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The Bulletin

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

Abenomics, again
World watches Japan juggling

Akinari Horii on Japan's productivity tasks
Sahoko Kaji on the perils of demography
Takehiko Nakao on the multicurrency system
Shumpei Takemori on foreign investors
John West on Tokyo's efforts on 'Womenomics'

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COVER STORY: Abenomics, again

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EDITORIAL

Japan interest rate juggling provides ECB lessons

Japan's monetary stance, long the subject of fascination for western observers, is becoming increasingly relevant for European Central Bank policy-makers and followers. Not least for this reason, we put Japanese monetary policies, and more generally the long-running 'Abenomics' juggling act orchestrated by Prime Minister Shinzo Abe, under the spotlight in the March edition of the Bulletin. Haruhiko Kuroda, governor of the Bank of Japan, in January breached a taboo by extending interest rates into negative territory, introducing a set of exemptions to try to prevent the move impinging over-negatively on banking profits. This is part of a macroeconomic remodelling – dubbed 'Abenomics 2.0' – because the first version plainly was not working as planned.

Some form of Japan-style 'tiering' of negative interest rates appears high on the agenda of the ECB's decision-making council when it deliberates fresh monetary easing on 10 March – in the face of widespread doubts over the efficacy of further asset purchases and cuts in the ECB's deposit rate, already at minus 0.3%.

Japanese monetary policy can excite strong emotions. As pointed out by Masaaki Shirakawa, Kuroda's predecessor, the pinnacle of bitter experience of BoJ underwriting of government bonds came with 1930s Finance Minister Korekiyo Takahashi. At first successfully, he initiated the practice, but was eventually assassinated in 1936 by militarists when he was trying to stop ever-growing demand for military spending, which eventually led to rampant inflation.

Events in 2016 are more low key, but do not lack drama, as explained by a variety of Japanese writers. Shumpei Takemori chastises the Japanese authorities for having lulled foreign investors into thinking that Japanese assets are safe. He praises OMFIF Chairman John Plender for telling purchasers of Japanese government bonds to beware the BoJ's increased governmental dependence. Akinari Horii says that the rise in asset prices thus far has not led to unsustainable bubbles – but he voices scepticism about negative rates. Chris Scicluna and Grant Lewis are more sanguine, pointing out how exemptions will shield retail depositors and bank profits. Sahoko Kaji writes that demographics is the weak link in Abenomics. John West emphasises the need for more migrants and expounds the benefits of 'Womenomics'.

Darrell Delamaide describes the change of mood at the Federal Reserve on interest rate increases, emphasising that the watchword for monetary policy in coming months is 'dead slow ahead'. Ben Robinson outlines the better growth climate in Spain, expounded by Luis Maria Linde, governor of the Banco de España, at an OMFIF meeting in London on 9 February. Ernst Welteke explains his scepticism about the ECB's rotating voting system.

In emerging markets, John Adams highlights the political frustration leading to the birth of the New Development Bank and the Asian Infrastructure Investment Bank. Haihong Gao describes the phasing out of China's hukou system of residence registration that has impeded economic development. David Smith says Argentina's landmark deal with creditors should allow newly-elected President Mauricio Macri to 'take his agenda to the capital markets'. Nick Butler analyses the effects on sovereign funds of the oil price fall. Gus O'Donnell says that collaboration between the private and public sectors will be key to fulfilling pledges made at December's COP21 climate conference in Paris. George Hoguet reviews a timely analysis of global recessions and recoveries. We round off with poll findings showing most members of the OMFIF advisory board expect China rather than Japan will better master its economic challenges in the next three years.

Demography challenge facing Japan

Government relaunches flagship economic policy

Sahoko Kaji, Advisory Board

The Japanese government has reluctantly admitted that Prime Minister Shinzo Abe's demand-orientated policies set down in December 2012 have not worked as planned. This is the main reason for the September 2015 launch of a new package, 'Abenomics 2.0'.

The new package aims at the 'dynamic engagement of all citizens... in a ¥600tn economy' and ensuring that Japan's population remains above 100m. Like 'Abenomics 1.0', the new plan has three 'arrows' – a strong economy, increased child support and social security. The first is a composite of the three arrows that together comprised the first package – monetary policy, fiscal policy and growth strategy. The second and third are more distributional in nature.

Uncertainty continues to weigh heavily on Japanese psychology and on the real economy. The Japanese authorities will have to assuage doubts about the future before capital investment and consumption can pick up again towards steady growth. Preliminary figures for the fourth quarter of 2015 indicate that capital investment grew by 1.4% while household consumption fell by 0.8%.

Productivity is held back by resource misallocation and ossified economic structures. Connections between the main political parties and established industries such as electricity, medicine and agriculture are blocking the creation of new industries, even following Japan's decision to join the Trans-Pacific Partnership free trade agreement.

And while the labour market is tightening – unemployment was just 3.3% in December – this is hardly cause for cheer when productivity (output per hour) is lower than in the US, Singapore, Australia, the EU, Hong Kong and Taiwan, according to the Asian Productivity Organisation. Wages are stagnating, while household spending fell by 4.4% year-on-year in December.

Elections are in the air. Not surprisingly in view of Japan's poor demographics – the population has fallen 947,000 since 2010 – the Abe administration favours the middle-aged and elderly over the young, reflected in a pledge to hand ¥30,000 each to 1.1m low-income elderly as part of a supplementary budget worth ¥3.3tn. There are fewer young people and they vote half as often as their elders. From their point of view, politicians are behaving rationally. The over-50s accounted for 62% of votes cast in the November 2014 general elections.

Japan needs to aim for longer-term goals of fiscal, demographic and environmental sustainability. This is unlikely to happen unless younger voters get more involved in the democratic process. So demography has emerged as a major impediment to positive change. ■

Prof. Sahoko Kaji is Professor of Economics at Keio University.

Briefings

Ghana-OMFIF meeting on Africa opportunities

At a meeting at the Ghana High Commission on 8 February, OMFIF Managing Director David Marsh discussed with High Commissioner Victor Emmanuel Smith some of the main themes of the OMFIF Press book *The Convergence of Nations*.

By developing financial markets and attracting private capital, African businesses can access long-term financing, crucial for investment to drive industrialisation. Curbing illicit outflows of capital – not just through regulation but by improving domestic investment returns – can improve Africa's self-funding capacity. The fall in oil and commodity prices, although painful for several key Africa economies, including Ghana's, can help put business and finance on to a more responsible footing, although curbing past excesses will take time.

Medcraft highlights blockchain potential

The world economy can benefit from new ways such as blockchain for assuring liquidity and helping transaction flows on securities markets, Greg Medcraft, chairman of the International Organisation of Securities Commissions, told an OMFIF meeting on 15 February.

The intervention by Medcraft, who is also chairman of the Australian Securities and Investments Commission, came as innovations in financial technology have been moving up the list of worrying factors for financial policy-makers and regulators. Medcraft made clear that regulators have to tread a fine line on technological innovations with potentially transformative implications such as blockchain, the open-ledger technology that supports bitcoin, the cryptocurrency, which itself is under scrutiny from regulators around the world.

Lawson outlines reasons for UK No to EU

Lord (Nigel) Lawson, former UK Chancellor of the Exchequer, told an OMFIF lunch on 10 February in London that over-regulation in Europe and the continent's overall loss of economic prowess were good reasons for Britain to leave the EU.

Lawson criticised the EU's 'democratic deficit' and said that Britain as a self-governing democracy with a global outlook could prosper outside. The discussion ranged over the security and economic implications of a British departure and the distraction for civil servants from a major exercise to put the relations of a non-member Britain with the remaining EU on to a new footing. Lawson said the UK's main defence relationships were with Nato rather than the EU. He played down suggestions that a UK departure would harm the prowess of the City of London.

Linde discusses growth and banking profitability

Spain's higher-than-average economic growth and the effects on Spanish banking profitability of further cuts in negative interest rates in Europe were among the issues discussed with Luis Maria Linde, governor of the Banco de España, at an OMFIF City Lecture in London on 9 February.

Spain has been among the beneficiaries of low oil prices and a weak euro, with growth the strongest out of any large euro area country. Structural reforms and fiscal readjustments, along with 'internal devaluation' through reimposed budgetary discipline and efforts to bring down industrial costs, have played their part too.

Labour market reforms which have made hiring and firing workers easier and which increase flexibility in labour and pay negotiations mean firms no longer 'adjust to economic slowdown by dismissing workers or closing down'.

Despite some promising signs, optimism in the euro area remains at a low ebb, notwithstanding 11 quarters of growth. Participants in the question and answer session suggested that low interest rates, low inflation and further quantitative easing were limiting confidence in the underlying strength of the euro area economy.

There is a general belief that QE has artificially lowered borrowing rates and increased moral hazard. This has distorted asset prices, led to diminishing returns and resulted in a misallocation of financial resources.

More worrying for some participants was the effect of these measures on the risk premia of sovereign debt on banks' balance sheets.

Low interest rates have reduced bank profitability in the euro area, creating further difficulties. The loan-deposit gap is at a historically narrow level. Several participants expressed concern over the prospect of a further reduction in interest rates at the 10 March ECB monetary policy meeting, where there has been speculation of a further cut in the ECB's deposit rate from minus 0.3% to minus 0.4%.

For a full account of the meeting with Luis Maria Linde, see p.18-19.

Rotation under scrutiny

Scepticism on ECB meeting votes

Ernst Welteke, Advisory Board

On 10 March, at the next monetary policy-making meeting of the European Central Bank's governing council, Jens Weidmann, president of the Bundesbank, will not have a vote. This is the result of an elaborate change in the ECB's voting procedures, under a decision in February 2003 (when I was a member of the ECB council) which took effect last year.

These circumstances are unfortunate, at a meeting that is widely expected to take somewhat controversial (in Germany at least) decisions on further monetary easing. Germany and its central bank are the biggest shareholder and the largest creditor in the euro system.

Weidmann's temporary disenfranchisement (for just one month) will probably not make much difference to the outcome, since other governing council members who hold contrasting monetary policy positions will also not have a vote. However, his absence from voting could have psychological consequences.

Weidmann's move from the voting lists reflects a 'rotation system' decided by the governing council 13 years ago. The decision, subsequently endorsed by the European Council, was designed to allow the ECB 'to take decisions in a timely and effective manner... in an enlarged euro area' by assuring that the total number of governors authorised to vote would not exceed 15.

As part of the governing council who took the decision, I must say that my scepticism was justified. Wim Duisenberg, the ECB president at the time, pressed me into setting aside my objections and voting for the motion. With the benefit of hindsight I can say that wider public discussion would have been helpful.

It is difficult to find a convincing argument in favour. All national central bank governors continue to participate in the governing council's discussions. So limiting voting rights neither increases nor safeguards the efficiency of its deliberations, nor mitigates their length.

The change in the voting procedures affects two ECB guiding principles: first, 'one member – one vote', second, that the governors are appointed in their personal capacity as experts and not as representatives of their member states. The latter is the basis for the former.

The power of the executive board, with constant voting rights, is strengthened. The system increases the voting power of the governors from the five largest economies over that of the smaller ones. Further adding to confusion, the system changes votes on a monthly basis, whereas the monetary policy meetings now take place every six weeks. All this raises the complexity of communicating the ECB's monetary policy decisions, at a time when these matters are subject to conflicting opinions.

Ernst Welteke was President, Deutsche Bundesbank, between 1999 and 2004.

Monetary union and the Holy Roman Empire

Neither holy nor Roman nor an empire was Voltaire's verdict on the patchwork of several hundred semi-sovereign principalities, townships and fiefdoms spread out over Europe from medieval times up to the early 19th century.

The French writer-philosopher would take a similarly dim view of economic and monetary union, which is not working economically, mixes up monetary and fiscal policy and is looking ever less like a union. But one point is clear – EMU appears increasingly similar to the Holy Roman Empire.

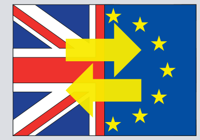
As results from the Irish legislative elections on 25 February underlined, the decision-making bonds among EMU states are becoming progressively weaker, partly because no one is actually in charge.

This was the third consecutive European election demonstrating dissonance and fragmentation, following similarly inconclusive outcomes and swings to smaller anti-establishment parties in Portugal in October and Spain in December.

Irish Prime Minister Enda Kenny – despite presiding over Europe's most impressive recovery following a deep recession in the wake of the euro's post-2010 crisis – failed to win sufficient support to assure his coalition government's return to office.

More disarray will be on show on 10 March. The governing council of the European Central Bank meets to decide further easing of monetary policy, probably including a further cut in negative interest rates. The measures will command a majority on the decision-making council. But they will end up pleasing virtually no one throughout the 19-member bloc.

Europe meetings



ECB's monetary policy: how to combat low inflation
Otmar Issing, Center for Financial Studies, Frankfurt and former member of ECB executive board
2 March, London

Monetary policy in Europe
Christian Noyer, former governor, Banque de France, former chairman, Bank for International Settlements
3 March, London

Britain's future in Europe
Wolfgang Schäuble, German finance minister, with British and German policy-makers debating the UK's potential EU exit
3 March, London

Europe's Deadlock by David Marsh
OMFIF discussion on how to solve the crisis of the single currency
22 March, London

Banking in central and eastern Europe
OMFIF Economists Meeting at the Narodowy Bank Polski
27 April, Warsaw

Asia meetings

Risk management in a multicurrency system
A roundtable for public sector asset managers, with John Mourmouras, deputy governor, Bank of Greece.
29 March, Singapore

Evolution of multicurrency reserve system
Renminbi Liaison Network in Beijing
24 May, Beijing

Capital markets for sustainable growth
Asian Development Bank-OMFIF seminar
21 July, Tokyo

Asia-Pacific and the global financial system
Sixth Annual Asian Central Banks' Watchers (ACBWG) Meeting
17 November, Singapore

Monetary policy in Japan
OMFIF Policy Meeting co-hosted with the Japan Center for Economic Research
21 November, Tokyo

Growth requires higher productivity

Japan emerges from deflationary mindset

Akinari Horii, Advisory Board

First the good news. The Bank of Japan's policy of quantitative and qualitative easing (the qualitative element targeting certain assets to drive up prices and reduce yields) has increased asset prices as part of an improvement in the BoJ's transmission mechanism, although this rise is yet to become excessive.

The risk of hyperinflation is even more remote than that of asset bubbles. There is no large-scale build-up of leverage in the private sector, and worrying about the risk of unsustainable bubbles in the economy is premature.

But there are risks attached to prolonged QQE, and – when exit finally approaches – the market will anticipate central bank action and interest rates could jump abruptly. This could trigger volatility on fixed income markets, disruption in the financial system and a premature economic downturn.

The BoJ announced in January that it would apply a negative interest rate to some excess bank reserves held at the bank. But central banking works effectively only in tandem with efficient money markets and a sound banking system. Negative interest rates could undermine this. The policy has no precedent in Japan's monetary history. It is unclear whether it will bring the desired equilibrium.

Premature central bank normalisation may undermine positive dynamics in the economy, but procrastination could eventually produce much higher inflation than desired. Both risks increase in proportion to the size of the fiscal imbalance and accumulation of public debt. Central bankers have cause to emphasise the importance of fiscal consolidation when engaging in ultra-easy monetary policy.

QQE and its critics

Critics argue that monetary policy alone cannot raise trend growth and that it only buys time before structural policy takes effect. They say that Japan's slow economic growth-cum-deflation can largely be attributed to a declining and aging population. In addition, deflation in Japan has been persistent and mild, and not caused problems on a par with the deflationary spiral of the 1930s.

Other critics maintain that QQE has swollen financial asset prices, distorted resource allocation and paved the way for the bursting of asset bubbles. They believe that additional liquidity cannot easily be drawn down, and that there is a risk of hyperinflation.

These risks have global implications. QQE in Japan and quantitative easing in the US have fuelled credit bubbles in emerging market economies.

I have some sympathy with such analysis, but disagree with the main arguments surrounding the monetary policy-economic growth nexus – or 'non-nexus' to be more precise.

The risk-sensitive critique is correct in that monetary policy influences financial asset prices. QQE has put upward pressure on equity and bond prices in yen, while putting the yen under downward pressure on foreign exchange markets.

These changes in financial asset prices have, in turn, influenced allocations and prices in a wider spectrum of assets such as commodities, property, goods and services. In other words, the change in liquidity in the system is shifting the old deflationary equilibrium into a new general equilibrium characterised by mild inflation.

> ***"Monetary policy influences financial asset prices. QQE has put upward pressure on equity and bond prices in yen, while putting the yen under downward pressure on foreign exchange markets.***

Deflationary equilibrium

Before Prime Minister Shinzo Abe launched the package of structural reforms known as 'Abenomics' in 2012, a general equilibrium had been reached under a relatively tight monetary policy.

This policy allowed deflation to persist, real interest rates to stay high and the yen to stay strong on exchange markets. A deflationary mindset was firmly established. Investments in cash, bank deposits and Japanese government bonds were encouraged as deflation enhanced their purchasing power. Equity investment, goods investment and borrowing were penalised.

From the individual's viewpoint, it made sense to minimise risk-taking and sit on cash. From a macroeconomic perspective, the lower the risk-taking, the lower the prospects for economic growth. A resurgence of economic growth would require technological innovation and resource reallocation from 'zombie' companies and sectors to more productive ones. By restraining risk-taking, tight monetary policy limited trend growth before QQE was launched.

Abenomics: Searching for a new equilibrium

Many domestic observers believe that a declining population is the main cause of slow growth, resulting in deflation. Population growth was 1% per annum in the 1960s, when the economy grew by more than 10% per year, and rose to a little over 1% in the early 1970s before gradually declining over time.

Before the bubble burst in the early 1990s, the economy grew at an annual rate of 4-5%. The recent annual growth decline to 0.5% mainly reflects lower productivity gains.

There are two other examples of 'growth arithmetic' which suggest the need for further evidence on the link between population and growth. First, while Germany's population barely increased in the 2000s and declined towards the end of the decade – even including migration – the economy grew without deflation.

Second, according to Bank of Japan Deputy Governor Hiroshi Nakaso in a speech in New York in February, average labour productivity in Japan was 30% lower than in the US or Germany in 2014. This suggests considerable room for productivity gains, and subsequent economic growth. The message for all concerned is clear: Japan's economic salvation must lie in creating an environment for higher productivity growth. ■

Akinari Horii is a Special Advisor and Member of the Board at the Canon Institute for Global Studies. He was Assistant Governor of the Bank of Japan between 2006 and 2010.

Yen remains hostage to risk

BoJ set to hold 50% of JGBs by end-2017

Chris Scicluna and Grant Lewis, Daiwa Capital Markets Europe

The Bank of Japan came to a fork in the road in January between more asset purchases or negative rates. It took the latter option, announcing a 'negative' interest rate on some excess reserves held at the central bank. The bank seems bound to push interest rates further into negative territory in due course – a move that may have to be accompanied by an eventual tapering of its asset purchase programme.

January's announcement therefore can be viewed as the first step towards a new monetary policy framework focused on interest rates rather than asset purchases – and mark the beginning of the end for a programme of quantitative and qualitative easing. The programme bolstered inflation without reaching the 2% inflation target the BoJ has set itself. The bank will take some satisfaction from a marked drop in Japanese government bond yields. But it will be aggrieved that, despite extensive easing, the yen remains relatively strong, hostage to fluctuations in global risk appetite.

Modest impact on interest rates

The move to negative rates took almost everyone by surprise. BoJ officials had consistently said that imposing a negative rate on excess reserves was not on the agenda – not least because this could work against its asset purchase programme and harm Japanese banks.

Little more than a week before its January policy meeting, BoJ Governor Haruhiko Kuroda was still insisting that the central bank was not seriously considering cutting interest paid on excess reserves.

January's announcement will not actually deliver a negative interest rate for the majority of banks' excess reserves held at the BoJ. Unlike the European Central Bank, where a single rate is applied to all such reserves, the BoJ has introduced a multi-tiered system closer to arrangements in place in Switzerland and Denmark.

As such, the impact on the average interest rate on bank reserves will be far more modest than the headline minus 0.1% rate implies. Only an increase in banks' current account balances will attract the negative rate.

On average, more than two-thirds of reserves will continue to earn 0.1% over the coming year, with a sizeable additional share earning 0%. Even assuming the full proceeds of BoJ asset purchases this year are recycled back into excess reserves at the central bank, the average interest rate applied to banks' current account balances will be more than 0.05%, rather than minus 0.1%.

If the BoJ continues to purchase JGBs and this prompts a corresponding increase in current account balances, the point could come at which the average rate on banks' reserves falls below zero. But the BoJ has said it will increase the amount of current account balances earning zero as outstanding balances increase in view of QQE.

The central bank will determine the size and frequency of adjustments as it weighs the impact of the new policy on money market interest rates against its effects on the banking sector. But it does not intend banks' reserves to be subject to a negative average interest rate for now, or possibly ever.

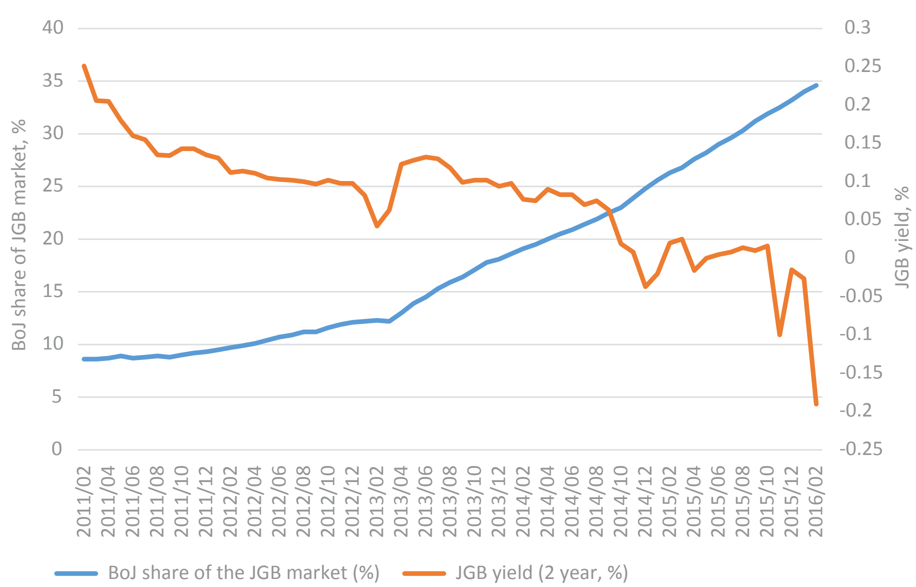
> ***"The impact on the average interest rate on bank reserves will be more modest than the headline minus 0.1% rate implies. Only an increase in banks' current account balances will attract the negative rate.***

This raises the question of why the BoJ is doing this at all.

With economic conditions having deteriorated and the BoJ cutting its core consumer price inflation forecast for 2016-17 from 1.4% to 0.8%, the central bank felt it needed to do something to maintain the slight improvement in underlying inflation in both November and December.

Rapid growth in Japanese government bonds held by Bank of Japan

BoJ share of JGB market against JGB yield, 2011-16



Sources: Japan Macro Advisors, Bloomberg

Reaching JGB purchase limits

But there is a growing realisation that – given the needs of banks and other institutions to retain some JGBs for collateral and asset-liability matching purposes – the BoJ may soon reach the limits to further JGB purchases at the current rate. If it continues to purchase JGBs at this rate, it will hold 50% of these assets by end-2017.

The BoJ has found itself in a difficult situation. It could raise its target for JGB purchases and risk missing it. Or it could introduce negative rates, threatening the achievement of even its current JGB purchase programme. The central bank is trying to steer a middle ground. It is introducing a negative rate on bank reserves to shift the yield curve lower, and is willing to buy JGBs at yields even lower than minus 0.1% to encourage institutions to sell them to it. But at the same time it is ensuring that banks are not subject to an overall negative rate at all. ■

Chris Scicluna is Head of the Economic Research Department and Grant Lewis is Head of Research at Daiwa Capital Markets Europe.

Japan's benefits from 'Womenomics'

Need to harness migrants to revitalise economy

John West, Advisory Board

Prime Minister Shinzo Abe's government needs to abandon its ad hoc, reactive approach to immigration. It should elaborate a comprehensive immigration policy as an integral part of the country's medium term growth strategy – particularly as immigration is an important complement to other policy issues.

As Japan's working-age population continues to decline, labour shortages are adversely affecting economic growth, a problem that has increased significantly over the past decade. The Daiwa Institute of Research has forecast labour shortages of between 340,000 and 660,000 in 2015-16, cutting GDP by around 2%.

Such shortages are most pronounced in the construction, healthcare, home help and long-term care, and restaurant sectors. This is challenging for reconstruction efforts following the 2011 earthquake, tsunami and Fukushima nuclear plant accident, as well as preparations for the 2020 Olympic Games.

Attracting foreign workers

Japan has traditionally been averse to immigration because of the notions of cultural uniqueness and homogeneity that pervade Japanese thinking. But immigration has become a topic of lively debate over the past couple of decades, particularly since the country's working age population began to decline in 1995.

While the foreign population has increased from about 1% of the total in 1990 to 2% today, Japan has the lowest foreign population as a share of the total of all the advanced Organisation for Economic Co-operation and Development countries, with the exception of Mexico.

Immigration policies for lower skilled migrants remain highly restrictive. And while Japan is very welcoming to highly skilled migrants, it has struggled to attract them. The Swiss-based International Institute for Management Development's *World Competitiveness Yearbook 2014* ranked Japan 48th out of 60 countries in terms of its 'attractiveness to foreign-born highly skilled professionals'.

Addressing the issues

The corporate sector and some commentators have called for Japan to become more open to immigration. 'Abenomics' – the government's flagship economic programme aimed at revitalising the economy – includes a policy to increase the utilisation of foreign workers.

But while the Abe administration has implemented some measures for highly skilled foreign professionals and for lengthening the stay of 'internship' migrants from three to five years, such responses remain very modest.

There seems to be little end in sight to Japan's labour shortage problems. Under one scenario, the government projects the labour force to shrink from 66.3m in 2010 to 56.8m in 2030, with economic growth remaining near zero.

> ***"Given its concern over the cultural suitability of potential migrants, Japan could make greater efforts to facilitate the integration of international students into the economy, following graduation.***

'Womenomics' – enhancing women's participation in the economy – is a potentially powerful element of the Abenomics programme. According to the OECD, GDP could increase by almost 20% if the female labour participation rate converged with that of men by 2030. But restrictions on immigration by home help and care workers make it difficult for Japanese women to combine work and family life.

Japan's performance has also been relatively weak in the fields of entrepreneurship and innovation. According to the Global Entrepreneurship Monitor, a university-led consortium monitoring levels of entrepreneurial activity worldwide, in Japan this has been particularly low since the consortium began collecting data in 1999. In 2014, it was the second lowest of more than 100 countries surveyed (just ahead of Suriname). In this context, many studies have shown that well-managed migration can be a powerful source of entrepreneurship and innovation.

Greater openness to immigration could aid the Abe administration's ambitious target of increasing the stock of foreign direct investment into Japan to 8%. Many migrants arrive with assets for investment, as well as being attractive to international companies seeking bilingual staff. At a time when Japan is seeking more diplomatic friends in Asia, greater openness to immigration would be an important gesture of friendship.

Given its concern over the cultural suitability of potential migrants, Japan could make greater efforts to facilitate the integration of international students into the economy, following graduation.

After a few years' study, such students are usually at ease with the Japanese language and cultural customs. But fewer than 10% currently seek working visas. Targeting international students as potential migrants could enhance Japan's attractiveness as an international education destination.

The question is whether Japan will open up to immigration as a potential source of economic revitalisation. Abe and many parts of the government remain steadfastly opposed to having an immigration policy, citing the social and political problems Europe has experienced with large-scale immigration.

Some government ministers have spoken out in favour of increased immigration, while a recent poll by national newspaper Asahi Shimbun showed that public opinion may be changing. According to the poll, 51% of respondents said they supported Japan accepting foreigners who want to settle in the country.

Revitalising the economy

For Japan, revitalising the economy is imperative. Growth has fallen to 0.5% and the population is slated to fall from its current 127m to 87m in 2060, when 40% of the population will be 65 or over.

Without more serious efforts, Japan could simply wither under the weight of poor demographics and the burden of massive public debt, increasing its vulnerability to growing fragility in the regional security environment. A well-designed immigration strategy could make an important contribution to Japan's future. ■

John West is Executive Director of the Asian Century Institute.

The trap of Japan's haven status

Foreign investors should guard against over-confidence

Shumpei Takemori, Advisory Board

Many foreign investors appear to believe that Japan is a safe haven for internationally mobile capital. But appearances can be deceptive. What seems like safety can actually be a trap.

The Japanese monetary authorities should teach the world the truth: Japanese investments are, in reality, replete with risk. The more markets trust in the safety of the Japanese system, the greater will be the upward pressure on the yen, which is inimical to the success of Prime Minister Shinzo Abe's economic policies – and the quicker Japan will slide towards inexorable decline.

In the topsy-turvy world of 21st-century economics, when the economy moves from an inflationary into a deflationary environment, the traditional moral code of monetary policy – the time-honoured distinction between virtue and vice – is turned on its head.

Whereas the lodestar for central banks used to be a reduction in inflation and a rise in the currency, the opposite is now true: higher inflation and currency depreciation are the sought-after objectives. For central bankers combating the adversary of currency appreciation, yesterday's enemy becomes your friend; your former friend is now the enemy.

One of the problem for the Japanese government and Bank of Japan is that the Chinese authorities are in the exactly opposite position. The financial markets distrust the renminbi system, and wish to push the currency down. Whereas the Beijing authorities, for the time being at least, want to keep the currency stable.

Amid tumbling stock markets, Chinese policy-makers are facing serious challenges. But the possibility that the renminbi could appreciate inexorably as the yen has done is not one of them.

Paradoxical exchange rate movement

In the Japanese case, there are some intriguing parallels to 2011 when, in the aftermath of the triple catastrophe of an earthquake, tsunami and nuclear accident, the yen hit record highs, prompting the G7 countries (Canada, France, Germany, Great Britain, Italy, Japan, and the US) to intervene in the foreign exchange markets.

The paradoxical exchange rate movement occurred because, seeing the homeland in crisis, Japanese financial institutions repatriated their dollar holdings, prompting large-scale dollar sales and yen-buying.

We see the same tendency today, albeit for different reasons: a super-strong yen would asphyxiate rather than revive the economy. The consequence is that the Tokyo government and central bank must combat the deeply ingrained but flawed perception that Japan is a safe haven.

The success of Abenomics rests on keeping the yen weak, boosting corporate earnings, spilling over into increased wages and leading to a pick-up in investment. A rising yen jeopardises this felicitous cycle.

Quantitative easing bottleneck

One of the reasons for the yen's renewed gains is that the markets believe that the Tokyo's policies on monetary easing have run out of steam – and that the yen will rise as a result. Market practitioners argue the Bank of Japan's quantitative easing through massive monthly purchases of assets will soon hit a bottleneck, reflecting the financial sector's aversion to parting with Japanese government bonds.

Many believe, too, the scope of the central bank's new instrument – a negative interest rate on banks' excess deposits held at the central bank – will be limited by the authorities' worries about reducing bank profitability.

In the authorities' campaign to disabuse markets of their belief in the safe haven effect, all weapons are good ones. OMFIF Chairman John Plender wrote in a commentary on 11 February: 'The supposedly independent Japanese central bank has become a tool in the hands of Shinzo Abe, the fiercely expansionist prime minister. This is perilous territory, where the potential for good or bad economic outcomes is finely balanced.'

Splendid! Plender has done our country a great service. The government might consider decorating him or recruiting him as a BoJ spokesman.

I could go a little further in inventing a new motto for our central bank, which might be used as a disclaimer on every contract for the purchase of a Japanese asset: 'The BoJ is a central bank completely subservient to and under the total control of the government. Its principal aim is to inflate away public debts of epic proportion, so that the government can continue to pursue pet projects. Occasionally, the central bank finds solace in harassing domestic banks by imposing high penalties for putting their money in our deposit account. We cannot take any responsibility towards foreign investors. If they imagine that money under the control of such an irresponsible institution can be sound, and decide to invest their money in our territory, they should take full responsibility for the disasters their own reckless action will surely invite.'

Poor long-term prospects

With adverse demographics, ultra-low growth and high public debt, the Japanese economy's long-term prospects are viewed as poor. But this has not prevented foreign investors from embarking on a buying spree.

Investors believe that they can safely offload their holdings of Japanese assets before doomsday arrives. If domestic market conditions suddenly deteriorate, they believe, the authorities will mobilise the array of domestic institutions – Japan Post Bank, the state pension fund, Japanese megabanks, and the Bank of Japan – to pick up assets dumped by foreign investors, who would then escape virtually unscathed.

> ***"The success of Abenomics rests on keeping the yen weak, boosting corporate earnings, spilling over into increased wages and leading to a pick-up in investment.***

This notion is in fact dangerous nonsense. Investors need to approach Japan with the same caution as they now show to China. If the People's Bank of China stops intervening in support of the currency – a costly operation that has resulted in a sharp fall in dollar reserves and the disappearance of renminbi liquidity from financial markets – the currency would plummet. This would give the over-indebted economy an escape route in the form of increased exports.

This would be costly for foreigners invested in China, since, if market conditions deteriorate, domestic investors would withdraw too. Indeed, armed with better insider-information, domestic investors would probably exit before their international counterparts, as has already happened. China consequently cannot be considered a safe haven. The challenge for the Japanese authorities is to persuade foreign investors that the same applies to Japan. ■

Prof. Shumpei Takemori is Professor of Economics at Keio University.

Dollar will remain the pivot

World still waiting for multicurrency reserve system

Takehiko Nakao, Asian Development Bank

The dollar is the key currency in the international monetary system. It is backed by trust, as well as by US economic, political, cultural and military might. It is supported by the liquidity and depth of US financial and capital markets and the settlement infrastructure maintained by the US monetary authorities.

Some argue that, with declining US political and economic power, challenges are growing to the dollar's position. However, the US economy seems to have the flexibility and diversity to undergo needed dynamic transformation.

Some would argue that changing to a system of multiple key currencies would enhance stability. Competition between currencies would, it is said, enforce macroeconomic discipline. Others maintain that such a system would be less stable as differences in economic performances and interest rates among reserve-issuing countries would increase volatility of capital flows and exchange rates.

Supporters of a multiple currency system often cite the 1920s, when the pound, dollar and French franc co-existed as key currencies. That system, however, was based on the gold standard, when the value of each currency ultimately depended on the value of gold. It is doubtful whether that framework was a genuine system of multiple key currencies.

During the 1980s and into the 1990s policy-makers espoused a vision of a tripolar currency system based on the dollar, yen, and D-mark, but such an idea has now receded.

When one considers the possibility of another currency becoming parallel to or replacing the dollar, the euro is usually seen as the most promising candidate.

However, a key currency requires deep and liquid financial markets. In the case of the euro, each member country has a separate market for its government bonds. Market depth and liquidity are lower compared with the dollar. Some intrinsically difficult issues about the euro system have been brought to the fore by the euro crisis.

Internationalisation of the renminbi

Some people have suggested that the renminbi will become a key currency alongside the dollar in the future. There have been many reports on the 'internationalisation of the renminbi'.

However, promoting the usage of renminbi, even only for trade settlements, requires the liberalisation of capital accounts. Exporters to China want to manage their proceeds and importers want to finance their bills in renminbi. But convertibility in capital account transactions, which should be preceded by deregulation of domestic financial markets – including the liberalisation of interest rates – still requires a great deal of time in China.

Comparing China's economic development model with Japan's past high economic growth, China's model is more open to mobilising international capital, reflecting the changed international economic environment, and the Asian network of overseas Chinese. China may be able to internationalise its currency more quickly than Japan did, but this is not a simple matter.

> ***"Policy-makers should focus on efforts by countries and regions to strengthen the current system's stability, based on the premise that the dollar will remain the key currency.***

The status of the yen

How should we view the status of the yen? Since the time of the US-Japan yen dollar committee in the early 1980s, the Japanese government has pursued yen internationalisation. Important objectives have been promoting the yen's international use, especially in Asia, and upgrading the conditions for the yen to be freely selected to meet the needs of those engaged in transactions.

The ultimate vision was to make the international monetary system 'tripolar'. The 1960 adoption of free yen accounts, allowing the yen to be used in trade, marked the beginning. This was followed by liberalisation of current transactions in 1964 and capital transactions in 1980. Institutional reforms were finalised by complete liberalisation of capital transactions in 1998.

Enthusiasm about the tripolar system was highest at the pinnacle of Japan's economy, described as 'Japan as No 1' in the 1980s. Unfortunately, however, following sluggish growth and low returns on yen-denominated assets, it is difficult to conceive of the yen becoming a global currency.

Synthetic special drawing right

The International Monetary Fund's synthetic special drawing right is another area of attention. The London G20 summit in April 2009 agreed on a new SDR250bn allocation, a roughly tenfold increase.

With this allocation, emerging market countries and developing countries were able to attain foreign currency reserves at a lower cost than on the market as a buffer against sudden reversals of capital flow.

Even after the new allocation, SDRs accounted for only 3% of the world's foreign currency reserves. Moreover, an SDR is a mere synthetic currency composed of the dollar, euro, yen, and pound. There are no SDR banknotes or coins that can be used for transactions in the private sector.

It would be difficult to conceive of currencies such as the euro, the yen and the renminbi becoming global reserve currencies and means of payment on par with the dollar in the foreseeable future, even though their usage might expand in neighbouring countries and regions. Similarly, it is difficult to imagine SDRs playing such a role.

Policy-makers should focus on efforts by countries and regions to strengthen the current system's stability, based on the premise that the dollar will remain the key currency.

First and foremost, it is important that the US pursues appropriate macroeconomic policies including responsible fiscal management. Other major economies including the euro area, Japan and China should manage their economies responsibly with due regard to the international impact of their economic policies. They should draw on peer review frameworks such as IMF surveillance (monitoring of economic policy) and G20 mutual assessment. ■

Takehiko Nakao is President of the Asian Development Bank. This paper, underlining the relatively static nature of issues affecting the world monetary system, is an abbreviated version, without any updating, of the author's speech of March 2010 at the Institute of International Monetary Affairs, Tokyo, made in his capacity as director general of the international department of the Japanese ministry of finance. Nakao served as vice minister for international affairs from 2011 to 2013. For the full version, see www.iima.or.jp/Docs/symposium/20100318/Mr_Nakao_Speech_text_e.pdf

Caution prevails at the Fed

Downside risks may delay interest rate hikes

Darrell Delamaide, US editor

Caution is the new byword at the US Federal Reserve. The minutes of the Federal Open Market Committee's late January meeting, released on 17 February, are full of it.

Assessing disappointing data on spending and production, developments in commodity and financial markets, and significant weakening in foreign economies, 'participants judged that the overall implication of these developments for the outlook for domestic economic activity was unclear'. But 'they agreed that uncertainty had increased, and many saw these developments as increasing the downside risks to the outlook'.

The policy-makers noted several factors indicating a tightening of financial conditions. These were declining equity prices, widening credit spreads, a further rise in the dollar's exchange value, and increased volatility on financial markets.

So while the economic outlook remained unclear, 'members observed that, if the recent tightening of global financial conditions was sustained, it could be a factor amplifying downside risks'.

The consequences for monetary policy were evident – dead slow ahead.

A gradual approach

'A more gradual approach is an appropriate response to headwinds from abroad which slow exports, and financial volatility that raises the cost of funds to many firms,' Boston Fed Chief Eric Rosengren (voter) said in a mid-February speech at Colby College in Maine.

'In my own view, if inflation is slower to return to target, monetary policy normalisation should be unhurried.'

Patrick Harker (non-voter), who became president of the Philadelphia Fed last year, also expressed concern about inflation in the current sluggish economic environment.

'Although I cannot give you a definitive path for how policy will evolve, it might prove prudent to wait until the inflation data are stronger before we undertake a second rate hike,' Harker said at the University of Delaware. 'I am approaching near-term policy a bit more cautiously than I did a few months ago.'

As things settled down over the course of the month, policy-makers grew a little less cautious.

John Williams (non-voter), the dovish head of the San Francisco Fed, told the Los Angeles Times in late February that 'the big picture for me hasn't changed'.

Williams declined to say whether he would support a rate hike as early as March, but said, 'The basic approach we took, which is a gradual rate increase, is still right.'

Esther George (voter), the hawkish head of the Kansas City Fed, said her expectation of solid growth this year remains intact, and that a March rate hike should still be considered despite financial market volatility.

'It absolutely should be on the table,' she said in a Bloomberg interview. 'At this point I would not say that the data have suggested there has been a fundamental shift in the outlook.'

Richmond Fed President Jeffrey Lacker (non-voter) is less concerned about lagging inflation. For one thing, he said in a speech at Johns Hopkins University in Baltimore, Maryland, medium-term expectations are for inflation to climb back towards the Fed's 2% target range.

For another, the natural real interest rate is currently at or above zero, compared with the actual real rate in federal funds, which is below minus 1% if inflation is taken into account.

Some economists, Lacker said, believe that the real short-term interest rate should track the underlying natural real rate of interest if the Fed is to keep close to its inflation objective. 'This perspective would bolster the case for raising the federal funds rate target,' he said.

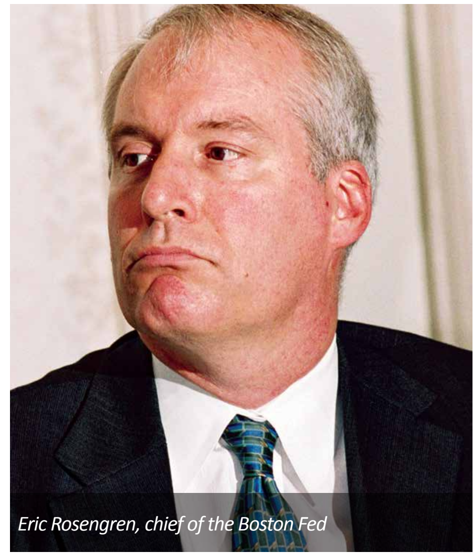
Decline in inflation expectations

However, St. Louis Fed chief James Bullard (voter) was less sanguine about inflation. In a mid-February speech to financial analysts in St. Louis, he said inflation expectations are now considered more important than the traditional Phillips curve effect (the historical inverse relationship between unemployment levels and inflation rates) and these expectations have him worried.

'I suggested during 2015 that inflation expectations would return to previous levels once oil prices stabilised,' Bullard said. 'Since then, inflation expectations have declined too far for comfort, the oil price correlation notwithstanding.'

The FOMC's 'normalisation' strategy of steady rate hikes presumed stable inflation expectations, but this has changed. 'I regard it as unwise to continue a normalisation strategy in an environment of declining market-based inflation expectations,' he said.

Newcomer Robert Kaplan (non-voter), who became president of the Dallas Fed in September, also remained cautious. He told the Financial Times in late February that a number of risks around the world might mean that the Fed would have to keep rates unchanged for a longer period.



Eric Rosengren, chief of the Boston Fed

"The consequences for monetary policy were evident – dead slow ahead.

'In order to reach our inflation objective, we may need to be more patient than previously thought,' the paper quoted him as saying.

'If that means we take an extended period of time where we stop and don't move, that may also be necessary. I am not pre-judging that.'

Fed Vice-Chair Stanley Fischer (voter), speaking at an energy conference in Houston in late February, also sounded a note of caution.

'If the recent financial market developments lead to a sustained tightening of financial conditions, they could signal a slowing in the global economy that could affect growth and inflation in the United States,' he said.

However, he noted that similar periods of volatility in recent years had had little impact on the economy. 'It is still early to judge the ramifications of the increased market volatility of the first seven weeks of 2016,' he said. ■

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

Oil exporters run down reserves

Fund drawdowns could cause wide economic damage

Nick Butler, Advisory Board

This year is shaping up to be a difficult one for oil producers and the sovereign wealth funds that have been built on oil revenues over the last decade.

Both of the world's benchmark crudes – Brent and West Texas Intermediate – have been trading below $40 a barrel since the start of the year (Chart 1). Even the prospect of a production freeze by Saudi Arabia and Russia, announced in February, has not lifted prices significantly. The production cut needed to reset the market still seems a long way off.

For countries that predominantly rely on oil export revenues – meaning all the member states of the Organisation of the Petroleum Exporting Countries as well as non-Opec members such as Russia and Mexico – this is very bad news. In most cases, national budgets for 2016 were based on assumed oil prices of $100 a barrel or more.

Many governments have begun cutting back on spending. But with growing populations and no alternative sources of revenue, they face hard choices. None of the countries involved has produced a plan that balances the books at $40 a barrel or less. The result is either increased borrowing or a rundown of reserves – or both.

Worldwide supply surplus

It seems clear that prices will remain low for the foreseeable future. The price decline has come despite conflicts across the Middle East and North Africa. Libya is in a state of civil war. Iran, despite last year's agreement with China, France, the Russian Federation, the UK, the US and Germany over its nuclear programme, is still subject to US sanctions. Oil production and export levels are below historic levels in both countries.

But worldwide there is still a supply surplus of around 2m bpd. Stocks are growing, and the overhang they create will limit any upward price movement for several years to come.

There is no obvious sign that either the Saudis, who could cut production if they wished, or the US oil producers who have benefitted from the revolution in fracking technology, are ready to change course. Supply remains strong and demand, particularly in China, looks set to offer no more than moderate growth over the next year at least.

Sovereign fund reserves

The most affected governments are turning their attention to the reserves that they have – in most cases held through sovereign funds.

The level of reserves varies, but anything is better than nothing. The expectation for the rest of 2016 must be that most, if not all, exporting countries will draw down their reserves. The rainy day has come and, given the choice, governments will raid reserves before imposing austerity.

The effect on the global asset market could be substantial. Sovereign wealth funds are now significant investors which for years have put money into a range of key asset classes, including equities, bonds and property.

Now this is being reversed, with some reports suggesting that sovereign funds recouped a net $46bn from asset managers last year, with around $58bn expected this year (Chart 2). With few funds in a position to invest more, the obvious question is who will buy. Asset prices could fall substantially.

> ***"The expectation for 2016 must be that most, if not all, exporting countries will draw down their reserves. Governments will raid reserves before imposing austerity.***

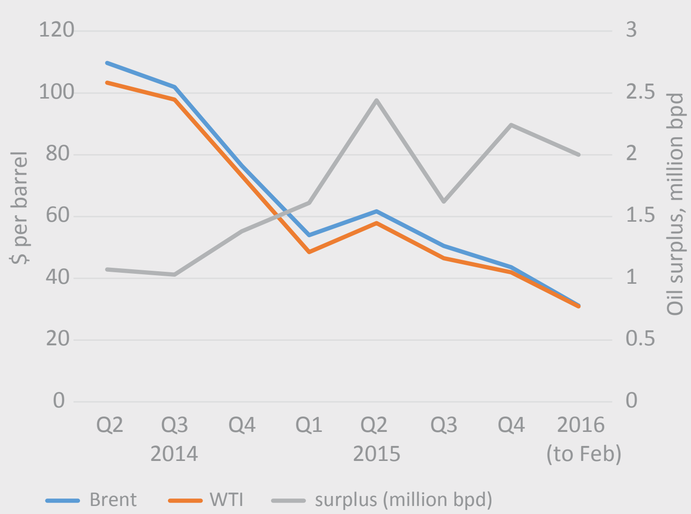
The traditional economic view is that falling energy prices benefit the global economy by giving consumers more money to spend. But that is too simplistic.

Significant parts of the economy, well beyond the energy sector itself, have come to depend on sovereign funds, which themselves are sustained by high oil prices. If prices remain low, the wider economic damage could be substantial. ■

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

Chart 1: Oversupply driving oil lower

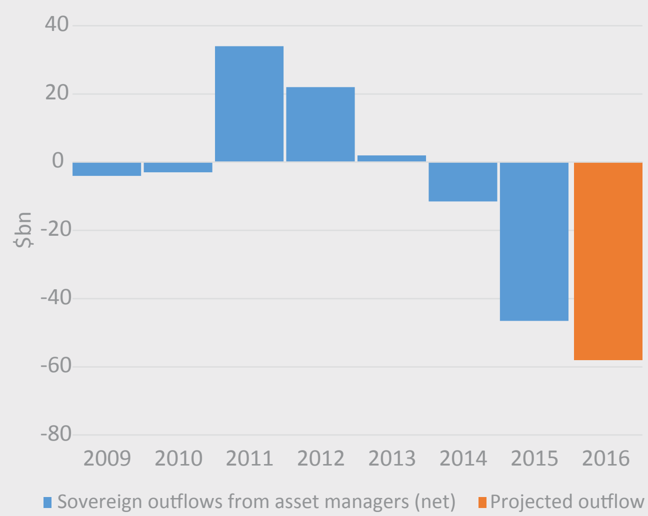
Price against surplus, 2014-16



Sources: International Energy Agency, Federal Reserve Economic Data

Chart 2: Net outflows increasing

Total sovereign outflows from asset managers, 2009-16



Sources: eVestment, Moody's

A product of political frustration

Danger signals for rules of engagement

John Adams, Advisory Board

The Brics Bank – now the New Development Bank – and the Asian Infrastructure Investment Bank were born out of political frustration and have highly political agendas.

Both reflect the frustration of China and the Brics countries with the voting systems of the World Bank – viewed as dominated by the West – and the Asian Development Bank, perceived as dominated by Japan. If the two newcomers can export China's enormous success in alleviating poverty since the end of the cultural revolution in 1976, this will be sufficient justification for their existence.

For China, this is a defining moment, when it can write its own rules of engagement for the first time.

Pressing domestic policy concerns

A large potential problem for these banks lies in the danger that they will be exposed to bureaucratic conflicts between states with heavily entrenched governmental policy bodies, slowing down decison-making and hampering coordination with other global development banks.

In addition the two banks may fall victim to the trend for the authorities in their respective countries to pay less attention to international financial issues, in view of pressing domestic policy concerns. The rise in bad loans across emerging market economies, a product of slower growth nearly everywhere, represents another headache.

Shanghai-headquartered NDB is an Indian initiative launched in July in which the five country shareholders – Brazil, Russia, India, China and South Africa – have equal voting rights. It will initially have capital of $50bn – again in equal shares, with around 20% to be paid in over the next seven years – eventually rising to $100bn.

The Chinese government launched Beijing-headquartered AIIB in October and holds 26.1% of the capital.

Both banks are seeking to lend to both governments and the private sector, and both are keen on public-private initiatives. The NDB views these as important, albeit not necessarily in significant amounts.

NDB projects will include infrastructure, though with a slant towards green technology and sustainable development. The AIIB will look at big ticket deals in Asia. There is no perceived competition from the Chinese side between the Chinese Export-Import Bank and the AIIB. There will also be some synergy between the two banks in coordinating projects and lending policies. This may slow decision-making a little, but is not viewed as a major problem.

Offsetting volatility

The NDB has one notable feature – a Contingency Reserve Arrangement of around $100bn. China effectively bankrolls this with a $41bn contribution and holds 39.95% of the fund's voting rights.

The fund's aim is to alleviate members' short-term balance of payment and liquidity pressures. Each of the five founder members will contribute in their own currencies, and the NDB will be able to make swaps both between these currencies and with the dollar.

The bank may use the currencies to make loans, including in renmimbi – increasing the amount outside China and the currency's international use.

> ***"Both banks are seeking to lend to governments and the private sector, and both are keen on public-private initiatives. The NDB views these as important, albeit not necessarily in significant amounts.***

One of the CRA's stated aims has been to offset volatility for NDB shareholders as the US withdraws from market easing and raises interest rates. That moment has now arrived. The potential negative effect on emerging market economies has been compounded by the collapse of the commodities on which some of the Brics nations depend. Furthermore, these countries' foreign exchange reserves are under pressure for the first time for several years, reducing available ammunition for the CRA just at the time when it may be needed. ■

John Adams is Chief Executive of China Financial Services.

New Development Bank

- Set up by Brazil, Russia, India, China and South Africa in July 2015
- Aims to fund infrastructure projects in developing nations
- Each country holds an equal number of shares and equal voting rights
- None of the countries has veto power
- $100bn contigent reserve arrangement
  China contributes $41bn, Russia, India and Brazil $18bn each, and South Africa $5bn
- India will preside for the first five years, followed by Brazil and Russia
- Based in Shanghai
- President K.V. Kamath, former managing director and CEO, ICICI Bank

Opening up the capital market channels

Macri deal with hold-out creditors pivotal for Argentina

David Smith, Advisory Board

March will mark the first 100 days of Argentina's new government and could be a key chapter in Mauricio Macri's presidency.

February ended with agreement in principle with all hold-out creditors, pending approval of the Argentine congress. It seems Argentina will pay around 75% of what it owes. The government plans to raise $15bn through a bond issue to fund this.

'Macri had to cut a deal with creditors holding out for top dollar,' said one of the country's leading construction magnates, who describes business as stagnant. 'We have to return to capital markets for investment, even to the International Monetary Fund, if we are to move forward. To grow again, we have to borrow, at a price we can afford.'

Hence the deal – an offer most creditors could not refuse.

'A deal may have been inevitable, but it was crucial,' said a major fund manager in Miami, whose clients include some of Latin America's wealthiest residents. 'Argentina is looking more and more like the key player to talk to in the region at large.'

The president has shown himself to be an astute pragmatist since taking power. Argentina has devalued by more than 40% following the lifting of capital controls imposed by his predecessor, Cristina Fernández de Kirchner. And the country is finally taking the medicine most economists deemed necessary to address rampant inflation and a sizeable fiscal deficit.

> ***"What matters now is Macri's capacity to take his agenda to capital markets, and raise the tens of billions of dollars required to kick-start the economy.***

The government has removed hefty export taxes on the country's vast agribusiness sector, encouraging farmers to return to world markets with soya, cereals, grain, beef and wine. The result is foreign exchange reserves relatively stable at $30bn.

What matters now is Macri's capacity to take his agenda to the capital markets, and raise the tens of billions of dollars required to kick-start an economy hampered by wasteful government spending, heavily regulated business practices and state subsidies.

'Macri gets it. The question is: does the public at large?' said one of the country's leading pollsters, who believes the president needs to articulate a way forward this month, particularly on inflation. The answer appears to be a resounding Yes. Macri's approval ratings show two-thirds of Argentines firmly behind the new leader.

A great deal is at stake. The deal could bring Argentina back to the international financial markets with a bond offering that would necessarily bear a much higher coupon than on most offerings. This could be very attractive to investors in the turbulent, low-yield market environment.

Macri's government, particularly with the encouragement of a US administration that views him as possibly its best ally in the sub-continent, could return to the IMF. This could pave the way to repatriation of large-scale foreign currency assets that Argentines hold outside their country.

'For so many wealthy Argentines, Macri is the last, best hope – the last chance to make our country normal,' said one wealthy Argentine investor from his home in exile in Miami. 'I can't predict what my countrymen and women will do. I do know they want to believe in Argentina once more.' ■

David Smith represented the UN Secretary-General in the Americas between 2004 and 2014.

China commits to hukou reforms

Increased worker mobility will help economic development

Haihong Gao, Advisory Board

China's hukou system – a modern form of residence registration discouraging workers from moving between rural and urban areas – has impeded the country's economic development. But reforms announced by the Communist party in November 2013 will see restrictions phased out in towns and smaller cities by 2020.

The system has its roots in a law drawn up to distinguish between rural and urban citizenship at a time of severe resource shortages and strict central government control over the economy. But China has experienced rapid economic growth since 1978, and the system has become outdated.

Reforms to the hukou system aim to increase labour mobility, strengthen social safeguards and create more education opportunities. For example, in small and medium-sized cities – with populations of no more than 5m – the differentiation between urban and rural citizens will be abolished. This means that more people will benefit from health insurance coverage and education.

China's economic structure reform and urbanisation will determine the pace of hukou reform. The system's restrictions helped prevent the establishment of large urban slums as huge numbers of migrant workers flowed into cities. They also allowed enterprises, particularly those in coastal areas, to keep labour costs low, allowing them to remain competitive in the global market. But China's most recent industrial upgrade and changes to the labour supply structure call for greater worker mobility, and an unreformed hukou system is a barrier to this.

The changes are closely linked to China's 'people-centred' urbanisation plan. By 2020, 60% of the population is expected to live in cities compared with 45% currently. An estimated 100m migrant workers will become urban residents by 2020. This will change China's social landscape while boosting domestic consumption.

Reform has to be gradual. As with all other reforms in China, removing such restrictions is about redistributing resources and wealth. The budgetary burden will largely fall on local governments. It is hard to believe that removing hukou restrictions can be the right choice without a well-established fiscal system and a sound medical insurance system.

A comprehensive reform agenda will be key to successful reform of the hukou system. The measures announced represent not only a policy guideline for key reform areas, but also a commitment by the Chinese government. As such, they have a greater prospect of success. ■

Haihong Gao is Director of the Research Centre for International Finance, Chinese Academy of Social Sciences.

Clean energy research gains $20bn

Co-operation is key to fulfilling Paris pledges on emissions

Gus O'Donnell, former UK Cabinet Secretary

Media reporting following December's climate change deal in Paris focused on pledges to reduce emissions to keep the increase in global temperatures 'well below two degrees', and to 'pursue efforts to limit the temperature increase to 1.5 degrees'. But there is widespread agreement that these pledges will be insufficient to reach this target, even if they are kept. There is also the issue of how exactly countries are going to fulfil these commitments.

In early 2014, Sir David King, the British foreign secretary's special representative for climate change, and six members of the UK House of Lords (upper house) outlined a radical proposal to achieve cuts of this nature using market forces – the Global Apollo Programme.

The idea was simple – to set the world's scientists, engineers and economists the goal of producing clean energy more cheaply than fossil fuels, much as President John Kennedy set US scientists the goal of putting a man on the moon within 10 years.

The idea gained traction in many countries, particularly after it was championed by British broadcaster and naturalist Sir David Attenborough, who mentioned the initiative to President Barack Obama. The US president, accompanied by other world leaders, launched 'Mission Innovation' at December's conference in Paris.

Twenty countries, including the UK, China and India, pledged to double public spending on research, development and demonstration in clean energy, particularly storage and transmission. Such spending will amount to $20bn a year by 2020.

In tandem, 28 investors, led by Microsoft founder Bill Gates, pledged to 'bridge the valley of death between promising concept and viable product'.

"Twenty countries, including the UK, China and India, pledged to double public spending on research, development and demonstration in clean energy, particularly storage and transmission.

Practical action

The next step is to turn these announcements into practical action. The way the world comes together to ensure that semi-conductors keep reducing in price offers a useful precedent – representatives from government and the private sector meet to discuss key obstacles and how they should be tackled.

Complex issues concerning intellectual property rights need to be resolved. Many innovations will take the form of public goods, which is why the private sector is unlikely to solve them. So collaboration between the public and private sectors is essential.

Economists at Frontier Economics, working with the Grantham Institute at Imperial College London, have produced a cost-benefit study showing potential gains based on past innovation programmes. Such gains are significant, but numerous innovations are likely to fail along the way.

Solar prices are falling rapidly, and innovations such as smart meters and smart appliances show great promise. But the key breakthroughs are impossible to predict.

Affordability and sustainability

In a world where governments are reducing subsidies for renewable energy as part of their drive to reduce public deficits, such initiatives are more crucial than ever. They raise the hope of a subsidy-free world where there is no tension between affordability and sustainability.

Of course this will take time. In the meantime, countries will continue to use fossil fuels, ideally shifting to lower emissions sources such as gas rather than coal.

This approach recognises that economic growth is an engine for reducing poverty and raising living standards in many parts of the world. The key to a sustainable future is to fuel this growth using renewable energy.

Man's ingenuity has led to significant progress around the world. We now need to harness and direct this ingenuity to ensure that such progress is sustained in the long term. ■

Gus O'Donnell is Chair of Frontier Economics and a former UK Cabinet Secretary.

Linde: Spanish outlook 'strong'

Limited confidence in underlying strength of euro area

Ben Robinson, OMFIF Economist

Spain is on target to achieve its expected growth rate of 2.8% this year, according to Luis Maria Linde, governor of the Banco de España, speaking at an OMFIF City Lecture on 9 February.

Luis Maria Linde, governor of the Banco de España, speaking at an OMFIF City Lecture

While this is partly due to 'temporary tailwinds' including low oil prices and a weak euro, Spain's growth – the strongest out of any large euro area country – is mainly a result of structural reforms and fiscal readjustments.

Above all, increased budget discipline and reforms to the labour market and public pensions have strengthened government finances and reduced unemployment by around 5.4 percentage points from its 2013 peak. Increased exports and deleveraging of corporate and household debt – debt-to-GDP ratios are down by 30% and 16%, respectively, since 2010 – have resulted in a current account surplus of around 1% of GDP (Chart 1).

The primary budget balance has moved from a deficit of 5.2% of GDP in 2010 to a 0.6% surplus in 2015. The general government budget deficit fell to 4.8% in 2015 from 11.1% in 2009, though it remains above the 3% target set by the European Commission (Chart 2).

Labour market reforms which have made hiring and firing workers easier and which increase flexibility in labour and pay negotiations mean firms no longer 'adjust to economic slowdown by dismissing workers or closing down'. These reforms were credited with increasing Spanish competitiveness, with the harmonised price index standing at around minus 0.4% in January against a euro area average of plus 0.4%.

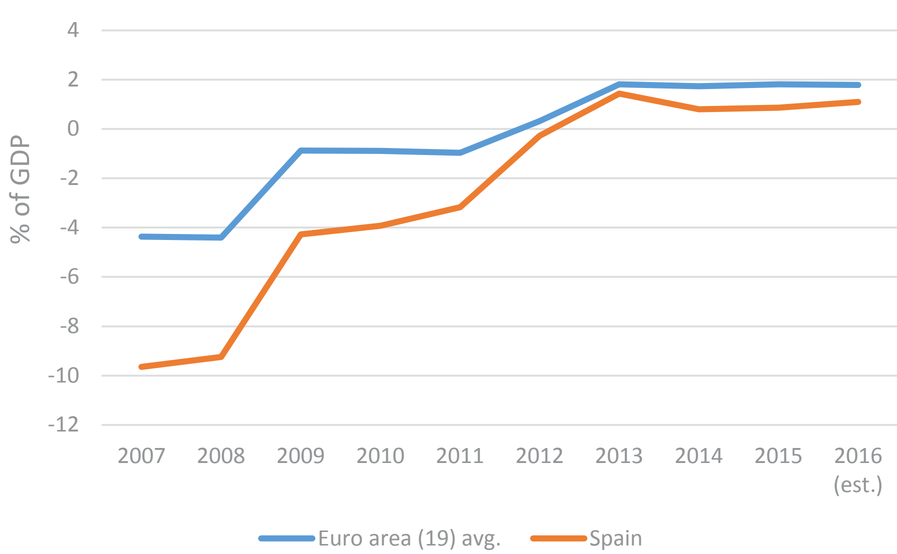
A restructuring of Spain's banking sector has reduced the extent of non-performing loans on balance sheets to 11.2% (Chart 3). While still high by historical standards, they are on a downward trend, having fallen 18.8% year-on-year to August (latest available data).

The composition of NPLs has shifted, as economic growth in Spain led to a decrease in domestic NPLs of 19.6% year-on-year to June.

Meanwhile bank solvency levels are above regulatory minimums, with common equity tier 1 capital standing at 12.4% and the overall capital ratio at 14.3% in June 2015, further strengthening the banking system.

Chart 1: How Spain has rebalanced its current account

Current account balance, Spain compared with euro area, 2007-16



Source: IMF

Euro optimism at a low ebb

Despite these promising signs, optimism in the euro area remains at a low ebb, notwithstanding 11 quarters of growth and a boost from low oil prices.

There are concerns that low interest rates, low inflation and further quantitative easing are limiting confidence in the underlying strength of the euro area economy.

Some participants suggested that it is increasingly difficult to separate successful national policies from the stimulus effects of European Central Bank monetary policy. This challenges the ability of investors and businesses to make long-term decisions. There is a general belief that QE has artificially lowered borrowing rates and increased moral hazard. This has distorted asset prices, led to diminishing returns and resulted in a misallocation of financial resources.

More worrying for some observers is the effect of these measures on the risk premia of sovereign debt on banks' balance sheets.

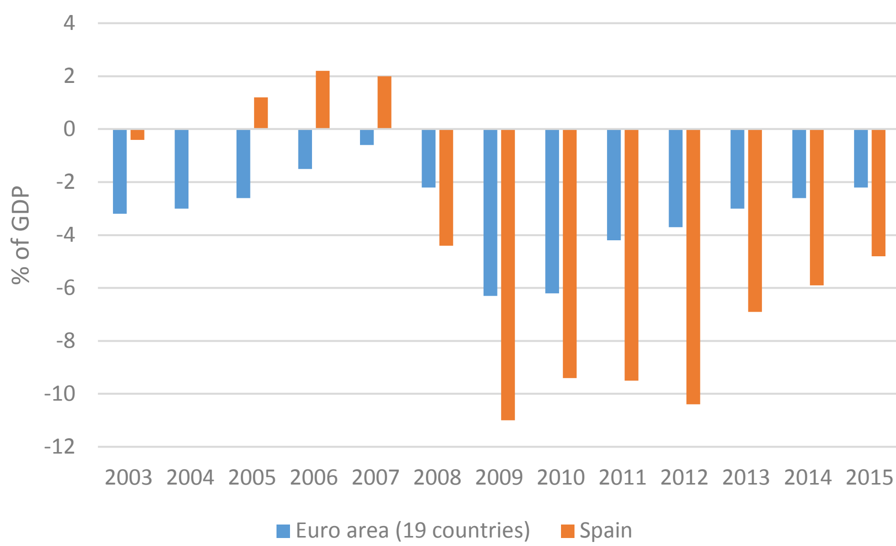
These are generally seen as being too low, requiring reclassification to a higher level of the sovereign debt of peripheral European countries.

Low interest rates have reduced bank profitability in the euro area, creating further difficulties. The loan-deposit gap is at a historically narrow level.

Several participants at the meeting expressed concern over the prospect of a further reduction in interest rates at the 10 March ECB monetary policy meeting, where there has been speculation of a further cut in the ECB's deposit rate from minus 0.3% to minus 0.4%.

Chart 2: Spain's budget position: improving but still weak

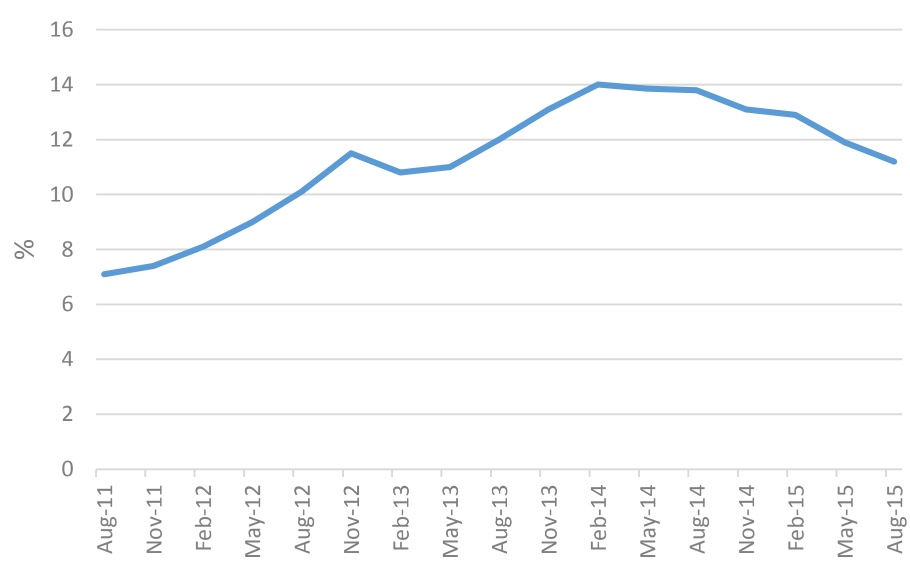
Public sector deficit, Spain compared with euro area, 2003-15



Source: Eurostat

Chart 3: Spanish banks have improved their loan positions

Domestic non-performing loan ratio, 2011-15



Source: Banco de España

Large-scale banking reforms

One potential solution to low bank profitability and low banking activity levels is to conduct large-scale banking reforms to

> ***"There is a general belief that QE has artificially lowered borrowing rates and increased moral hazard. This has distorted asset prices, led to diminishing returns and resulted in a misallocation of financial resources.***

address foreclosure and bankruptcy laws, expand the role of bad banks and allow room for cross-border consolidation.

However there is some doubt about the political appetite in Spain for such a restructuring, especially in view of the political limbo since the 20 December elections.

An alternative is to open up the consumer banking market to cross-border competition, part of attempts at increasing competitiveness through banking union. Such proposals would require an increase in European financial and political integration, which faces significant public opposition.

On 8 February the presidents of the German and French central banks stated that the only two viable alternatives facing the euro area were closer integration – including a common euro area treasury – or a decentralised approach to decision-making, which might imply a reassessment of the risk premia paid by different sovereigns.

Closer economic integration is an unlikely development in the near term. Meanwhile the prospect of increasing risk premia – which participants at the meeting emphasised are set by the markets and not by the ECB – was generally agreed to have severe implications for financial stability. Participants suggested that the move towards integration would be via 'small steps', rather than a 'single leap'.

Further structural changes

Other potential structural changes in Europe include the apparent willingness of Germany to agree to the UK's demand that the EU be considered a 'multicurrency bloc'.

Participants were unsure of the implications of such a proposal, and whether it would require a change in the framework of the EU.

Some suggested that it would require abandoning the 'guiding philosophy' of the EU since its inception, which has always been about economic integration and the single currency. It may also make coordination between European states impossible, given that each country would gain greater control over domestic financial regulations in a multicurrency bloc, leading to intra-European regulatory differences. ■

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Pooling policies to beat downturns

Recessions following financial crises particularly severe

George Hoguet, Advisory Board

***Collapse and Revival: Understanding Global Recessions and Recoveries* by Ayan Khose and Marco Terrones is a timely, illuminating and sobering book. Timely, because global investors are anxiously evaluating the odds of a recession in both the US and China in 2016. Illuminating, because it provides a systematic framework for analysing global recessions. And sobering, because it reminds us that at least 30m people lost their jobs during the 2009 recession.**

Khose, director of the World Bank's Development Prospects Group, and Terrones, deputy division chief in the research department of the International Monetary Fund, have written a book that is rich in data and empirical findings, well researched (a 30-page bibliography) and highly systematic.

Global recession – a definition

Surprisingly, there has been no uniformly accepted definition of a global recession and global recovery.

In the first half of the book the authors review the global business cycle and establish a global database. They define a global recession as 'a contraction in world real GDP per capita accompanied by a broad decline in various other measures of global economic activity'.

They suggest that world real GDP per capita is a primary measure of well-being, and calculate this metric decade by decade since 1960, both on a purchasing power parity and nominal exchange rate basis.

The authors identify and analyse four global recessions since 1960, starting with 1975, when oil prices increased fourfold. Then came 1982, following a second oil shock, tight monetary policies in several advanced economies, and the Latin American debt crisis. A third occured in 1991 following banking and currency crises in Europe, the bursting of Japan's asset price bubble, the US savings and loan crisis, and the first Gulf War. The last, in 2009 – the Great Recession – followed the worst financial crisis since the Great Depression.

The average decline in world output per capita during these periods was 0.7%, roughly three percentage points below the historical average global per capita growth rate. Using purchasing power parity weights, all of these recessions lasted one year. On average, equity prices declined three times more than house prices. Between 1960 and 2014 there have been eight US recessions, but only four global recessions.

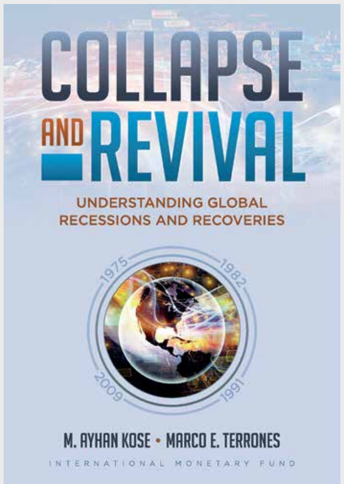
Each global recession led to a fundamental 'rethink' of macroeconomic models. The 'stagflation' of the 1970s led to increased focus on the supply side of the economy and 'rational expectations'. The 1982 and 1991 recessions led to progress in the design and objectives of monetary policies, and institutional enhancements such as increasing central bank independence and explicit inflation targeting. The Great Recession highlighted the limitations of models that fail to adequately incorporate the financial sector.

Recessions associated with financial crises are particularly severe. The authors find four common elements to such crises. These are rapid appreciation of asset prices, credit booms, the emergence of systemic risks such as unhedged borrowings in foreign currency, and regulatory laxity.

Synchronisation of business cycles

The second half of the book discusses the Great Recession and the growing synchronisation of global business cycles via trade and financial linkages. The authors find that the impact of the global cycle on national cycles is much more pronounced during global recessions than expansions.

The last chapter discusses the lessons of these recessions and policy implications. These include the importance of having adequate fiscal and monetary policy flexibility to combat downturns, with the necessity for monetary policy to promote macrofinancial stability and to monitor the financial cycle. The authors also highlight the desirability of a balanced growth strategy, including highly diversified exports and trading partners,



and a greater reliance on domestic demand. Finally, the authors deem essential the need for enhanced policy coordination during global recessions. The G20 commitment in 2008-09 to coordinate expansionary fiscal and monetary policies is an example.

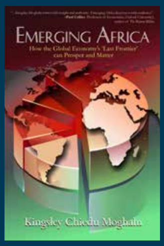
This book contains recession timelines and many useful exhibits. A CD emphasising the main findings and the central position of the IMF in moderating downturns and enhancing global financial stability accompanies the text.

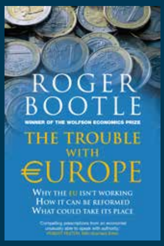
Throughout the book the authors emphasise that the global business cycle is alive and well, the odds of significant global slowdown or recession in any given year have been 11%, and that recessions accompanied by financial crises are particularly devastating.

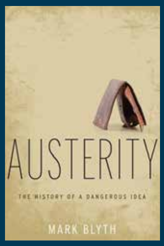
They explain that synchronised recessions are longer and deeper than normal recessions and the structure of the world economy is constantly changing. Emerging markets are playing a more important role, having led the world out of the 2007-09 downturn. They add that our knowledge of the dynamics of global recessions is incomplete.

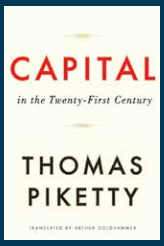
This book presents very valuable research that will be of interest to global investors and policy-makers alike. ■

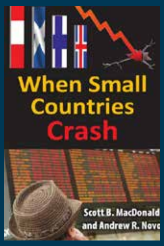
George R Hoguet is Global Investment Strategist in the Investment Solutions Group of State Street Global Advisors.

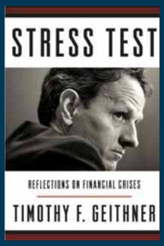


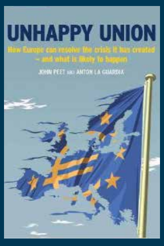












The three-year outlook for China and Japan

OMFIF Advisory Board expects China to better face challenges

China and Japan face contrasting economic challenges. China is moving towards a more market-driven approach and opening its capital markets at a time of uncertainty over renminbi policy and slowing growth. This coincides with the Communist party's struggle to maintain its hold over an increasingly wealthy, internationally mobile and politically astute population.

Japan, by contrast, is attempting to kick-start a moribund economy. It has done so first with a package of fiscal, monetary and structural reforms dubbed 'Abenomics' and, more recently, a rebooted version that combines the three 'arrows' of Abenomics with increased child support and social security.

The question put to the Advisory Board was: 'China and Japan are facing different economic challenges in 2016 – which country will better address those challenges in the next three years?'

Two-thirds of respondents said that China would achieve greater success. Despite recent 'missteps' – including ill-executed intervention in domestic equity markets – there was a consensus that mistakes were inevitable at this stage of China's economic development. Respondents pointed to the authorities' long track record of implementing reforms in support of investment and productivity.

Support for the view that Japan will better address its challenges was less widespread, with just 26% voting in favour. But there were mitigating factors for Japan. Respondents cited idiosyncratic policy-making in Beijing and the prospect that Japan has learned the lessons of previous monetary and banking policy mistakes. ■

'Government strategy in China seeks to promote more balanced economic growth. China will continue to be one of the top performers among the major global economies.'
Hemraz Jankee, Bank of Mauritius

'China is facing challenges it has never experienced before, so mistakes are inevitable at the beginning. Japan's problems are the same ones the country has faced for over 20 years, and it has still not figured out what to do about them.'
George Milling-Stanley, formerly World Gold Council

'China has a long track record of implementing structural reforms that support investment and productivity. In Japan, the third arrow [of Abenomics] is misfiring, and this is the most critical arrow in terms of addressing secular stagnation in the country.'
Mark Crosby, Melbourne Business School

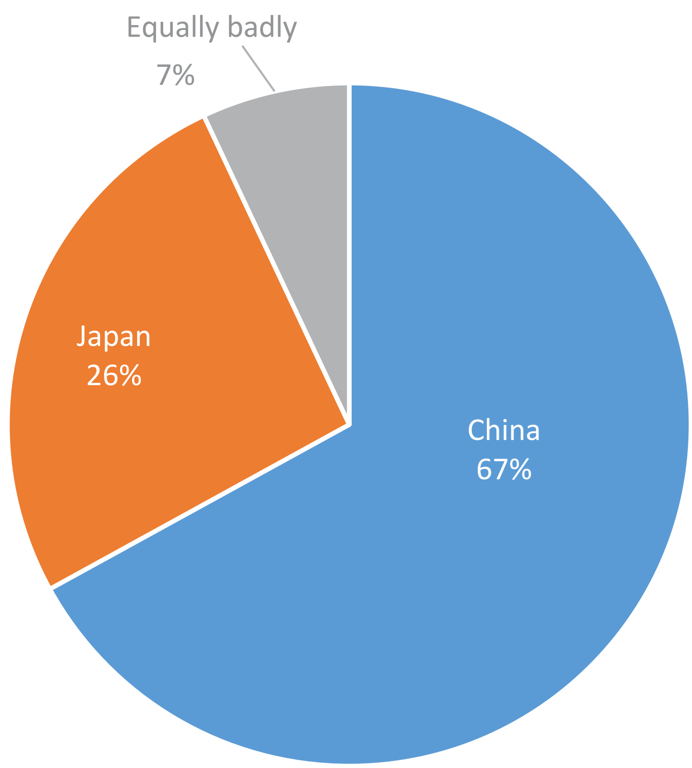
'China has ample room for policy manoeuvre in coming years, particularly on monetary policy. One should also not underestimate the potential positive economic impact of China's One Belt One Road policy and the Five Year Plan that will move the Chinese economy up the value curve.'
Gerard Lyons, Greater London Authority

'China's policy options will still be constrained by idiosyncratic factors (political system) and many of their challenges have significant connections... I would therefore expect Japan to be able to face its challenges more effectively despite its exposure to the repercussions of possible problems in China.'
Vilem Semerak, Centre for Economic Research & Graduate Education, Prague

'Both countries are saddled with financial problems (albeit of a different nature) and severe demographic liabilities (getting worse for China without getting any better for Japan). They have a huge potential for natural and industrial disasters. It is the political decision-making process which will be of the essence.'
François Heisbourg, Fondation pour la Recherche Strategique

China expected to do better than Japan by 2019

Two thirds of respondents say China will fare better than Japan



March question

Do you believe Britain would be safer, more secure and more prosperous inside or outside the EU?

With regard to the rest of the EU, would a British exit promote?
a) disintegration
b) integration?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