Bulletin

Global insight on official monetary and financial institutions

April 2014
Vol. 5 Ed. 4

Monetary tussles

Independence frayed

Noyer on Europe
Sovereign diversification
Future of Africa
Learning from Chinese restraint
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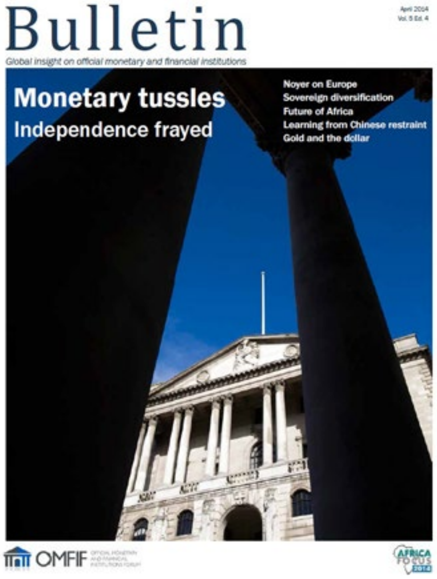
Cover story

Central bankers have to be sensitive to external changes that make them more powerful yet more vulnerable. These changes expose them to market and reputational risks that could erode the one key asset that they prize more than gold and foreign exchange: credibility. This edition looks at the diverse ways in which this prize is threatened by devaluation – and what can be done about it. One important reason why independence is looking frayed stems from pressure on central banks' budgets caused by low interest rates. See p.8-9.



AFRICA FOCUS 2014

The outlook for African transformation was on display at the fourth EU-Africa summit in Brussels on 2-3 April. Beyond the rhetoric of such meetings, there are genuine reasons for confidence. A key condition for success is that Africa and Europe take steps to build a 'learning community' that allows both sides to learn lessons from each other – and use these to implement action. See p.28.

International monetary policy

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Carney faces pressure at Bank of England

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Promoting dialogue for world finance

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

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

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

Since its inception in January 2010 OMFIF has held 230 meetings in 41 host countries with the participation of 170 different official financial institutions.

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OMFIF's 152-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars and other OMFIF activities. See p.18-19.

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

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

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Patterns of uncertainty

Central banks must adjust to new era of constraint

David Marsh, Chairman

The world economy remains influenced by a pattern of light and shade. Janet Yellen, the chairman of the Federal Reserve, has been subjecting markets to a variety of signals, most of which buttress her credentials as fully paid-up head of the world dovish fraternity. Signs of deflation in the euro area have multiplied, strengthening the euro in a way that makes the debt problems of the ill-placed peripheral counties still harder to bear. All this puts fresh onus on the European Central Bank to take some kind of easing action.

Some form of quantitative easing may be getting closer after the positive comments made on the subject by Mario Draghi, the ECB president, on 3 April. On the other hand, Draghi – rather as he did over the so-called Outright Monetary Transactions programme – may be trying to get maximum impact from cleverly-worded verbal interventions without actually having to take real action.

The risks that markets could face a conflagration over Ukraine and Russia has diminished somewhat, but following Moscow's annexation of Crimea nervousness abounds. A range of other important emerging market economies including China, India, Brazil and Turkey face economic and political uncertainty of different kinds.

Our cover story focuses on the difficulties faced by central banks as they adjust to a new environment in which they were afforded wider powers after the financial crisis but must inevitably live now with greater constraints, including on their much-cherished independence.

This was a subject we brought to wider attention in a joint report issued with Ernst & Young in November 2012: worthy of further explanation in the future. In the April edition, we highlight the challenges to the credibility of one of the most celebrated and best-regarded central banks, the Bank of England, now subject to wide-ranging structural change under its new governor Mark Carney.

The ECB, too, has become more exposed to political influences of different kinds. This forms part of an extension of its authority into banking supervision and financial stability and of the long overdue efforts to intensify economic integration in the euro area. And we shed light on one relatively little-illuminated reason for limitations on central banks' independence. This reflects a fall in their profits from reserve asset operations as a result of the decline in yields on the central banks traditional home for their reserves in triple A-rated bonds and bills issued by the major industrialised countries.

This shift is exposing central banks to the need to confer with their governments over their budgets, or even to seek additional official funds to prop up their balance sheets. Neither phenomenon is propitious for the lofty attitude central banks like to propagate with respect to government financing.

Julia Leung explores the burgeoning activity in China's shadow banking sector, but concludes that the Chinese banks are making adequate profits to withstand any perturbations from selective defaults.

Gabriel Stein puts under the microscope indications of deflation in the euro area, which he calls the biggest single risk factor for the world economy this year. He bemoans the ECB's lack of response in tackling the issue. Christian Noyer, governor of the Banque de France, one of the most experienced members of the ECB governing council, believes the euro area is on the right tack. But he admits that low inflation – which he firmly says is not deflation – creates headaches, because of it holds back adjustment, prevents economies profiting from low or negative real interest rates and raises the possibility that the euro area could fall into outright deflation if it were to suffer an external shock (such as renewed emerging market flare-ups). The effect of the rising euro on the competitiveness position of the most indebted countries is a further worry.

Edwald Nowotny, governor of the Austrian National Bank, describes the background factors helping his country to weather the financial crisis with less difficulty than many of its neighbours. Stefan Bielmeier meanwhile takes a negative view on whether the euro crisis is really over.

France has been in the news with the predicted drubbing for President François Hollande's ruling Socialist party in the municipal elections on 23 and 30 March, followed by the speedy naming of a new prime minister, Manuel Valls. Denis MacShane, who has extensive experience of European Socialist party politics and has met Valls several times, explains the considerable headwinds the new leader faces from within and outside his party.

In the US, Darrell Delamaide's monthly round-up of Federal Reserve news relates how Fed chairman Yellen's first press conference on 19 March sparked off worries that a persistent dove has turned hawkish. Later in the month, these doubts appeared to dissipate. Trevor Greetham writes that the US recovery is expected to strengthen in the second quarter with the absence of inflation still favouring the equity market.

In our emerging markets section, Gary Smith investigates growing convergence between sovereign fund investors and central bank reserve managers. Ludger Kühnhardt says Africa and Europe need to develop a 'learning community' to foster sustainable growth. Kishore Mahbubani calls on the west to emulate China's restraint over Ukrainian-Russian tension.

In his customary bittersweet commentary on international financial affairs, William Keegan reflects on continuity between Labour and Conservative-led governments in the UK. He says some responsibility for the UK house price boom must lie with the Bank of England and its new governor. ▪

David Marsh

ADVISORY BOARD

OMFIF welcomes two new members, José Alberto Tavares Moreira and Willem Middelkoop. Their appointments take the number of Advisory Board members to 152. For full list of members see p.18-19.

José Alberto Tavares Moreira is an economist and banker. He is a member of the Advisory Board of the Banco de Portugal. He was Portugal's Secretary of State of the Treasury (1980-81); Secretary of State of the Minister of Finance and the Treasury (1985-86) and Governor of Banco de Portugal (1986-92). Like Niels Thygesen, a long-standing member of the Advisory Board, Tavares Moreira was a member of the Delors committee that set down the groundwork for economic and monetary union in 1988-89.

Willem Middelkoop is a fund manager and writer. He worked until 2008 as a business commentator for RTL Z, before starting the Commodity Discovery Fund. A prominent commentator on the gold market, he founded Amsterdamgold.com in 2008.

EXPERT SEMINARS

Bank of Japan seminar measures progress of Abenomics

Bank of Japan

Prime Minister Shinzo Abe's radical measures to revitalise the stagnant Japanese economy that has been mired in recession for most of the past 20 years was the topic of discussion at an OMFIF seminar on 3 March. It focused on the Bank of Japan's view of monetary policy, Abenomics and the prospects for Japan's economy. Taking place against a background of greater pessimism about whether Japan can meet targets for higher growth, the meeting for fund managers and analysts was hosted by Shigeto Nagai, the BoJ's General Manager for Europe and Chief Representative in London.

POLICY GROUP

China's shadow banking sector under the spotlight

The shadow banking industry in China was scrutinised at an OMFIF meeting organised on 17 March. Armstrong Sheng Chen, Deputy Director, Banking Innovation Supervisory Department at the China Banking Regulatory Commission, outlined measures to regulate China's shadow banking sector. The perceived lack of transparency at Chinese government agencies is a significant factor contributing to rising investor unease abroad. Foreign investors are looking to Chinese regulators to provide greater clarity on how they plan to manage and respond to a potential wave of corporate defaults. See Julia Leung's commentary on Chinese shadow banking, indicating how the sector can solve its problems, on p.15.

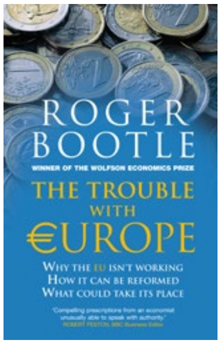
BRIEFINGS

Bank of Canada says solidity based on sound supervision

Deputy Governor of Bank of Canada Tiff Macklem (pictured left), spelled out how the Canadian economy has developed since the short-lived 2009 recession at a briefing on 18 March in London. The Canadian approach has focused on sound banking supervision and 'getting the basics right'. Macklem explained that sound policy measures were put in place in the 1990s. These measures include capital standards, a limit on leverage, proactive supervision and the adoption of an inflation target. Relative to the US, the UK, the euro area and Japan, Canada has demonstrated relatively robust domestic demand, which recovered quickly after the crisis. Canadian exports tell a different story, explained Macklem. The Canadian economy has been considered a safe haven in an otherwise risky world. Despite its ability to navigate through the crisis, he added that Canada has lost some of its appeal to investors owing to the fluctuating exchange rate against the dollar.

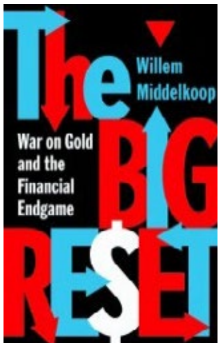
BOOKS & THE ADVISORY BOARD

Europe's sovereign debt crisis and possible return of gold



Europe's sovereign debt crisis attracts an ever increasing tide of commentary. In the Bulletin's round-up, Wilhelm Nölling examines Roger Bootle's assessment of the European Union's weakness and recipes for correcting what appears to be Europe's wayward course. Bootle's book, *The Trouble with Europe,* describes the role Britain should play in finding a solution. Nölling recommends the book for 'Europhiles as well as sceptics,' describing it as a 'comprehensive and constructive guide.' See p.30-31.

Roel Janssen reviews Willem Middelkoop's book, *The Big Reset,* describing it as 'a provocative alternative to conventional wisdom about financial developments.' Middlekoop takes an apocalyptic view of the present monetary malaise, summarising the history of gold in the world's money and the build-up of unsustainable debts. He believes a new crisis is imminent and foresees a return to favour of gold and silver. See p.33.



GOLDEN SERIES

Banque de France's Noyer outlines emerging market concerns

Speaking at an OMFIF Golden Series lecture on 27 March at Grocers' Hall in London, Christian Noyer, Governor of the Banque de France, said the most dangerous outcome for euro stability would be a disturbance outside the euro area, above all from economies in emerging markets. China, India and Brazil were all being monitored carefully. The euro crisis is not over but the situation has improved in the past year, Noyer said. The strength of the rebound varies across the region. Noyer saw low inflation as a major challenge. However it was incorrect to compare Europe's low inflation with Japanese deflation. One of the reasons for the subdued inflation rate was an unexpectedly strong euro and its effect on import prices, as well as weakening energy and raw materials prices. Noyer said the key question for the EU is how to increase competitiveness. Labour markets must become more flexible, especially in the periphery. See p.11-12.

John Nugée
Christian Noyer
David Mars

INTELLIGENCE

Russia and Ukraine stand-off debated at OMFIF briefing

An OMFIF telephone briefing on the crisis in Ukraine on 31 March reflected on the shorter and longer-term consequences of western sanctions against Russia following Moscow's annexation of Crimea. The five participants, in a 45 minute session moderated by David Marsh, were Vasily Astrov from the Vienna Institute for International Economic Studies; David R. Cameron, Professor of Political Science, Yale University; Stephen E. Hanson, Vice Provost for International Affairs, William and Mary College, Virginia; Pawel Kowalewski, Deutsche Bundesbank, and former Head, European Integration Department, National Bank of Poland; and Marina Shargorodska, Head of Business Development, Quantum Global. The discussion reached some consensus on the west's lack of understanding of underlying Russian attitudes towards Ukraine. This made some kind of backlash inevitable after the European Union offered Ukraine an association agreement last year but no significant increase in financial assistance to alleviate its chronic economic difficulties. There was general agreement that sanctions against Russia would have little immediate effect on the Russian economy but would start increasingly to bite over time, especially if American gas exports to Europe came on stream in sufficient quantities to offset European dependence on Russian energy. Amid a wide range of five-year forecasts, most of the five respondents rated the chances of a stable outcome at no more than 40-50%.

President Vladimir Putin

A problem of overreach

Bank of England governor's challenge over financial stability

Michael Klimes, Deputy Editor

Mark Carney, governor of the Bank of England since July last year, has shown that he understands a great deal about how monetary policy failures contributed to the 2007-08 financial crisis and the ensuing recession. But it is far from clear whether his new approach will prove successful in warding off a repeat in coming years.

Carney may eventually rue his decision to opt for a five year term as governor rather than the eight years originally under offer. Over the next four years of his mandate, there will be ample opportunity to test his thesis backing more central bank intervention in markets – but not enough time to judge whether the policy really brings success.

The focus of monetary policy is on producing relatively benign outcomes through the shaping of expectations. The Bank's new framework is designed to meet that objective.

Yet Carney's new 'forward guidance' policy has already been wrong-footed by faster-than-expected UK economic improvement, raising doubts whether he can uphold the commitment to keep interest rates at the ultra-low level of 0.5% in the long-term.

Mais Lecture

In Carney's Mais Lecture in London on 18 March, he argued that central bankers' prime pre-crisis intellectual failure was the belief that concentrating on an inflation target was crucial to safe economic management. This failure, he argued, undermined cooperation between policy-makers in charge of financial stability and monetary policy.

'This reductionist view of the central bank's role which was adopted around the world was fatally flawed. In particular it failed to recognise that financial stability is as important an objective of macroeconomic policy as price stability and it downplayed the relationship between the two.'

The measures Carney is implementing are in step with the reformist agenda established by Chancellor George Osborne when he took office in in May 2010.

Osborne gave the Mais Lecture in that year where he drew a number of conclusions about the origins of the UK's banking crisis. He called for better fiscal/monetary policies and institutions to be created to prevent a repeat of the 2009 recession. The chancellor specifically criticised the obsession with inflation targeting pursued rigorously by numerous central bankers in the run-up to the crisis.

Carney seems to have taken the Treasury's view to heart but his interventionist approach, in which he may end up amassing undue power in a more centralised monetary structure, could be as risky in the future as too little intervention was in the past.

'Both [monetary policy and financial stability] are fundamentally about maintaining the public trust and confidence in money and the financial intermediation that is essential to oil the wheels of commerce. Central banks have a primordial responsibility to act as guarantors of trust and confidence in money.'

To implement structural changes, and ensure that financial stability responsibility is a part of monetary policy, new appointees will join the ranks of top management. These include Andy Haldane as chief economist, and Ben Broadbent and Nemat Shafik (hired from the International Monetary Fund) as deputy governors.

During his Mais Lecture, Carney explained how the BoE would use its enhanced powers to make the communication of monetary policy less complex and opaque. As part of this initiative, an independent oversight committee will be introduced, rendering research more publicly available and promoting a cultural change at the Bank.

Some have argued that Carney's famous forward guidance policy and reforms at the BoE are making monetary policy more contradictory than consistent, regardless of how many safeguards are put in place to ensure no mistakes are made by the Bank.

For instance, some critics of the BoE have claimed the three 'knockout conditions' put in place to override forward guidance to raise interest rates as evidence of inconsistency in the deliberations of policy-makers.

The BoE said that it would discard forward guidance if inflation rose above 2.5% over the 18 to 24 months; medium-term inflation expectations became insufficiently well anchored; and financial instability developed. These were all taken as evidence that Carney's innovations were somewhat confusing.

In his lecture, Carney admitted that there could be tension between different parts of the BoE trying to balance both monetary policy and financial stability.

'Tension between monetary policy and financial stability is best managed in a co-ordinated way in a single institution. The use of macroprudential tools can be used to stop the diversion of monetary policy from managing the business cycle to hit the inflation target to manage the credit cycle.'

Carney outlined how financial stability and monetary could be at cross purposes on capital requirements.

Policy-makers at the microprudential level have the task of maintaining capital buffers to ensure that banks remain safe and do not overextend themselves through risky lending.

Conversely, macroprudential regulators have the job of supporting growth and jobs through the loosening of controls to boost the supply of credit to firms. Carney said that this type of tension was best resolved in one institution as the 'objectives' of financial stability and monetary policy 'most of the time are mutually reassuring'.

Too much power

This assumption ignores the warnings about the concentration of too much power in the hands of a few experts who, despite the best intentions, mess things up. Partly for reasons beyond his control, Carney has raised expectations of what the BoE can do under his leadership to extraordinarily high levels.

Those sceptical of any type of intervention in financial markets, whether it is by government or central banks, frequently cite the concept of unintended consequences and ignorance of these impacts.

The past five years' exceptionally accommodative monetary policy, with low interest rates and quantitative easing, has in a sense been amplified by forward guidance. The setback this has suffered since the beginning of 2014 has not been helpful for the Bank's (and Carney's) credibility.

Economists following Friedrich Hayek's Austrian School of thought (with its emphasis on the dangers of credit growth fuelling perilous bubbles) would not be surprised if the emergency measures introduced by the BoE lead to grotesque distortions in the functioning of markets.

Many would argue that this development has already taken place. In his writings on the political economy, Hayek frequently muses on the complex, nuanced and interdependent workings of a sophisticated economy. Hayek might conclude that misallocation of credit and money caused the 2009 recession, with the blame resting on poor decisions by central banks.

Hayek's scepticism

A number of modern economists seem to echo Hayek's scepticism on the role of central banks in a dynamic economy. A paper published in March by the Bank for International Settlements, owned by 60 leading central banks from around the world, suggested central banks that employ forward guidance could risk creating financial instability by revising their policies frequently or by keeping the cost of borrowing too low for too long.

Such views find considerable resonance in many countries, where conservative experts are certainly preparing their ground for an all-out counter-attack if forward guidance is seen as comprehensively failing. As a foretaste of this, Miroslav Singer, Governor of the Czech National Bank, in the January OMFIF Bulletin argued plausibly that forward guidance increases rather than lowers uncertainty. Carney has formed a definite view of the origins of the financial crisis and how to prevent a recurrence. He should get ready for a real-life experiment to challenge how well his resolve stands up to the pressure of events. ▪

Central banks must place focus on institutional as well as technical excellence

The 2007-08 financial crisis exposed fault lines within and between central banks, financial regulators and government, whereby institutional structures inhibited rather than supported good policy outcomes, *writes Sue Milton in London.* As a result of their focus on monetary stability, central banks often focused on one central objective, such as inflation targeting. Consequently, other threats to stability went unrecognised, demonstrating that an excessively narrow focus contains can backfire badly.

Central banks came under particular scrutiny on why they had not identified and acted upon the evidence available at the time to mitigate the impact. Institutional excellence trailed behind technical excellence. The latest example of this is the foreign exchange rigging scandal, where the institutional arrangements of the Bank of England failed to act on the technical evidence.

Central banks are now under much closer observation: formally via parliamentary scrutiny; less formally through media coverage; academic publications and by hearsay within social media and general popular interaction. Building and maintaining trust requires a continuous process of reporting and assessment.

In order to address these fault lines, an ideal framework to improve governance of central banks would examine every aspect of institutional activity. This would cover mandate, funding, capability, culture, reputation, organisation and management and communication and crisis management.

An ideal framework provides for each dimension a rating against a set of locally defined targets, and then assesses achievement against each rating. This calls for realistically challenging targets, an action plan to rectify shortfalls and achieve improvements and independent verification to achieve credibility.

Even at the fundamental level of a central bank's mandate, there has been confusion regarding the definition and interpretation of these main goals and how they align with statutory obligations.

Last month's Advisory Board poll highlights potential for confusion in the case of the the Federal Reserve, where some interpret its mandate as covering solely US domestic requirements and others say that a broader remit is necessary to deal with spillover effects.

Some members explained that the Fed's legal remit is contained to the requirements of the US, while others expressed that the spillover effects of their policy decisions – particularly to emerging market economies – necessitate a broader mandate. If multiple interpretations and potential confusion exist for something as tangible as mandate, then consider how difficult it becomes to interpret such things as 'capability' or 'management'. Central banks must take advantage of the aftermath of the financial crisis to assess their ability to meet national and global expectations.

A comprehensive framework of institutional excellence would increase organisational, operational and cultural understanding, and improve relationships with stakeholders, such as the Ministry of Finance.

Furthermore, this may break down silos, providing a better understanding of internal and external patterns of dependence. Increasing institutional excellence will place central banks in a better position to act and react more flexibly and efficiently to changes in the economic environment. ▪

Sue Milton is an independent adviser on governance. She co-developed the institutional framework INEX© with a number of experts.

How central banks need to adjust

Greater political influence over central banks is a reality

Pooma Kimis, Director of Markets and Institutions and David Marsh, Chairman

In the immediate aftermath of the 2007-08 financial crisis, central bankers appeared to wield unbridled power. By rapidly expanding their operations and moving into many new areas of financial control and influence, they have attracted, from diverse sides, attention tinged with suspicion.

The ineluctable result is that central banking independence is now being mitigated by more political control, overt and non-overt. Rather than bemoaning this state of affairs, we should welcome it as a sign of a realistic reordering of society.

Over the past 30 years, central banks in industrialised and developing countries gained significant degrees of operating freedom, above all because of the belief that decisions on controlling the volume of money are best left to operators outside the political sphere. Now that the pendulum has swung back against untrammelled independence, we need careful checks and balances to make sure that the pendulum does not swing back too far in the direction of politicians interested in their own and not their electorates' futures.

Central bankers were rarely more adept than anyone else in spotting the financial crisis in advance, let alone in preventing it. The financial upheavals and the ensuing economic shock were partly their fault. Despite this, central banks emerged with enhanced powers.

Winning acceptance and respect both of the market participants central banks are trying to influence and of the politicians who set the framework for their operations depends on a complex mix of technical, psychological and communications skills.

In a system of fiduciary currency, central banks' powers are ethereal. Through the medium of electronic payments as well as the printing press, they are able to conjure up money out of thin air. But magic can be overstretched. If they overstep their independence, try to shift it into too many areas, or ignore its natural limitations, they will end up losing it. In many cases, that is happening.

One source of restrictiveness has stemmed from central banks' own actions to reduce interest rates after the financial turbulence. In the UK, US and continental Europe, central bank governors have faced much greater scrutiny over what has become known as 'forward guidance' – an attempt to inject semi-scientific methodology into efforts to keep interest rates low for longer than normal. As has been shown in the cases of Janet Yellen, the Federal Reserve chair, and Mark Carney, the Bank of England (BoE) governor, these initiatives embody clear risks of backfiring and hence damaging credibility.

Nearly universally, low interest rates on central bank reserves have worked through to increasing political constraints. Low returns bring pressure on central banks' budgets and even a need to seek government funds for recapitalisation. Furthermore, by seeking greater profitability on their reserve asset management, central banks have been forced to enter into riskier fields. These include non-sovereign bonds (both industrialised and emerging market economies) equities and a broader set of hard and softer currencies. The spreads of their investment range beyond their traditional destinations of highly-liquid top-rated government securities. If such investments fail to bring anticipated rewards and even result in losses, then efforts to increase operating freedom will result in more, not fewer, political reverberations.

A much-publicised case surrounding the Nigerian central bank represents the most open case of in-fighting. President Goodluck Jonathan has suspended Lamido Sanusi over alleged misconduct and 'financial recklessness' after the internationally-respected central bank governor produced evidence of an alleged $20bn hole in the country's oil accounts. The Nigerian imbroglio cannot be dismissed as a purely African struggle, as it highlights issues that have come to the surface, albeit less luridly, in other countries.

In Japan, the co-opting of the central bank as a full participant – through massive purchases of government bonds – in Prime Minister Shinzo Abe's anti-deflation policies has been viewed as an assault on central banking independence. If the policy succeeds in bringing sustained growth, Japanese political life will adjust to the new environment. If, as seems more likely, 'Abenomics' results in failure or, at least, continuing uncertainty, then there will be moves from within and outside the central bank to reassert autonomy.

Intertwining of governmental and central banking policy has led to contortions in many countries. In Korea, a swing back towards greater central banking independence appears under way. Lee Ju-yeol, a Bank of Korean veteran, has taken over the governorship after the expiry of the four-year term of predecessor Kim Choong-soo, who was criticised for being overly submissive to governmental pressures to reflate the economy after the crisis six years ago. Everywhere, interplay between central banks and politicians has become more complex. ...continued on p.24

Happier Days: Governor Lamido Sanusi (centre) takes part in a discussion with Lord (Meghnad) Desai (left) and Linda Yueh (right) at the OMFIF meeting, 'Africa and the Indo-Pacific: The new economic mainspring' - at the Bank of Mauritius in Port Louis in November 2012.

The perils of persistently low inflation

Europe must increase competitiveness as part of recovery

Christian Noyer, Banque de France

The situation in the euro area is difficult but not hopeless. The second quarter of 2013 marked a turning point that put an end to six consecutive quarters of recession. The euro area finally saw a return to positive growth, with a 0.3% expansion, and this was confirmed in the third quarter with 0.1% growth, and again in the fourth quarter with 0.3% growth.

Nonetheless, the euro area will have seen a 0.4% contraction over the year 2013, due to a negative growth overhang from the end of 2012. The recovery in 2013 was modest and unequal across countries. However, this still reflects a sharp improvement in the overall trend, which is continuing and gradually getting stronger. ECB staff projections foresee annual real GDP increasing by 1.2% in 2014 and 1.5% in 2015. Compared with the December 2013 euro area staff projections, the projection for real GDP growth for 2014 has been revised slightly upwards.

Europe's rebound

Although the strength of the rebound varies across countries, it is important to highlight the return to positive growth in those countries most affected by the crisis and which are of major importance to the euro area: above all of Spain and Italy, where exports have rebounded sharply and are driving economic activity.

On a financial level, economists see a significant return to normal in the euro area. Bond markets in periphery countries are continuing to stabilise and interest rates have come back down to sustainable levels, with several periphery countries or programme countries recently managing to obtain market financing at perfectly satisfactory rates.

Similarly, fragmentation within the euro area is decreasing over time – as shown by the decline in liquidity surpluses and Target 2 balances.

Furthermore, credit dynamics are still subdued on the whole, due to continuing weak demand and bank deleveraging in response to the new regulations and, in all likelihood, the Asset Quality Review being conducted by the ECB.

Overall, and as predicted, we have seen a trend towards recovery since the middle of last year. However, this recovery remains weak and fragile. The risks are still mainly on the downside, and the need to pursue deleveraging in the public and private sectors in certain countries is likely to continue weighing on the recovery. As far as unemployment is concerned, although it has been stabilising for the past few months, the overall level is still far too high.

In this context, the key question at the heart of debate is: How can we amplify this recovery? What Europe needs in order to strengthen its pace of growth is to improve its competitiveness in today's globalised world.

On this issue of reforms, the euro area has made considerable progress these last few years, especially in those countries with the biggest competitive lag relative to the rest of the region. These countries been plunged deeper into crisis than their neighbours. Cost competitiveness, as measured by unit labour costs, has improved substantially. The same nations have shown a strong correction in current account balances.

With regard to structural reforms, the euro area is moving in the right direction. However, it still has a lot of work to do, particularly in liberalising goods and services markets, making labour markets more flexible, and increasing profit margins to enable companies to start investing in innovative technology again. This is without doubt the most important lever for guaranteeing a strong and sustainable recovery in the euro area, and one that will create jobs.

Level of inflation

No summary of the euro area situation would be complete without talking about the low level of inflation, which poses a major challenge for the euro system, and for the euro area economy as a whole.

Inflation has been falling recently in all advanced economies.This fall was especially marked in the euro area, from 2.7% in 2011 to 0.8% in February 2014. Let me make a few points on this. First, low inflation is not deflation. Deflation is a permanent and cumulative process of decrease in the overall price index, fuelled by negative expectations.

Deflation is especially dangerous because, as the experience of Japan has shown, once it becomes entrenched, it is very difficult to stop. From this perspective, there is no deflation today in the euro area.

Prices are still increasing and, most importantly, so are nominal wages. Inflation expectations remain firmly anchored in positive territory, even in the short-run.

Second, low inflation provides economic stimulus by boosting real income. In most parts of the euro area, nominal wages are downward rigid. Every time inflation 'surprises' on the downside, it creates an unexpected increase in real wages and purchasing power.

Economic sentiment

There is evidence that this mechanism is playing some role by improving economic sentiment and supporting consumption as we have seen in the euro area over the past months.That said, when inflation is too low, it carries very significant dangers and risks.

First, it makes real adjustment more complicated. With low inflation, there is less scope for downward adjustment in relative prices and real wages. The euro area strongly needs such adjustments in order for some countries, including France, to regain competitiveness. This would no doubt be made easier if the overall euro inflation rate stays closer to the ECB definition of price stability.

Second, low inflation makes it difficult to attain low, or negative, real interest rates, which are necessary in all advanced economies at the current juncture. Finally, low inflation increases the risk that the economy could fall into outright deflation if and when it is hit by a negative shock. The 2% target is meant to act as a cushion against that risk. That cushion is not available at the moment. If this situation persists, it could prove dangerous in a very uncertain economic environment.

To sum up, the situation today calls for a very careful assessment of the balance of risks. Precisely because deflation is hard to reverse, even small probabilities should not be neglected and they should be fully factored into policy-making.

French economy

If one takes a closer look at the situation in France, which has its difficulties, recent indicators have been positive. Growth is expected to be a bit below euro area average in 2014, at just below 1% compared with 1.2%

John Nugée
Christian Noyer

John Nugée (left) discusses a point with Governor Christian Noyer (right) following his Golden Series Lecture

for the euro area and 1.7% in Germany.

French corporate profit margins are low, which is weighing on investment, competitiveness and growth. Substantial work still needs to be done in terms of fiscal consolidation.

The country has begun implementing major structural reforms, but these must go further (labour market, pensions) or be clarified (the Responsibility Pact, the 'simplification shock'). Others reforms still need to be initiated (for example the financing of social spending, liberalisation of regulated sectors, and so on).

Financial system

Fortunately, France has an efficient financial system which has always managed to play its role in financing the economy. French banks have made the necessary efforts to meet the Basel 3 solvency requirements, and are also improving their liquidity levels in a highly favourable monetary policy environment. I have no particular worries about the outcome of the asset quality review currently being carried out by the ECB.

France's infrastructure

France has considerable strengths to compete in the global economy: dynamic demographics, a well-trained labour force, expertise in strategic or high-tech sectors such as mathematics, aeronautics and nuclear engineering and excellent infrastructure.

As far as I can see, France's main priority today is to ensure that it can take full advantage of these strengths by implementing structural reforms that reduce the burden of taxation and simplify administrative formalities. There must be more details on the specific implementation of the Responsibility Pact, which are due to be announced on 15 April.

There is no doubt that the government is committed to making it work and shares my view of the causes behind our current problems and the solutions that we need to implement as soon as possible. ▪

This is an edited and abridged version of Christian Noyer's Golden Series Lecture in London on 27 March 2014. Noyer has been Governor of the Banque de France since 2003 and is a member of the Governing Council of the European Central Bank.

Noyer's view: 'Corner has been turned'

Governor rejects similarities with Japanese-style deflation

John Nugée, Senior Adviser

OMFIF's latest Golden Lecture saw Christian Noyer, Governor of the Banque de France, speak on three main themes. He discussed the economic and financial situation in the euro area, the challenge of low inflation and the specific outlook for France in the mid-term. On all three of these, he was cautiously but resolutely upbeat and determined to dispel some of the more gloomy prognoses of the doomsayers.

On the euro area, Noyer declared firmly that the corner had been turned. Growth had returned and was gradually getting stronger, and the softer indicators such as sentiment were also moving into more positive territory.

He made a point of stating that the euro crisis was receding, with creation of the banking union not only proceeding in theory but also delivering in practice: the fragmentation of the euro area into national banking systems was being healed and financial imbalances, as measured by the Target 2 balances, were decreasing.

There remain too many rigidities in some national economies and an overall need to improve competitiveness, but Noyer's defiant stance was that 'rumours of the euro area demise are premature'.

On inflation, Noyer admitted that there was a challenge and that inflation was lower than the European Central Bank would like. But he stated that this is not just a euro phenomenon; it is shared by all major economies, and as he observed for the home audience, 'even the UK has inflation below its target again'.

He also drew comfort from the difference, in his view significant, between inflation that was very low but still positive and outright deflation as in Japan.

Indeed in questions he explicitly rejected attempts to liken Europe's situation to Japan's 'lost decade' . He explained, 'We are different in so many ways from them.' He emphasised that in Japan, 60% of items in the consumer price index basket had shown falling prices. This was symbolic of entrenched and economy-wide deflation.

By contrast, less than 20% of items in the euro area inflation index had shown reduced prices. And much of this was as a result of peripheral euro area nations regaining competitiveness: between 2008 and 2012 per capita labour costs in Portugal, Ireland and Greece fell by 12% compared to the euro area average. area became more competitive.

This theme of 'things are not as black as some people say' continued with his assessment of France. Yes, growth is weak, but it has returned. Yes, rigidities remain in the economy and taxes are too high, but the government knows this and will act. And underneath all, France still has a strong economic base with good infrastructure and a sound financial system.

This was a quieter lecture than some – no flashy statements or grand claims, just a confident assertion that things are improving.

The extensive questions after the lecture suggested that not everyone was fully convinced, but one could not fault the Governor for his solid defence of the euro area economy and the ECB's management of its affairs. ▪

John Nugée is Senior Adviser to OMFIF.

Noyer delivers his lecture to a packed audience at the Grocers' Hall in London

New French leader and his adversaries

Hollande's team, like France, moves to the right

Denis MacShane, Advisory Board and David Marsh, Chairman

France's embattled Socialist president, François Hollande, has moved his government to the right with the appointment as prime minister of Manuel Valls, a pro-market Atlanticist who makes no secret of his admiration for Britain's former leader Tony Blair.

The move appears to resonate with part of the mood in France, where right wing parties showed their traditional strengths in municipal elections on 30 March, in which the ruling Socialists suffered their predicted drubbing.

France needs massive reforms and a revolutionary assault on entrenched trade union interests and old state-centred thinking. Valls does not lack ambition, will and energy. The new prime minister, and the president, face two problems.

French parliament

The first is that Valls may not command sufficient support in the French parliament and in the Socialist party, which is deeply split on the wisdom and the electoral acceptance of Hollande's recent conversion towards pro-business reforms.

The second is that Valls' line in favour of further European integration may grate with a large part of the electorate that appears suspicious of the encroaching power of European Union institutions over large parts of France's political and economic life.

A great deal depends on Valls' performance over the next year, which will be punctuated by the May European parliament elections, when Hollande can expect a further erosion of the Socialists' vote. One of Valls' most problematic initial challenges will be to mount persuasive action at the European Commission in Brussels, and, by extrapolation, at the office of Chancellor Angela Merkel, to seek leniency on the (already once-postponed) obligation to reduce the budget deficit to 3% of GDP by 2015.

The new prime minister and his finance minister, Michel Sapin, a veteran of currency skirmishes with the Germans in 1992, will have their backs to the wall . His nomination came after the Socialists' humiliation in Sunday's elections. The Socialists lost control of 115 cities and towns. The centre-right opposition UMP was the main winner but its share of the vote at 45% was lower than the 46% it won in 2008 in similar mid-term elections. Marine Le Pen's nationalist-populist Front National won 7%. The level of abstention reached 40%.

If Valls succeeds in lifting French growth in sustainable fashion in the next 12 months or so, his country will return as a co-equal with Germany in the modern concert of Europe. Yet, chillingly, many entrenched left-wingers in France will not want him to do well. In that case, Hollande's fate is sealed. He will lose comprehensively the next French presidential elections on 2017 - and yet another French governing party will be consigned to a period in opposition only a short time after taking power

The political ups-and-downs in Paris should not distract attention from the wider picture. Through a combination of open power-play and behind-the-scenes diplomatic and monetary maneuvering, Germany is moving into a position under which, as condition for stablising the currency bloc, it can exert much greater control over a weakened France and over the euro bloc as a whole. This may be the only way to put the single currency on to a sustainable long-term footing. But it will not meet an enthusiastic response in Paris, Rome or Madrid.

The French president, for 50 years the classic counterweight to German influence in Europe, has lost power and prestige in a highly visible way and at a supremely difficult time for Europe. A prolonged growth slowdown has brought resolution of some of the euro area's crassest economic imbalances – but the pernicious side-effects include indications of incipient deflation.

The delicate political position in both France and Italy is one more factor preventing the European Central Bank from taking any decisive action on easing its monetary stance. The ECB and its president Mario Draghi indulge in much talk of 'action programmes' under study in the event of a further euro shock.

This encompasses the possibility of further setbacks in emerging market economies, including Ukraine and Russia. Yet the ECB is obsessively reluctant to take steps that could scale back pressure on politicians to take corrective reforms at home.

Rather than any dramatic short-term moves, a longer-term consolidation appears more likely, under which Germany undertakes patient political and economic measures to strengthen the euro bloc while reinforcing an explicit and implicit hold over euro member's' economies.

One possibility is that sweeping personnel changes could take place in the next two years under which Jens Weidmann, the Bundesbank president, becomes head of the ECB. Before too long Draghi could face persistent calls to return to Rome to take over the presidency of Italy from Giorgio Napolitano, the 88-year-old head of state.

His replacement by a younger man with a reputation for international economic management could help accelerate Italy's tenuous progress in economic reforms – arguably the euro area's most difficult and crucial economic task.

Much-feted saviour

If Draghi were to bow out in 2015, half-way through his eight year term, he would depart as a much-feted saviour after his so far (and probably never to be) unrequited 2012 promise to purchase unlimited quantities of government debt. As a former governor of the Banca d'Italia, Draghi would follow in the footsteps of Carlo Ciampi, the former central bank governor who was prime minster in 1993-94 and head of state between 1999 and 2006.

Draghi would certainly leave Frankfurt with Germany's blessing, all the more because this could pave the way for Weidmann to take over at the ECB.

Temperamentally and politically, Weidmann – a former adviser to Chancellor Merkel – would be a far better choice than the former Bundesbank president Axel Weber. Weidmann's predecessor was groomed for the job (eventually taken by Draghi) in 2010 but finally rejected the idea in early 2011 after Merkel gave him only inadequate assurances that she would back him in European in-fighting.

Sabine Lautenschläger, the former Bundesbank vice president, who has just moved to the ECB board, could return to the Bundesbank as president if Weidmann went to the ECB in the next two years.

To complete a triangle of appointments, Jörg Asmussen, the former ECB board member and former German finance ministry state secretary, who moved to Berlin as state secretary in the Labour Ministry earlier this year to build up his foothold in the Social Democratic party, could achieve a long-held ambition of taking over the finance ministry post from Wolfgang Schäuble. This assumes the incumbent will retire in 2015. ▪

Denis MacShane is an OMFIF Advisory Board Member and David Marsh is Chairman of OMFIF.

China's shadow banking sees the light

Reforms reflect efforts to strengthen market economy

Julia Leung, Senior Adviser

To compare China's 'shadow banking' to the US subprime crisis makes catchy headlines. To suggest that China is facing a 'Lehman moment' sounds scary. One shouldn't be surprised that, on China, market commentators are in a state of either euphoria or depression. The truth lies somewhere in between.

Although the growth of shadow banking has undoubtedly brought risks, this is not a problem on a systemic scale. The China Banking Regulatory Commission (CBRC) has taken a series of actions to contain the sector's growth. Further development of the system is likely to be messy, as more trust loans will go bad amid China's slowdown. Non-performing loans will increase.

But China's banking sector, long protected by interest rate ceilings, is hugely profitable and adequately capitalised to cope with a serious rise in non-performing loans from the average 1% seen up to now.

Tightening prudential regulation to contain the growth of shadow banking may be necessary. But this is merely a shorter term expedient. The real solution lies in tackling the root of the distortions caused by the interest rate structure of the domestic financing sector. The best way to encourage banks to bring their lending business in from the shadows would be for the authorities to liberalise remaining controls on deposit rates. Finding remedies for shadow banking reflects part of a general effort to bring about deep-seated structural reforms across the Chinese economy.

One distinction needs to be made. China's shadow banking, which experienced phenomenal growth in the past four years, is very different from that in the US. In the west, shadow banking normally refers to non-bank financial products such as money market funds (MMFs), asset-securitised products in the wholesale market which has become an important source of short-term liquidity for banks.

'Lehman moment'

The 'Lehman moment' came in September 2008 when funds that had invested heavily in Lehman papers 'broke the buck', triggering a run on MMFs and the seizing-up of the wholesale funding market.

In China, a significant part of its shadow banking is de facto bank financing off balance sheet. This credit comes in three main forms. First come trust loans, which are lending extended by trust companies, often with the latter acting as a conduit for bank lending. Then we have entrusted loans, a kind of peer-to-peer lending mechanism among companies, with banks acting as middleman. Third come, corporate bonds and riskier commercial bills, known as undiscounted bankers' acceptances.

Total financing

The amount of credits generated in this new form is staggering. According to data from the International Monetary Fund and the People's Bank of China, these three categories at end-2013 stood at just over Rmb30tn ($4.8tn) or roughly 25% of total financing in China, up 30% from a year earlier.

By comparison, bank loans make up 70% of the total stock of financing. But in flow terms, shadow banking is much more significant, accounting for 40% of new total financing last year, while banks took up 50%. Rapid growth in this sector has been the main reason driving total financing to 200% of GDP in the fourth quarter of 2013, from 129% of GDP in 2008, according to IMF data.

China's shadow banking is a by-product of the massive fiscal and monetary stimulus announced in late 2008 to offset the shortfall in external demand following the near-meltdown of global finance. This gave the green light for provincial governments to step on the gas pedal.

Using land as collateral, local governments used their own financial platforms and trust companies to borrow from banks to finance infrastructural projects and real estates. Such financing needs are insatiable, limited only by the supply of credits.

In China, credit quotas and loan-to-deposit (LTD) ratios (75%) used to be an effective tool to rein in credit expansion. Commercial banks wishing to expand lending traditionally have to expand their deposit base, but regulated deposit rates prevented them from competing through price.

This is where the banks, particularly those with smaller deposit bases, became innovative. Collaborating with trust companies, banks started the practice of selling trusts' investment products and wealth management products (WMP) to high net worth individuals at 8-10% returns, more than double the rates they receive on term deposit accounts.

The banks used such WMP proceeds to purchase assets in areas like real estate, coal mines etc. When bank regulators issued decrees limiting such activities, they kept a step ahead by burying such financing deeper off-balance sheet.

This kind of behaviour is not wholly bad. Banks have been trying to play a much-needed role to help bring flexibility into a partially liberalised interest rate system. They are attesting to intermediate between savers looking for higher returns and borrowers, including smaller and medium-sized companies, willing to pay market rates.

But such off-balance sheet financing is opaque and under-regulated. Risks abound. In addition to taking on riskier credits, banks face serious liquidity risk in tapping WMP proceeds to fund illiquid long term projects. Disclosure and standards for investor protection are often inadequate.

No simple answers

There are no simple answers to the question of who bears the losses if borrowers default. I am told that the legal documents would say it's not the trust company or the bank which sells them.

When China Credit Trust's loan to a Shanxi coal mine went sour, investors were bailed out with full repayment of principal, but not the promised 10% interest rate. Moral hazard is high. Partly because of this, the authorities have allowed the first corporate bond default without a bail-out.

The market is guessing that the same would apply to shadow banking. That might unsettle markets in the short-term. Yet over the longer-term such steps form part of progress towards China becoming a more market-oriented and efficient economy. ▪

Julia Leung is former Undersecretary for Financial Services and the Treasury in Hong Kong and Senior Adviser to OMFIF.

Yellen's 'six months' unsettles markets

Interest rate uncertainty highlights Fed's communications tests

Darrell Delamaide, US Editor

Janet Yellen creates a stir at first press conference in Washington on 19 March

US Federal Reserve Chairman Janet Yellen (voter) got a baptism by fire in her first press conference on 19 March when she responded to a question about just how long was the 'considerable time' mentioned in the Fed statement as the interval between the end of bond purchases and the first hike in rates.

'Around six months,' was her too-honest reply, prompting a sell-off in stock and bond markets.

Traders may leave higher maths to their computer programmes. But they are good enough at arithmetic to figure out that if the Fed continues to reduce bond purchases by $10bn a month at each meeting of the Federal Open Market Committee, then Yellen's remark meant that interest rate hikes could start in the first half of next year, two or three months sooner than expected.

Rookie mistake

A 'rookie mistake' was the generous judgment of the market, but nonetheless the perception persisted that the Fed had grown more 'hawkish,' whatever caveats about the economy and employment Yellen commented on.

St. Louis Fed Chief **James Bullard (non-voter)** was quick to reassure markets that Yellen wasn't saying anything new. The surveys that I had seen from the private sector had that kind of number penciled in,' he told journalists that same week. 'That wasn't very different from what we had heard from financial markets. So, I just think she's just repeating that.'

Charles Plosser (voter), head of the Philadelphia Fed, also found the market's reaction puzzling. 'I don't think the Fed changed its position,' he said in an interview with CNBC. 'In fact, it tried to say very explicitly in its statement that we believe forward guidance or the expectations have not changed as far as we're concerned.'

Unemployment target

The FOMC did abandon a numerical target on unemployment as a guideline for policy action because the 6.5% jobless rate it had targeted has virtually been reached.

Chicago Fed Chief **Charles Evans (non-voter)** had indicated that a change was in the wind ahead of the mid-March meeting. 'We are going to have to come up with a different language formulation that doesn't mention 6.5%,' he told an audience in Columbus, Georgia.

'That is why I say I expect it will be a qualitative description. It ought to be something that captures the fact that it is going to continue to be low well past the time that we change the language.'

It was Evans who first formulated the target of a 6.5% unemployment rate for keeping rates low as long as inflation remained below 2.5%, in what became known as the Evans Rule.

Narayana Kocherlakota (voter), head of the Minneapolis Fed, formally dissented from the consensus statement because it 'weakens the credibility of the committee's commitment to return inflation to the 2% target from below and fosters policy uncertainty that hinders economic activity'.

He explained his dissent more fully in a statement he released later that week: 'The FOMC's new forward guidance does not communicate purposeful steps being taken to facilitate a more rapid increase of inflation back to the 2% target.

Weakened credibility

'The absence of this kind of communication weakens the credibility of the committee's inflation target, by suggesting that the committee views persistently sub-2% inflation as an acceptable outcome.'

Kocherlakota was also concerned that targeting 'maximum employment' without providing a specific target or time frame created uncertainty. 'These omissions create uncertainty about the extent to which the committee is willing to use monetary stimulus to foster faster growth, and this uncertainty is a drag on economic activity,' he said in his statement. He added that he would have preferred a new target of 5.5% unemployment as long as inflation remained below 2.25% and inflationary expectations were in check.

Concern over deflation

Plosser also expressed concern about inflation being too low, in another television interview. 'I would like to see inflation creep up a bit,' he told Fox Business News. The Fed has set a 2% target and he feels it is 'important to defend that target.' He added that he does expect inflation to creep up 'over the next year or two.'

Atlanta Fed Chief **Dennis Lockhart (non-voter)** said he was concerned that the low inflation rate could indicate 'some more fundamental weakness' in the economy. Combined with the continued weakness in the US labour market, this would mean a tightening of monetary policy later rather than sooner.

'The second half of 2015 is a reasonable timeframe in which we might get to what we're calling liftoff,' he said at a business conference in Atlanta.

This is not inconsistent with Yellen's remarks at the press conference, said Lockhart, who is considered a centrist on the policy-making panel. When she referred 'in a sort of off-hand way' to a six-month timeframe, 'that is really a minimum, not a maximum,' he said.

End of stimulus

John Williams (non-voter), head of the San Francisco Fed, told the Washington Post that a 'considerable period' is not specific about a time frame, and wording it that way was a conscious decision.

'My view is if the economy evolves the way I expect, I expect us to end the asset purchase programme late this year,' Williams said. He added: 'I don't expect us to start raising interest rates until the second half of 2015.'

In the meantime, Fed officials have been engaging in an occasional debate about using monetary policy to deflate asset bubbles.

At a Fed conference in Washington. Fed Governor **Jeremy Stein (voter)** suggested that policy-makers should at some point be more explicit in incorporating concerns about financial stability in to interest-rate decisions.

'To be specific,' he said, 'are there cases in which one might tolerate a larger forecast shortfall of the path of the unemployment rate from its full-employment level than one would otherwise, because of a concern that a more accommodative policy might entail a heightened risk of some sort of adverse financial market outcome?'

Conceding that such musings are theoretical for the moment, his answer is yes, there is a cost in accommodative policy in the form of enhanced risk to financial markets. 'Even with inflation concerns entirely set aside, monetary policy faces a tradeoff,' Stein said.

Williams, speaking this time at a Brookings Institution event, disagreed, saying interest rates should not be used to deflate asset bubbles or maintain financial stability.

Williams, who served as chief economist when Yellen led the San Francisco Fed, said the Fed should look at 'what tools do we have instead of going to the old debate of using monetary policy to deal with financial stability issues.' ▪

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

US economy set to rebound after winter weather spell

The US economy is set to recover in the second quarter of 2014, following its winter weather spell that severely disrupted supply chains and dampened global growth. US industrial and housing data is expected to pick up after poor first quarter results that blurred an underlying bullishness for the world's largest economy, *writes Trevor Greetham in London.*

The threat of inflation remains absent which favours equities over stocks as an asset to invest in the long-term. Similarly, many believe stocks will be a better play than commodities. Those in US and Japanese markets are best positioned to take advantage of gathering US momentum which underpins any positive expectations going forward.

Fears of deflation are supported by the public statements from Janet Yellen whose comments point to widely known fears that growth in the developed world is not robust enough to be self-sustaining. Mario Draghi, Janet Yellen and Mark Carney have repeatedly emphasised that they do not intend to tighten monetary policy through an abrupt hike in interest rates, sudden withdrawal of asset purchases or shock policy actions in the near future.

The predictable stance of the Fed is meant to sink a firm monetary anchor to the US recovery by reassuring markets that it is still ready to intervene if there is a reversal of fortune. The picture of improving growth prospects in the US economy is reflected in projections for the UK, the European Union and Japan. However, the Bank of England, European Central Bank and Bank of Japan have all stressed that radical monetary policies cannot be withdrawn until the economic fundamentals are on a surer footing.

China and commodities

Meanwhile the expectation of a hard landing in China remains a theme of investor sentiment. Data from the first quarter were weak as authorities took actions that attempt to curb excessive credit growth.

There are fears that China's shadow banks have made too many loans that could eventually lead to corporate defaults, thereby destabilising the wider economy and upsetting the 7.5% annual growth rate target set by the Chinese Communist party.

Tied to China's fragile growth are the long-term prospects for commodity prices. Recently geopolitical tensions over Ukraine and bad weather boosted the prices of energy, precious metals and agriculture. But the slowdown in China connected with its sensitive industrial metals shifting downwards is expected to bring commodity prices downwards throughout the year.

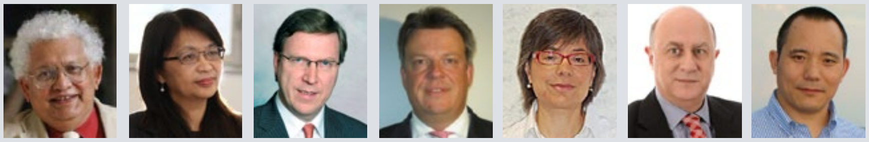
Volatility versus stability

There could be some volatility but many analysts expect equity markets in the developed world to continue to trade higher and weather any storms from financial crises, downturns or recessions that might be on the horizon. The effect of the Ukrainian crisis on markets at a global level is yet to be seen.

A resumption of dollar strength is probable as the crisis in Ukraine dents confidence in Europe. Ultimately emerging equity markets are caught between the slowdown in China and the unwinding of US monetary policy. ▪

Trevor Greetham, member of the Advisory Board, is Director of Asset Allocation and Portfolio Manager at Fidelity Worldwide Investment.

Chinese President Xi Jinping



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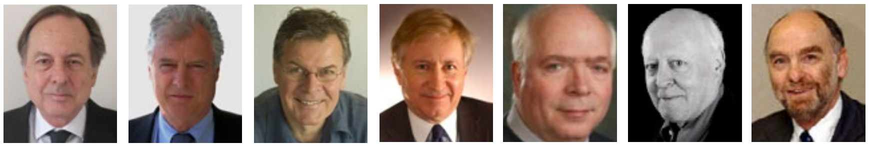

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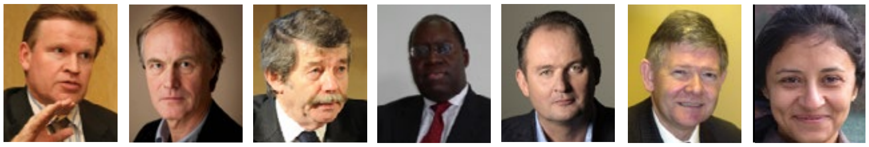

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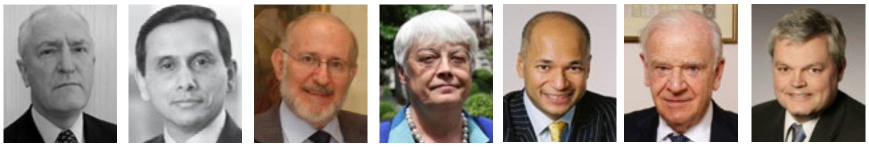

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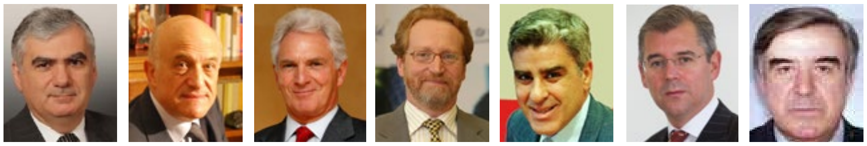

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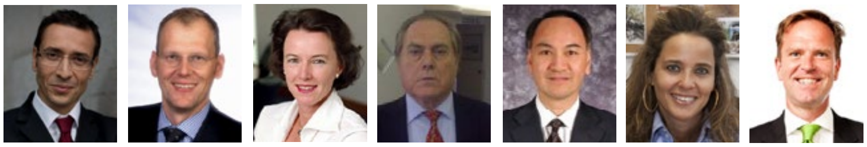

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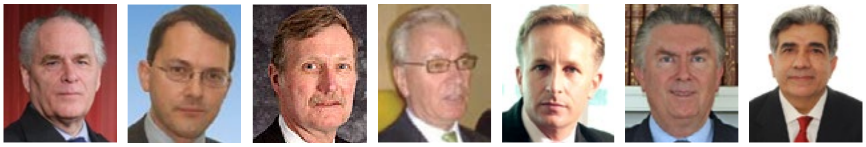

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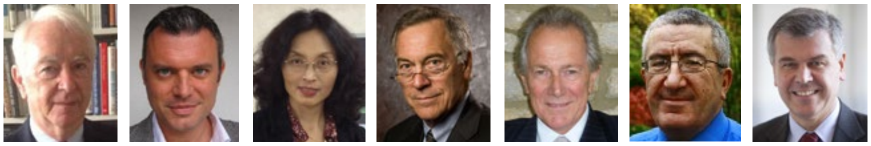

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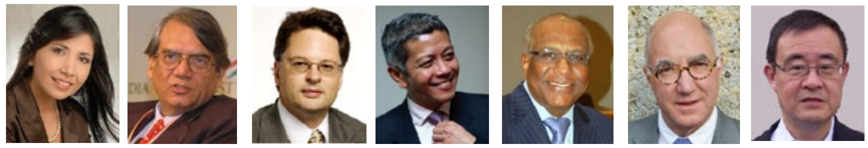

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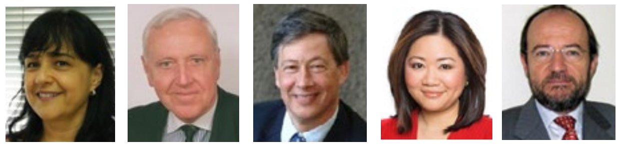

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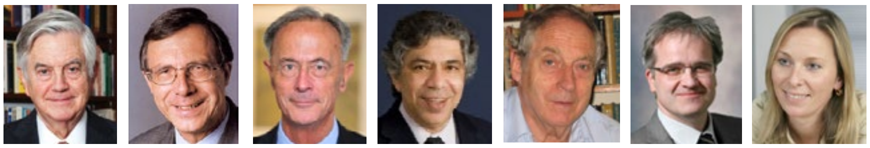

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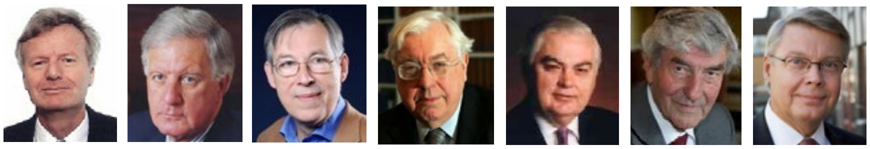

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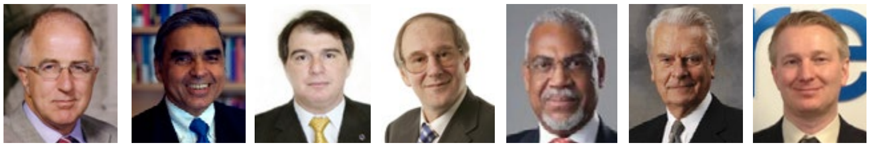

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Euro area separates from the rest

ECB should pay attention to deflationary dangers

Gabriel Stein, Chief Economic Adviser

World broad money growth trends continued to diverge in the first quarter of the year. The threat of deflation should be on the minds of policy-makers at the European Central Bank as they appear to not take the possibility of Japanese-style deflation seriously.

In fact I believe that the risk of deflation in the euro area is the biggest hazard for the world economy this year, more serious than dangers eminating from emerging markets. Japanese developments in the 1990s mark the most potent example of the consequences when monetary policy becomes impotent because of economic stagnation.

At his April press conference Mario Draghi made clear that the ECB does not rule out any options and that the Governing Council is 'unanimous' on the use of unconventional measures, including quantitative easing, to ward off possible deflation. But he stopped short of actually announcing any measures, preferring to wait for inflation to rise again. It may – or it may not. That may well be so.

But deflation, like excessive inflation, is easier to avert than to cure. This is worrying. Milton Friedman famously said: 'Inflation, over any sustained period of time, is always and everywhere a monetary phenomenon,' and, 'so, too, is deflation.'

Given that the ECB, at least nominally, is an avowedly monetarist central bank, it should be more worried about the deflation risk. The ECB ostensibly has a 4.5% medium-term reference value for M3 growth. But broad money growth has not been that high since April 2009. The latest numbers show M3 growing barely above 1%.

On a three-month annualised basis, a volatile measure but still a guide to the latest trends, broad money growth in the euro area has been less than 1% since November 2013. Meanwhile, credit to the non-bank private sector continues to contract on a 12-month basis.

Furthermore, this is not a question of weakness in the periphery dragging down the pan-euro area measure. With the exceptions of Germany and Austria, where the national contribution to M3 growth is a weak 3%, both core and periphery countries of any size are showing broad money growth either low or weakening. Averaging the last three months of 12-month growth, the countries where M3 growth is above 3% (already a very weak number) add up to around 5% of euro area GDP. (See Charts 1, 2 and 4.)

The ECB's Asset Quality Review and regulatory pressure on banks to raise their capital/asset ratios will put further downward pressure on broad money growth.

The problem for the euro area is the high levels of debt, whether in the non-bank private sector, the banking system or the public sector. Deflation means little or no nominal GDP growth, which means that the debt burden is not reduced as much as it would be if nominal GDP expanded.

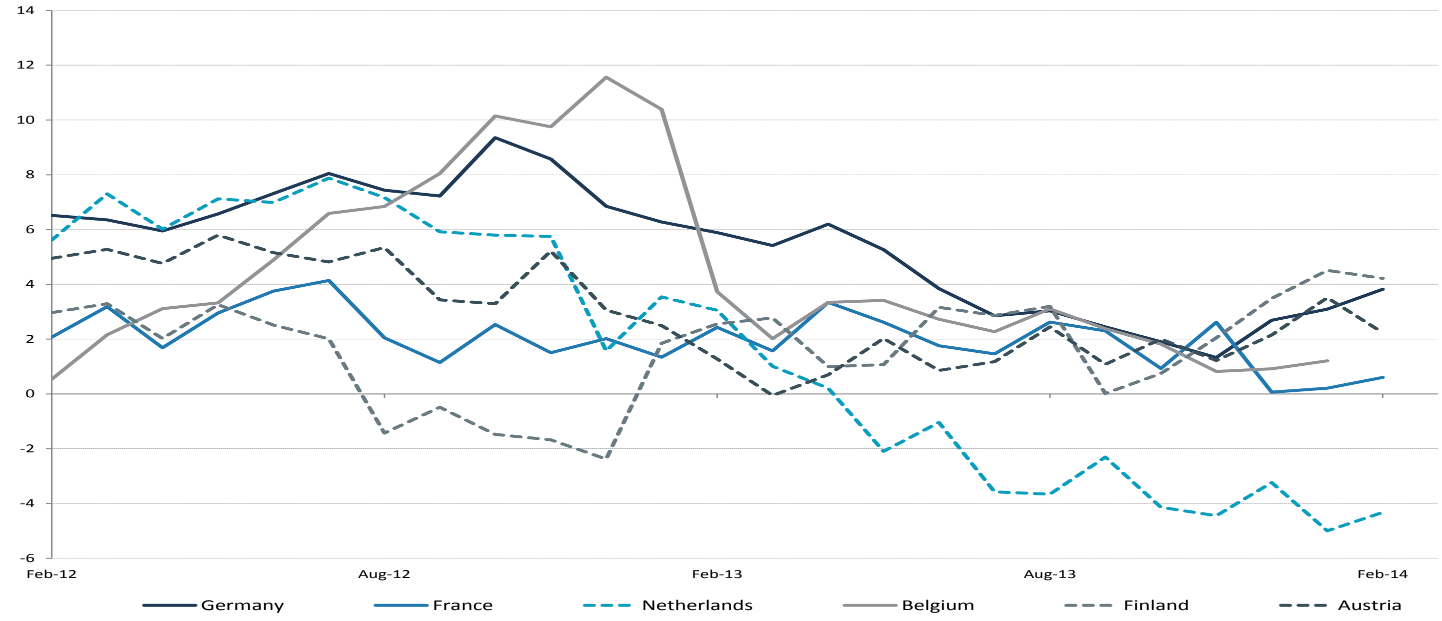
To avert deflation, the ECB must boost broad money growth. Since the overwhelming share of broad money is the bank deposits of the non-bank private sector, the easiest way to do this is to buy assets that belong to this sector.

Other measures that have been discussed – e.g. further very long-term refinancing operations (VLTROs), introducing negative interest rates on banks' deposits with the ECB or cutting interest rates further to zero from 0.25% – are unlikely to have much impact. Pushing down the exchange rate of the euro would help, but the ECB has so far had little success in doing so, partly for want of trying.

The asset normally thought of in this context (not solely because of the Japanese, American and British experiments with quantitative easing) is government bonds. However, there are reasons why this may not be the best way forward for the ECB.

First, because a programme of bond purchases, if successful, will eventually push up long-term interest rates, leading to

Chart 1: Core countries' national contribution to euro area M3, 12-month change, %



Source: ECB

a capital loss. Second, bonds will, to a large extent, be owned by the banking sector. Hence their purchases by the ECB will have less of an impact on money supply, since cash or deposits held by banks are not included in broad money.

Furthermore, this would raise political problems, ranging from the ban on financing government spending to the selection and number of bonds purchased. These include whether the bonds targeted would all be triple A-rated or whether they would be weighted by GDP, by shareholding in the ECB or by outstanding stock of debt.

ECB equity purchases

One possible way forward that bypasses many of these issues would be for the ECB to buy equities. Equities are generally owned by the non-bank private sector. Hence ECB purchases would have a direct and immediate impact on the stock of broad money. If the programme was successful so that it averted deflation and spured output growth, the shares bought would rise in value and could be sold at a profit.

However, there are real problems with this approach. Leading European monetary officials say European stock market prices are already excessively high after bubble-like conditions in equities over the last 12 months. Purchasing equities in overt fashion by the central bank would be unusual even if stock markets were depressed, but would be revolutionary when equities are close to post-crisis highs. Additionally, no one really wants the central bank of any country to be a large owner of the corporate sector.

One intriguing sign of a conservative European central bank breaching this rule reflects the actions of the Swiss National Bank (SNB), which has built up a large stock of equities. The SNB annual report for 2013 showed that the share of the SNB's investments in its equity portfolio via its currency reserves rose from 12% to 16%. over the course of the year.

Another possibility, which would have an immediate impact on household wealth (although would not directly boost broad money growth), would be for the ECB to buy mortgage debt and write it off. But this would remain reasonably consistent with the continued global economic recovery. This is not the case, however, in the euro areaas it would almost certainly be a step too far for at least some euro area members, as it would give the appearance of rewarding 'feckless borrowers' at the extent of 'prudent savers'.

Yet, the ECB must do something. Sustained deflation would be damaging for the euro area and the world economy as a whole. This is the biggest downside risk to the global economic recovery in 2014 and 2015. The monetary data highlights this risk. It is now up to the ECB to do what it can to avert it.

American broad money – the equivalent of the old M3 measure discarded by the Federal Reserve in 2006 – continued its steady, if unspectacular advance of 5-6% per annum. While still somewhat slower than the growth rate historically consistent with trend output growth, it is strong enough to indicate a continued recovery in the US economy. The Fed is on course for ending its quantitative easing later this year and for raising interest rates in 2015.

Disregarding Yellen's 'around six months' comment (regarding the possibility of interest rate increases after the end of tapering) as a slip of the tongue, rather than a clear steer, members of the Federal Open Market Committee expect the Fed Funds rate to end next year at 1%. This implies three (or four, depending on how you measure the current 0-25bps rate) increases over the course of 2015.

UK developments

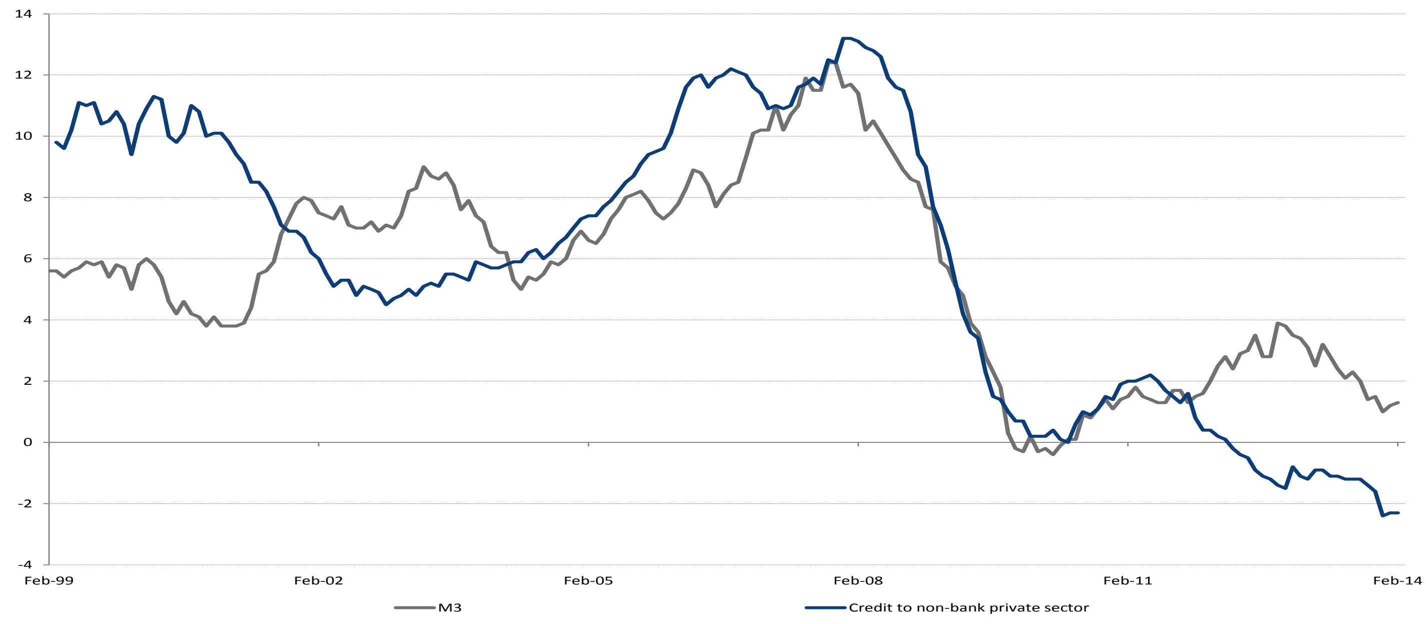
Monetary developments in the UK and the US show some contrasts. US broad money growth is accelerating, while growth of the Bank of England's preferred broad money measure, M4x (i.e. broad money less the deposits of so-called Other Financial Institutions) is slowing.

In early 2013, M4x grew at around 5%, showing the recovery in the UK economy. Since then, the rate has slowed to 3-4%, well below what would be desirable. (See Chart 3.)

However, falling unemployment and a strengthening housing market imply that broad money growth should turn around in 2014. The similarity with US developments is that broad money growth is not anaemic and indicative of a growing economy.

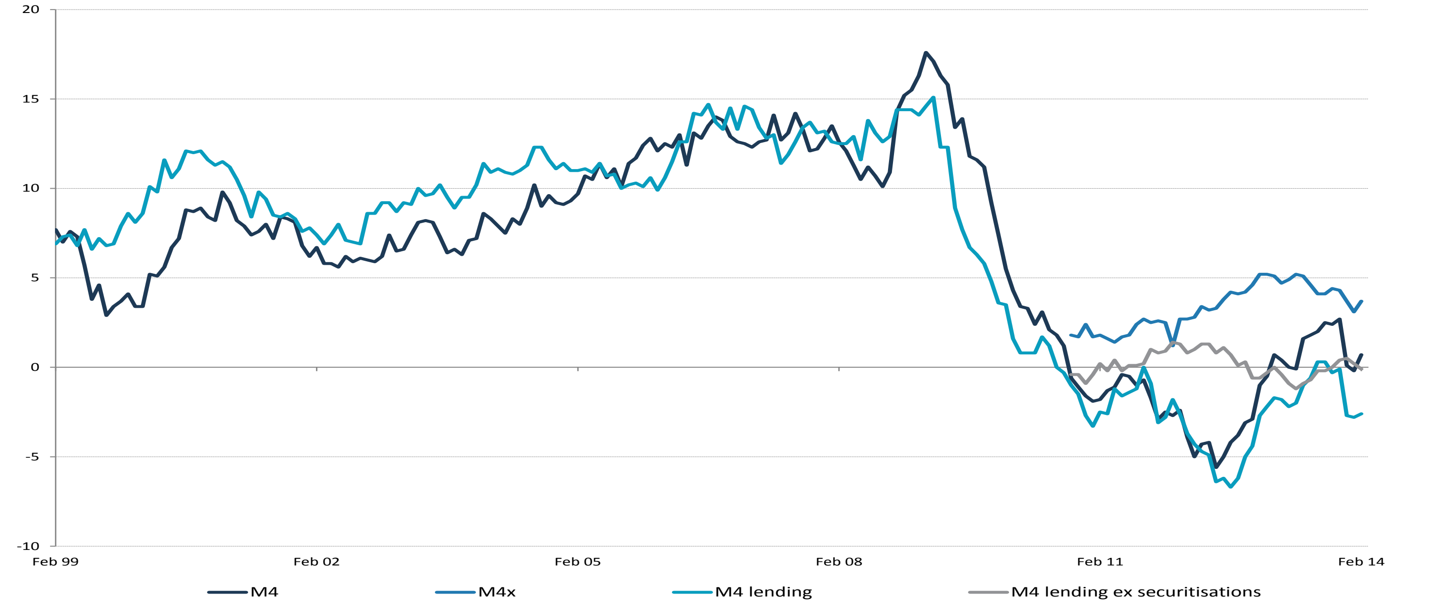
The BoE, having been wrong-footed by its failure to predict the strength of the labour market, is likely to move more or less in tandem with the Fed, beginning to raise interest rates next year.

Chart 2: Euro area broad money and credit, 12-month change, %



Source: ECB

Chart 3: UK broad money and credit, 12-month change, %



Source: Bank of England

In both these countries there is a case for arguing that interest rates should rise in 2014. Not much and not more than once, but as a sign that economic conditions are beginning to recover, and that it is time to start normalising interest rates. However, with both central banks afraid of aborting still fragile recoveries, that is less likely.

Both the Fed and the BoE have stressed that interest rates will remain lower than in the past for some time to come. Strangely, both central banks keep referring to nominal interest rates. But, surely, the relevant measure is real interest rates, i.e. adjusted for the rate of inflation. The long-term average real effective Fed Funds rate is around 2%.

The average real effective Fed Funds rate since 2008 is -1%. Even raising the Fed Funds rate to 3% (a highly unlikely near-term development) would therefore still leave interest rates low by historic standards.

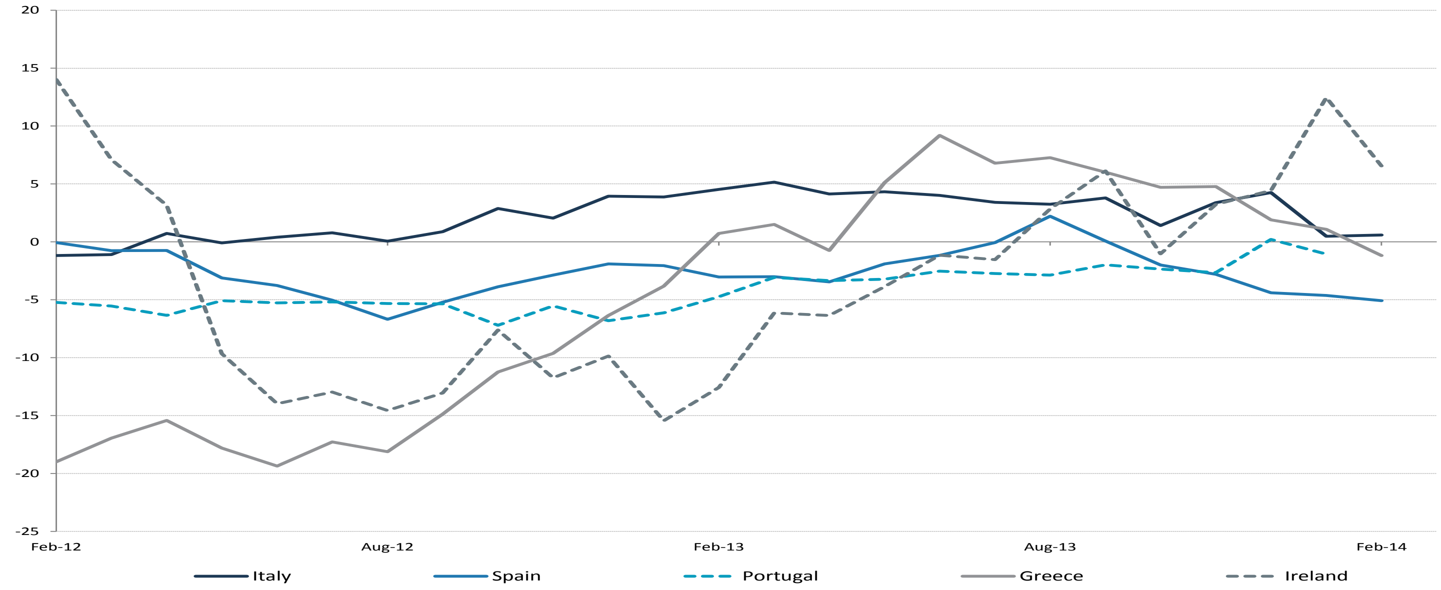
In the world's No.2 economy, Chinese M2 growth ended 2013 13.6% up from 2012, higher than the 13% target set by the People's Bank of China. Average 12-month growth over the year was higher, at 14.8%. In the first two months of 2014, broad money growth has slowed further, partly because of the tightening bias displayed over much of 2014 by the PBoC.

However this bias shifted in early 2014 and it now looks as if the next PBoC policy move may be to ease, possibly by cutting the reserve requirement ratio (RRR) from its current 20% (for large banks: some banks have a lower RRR).

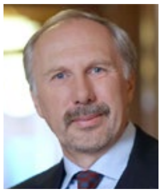
Meanwhile, Japanese M3 growth is edging up, having passed the 3% growth number in June 2013 to 3.5% in late 2013 before falling back slightly in January and February. In contrast with the large central banks, the Bank of Japan is more committed to easing than to tightening monetary policy. ▪

Prof. Gabriel Stein is OMFIF's Chief Economic Adviser.

Chart 4: Periphery countries' national contribution to euro area M3, 12-month change



Source: ECB



Austria's example in Europe's recovery

Labour reforms and preventative measures safeguard economy

Ewald Nowotny, Austrian National Bank

The Austrian economy recovered rapidly following the financial crisis of 2008-09 and performed well in 2012-13 relative to the euro area. Austria is increasingly recognised for its very high degree of stability, which has shaped growth prospects for the future.

Several lessons may be drawn from the Austrian recovery, resulting from the interaction of various factors. These helped Austria weather the financial storm.

A rather simple but important observation to make about economic crises is that strong fundamentals help to cope with external shocks to the domestic economy. The case of Austria is worth studying in this regard.

Austria's economy exhibited robust growth due to structural resilience of the country's economic model. Macroeconomic developments were balanced and international competitiveness was strong – as was productivity and employment growth. Austrian labour markets remained flexible and correctly anticipated the short-term nature of the crisis. The pronounced flexibility in working hours rather than in headcounts helped the labour market cope with the recession. Austria's labour market is comparatively flexible to others in Europe. Coordinated wage setting and a strong macro-orientation of entrepreneurs' associations and of the labour union led to enhanced flexibility in working hours and wages.

This was accompanied by a high degree of sectoral wage differentiation according to sectoral productivity and sector-specific working time regulations. Apprentice schemes helped keep youth unemployment low.

A significant and immediate fiscal stimulus was followed by gradual fiscal consolidation. Active labour market measures supported short-term work or aimed at improving the employment chances of workers at risk of unemployment. Policy-makers adopted a comprehensive banking sector support package, thus stabilising expectations and containing the fallout from the crisis.

Austria benefitted from implementing sound policies in the good times. For instance, a differentiated system of active labour market policy measures. These were in place at the time of the crisis and cushioned Austria from the harshest impact of the 2009 recession.

Furthermore the country benefitted from stability and social consensus. The Austrian Social Partnership facilitated the response to the recession. The Austrian-wide consensus to combine both supply-side and demand-side policies put the economy on a firmer footing for the long-term. Furthermore, entrepreneurs' associations and labour unions helped workers cope with this difficult period.

Austria and central, eastern and south-eastern Europe (CESEE) are partners. Since the height of the CESEE market turmoil in early 2009, Austrian banks' exposure to the region has increased by a cumulative 6% (or close to about 3% when adjusted for exchange rate effects). While exposure shrank in countries in which banks faced a difficult economic environment or a politically-induced tightening of bank regulation and taxation, this was more than compensated for with greater exposure in other CESEE countries.

During the crisis, the only way to assure sustainability for the whole euro area was for foreign banks to remain engaged in the countries in which their subsidiaries worked. Therefore Austrian policy-makers recommended higher capitalisation of domestic banks and more sustainable funding of bank subsidiaries abroad. ▪

Ewald Nowotny is Governor of Austrian National Bank.

UK house price boom is partly Bank of England's responsibility

Politicians of my acquaintance often bemoan the opinion poll findings that they cannot be trusted. They are almost as bad as journalists it is said. Well, here we go again with the British Chancellor of the Exchequer George Osborne, writes William Keegan in London.

There was an indication of the need to distinguish between what he says and what he does in the appointment of Mark Carney to be governor of the Bank of England.

In opposition Osborne went out of his way to claim that he was going to end the speculation that inevitably developed towards the end of a governor's traditional five year term by announcing that under his rule there would be a one-term governor, with an eight year appointment, and that would be that.

His favoured candidate soon bargained him out of this rock solid commitment, and that was that. Carney, a relatively young and ambitious man, would come only for five years.

Another of Osborne's promises was that, unlike his favourite scapegoat Gordon Brown, he would be careful with the government's finances. As a sign of his good intent, he set up the Office for Budget Responsibility, to provide independent and honest forecasts and hold the chancellor to his word.

Osborne's criticisms of Brown were always overdone, but he has been a skillful propagandist. However, instead of the house price boom we experienced under Labour, we now have a house price boom under the Conservatives, not least in London. It is no secret that the chancellor has been encouraging this boom with various measures.

The Office for Budget Responsibility is discreetly sounding the alarm, but politics are politics, and Osborne wants to win an election and take over from David Cameron should the latter retire (an option about which one has one's doubts).

Back to Carney. With 'forward guidance' about his commitment to keeping interest rates low he has certainly made his contribution to the house price boom. The BoE has macro- and microprudential tools with which to try to control house prices, as well as the interest rate weapon. With loan-to-value and borrowing-to-income ratios already close to what happened when the Brown Bubble burst, the pre-election economic policy is already looking somewhat irresponsible.

Yet in London, which increasingly dominates the UK economy, Carney complains that his hands are tied. Why? Because the boom is being led by cash buyers from overseas. Osborne no doubt hopes the bubble will not burst until after the next election. But that is not due until. May 2015. I foresee trouble before then. ▪

William Keegan is Chairman, Editorial and Commentary Panel.

Crisis in Crimea sours investor outlook

German economy starts 2014 strongly but will slow

Michael Holstein, Advisory Board

The crisis in the Ukraine has kept financial markets in a state of permanent anxiety in recent weeks. Despite some sharp temporary falls, most equity markets have held up. In March 10-year Bund yields fell on balance as risk aversion emanating from the Crimea crisis drove investors to safe havens. Unexpectedly negative fundamental data from China was an additional factor depressing yields.

China's manufacturing sentiment indicators have already softened markedly in recent months, and now the first 'hard' data on the economy has confirmed Chinese growth has weakened further this year. The latest figures show slower industrial production growth. Retail sales data reveal weaker consumption, too. The most likely explanation is that the Chinese economy is passing through a soft patch and that the negative trend will not prove permanent.

The first quarter is likely to show a slight growth slowdown, with a flat profile for the full year. China's exports will profit from the US and European recoveries. Some Chinese reform initiatives are starting to weigh on the economy, in an effect that will strengthen later in 2014. A slump remains unlikely. All the indications are that Beijing will not rush the reform process and is more likely to act too slowly than too quickly.

While this is a risk to longer-term growth, such a prudent approach will be a stabilising factor in the medium term. The Chinese government could boost growth through smaller-scale stimulus programmes if needed.

The Ukrainian crisis is visible in German economic indicators. The March Ifo survey showed the first small downturn in German business confidence since last autumn. While respondents rated their companies' operating environment as slightly better than the high level of the previous month, they demonstrated significantly less confidence for coming months.

The ZEW's economic expectations survey shows economic sanctions on Russians are a risk factor for the economy. Meanwhile, 'hard' indicators signal a robust first quarter for the German economy. Afterwards growth is expected to slow. The mild winter boosted construction earlier on, and this will be corrected in the spring quarter. First quarter growth will be around 1% (quarter on quarter), but a marked slowdown is likely in the second quarter, with full 2014 growth seen as accelerating to above 2%.▪

Michael Holstein is Head of Macroeconomics at DZ BANK.

DZ BANK Economic Forecast Table

GDP change (%)	2011	2012	2013	2014	2015
US	1.8	2.8	1.9	3.2	3.0
Japan	-0.4	1.5	1.5	1.4	1.5
China	9.3	7.7	7.7	7.5	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.4	2.3	2.6
France	2.0	0.0	0.3	0.8	1.3
Italy	0.6	-2.4	-1.8	0.4	1.3
Spain	0.1	-1.6	-1.2	0.8	1.5
UK	1.1	0.3	1.7	2.4	1.7
Addendum					
Asia excl. Japan	7.6	6.0	5.9	6.3	6.3
World	3.8	3.0	2.7	3.4	3.6

Consumer prices (% y/y)					
US	3.2	2.1	1.5	1.9	2.3
Japan	-0.3	0.0	0.4	2.1	1.7
China	5.4	2.7	2.6	2.9	3.6
Euro area	2.7	2.5	1.4	1.1	1.8
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	0.8	1.6
Italy	2.9	3.3	1.3	0.6	1.4
Spain	3.1	2.4	1.5	0.0	1.3
UK	4.5	2.8	2.6	2.2	2.8

Current account balance (% of GDP)					
US	-2.9	-2.7	-2.3	-2.3	-2.5
Japan	2.0	1.1	0.7	0.6	1.8
China	1.9	2.3	2.0	2.0	1.6
Euro area	0.1	1.4	2.2	2.3	2.3
Germany	6.2	7.1	7.0	7.2	6.5
France	-2.5	-2.1	-1.9	-2.1	-2.2
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.2	1.1	1.8	2.3
UK	-1.5	-3.7	-3.8	-4.3	-4.0

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How central banks need to adjust

...continued from p.10

This is as a result both of central banking incursions on to bond markets to buy debt as well as the central banks' new responsibilities for financial as well as monetary stability.

Yellen can cope with these pressures best, partly because she was not President Barack Obama's first choice for the job, partly because the Fed's de facto mandate has changed less than that of the Bank of England and the European Central Bank (ECB). All three central banks face conflicts between monetary and financial stability as the result of the need to raise interest rates in the next two years as economies pick up speed.

Both former BoE governor Mervyn King and his Canadian successor Carney have faced complaints that they have become unduly attuned to UK government policy. The make-up and actions of the ECB have become more politicised as a result of doubts about the euro's sustainability in the past five years.

The Cypriot president has forced out of office Panicos Demetriades, the country's central bank governor, over alleged misdemeanours – the first time a member of the ECB governing council has been caught up in such cross-currents. Nominations for the ECBs six-person board are now much more political than when the ECB started in 1998. This is a sign of how much has changed in that period. ▪

Optimism about Europe is premature

Risks over inadequate reforms are greatest in France and Italy

Stefan Bielmeier, Advisory Board

Moody's was the first major rating agency to declare an end to the euro crisis. However, it is premature to say the problems have been resolved definitively. Fundamental flaws in monetary union, which were built in at the onset, remain at the heart of the problem.

For peripheral countries, joining the euro led to a number of benefits including significantly lower refinancing costs. Spain and Portugal had to pay interest rates of around 10% on bonds in the mid-1990s – compared with only 5% in 1999. The crucial factor was that international investors assumed that the European Central Bank would ensure low inflation, the Stability Pact would enforce solid budget policy and the no-bail-out clause would be suspended if a member state failed.

The lower interest rates made it possible for the periphery countries to assume higher debt, most of which was used for public spending, consumption and property investment. This is evident from the massive widening of current account deficits and the surge in property prices from 1999 to 2008.

Strong growth fuelled by debt overshadowed structural weaknesses in these countries. Governments failed to implement longer-term investment policies and reforms to improve competitiveness. Economic savings resulting from low interest rates were absorbed in consumption and not in long-term development.

Corrective measures

Peripheral countries' budgets deteriorated steadily. The Stability Pact – originally conceived as a corrective measure – was suspended by Germany and France in the early 2000s, a foretaste of the budgetary overshoots that have been a constant feature of euro area economic performance in intervening years.

When the US property crisis started in 2007 followed by the collapse of Lehman in 2008, structural deficits in the problem countries were thrown into sharper relief as investors sought refuge in safe havens.

The euro area was no longer regarded as a single entity, but as a disparate collection of individual countries.

The concepts of 'core' and 'periphery' were born. As interest costs increased massively, Greece and Ireland had to be bailed out with EU funds in 2010, followed by Portugal in 2011.

Bail-out mechanism

Newly created bail-out mechanisms such as the EFSF/ESM were used to shore up the Spanish banking sector. In Italy, the government of Silvio Berlusconi – which refused to implement reforms – was replaced at the end of 2011. Tough austerity programmes were imposed on all the periphery countries.

However, the sovereign debt crisis only really started to abate when the ECB intervened by initiating the Outright Monetary Transactions (OMT) programme. The announcement by ECB President Mario Draghi that the euro and the currency union would be stabilised at any cost created an environment which allowed the periphery countries to work on their programmes of reforms and savings and to regain confidence. These countries started to demonstrate a degree of success.

Countries such as Ireland and Portugal are now able to raise finance independently in the capital market after an improvement in budget figures and the implementation of reforms to improve competitiveness. All the periphery countries reported positive – albeit low – quarterly growth figures at the end of 2013.

As a result, there have been an increasing number of rating upgrades or improvements to the rating outlook. The yields and Bund spreads of sovereign bonds in most periphery countries are now trading at their lowest levels for several years.

However, the sovereign crisis is not over, despite the announcement by agencies such as Moody's. The improved outlook for Germany and Austria, as well as lower risks on sovereign debt, are normally cited as the main evidence for such statements of confidence.

Strong performance in peripheral bond markets last year is attributable partly to the efforts of individual countries, but also to a large extent to global investor purchases under the influence of the OMT.

However, confidence is fragile and could be reversed. Unemployment in some countries has climbed to extremely high levels.

The prolonged phase of 'internal devaluation' has led to increasing 'reform fatigue'. It has strengthened the hand of political extremists.

To provide some respite, and counteract extremist tendencies, the European Commission and European governments are turning towards making concessions to countries under pressure.

This will lead to a delay in necessary reforms. The Agenda 2010 reforms in Germany, which are perceived to have made Germany more competitive, have been held up as an example for the troubled peripheral countries, yet they have not been implemented in many cases.

Degree of determination

Some countries such as Ireland, Portugal and Spain are still pursuing reforms with a degree of determination.

However, trends in Italy and the former 'core country' France carry much greater risks if their governments fail to produce genuine changes in economic structures.

France has long been relatively unwilling to implement reforms. Only recently has it moved in this direction. In Italy, much hangs on the success of the reforms planned by the new government of Matteo Renzi. If Renzi fails, Italy could descend into political chaos.

The risks for both these countries are immense. The challenges for the second and third largest economies in the euro area are significantly greater than those in the smaller and less significant peripheral members. But serious problems in France and Italy could spill over in to the periphery. These countries would not be able to digest a potentially prolonged period of interest rate rises.

Core countries

Core countries such as Austria and the Netherlands are struggling with internal problems, for example with the Hypo Alpe-Adria bank imbroglio and in the property sector. These bring corresponding rating risks. In Germany some hard-won reforms have been reversed. This sends the wrong signals to other countries.

No one should be under any illusions. Many efforts have been expended. Some improvements have been seen. Yet the euro crisis is still with us. ▪

Stefan Bielmeier is Divisional Head of Research & Economics at DZ BANK.

Lower yields, higher risks

Towards new diversification for sovereign investors

Gary Smith, Advisory Board

Fund managers have not had an easy time winning high returns for their investors over the past half-decade. Years of low interest rates, anaemic growth in the developed world and a nearly constant stream of crises have made investment strategy difficult.

To combat low returns, reserve managers at central banks and state pension funds are on the move into the territory that was the previous domain of sovereign wealth funds (SWFs). Both types of institutions are looking to diversify their portfolios away from their traditional areas of investment.

The pressure on central banks comes from two areas: reserves are growing and interest rates on investments are low. This combination is encouraging central bank reserves managers to add new asset classes to their portfolios.

Government yields

Because yields available on government bonds denominated in the traditional reserve currencies are at historically low levels, the cost to any central bank of investing in these assets has risen relative to other assets.

As a consequence, in this environment the appeal of international equity markets has been enhanced and some central banks have moved into this area since the 2009 recession. The Bank of Korea (BoK) is one such example. The perceived success of the BoK strategy has made other managers question whether they should not also shift some of their investments into equity markets around the world.

Looking abroad

Meanwhile public pension funds that have traditionally invested in domestic bond and equity markets have been encouraged to look abroad. This move has been because of low interest rates at home and, in some cases, because they have become too large to operate efficiently in domestic markets. International bond and equity markets offer a potential solution that can bring higher investment returns. In addition, at least in that part of their portfolio containing international publicly-traded securities, SWFs are increasingly investing alongside their local central bank and public pension funds.

The diagram below represents a simple model of how asset allocation has evolved for the sovereign investor sector. It is not intended to illustrate exactly the position of any individual nation but is intended to highlight broad trends affecting sovereign investors.

From the widening of the pyramid, one can see a general increase in the various categories of assets under management over the period since 2000. The pyramid shows that, over time as interest rates have fallen, sovereign investors have added new asset classes and steadily increased portfolio diversification.

The lower tiers of the diagram reveal that the most recent trend has seen the adoption of what might be described as a disaggregated approach to investing. Narrower asset classes, such as core government bonds and investment grade credit, were preferred at the expense of broader or aggregated asset classes.

To help funds invest more in specialised asset classes (such as high-yield bonds, emerging market debt, equities, and even alternatives, such as real assets), these funds will either need to recruit local expertise in those markets, or seek help from external managers.

Lack of clarity on liabilities

The relatively fluid approach to asset allocation preferences can in part be explained by the reality that liabilities for these investors are not usually well defined. Rather, liabilities can be multiple, layered, and shifting. The problem is not so much that liabilities cannot be identified, more than they are difficult to calculate.

Liability-driven investing is not feasible for these institutions, even for many public pension funds, because many do not have defined and inviolable liabilities. Instead they make soft promises, which are not aligned with the style of liability-driven approach to investing that can be seen with corporate pension plans.

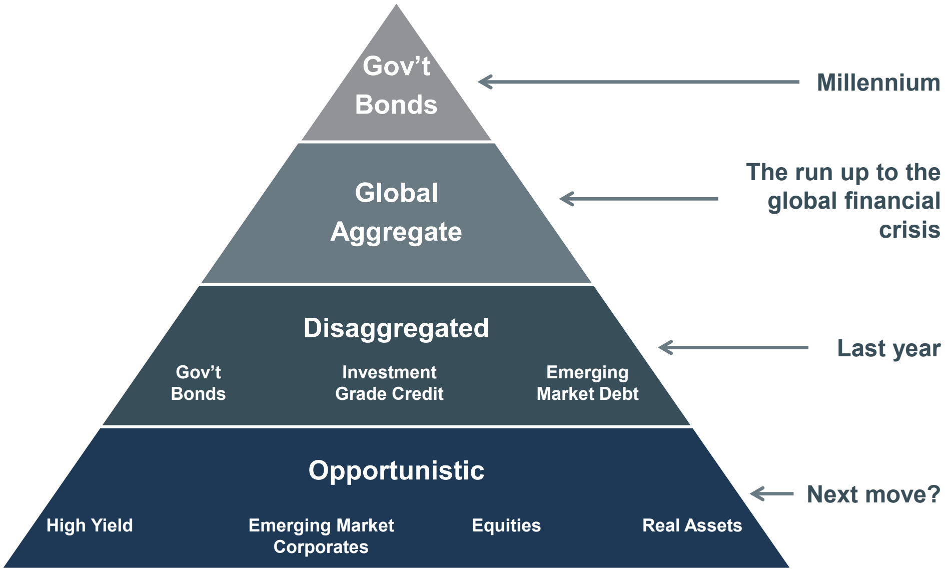
Responsibilities of managers

Sovereign fund managers are responsible for making sound investments and minimising costs. The economic stagnation of recent years helps to explain the pressures on asset allocators, and ultimately helps to explain the evolution in asset allocation illustrated in the pyramid.

However, governments must provide greater clarity on their investment goals to asset managers in central banks, pension funds and sovereign wealth funds. Without improved clarity on guidelines and objectives, managers may be tempted to employ safety-first strategies that risk forgoing potential returns. ▪

Gary Smith is Head of Sovereign Wealth Funds and Official Institutions at Baring Asset Management. He works across the asset management companies of the MassMutual Financial group: Barings, Babson Capital, and OFI Global.

Asset allocation model for the sovereign investor sector



Source: Barings

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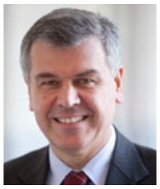

'Learning community' needed for Africa

Funding from Chinese diaspora sets example

Ludger Kühnhardt, Advisory Board

Africa is in the news as a force for positive change as many economic uncertainties haunt industrialised and developing countries. Many now believe Africa offers hope and has a bright future.

The outlook for transformation has been on show at the fourth EU-Africa Summit in Brussels, convening under the well-meaning slogan 'Investing in people, prosperity and peace.' Beyond ritual self-congratulation and platitudes, there are genuine reasons for confidence. A key condition for success is that Africa and Europe take genuine steps to build a 'learning community' that allows both sides to learn lessons from each other – and use these to implement action plans to change economies and lives.

Two dozen African countries now register annual average growth of around 6%. The number of violent conflicts, internal or external, is at its lowest in modern times. The roll-call of democratically-elected leaders is at a high. A new Africa is now in view, with an emerging middle class and a stronger sense of ownership and responsibility. There is a vibrant mobile phone culture right down to village level and a youthful population aspiring to a better life in their own countries.

The key to sustaining change is easy to formulate and yet difficult to realise: formal jobs and better infrastructure. To help achieve these goals, a 'learning community' is needed. This means learning from the presence of China, India, Brazil, the US and Turkey in Africa; learning lessons from Africa's own shortcomings; and learning how to redefine 'development'.

Two important aspects are how to make better use of the know-how of the African diaspora and how to gather resources of African citizens outside Africa for investment in the continent. We should bear in mind that one of the important agents of change in China over the past 30 years has been the many overseas Chinese who invested their money in the People's Republic and accelerated Chinese modernisation.

Since the first EU-Africa Summit in Cairo in 2000, the relationship is supposed to have moved on from that of donor-recipients towards that of a partnership of equals, but we are a long way from achieving that objective.

Africa today is sometimes described as a new Asia in the making. But progress, where it has happened, has been mainly due to the activities of the private sector and civil society rather than political strategies. African modernisation, sometimes labelled as African capitalism, is under way in a growing number of countries. But more often than not political rhetoric and interference slow it down.

The role of politics should be to provide an appropriate framework for private investment, including regulatory mechanisms for transnational banking and all kinds of business. A political set-up is needed to identify responsibilities about who is doing what (or not) in the context of African development. Benchmarks are needed for implementing and monitoring existing strategies, for example, for infrastructure projects as well as those for education, science and research.

Building a learning community is the key. We need to move on from the intellectual mindset of the Cold War. All societies, north, south, east and west, are now in constant transformation. Europe's aim can no longer be to tell Africans what they should do, but to help give them the means to carry out actions that they must decide and implement themselves.■

Prof. Ludger Kühnhardt, Director of the Center for European Integration Studies (ZEI) in Bonn and the author of Africa Consensus: New Interests, Initiatives and Partners.

Gold could develop as bridge between dollar decline and renminbi rise

The OMFIF report, 'Gold, the renminbi and the multi-currency reserve system,' relaunched this month, looks at the role gold will play in an increasingly volatile economic environment. Gold has been the traditional safe haven governments and investors looking to hedge against the risk of losses in their assets from currency swings.

Over the coming decade, Chinese policymakers will look at ways to invest their country's growing wealth in a stable and fixed asset such as gold. The increasing appetite for gold reflects the fragile international monetary system where reserve currencies such as the dollar and euro no longer command the confidence of financial markets as they once did. This is the main lesson to take from the report.

Gold might develop as a bridge between the decline of the dollar and the rise of the renminbi as a fully fledged reserve currency. This means it could play a prominent role in the reform of international monetary policy.

Meghnad Desai, chairman of the Advisory Board at OMFIF, who writes the foreword to the report, believes that the IMF's Special Drawing Right should be enlarged in scope to include the developing countries' currencies, the renminbi, rupee, real, rand and rouble, together with gold. He is convinced that gold, moving counter-cyclically to the dollar, could be a stabilising factor for the SDR and make a come-back for the first time since the collapse of the Bretton Woods system.

OMFIF

Gold, the renminbi and the multi-currency reserve system

April 2014
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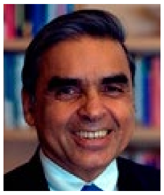
'As China weighs up its options for joining in the reserve asset game, gold – the official asset that plays no formal part in the monetary system, yet has never really gone away – is poised, once again, to play a pivotal role.'

Lord (Meghnad) Desai, Chairman of the Advisory Board



West should copy China’s restraint

A way to reverse 10 years of geopolitical failures

Kishore Mahbubani, Advisory Board

Tapering is taking place not simply as a mechanism under which the US Federal Reserve scales back its monetary stimulus to financial markets. What we are seeing in the western response to Russia over the Ukrainian stand-off is a tapering of western geopolitical wisdom.

The west, led by the US, would do well to emulate the restraint shown by China over Russia/Ukraine (and in other important matters). Arguably, declining powers (such as the west) need to exercise restraint even more than expanding powers such as China. Taking a leaf out of China’s book could be one way for the west to end 10 years of geopolitical failures.

I say this to drive home the point that the west has experienced a decade of geopolitical shortcomings. Despite massive military and financial interventions, Iraq and Afghanistan are failing. Three years ago the US announced: ‘For the sake of the Syrian people, the time has come for President Assad to step aside.’ He remains in office. And now the west is on the verge of handing China a geopolitical gift by alienating Russia.

These failures are surprisingly simple to explain. After two centuries of success, the region’s leaders assume their role is to sustain the expansion of western power. Not one of them has wrapped their heads around the undeniable reality: the real challenge of the west is to manage decline.

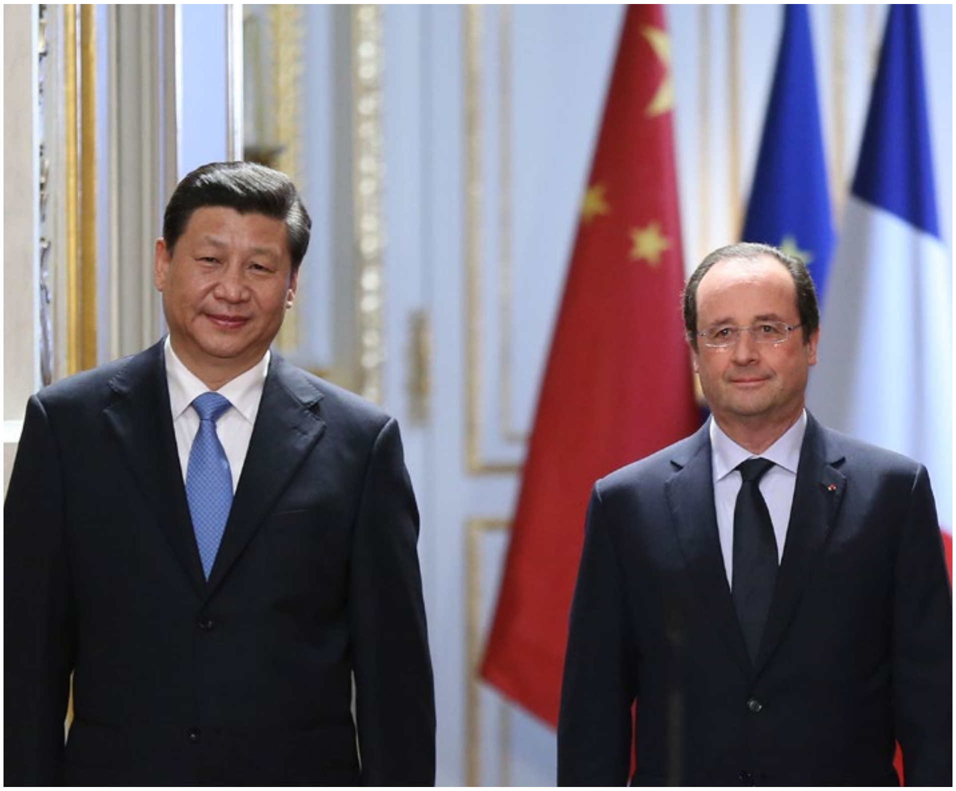
A simple statement by Barack Obama captures this flawed mindset. The US president announced that Russia was on ‘the wrong side of history’, implying that the west was on the right side of history.

This is questionable. Over the next few decades, some trends will prove irreversible. The western share of global population, economic weight and, inevitably, political and military power will decline.

The recent setbacks in emerging markets have given rise to wishful thinking that the west is back. Yes, maybe for a year or two. But the logic of long-term trends of decline will continue after this blip. The west could take three simple steps to help manage its decline.

First, end the ideological crusade of promoting democracy. The Ukraine fiasco is a direct result of the west encouraging street protests instead of encouraging political compromise between the two camps.

This reckless geopolitical behaviour was a direct result of the belief – to borrow the phrase used by former Soviet leader Nikita Khrushchev – that ‘history is on our side’. Actually, as Henry Kissinger, the former American secretary of state correctly pointed out recently, it would be unwise to ignore vital Russian interests in Ukraine.



French President François Hollande with Chinese President Xi Jinping in Paris on 26 March during the Chinese leader’s inaugural four-nation European tour dominated by trade and investment issues.

Democracy will not stop expanding if the west stops pushing it. On the contrary, it will emerge organically and, as a result, be naturally sustainable.

Second, embrace Russia and do so meaningfully. The western media have unleashed a cascade of abuse on President Vladimir Putin and Russia. Yet few have pointed out that the west painted Putin into a corner and gave him no way out. Western leaders repeatedly assured Mikhail Gorbachev when he was Soviet leader that Nato would not expand into the east.

These assurances were violated. Today, can any Russian leader believe any western assurance that no Nato naval base will be set up in Crimea if Russia withdraws?

Unwise western expansion of Nato has not enhanced western security. Rather the opposite: it has alienated Russia. Yet when the west finally wakes up to deal with a rising China, Russia would provide just the sort of geopolitical heft needed to balance Beijing’s power. Today, in direct violation of its own long-term geopolitical interests, the west is driving Russia towards China. This compulsion to act against its own interests perfectly illustrates declining western geopolitical wisdom.

Third, study and learn from China. Beijing has pulled off a geopolitical near-miracle by emerging as the number two power without shaking the world order. This was partly the result of strategic restraint.

Despite a few near-mishaps in the South China Sea, East China Sea and at the Indian border, China has remained at peace. More miraculously, it has quietly defused one of the world’s biggest flashpoints, the Taiwan Straits.

Learning from China may not be a popular strategy to put forward. China is on the way up, the west on the way down. The process can be made easier if, along the way, the two sides learn from each other. ▪

Kishore Mahbubani, member of the Advisory Board, is Dean of the Lee Kuan Yew School of Public Policy, NUS, Singapore.

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Money at the heart of Europe's weakness

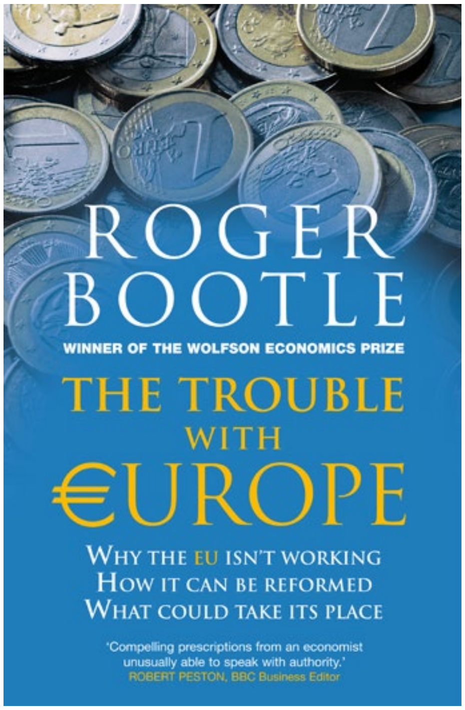
Comprehensive guide to navigating Europe's arduous journey

Wilhelm Nölling, Advisory Board

In this clear-minded, thorough and highly readable book, Roger Bootle puts his finger on one of the main reasons for the European Union's present weakness: money. By deciding the premature introduction of the euro, the European authorities tampered recklessly with a central pillar of the continent's economic and political structures.

Toying with the currency, without the necessary competence or powers to rectify matters when things go wrong (as has unfortunately been the case in Europe), is tantamount to planting dynamite under the continent's foundations.

Any ensuing explosion would wreck the EU, relegating all other considerations, for example, whether the UK should stay or leave, to matters of rather minor importance. Unfortunately, as we have found, the explosive charge, once laid, is very difficult to defuse.


ROGER BOOTLE
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Therefore, using my experience of studying (and helping to influence) international monetary issues for more than 50 years, I have always advocated that the UK should avoid the snare of the single currency by staying outside this difficult and dangerous experiment.

Europe's dilemma

Bootle identifies the dilemma at the crux of Europe's difficulties. His dictum 'currency and states belong together' is correct. This been the guiding principle of legal action against the single currency at the German Constitutional Court, brought during the past 15 years by myself and other plaintiffs (largely, it must be said, with disappointing results).

There is no doubt whatsoever that the result of the European single currency has been – for all concerned, both creditors and debtors – entrapment of the most devilish insidious kind. The circumstances are summed up by Mephisto's chilling phrase in Goethe's *Faust:* 'The first move we are free to choose, the next one makes us slaves.'

As Bootle says, the need for more integration among members of the currency union 'is pushing it towards full political union' but there is a crucial, self-blocking caveat: the author believes this would end up in dissolution and chaos.

Bootle abhors the idea of 'safeguarding Europe's future by muddling through', wishes to reform Europe and sweep away the sources of waste and inefficiency, yet he is highly doubtful whether this can be done.

Bootle, although clearly of the eurosceptic persuasion, provides a fair-minded analysis of Europe's economic balance sheet. He concludes that 'the EU has not been an outright failure' but points out that, after 'earlier success', the Union has become one of the world's 'hotspots of unemployment'.

Poor EU growth

Internationally it is an 'under-achiever' and the 'Common Agricultural Policy has been close to a disaster'. He is unquestionably right in concluding that 'EU growth has not slowed down recently but has been poor for a good while'.

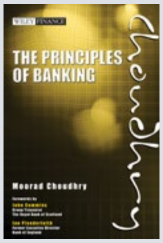
Undeniably, some non-EU, non-euro European nations have been doing much better than the EU itself in terms of average growth rates. Germany itself has been lagging behind its pre-1990 performance.

Contrasting with the widespread belief that the Federal Republic has been one of the main beneficiaries of the euro's introduction, the Germans have done less well overall since 1999 than countries like Austria, Denmark, Finland or even France.

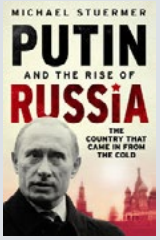
Bootle is less sure-footed when analysing his own country. He proudly compares the EU's relatively poor results with the UK's 'decent macro-performance' which, he says, is 'despite its huge supply-side inadequacies … largely due to policy'.

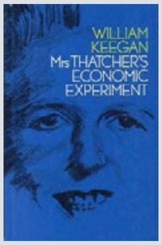
UK's domestic policy

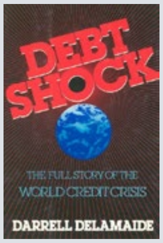
For all Europe's well-publicised shortcomings, it is in fact highly debatable whether the UK's domestic policy really has been better than the one practised by EU nations. Bootle should have mentioned the UK authorities' almost desperate attempts to

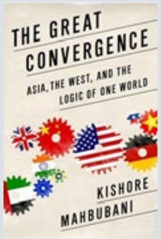


WHY KOSOVO STILL MATTERS
DENIS MACSHANE

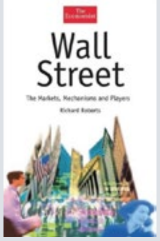








DEAD ON TIME
Meghnad Desai



reindustrialise the country, borne of the belated recognition that this is painfully necessary.

Britain runs persistent external deficits and pays insufficient attention to basic matters like assuring reliable energy supplies. Bootle goes out of his way to defend the interests of the City, a pivotal sector of the economy, whose share of total national income (less than 4%) is 'more important than the figure shows'.

Bootle clearly regards with distaste the prospect of Brussels bureaucrats 'encroaching' on the power of banks and the financial markets through 'death by a thousand cuts'.

Bootle is admirably lucid about the euro's consequences. They are not good. In 1980-98 the average annual growth rate of the euro area was just over 2%, below the levels in Australia, Norway, the US, the UK and Canada.

Between 1999 and 2012, the euro area's average growth was the lowest in the above mentioned group of countries (just under 1.5%).

The record looks even more mediocre if one takes into account the gradual shift to a less democratic, less productive and more tension-prone economic and social order, which has already begun to develop, seemingly inexorably, into a full-fledged transfer system between creditor and debtor states. The principle of European solidarity is being taken too far – one could say it is being worked to death – and here are witnessing the gradual dislodging of one of the principal cornerstones of a libertarian, effective and just society.

Britain's exit

With regard to the complexities of Britain possibly leaving the EU, Bootle writes, with precision, 'The advantage from staying or leaving is comparatively small … as far as narrow economic factors are concerned.' Bootle stresses the need for fundamental EU reforms, which he regards as unlikely to occur within a reasonable time span.

Yet in contradiction to his proclamation of the need for EU states to renationalise policy-making, Bootle holds out a somewhat benign outcome: 'So once the process of integration is complete and nation states have sunk back in importance, if not actually disappeared, perhaps the quality of decision-making in the EU would improve.'

All this flies somewhat in the face of Bootle's analysis. I am inclined to draw on the wisdom of an authority greater than the two of us, William Shakespeare: 'Are these things then necessities? Then let us meet them like necessities.'

Indeed, Bootle does deliver another, to my mind, more realistic scenario: 'If "ever closer Union" were abandoned as an objective … gone would be all pretentions to the United States of Europe'. The UK would then be in a strong position to negotiate reforms.

If it failed in this ambition, Bootle believes the UK could and should leave the EU. He concedes there would be a risk of lost access to the single market, but the country would be in the same position as that occupied by the US, India, China and Japan, all of which manage to export to the EU with relative ease.

Free trade agreement

He recommends that the UK should negotiate a free trade agreement with EU as well as many other countries. This should be buttressed by membership by Nafta and enhanced ties with Commonwealth countries.

I believe, in apparent contrast to Bootle, that the outcome of such a policy would be hazardous. Managing it smoothly and effectively would be highly difficult.

A small country might be able to leave the EU more or less overnight, but this would not be the case for Britain. Without a doubt, the trail on which Bootle believes the UK may be embarking is fraught with danger, for the country itself and its partners and neighbours.

But it is one for which we should all be prepared. This book is a comprehensive and constructive guide to navigating this journey. For Europhiles as well as sceptics, I recommend it heartily. ▪

Wilhelm Nölling, former President of the State Central Bank of Hamburg, is Professor at the University of Hamburg.

中国资本账户自由化

从全球各国汲取经验教训

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February 2014

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System close to unravelling

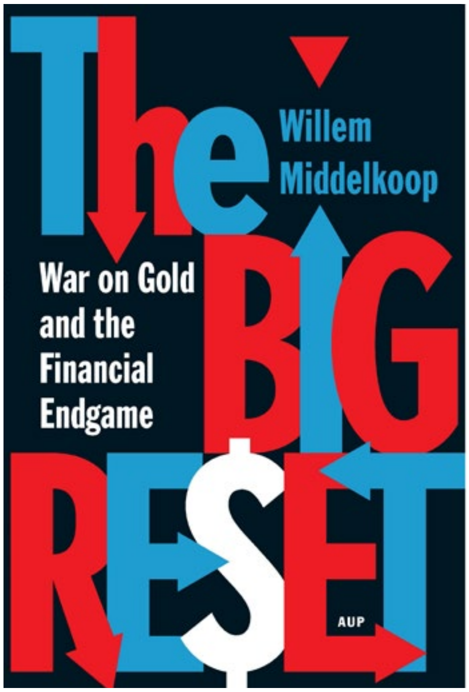
An apocalyptic view of the dollar and gold

Roel Janssen, Advisory Board

Looking at the world economy from the perspective of gold offers a provocative alternative to conventional wisdom about financial developments. In *The Big Reset*, Willem Middelkoop puts forward his view that central bankers and governments have undermined the international monetary system by giving up the gold backing of money.

Middelkoop believes that the world is heading for a financial apocalypse that will bring the restoration of gold's traditional role as a store of value and denominator of currencies.

A former journalist and market commentator for a business channel on Dutch television, Middelkoop is a self-made gold expert. Some years ago, after he discovered the potential of commodities, he started his own commodity fund and became known in the Netherlands as a staunch advocate of investments in gold. He wrote several books variously predicting the credit crisis that started in 2007, a surging gold price and a dollar collapse.



The Big Reset, his fifth book, is his first in English. Like his previous best-selling books in Dutch, it contains short chapters, each of them starting with a question followed by anexplanation accessible for a broad audience. It summarises the history of gold's role in world money and the importance of central banks in trying to police a system that he sees as inherently unstable.

As a result of an unsustainable debt build-up, he concludes that a new crisis is imminent and that gold and silver will be the only trustworthy investments as the financial system breaks up.

Middelkoop is no friend of central banks. He believes a 'secret war on gold' has been taking place since the 1960s. Since President Richard Nixon severed the link between the dollar and gold in 1971, he writes that 'gold has become the No. 1 financial enemy of WallStreet and the White House.'

The Federal Reserve, according to Middelkoop, is conducting a clandestine campaign to keep the gold price undervalued in order to protect the dollar.

Middelkoop claims that other central banks support this scheme. He maintains that they are merely buying time while piling up more debt on their balance sheets. As debts become unsustainable, Middelkoop claims some of these central bankers are preparing themselves secretly for the next 'big reset' that he expects will take place well before 2020'.

In a new global monetary system, Middelkoop predicts that the dollar will lose its role as the world's premier reserve currency. Gold, other currencies and the International Monetary Fund's Special Drawing Right will take The dollar's place. Middelkoop refers, slightly misleadingly, to a report from OMFIF last year (relaunched in April 2014) which speaks about a possible enhanced role for gold in the world reserve system as part of a rebalancing of the dollar and the renminbi - but specifically rules out any return to the gold standard.

Middelkoop maintains that China has been preparing for a new phase in the international financial system by purchasing large quantities of gold quantities of gold, hidden from public view. He foresees the return of some form of a gold standard, which will encompass a global debt restructuring and a spectacular rise in the value of gold, which he has predicted (in an interview with a Dutch newspaper) will rise to $5,000 an ounce.

Historically, currency collapses are a fact of life. Middelkoop presents an overview of a staggering 598 demonetised currencies between 1700 and 2013. Some have disappeared because of wars, revolutions or hyperinflation – others because they merged into new currencies like the dollar or the euro.

The Big Reset is a stimulating book, not the least because it contains little-known details about gold and central banks. It rightly warns about the unsustainable amount of government debt that central banks of the US, UK, Japan and the euro area have taken on their balance sheets. Middelkoop is aware, however, that some of his assertions can look dangerously like conspiracy theories.

Whether the current imbalances in the international monetary system end up in a collapse and a return of the gold anchor remains to be seen. This is a mystery tale that, like the overall story of gold in the monetary system, is still unfolding. ▪

Roel Janssen is a Dutch writer, the author of Fout Goud (Guilty Gold).

‘The People’s Bank of China has deliberately pushed the renminbi lower in recent weeks to warn speculators and inject volatility into the exchange rate. The central bank has also widened the renminbi’s daily permitted trading band against the dollar to 2%.

Do you think that in 12 months the renminbi will …

... be stronger against the dollar, **43%**

... be weaker against the dollar, **43%**

or

... remain the same?’ **14%**

‘My vote is for no.2. This is because of the relatively stronger growth in the US and relatively weaker growth in China.’ — **Gabriel Stein**

‘There is little official transparency about the exchange rate policy from the Chinese authorities. In the medium-term, however, one hopes that the renminbi will reflect more of the macroeconomic fundamentals of the Chinese economy as China embarks on structural reforms and capital account liberalisation.’ — **Andrew Large**

‘My vote is for no.1, but only on balance. It depends on when/whether there are a number of bond defaults in China. If these precipitate some kind of crisis I would in fact predict that the renminbi would go up since after the clean up, the overall situation for the economy will be more robust. As for the dollar, it all depends on timing of tapering. For both countries depends on timings, both of events and perceptions!’ — **Hemraz Jankee**

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