January 2015 was estimated by the US Energy Information Administration at 0.97m bpd and the corresponding estimate for June 2015 is 0.63m bpd.

Hence, the estimated decline in US tight oil production should correct a substantial proportion of the world supply surplus by the summer. ▪

Fabio Scacciavillani is Chief Economist at the Oman Investment Fund.

## Sovereign Notes: How global public investors can respond to oil fluctuations

**Global Public Investors are grappling with the aftershocks of low oil prices. The ramifications are most pronounced for reserve managers and other sovereign asset owners from oil-producing countries facing risks to revenue yet still having to reap some yield from investments.**

The key to mastering the current climate is by defining a purpose, driving execution, and re-evaluating fundamental variables regularly. Defining the purpose of the portfolio is key. Central banks and sovereign funds have a dominant liquidity objective so are focused on high-quality government securities. Diligent monitoring is necessary to evaluate which securities are and are not in line with the purpose of the portfolio.

For example, the high-yield bond market is strongly influenced by the energy sector. The bond market is the quickest and easiest way for capital-intensive energy companies to raise funds from institutional investors. The slump in oil prices has reduced the value of these bonds. Yet GPIs should be careful not to cut out completely this asset class as part of an effort to rebalance portfolios out of oil or energy more broadly.

There is an important distinction here. Careful and diligent evaluation is not the same as forecasting. Forecasting is a practice that can combine elements of instinct with scientific methodology. But it is difficult to take account of sudden market fluctuations and sweeping changes in asset prices driven by political or psychological factors.

GPIs need to look beyond current asset prices and evaluate influences on future developments by considering risks that may not yet be visible. The problem with a non-perishable good like oil is that price depends partly on production costs. The price of oil rarely breaches the lower bound of production costs (covering operations and exploration activities) because companies need to make a profit. But strange things happen in the short run, especially when Opec plays a role. Last year's fall in oil prices took longer to happen than many expected, and prices dropped faster than most observers thought they might. Unexpected changes pose big risks, especially in an industry where several different varieties of governments and economic systems are competing for production and supply dominance.

An alternative asset class for many sovereign investors could be gold. It stores value, is a tradable commodity and can be exchanged, but it provides little or no yield. Nonetheless, in the current economic climate of negative returns, anything that does not drain money seems an obvious choice. Gold prices rallied earlier this year, but are now close to multi-year lows as a result of the strong dollar. The correction since 2012 represented a necessary adjustment following years of price rises and makes gold still affordable as a diversification tool.

The vicissitudes in oil underline how sovereign investors must understand the fault lines in their portfolios. Markets are not logical and investors are never truly objective. GPIs can capitalise on their liquidity positions and decide asset preferences based on longer-term approaches than most investors. ▪

Pooma Kimis is Director, Markets and Institutions. She is writing from Abu Dhabi.

# Brics divided on oil price impact

## Russia suffers while rest of group enjoy cheaper imports

Canuto Otaviano, Advisory Board

**Brent oil prices fell to $45 pb at the end of January, marking the end of a four-year period of fluctuations in the range of $93-$118. Most forecasts point to prices oscillating between $50 and $80 pb into 2016.**

Supply-side developments play a major role. The steady increase of US shale oil production, together with unconventional oil sources elsewhere, have led to a persistent excess of global production over consumption.

Saudi Arabia, the 'swing' global producer, started disrupting the previous price-setting norm in August 2014, by discounting prices to Asian consumers to protect market share.

The Opec decision to uphold its production level in late November corresponded to a structural break in oil price formation, in the sense that maintaining market shares clearly superseded targeting any oil price band.

### Shale oil production

Shale oil production can rise or fall faster than conventional oil in response to market price fluctuations. So many observers believe that the change of the price-setting regime is permanent, although other experts point out that the shifts engendered by the build-up of US shale oil should not be exaggerated.

The overall net impact of the lower oil price on global GDP is expected to be positive. Besides a boost to global demand derived from the transfer of purchasing power from oil producers to consumers, lower oil prices have enabled (temporary) expansive monetary policies and lower energy subsidies. There have been winners and losers across countries and regions, but negative impacts on the latter are less significant than benefits to the former.

From the standpoint of individual emerging market economies, the consequences depend on the role and weight of oil production and consumption in the economy.

Net exporters of oil have been hit by the deterioration of terms of trade, accompanied by corresponding income shifts between producers and users within the country. Fiscal impacts have been negative where taxes on exports and consumption of oil constitute an important source of government revenues. The country-specific nature of the impact of lower oil prices can be illustrated by the diversity of circumstances among the Brics economies.

Russia is an extreme case. As oil and gas account for more than 70% of Russia's exports and nearly half of its budget revenues, its economy has suffered strongly from lower oil prices. The energy sector is responsible for 17-25% of Russian GDP. The oil price fall came on top of economic sanctions from the EU, Japan and the US, related to the Ukraine crisis. While current account balances have remained positive, annual resident capital outflows were running at 4-5% of GDP in December.

Devaluation pressures on the rouble have gathered pace. As a result, not only has inflation moved above 10% this year, but the $600bn foreign debt of Russian banks and non-banking firms – already facing a sanctions bar from refinancing with US and European banks – became an increased source of concern. Although large foreign reserves may still serve as a buffer against a balance of payment crisis, real GDP is expected to slump by more than 3.5% this year, followed by another 1.5% in 2016.

### Oil importers

According to World Bank estimates, a 10% decrease in oil prices is expected to lift growth in oil-importing economies by 0.1-0.5 percentage points, depending on the share of oil imports in GDP. This leads to a positive impact on the fiscal and current account positions. China, India, and South Africa are beneficiaries.

In China, the World Bank estimates an activity-boosting effect of lower oil prices of 0.1-0.2% of GDP, given that oil comprises only 18% of energy consumption.

A deflationary impact is on the cards, although it will be limited as energy and transportation correspond to less than 20% of the consumer price index. Fuel subsidies amount to only 0.1% of GDP, so fiscal impacts will not be significant. On the other hand, as China remains the second-largest world importer, lower oil prices in 2015 will increase the current account surplus by 0.4-0.7 percentage points of GDP.

India has an oil import bill of 7.5% of GDP and has derived high terms of trade gains from the oil price evolution. Its challenges with fiscal deficits and high inflation have been made easier. The government has already taken the opportunity to phase out diesel subsidies and hike taxes on oil derivatives. Falling oil prices have helped to bring inflation down to less than 4.5% a year in December, opening space for monetary policy loosening ahead.

South Africa is also a net importer of oil and a beneficiary from lower prices, including by corresponding effects on inflation and imports. As far as current account deficits and GDP are concerned, recent oil price developments have come as a relief after the decline of metal prices and minerals that comprise a substantial chunk of the country's exports and GDP.

Brazil has a small deficit on its oil foreign trade, so it will benefit from declining prices. It can use the lower oil price for a helpful realignment of domestic energy prices. Brazil had hoped to become a net oil exporter, as a result of ambitious investment planning to expand oil production in recent years. Together with the unfolding corruption scandals in state-controlled Petrobras, world oil price developments have prompted a cutback in such investments.

### Cleaner energy

Those oil-exporting countries that prepared themselves for the downward phase of the price cycle, constituting fiscal and international reserve buffers during good times, have been able to cope better with the new scenario. Other oil exporters realise the overriding requirement of diversifying the economy from excessive dependence on a single commodity, even though they may benefit as the price rebounds.

Across both oil exporters and importers, the price correction offers an excellent opportunity for suppressing distortions caused by excessive fossil fuel subsidies. If that is accompanied by appropriate carbon taxation, this will be a salutary stimulus for cleaner energy production. ▪

Otaviano Canuto, member of the OMFIF Advisory Board, is Senior Advisor on Brics Economies and ex-Vice President at the World Bank. All opinions expressed here are the author's own and do not necessarily reflect those of the World Bank.

# Achieving security through diversification

## Nigeria must escape crude oil dependence

Donald G. Mbaka, Central Bank of Nigeria

**The drastic fall in the price of crude oil has caused Nigerian economic managers serious concern.**

This is largely due to the widespread dependence of economic activities on proceeds from the sale of crude oil. Government expenditure, which is the major driver of economic activities, is largely financed by crude oil proceeds.

Latest official data show that crude oil constitutes about 72% of exports. Proceeds make up about 95% of foreign currency receipts and 70% of the annual budget.

The swings on the international oil market are a clear reminder that Nigeria's oil dependency is an unacceptable risk for the economy and country's long-term potential must lie in much greater diversification.

### Regulatory measures

Because of the shortage of domestic products, Nigeria suffers from a cultural propensity to favour imports over exports, often backed by regulation. The Central Bank of Nigeria is compelled to implement such regulatory measures because of their direct implications on monetary policy.

Achieving low and stable prices could be jeopardised by exchange rate volatility and the associated increases in prices caused by more expensive imports. In view of this, it is not surprising that the immediate past and current governors of the central bank have stated that the authorities will not allow the exchange rate to depreciate in an unhealthy fashion. A testament to currency pressures was the recent depreciation of the naira from N155 to N168 against the dollar.

The greater challenge lies on the fiscal end, which is largely expected to drive economic growth. Various measures aimed at stimulating private sector participation have yielded impressive results, but government expenditure remains the catalyst for economic activity. Falling crude prices immediately impacted the budget.

A medium-term expenditure framework and fiscal strategy paper for 2015-17 had been prepared with an assumed price of $80 per barrel of crude oil. But the fall in prices, which started in mid-2014, led to a re-evaluation and revision of previous estimates. Indeed, crude prices touched $50pb and put the implementation of fiscal plans and the 2015 budget in jeopardy. Various calibrations led to the adoption of $65pb for budget estimates.

Recent recovery in the international price of crude oil gives reason to be optimistic. The international oil trade has, no doubt, yielded immense benefits for the Nigerian economy.

Earnings from these transactions have financed diverse projects across the country, and contributed to the achievement of numerous goals.

But crude oil is a vanishing resource. The bountifulness of crude oil receipts will not last forever.

### Fracking

The use of hydraulic fracturing technology to exploit shale oil in the US and Canada has made the US nearly self-sufficient for its oil needs, resulting in the US drastically reducing its imports from Nigeria (see chart).

This has coincided with enhanced demand from India, a saving grace for Nigeria. But the overall impact has been a global glut in oil supply and a crash in prices as shale production came on stream with a low break-even point for many producers. Crude prices may recover, albeit at lower levels. Nigeria must get used to the prospect of much lower oil earnings.

The solution lies in a broad diversification of the economy. Various administrations have realised this and taken steps in that direction, but outcomes have been far from convincing.

### Diversification

There is a general realisation that before the advent of oil, the Nigerian economy survived on proceeds from exports of agricultural products. In fact, they were used to finance the construction of the country's oil refineries. And many other propitious sectors show good prospects. Information technology, entertainment, sports, construction and manufacturing all hold immense potential.

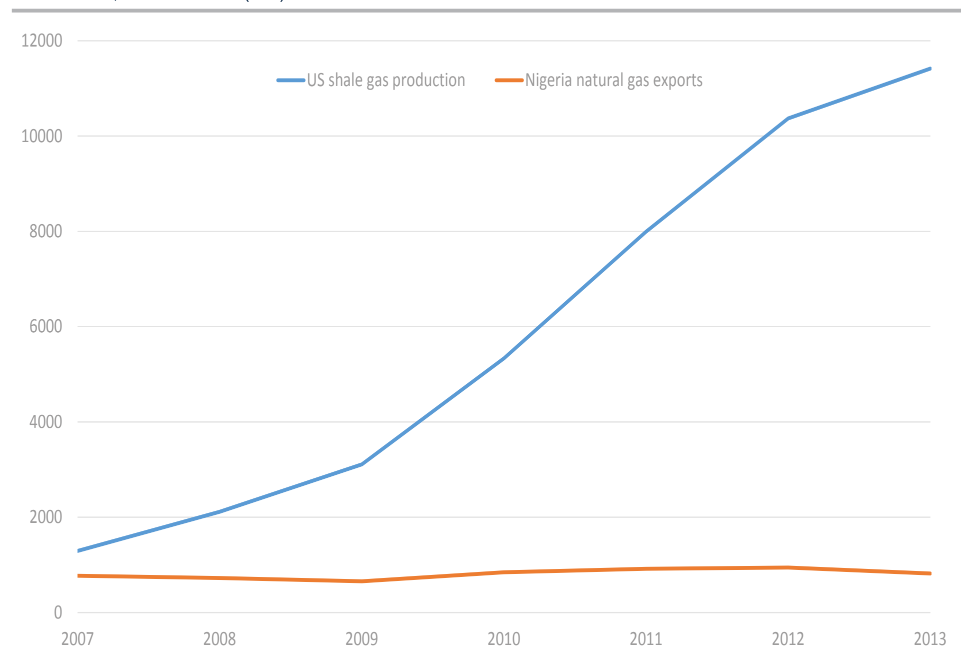
Careful implementation of strategies to exploit these potential sectors would unleash great opportunities for economic expansion and development.

Nigeria has depended on crude oil exports as the mainstay of the economy. But this has led to other outcomes that are detrimental to development. Opening up other sectors of the economy holds the key to a brighter and more secure future. ▪

Donald G. Mbaka is Economist of the Central Bank of Nigeria. The views expressed here are those of the author and may not reflect the views of the Central Bank of Nigeria.

### US shale production and Nigerian natural gas exports

2007-13, cubic feet (bn)




Source: US Energy Information Administration and Opec

# Putin defies economic imperatives

## Failing to diversify Russia's commodity-heavy economy

Anthony Robinson, Advisory Board

**The snarling bear now wreaking havoc in eastern Ukraine is ranked ninth in the 2013 World Bank ratings with a GDP of $2.1tn, just below Italy. Given the collapse of oil prices since then, Russia's ranking for 2014 could well drop to around 12th place – below India and Canada.**

However, in a breathtaking demonstration of political will, Russian President Vladimir Putin is defying economic imperatives and shrugging off weakness by deploying well-equipped clandestine forces in eastern Ukraine. He threatens more of the same for his Baltic and central Asian neighbours while exposing the political weakness and internal divisions of Europe and the US.

**Russia's weaknesses**

This is some achievement, given that the combined national wealth of the US and the top four EU states theoretically ranged against him boast a combined GDP of over $28tn. The transatlantic alliance is home to many times Russia's ageing 140m population and collectively possesses much bigger armed forces and overwhelming technological and financial superiority.

Putin's initial invasion and annexation of Crimea took place before the collapse in oil and mineral export prices. But his subsequent incursion into eastern Ukraine continued despite falling tax revenues, rising inflation, outrage at the downing of a civilian airliner and economic sanctions targeted at Russia's financial and technological weakness.

Assuming, as Putin does, continuing Nato reluctance to provide Ukrainian government forces with the weapons and training needed to halt and reverse Moscow's military expansionism, the big question is how long Putin will continue to enjoy popular support for his version of traditional Russian great power chauvinism in the face of declining living standards.

Russia's former Finance Minister Alexei Kudrin

According to a International Energy Agency report released in early February, 'Russia faces a perfect storm of collapsing oil prices, international sanctions and currency depreciation' and will produce 560,000 barrels a day less than the current 10.9mbd by 2020. Future growth, the IEA added, was predicated on new fields in the Arctic and eastern Siberia of which development requires the kind of technological and financial co-operation of foreign companies specifically banned by US sanctions.

The combination of lower prices and volumes is dangerous for a regime which relies on oil and gas to provide half its budget revenues, the clearest indicator of Putin's failure to diversify the commodity-heavy economy.

**Capital flight**

Former Finance Minister Alexei Kudrin told a Davos audience in January that lower oil revenues are exacerbated by capital flight which he predicted would reach $90-$100bn this year, after $150bn in 2014. Sanctions, he added, would make it much harder for corporate and other debtors to roll over the estimated $120bn of loans which fall due this year.

The haemorrhage of Russia's wealth is especially galling for Kudrin who built up Russia's financial reserves despite pressure from powerful 'siloviki' from the military and security establishment. But the free spending siloviki came to the fore after Kudrin resigned in 2011. He left government partly in pique at not being promoted to replace Dmitry Medvedev as prime minister, but also in protest against Putin's $500bn military modernisation programme, the fruits of which can be seen in Ukraine – but with costs which threaten to sink the economy.

Significantly, Kudrin, alongside fellow economic liberal and head of Sberbank German Gref, was invited to a special anti-crisis meeting chaired by Putin in mid-February. Surrounded by mediocrities and yes-men, Putin is being forced by economic pressures to listen more attentively to people like these, even though they call for drastic cutbacks in military expenditure and pensions and an end to vanity projects such as the $50bn Sochi winter Olympics.

A similar point was made late last year by Finance Minister Anton Siluanov who told Putin bluntly that Russia could no longer afford its military budget.

**Economic reform**

Kudrin's return to grace could be a key indicator of Putin's changing intentions, if it happens. Replacing the ineffective Medvedev as prime minister would put in charge of the government a man who has demonstrated personal loyalty to Putin as well as a passion for economic reform. Additionally, he sees a European not Asian future for Russia and the courage to stand up to the corrupt siloviki with whom Putin feels so comfortable.

Such a significant shift might only take place, however, once Putin has carved out an economically viable chunk of eastern Ukraine, including a land bridge along the Azov Sea coast to supply his 2.7m hungry new citizens in Crimea. Only then, perhaps, might priority shift from occupying territory to halting the fighting and focusing on real negotiations to secure the lifting of sanctions.

Over 50 years ago, at the summit which preceded Moscow's decision secretly to send nuclear missiles to Cuba, President John F. Kennedy complained that Nikita Khruschev only negotiated on a 'what is ours is ours, what is yours is negotiable' principle.

Little has changed. Putin is a worthy successor to Khruschev. But, soon after Kennedy successfully faced down the Soviets, Khruschev was removed through a party coup led by Leonid Brezhnev who dismissed him as 'a hare-brained schemer'.

Whether Vladimir Putin will eventually suffer a similar fate is an open question. But this is definitely not the time for the western alliance to go soft. Instead the west should rally its superior strengths and prepare for a long haul over the troubled state of Russia. ▪

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

# Oil price decline and banks' margins

## Negative interest rates bring negative profit impact

Moorad Choudhry, Advisory Board

**The fall in energy prices, led by crude oil, has had a dramatic effect on inflation in the EU. While the general expectation is that the oil price will continue to recover in 2015, we are not likely to see prices back at $100 or more for some time. This will have an impact on monetary policy.**

In the euro area, the fear of deflation, together with continued economic stagnation in the southern euro countries, has resulted in the European Central Bank introducing large-scale quantitative easing.

On the surface QE looks something of a benefit to the European banking sector, as was the case in the UK and US. But in fact QE has both good and bad implications for EU banks, and potentially much more of the latter when combined with continued zero interest rates.

The ECB's €1.1tn QE programme adds up to more than just a cheap source of funds. Certainly a central bank buying sovereign bonds leads to banks ending up with low cost funding that they can use to invest in higher interest assets. However, the significance goes well beyond this.

Without QE, banks would have viewed the spectre of deflation with trepidation, because a fall in prices means a rise in the real value of borrowers' debts. This would have led weaker borrowers into default, thereby hitting banks' capital levels just as the Capital Requirements Regulation and Directive IV (CRDIV) is starting to take effect.

And the likelihood that consumers defer spending in a deflationary environment would have hit banks badly.

### Net interest margin

On the negative side, QE puts pressure on banks' net interest margin and increases the prospect that base interest rates will remain low for longer. Net interest margin is a key component of net interest income, which is a transparent and easily understood measure of a bank's profitability. On the liabilities side, ever since the financial crisis, the rate paid on customer deposits has been negligible. For many depositors it is close to zero.

As rates stay close to zero, it becomes difficult for banks to reduce the rates paid on customer funds. And there is very little chance of banks setting a negative interest rate – unlike the ECB, which perversely sets a negative rate on euro deposits from euro area banks while also printing money to alleviate a supposed liquidity shortage. For high street banks, the attendant negative publicity would be difficult to bear.

Borrowers on the other hand will demand lower rates on loans as yields fall. This highlights a double negative impact on banks' net interest income and margin, producing a significant deterioration for income.

Markets expect QE and low rates to be around for some time – possibly for years. This means the yield curve will stay flat. The problems do not stop there. Low base rates and a flat curve means that the traditional route to raising net interest margin in a bank – increasing the maturity transformation 'gap' by borrowing very short term and lending very long term – can no longer be a solution.

Even 30-year German government bonds are now yielding close to 1%. So increasing the gap will no longer be a viable solution. Of course EU bank customers do not borrow at the same levels as the German sovereign authority. But the potential reduction in banks' interest income is a reality all the same.

It is possible to increase spread and net interest margin by going down the credit curve: the riskier the borrower, the greater the lending spread. So all this means that banks will find it difficult to meet shareholder return targets without recourse to more risky assets and/or new regional lending. Any parallel lowering of loan origination standards in pursuit of higher net interest income runs the risk of a re-run of the negative circumstances of 2007-08.

The negative background for interest rates and banks' margins compounds the wider challenges that banks face as a result of the pressures of regulation. Multinational banks in particular have a heavy workload as they prepare to comply with Basel III, the CRDIV, the Dodd-Frank Act and Volcker rule, European Market Infrastructure Regulation (Emir) and the Markets in Financial Instruments Directive (Mifid-2).

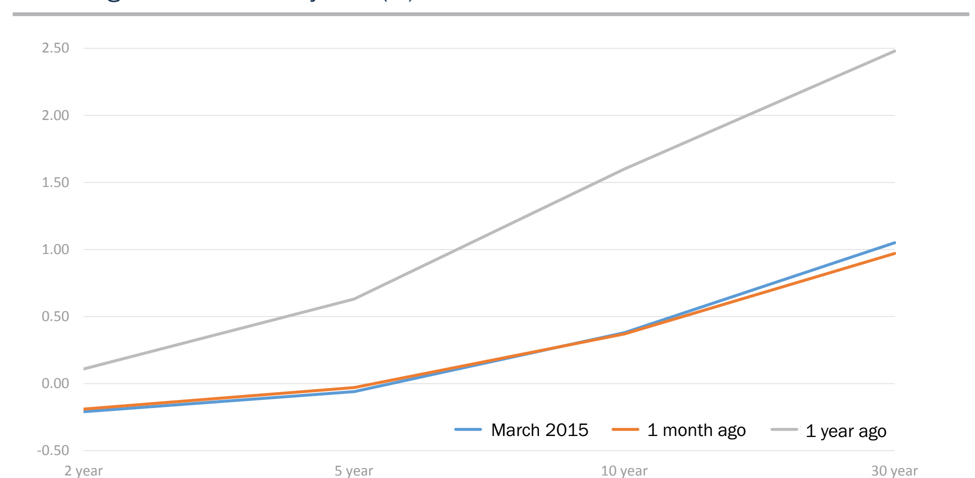
The tide of regulation seems relentless. The most recent consultative paper from the Basel Committee concerns a change to the standardised approach to risk-weighted assets calculation. Standardised, so even the smallest banks will have to make more changes to their operating procedures in due course.

So the EU banking sector is only just recovering from the trials of 2008-09. Considerable central bank support still in place indicates that structural problems with bank balance sheets remain a persistent handicap. The juxtaposition of interest rate-driven pressure on margins and new regulatory burdens presents banks with a serious dilemma. Now is not the time to be lowering origination standards to combat severe pressure on margins. On the other hand, a combination of falling energy prices, deflationary worries and continuous interest rates challenges may lead banks to view such action as the only alternative. ▪

Moorad Choudhry, member of the Advisory Board, is author of *The Principles of Banking* (John Wiley & Sons Ltd 2012).

### How negative yields have gained ground in Germany

German government bond yields (%)




Source: Bloomberg

INVESTED

During our 230 year history, we've acquired many laurels, but none we're willing to rest on.

At BNY Mellon, we provide investment management and investment services that are unrivaled in scale, precision and quality, helping our clients to conduct business and manage risk in over 100 markets. Today, with over $28.5 trillion in assets under custody and/or administration, and $1.6 trillion in assets under management, we're invested in the world like never before. To learn more visit bnymellon.com

BNY MELLON | Invested

This advertisement is for general informational purposes only and is not investment advice. If distributed in EMEA, this advertisement is a financial promotion for Professional Clients only. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may also be used as a generic term to reference the Corporation as a whole or its various subsidiaries. Products and services may be provided under various brand names and in various countries by the subsidiaries, affiliates and joint ventures of The Bank of New York Mellon Corporation where authorized and regulated as required within each jurisdiction. Not all products and services are offered in all locations. This material is not intended, and should not be construed, to be an offer or solicitation of services or products or an endorsement thereof in any jurisdiction or in any circumstance that is contrary to local law or regulation. Issued by The Bank of New York Mellon Corporation with respect to services other than investment management. Issued in EMEA, with respect to investment management, by BNY Mellon Investment Management EMEA Limited, BNY Mellon Centre, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Conduct Authority. BNY Mellon Investment Management EMEA Limited is ultimately owned by The Bank of New York Mellon Corporation. ©2014 The Bank of New York Mellon Corporation. All rights reserved.

# Oil price impact on currencies

## The link between monetary policy and demand

Simon Derrick, BNY Mellon

**Many supply factors have helped in the sharp declines in oil prices since the summer, most obviously Opec's drive to maintain market share. Yet there is no escaping the fact that the decline in oil prices since last summer has coincided with a rally in the dollar.**

The potential link between the two is simple enough. If money was flowing back into the dollar as the Federal Reserve entered the final stages of winding up the programme of quantitative easing, then it made sense that assets that had previously benefited from outflows from the dollar (such as oil during the second half of 2007 and the early part of 2008) were now finding themselves under pressure. There is little to suggest that the Federal Open Market Committee will be swayed from its course in 2015, and Opec appears committed to keeping the taps on as it squeezes out higher cost producers. So the question is whether this trend will continue and, if so, how likely it is to play out in the currency markets.

One starting point for such a discussion is the US Energy Information Administration's list of top net exporters and importers of oil in 2012. From the foreign exchange market's perspective, probably the most interesting of the net exporters (because their currencies are free floating) are Russia, Norway and Canada. The top net importers were (in descending order) the euro area, the US, China, Japan, India, South Korea, Singapore, Taiwan, Turkey and Indonesia.

The opening weeks of 2015 saw currencies of a number of key oil importers significantly outperforming the rest of the pack, while at the other end of the spectrum the rouble came under new pressure.

With, on the one hand, Fed officials continuing to hint at an initial rate hike this summer and, on the other, no sign that Opec members are preparing to turn the taps off, it could be argued that the downward pressure on oil prices should remain in place for some time.

However, there is a complicating factor. This is that while the Federal Reserve might be preparing to tighten monetary policy in 2015, many other major central banks (including the European Central Bank and the Swiss National Bank) are rushing to ease monetary policy as fast as they possibly can.

Looking back over the past 15 years at the performance of Brent crude prices it is easy to make a link between the major moves and shifts in US monetary policy. The start of the 2001-08 rally, for example, came after 11 months of aggressive easing by the FOMC, while latter stages of the move (between August 2007 and June 2008 ) were fueled by a rapid series of rate cuts from the Fed in the face of a slowing housing market. Equally, between the end of November 2008 (when the US first introduced QE) and summer 2014 (as the FOMC came close to ending its asset purchase programme) Brent crude in dollar terms rose 137%.

### International influence

It is worth noting that between March 2001 (when the Bank of Japan introduced QE) and March 2006 (when the policy was lifted) Brent crude rose by 136% in yen terms. Similarly, it can be argued that the post-2008 rally was not just fuelled by QE from the Fed but by a similarly aggressive policy from the Bank of England. In short, while there seems to be a fairly direct link between ultra-easy monetary policy and demand for a hard asset such as oil, it is not just US monetary policy that matters when considering oil price moves.

Offsetting the prospect of a US rate hike later this year is the promise from ECB President Mario Draghi that the ECB's expanded asset purchase programme will remain in place until at least September next year. This has had a powerful effect on, seen in the strong performance of currencies such as the peso, rupee, rand and dollar this year. Given this, another question is whether there is any evidence emerging of better price dynamics for oil. For the moment the jury remains out. However, it is interesting to note that since 14 January (the day before the Swiss National Bank abandoned its exchange rate policy and it became clear the ECB was preparing to carry out full-scale QE), Brent crude oil prices have stabilised.

### Under pressure

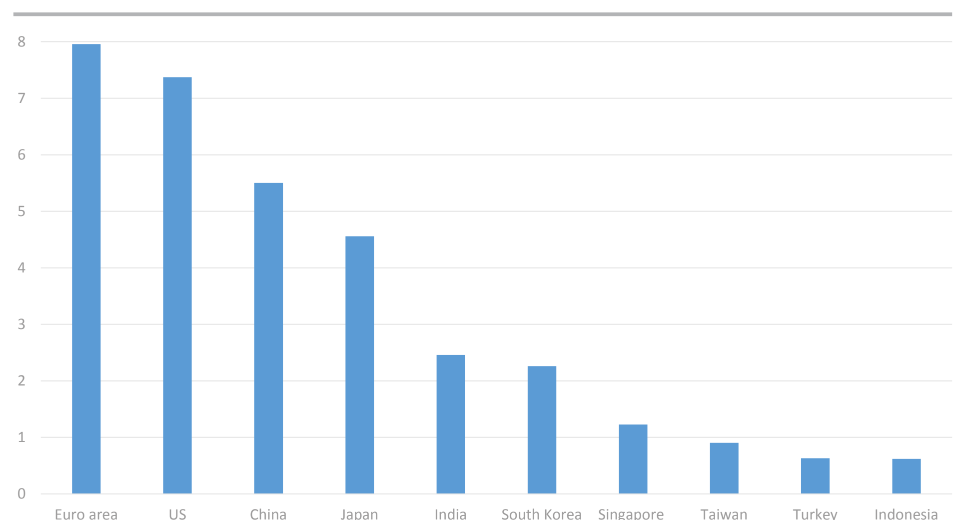
Moreover, while the rouble and Canadian dollar have remained under pressure (not least due to some aggressive monetary policy moves in Russia and Canada), it is noticeable that the pace of losses for the Norwegian krone has slowed significantly.

This is not sufficient evidence to start building a case for a sustained recovery in oil prices and associated currencies. However, there is a clear correlation between oil price movements and fluctuations of currencies from countries which face corresponding economic repercussions. Currency operators should be prepared for further evidence of these relationships in coming months. ■

Simon Derrick is Chief Currency Strategist at BNY Mellon. The views expressed herein are those of the author only and may not reflect the views of BNY Mellon. This is not a solicitation, does not constitute investment advice, or any other business or legal advice, and it should not be relied upon as such.

### World's top 10 net oil importers

Millions of barrels per day (2012)




Source: US Energy Information Administration

# Mercantilists on the warpath

## Weaker oil, strong dollar and manipulation fears

Steve Hanke, Advisory Board

**Currency wars threaten again. The strong dollar has inflamed US currency hawks led by Democratic Senator Chuck Schumer and Republican Senator Lindsey Graham. These mercantilists argue that 'cheap' foreign currencies give the US's trading partners an 'unfair' advantage.**

The dollar has been strengthening. As Chart 1 shows, the currencies of all the US's top trading partners have lost value against the dollar over the past six months. These losses have ranged from 1.8% for the renminbi to 21.6% for the real. Russia, the 15th largest trading partner of the US, has seen the rouble fall 39.5% in six months.

### Currency manipulation

The Trans-Pacific Partnership, a trade agreement between Asian countries and the US, has provided a new opening for old complaints of so-called currency manipulation. US senators want to insert enforceable rules against it, aimed particularly at Japan and China, which have accounted for the lion's share of the US trade deficit over the past 20 years (see Chart 2).

The senators do not realise that the term 'currency manipulation' is hard to define and, therefore, is not an operational concept that can be used for economic analysis. In consequence, currency manipulation rules in the TPP would be almost impossible to implement.

The US Treasury has acknowledged this fact in reports to Congress. Indeed, in 2007, the Treasury attempted to have the International Monetary Fund act as a currency cop and go after manipulators. Raghuram Rajan, governor of India's central bank and the IMF's chief economist in 2007, described the episode as an 'unmitigated disaster.'

### Japan-US relationship

From the early 1970s until 1995, bilateral trading with Japan increased the US trade deficit. Washington argued that it could be reduced if the yen appreciated against the dollar – a 'weak dollar policy' – and even tried to convince Tokyo that an ever-appreciating yen would be good for Japan.

The Japanese complied and the yen strengthened, moving from 360 to the greenback in 1971 to 80 in 1995.

In April 1995, Treasury Secretary Robert Rubin belatedly realised that the yen's appreciation was causing the Japanese economy to sink into a deflationary quagmire. The US stopped arm-twisting the Japanese government about the value of the yen.

While this policy switch was welcomed, it was too late. Even today, Japan continues to suffer from the mess created by the yen's appreciation.

As Japan's economy stagnated, its contribution to the increasing US trade deficit declined, falling from its 1991 peak of almost 60% to 9.3% today. While Japan's contribution declined, China's surged from slightly more than 9% in 1990 to 47.2% today.

The combined Sino-Japanese contribution to the US trade deficit has actually declined from its 1991 peak of over 70% to 56.7%. This has not stopped the mercantilists from claiming that the renminbi is grossly undervalued, and that this creates unfair Chinese competition and a US bilateral trade deficit with China.

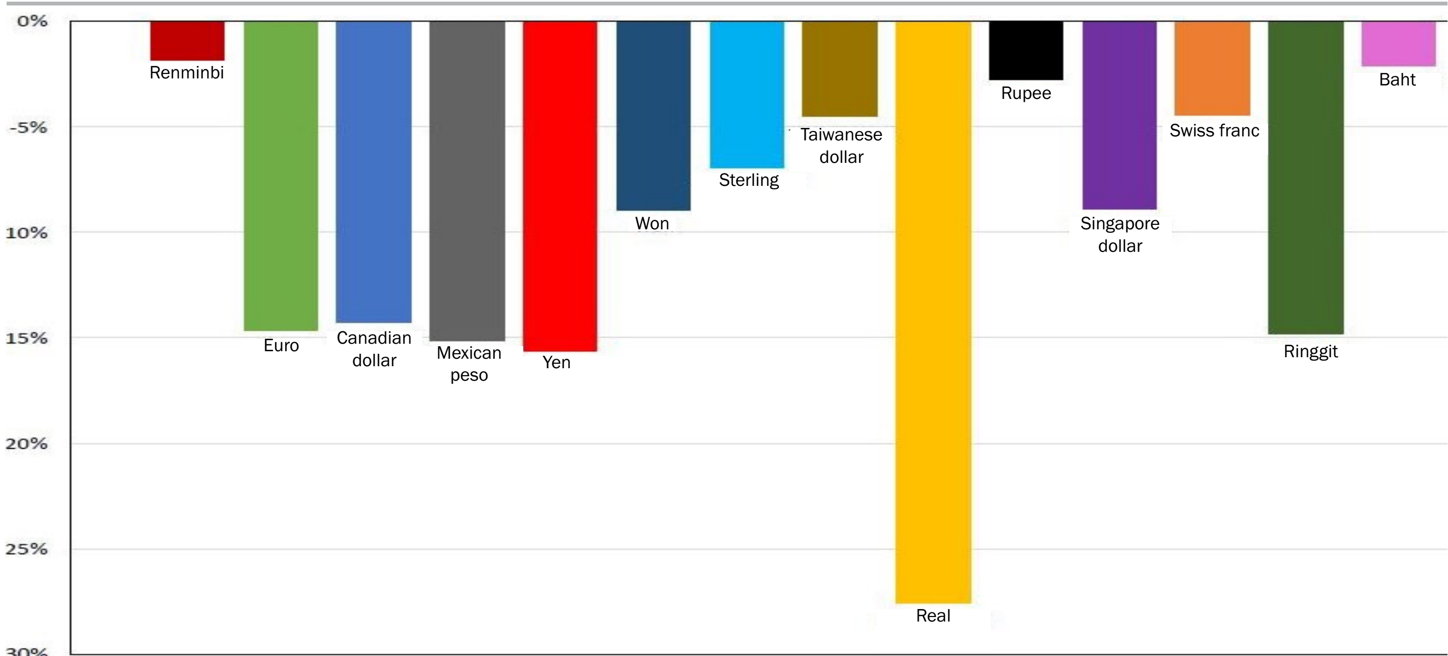
### Exchange rate argument

The obvious question is whether a weak yen or renminbi vis-à-vis the dollar (in nominal terms) can explain the contribution of Japan and China to the US trade deficit.

When it comes to Japan, whose contribution to the US trade deficit has been declining for the past 20 years, there is a very

**Chart 1: How currencies of America's top trading partners have lost value**

Exchange rates against the dollar, past six months




Source: Federal Reserve, Bloomberg and calculations of Prof. Steve H. Hanke, The Johns Hopkins University

weak relationship between the yen's strength and Japan's contribution to the trade deficit (see Chart 3). As for China, the relationship between the strength of the renminbi and China's contribution to the US trade deficit contradicts the mercantilist conjecture (see Chart 4).

Indeed, the renminbi has appreciated in nominal terms relative to the greenback over two decades, and so has the Chinese contribution to the US trade deficit. Unfortunately, this kind of raw evidence is often insufficient to sway the mercantilists.

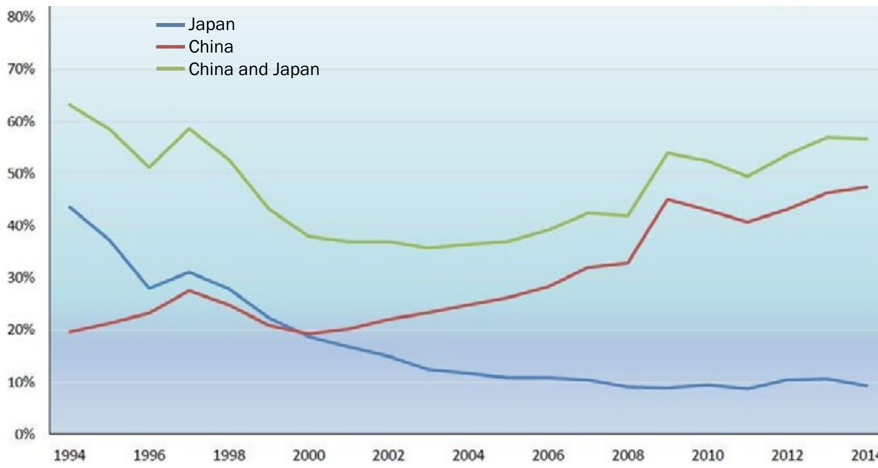
In short, the US trade deficit is the result of a US savings deficiency, not exchange rates.

As a result, the trade deficit can be reduced by some combination of lower government consumption, lower private consumption or lower private domestic investment. ▪

Steve H. Hanke, a member of the Advisory Board, is a Professor of Applied Economics at the Johns Hopkins University in Baltimore.

### Chart 2: China and Japan: biggest contributions to US deficit

Share of US trade deficit (%)




Source: US Government Census and calculations of Prof. Steve H. Hanke, The Johns Hopkins University

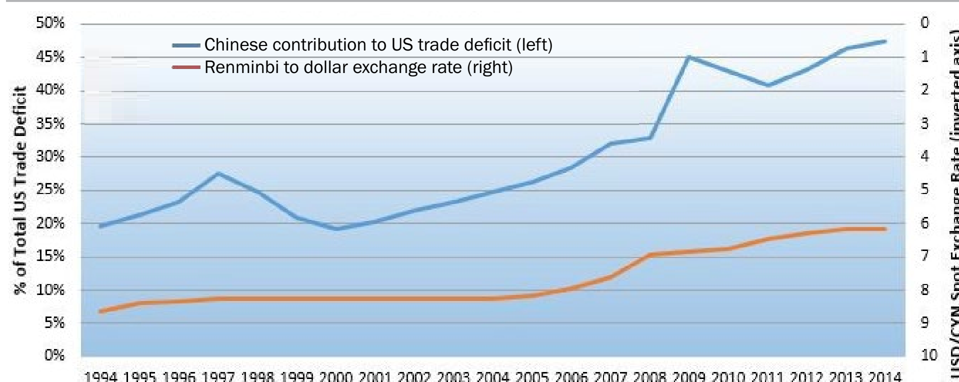
### Chart 3: Weak correlation with Japanese currency moves

US-Japan trade deficit against dollar/yen exchange rate

Source: US Government Census, Bloomberg, and calculations of Prof. Steve H. Hanke, The Johns Hopkins University

### Chart 4: Renminbi moves up with China trade surplus

US-China trade deficit against dollar/renminbi exchange rate




Source: US Government Census, Bloomberg, and calculations of Prof. Steve H. Hanke, The Johns Hopkins University

## CURRENCY NEWS

Three months into 2015, and the global currency landscape is already beginning to look decidedly tense.

Differing monetary policies of central banks have resulted in some countries becoming increasingly reliant upon their currencies to boost their economies. As the Fed heads towards interest rate normalisation, with an accompanying inflow of funds supporting the dollar, both the Bank of Japan and the European Central Bank are increasing the size of their balance sheets.

This quantitative easing, accompanied by an expected continuation of low rates, is sparking a wave of currency appreciation among central banks that have not brought in QE.

The dollar has strengthened against currencies of most other advanced nations. Domestic fears are rising about the repercussions of a strong dollar on exports and on the value of US companies' foreign profits. The US Treasury has vowed to 'push back very hard' against countries targeting weaker exchange rates in search of trade advantages.

In the meantime, all eyes are on China to see how it might respond. Many believe China has already signaled its participation in the interest rate and currency game by launching a monetary easing cycle. Following two rate cuts the renminbi has depreciated against the dollar, ending a long run of appreciation. China could still widen the band in which the currency trades to facilitate a speedier depreciation, in which case other Asian countries may follow suit. The US might find it difficult not to take retaliatory action, depending on the mood in Congress.

With regard to the rupee, owing to strong capital inflows into India, the rupee has moved out of line with the general trend. The rupee's trade-weighted value has risen compared with other emerging market currencies. This is a potential source of vulnerability for India as an over-strong rupee would hold back exports and growth. This would not be popular with the Reserve Bank of India and a policy response would undoubtedly follow. ▪

Jamie Bulgin is Deputy Director, Markets and Institutions.

# Cheaper oil and slowing China

## Japan example may spur further Beijing easing

John Adams, Advisory Board

**The recent decline in the world oil price, unerringly attributed in the western press to the rise of shale oil production and fracking in the US, has another very different mirror image in the fall in overall Chinese demand, with GDP growth down from previous averages of 10-12% to around 7.3% currently.**

Indeed, some analysts have attributed the previous rise of oil prices from $20 in 2001 to $140 by 2007 to the extra demand in Chinese manufacturing subsequent to its joining the World Trade Organisation. China effectively added another Japan to world oil demand in that short six-year period. A similar secular price push can be seen in the Chinese demand for copper and other commodities over that time.

Oil alone is around 11% of China's total imports and the country stands to gain around $4.5bn per month in reduced import costs. Given weak growth in Chinese imports, and a 10% growth in exports, China's trade and current account surpluses do not seem likely to fall back soon. The 2014 trade surplus was a record $382bn – up 47% on 2013; the current account surplus is a steady 2.3% of GDP.

One question is whether the fall in oil prices will affect China's renminbi internationalisation policy. The world oil price is denominated in dollars, so that the link of the renminbi to the dollar is critical.

A year ago the rate was Rmb6 to the dollar. It is now around Rmb6.3, a 5% depreciation. It seems as if the Chinese authorities were willing to offset some of the massive gains from the lower oil price with a lower currency that stimulates exports.

### Capital account liberalisation

Exports by value were up nearly 10% in 2014, while imports by value were static, reflecting oil's lower cost. But the day cannot be far away when China may be tempted to liberalise its capital account and see the renminbi used as a currency of denomination for oil and other commodities, for most of which it is now the world's largest consumer.

China was effectively self-sufficient in oil production until the early 1990s. But domestic production has since then been stable at 3-4m bpd (though China is the world's fourth largest oil producer). Total demand in 2015 will probably hit 12m bpd – China is now the world's largest importer and consumer of oil. And while the economic implications of the falling oil price are important for China, its geopolitical dilemmas are also pressing. China needs to decide how to secure supplies, and with which countries. It needs to extend the range of its fleets into the Indian Ocean and to the Straits of Hormuz, to guarantee its major oil supply routes.

In this context, the crisis-ridden Middle East provides 40% of China's oil, with Saudi Arabia at about 20%, while Iraq and Iran both provide 8%. Russia, with its long border with China, provides 9%, and increasingly needs Chinese consumption of its oil and natural gas as a source of steady revenues. The outlier is Angola, at 14% of China's supply: this is half of Angola's total oil production, and oil is 60% of Angola's GDP.

In late 2014 China advanced $2bn to Angola to tide it over the plunge in oil prices. Angola appears now to have swung into the gravitational orbit of a newly powerful and rich China, and may find the Dragon's further embraces hard to resist.

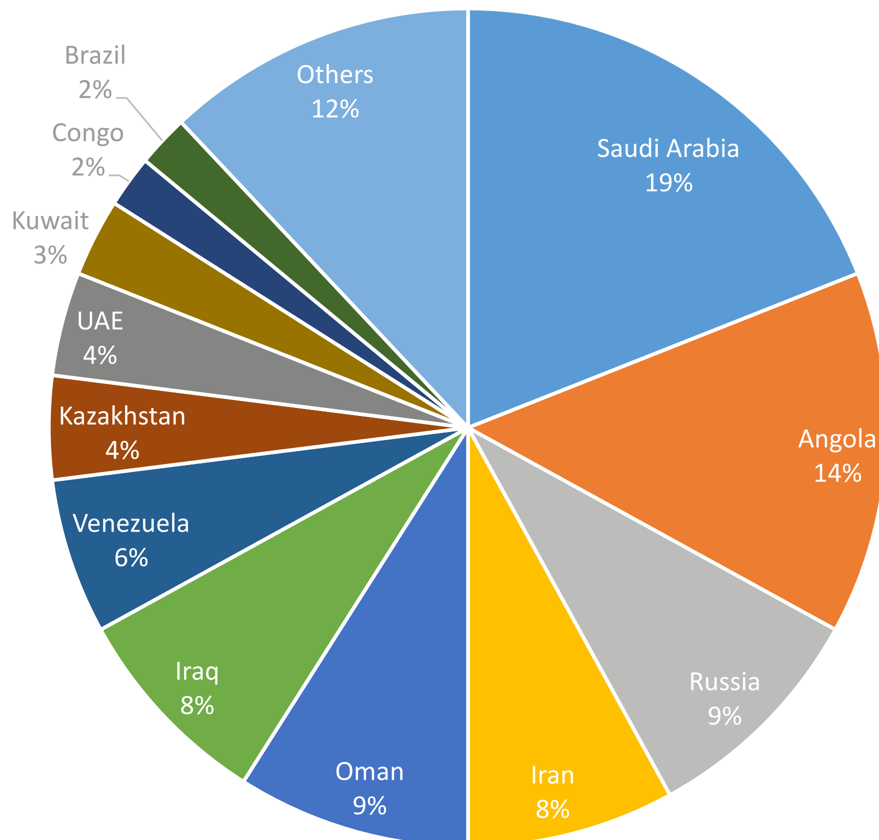
Sudan, too, is another country where China has dominant oil and stability interests, and is able to use its economic clout to advantage. China is securing its means of supply, but is being drawn into impossible geopolitical calculations as were imperial Britain and the US in the past.

### Transport challenges

China also has a strategic oil problem nearer to home – a large part of its imports have to pass by tanker through the Malacca Straits and then into the South China Sea. Here China has inflamed local antipathies (mainly in Vietnam, Brunei, the Philippines and Malaysia) by claiming most of the area as its own territorial waters – despite the southernmost point of China's claim being 1700km away from the nearest Chinese landmass.

**China's suppliers**

China's crude oil imports by source, 2013




Source: US Energy Information Administration

China's alternative strategy is to avoid oil shipment via the Indian Ocean and South China Sea by piping oil up through Pakistan, and it has secured a port franchise in Pakistan for that purpose.

But whether Pakistan can guarantee the necessary internal stability is another question altogether.

China has since 2008 been diversifying its sources of oil by purchasing assets abroad. But this presented unscrupulous actors with attractive opportunities both to get cash outside China, and for bribery. As part of President Xi Jinping's long-running anti-corruption campaign, several senior officials at China National Petroleum Corporation have been arrested, two of them after apparently buying useless dry oil wells for $350m in Indonesia.

The campaign has enmeshed Zhou Yongkang, both a former CNPC general manager, and head of security in China. This extension of the anti-corruption drive demonstrates the importance of the oil sector for China's strategic thinking and the critical view the government takes of the country's exposure to oil politics.

**Strategic oil reserve**

China is building a strategic oil reserve, with the target of 500m barrels by 2020. This would be the equivalent of about one month's consumption, so this is not a major force in driving world or Chinese demand. The original target was 90 days' demand, but this proved impossible to meet, in view of high demand growth. Perhaps with the present low price China might revisit this option.

About 70% of China's 1250GW electricity generation is still by coal, while less than 20% is oil-fired. (The remaining 10% is natural gas, hydro-electric and nuclear.) Oil provides about 250GW of electricity, and there may be the possibility of looking at expanding this and the gas-fired sector to alleviate China's chronic pollution from coal and vehicle exhausts. (By way of comparison, total UK peak electricity consumption is a paltry 50GW, and the US about 1,000GW).

**Cars driving growth**

There are 300m cars in China, growing by 25m a year. If China emulates the US, it would be running at 800 cars per 1,000 people – or around 1.2bn cars. Cheaper petrol and rising affluence favour this scenario, although it is plainly impossible and unsustainable from an economic and environmental point of view.

China is heavily committed to the car, and one Chinese city, Wuhan (twinned with Manchester), is able to produce more than the UK's total annual car registrations, at about 3m units per year. But there are clear limits. The index at the US Embassy pollution monitoring station in Beijing, outlined during a recent OMFIF fact-finding mission on monetary policy, was approaching 1,000 for the highly dangerous particulate matter PM2.5. The maximum safety guidelines recommend a level of around 200.

Pollution was a key issue covered by Prime Minister Li Keqiang in his address to China's Parliament. Although a politically contentious private film on this issue was first allowed, it was subsequently pulled from China's websites.

A major issue is whether environmental considerations as well as lower oil prices will stimulate or restrain the Chinese economy. Probably the oil price impact will be more negative than positive. China's booming economy in recent years has been a result above all of export demand and a steady supply of land for property development and for security on loans to local authorities.

China's exports may become cheaper as result of lower oil prices, but they are heavily dependent on external demand, which cannot be guaranteed. The real story in China is not about ever-increasing exports, but rebalancing the structure of the economy to support domestic demand – still just out of the grasp of the planners.

Recent data also show that land sales are down 25%, and that local governments are waking up to a headache of unmanageable debt. Cheaper oil will not ease this problem. Since property investment is 15% of GDP, this may have a considerable effect.

**Inflation conundrum**

China faces the same conundrum as Europe on account of falling oil prices. China's consumer price inflation, affected by the lower oil price, was running at only 0.8% in January – the lowest for six years. This might push China's prices temporarily into negative territory in 2015. According to most forecasts, the consumer price index will rise by about 2% in 2015.

But on its doorstep China has the example of Japan's two decade deflation, brought on in part by similar property bubbles. As a result of this negative example, China may well be tempted to engineer further easing of monetary policy.

This seems to be the policy the authorities are following. After two years of stability, deposit and lending rates were cut in November 2014 and again in March 2015.

The advantage is that indebted firms and local authorities may refinance themselves at lower interest rates. As the Fed prepares to raise US interest rates, and the European Central Bank starts purchasing official assets, the rest of the year will show whether this policy produces the desired result. ▪

John Adams, member of the Advisory Board, is Director of China Financial Services.


## China, the Special Drawing Right, and the world reserves system

**22 May 2015**
**Beijing**

The issue of whether the renminbi should be part of the International Monetary Fund's Special Drawing Right, the composite reserve currency used in official financing, is highly technocratic, but the political questions at stake go to the core of world money.

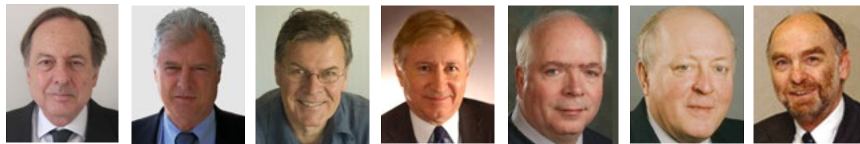
The decision on a new SDR structure, to be made in the next six months, will influence how China and its currency can play a bigger role in driving world trade, investment and capital flows. Beijing wishes to develop a set of standards that will be helpful for promoting stability and allowing financial globalisation for the good of emerging economies.

These issues will be discussed at a joint seminar hosted by OMFIF and the International Monetary Institute of Renmin University.

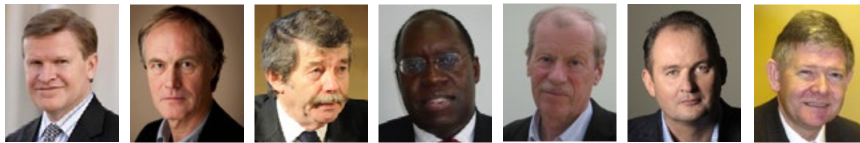
For more information, please contact Adam Cotter: adam.cotter@omfif.org or +44 (0) 20 3008 5209.

**Meghnad Desai,** Chairman
**Philip Middleton,** Deputy Chairman
**Frank Scheidig,** Deputy Chairman
**Paola Subacchi,** Deputy Chairman
**Songzuo Xiang,** Deputy Chairman
**Jai Arya,** Director
**Jean-Claude Bastos de Morais,** Director

## EDITORIAL & COMMENTARY



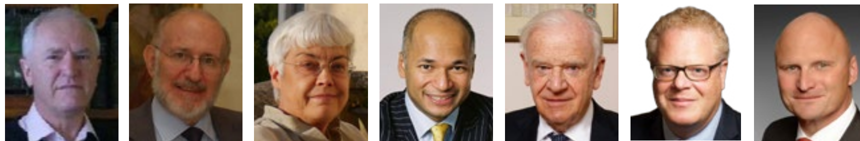
**Paul Betts,** formerly Financial Times
**Nicholas Bray,** formerly OECD
**Peter Bruce,** Business Day
**Reginald Dale,** Center for Strategic and International Studies
**Darrell Delamaide,** Market Watch
**Jonathan Fenby,** China Research, Trusted Sources
**Stewart Fleming,** formerly Financial Times



**Harold James,** Princeton University
**Roel Janssen,** NRC Handelsblad
**William Keegan,** The Observer
**Joel Kibazo,** formerly Commonwealth Secretariat
**Jürgen Krönig**, Die Zeit
**Willem Middelkoop,** Commodity Discovery Fund
**Peter Norman,** formerly Financial Times

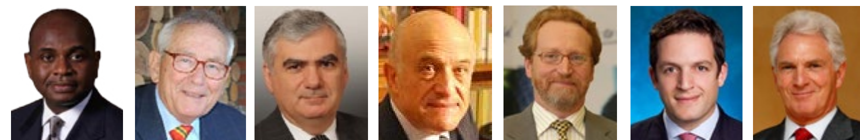
**Janusz Reiter,** former Polish Ambassador to US
**Anthony Robinson,** formerly Financial Times
**David Smith,** formerly United Nations
**Michael Stürmer,** WELT-Gruppe
**David Tonge,** IBS Research & Consultancy
**John West,** Asian Century Institute
**Lifen Zhang,** Financial Times

## BANKING



**John Adams,** China Financial Services
**Mario Blejer,** Banco Hipotecario
**Consuelo Brooke,** Alliance Trust & BlackRock
**Moorad Choudhry,** Brunel University, London
**John Chown,** Institute for Fiscal Studies
**Michael Cole-Fontayn**, BNY Mellon
**Christian Gärtner,** DZ Bank

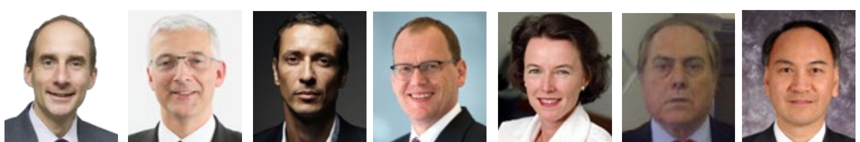
**José Manuel González-Páramo,** BBVA
**Dick Harryvan,** formerly ING DIRECT
**Akinari Horii,** formerly Bank of Japan
**Philippe Lagayette,** Fondation de France
**Andrew Large,** formerly Bank of England
**Thomas Laryea,** Dentons
**Oscar Lewisohn,** Soditic



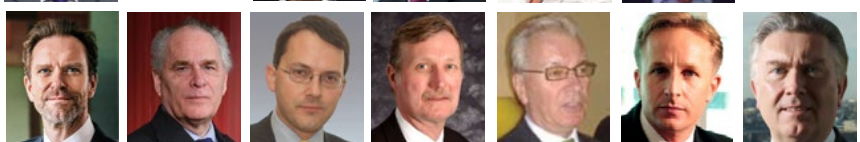
**Kingsley Chiedu Moghalu,** formerly Central Bank of Nigeria
**Wilhelm Nölling,** formerly Deutsche Bundesbank
**Athanasios Orphanides,** formerly Central Bank of Cyprus
**Francesco Papadia,** formerly European Central Bank
**Martin Raven,** formerly Foreign and Commonwealth Office
**Philippe Sachs,** Standard Chartered Bank
**Nasser Saidi,** formerly Bank of Lebanon

**Fabio Scacciavillani,** Oman Investment Fund
**José Alberto Tavares Moreira**, formerly Banco de Portugal
**Jens Thomsen**, formerly Danmarks Nationalbank
**Makoto Utsumi,** Japan Credit Rating Agency
**Ernst Welteke,** formerly Deutsche Bundesbank

## CAPITAL MARKETS & INVESTMENT

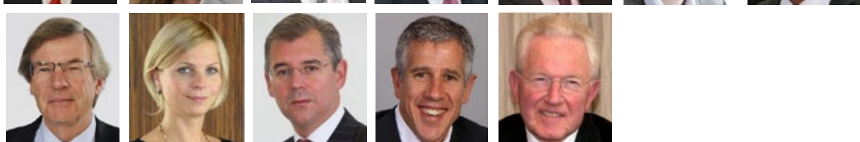


**Andrew Adonis,** House of Lords
**David Badham,** Cass Business School
**Jean-Claude Bastos de Morais,** Quantum Global
**Stefan Bielmeier,** DZ BANK
**Caroline Butler,** Walcot Partners
**Stefano Carcascio,** formerly Banca d'Italia
**Hon Cheung,** State Street Global Advisors

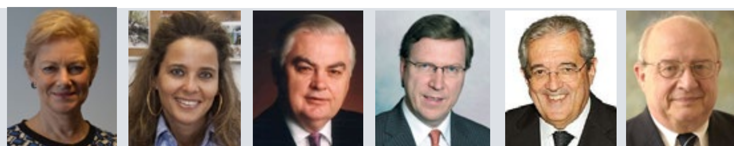


**Stefan Georg,** Delta Economics
**Peter Gray,** Berkeley Capital
**Trevor Greetham,** Fidelity Worldwide Investment
**George Hoguet,** State Street Global Advisors
**Frederick Hopson,** formerly Hessische Landesbank
**Matthew Hurn,** Mubadala Development Company
**Paul Judge**, Schroder Income Growth Fund

**Mumtaz Khan**, Middle East & Asia Capital Partners
**Celeste Cecilia Lo Turco,** Italian Ministry of Foreign Affairs
**George Milling-Stanley,** formerly World Gold Council
**Paul Newton,** London & Oxford Capital Markets
**Saker Nusseibeh,** Hermes Fund Managers
**Bruce Packard,** formerly Seymour Pierce
**Robin Poynder,** formerly Thomson Reuters

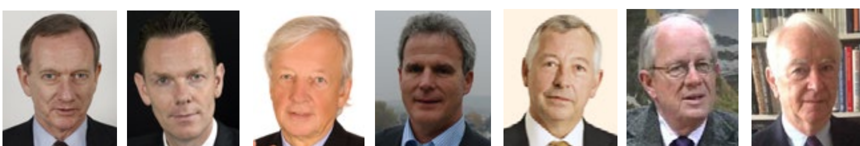


**Colin Robertson,** formerly Aon Hewitt
**Marina Shargorodska,** Quantum Global Investment Management SA
**Gary Smith,** Baring Asset Management
**Hendrik du Toit,** Investec Asset Management
**Jack Wigglesworth**, formerly LIFFE

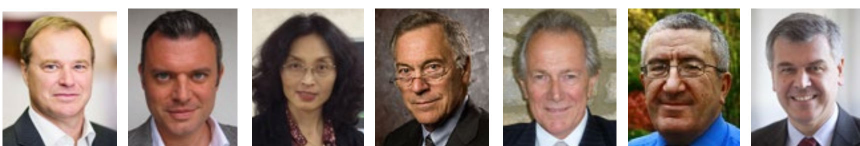


**Bronwyn Curtis**, Chief Economic Adviser
**Aslihan Gedik**, Senior Adviser
**Norman Lamont**, Senior Adviser
**John Nugée**, Director & Senior Adviser
**Fabrizio Saccomanni**, Senior Adviser
**Ted Truman**, Senior Adviser

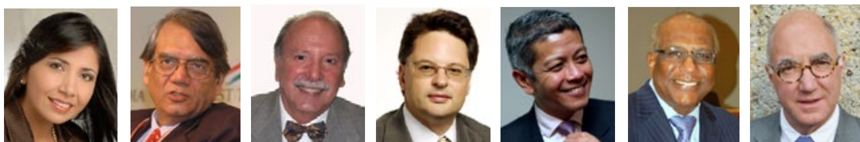
## EDUCATION & RESEARCH



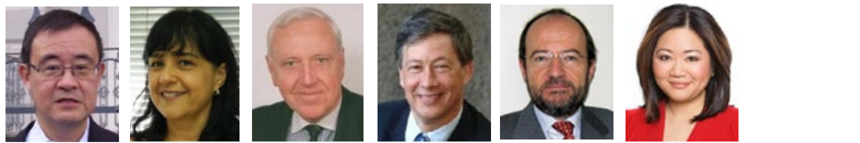
**Iain Begg**, London School of Economics
**Harald Benink**, Tilburg University
**Gottfried von Bismarck**, Körber Stiftung
**Michael Burda**, Humboldt University, Berlin
**Nick Butler**, King's College, London
**David Cameron**, Yale University
**Forrest Capie**, CASS Business School



**Mark Crosby**, Melbourne Business School
**Jon Davis**, Queen Mary University, London
**Haihong Gao**, Institute of World Economics and Politics
**Steve Hanke**, Johns Hopkins University
**John Hughes**, former UK Ambassador to Argentina
**Ray Kinsella**, University College, Dublin
**Ludger Kühnhardt**, Center for European Integration Studies

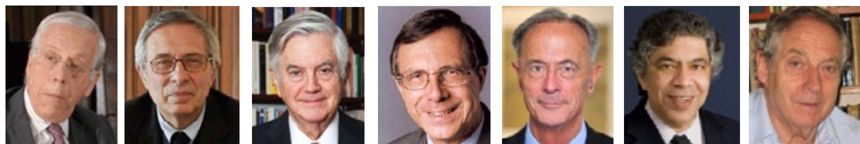


**Mariela Mendez**, Escuela Superior Politecnica del Litoral
**Rakesh Mohan**, International Monetary Fund
**José Roberto Novaes de Almeida**, University of Brasilia
**Michael Oliver**, ESC Rennes School of Business
**Danny Quah**, London School of Economics
**Abdul Rahman**, International Academy of Retail Banking
**Richard Roberts**, King's College, London

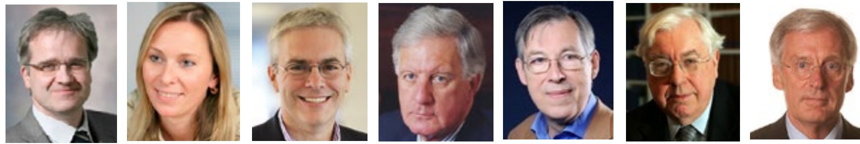


**Shumpei Takemori**, Keio University
**Maria Antonieta Del Tedesco Lins**, University of São Paulo
**Niels Thygesen**, University of Copenhagen
**Daniel Titelman**, ECLAC
**Peter Walton**, ESSEC Business School
**Linda Yueh**, BBC

## PUBLIC POLICY

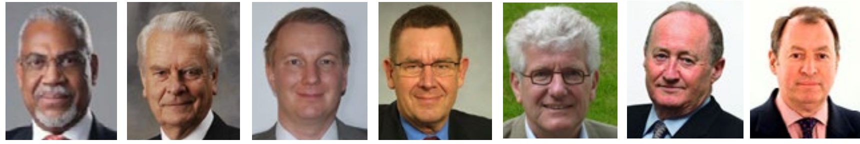


**Antonio Armellini**, former Abassador, OSCE
**Franco Bassanini**, Cassa Depositi e Prestiti
**Frits Bolkestein**, formerly European Commission
**Laurens Jan Brinkhorst**, University of Leiden
**Colin Budd**, formerly UK Diplomatic Service
**Otaviano Canuto**, World Bank
**Desmond Cecil**, Areva UK



**Neil Courtis**, Sensible Media
**Natalie Dempster**, World Gold Council
**Jonathan Grant**, Policy Institute at King's
**Peter Heap**, former UK Ambassador to Brazil
**François Heisbourg**, Fondation pour la Recherche Stratégique
**John Kornblum**, former US Ambassador to Germany
**Ben Knapen**, European Investment Bank

**Ruud Lubbers**, former Dutch Prime Minister
**Bo Lundgren**, formerly Swedish National Debt Office
**Denis MacShane**, former British Minister for Europe
**Kishore Mahbubani**, Lee Kuan Yew School of Public Policy
**Boyd McCleary**, former HM Diplomatic Service
**Luiz Eduardo Melin**, Brazilian Development Bank
**Célestin Monga**, UNIDO

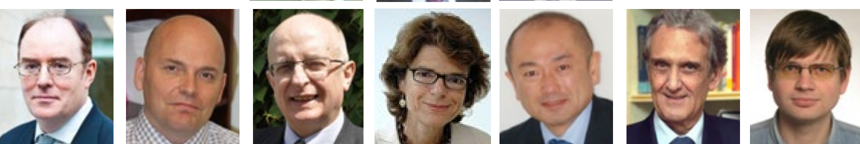


**Murade Miguigy Murargy**, CPLP
**David Owen**, House of Lords
**Jukka Pihlman**, Standard Chartered Bank
**Poul Nyrup Rasmussen**, former Danish Prime Minister
**Paul van Seters**, Tilburg University
**Christopher Tugendhat**, House of Lords
**Paul Wilson**, De La Rue

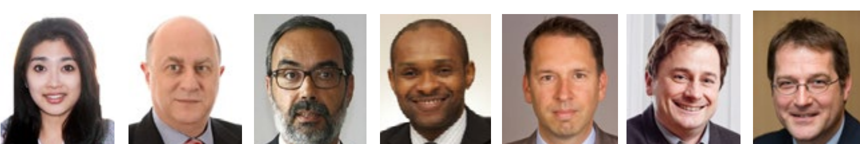
## ECONOMICS & INDUSTRY

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

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



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



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

# US central bank patience has its limits

## Yellen hints that Fed will keep option of June hike open

Darrell Delamaide, US editor

**In her semiannual testimony to Congress in late February, Federal Reserve Chair Janet Yellen (voter) did not say anything different from January's Federal Open Market Committee statement, but she did offer a little forward guidance on the Fed's forward guidance.**

In back-to-back appearances before Senate and House committees, Yellen patiently parsed for the law-makers exactly what 'patient' means in Fed-speak.

She noted that the FOMC felt in December and January that, given low inflation and sluggish improvement in labour market conditions, the Fed could be patient in beginning to raise interest rates. This means, she spelled out, 'that the committee considers it unlikely that economic conditions will warrant an increase in the target range for the federal funds rate for at least the next couple of FOMC meetings.'

### Decisive criterion

This is what everyone knew. But she went on to explain that if economic conditions continue to improve, as policy-makers expect, the FOMC will at some point begin considering an increase in rates on a meeting-by-meeting basis. Before then, however, the panel would have to change its forward guidance, namely by dropping the word 'patient.'

'However,' Yellen added by way of caveat, 'it is important to emphasise that a modification of the forward guidance should not be read as indicating that the committee will necessarily increase the target range in a couple of meetings.'

All clear? In other words, if the FOMC drops 'patient' from the March statement that does not mean it will automatically raise rates in June – but it could. It could also opt to wait until July or September, or even later.

The decisive criterion for Yellen, presuming labour market conditions continue to improve, would be when the panel 'is reasonably confident that inflation will move back over the medium term toward our 2% objective.'

Yellen's semantic dance was her solution to a communications problem highlighted by St. Louis Fed chief **James Bullard (non-voter)**, among others. At a panel discussion early in February at the University of Delaware, Bullard said he would like to delete the word 'patient' from the FOMC statement. 'If it was me, I would take it out to provide optionality for the following meeting,' he said. He reiterated his remarks the week before Yellen's testimony in an interview with Sirius satellite radio.

The hawkish head of the Cleveland Fed, **Loretta Mester (non-voter)**, said in an interview with The Wall Street Journal that any interest rate hike in March or April has been ruled out by the Fed's definition of patient.

June, however, remains a 'viable option,' Mester said, although that would mean altering the March statement to eliminate that word. 'The hard thing about it is going to be how do you have June be a viable alternative, but not lock the committee into necessarily moving in June because we don't know if we're going to move in June,' Mester said. 'That is a challenge for communication.'

Yellen dealt with that in her congressional appearances, but Mester wondered aloud whether the Fed wouldn't be better off using less code. 'We would probably do better to be a bit more plainspoken,' she said. 'I was in London and I spent a lot of time looking at some of the recent Bank of England communications. They seem much more straightforward.'

The minutes of the January meeting, released in mid-February, reflected the debate going on within the committee.

### Communications challenges

On one hand there are the hawks: 'Several participants noted that a late departure could result in the stance of monetary policy becoming excessively accommodative, leading to undesirably high inflation. It was also suggested that maintaining the federal funds rate at its effective lower bound for an extended period or raising it rapidly, if that proved necessary, could adversely affect financial stability.'

Then the doves: 'Some participants noted the communications challenges associated with the prospect of commencing policy tightening at a time when inflation could be running well below 2%, and a few expressed concern that in some circumstances the public could come to question the credibility of the committee's 2% goal… Many participants indicated that their assessment of the balance of risks associated with the timing of the beginning of policy normalisation had inclined them toward keeping the federal funds rate at its effective lower bound for a longer time.'

Needless to say, Fed watchers spend a lot of time deciding how many policy-makers lie behind the words 'few,' 'some,' and 'many.'

In the meantime, outgoing Philadelphia Fed chief **Charles Plosser (non-voter)** supplied the very definition of inflation hawk when he told Bloomberg TV that the 'jury is still out' as to whether the Fed's extraordinary monetary accommodation will have inflationary consequences.

'We will have to see as we exit this period of extreme accommodation, seven plus years of zero interest rates, whether we will have inflation – inflationary consequences from that,' he said. 'That is something we still don't have an answer to.'

### Concentration of power

The other regional bank chief on the way out, **Richard Fisher (non-voter)** of Dallas, questioned as his parting shot the primacy of the New York Fed in the system.

'I think we at the Fed must fully and frontally address the concern of many who feel that too much power is concentrated in the New York Fed,' he told an audience in New York, no less.

With all due respect to New York Fed chief **William Dudley (voter)** and the staff, Fisher said, 'I understand the suspicions that surround the New York Fed' given its *primus inter pares* role as executor for the system's open market operations and the ex officio status of the president as vice chair of the FOMC.

With a typical flourish, Fisher cited 'an ancient Arab saying' to the effect that one should 'trust in Allah but tie your camel.'

His solution: Rotate the vice chairmanship of the FOMC among all 12 regional banks.

During Yellen's appearance before the Senate Banking Committee, the chairman, Alabama Republican Richard Shelby, asked her what she thought of Fisher's suggestion, as well as other possible 'structural reforms' of the Fed, such as reducing the number of regional banks from 12 to five.

Yellen said that is up to Congress. Law-makers carefully weighed many things when they established the Fed, she noted, and the structure they came up with has worked pretty well, in her opinion. For her part, she wouldn't recommend any changes. ▪

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

# Greece's last chance

## Europe shows its prowess in muddling through

Michael Burda and Holger Schmieding

**Nobody can muddle through better than Europe. The last-minute deal at the end of February to keep Greece afloat for another four months sparked a largely predictable reaction.**

'Kicking the can down the road,' howled the Eurosceptics, while the pro-euro camp hailed 'a face-saving compromise'. Most agree that Greece is on its last chance from European taxpayers to get its house in order.

The outcome is uncertain. Taming Alexis Tsipras, Greece's radical new prime minister, while preventing a train-wreck will be no mean feat. And it is only natural to be sceptical regarding a country that has defaulted five times on its international obligations since its independence in 1832.

Yet if Europe and the IMF play their cards well and learn from their previous mistakes, it could be different on this occasion. Having bought extra time while giving the Greek populists a first taste of reality, Europe and the IMF now have a chance to negotiate finally a programme for Greece that works.

### Regime change

At the end of January the Greek electorate booted out much of their old political class, handing a sweeping election victory to radical populists promising to free them from austerity and the yoke of Greece's external debtors without providing the essential details. It is not hard to understand why.

The largely IMF-designed adjustment programme for Greece was less than optimal, imposing too much short-term austerity while securing too few tangible pro-growth structural reforms.

After all, it is much harder to implement structural reforms against entrenched lobbies than to raise taxes and slash investment expenditure.

Savage fiscal cuts in an inflexible economy and tax increases – regressive and unpopular ones like the VAT and uncollectable ones like wealth taxes – worsened already existing distortions, causing price increases for those who could least afford them and chasing the tax base further underground.

Because this policy caused so much collateral damage, much of the debate about Greece still revolves around debt forgiveness and the primary government deficit.

Most of these arguments miss the point. Greece needs a competitive economy to generate growth, jobs and tax revenues much more than it needs debt relief. Over the next four months, Greece and Europe need to negotiate a new deal. It should focus on the supply side much more than on the debt.

### New Deal

Our 'New Deal for Greece' consists of the following steps. Greece should undertake credible reforms of its product and labour markets and raise the minimum wage in stages, linking increases to improvements in private sector employment. It should keep lower minimum wages for young people, exempt very small enterprises, and strive to reduce its currently punitive payroll tax 'social contributions' rate, which is among the highest in the OECD.

Furthermore, Greece must reform its system of tax administration to expand the tax base and improve tax revenues while reducing some tax rates. The tax authority ought to be made free of political interference. In the long run, a more manageable system of comprehensive flat taxation with generous allowances for low income households should be introduced at many levels. Credibility and transparency of the tax system should be drastically improved for foreign investors.

In return, Europe can ease targets for the Greek primary surplus, focusing less on austerity and intrusive supervision, and more on supply-driven growth. The new government, less beholden to vested interests represented by the old parties New Democracy and Pasok, can better tackle cartelised structures.

Next, the OECD, a recognised expert on supply-side reforms, should be added to the team of monitors of Greek commitment: ECB for banks and banking, IMF and European Commission for fiscal policy, and OECD on supply-side reforms. Talking individually to these 'quartet' institutions rather than as a group, Greece can claim to have ditched the despised 'troika'.

Privatisations which have already been announced should be carried out. The EU should offer assistance for further sales of state assets in the form of debt-for-equity swaps at terms favourable to Greece. These assets could be sold off later under the auspices of an EU trust fund, under less time pressure and for a better price. Excess proceeds could be returned to the Greek Treasury, and be used to retire debt or finance infrastructure investment.

Finally, the EU could supply targeted additional funds for humanitarian relief such as food and medical assistance, infrastructural aid and other technical help.

### Pressure on Tsipras

The battle is not yet over. Tsipras and his government face pressure at home to deliver on promises which were clearly at odds with economic logic and international obligations, most importantly Greece's membership of the EU and the euro area.

Tsipras must convince the people that the key issue is sustainability rather than debt. This means competitiveness and the supply-side. Abandoning deregulation and privatisation initiatives would ensure that Greece is back for more money in another three to four years.

A new deal will not be easy. The risk of Greek exit from monetary union may re-emerge. But it would be a grave mistake and a misreading of European history to let the Grexit train-wreck happen.

A post-default Greece would have to earn its imports in a period of turmoil with little hope for international credit for many years to come. While a devaluation may help in the short run, ordinary Greeks would suffer a large hit to real wages, much worse than austerity.

At the same time expatriate Greeks would return with their bundles of euros to pick over the pieces, hardly consistent with basic notions of social fairness. The political impact for Europe could be even more serious than the economic damage.

Staying in the euro is for the long haul. Nothing is for free. Greece needs to reinvent itself, much like Germany reinvented itself in 2003 with the Agenda 2010. Historic opportunities rarely present themselves as they have now. Europe and Greece need to seize the moment. ▪

Michael Burda is Professor of Economics at Humboldt University, Berlin. Holger Schmieding is Chief Economist at Berenberg Bank.

# Institutions react to changing landscape

## Keeping the world's financial sector resilient and competitive

Henry Quek, State Street

**Long-term institutional investors around the world have been in the market spotlight in the past year. They are likely to remain so in coming months.**

Whether it is a decision of a central bank to unlock a currency cap, a pension fund to adjust its asset allocations or a sovereign wealth fund to acquire industrial and commercial real estate, these institutional investors are an important bellwether. As the world's biggest investors, their decisions are scrutinised carefully, particularly at times of market volatility.

### Aggressive measures

Official institutions have worked to tackle the challenges of keeping the world's financial sector resilient and competitive. In recent years, central banks globally have adopted exceptional monetary policy measures and have kept interest rates ultra-low.

A diverging monetary policy path is set to emerge in 2015, with the US expected to hike rates while Japanese and euro area central bankers continue with accommodative or easy monetary policies.

The twin factors of a stronger dollar and impending turn in the US rate cycle have complicated asset allocation decisions.

Falling commodity prices are a double edged sword for official institutions. Their focus is on whether oil-producing countries and their sovereign wealth funds will continue their aggressive investments abroad. The continued decline of crude oil prices may result in oil-exporting countries having less to invest in fixed income and equities. Borrowing costs may rise, adding pressure to equity prices.

On the other hand, major oil-consuming countries such as the US generally view lower energy prices as a net positive for economic activity and employment.

Declining oil prices had a smaller effect on inflation in emerging market economies, reflecting the greater prevalence of administered energy prices.

### New markets

Faced with low yields in mainstream markets, official institutions are looking to new markets and a broader range of asset classes to continue to meet their investment goals.

A State Street and FT Remark research survey of 62 official institutions globally has shown that, in the persistently low interest rate environment, these investors have a greater appetite for new geographies and a broader range of asset types.

Some central banks have looked beyond traditional fixed income investments to commodities and precious metals such as gold, while sovereign wealth funds are pursuing investments in emerging markets and alternatives.

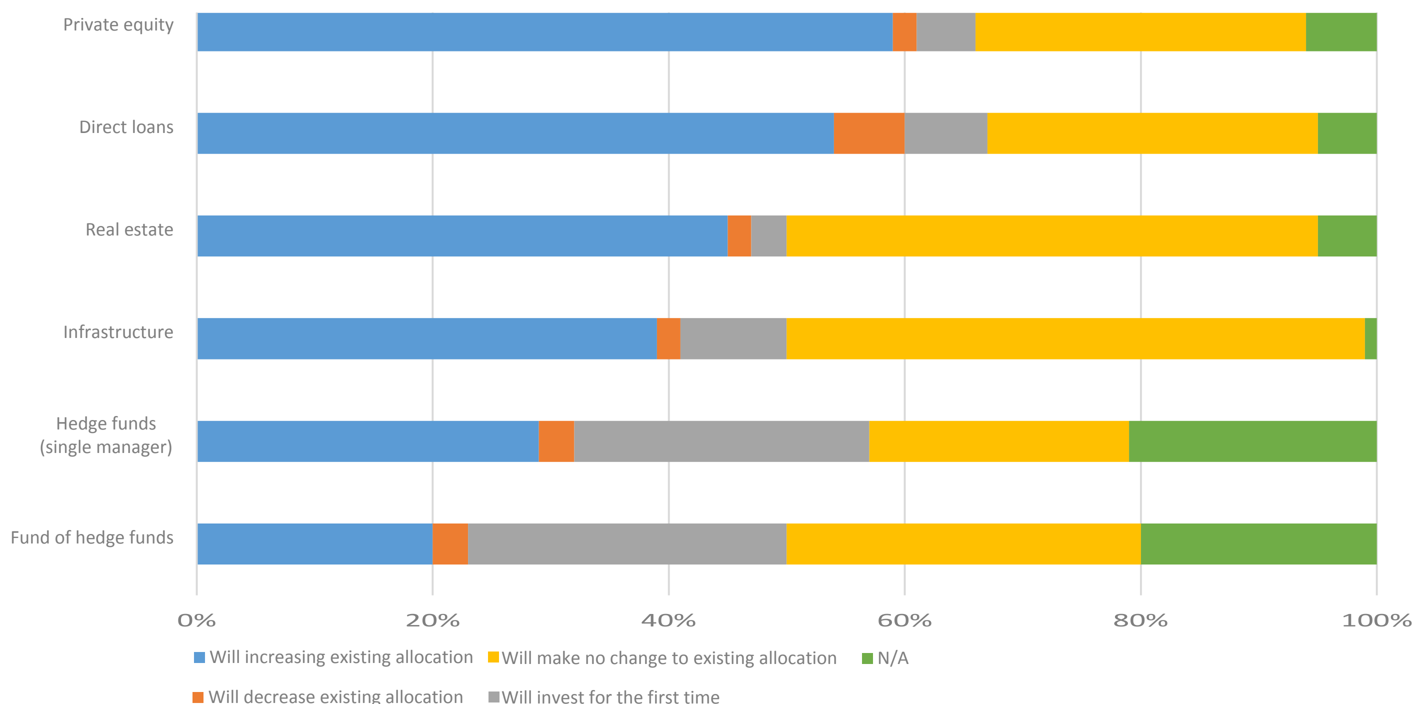
Over the next two years, 80% of respondents plan to increase their exposure to emerging market equities. Nearly half are looking to invest more in real estate and infrastructure.

The move to diversify portfolios has big implications for official institutions in terms of risk, performance, operational efficiency and recruitment.

Adjusting to higher interest rates is the single biggest investment strategy challenge facing official institutions, according to 38% of respondents. Almost as many were worried about managing the volatility associated with emerging market investments. In addition,

### Chart 1: Asset allocation

Private equity is the top priority of all alternative asset classes globally




Source: State Street 2014 Asset Owners Survey, conducted by Economist Intelligence Unit. Pension fund respondents.

official institutions must keep on top of an evolving global regulatory environment. This is increasingly difficult.

**Pension industry**

Like official institutions, asset owners such as pension funds and endowments are adapting their investment strategy to a changing environment.

Weak investment returns, a shrinking workforce and longer life expectancy of retirees have left the pension industry with a growing funding gap.

A State Street survey of 134 pension funds by the Economist Intelligence Unit found that 77% of respondents expect their institutions' investment risk appetite to increase over the next three years. This figure is even higher among respondents in Asia Pacific at 88%.

Pension funds are undertaking a root-and-branch reassessment of their portfolios. They are looking for the right mix of assets to drive higher returns, while keeping costs low and minimising overall risk exposure.

Alternative investments traditionally made up just a small part of pension funds' portfolios compared with equities and fixed income products. Now, despite some high-profile withdrawals from hedge funds, pension funds overall intend to increase exposure to alternatives, which they expect to generate enhanced returns.

The total global alternative assets under management by institutional investors reached $5.7tn in 2013, according to Towers Watson.

In our asset owners survey, private equity is the top priority of all alternative asset classes globally, with three-fifths of pension fund respondents planning to increase allocations in this area (see Chart 1).

A significant proportion of pension funds in the survey said they will invest more in infrastructure (39%) and real estate (45%). These investments are attractive partly because, as long-term assets that deliver returns over their life cycle, they suit pension funds' long-term liabilities.

**Hiring hedge funds**

California Public Employees' Retirement System (CalPERS) decided in September 2014 to pull $4bn from its hedge fund investment programme – an announcement that sparked speculation that other pension funds would follow suit. But the general trend looks positive for hedge fund managers able to offer a reliable source of alpha returns.

Pension funds are targeting single-manager hedge funds for investment. Globally, 29% of pension funds that already invest in hedge funds say they will increase their allocation, while 25% will invest for the first time.

This result concurs with another new survey conducted by State Street and Citigate Dewe Rogerson examining this trend from the perspective of hedge funds themselves. The survey of 235 hedge fund executives reveals that the global industry expects to see a period of radical change in the next five years.

More than half of respondents think inflows from pension funds will increase over the next five years. Even more expect increasing inflows from ultra-high net worth individuals (65%) and institutional investors, including pension funds (63%).

**Regulatory burden**

Hedge funds recognise that they face challenges. Like all investors, they are unsure about the full impact of the increasing regulatory burden.

According to our survey, 83% of hedge fund managers expect regulatory scrutiny to increase in their sector in the next five years. New regulations such as Basel III – the global regulatory standard on capital adequacy and market liquidity risk – fundamentally impact the business processes of financial companies globally.

Hedge funds may find that Basel III affects their current funding arrangements. Many are uncertain about the regulation's potential implications. In our survey, 29% of respondents believe Basel III will significantly increase their firms' costs of financing. A further 29% say they do not know what the effects will be.

Given that institutional investors are increasing their investments into alternative asset classes, hedge funds appreciate that they need to adapt their business strategies to take advantage of these new opportunities. More than nine out of 10 respondents (91%) acknowledge that they need to step up efforts to demonstrate their value to prospective investors to attract new capital.

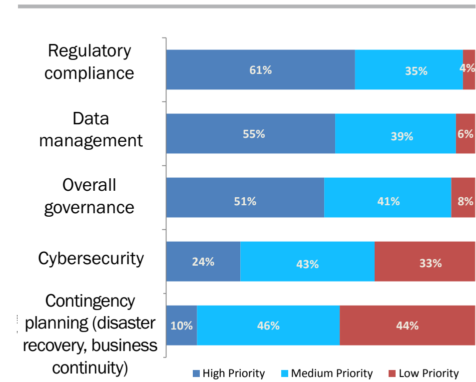
One way to provide a better proposition to investors is to offer a wider range of investment strategies. Three out of five (60%) hedge funds in our survey plan to broaden their investment strategies over the next five years.

More than a third (37%) of respondents intend to expand their global footprint to reach new investors. One in 10 intends to acquire another firm, while 17% intend to reposition themselves as niche providers.

Hedge funds face increasing competition with significant interest emerging in liquid alternatives. These have some of the characteristics of hedge funds but within a mutual fund vehicle, so they offer the liquidity benefits of mutual funds. They follow the reporting and compliance standards of 40 Act funds (regulated under the 1940 Investment Company Act) and Undertakings for Collective Investment in Transferable Securities.

## Chart 2: Areas for improvement

Pension funds' top priorities




Source: State Street 2014 Asset Owners Survey, conducted by Economist Intelligence Unit. Pension fund respondents.

**Coping with change**

Our research shows that taking on and reporting on risk is a fundamental challenge for many institutional investors from central banks to pension funds.

A core focus is investing in expertise and systems to manage risk, including compliance and talent. Investors need to find ways to make risk management processes simpler and more efficient.

Evolving regulations, portfolio diversification, managing the increasing number of risks, generating greater operational efficiency, setting up sound data infrastructure and recruiting the right talent to support their strategies are among the challenges these institutions have to face.

A willingness by financial institutions to adapt and innovate, and develop creative tools to manage these challenges, will help ensure that they can succeed in the fast-changing business environment. ▪

Henry Quek is senior managing director and head of official institutions for Asia Pacific at State Street.

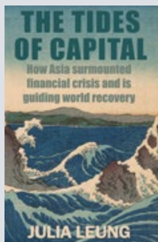
**Surveys**

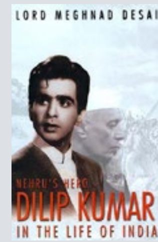
State Street 2014 Asset Owners Survey conducted by the Economist Intelligence Unit, November 2014

Global Alternatives Survey 2014 by Towers Watson, July 2014

State Street 2014 global survey of 235 hedge fund executives, conducted by Citigate Dewe Rogerson, October 2014

New Horizons for Official Institutions, a State Street and FT Remark study, March 2014





# Currency winners and losers

## The politics of exchange rate determination

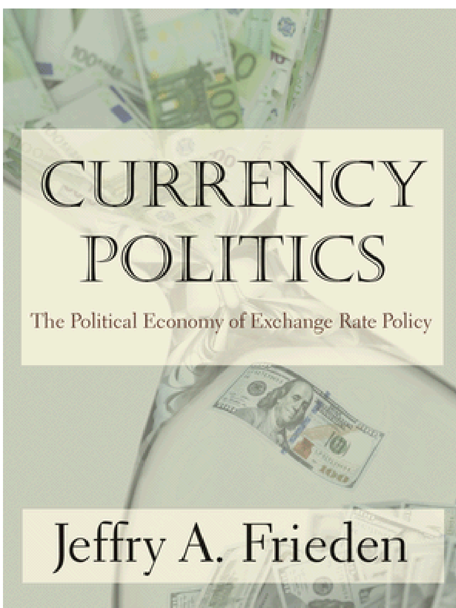
George R. Hoguet, Advisory Board

**One may question Jeffry Frieden's assertion that the exchange rate is the most important price in any economy. What about interest rates? But there can be no doubt that he has written an ambitious and illuminating book.**

In *Currency Politics – The Political Economy of Exchange Rate Policy*, Frieden, professor of government at Harvard, presents a socioeconomic theoretical framework for analysing the politics of exchange rate determination. He then tests the theory against historical experience in the US, Europe and Latin America.

Frieden argues that international coordination on exchange rate policy could be 'Pareto improving' – harming no-one and benefiting at least one party.

Yet exchange rate policy creates winners and losers. A country's exchange rate policy preference reflects the structure of output and the relative strength of interest groups, including urban consumers. The relevant dimensions are the regime (fixed or floating), and the level (appreciated or depreciated). Everything else being equal, foreign-currency debtors, financial firms and institutions heavily involved in cross-border trade and investment will favour a fixed exchange rate.




Firms with large tradable output will tend to support a weaker exchange rate. Firms with large net foreign currency liabilities will favour a stronger one. The degree of pass-through (the extent to which changes in the exchange rate are transmitted to domestic prices) is an important variable. Tradable producers (high pass-through) will favour a depreciated currency. The more open an economy, and the lower the level of tariffs, the greater the interest in currency policy.

### US policy

Frieden then applies this framework to the politics of US exchange rate policy from 1862-96. The debate on the gold standard, pitting Wall Street proponents of hard money against Main Street and agricultural proponents of soft money, was acrimonious. He tracks the dollar to sterling exchange rate during this period and the reaction to it.

In a particularly impressive piece of scholarship, Frieden analyses votes by Congressional district on various pieces of monetary legislation, including the Contraction Act, the Inflation Act, and the Free Coinage Bill. He regresses these votes against factors such as 'farm output per capita'. While there are many cross-currents (some agricultural products are not tradable), the data during this period tend to confirm his hypotheses about the exchange rate preferences of various groups.

Frieden views the euro area as a special case of a fixed currency regime. He rejects the view that economic and monetary union was a quid pro quo for German unification. Rather, the political economy of trade integration led to monetary integration. As Frieden suggests in his discussion of the impact of the Brazilian devaluation of 1999 on Mercosur, protectionist pressures frequently result when a neighbour devalues.

In the context of the EU, these pressures could have threatened the foundation of the single market.

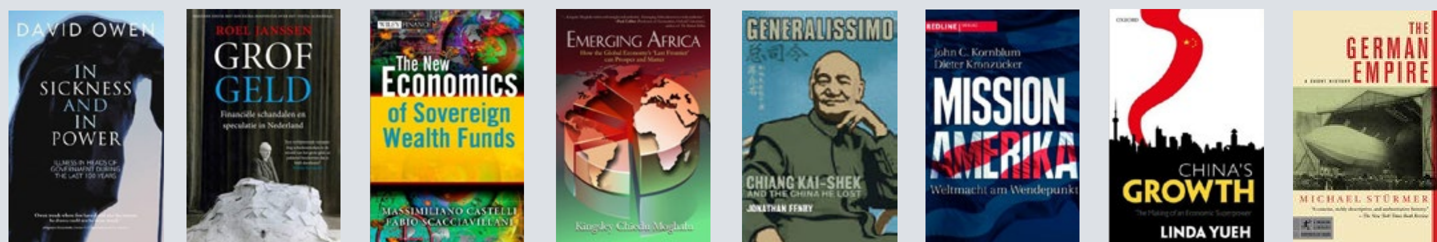
The chapters on Latin America, a fecund currency laboratory, review the region's transition since 1971 from import substitution policies to a more outward looking orientation. Special interest groups, including urban consumers, manufacturers and foreign currency debtors heavily influenced policy choices. As countries became more democratic and beholden to consumers, governments tended to delay required exchange rate adjustments, often with devastating consequences.

This book is rich in historical detail. We tend to forget, for example, that US manufacturers benefited for many years from substantial tariff barriers. Frieden's thesis is surely correct. Exchange rate policy must take powerful political pressures into account, and the distributional aspects of exchange rate policy cannot be ignored.

Aspects, however, of Frieden's impressively granular taxonomy could be questioned. For example, Paul Volcker, former Fed chairman, has argued that banks desire currency volatility, as it is a potential source of trading profits. And a curious omission in the book is any lengthy discussion of East Asian currency policy.

Given the vast literature on theories of exchange rate determination, this book reminds us of the primacy of politics. It integrates theory, statistical methods, and historical analysis, and will be of interest to social scientists, policy-makers, and money managers alike. ▪

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



# A tale of two crises

## Lessons heeded and unheeded from the 1930s

Graham Hacche, Advisory Board

**Six years after the financial crisis of 2008-09, the world economy is still struggling to restore normality. The costs of the crisis and the Great Recession have been exorbitant. But for most countries and the global economy, the Great Depression of 1929-33 was much more costly. Global GDP fell by 0.4% between 2008-09 before resuming growth, but by 15% between 1929 and 1932.**

Lessons from the interwar experience informed policies in the recent crisis and helped to ensure a less disastrous outcome. But should policy-makers not have done even better this time, given the lessons from the past? This is the question central to *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses – and Misuses – of History* by Barry Eichengreen, professor of economics and political science at the University of California, Berkeley.

**Lessons not learned**

To address this question, the book provides interwoven, detailed histories of the two crises. The application in the recent crisis of policy lessons from the Great Depression was apparent in the readiness of central banks to act as lenders of last resort, to provide liquidity to their financial systems, and to co-operate internationally; in governments' initial avoidance of policies of fiscal austerity; and in their attention to international economic co-operation rather than protectionism.

These policies helped contain the damage, as did various structural and institutional changes that had occurred since the 1930s, including stronger social safety nets and new institutions of international co-operation. But there were also failures.

First was the failure to prevent the crisis, even though it was preceded by housing and stock market booms that paralleled developments in the 1920s. Too many policy-makers suffered from a 'naïve belief' in a Great Moderation. Complacency developed about the adequacy of self-regulation in the financial sector, and insufficient attention was paid to weakly regulated shadow banking systems. Policy-makers focused on risks associated with widening global payments imbalances, when they should have been more worried about housing and mortgage securitisation.

A view developed – helped by Federal Reserve chairmen Alan Greenspan and Ben Bernanke – that because of the difficulty of identifying asset market bubbles, it was best to deal with them after they burst. Bernanke downplayed the weakening of US house prices, saying there had never been a decline on a national basis; but Eichengreen shows that house prices fell 25% between 1929-33. US officials pointed to the supposed resilience of the financial system; Eichengreen calls this a 'one-eyed assessment', neglecting the structure of housing finance.

Second, there was a failure to contain the crisis. For Eichengreen, the 'single most important policy failure of the crisis' was the failure of the US Treasury and Federal Reserve to obtain the authority to wind up Lehman Brothers in an orderly way before its collapse in September 2008. They were making a statement that they took seriously the potential problem of moral hazard. The lesson from the 1930s that the central bank's first responsibility is to head off a panic, after which there would be ample time to deal with moral hazard, had not been fully assimilated.

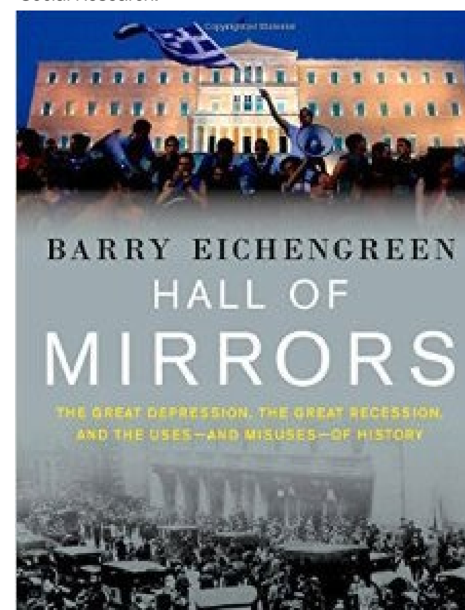
Third, there was a failure to bring about a strong economic recovery after the crisis. Eichengreen rejects the view that recovery after a financial crisis is inevitably slow, pointing to US average GDP growth exceeding 8% a year between 1933-37. He argues that policies of fiscal austerity and inadequate monetary accommodation have both been to blame.

With regard to the UK since 2010, he finds 'the coalition government's obsession with austerity more than a little difficult to understand'

Fourth, there have been the policy mistakes of the euro area, and the failure to complete the construction of Europe's 'monetary house'. Eichengreen's critique of policies in the euro area is wide-ranging. Underlying some of the policy mistakes – such as the ECB's hike in interest rates in 2008 – has been Germany's inflation-phobia, born in the 1920s.

Yet Eichengreen recalls how the rise of the Nazis followed more closely the fiscal austerity of 1930-31. He decries the continuing failure to secure the foundations needed for a smoothly-functioning monetary union, including an interstate system of taxes and transfers. He observes, 'The idea that monetary union could proceed without political union turned out to be a fatal mistake.' And one fears that he may be right. ▪

Graham Hacche, member of the Advisory Board, is Visiting Fellow at the National Institute of Economic and Social Research.



# Russia's reaction to western encroachment

## Ukraine conflict began when Cold War ended

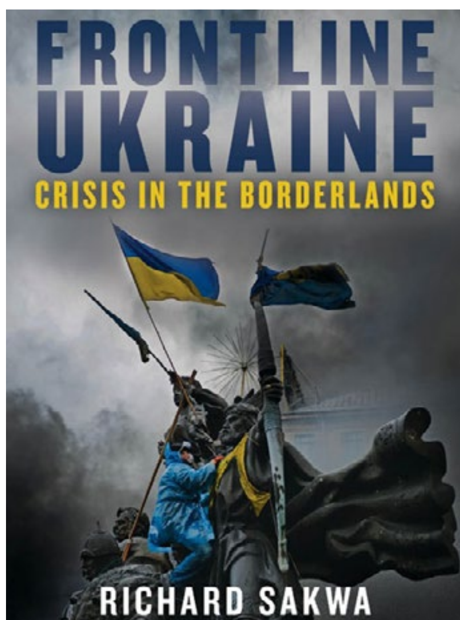
Sophie Lewisohn

**One hundred years on from the war to end all wars, Richard Sakwa's F*rontline Ukraine* explores the lessons Europe has failed to learn from history. His book examines the causes of conflict in Ukraine, domestic and international, some of it often missed in media coverage.**

The crisis was set in motion by the EU's attempt to absorb Ukraine with an Association Agreement in November 2013. It would have eliminated trade quotas and tariffs – but was incompatible with an existing network of partnerships, including Ukraine's free trade agreement with Russia, which feared being flooded with European goods.

More worrisome still for Russia was Article 7 of the agreement, which concerned Ukraine's security alignment. Though expressed in terms of peace and development, it implied direct competition with Russia. And as Sakwa notes, Ukraine's border is a mere 480km from Moscow. This ability to explore events from both perspectives is a strength of the book, which will be of interest to anyone attempting to fathom the forces shaping Europe's future.

Sakwa, Professor of Russian and European Politics at the University of Kent, traces the roots of the Ukraine crisis back two decades to the asymmetric resolution of the Cold War. While the Warsaw Pact was dismantled, its counterpart the North Atlantic Treaty Organisation continued to expand, albeit under the peaceful guise of the European project of economic integration, market reform and liberal democracy.




Since 1989, all new members of the EU have also joined NATO, leading to Russia's perception that the west is using 'democracy promotion' to advance strategic aims. Where the west erred, Sakwa says, was in expecting Russia to behave like a defeated nation along German or Japanese lines and embrace democratic rebirth under western influence. It was irresponsible to expand to Russia's borders, absorbing Poland, Hungary and the Czech Republic, then the Baltic states in 2004, without expecting a response. Attempting to absorb Ukraine crossed Russia's red line.

This is the international aspect of the Ukraine conflict, with the country pulled east and west in an international tug-of-war. It has amplified Ukraine's domestic conflict – a separate crisis of unresolved tensions latent since Ukraine's independence in 1991.

### Domestic concerns

The project of Ukrainian nation-building has struggled to accommodate the diversity of languages, ethnicities and religions of 27 regions. Sakwa defines two competing ideals.

The unitary vision is of a pure Ukrainian nation administered from Kiev and excluding diversity – especially Russian-speakers. On the other hand, the pluralists would decentralise power to the regions and embrace the various cultural heritages across the country.

These domestic concerns blur into whether Ukraine should look east or west on the international stage. On 21 November 2013, as so often, it came down to cash. The EU was not promising much more than trading benefits and support, while asking Ukraine to adopt governance reforms and bring legislation in line with EU standards – the 100,000-odd pages of acquis communautaire.

Russia, in contrast, offered $15bn in support and preferential gas tariffs. This was all but impossible for Prime Minister Viktor Yanukovych to refuse. Ukraine's economy is smaller than in 1991. One in three people lives below the poverty line. Two decades of misrule have led to 100 people owning 80-85% of Ukraine's wealth, the shadow economy making up 44% of output, and monthly wages nine times lower than in Moscow.

By the time Yanukovych signed up with Russia on 17 December 2013 to reduce Ukraine's gas price by a third, half a million protestors had occupied buildings around the Maidan, Kiev's main square. The protest quickly shifted from a movement for an ideal to a violent revolution against the regime. Sakwa details shadowy US involvement revealed in taped exchanges. One of the minor but somewhat astonishing revelations of the book was that the EU spent €496m 'subsidising front groups' in 2004-13.

Russia, meanwhile, annexed Crimea, site of its Sevastopol naval base. While the west saw this as Russia tearing apart the status quo in an attempt to re-establish the USSR, Sakwa suggests that Russia behaved as a rational, conservative power, ratifying its borders.

The west's response of sanctions have not been a success. Diplomacy between equals gave way to asset freezes and travel bans on individuals (who have little to do with shaping Russian policy). Economic warfare – including blocking access to debt markets – has led Russia to deepen relations with Asia and the Brics, with effects yet to be seen.

### The way forward

Illusions that globalisation and trading interdependence would nullify conflict have been quashed. Sakwa advocates a commitment to pluralism in Ukraine's vision of statehood, and a pledge not to join a military alliance hostile to Russia – or indeed any military alliance.

Despite its disastrous economic performance, Ukraine has potential. It has an advanced shipping industry, 30% of the world's 'black earth' soil producing grains, sugar and vegetable oils, and oil and shale gas – albeit dominated by oligarch interests.

Ukraine could attempt to forge a path of its own, independent of east and west, and be the 'Switzerland of Eurasia' – allied with none but friends and traders with all. But confrontation will continue until there is a change in political leadership and willingness to engage in dialogue on all sides. To this end, this book is a timely contribution to efforts to grasp Russia's mode of thinking in a psychological and political conflict that could still tear Europe apart. ▪

Sophie Lewisohn is Editorial Manager, OMFIF.

# Oil prices expected to rise steadily

## OMFIF Advisory Board predicts a return to near $80 a barrel

In early February, when the oil price was around $50 per barrel, OMFIF asked its Advisory Board to estimate where the oil price will be every three months until March 2016. Answers ranged from peaks of $140 a barrel to lows of $45 a barrel. On average, responses showed the price rising steadily throughout the year to just below $80 a barrel in 12 months. The expected price points were $56.5 in June, $62.8 in September, $70.5 in December and $77.5 in March 2016.

### Oil prices, global events and OMFIF Advisory Board predictions

Brent crude Europe spot price (2000-15)

All time high: $145.61 (July 2008)

150
130
110
90
70
50
30
10

2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

Terrorist attacks on US

Lebanon conflict

Global financial crisis

Arab spring

Euro area crisis

OMFIF Advisory Board poll

$77

$71

$63

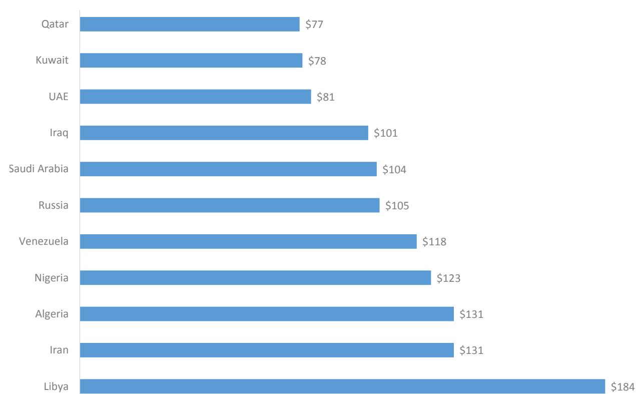
$56

Source: US Energy Information Administration

### Factors behind oil price fluctuations – oil exporters' budgets and US and Canadian supply changes

### Impact of oil price on exporting countries

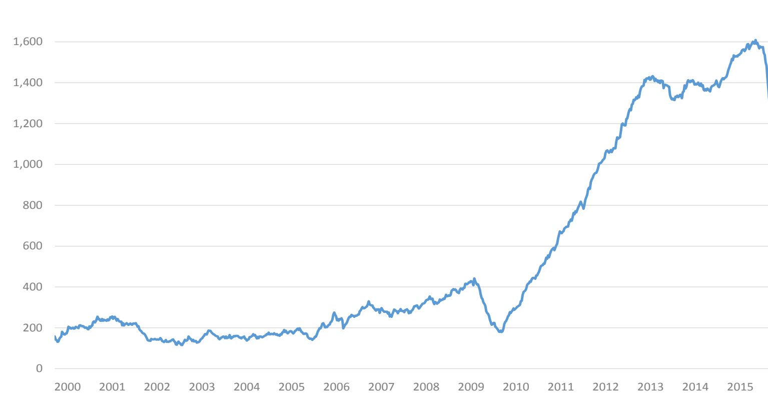
Oil price needed to balance budgets




Source: IMF and Deutsche Bank

### Active onshore oil rig count

North America 2000-14




Source: Baker Hughes

BANK ON GERMANY

As a central bank for more than 1,000 cooperative banks (Volksbanken und Raiffeisenbanken) and their 12,000 branch offices in Germany we have long been known for our stability and reliability. We are one of the market leaders in Germany and a renowned commercial bank with comprehensive expertise in international financing solutions, maintaining representations in major financial and commercial centers. Find out more about us: **www.dzbank.com.**