The Bulletin

April 2015
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Official monetary and financial institutions • Asset management • Global money and credit

New Asia balance

Shifting institutional leverage

Chin Leng Lim on trade and Asian growth
Fabrizio Saccomanni on world finance
Eduardo Borensztein on smart debt
Ted Truman on Ukraine and the IMF
Staci Warden on African integration
Abdullah Saud Al-Thani on Qatar and oil

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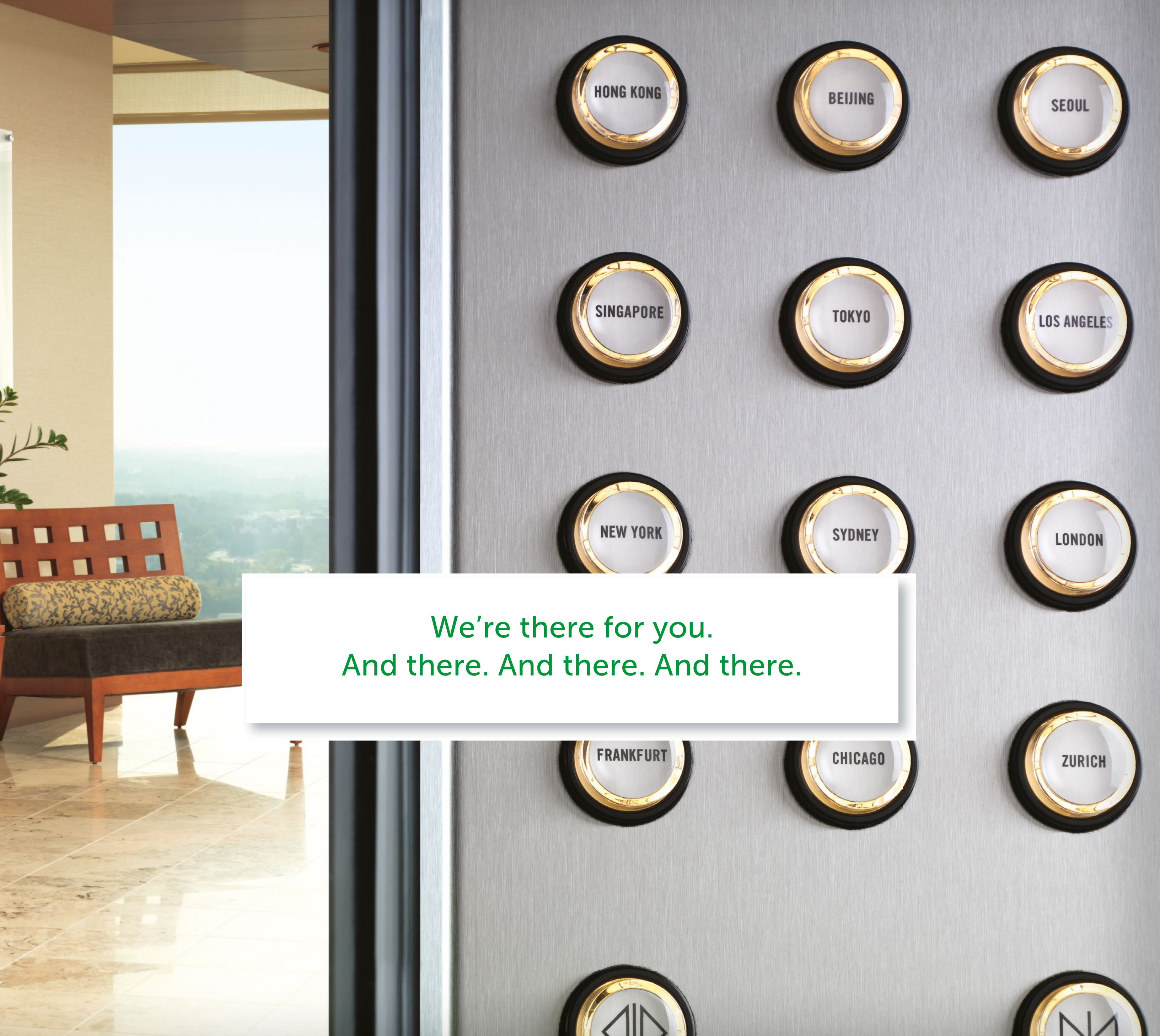

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New Asia balance

The world is moving to a new balance in which Asian monetary precepts join the economic mainstream. The transition is part of a gradual shift in monetary power and institutional leverage, notwithstanding the multiple questions still facing Asia's diverse nations. China in coming decades may wield similar global monetary influence to that of the US. Beijing's campaign over the Asian Infrastructure Investment Bank could mark a new trend.

Book reviews

George Hoguet evaluates Scott Stewart's *Manager Selection*, a book intended for investors and useful for anyone charged with selecting investment managers and trying to 'beat the market'. William Keegan reviews Denis MacShane's *Brexit: How Britain will leave Europe*, detailing the centrifugal forces facing the UK ahead of the general elections on 7 May. MacShane says pro-Europeans must make their case or risk exit. See p.32-33.

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Official Monetary and Financial Institutions Forum

30 Crown Place
London
EC2A 4EB
United Kingdom

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

www.omfif.org

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T: +44 (0)20 3008 5262

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

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

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OMFIF's 176-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities.

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

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

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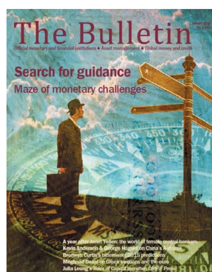
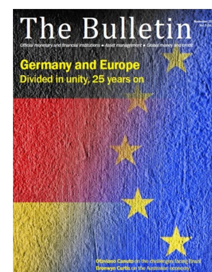
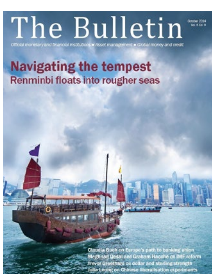






EDITORIAL

China and Asia set a new balance

The world economy is nearing a series of turning points; but the timing of the turns is wholly uncertain. No one is sure when the US and UK will raise interest rates, when the Chinese economy will finally run out of steam or when the European Central Bank and Bank of Japan will end their bouts of quantitative easing. One fact appears assured. Asia's weight in the global economy will be higher in 10 years than it is now. In this month's issue, coinciding with the IMF and World Bank spring meetings in Washington, Julia Leung and David Marsh describe how a series of Asian monetary precepts is moving to the fore in world finance, at the same time as China is challenging US supremacy in the Bretton Woods institutions and mounting a drive for the renminbi to join the Special Drawing Right.

Amid the relative success of the continent's new path, Asia itself faces many unresolved questions (some of which we will be laying out in detail in the May Bulletin). At the heart of many questions is the need to steer a mid-path between contrasting or opposing forces. Fresh from the inaugural Bank Negara-OMFIF KL Debate in the Malaysian capital, Michael Plummer and Chin Leng Lim focus on the balance between regionalism and multilateralism in international trade. Fabrizio Saccomanni and Pascal Lamy reflect on the difficulties of finding the right equilibrium between domestic repairs and international reforms for fixing the world economy. Darrell Delamaide extends the never-ending saga of Fed pondering over tighter credit. Moorad Choudhry underlines the harm done to bank profitability by low interest rates.

Eduardo Borensztein, David Marsh, Chris Golden and Con Keating dwell on different aspects of the Greek debt imbroglio. Using similar arguments to those from Greek politicians (and underpinned by some German commentators) Simon Tilford says Germany bears part of the blame for European imbalances, which are damaging the country's own interests. Ted Truman spells out the sobering lessons for the IMF's 'exceptional access' facility from Ukraine's debt accord. John Kornblum warns that, in the aftermath of the Russian invasion, the west risks losing a propaganda war with President Vladimir Putin.

In our detailed currency reports, Jamie Bulgin notes Russia's monetary reserve decline is part of a general drop in international reserves, reversing a decade-long rise. William Baunton explores differences in methodology between the UK's national statistics office and the Bank of England recording Britain's balance sheet with the rest of the world. Jeffry Frieden expounds the effects of currency fluctuations on emerging market debt dynamics. John West warns on China's debt build-up. Staci Warden reports on encouraging signs of capital markets integration in east Africa, which she says can set off self-feeding gains in economic prowess. Qatar Central Bank Governor Abdullah Saud Al-Thani explains his country's resilience to falling oil prices, George Hoguet reviews a guide for picking skilful managers, William Keegan says the UK is at the mercy of centrifugal forces, and Kishore Mahbubani bids farewell to Lee Kwan Yew. ▪

Pinpointing blame when bubbles burst

Rearguard action likely on ECB quantitative easing

John Plender, Chairman

After months if not years of agonising, the European Central Bank finally started its quantitative easing purchases of government bonds last month just as the euro area economy appeared to be on the turn. While the corporate sector enjoys the benefit of renewed competitiveness through a concomitant fall in the euro, the wider private sector is experiencing a big stimulus to consumption as a result of the drop in oil prices. The OECD and other forecasters have revised upwards their growth predictions for the euro bloc.

Euro area QE may have a shorter life than assumed. If the trends of the past month continue, the Bundesbank and other 'hard money' central banks in the euro system may mount an action in the next few months to stop QE before the planned limit of September 2016.

Signs of a slowdown in the US recovery, which could well delay the Fed's anticipated tightening to beyond the summer, could postpone the timing of any deliberations over withdrawal of ECB stimulus. So could further upsets over Greece. And many technical questions remain about how smoothly the ECB can make an exit from this huge bond-buying programme. In the strange, low or negative income world they now inhabit, central banks have no secure route maps.

The scope for any monetary move to have unintended consequences is depressingly large. One of these consequences concerns the exchange rate. The last thing Germany needs is devaluation. The German current account surplus was running at around 7.5% of GDP last year. While wage growth is accelerating and private consumption is increasingly driving growth, there remains a risk that the surplus will become even bigger.

Imbalances within Europe's monetary union will be exacerbated. And since QE takes away some of the pressure on governments to reform, this great central banking experiment will end up highlighting the difficulties of running a monetary union with flawed fiscal and institutional infrastructure. At the same time, there is a serious risk of asset bubbles. Bond market valuations are in historically unprecedented territory. Negative yields on sovereign debt could be justified only if the euro bloc is about to be engulfed by deflation. That seems increasingly unlikely.

The negative ECB interest rate policy is intended to push euro area banks into firing up the real economy with increased lending. A shortage of safe assets in the bond markets has collided with the reality that large parts of the world, including the euro bloc, are saving more than they invest. Bubbles are well-nigh inevitable. The challenge for investors is to escape from their fall-out in good time. When the bubbles burst, the central banks whose actions played a significant part in causing them may get the blame for bringing them to an end. ▪

ADVISORY BOARD

OMFIF has appointed John Campbell and Marsha Vande Berg to the Advisory Board, which has risen to 176 people, subdivided into six groups ranging from Capital Markets & Investment to Economics & Industry. For the full list of members see p.26-27.

Marsha Vande Berg is an elected member of the Council on Foreign Relations, New York, and of the International Institute for Strategic Studies, London. She serves on the Advisory Boards of the RAND Center for Asia Pacific Policy and the Stanford University Center for International Development. She is a member of the Executive Committee of the 1990 Institute. She was previously chief executive of the San Francisco-based Pacific Pension Institute. She joins the Capital Markets & Investment panel.

John Campbell is co-founder of Campbell Lutyens. He has over 40 years experience of corporate finance and private equity. Between 1976-87 he was executive director of Noble Grossart, and from 1979-82 he was managing director of McLeod Russel, the international agribusiness group with principal operations in Africa, Asia and Australia. Between 2006-14 he was the only European-based director of the Pacific Pension Institute.
He joins the Capital Markets & Investment panel.

BRIEFING

Quantitative easing in Europe and the great monetary polarisation

Against the backdrop of the European Central Bank beginning quantitative easing six years after similar exercises in the US and the UK, OMFIF assembled an expert panel to discuss the challenges and opportunities from an extraordinary polarisation of monetary policies in the world's leading economies. In the telephone briefing on 12 March, speakers included John Plender, OMFIF chairman; Stefan Bielmeier, chief economist, DZ BANK (left); Robert Bischof, German-British Chamber of Commerce and Industry; and Lorenzo Codogno, former chief economist, Italian ministry of economy and finance. The panel's view was that the ECB's QE was helping growth but was already leading to a bubble on the bond market which could extend to the equity market.

People's Bank of China learns from British experience

In a bid to learn from the UK's banking experience, delegates from the People's Bank of China met OMFIF representatives and members on 12 March as part of a tour of the London financial community. A discussion followed by dinner took place at the London Capital Club (below). China's banks are, by some measures, the largest in the world. They are increasingly becoming 'universal' – covering not just traditional retail and corporate banking, but expanding into asset management, wealth management and other areas. In many ways, China's financial sector is following the trend of the UK and US up until the 2008 financial crisis. A key theme discussed with the OMFIF representatives and in other meetings in London was the best way to deliver relevant financial services to the economy and consumers, in a fashion that provides cost efficiency to the bank, while preserving financial stability.

Clockwise from top left: Sean Zhou, Bu Yongxiang, Jagjit Chada, Pasquale Urselli, David Marsh, Michael Stürmer, Barry Eichengreen, John Adams, Sam Lewis, Kheng Siang Ng, Pooma Kimis, Jade Lu, Deng Ying, Tao Ling, Bahar Alsharif, Wang Yu, Chen Yingmei, Nadine Resha, Eva Cai.

Success of crisis measures 'stopped reforms half way'

University of California Economics Professor Barry Eichengreen discussed the parallels between the Great Depression of the 1930s and the 2008-09 crisis over tea at the London Capital Club on 12 March. While knowledge of history allowed central bankers to avoid many of their predecessors' errors, the success of the initial response to the crisis meant the reform effort stopped halfway. As Eichengreen argues in his latest book *Hall of Mirrors*, this has left the west vulnerable to a new financial shock. The audience of fund managers and economists (left: Eichengreen signing his book for Chris Loewe, Bluecrest) heard the author take a distinctly downbeat view of US economic prospects despite apparently continuing recovery.

OMFIF CITY LECTURE

Rohde firm on Danish currency peg

Lars Rohde, governor of Danmarks Nationalbank, told a London audience on 12 March that Denmark would stick firmly to its fixed exchange rate against the euro. This was in spite of the weakness of the European single currency in the wake of European Central Bank quantitative easing. Rohde said Denmark's determination was backed by the entire political and industrial establishment. He discussed the impact of household debt on financial and macroeconomic stability, in a wide-ranging overview of Denmark's financial and economic performance against the background of uncertainty in economic and monetary union. Denmark remains in a version of the exchange rate mechanism but is unlikely to join EMU in the foreseeable future, despite possible economic advantages from the move.

Evans sees no reason to rush US interest rate rise

Speaking at Armourers' Hall on 25 March, Chicago Federal Reserve Bank President Charles Evans recommended waiting to see how events unfold in coming months, with core inflation and wage growth weak, before considering an interest rate rise. Evans, well-known as a leading 'dove' on the Federal Open Market Committee, was dismissive of the inflation risks associated with maintaining a near-zero interest rate policy.

He said he wanted to see firm data confirming that inflation would exceed 2% before acting to tighten credit. He played down the impact of dollar strength, saying he still believed the real economy would stay strong in spite of the US economy's large effective revaluation over the past 12 months. See article by Darrell Delamaide on p.16.

Fed should hike rates early, says St Louis hawk Bullard

James Bullard, St Louis Federal Reserve Bank president, urged an early US rate rise to damp financial risks at an OMFIF meeting in Frankfurt on 26 March. He said the US needed higher interest rates to head off asset bubbles. The strong dollar was much less of a risk to US expansion than generally thought, whereas US unemployment was falling much more rapidly than earlier predicted. Putting the diametrically opposite argument to Charles Evans, Bullard – who does not have a vote on the FOMC this year but is one of the most outspoken of the committee's 'hawks' – outlined data showing that the strong dollar, rather than holding back expansion, historically had been a leading indicator of higher GDP growth.

EXPERT SEMINAR

Ukrainian minister calls for support

Natalie Jaresko, Ukraine's finance minister, urged western support and outlined reform plans for Ukraine's hard-hit economy at an OMFIF meeting in London on 23 March. Speaking at the London Capital Club, Jaresko discussed the implications of the IMF debt accord and gave details of her hopes for better governance and a more efficient energy industry and tax system. She said some progress has been made, but support is needed from Europe to help rebuild infrastructure and restart growth.
See articles by Ted Truman and John Kornblum on p.22-24.

Future of the international monetary system

At a dinner hosted on 24 March by Lord (Meghnad) Desai (left) and Lord (Norman) Lamont with special guests Rakesh Mohan, executive director, IMF and James Bullard, president and chief executive officer, Federal Reserve Bank of St. Louis, OMFIF guests explored the challenges facing the international monetary system. Major topics of discussion were the reform of IMF governance principles as well as the outlook for resolution of the Greek debt crisis. See articles on p.18-20.

INAUGURAL KL DEBATE

Regional integration and global integration: is there a conflict?

Governor Zeti Akhtar Aziz (below left) of Bank Negara Malaysia delivered the keynote address at the inaugural KL Debate on 20 March in Kuala Lumpur, co-hosted by Bank Negara Malaysia and OMFIF, starting off the second day of the 19th Asean finance ministers meeting. The debate focused on whether regional integration is contradictory to the World Trade Organisation agenda; the growing role of regional co-operation initiatives and whether this weakens the global liberalisation effort; and whether growth will be driven by regional rather than global initiatives. The 400-strong audience showed a sharp swing in support of the notion that regional and multilateral initiatives were complementary. See p.12.

From left: Governor Zeti Akhtar Aziz, Bank Negara Malaysia; Muhamad Chatib Basri, former Indonesian finance minister; Martin Soong, CNBC; Ben Knapen, European Investment Bank; and Chin Leng Lim, University of Hong Kong

OBITUARY

Philip Whyte (1966 - 2015)

Born in London on 20 February 1966, Philip, former chief economist at the Centre for European Reform and member of the OMFIF advisory board, spent most of his childhood in France and Britain. After leaving Marlborough College, he attended the Institut d'Etudes Politiques de Paris ('Sciences Po'), before returning to Britain where he completed undergraduate and postgraduate degrees at the London School of Economics and Political Science. Europe was the focus of his working and personal life. Philip joined the Bank of England in 1990, where he worked on legislation to complete the EU's single market. In 1996, he moved to the Economist Intelligence Unit, where he wrote about the political economy of Western Europe. In 2007, he joined the CER.

Although a passionate supporter of Britain's membership of the EU, Philip was often at odds with the orthodoxies of the pro-European tribe. In the aftermath of the global financial crisis, he was just as critical of policies in Brussels, Frankfurt and Berlin as he was of the eurosceptic tide in London. He died on 5 April after being diagnosed with incurable cancer 18 months ago.

Towards a system with Asian hallmarks

'Intrusive measures' enter the monetary mainstream

Julia Leung and David Marsh

For 25 years, between the early 1980s advent of free market governments in the US and UK and the 2008-09 financial crisis, a near-universal belief in the beneficial effects of unfettered capital movements was part of the international norm.

The next 25 years are likely to see a much more managed system of world money with characteristics bearing the hallmark of China and other generally successful economics of Asia that have, in many ways, drawn ahead of the western nations.

In the absence of comprehensive international monetary reform, the world is moving towards widespread acceptance of temporary capital controls and other short-term measures for countries seeking to protect themselves from disruptive forces, including the adverse repercussions of other nations' monetary policies.

Up until a few years ago, many in the west regarded such intrusive measures as anathema. By now, they are becoming part of the mainstream – part of what one might call a strengthening 'Asian framework' in international monetary affairs.

This is part of a gradual shift in the balance of global monetary power, taking place in an ad hoc manner rather than through cohesive steps. China in coming decades may well wield the kind of global monetary influence traditionally applied from the US. Beijing's outmanoeuvring of Washington in winning European and other allies' support for setting up the Asian Infrastructure Investment Bank could mark the beginning of a trend.

Monetary constellation

Another indication is the Chinese action to keep the renminbi firm on exchange markets as part of Beijing's efforts to bringing the renminbi into the Special Drawing Right, the International Monetary Fund's composite currency unit, under a review process to be concluded by end-2015.

A key aspect of this new monetary constellation is that different countries and monetary blocs around the world – in North America, Europe and Asia – are adopting very different policies to accompany the slow post-crisis move out of recession.

We see a new tolerance under which individual nations are relatively unhampered in taking monetary actions in their own interest – and where others, adopting similar freedoms, can decide appropriate defensive steps to protect themselves against possible disruption from these moves. Individual economies now have the right to decide competitive monetary easing to get them out of difficult economic circumstances, to carry out currency intervention to counter excessive currency appreciation or depreciation pressure, to build up foreign reserves as part of self-insurance against currency attacks, and to introduce capital controls where necessary to maintain stability.

Some of these elements are relatively controversial. All are on plentiful display around the world. And the antecedents in many cases are Asian.

Currency reserves

Among the main industrialised countries, first the US and now Japan and Europe have been running incontrovertibly easy money policies as part of efforts to beat recession. One of the main aims of these policies is domestic currency weakness, echoing policies that were widely followed (and much criticised in the west) by Asian emerging market economies.

These positions change over time. Plainly not every country can constantly devalue against everyone else. But policy-makers appear to have accepted that currencies should go through successive bouts of depreciation – with the yen and, now, the euro the latest candidates – as a means of raising dangerously low inflation and bolstering GDP through exports.

When excessive currency fluctuations are not desirable, it is legitimate for central banks to carry out offsetting currency interventions, as we have seen not just in Asia but also in western European counties, notably Switzerland. Countries like the UK, Poland and Denmark have made efforts to build up currency reserves to add to credibility of their stability policies.

Capital controls

Capital controls were sanctioned in 2012 by the International Monetary Fund (under the somewhat obfuscatory heading 'capital flow management measures') as long as they are temporary in nature and are supported by other more fundamental moves to shore up stability.

Although formally against the rules of European monetary union, capital controls have been enforced since 2013 in the euro area in Cyprus. Other less controversial parts of the Asian framework include the widespread introduction of the goal of financial stability as part of central banks' mandate and as well as the recognition that monetary policy must be supplemented with macroprudential tools to deal with asset bubbles. There is considerable logic in combining the prudential regulation of systemically important financial institutions with central banks' lender of last resort function.

Managed system

Many western countries in recent years saw these tools as a new concept. But rethinking of central banks' mandate represented a reversion to a norm traditional in Asia. Asian countries had used these instruments at a micro level over many years to rein in credit growth, damp excess leverage and restrain asset bubbles under the old name of 'prudential regulation'.

Even as China is rapidly liberalising its capital account and making the renminbi increasingly convertible, Beijing is moving toward a managed system in the Asian tradition. The People's Bank of China, which abhors unfettered cross-border capital flows, is putting in place a framework of macroprudential controls, close surveillance and a managed currency float. These are all steps maintaining previously more overt restrictions on capital and currency movements.

Some might argue that thoroughgoing interference with the free functioning of markets might bring disadvantages by reducing financial integration or hampering management of cross-border banks. Certainly controls should not be introduced as a cover for financial protectionism. But these active methods for maintaining stability have been tried and tested in Asia over the past 20 years.

Such steps frequently attracted criticism and disdain from the west, as tussles with the IMF over Asian precepts for dealing with the region's financial crisis in 1997-98 remind us. Yet on the whole they produced beneficial results.

The scale, speed and inherent volatility of capital flows, fuelled by much larger trading volumes and numbers of financial market participants, makes intrusive intervention in money markets and regulatory systems more necessary than in the past. Now there is growing recognition – spreading well beyond Asia – that they are the best available means for dealing with multiple sources of uncertainty. ▪

Julia Leung, former Undersecretary for Financial Services and the Treasury in Hong Kong, is Executive Director for investment products at the Hong Kong Securities and Futures Commission and author of *The Tides of Capital*, published by OMFIF Press. David Marsh is Managing Director of OMFIF.

A watershed in postwar history

America's predictable defeat on infrastructure bank

America's spectacular yet predictable failure to block the incorporation of the Asian Infrastructure Investment Bank with a sizeable number of western countries as founder members appears as a watershed in postwar monetary history.

The US and China, the world's two main economic powers, have locked horns over establishing a major development bank that could rival the twin Bretton Woods institutions – and Beijing has emerged, for the first time, as the clear winner.

US disarray has been underlined by a progressive increase in the number of western countries signing up to join the AIIB from the outset.

Shortly before the 31 March deadline, Australia announced it would join along with the UK, Germany, France, Italy and Switzerland and other American allies in defying Washington's wishes. The total number of founder members is more than 50 states.

Beijing meanwhile is adopting a magnanimous policy with regard to US discomfiture. As the instigator of the development institution that will challenge the World Bank and the Asian Development Bank in some key spheres, China is indicating it will take a statesmanlike line on what Beijing sees as a American diplomatic miscalculation.

China is likely to hold out an olive branch by saying it wishes Washington to come on board the AIIB in future years, drawing a discreet veil over the likelihood that the US congress would refuse the administration's request to join even if it wanted to.

Beijing appears to understand the divergent views within the administration of President Barack Obama, with the US Treasury much less heavy-handed than other factions which have been making the running in publicly opposing the emergence of an institution most people knew was difficult to stop.

International management

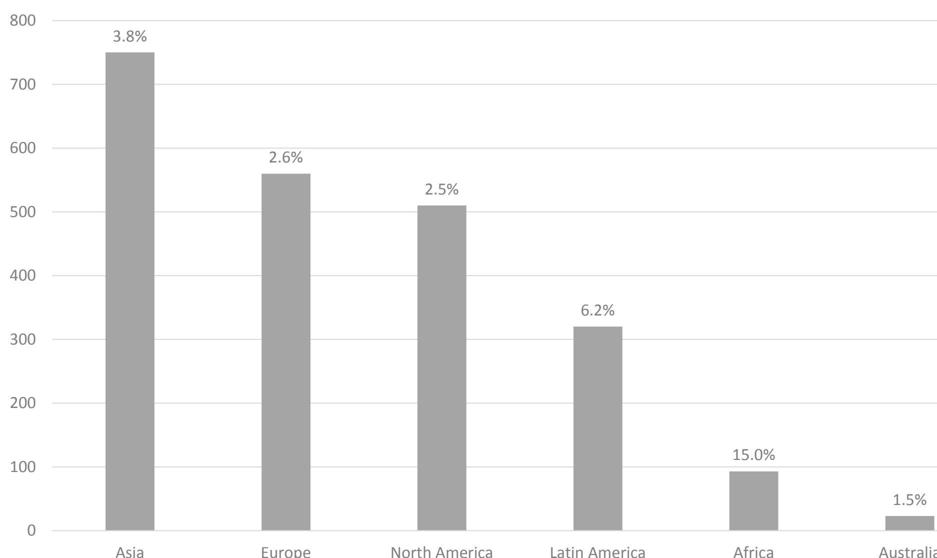
China will do its best to scotch western concerns over the AIIB's governance by recruiting top-notch management and policing a firm line on environmental and social standards for the bank's lending.

There is a link between the AIIB and Chinese efforts to become part of the Special Drawing Right, the International Monetary Fund's composite currency unit, under a review to be concluded by the end of the year.

A key component of China's bid for the renminbi's SDR inclusion, despite the renminbi's lack of full-scale formal convertibility, is that the SDR could be reinforced by bringing in the relatively strong Chinese currency.

Regional financing needs – annual infrastructure gap

Estimates by region ($bn, % of GDP)



Source: Long Finance report 'Financing the Transition' March 2015, World Bank, ADBI, Inderst & Della Croce, ECLAC, S&P

The renminbi has matched the dollar's gains over the past 12 months against the weak euro and the yen, two of the SDR's four components (along with the dollar and sterling).

SDR enlargement

Enlarging the SDR to include an emerging market currency could promote the SDR's adoption as the AIIB's unit of account, extending the SDR's use by other international organisations such as the Bank for International Settlements and the African Development Bank.

Momentum to forge the AIIB has risen sharply since it was first broached in 2013. One strong reason for the inception is Asia's frustration over the US congress's refusal to ratify modest reform of the IMF decided by member countries in 2010, which would give China and other leading emerging economies slightly more say in running the Fund.

In addition, more financing is plainly needed in the light of Asia's large backlog for infrastructure development since the Asian financial crisis of 1997-98.

The ADB says the Asia-Pacific region needs $8tn in infrastructure funding up to 2020 to overcome these shortcomings. As the chart shows, Asia's infrastructure gap is significantly larger than for other continents.

Initial capital for the AIIB is planned at $100bn, with operations starting by the end of 2015. Non-Asian countries' race to join as founding shareholders reflects western governments' desire to gain infrastructure contracts for their companies, as well as efforts by countries like Britain, Germany and Luxembourg to win renminbi trade, investment and other financial market business as the Chinese currency's cross-border use grows.

Wrangling over governance looks set to continue. Australian Prime Minister Tony Abbott, announcing that Australia would be signing up to the AIIB after months of hesitancy, has made clear that Australia wants a hands-on board of directors representing shareholders that would control main investment decisions. China wishes most decision-making to be devolved to management. The bank and is senior staff likely to be based in Beijing, even though Indonesia is holding out for Jakarta as an alternative. ▪

Regionalism can help multilateralism

Benevolent side-effects from regional trade accords

Michael G. Plummer, Johns Hopkins University

Regional trading agreements throughout the world and in the Asia-Pacific region in particular have risen significantly since the beginning of the century.

Most of these arrangements are bilateral free trade areas but there do exist a number of salient regional FTAs, such as the European Union and the North American Free Trade Area in the OECD, and the Association of Southeast Asian Nations and the Common Market of the Southern Cone among developing economies.

As these bilateral and regional FTAs discriminate in favour of partner countries, this is a contradiction of the 'most favoured nation' principle, enshrined in Article I of the General Agreement on Tariffs and Trade/ World Trade Organisation.

Exemptions are allowed only under certain conditions and are characterised by both positive and negative effects on economic welfare. The positive effects are due to a more efficient allocation of resources within the grouping itself (trade creation). The negative effects reflect the advantage accorded to partner countries, which may be less economically efficient than outsiders (trade diversion).

Trade liberalisation

Multilateral trade liberalisation uniformly supports trade creation, making it a 'first best' policy (and FTAs second best). The need for 'rules of origin' in an FTA can be costly. Such rules create incentives for investment diversion, as firms move within the borders of the FTA to take advantage of inherent preferences.

There is always the risk that FTAs could lead to a segmentation of the global marketplace. So some economists are worried about the rising importance of regionalism in international commercial policy.

It is true that regionalism is a second-best policy and a segmentation of the global marketplace would be problematic. However there are some compensating factors. There is reason to believe that the regionalism movement could be a positive development for the world economy, reflecting several prominent factors.

First, the WTO has hitherto mainly picked relatively easy-to-implement measures for opening trade – for example, relatively simple trade barriers like tariffs in non-sensitive sectors – as a result of its diverse membership. Regionalism, on the other hand, allows member states to proceed to less easily accessible action by bringing together like-minded economies.

With 160 very diverse member countries in the WTO, it has been extremely difficult to get consensus even on minor issues, let alone the more important ones.

Second, regionalism has been criticised as being potentially harmful to the global system for at least 50 years. Empirical analysis of FTAs and other regional trading arrangements tends to show positive effects. Such agreements lead generally to significant increases in trade flows and net trade creation, rather than trade diversion.

The EU, Asean and Nafta have been highly successful at stimulating trade and improving the aggregate welfare of member states. For example, I do not think Asean would have been better off without the Asean Free Trade Area and the Asean Economic Community. The same is true for the EU and its Single Market Programme.

In addition, regionalism, via trade creation, has served to expose and counter the most intransigent political forces opposing liberalisation. With the Transpacific Partnership, for example, Japan's agricultural lobby will become less powerful. And its ability to constrain Japan at multilateral negotiations will be much less significant.

Building blocks

Third, emerging mega-regionalism arguably offers the best possible building block toward multilateral free trade. Mega-regional accords – in particular, the TPP – are charting out the key areas of trade policy that will be necessary for a truly globally integrated marketplace, which is the ultimate goal of WTO. Even if the 'spaghetti bowl' of bilateral FTAs has generally had a positive effect on trade, these bilateral agreements are relatively inefficient and costly, particularly given the rising importance of regional production networks in Asia and elsewhere.

Bilateral FTAs are yielding to the economic logic of regional agreements such as the TPP, the Regional Comprehensive Economic Partnership, and the Transatlantic Trade and Investment Partnership. Further, these mega-deals create a strong incentive to return to a global framework. In other words, much as bilateral FTAs have paved the way for mega-regional agreements, the latter could pave the way for deep multilateral liberalisation. In this sense, regionalism would be a building block to global free trade, rather than a stumbling block.

Asean–China Free Trade Area

10 Asean member states and China

Negotiating agreements

So a review of all the arguments would lead to the conclusion that multilateralism is without doubt 'first best'. However, multilateral liberalisation under the WTO Doha Development Agenda 'single undertaking' is basically at an impasse and is unlikely to move forward in the near future.

WTO is still extremely important in terms of governance. But bringing down tariffs and non-tariff barriers, addressing behind-the-border measures, and putting in place harmonised commercial policies where appropriate will be favourable medium-term side-effects from regionalism.

When policy-makers are negotiating regional agreements, they should be aware of the possible drawbacks as well as the potential advantages. And they should never lose sight of the ultimate prize: a truly global marketplace. ▪

Michael G. Plummer is Director, SAIS Europe, and Eni Professor of International Economics at the Johns Hopkins University. Plummer took part in the Bank Negara-OMFIF KL debate on 20 March.

Overcoming the Geneva impasse

Why regional agreements can help global trade

Chin Leng Lim, University of Hong Kong

The World Trade Organisaton's rules have permitted regional trade agreements since 1947. Over the years its membership has made only half-hearted efforts to tighten these rules. Without ignoring some well-known drawbacks which attend regional trade agreements, we need to understand the reasons for this hesitancy: regional agreements can help global trade.

Imagine a well-known US auto manufacturer with plans to establish an Asian office in Singapore. It will find the US-Singapore free trade agreement useful. It may also wish to set up a subsidiary and manufacturing plant in Chennai in India. The Singapore-India free trade agreement and the Asean-India FTA could facilitate this.

Sourcing strategy

Singapore does not impose a capital gains tax and a Mauritius-style double-taxation agreement would exempt from Indian capital gains tax an 80% equity infusion into the Chennai plant, raised through Singapore banks. The plant in Chennai might find an eventual India-Thailand FTA useful for a strategy of sourcing the parts from Thailand.

There could be a problem with meeting rules of origin, but the Thai assembly plant may get to count design and research and development work done in Malaysia.

Thus, the parts could be designed in Malaysia, manufactured in Thailand, and shipped to Chennai for further assembly. The wholly built-up vehicle could be shipped from India to Japan where, again, the India-Japan FTA could prove quite useful.

This demonstration shows that the auto manufacturer, like other businesses, can find today's RTAs indispensable.

Tariffs and trade

While Geneva talks on further multilateral liberalisation have been at a near-standstill for 15 years, nations have been to work with RTAs. There are now some 400 agreements. Some say that such proliferation is problematic. But the higher the number of agreements, the less discriminatory they are likely to become, since the margin for discriminatory preferences grows thinner each time.

According to the 2011 World Trade Report, 50% of world tariffs are already at zero, and only 16% of world trade benefits from positive preference margins under RTAs. The rest flows either free of tariffs or under positive non-discriminatory tariffs.

This illustrates that, after more than a half-century of reducing global tariffs, trade diversion by RTAs has become less threatening.

Today, nations from Japan to India are engaged in RTA negotiations which aim to bring down long-lasting trade barriers. Nothing of equivalent effect is being done at the multilateral level in Geneva.

Nations in Asia see as an ultimate goal a regional comprehensive partnership, in the form of one 'mega' agreement. In the case of Asia, this would require Sino-Indian and Sino-Japanese engagement, which might be difficult to achieve in Geneva, although it would bring positive security implications for a fragile continent.

As for the other mega-regional deals, the US-led Transpacific Partnership talks are nominally the most ambitious.

Talks on the Transatlantic Trade and Investment Partnership, too, set a high objective in cutting through regulatory barriers and merging American and European regulatory standards.

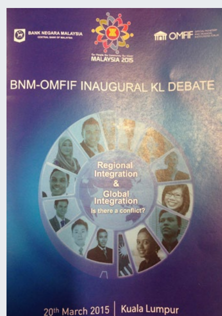
This is important because, today, trade barriers lie no longer at but behind national borders. We require national regulation to harmonise discordant food, health and safety, environmental and other standards.

All these examples show that regionalism – in Asia, across the Pacific, and across the Atlantic – is now playing a major role in opening global markets and driving growth.

Regionalism has taken over from multilateralism in promoting these and other objectives. These two instruments point in the same direction. ▪

Chin Leng Lim is professor of law at Hong Kong University and serves on the Committee on Pacific Economic Co-operation which advises Hong Kong's Secretary for commerce. Lim took part in the Bank Negara-OMFIF KL debate on 20 March

'No conflict' between regional and global integration, EIB's Knapen tells KL Debate audience



Regional economic co-operation in Asia will enhance the wealth and status of members of the Association of Southeast Asian Nations, and also improve Asean's influence in the world economy, according to Ben Knapen (right) of the European Investment Bank.

Arguing there was 'no conflict' between regional and global integration, Knapen, the EIB's Brussels permanent representative and a former state secretary in the Dutch foreign ministry, was taking part in the inaugural KL Debate organised by Bank Negara Malaysia and OMFIF in Kuala Lumpur on 20 March.

Muhamad Chatib Basri, former Indonesia finance minister, now president of Indonesia Infrastructure Finance, said 'theoretically' there was a conflict as proliferating bilateral free trade agreements could be risky for globalisation. He said it was important to incentivise Asean members to take part in Asean trade agreements to smooth the integration process.

Prof. Michael Plummer of the Johns Hopkins University in Bologna saw a potential conflict between regional and global integration, while Chin Leng Lim, law professor at Hong Kong University, argued that the two objectives were compatible.

The debate saw a sharp swing among the 400-strong audience in favour of the notion that global and regional integration were self-reinforcing. 63% of the audience, according to electronic voting, said the goals were in conflict, while at the end of the two hour session the two sides had drawn level – a clear victory for the position adopted by Knapen and Lim.

Asean emerges as world growth engine

Single market plans will boost international trade flows

William Baunton, Economist

After 48 years in existence, 2015 will be the most significant year for the Association of Southeast Asian Nations when the Asean Economic Community is established at the end of the year. The AEC will form a common market, composed of the 10 member nations.

The single market will provide an unrestricted flow of goods, services, investment, skilled labour and freer flow of capital between members. This is a significant development for the world economy, and underlines that the Asian economy is driven by a wider group of nations than the largest economies, China, India, Japan and Korea.

Growth areas

Asean is now one of the world's brightest regional growth areas. The main economic influence of the past 12 months has been the fall in oil prices, exerting a positive impact, particularly in lowering inflation. Problems over inflation had previously be seen as requiring additional central bank tightening to bring under control.

If Asean were a single economy, it would be the world's seventh largest. The Asian Development Bank expects Asean's GDP to grow 5.1% in 2015, well above the world average of 3.5%, illustrating how the region has acquired greater prominence.

The biggest economies within Asean are Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam, together providing 95% of GDP in 2014.

Significant drop

The significant drop in oil prices has been mostly a welcome development for economies in Asean, reducing inflationary pressure and costs for local businesses, particularly in Thailand, Vietnam and the Philippines.

Singapore entered a period of threatened deflation at the end of 2014, partly due to measures to cool the property market.

Low oil prices enabled Indonesia to scrap or adjust most of its fuel subsidies, making nearly €15bn available to spend in priority areas, such as infrastructure, as well as funding the budget deficit. Indonesia raised administered fuel prices in November, pushing the country's inflation rate temporarily to its highest level in six years.

Biggest loser

Malaysia is the biggest loser from falling oil prices among the Asean group. Malaysia is a net exporter of oil, which makes up 30% of government revenue and 20% of GDP.

The government has lowered its 2015 growth estimate to 4.5-5.5%. The fiscal deficit will be higher than forecast at 3.2% of GDP.

As in Indonesia, Malaysia has used falling oil prices to make much needed reforms of government fuel subsides.

Lower oil revenues have strengthened pressure on Malaysia to diversify its economy further away from undue dependence on energy, a move that many economists both inside and outside Malaysia see as overdue.

Thailand has been struggling to recover, a result of weak domestic demand and exports. Growth last year was only around 1%, but is expected to pick up in 2015 to around 3%. Falling inflation caused by low oil prices allows the central bank to focus on stimulating growth by loosening monetary policy.

The Monetary Authority of Singapore, in its first unscheduled statement since 2001, announced it would allow the Singapore dollar to appreciate at a slower rate against a trade-weighted basket of currencies.

The surprise move on 28 January brought repercussions throughout the region, for example by increasing pressure on the ringgit and the baht. However the MAS move was seen as necessary to help ward off the threat of deflation and ensure growth remains at 3%.

Welcome stimulus

The Philippines grew 6.1% in 2014, after growth of 5.4% in 2013, a welcome stimulus for the region. Cheaper oil will boost growth through 2015, pushing it towards the Manila government's target of 6.5%.

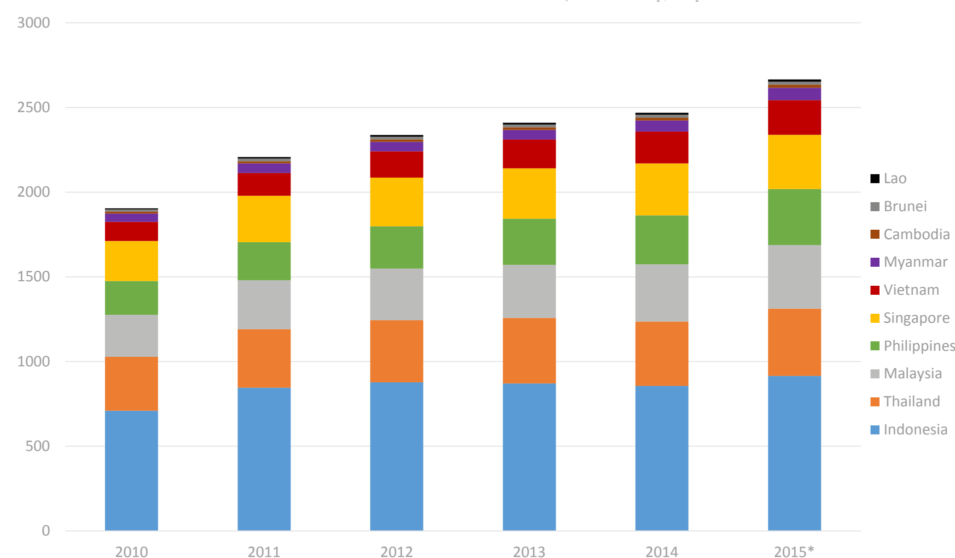
Low oil prices will help the struggling agricultural sector and compounds the positive effects on growth of flourishing services businesses. Successful credit tightening by the central bank has eased inflation concerns, again aided by lower energy prices, allowing the central bank to concentrate on promoting growth.

Vietnam's economy grew 6% in 2014 and 5.4% in 2013 thanks to rising manufacturing output and inward investment. The country is sustaining a healthy current account surplus, despite a weak banking sector and inefficient state-owned enterprises.

Rating agencies announced an improvement in Vietnam's credit rating late in 2014, a timely boost enabling the government to raise $1bn on international capital markets. The government is targeting growth of 6.2% and inflation below 5% for 2015. ■

The components of Asean growth

Nominal GDP of Asean members, 2010-15 ($bn)



Source: IMF World Economic Outlook database, October 2014. *IMF forecast

How to fix world finance

Combining domestic repairs and international reforms

Fabrizio Saccomanni, Senior Adviser

There is a deep divergence of views on what should be done to fix the financial system. We are witnessing a confrontation between two schools of thought: the house-in-order approach, based on sound domestic macroeconomic policies plus floating exchange rates, and a more co-operative, pro-active approach to the management of international financial disturbances.

Finance ministers and central bank governors of the G7 countries stated their position on these issues in February 2013: 'We reaffirm that our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments and that we will not target exchange rates. We are agreed that excessive volatility and disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will continue to consult closely on exchange markets and cooperate as appropriate.'

Asian framework

House-in-order, greater transparency, better communication, a promise of liquidity: is that enough? There are different opinions. In an illuminating book, *The Tides of Capital**, based on her long experience in the Hong Kong Monetary Authority and government, Julia Leung outlines the key aspects of 'an Asian framework', taking for granted that 'competitive monetary easing is a fact of life'.

The Asian framework as set down by Leung would include features that are by now uncontroversial, namely that 'financial stability should be part of central banks' mandate' and that 'monetary policy must be supplemented with macroprudential tools to deal with asset bubbles'.

US President Barack Obama

In addition, Leung has strong feelings on subjects that are less frequently part of the conventional wisdom. She opines that 'currency intervention is the norm to cope with excessive currency appreciation or depreciation pressure', that 'building up foreign reserves has become a significant instrument of self-insurance' and that 'capital controls are an essential part of a comprehensive set of tools to maintain stability'.

Policy coordination

If international monetary policy coordination is precluded by political considerations and/or the domestic orientation of central bank mandates, then the issue is how to devise the right strategy to manage the capital account. This goes beyond regulatory measures to strengthen the capital base and the liquidity position of banks and financial intermediaries.

This process is well underway within the Basel and Financial Stability Board forums, and it is being implemented in both advanced and emerging economies.

Management of the capital account will inevitably involve the introduction of restrictions on capital movements and/or the adoption of a comprehensive set of macroprudential measures. It implies frequent currency market intervention and the accumulation of massive precautionary foreign exchange reserves. Eventually the process may lead to a drift towards financial protectionism.

Even macroprudential policies may involve forms of geographical ring-fencing that could hamper the efficient management of cross-border banks and financial intermediaries.

Is this what the world economy needs? To roll back financial integration and promote financial fragmentation? And what for? To preserve temporarily the independence of national policies until the next crisis, when all countries will be forced to co-operate under the pressure of events? This seems a shortsighted approach that could hamper world growth.

Rather, it should be possible through less extreme measures to improve our ability to prevent and mitigate financial crises. The key point is to combine the necessary but insufficient house-in-order approach with reforms to strengthen the instruments and the procedures for managing financial instability. And we can use the institutions that have been created over the years with these aims in mind.

A first priority would be to implement the reforms of IMF governance and quotas agreed in 2010 which are still awaiting US congressional ratification, despite the efforts of President Barack Obama. As breaking the US political impasse is not considered possible at present, the IMF should find alternative ways to achieve the rebalancing of votes and voices in favour of emerging economies. This will enhance the IMF's credibility and legitimacy.

A more general reform would entail the expansion of global safety nets, sufficient to discourage an excessive accumulation of reserves, which can depress economic activity and foreign trade. The reform would involve primarily IMF facilities, but should also envisage a greater role for regional arrangements. Significant progress has been achieved in the EU in building the instruments and procedures for dealing with systemic crises and the risk of contagion. Asian countries should consider full institutionalisation and expansion of the Asian safety net established under the Chiang Mai Initiative.

Policy co-operation

The most necessary and difficult reform concerns international policy co-operation. Since the outbreak of the crisis the G20, IMF, World Bank, Bank for International Settlements and OECD have assembled an important array of information and proposals in this domain. But, with a few exceptions, the results of these efforts have been modest.

National authorities need to take into account the effects of their actions on other economies and the corresponding feedbacks on their own jurisdictions. Governments and monetary authorities have the ability to gear the expectations of global financial markets towards stability objectives, provided they are ready to use all available policy instruments for that purpose.

Ideally, the output of an enhanced form of international co-operation would be a 'multilateral forward guidance' covering both interest rates and exchange rates in such a way as to minimise the risk of destabilising spillovers and financial cycles. ■

Fabrizio Saccomanni is a former Italian minister of Economy and Finance. This is an extract from a speech at a Bank for International Settlements meeting in Manila on 6 February. *The Tides of Capital,* published by OMFIF Press, can be purchased on Amazon.

Global trade governance – to benefit all

How to overcome regional threat to integration

Pascal Lamy, Jacques Delors Institute

Whether regional trade agreements are stepping stones or stumbling blocks to multilateralism has been a matter for debate in trade literature for decades. Could burgeoning regionalism signal a weakening of the international commitment to open trade, and foreshadow a return to a more fragmented trading system?

Alternatively, could the willingness of some countries to move further and faster than others in trade rule-making have positive repercussions, encouraging multilateral co-operation? What matters is the reduction of obstacles to trade and whether the agreements contribute to the removal of those barriers.

The development of so-called mega-Regional Trade Agreements may well have a negative impact on global trade regulation. Three such agreements under negotiation are the Transpacific Partnership between the US and 11 Asian countries; the Transatlantic Trade and Investment Partnership between the US and the EU; and the Regional Comprehensive Economic Partnership between the 10 Asean members and Australia, China, India, Japan, New Zealand and South Korea.

Deeper integration

These agreements aim to achieve deeper integration and enhance global production networks, reflecting a fall in the relative importance of tariff protection.

A growing proportion of obstacles to trade today are differences in standards and norms of production. Measures adopted in each country to protect consumers from risks (standards, norms, certification systems) often differ, presenting exporters with a patchwork of different regulatory regimes, adding up to an important source of international imbalance.

Rather than being protectionist measures, standards play an increasing role in market integration. They allow suppliers and clients to link up on the same supply chain. Suppliers tend by themselves to adopt private standards that signal that they could be desirable suppliers. Coordinating private with public standards would drive market integration.

Mutual recognition of conformity and certification systems (for instance, to avoid a single product having to be tested twice) and the simplification of rules of origin would greatly help to reduce the costs of regulation.

It is no surprise that the economies of scale to be gained from regulatory convergence are at the heart of the new mega-trade deals, especially those among large economies with sophisticated regulatory systems. The most obvious case is TTIP.

If the negotiations succeed, 80% of the expected benefits would come from economies of scale and reduced transaction costs from regulatory convergence, as well as from the opening of trade in services and public procurement.

The risk for the future is that the multilateral playing field will be overshadowed by a proliferation of divergent regulatory regimes, with the establishment of 'regulatory blocs' disrupting global supply chains and leading to major trade diversion.

Regulatory convergence

As far as regulatory convergence is concerned, we can envisage three types of potential relationship between future regional and multilateral trade regimes.

The first could be described as a 'clash of the titans', in which a US–EU regulatory bloc faces a Chinese regulatory bloc, leading to a new form of fragmentation of global trade, with negative impacts for Africa, Latin America, Russia and others.

In the second scenario, TTIP negotiations reach a successful conclusion and are complemented by two bilateral agreements between Japan and the EU and Japan and the US (via the TPP). This would give a dominant world position to the norms and standards arising out of these agreements. This would return us to the 20th-century dominance of the old industrial countries, with other trade partners aligning themselves with the leading norms and standards.

In the third alternative, regulatory convergence would be overseen at the global level for the benefit of all. To prevent unnecessary tensions and to ensure world growth, global trade governance would be updated with a common strategy to manage regulatory convergence. This third scenario is far from ideal and would require two important initiatives while current regulatory convergence negotiations remain open.

First, giving the World Trade Organisation a supervisory role over regulatory convergence would help bring the subject into a multilateral framework and enhance convergence between public and private standards. Second, the legal basis provided by WTO Article XXIV, which deals with discrimination resulting from tariff preferences, would need to be adapted to encompass regulatory preference.

International dialogue

Greater transparency, too, is needed. A consortium of institutions – the International Centre for Trade and Sustainable Development, the Inter-American Development Bank, and the Asian Development Bank Institute – is now producing a 'RTA Exchange' to promote international dialogue, deeper analysis and information sharing.

The work of the Asia-Pacific Economic Co-operation in developing best practices for RTAs serves as a good example of how to move forward. The WTO could consider multi-tier multilateralisation.

The first tier, establishing voluntary best-practice guidelines for new RTAs, would encourage nations to consider the impact of their agreements on non-party WTO members and help reduce differences in wording (and thus interpretations) across RTAs. The hierarchy of best-practice guidelines – tailored to north–north, north–south and south–south RTAs – would allow for developmental differences.

The second tier would involve agreeing on basic principles, including national treatment, third-party Most Favoured Nations and transparency, already widely included in deeply integrated RTAs.

So far multilateralism has not been threatened by regionalism. But prospects for the future are more blurred. Whether or not a new generation of mega-RTAs based on regulatory convergence such as TTIP will eventually lead to multilateral convergence depends on numerous parameters that have yet to be clarified. Connecting the bilateral and multilateral aspects of trade negotiators remains a challenge for the future. ■

Pascal Lamy is President emeritus of the Jacques Delors Institute, and former Director-General of the WTO. This is an extract from 'Is trade multilateralism being threatened by regionalism?', Adelphi Series, reprinted by permission of Taylor & Francis on behalf of The International Institute for Strategic Studies.

Fed free to raise rates but doves resist

Connecting the dots on policy-maker forecasts

Darrell Delamaide, US Editor

While the decision of Federal Open Market Committee to drop the word 'patient' from their official statement after the March meeting grabbed the headlines, it was the dot chart that helped market participants understand just where the Fed is headed.

Chicago Fed president **Charles Evans (voter)** used the chart plotting the expectation of individual FOMC members for the Federal Funds Rate to illustrate his remarks to those attending the OMFIF City Lecture in London.

He noted that 15 of the 17 members expected the Fed to raise the benchmark rate sometime this year and the median forecast was for it to reach 50 basis points by the end of the year. He made it clear, however, that he was one of the two who wanted to wait until next year to start raising rates.

'I think economic conditions are likely to evolve in a way such that it will be appropriate to hold off on raising short-term rates until 2016,' Evans said in his speech. 'Economic activity appears to be on a solid, sustainable growth path. However, inflation is low and is expected to remain low for some time — and I have serious concerns that inflation will run even lower than I expect.'

Market expectations

He pointed out that market expectations on interests rates are running below the median forecast of the dot chart, which has the fed funds rate at 1.75% by the end of 2016. Market expectations, by contrast, have it at just 1%, 75bp below the FOMC median forecast, he said.

Some analysts pointed out that the latest dot chart shows a marked decline in FOMC expectations, which in late 2013 had forecast a rate much closer to 1% by the end of this year.

As it stands now, Evans remarked in his speech, even the median forecast represents an average 25bp increase every other meeting, 'a considerably slower, more gradual pace of rate increases than those implemented in 2004 through 2006.'

St. Louis Fed chief **James Bullard (non-voter)** presented a contrasting point of view to those attending the OMFIF City Lecture in Frankfurt. Bullard, who has been urging the Fed to start raising rates sooner rather than later, reiterated his position in his Frankfurt presentation.

'The risks of remaining at zero too long may be substantial,' he said. He said that starting the process soon would mitigate the risk of an asset bubble developing, while keeping it gradual would still provide ample accommodation for the economy and even extend the period of expansion.

'If a bubble in a key asset market develops, history has shown that we have little ability to contain it,' he warned.

Growing impatient

This taste of the debate within the Fed in back-to-back OMFIF events came after Fed chair **Janet Yellen (voter)** cautioned that removing the word 'patient' from the official statement did not mean the panel was growing impatient.

The committee had previously said that 'patient' meant there would be no rate increase in the next two meetings, but Yellen emphasised in her press conference following the March meeting that removing it did not necessarily signal an impending change.

'Let me emphasise again that today's modification of the forward guidance should not be read as indicating that the Committee has decided on the timing of the initial increase in the target range for the federal funds rate,' she said. 'In particular, this change does not mean that an increase will necessarily occur in June, although we can't rule that out.'

In fact, her emphasis on the need for inflation to be clearly moving back upward in the direction of 2% were widely perceived as dovish by market participants, with many now looking for the initial increase as late as October.

Panel centrist

Atlanta Fed president **Dennis Lockhart (voter)**, considered a centrist on the panel and something of a bellwether, suggested a June-July-September time frame for the initial rate hike. 'If we were to go beyond September, it would be because we were really disappointed in the stream of data that come in,' Lockhart said in an interview with The New York Times.

In any case, he said, it's 'highly likely' the rate hike would come this year. 'If we reverted to a decision point after the end of the year, it would probably reflect either a shock to the economy that really changed the trajectory of the economy or we would have been misreading something pretty seriously,' Lockhart said.

Fed vice chair **Stanley Fischer (voter)** also expressed confidence that the first rate increase would come this year. 'Although the recovery has been slow, there has been significant cumulative progress,' he said in a speech to the Economic Club of New York. 'An increase in the target federal funds range likely will be warranted before the end of the year. Lift-off should occur when the expected return from raising the interest rate outweighs the expected costs of doing so.'

Fischer said that even with a rate increase this year, the Fed has a long way to go to get back to normal. 'When we raise the interest rate,' he said, 'we will be moving from an ultra-expansionary monetary policy to an extremely expansionary monetary policy.'

Speaking before the mid-March meeting, the head of the Cleveland Fed, **Loretta Mester (non-voter)**, the former chief economist at the Philadelphia Fed, said a June rate hike would fit her reading of the economy.

'If incoming economic information continues to support my forecast, I would be comfortable with lift-off in the first half of this year,' she said at the annual policy conference of the National Association of Business Economics in Washington. She wanted the statement to leave that possibility open, which it did by dropping the word 'patient.'

Consensus forecast

She also urged the Fed to adopt a consensus forecast to provide markets with the context for the Fed's forward guidance. Previous attempts to do so have foundered on the ability to reach a consensus. Failing that, she said, it would be helpful to relate the various forecasts for inflation, unemployment, and growth contained in the quarterly dot charts to the forecasts for interest rates.

Connecting the dots in this fashion, so to speak, 'would convey information on each individual policy-maker's view of the relationship among the variables and on his or her monetary policy reaction function,' without having to reveal the identities of each individual. ▪

Darrell Delamaide is a writer and editor based in Washington.

Escaping the interest rate trap

Zero interest rates help debtors but harm banks

Moorad Choudhry, Advisory Board

High absolute debt around the world is a significant drag on resumption of growth in output. Governments could take certain steps themselves to address the issue rather than leave the solution solely to the central banks, for example by reducing tax subsidies on residential mortgage lending. But, just like reform of the welfare state, once voters get used to a certain level of support, it becomes extremely difficult to unwind.

Central banks in the main industrial countries appear to judge that the economy cannot withstand rates even 25 or 50 basis points higher than current levels. As seen by hesitation on this issue by the US Fed and the Bank of England, and substantial monetary easing by the Bank of Japan and European Central Bank, the expectation is that leading central banks will not start raising rates until growth resumes and debt ratios start falling.

Volume of debt

So we are trapped in a spiral that seems difficult to escape. The large volume of debt can be sustained only with low rates, but low rates themselves are a manifestation of the problem.

At the macroeconomic level, a larger amount of debt is by no means unhealthy. Higher absolute levels may well reflect an economy at a fast stage of development, and are a valuable way for lenders and borrowers to spread cash flows over a period that suits their balance sheets.

In an advanced economy with the freedom to print its own currency, and with the appropriate mature and dependable institutions there is probably no theoretical limit on the level of debt which might be said to be unbearable. But, as the post-crisis experience of western economies shows, such thinking is flawed.

Global debt levels have continued to rise since 2008 and are up by $57tn since that year, an increase of 5.3% that is not far off the 7% increase observed during 2000-07 (see Chart). Since the earlier period is viewed as a 'credit boom', this credit growth hardly indicates an economic slump – and yet growth rates have fallen sharply. It is evident that high debt levels do indeed hamper growth.

Part of the problem is that a significant amount of borrowing is property-related, with borrowers assigning residential or commercial property assets as collateral against the loan.

In a market where prices are rising, property owners pay up for higher prices and borrow more, which banks are only too willing to facilitate. However, when there is a real-estate crash, both borrowers and lenders are worse off. The former lose equity and the latter suffer a loan write-down loss.

It was the housing market crash that drove the recession in the US and UK, Spain and Ireland, as homeowners lost equity and banks lost capital. Today, a number of EU countries remain at risk from a housing market crash spiralling into wider bank sector contagion.

The other issue concerning high levels of borrowing is the short-term tenor of much corporate and sovereign debt. A number of EU countries have experienced an increase in debt of over 50% of GDP since 2007. The average tenor of their debt is lower than five years in all cases, so a large share of the overall annual GDP must be raised in borrowing every year. This is where the problem begins. In a growing economy lenders will remain confident and continue to advance funds, but in a stagnating economy the fact that so much debt needs to be refinanced every year can quickly lead to a loss of confidence in borrowers' ability to honour debt repayments. Lending flows dry up and markets spiral downward. From a lender's perspective, confidence is steadily eroded as the debt ratio rises.

Downward spiral

A downward spiral is exactly the problem for many countries in the EU. The only certain way to reduce high levels of debt-to-GDP is strong economic growth. However the EU has struggled even to emerge from recession.

Growth is hampered by high debt servicing burdens and significant social welfare payments. There is an important connection with monetary policy. For countries able to print their own currency (a characteristic which is not open to members of the euro area like Greece) one solution would be to depreciate the currency and use inflation to erode debt. However one of the reasons for establishing the euro was to rule out that course of action in member countries.

Not all countries can depreciate their currencies at the same time, but many appear to be embarking on this course. As a result we have had near-zero interest rates in western economies for six years, as well as a large-scale underpinning of the private sector by the public sector via quantitative easing. This has not resulted in growth meaningful enough to see a reduction in the debt ratio.

Zero interest rates present banks with a net interest margin problem. Borrowers expect rates to come down with central bank easing, but depositors expect to receive some yield on their funds. The result is a dual burden for banks and for a substantial group of their customers.

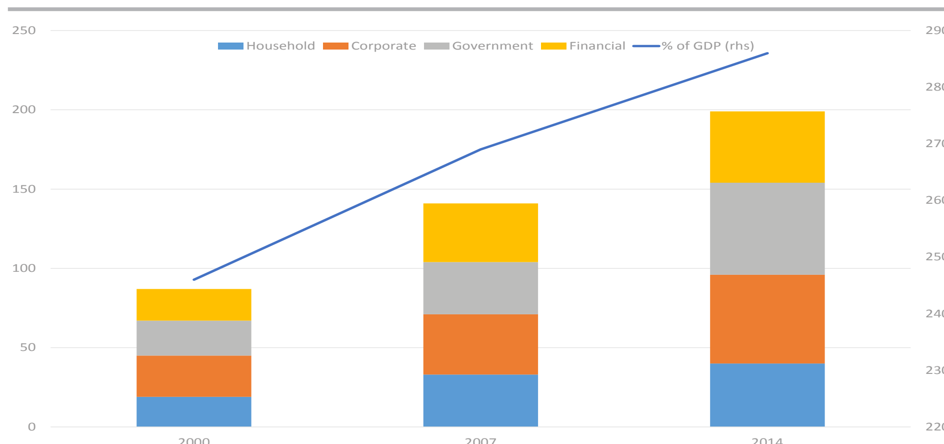
Prosperous economies need healthy banks. Without this condition, growth will necessarily be slow. This unfortunate juxtaposition exposes the global economy to an interest rate trap.

Bank balance sheets cannot be returned to health while interest rates stay at such low levels. But higher interest rates would stifle the growth needed by banks to rebuild their business. ▪

Moorad Choudhry is the author of *The Principles of Banking.*

Increasing world debt

Global stock of debt outstanding, 2001-14 ($tn, % of GDP)



Source: McKinsey Global Institute, BIS, Haver Analytics, IMF, national sources

Smart debt engineering to the rescue

Saving Athens with GDP-linked bonds

Eduardo Borensztein, Advisory Board

Dealing with the sustainability of Greek debt is an enormous problem. Yanis Varoufakis, Greek finance minister, has proposed 'smart debt engineering', including linking debt payments to Greek GDP, namely a growth-linked bond.

Growth-linked securities are an old idea, but there is now a potentially helpful new area of implementation. In such instruments, debt service is related to the rate of growth of the economy, or to the level of GDP, instead of being a fixed coupon.

A simple formulation would be analogous to variable interest rate securities, in which the coupon is a function of the rate of growth. For example, the coupon could be equal to the rate of growth of the economy plus one percentage point, with a minimum of zero.

Linking debt payments to economic performance has a number of advantages.

In bad times, when financing may be scarce and expensive, the bond would pay a low coupon and public finances would get a temporary relief.

In good times, payments would be correspondingly higher. On average, the GDP-linked bond may have a return similar to that of a regular bond, but its growth-dependent pay-off structure can provide significant benefits.

Problem of solvency

Greece's debt problem, however, requires more than just shifting the schedule of payments over time. As Varoufakis says, the country is basically insolvent. Government debt surpasses €300bn, which is almost 175% of GDP. Even under fairly optimistic assumptions about growth and interest rates, Greece would need to run a primary surplus (excluding interest payments) in excess of 5% of GDP just to keep the debt from growing relative to the size of its economy.

In addition to the economic difficulties stemming from such austerity, there are deep political concerns. It is doubtful whether Greece can run such a large primary surplus for an extended period amid legitimate demands from a population that has already suffered years of hardship. The signs of adjustment fatigue are quite evident already. If debt is unsustainable, restructuring will become unavoidable. Left at the mercy of its own internal dynamics, debt will grow uncontrollably.

Sooner rather than later, creditors – most of which are now in the public arena – will balk at continuing to finance what they perceive as a Ponzi scheme under which new money is used to pay off former debts rather than finance growth-generating investments and general enhancement of the economy.

Virtuous circle

There is, however, a more optimistic scenario. If Greece started to grow consistently at 4-4.5% annually (as it did in 2000-07), it could achieve debt sustainability. This would cause interest rates on Greek debt to fall, starting a virtuous circle. Greece has a 40% productivity gap with the European Union average. Economic integration could close this gap, and this could be a reason for long-term growth optimism.

Under the right economic conditions, Greece, with only 11m people and generally benevolent weather conditions, could sustain a much larger population. The Netherlands, with an area less than a third of Greece's, has a population of 17m.

The question is how to create a structure that makes the optimistic scenario more likely. Linking debt payments to Greece's economic performance would not only give a better chance to economic recovery: it might also be perceived as more fair for all concerned. By linking coupon rates to economic growth, ideally with a short lag, Greece would obtain an immediate budget relief and more space for investments and reforms.

Since Greece's problem is one of solvency, the formulation should go beyond cyclical considerations. Linking the value of the debt to the gap between Greece's GDP per worker and the EU average would be one option. This would help bring down the debt-GDP ratio immediately, a key market factor.

Moreover, if Greece is successful in achieving recovery and economic convergence, bondholders investing in the new debt instruments would receive a relatively high return.

The EU has excellent statistical agencies overseeing official figures from the Greek government. This would be a major factor boosting credibility of GDP-linked bonds. With about 80% of Greek debt held by the European official sector, creditors already have direct oversight of macroeconomic statistics.

This creates a powerful mechanism as well as the right incentives for such new instruments to succeed. Greece has already issued GDP-linked securities in conjunction with its 2012 restructuring of privately held bonds, largely at the request of bondholders. This provided a modest incentive to encourage acceptance of the offer, and shows this may produce an appropriate way forward.

In work at the Inter-American Development Bank with a former IMF colleague in connection with such instruments, we have estimated that the current fair market value of the GDP warrant is about 1 cent per euro of newly issued debt at the swap. The calculation involves projecting the expected growth rate of GDP over the lifetime of the security and calculating its present discounted value.

The procedure is repeated 1,000 times in what is termed a Monte Carlo simulation that takes into consideration the random elements that determine the future evolution of GDP.

It is important to consider the volatility of GDP because this has an important effect on the valuation, given the design of the security. The markets' valuation of the Greek GDP has not been too far off our estimate. The price of the warrant was about 1.4 cents until it collapsed under the weight of political risks. So, even for private markets, statistical credibility does not seem a major issue.

A growth-linked structure provides a solution to Greece's debt problems that avoids default and a possible break from the euro. Such an initiative could give Greece room to invest and reform and its creditors the opportunity to share in its future prosperity. ▪

Eduardo Borensztein is regional economic advisor at the Southern Cone Department of the Inter-American Development Bank.

How Greece resembles East Germany

Germany's psychological attrition with weaker states

David Marsh, Managing Director

Greece's seemingly interminable wrangling with its creditors over resolving its unsustainable debt demonstrates many characteristics that are strongly reminiscent of the years of psychological attrition between East and West Germany before reunification in 1990.

Financial and political polarisation between Greece and Germany – the most vocal debtor in the euro area and the largest (and most vulnerable) creditor – displays significant similarities to the tensions between the two halves of the German nation split by the aftermath of the second world war.

In divided Germany, the two German states formed in 1949 eventually came together again after 41 years of separation. This was a result of the fading of the post-1945 geopolitical force field – the superpower confrontation between the US and Soviet Union, each one shielding its respective client state West and East Germany – that had kept them apart.

Model nation

Germany and Greece can be seen, too, as mirror images. In line with Europe's fluctuating fortunes over the past seven decades, the former prospered and became a model nation and creditor. The latter declined and became a case study for mismanagement and a serial debtor.

West Germans found it difficult to heap too much opprobrium on East Germany because they were uneasily aware that the Germans east of the Elbe were in economically dire straits partly because of arbitrary post-war developments.

In the same way, despite Berlin's exasperation with the Greek government, and the widespread feeling in German public opinion that Greece should not be in the euro, German government spokesmen find it near-impossible to criticise Greece directly, let alone to call for its expulsion from the currency bloc.

This reflects residual German feelings of shared responsibility for Greece's parlous state, a consequence of the Nazis' second world war crimes against the Greek population as well as Germany's more recent role in forcing more debts upon a country that was already unable to repay its existing borrowings.

Greece, like East Germany 25 years ago, owes the German government huge sums that all sides know can be recovered only if the debtor's health improves. Greece's Syriza-led government has adroitly focused attention on these German points of vulnerability. Although Greek behaviour has irritated many in Europe, there are signs that Athens' policy of widening responsibility for the country's problems has started to bear fruit.

'Nuisance value'

The forces on the two halves of Germany 25 years ago were ultimately centripetal, resulting from West Germany's constitutional commitment to reunification and the overriding wish of most East Germans to accede to western prosperity and stability.

Greece and Germany, on the other hand, may be ultimately driven apart by centrifugal forces, as Germany and the rest of Europe reassess whether the continent will be more or less stable if Greece remains in the euro. But Greece will leave the euro bloc only if Europe believes that Greece's 'nuisance value' in destabilising its neighbours and partners is greater inside the single currency than outside.

For many years, East Germany was regarded as the pivotal state in the Soviet bloc, the removal of which from Moscow's influence would cause the collapse of the postwar European constellation and possibly the third world war. In a similar way, Greece has a hold over the rest of Europe that is considerably larger than its relatively small economic size would warrant.

As chancellery minister and then interior minister in Chancellor Helmut Kohl's government in the sensitive years leading to and during reunification 25 years ago, Wolfgang Schäuble, now Germany's finance minister, took a highly cautious line on the prospect of East German destabilisation.

He feared a superpower conflict that could cause both parts of Germany to go up in flames.

Schäuble's analysis a quarter of a century ago shows some remarkable parallels to his judgment now that Greece – whatever its non-compliance with bail-out packages – would be a considerable source of geopolitical instability if it quit the euro.

This reflects political and social volatility in an 'arc of crisis' that runs from Ukraine through southeast Europe and the Balkans into Turkey and the Middle East. In the weeks before the fall of the Berlin Wall in November 1989, Schäuble like many in the Kohl government feared the Soviet Union would send tanks and troops into Berlin, which could have triggered a nuclear holocaust.

Similarly, there is considerable anxiety today that overt hostility to Greece now could send Athens into the arms of a revisionist and resentful Russian government – fears that the Syriza administration has been quick to augment and exploit. Chancellor Angela Merkel, like her predecessor Kohl in his relations with the East German regime, has been conciliatory and even-handed in her dealings with the Syriza government.

There is one fundamental difference between Greece and East Germany. West Germany cannot unite with Greece to resolve the latter's difficulties. The absence of a direct answer to the imbroglio forestalls any direct clear-cut outcome to the debt crisis.

Greece may limp on in monetary union in a half-in half-out limbo state, possibly with exchange controls to keep money in the country, for some considerable time. German unification in 1990 solved a lot of problems. To overcome the complexity of the relationship between Athens and Berlin there are no easy solutions. ▪

Greek Finance Minister Yanis Varoufakis

From serial defaulter to model nation

How Germany stopped being Greece

Chris Golden and Con Keating

Imagine a country that finds itself so heavily indebted that it cannot adequately repay its creditors. The debts were incurred by a previous government, largely as a result of non-productive, profligate spending. The country's best efforts in trying to repay its debts led to deep recession and great social unrest.

This debt was renegotiated on more than two occasions and very significant debt write-downs applied, with the remaining debt to be paid over a stretched-out period. A later government defaults entirely on the debt, but still manages to lead the country into deeper and deeper problems.

Track record

This sounds like a description of how Greece got into a debt mess – and a prescription for how to clean it up. In fact it describes the position up to the 1953 debt restructuring for Germany, one of the 20th century's most notorious serial defaulters among sovereign nations, with one of the worst inflation records and a penchant for changing its currency.

Germany's record of international co-operation was cataclysmic. But with the help of debt relief agreed with a 'troika' of international lenders (France, the UK and the US) at the 1953 London debt conference, Germany (under a negotiating delegation led by Hermann Josef Abs of the Deutsche Bank) put its house in order. It became an international success story and a model nation.

The clearest parallel between Greece today and Germany in 1953 is that neither had a good track record. Germany was seen as a hopeless case, as Greece is accused of being today. The second important parallel is that, without a generous renegotiation of all of Germany's debt in 1953, the country would have become quickly insolvent. The same holds true of Greece today.

There are two key differences between Germany 62 years ago and Greece today. First, Germany, even as a serial defaulter, had a history as an industrial powerhouse, which gave creditors some confidence that they would eventually be repaid, albeit at a much lower rate than anticipated when they bought German bonds.

The second difference is geopolitical. Germany was an occupied country. Its viability as a buffer state shielding the rest of western Europe from Soviet domination needed to be bolstered. A viable (West) Germany was essential to the US and Nato strategy of containment. Notwithstanding the geopolitical sensitivities about Greece's position in a volatile part of southeast Europe, the country is not in the same acutely vulnerable circumstances.

During the uncertainty at the beginning of the cold war, Germany more than doubled its debt. Whereas prewar debts totalled some $2.5 bn ($22bn in 2015 dollars), debts incurred after 1945 totalled $3.5bn ($30.5bn in 2015 dollars), so the total under negotiation in 1953 was $52.5bn in today's money. A syndicate of 31 creditors was formed to find a solution.

Eventually, a satisfactory compromise was found, involving reducing the amount of the debt by about 50%, payable over 30 years with reduced interest rates and a grace period of five years.

Debt repayments

Debt repayments were limited to 3% of export revenues in any year. Where Germany felt it could not meet those sums, it had recourse to arbitration. There were a number of contingent repayments. For example, German reunification in 1990 triggered the repayment of interest accumulated up to 1953 after Hitler's default in 1934 on the Dawes loan of 1924 and the Young and Kreuger loans of 1929.

The 1953 settlement gave the Federal Republic an exemption on repayment of East Germany's debts. They became repayable on reunification in 1990, in the form of 20-year bonds which matured and were repaid in 2010. There were further contingent reschedulings, including debts of the state of Prussia, which will be renegotiated if and when the lands in question are reunified into Germany.

These negotiated contingency plans could be similar to various ideas for Greek rescheduling put forward by the Athens government, which has suggested repayments linked to GDP growth – assuming that the Greek economy eventually turns the corner.

The tortuous nature of the creditors' agreements with Germany are strongly reminiscent of the vicissitudes over Greek debts. On more than two previous occasions between the first and second world wars conferences were called to discuss and eventually restructure German debt.

This was initially reparations debt, but this was extended by massive German public and private borrowing under the Weimar republic. By 1932, the German share of total world debt was about 14%. Almost 12% of all foreign loans issued in the US between 1924 and 1929 went to German cities.

International restructuring

The first restructuring took place under the Dawes plan in 1924, lengthening the repayment period significantly as well as providing Germany with an international 7% loan of $230m (around $3.1bn in 2015 dollars). Germany could not keep up the payments and a second restructuring was secured under the Young plan of 1929-30.

That plan reduced the amount outstanding to $100bn (2015 dollars) and extended the repayment period to 59 years until 1988. A loan of $351m ($4.9bn in 2015 dollars) was issued to the public. The Bank for International Settlements was created to handle the payments.

The global crash began in May 1931. In January 1933 Hitler was appointed Chancellor. The new regime wasted no time in abrogating payments. Rather than openly declaring default, it pursued a complicated policy motivated partly by the need to maintain trade ties.

In March, Reichsbank President Hjalmar Schacht said, 'I believe one could name several South and Central American republics which defaulted three or four times, but have always been given credit again.'

That cynical announcement underlines a constant reality about international debt negotiations. Whatever the ups and downs of international restructuring, appetite by both debtors and creditors to contract fresh loans seems practically insatiable. ▪

Chris Golden is Chairman, European Federation of Financial Analysts Societies (EFFAS) European Bond Commission. Con Keating is Head of Research, Brighton Rock Group.

German imbalances are harming Europe

Berlin's interests lie in more spending and lower saving

Simon Tilford, Centre for European Reform

The German authorities and media regularly point to data allegedly showing that rebalancing of the German economy is in progress. Newspaper articles froth about German consumers rediscovering shopping, and the government intones that the economy is now being driven by domestic demand. But the data tell a different story.

The country's current account surplus hit a record 7.5% of GDP in 2014. At over €200bn this was easily the biggest surplus in the world, larger even than China's.

Germany is in breach of the EU's excessive imbalances procedure (which requires member states to restrict current account surpluses to no more than 6% of GDP, and deficits to 4%). German policy-makers are proud of the country's export success, but a much smaller surplus would be in Germany's interests and those of its trade partners.

Europe is awash with talk of the need for structural reforms, but little attention is paid to the chronic imbalances in Germany's economy, which comprise perhaps the biggest structural problem of all. It is not in Germany's interest to run such a large surplus. Living standards and investment are lower in Germany than would otherwise be the case.

Moreover, the country has lost almost a third of the money it has invested abroad over the last 15 years; it would have made much more sense to invest the money at home.

At the same time, German imbalances represent a formidable obstacle to a sustainable economic recovery in Europe.

How did Germany's economy become more imbalanced when it was supposed to be growing robustly and unemployment has been low? The reason is that growth in domestic demand has been anaemic – averaging 0.4% a year in 2012-14 – while economic growth averaged 0.8%.

The difference was accounted for by exports growing more rapidly than imports. Domestic demand accounted for most of 2014's GDP growth of 1.6%. Yet a greater contribution to growth from domestic demand than the external sector does not mean the economy is rebalancing.

Domestic demand

Domestic demand accounts for the overwhelming proportion of GDP, so it can be the principle driver of GDP growth even when expanding very weakly. If net exports are positive – that is, exports are rising more rapidly than imports – the economy is still becoming more, not less, imbalanced. For the German economy to rebalance in any meaningful way, net exports will need to be negative for a prolonged period. This will require the German government and private sector to save less and invest more.

If both the private sector and the government are saving, as is the case in Germany, then other countries must be borrowing those surplus savings. In other words, they must be living beyond their means, something German policy-makers and economists like to criticise. Since it is a net saver, Germany has to 'import' demand from other countries which are running a current account deficit, and which are therefore borrowing money from Germany. Germany has substituted external demand, in the form of additional net exports, for deficient demand at home. The German economy is not about to rebalance significantly.

Real wage growth will accelerate in 2015 as a result of falling commodities prices, but will not put a significant dent in the country's surplus. For this to happen the government will need to embark on a series of policy interventions.

A fiscal stimulus is the most obvious way of soaking up some of the country's surplus savings, and Germany has plenty of fiscal space to provide one. A more progressive tax system would also help: Germany relies too much on consumption taxes, whereas corporate income, wealth and property are undertaxed.

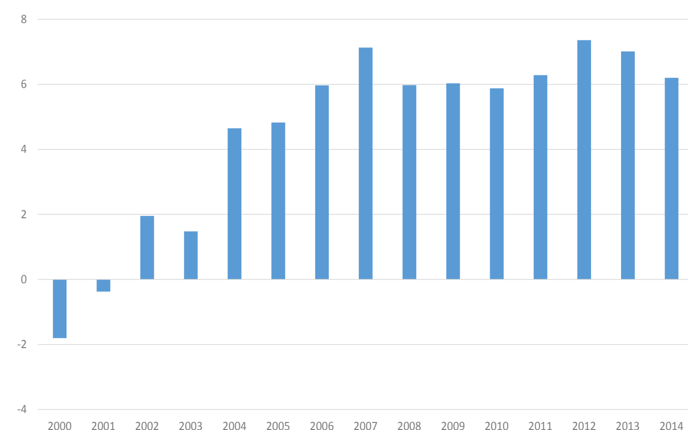
Financial liberalisation to encourage greater home ownership could help to address Germany's highly unequal distribution of wealth, lowering households' precautionary savings in the process. In addition, the German authorities could openly back aggressive ECB monetary easing.

There is no sign of any inflationary pressure in Germany. Awareness that interest rates will remain very low for a prolonged period of time could deter German households from saving as much as at present – with positive results for the whole for Europe. ▪

Simon Tilford is deputy director at the Centre for European Reform. This is an extract from his paper 'German rebalancing', first published by CER.
www.cer.org.uk

Germany's current account balance

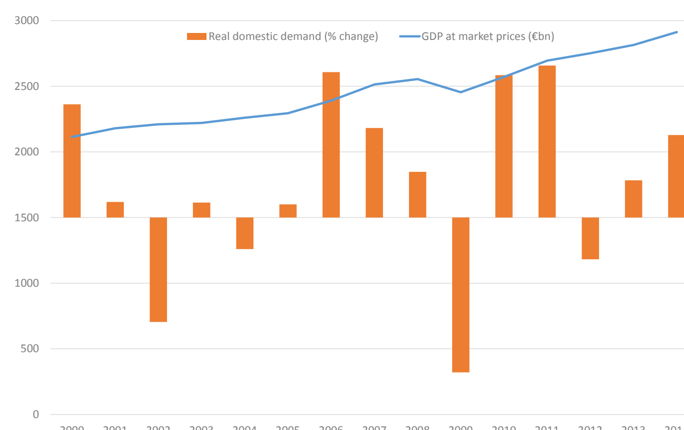
2000-14 (% of GDP)



Source: IMF World Economic Outlook database, October 2014

German GDP and domestic demand growth

2000-14 (€bn, % change)



Source: OECD

The limits to exceptional access

Lessons for IMF from Ukrainian debt negotiations

Edwin 'Ted' Truman, Advisory Board

On 11 March, the executive board of the International Monetary Fund approved a $17.5bn economic and financial support programme for Ukraine under its policy of exceptional (abnormally large) access to IMF financial resources.

The IMF programme is the keystone of a $40bn package that includes other multilateral lending institutions (World Bank and European Bank for Reconstruction and Development), bilateral assistance from the US, European Union and other sources, and a debt operation to be completed by mid-June that is expected to yield $15bn in financial relief.

Aside from the substantial geopolitical and implementation risks, the ambitious Ukrainian programme will provide guidance on two important issues.

The first question is whether it will be possible to negotiate a voluntary market-friendly debt reduction of the expected size within the stipulated period for completion. The answer is likely to be no. The second question is what we should learn from the Ukraine case about the IMF's policy on exceptional access. The answer is that the policy is unrealistically rigid.

Exceptional access

In 2002, after much discussion, the IMF executive board adopted four criteria that a member should meet before it could obtain 'exceptional access' to the IMF's financial resources beyond the normal standard of 200% of a country's quota for borrowing from the fund in any one year and 600% over three years. The criteria were slightly modified in 2009.

They lay down, first, that the member seeking such resources 'is experiencing or has the potential to experience exceptional balance of payments pressures' on the current or the capital account resulting in a need for Fund financing beyond the normal limits.

Second, the country has to submit to 'rigorous and systemic analysis' indicating a high probability that public debt is sustainable in the medium term. Third, the member has to show 'prospects of gaining or regaining access to private capital markets within the time frame when Fund resources are outstanding'.

Fourth, the policy programme has to hold out a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver on that adjustment.

Debt restructuring

The presumption was that if a country could not satisfy the second criterion, it would have to seek a restructuring of its debt either prior to the approval of its programme or as part of that programme. The Ukraine programme is the first since 2002 in which this presumption has been incorporated into an IMF programme involving exceptional access.

In the judgment of the IMF staff, for Ukraine to resolve its balance of payments problem and achieve 'debt sustainability with a high probability' its programme should include 'private sector involvement through a debt operation.' The aim would be to 'generate $15bn in public sector financing during the programme period [2015-19]; bring the public and publicly guaranteed debt-GDP ratio from a projected 80% of GDP to under 71% of GDP by 2020; and keep the budget's gross financing needs at an average of 10% of GDP (maximum of 12% of GDP annually) in 2019-25.'

Principal reduction

These three laudable objectives will be very difficult to achieve. The associated reduction in the net present value of Ukraine's public and publicly guaranteed debt at the end of 2014 estimated at $70.8bn, could be achieved via many different combinations of principal reduction, interest rate reduction, and reprofiling of when obligations are due.

The holders of Ukrainian debt range from domestic banks to foreign investment funds and the Russian sovereign wealth fund.

If the mid-June target is not met, a substantial part of the benefits of the private sector involvement in the debt operation will be lost for 2015. The gross external financial requirements of the programme are that $5.2bn of the $15bn in 'exceptional financing' (code for the debt operation) will be achieved in 2015.

As 15 June approaches without a deal, Ukraine either will have to scale back its goals for the debt operation or will have to abandon the voluntary, market-friendly approach and suspend payments on some or all of its debts.

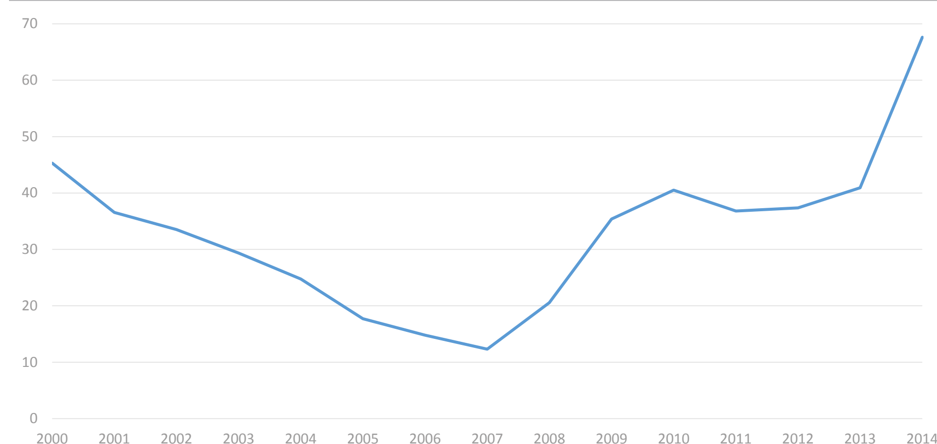
The latter option is most likely. This would shift the incentives for consummating the debt operation in Ukraine's favour but with a substantial delay and at the potential cost of considerable financial market disruption. Under either option, significant uncertainty about the Ukrainian programme will persist. The IMF will have to rethink its approach to sovereign debt and the policy on exceptional access.

There are parallels to the Greek debt crisis. In May 2010, when the Greek programme was presented to the executive board, the IMF staff stated that it considered Greece's debt to be sustainable but the 'significant uncertainties associated with that judgment make it difficult to state categorically that this is the case with a high probability.'

However, the staff justified the programme on the grounds that 'Fund support at the proposed level is justified given the high risk of international systemic spillover effects.' Thus, a 'systemic exception' was added to the second criterion. *continued on p.24...*

Ukraine's debt-GDP ratio

Ukraine gross government debt, 2000-14 (% of GDP)



Source: IMF World Economic Outlook database, Oct 2014

The real battle for Ukraine is global

In a network age, west must reinforce digital democracy

John Kornblum, Advisory Board

Hardly a day goes by without more evidence of Russia's success in creating its own narrative about the crisis in Ukraine. Global TV networks pump out Moscow's line around the clock. It is not yet clear how President Vladimir Putin's wooing of Greek Prime Minister Alexis Tsipras, who visited Moscow on 8 April, will turn out.

To those of us who lived through the cold war, this type of campaign is nothing new. What has changed are the implications of Russia's traditional reliance on information warfare. The cold war was a global confrontation played out on the relatively focused European stage. Ukraine has become the first geostrategic crisis painted in real time on a global digital canvas.

An example of a tendency towards apparent misinformation is Richard Sakwa's *Frontline Ukraine*, reviewed in the March edition of the Bulletin (p.30). As part of a Russian propaganda strategy, Putin has concocted a story of western encroachment on Ukraine to cover his own weakness and the aggression it has engendered.

Integrated information

Getting the story right in Ukraine is important not just for the Ukrainian people. Of greater historic significance will be how this confrontation affects the west's ability to manage globally integrated information networks that increasingly form the heart of 21st-century life.

Putin and his allies have built an aggressive narrative based on purported western threats which are said to be aimed at the Russian soul. Promises made after the end of the cold war are alleged to have been broken. Russia feels abandoned and surrounded.

Russia's invasion of Ukraine is justified as protecting Moscow's interests against an increasingly ravenous west, especially the US.

As in the cold war, this message often finds ready believers in the west, especially in Germany. But this time, the message resonates on a global scale. Russia is only one of many societies which has open ears for Putin's claims that western capitalism is suppressing national and cultural identity.

The digital tools of modern information technology spread this twisted version of reality daily to many societies around the world. Putin has been able to use his agitprop to stimulate the world's first truly digital confrontation. He has been able to argue convincingly that his aggression against Ukraine was a humanitarian intervention in a civil war, started by a nationalist leadership bent on destroying Russian speaking minorities. A pinch of fascism is usually added, to make clear that Russia continues the battle begun in the second world war.

Technological advantage

So far, the western democracies have a major technological advantage and control the hardware. But we are losing the war of words and thus control of the software. Even the nations of the European Union have begun to echo Moscow's claim that modern information technology is threatening human values, as seen in the regular diatribes in Germany and France against US companies leading the world in information technology.

With regard to the facts of the Ukrainian stand-off, as one who took part in negotiation of just about every agreement with a new Russian leadership between 1992 and 1997, I can say that this Russian narrative could not be further from the truth.

Americans and Russians shared a common goal in those years: to establish democracy and the free market as the basis for the reunification of Europe.

Today, we can be proud of the secure and prosperous democratic community of nearly 1bn people stretching from the east of Europe to the tip of Alaska.

This commitment to democracy is what the Russian people really need, not more diplomatic negotiations or old-fashioned European security structures.

The real threat for Russia's authoritarian rulers is not Nato expansion, but the attraction to their citizens of western economic and political success. This is why the Russian counter-attack, military and digital, has been so vicious. Russia's leaders, from Putin downwards, appear to view the growing encroachment of the western way of life as an existential challenge.

I favour military assistance to help Ukraine regain its footing. But I believe that reinforcing the west's ability to conduct the information war is equally important.

Russian President Vladimir Putin, May 2012

Unless western democracies wrest the rhetorical high ground from Russia, Putin is likely to become more arrogant and more dangerous. His sense of media control could ultimately make him over-confident and prone to disastrous mistakes.

Today's technological challenges demand a technological but also a political response. The west needs to champion a democratic operating system for digital society to counter Putin's information campaign. This calls for a battery of initiatives that are today's equivalent of western support for political democracy during the cold war.

Geostrategic map

The radical integration of the world through high-speed information networks and modern logistics is redrawing the geostrategic map. Everyone, including Russia, will profit if the principles of western democracy are firmly established as the basis for global integration.

If, however, the debate lends credence to those who reject the operating of western values, the rebuttal won't stop at Russia or Ukraine, but will progress throughout Europe and beyond. In a networked world, no country any longer is unimportant and far away. A new generation of digital diplomats will have to learn how to master the new rules of network democracy.

If the west fails to rise to the challenge, the drawbacks for all of our societies will reverberate for many years – and will affect many areas of life that we in the west today take for granted. ▪

John Kornblum is a former US Ambassador to Germany and Senior Counselor at Noerr LLP. This is an edited and modified extract from his testimony on 10 March to the US Senate Foreign Affairs Committee.

The shadow of US rate hikes

Russian reserve fall leads official asset decline

Jamie Bulgin, Markets and Institutions

Between 2009 and 2012, US quantitative easing led to gross capital inflows of $4.5tn into developing economies – half of all global capital flows during that period. A forthcoming US rate hike is likely to spark a sharp turnaround, affecting central banks around the world.

IMF Managing Director Christine Lagarde has publicly warned that periods of accommodative monetary policy can lead to vulnerability. This can unwind suddenly and drastically when policy is reversed, creating substantial volatility.

Already we have seen signs from IMF figures showing a decline in global reserves to $11.6tn in March from a record $12tn in August 2014, reversing a five-fold increase that began in 2004. One of the biggest falls has been in Russia, where reserves fell 25% over the past year to $360bn in March, a result of outflows caused by the crisis over Ukraine as well as oil price uncertainties. China's reserves fell $200bn to $3.8tn in December from a peak of $4tn in June.

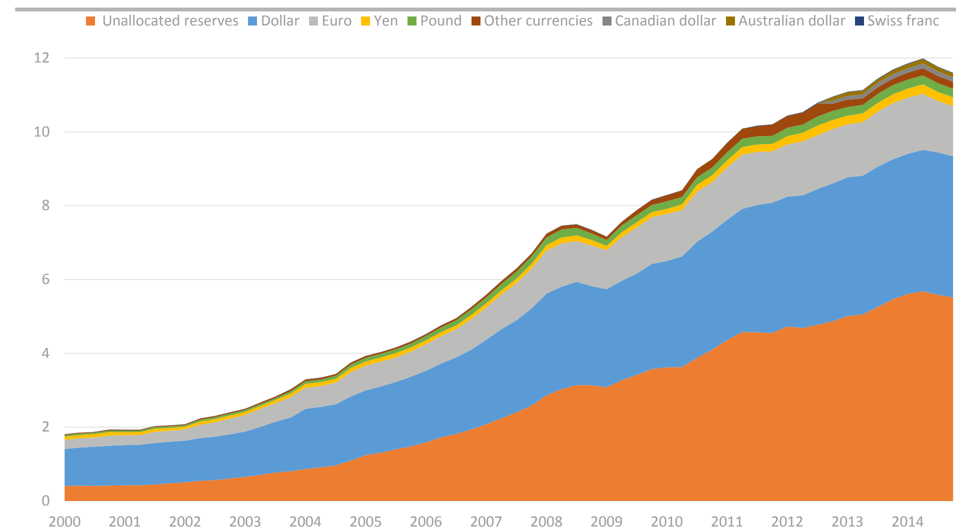
Emerging markets face tension brought by the strength of the dollar. Indebted companies which took full advantage of previously low rates to borrow in dollars, but now have assets or earnings in other currencies, face sudden jumps in costs to service their debt. India's corporate sector is thought to be particularly vulnerable.

At the same time emerging markets have been reinforcing dollar holdings in their foreign exchange reserves to take account of the US currency's strength. Quarterly statistics from the IMF, known as the Cofer data, show the dollar's share rose to 62.9% at the end of 2014 from 62.4% in the third quarter.

Reflecting the turn away from the euro accentuated by the European Central Bank's proclamation last August that it wished a lower currency value, reserve holdings of euros fell to 22.2% from 22.6% in the final three months of last year. Further falls in the euro share of reserves are expected later this year, as central banks accept the declining attractiveness of holding often negatively-yielding euro assets. ▪

How euro weakness has bolstered dollar reserve supremacy

Composition of world foreign exchange reserves, 2000-14 ($tn)



Source: IMF

Lessons for IMF from Ukrainian debt negotiations

...continued from p.22.

The debate over the IMF's exceptional access policy centres on this exception. The principal objections to this exception are three. First, the 2002 exceptional access policy was a set of immutable rules that were not subject to modification. This argument is specious because IMF policies are always open to revision. Second, the systemic exception for Greece is associated with a failed IMF programme, demonstrating that use of the exception failed. However, the systemic exception was also invoked in the reasonably successful programmes with Ireland and Portugal. Third, the systemic exception is inequitable because it favours large countries and violates the provision in the IMF Articles that requires equal treatment of all members. This argument is fallacious because it ignores the fact that prevention of large spillovers, the motivation of the systemic exception, provides substantial benefits to all members of the IMF and not exclusively, if at all, to the country concerned.

The general assumption is that the Ukraine case will involve some reprofiling of its debt. Thus, the Ukraine case will test the view that the IMF can successfully revert to the earlier version of its policy on exceptional access and, where there are significant uncertainties about a country's debt situation, whether reprofiling will help to resolve them. I suspect that Ukraine ultimately will have to suspend payments on its debt. Even with a suspension in payments, if completion of the debt operation is delayed, Ukraine will have serviced more of its debt than was anticipated. As a result, at the first review of Ukraine's programme in June, the IMF will be confronted with the same issues about Ukraine's debt as in March: the uncertainty about the sustainability of Ukraine's debt will not have been removed.

The IMF will have to decide whether to delay completion of its review, jeopardising the Ukrainian programme, or implicitly or explicitly to make another adjustment in the application of its framework for exceptional access. In that case, what lessons should be drawn for the IMF's exceptional access policy? First, the IMF framework for exceptional access to its financial resources should not be rigidly constrained. Second, IMF policy on exceptional access should be reconsidered from the bottom up. Until 2002, the IMF interpreted the key provision on this issue in Article V of its charter in terms of prospects for the overall success of the programme: the fourth criterion in the current exceptional access framework.

That should remain the overriding criterion. This approach would help to introduce an appropriate balance in judgments, in particular in dealing with programmes in which there are significant uncertainties. This approach would force the IMF management and staff as well as the executive board to consider some of the trade-offs between, for example, the requirements for fiscal adjustment and the associated impact on GDP. ▪

Edwin 'Ted' Truman is Senior Fellow at the Peterson Institute for International Economics.

UK may be creditor despite deficits

Bank of England estimates paint a rosier picture

William Baunton, Economist

The UK's balance sheet with the rest of the world is a key indicator of the health of the economy. The net international investment position shows the stock excess of UK claims on the rest of the world over the rest of the world's claims on the UK. These take four forms: direct investment, portfolio investment, other investment and reserve assets.

It is notoriously problematic to track NIIP accurately. The UK's balance sheet is six times the size of annual GDP. The NIIP is the difference between gross assets and liabilities, so small errors or measurement disparities cause large swings and revisions when measured as a proportion of GDP.

The Office for National Statistics finds that the UK's NIIP has been deteriorating since mid-2011. Its most recent figures estimate the UK to be a net debtor equal to 25.5% of GDP. According to the ONS, the UK was only briefly a net creditor in 2008 when the pound depreciated significantly as the financial crisis unfolded.

However, using a different method, the Bank of England finds the UK to be a net creditor of 31.6% of GDP, with positive net assets since 2005. The significant difference, aside from currency fluctuations, lies in the method of calculating the value of foreign direct investment stocks. The ONS, like many others, uses book value, and where necessary, historical cost value. The alternative approach devised by the Bank of England is an estimate based on foreign direct investment measured using market value.

This method in some cases increased the value of UK-owned foreign assets by 75% and increased the value of foreign-owned UK assets by 50%. By this metric, favourable net returns on overseas investments have allowed the UK to run current account deficits without becoming a net debtor.

The real story is in net positions between sectors of the economy. The distribution of assets and liabilities across sectors is vital to ascertaining whether the UK is vulnerable to external shocks. Foreign assets and liabilities may have different maturities or be denominated in different currencies, which pose potential risks, particularly in illiquid markets.

In the UK's case, short-term external liabilities are held primarily by financial institutions (equal to about 25% of GDP) while long-term liabilities are held by the corporate and government sectors (30% and 25% of GDP respectively).

The largest proportion of external assets is held by insurance companies and pension funds, which are long term and equal around 60% of GDP. This reveals a maturity mismatch.

The mismatch has improved significantly since the crisis, when large net short-term foreign currency liabilities were particularly pronounced and swap lines with the Fed were required to alleviate a shortage of dollars. Financial institutions have since reduced their net short-term foreign currency liabilities.

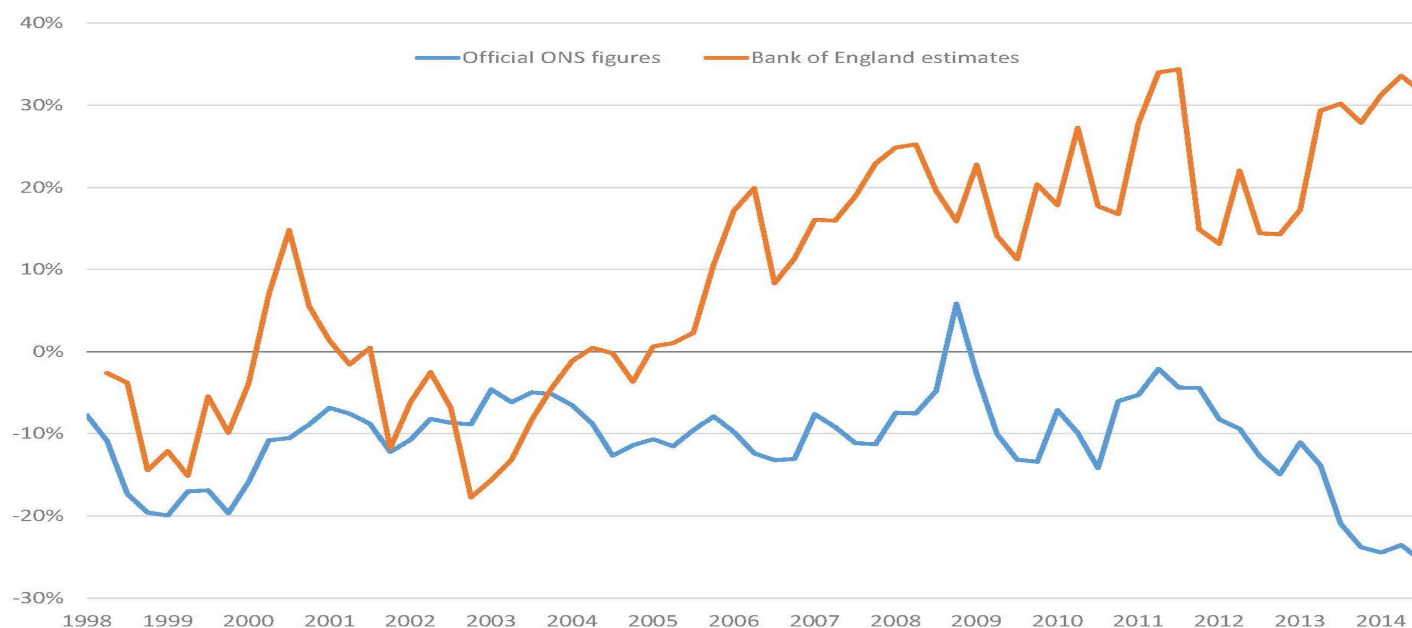
There is no rule dictating how large debt positions must be to leave a country vulnerable. Greece has a net debt position of around 120%. Ireland, Cyprus and Portugal have net positions exceeding 100% of GDP.

The IMF estimates that vulnerability in advanced economies is heightened when the net liability position exceeds 60% of GDP.

The IMF predicts stock imbalances will rise from the current level of 40% of world GDP to 45% by 2019, enforcing the need for increased international focus on this issue and a coordinated effort to curtail the trend. The Bank of England's measurement shows a healthier picture than the official estimates. The UK may be better placed to withstand financial volatility than many believe. ▪

Bank of England data paint a healthier picture

UK net international investment position, 1997-2014 (% of GDP)



Source: ONS, Bank of England

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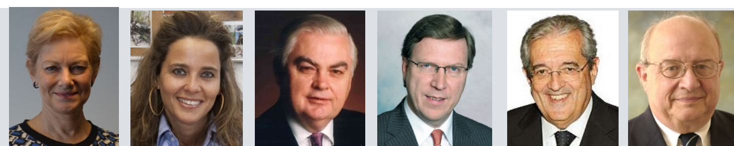

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Dangers from rising currency debt

Magnifying effect of integration and volatility

Jeffry Frieden, Harvard University

Currency wars, the fate of the euro, internationalisation of the renminbi, currency manipulation – exchange rates are at the centre of international economic controversies. No wonder: currency movements have powerful effects, and exchange rate policy is inherently political.

Whether currencies are fixed or floating, strong or weak, is subject to all manner of political pressures. Exchange rates are central to the complex debt dynamics of today's international finance. Currency movements can cause debt crises, just as debt problems can cause currency crises.

Driving forces

These 'twin crises' are not new – there were plenty in the 19th and early 20th centuries – but the forces that drive them have changed. Traditionally, currency values have mattered primarily as they change relative prices of domestic and foreign goods, hence incentives to produce, or to consume, local and foreign goods and services. But today currency values are particularly important for their impact on the relative prices of assets and liabilities.

Generations of debtors have been bankrupted by a depreciation that raised the real cost of foreign currency liabilities. This was abundantly true of the developing country debt crisis of early 1980s, as massive devaluations ruined debtors around the world.

The same dynamic was at play in Mexico's 'tequila crisis' of 1994, in the 1997-98 Asian financial crisis – indeed, in virtually all emerging market debt crises. These experiences led to the conclusion that a central problem of emerging markets was 'original sin', the inability of governments to borrow long-term in their own currency. This left emerging market sovereigns subject to currency mismatches in a world of volatile exchange rates. But even as the 'original sin' hypothesis was widely accepted, reality began to change. Starting around 2000, emerging market governments found foreign investors increasingly willing to hold local currency-denominated government debt.

As Wenxin Du of the Federal Reserve Board and Jesse Schreger of Harvard University showed in their December 2014 report 'Sovereign Risk, Currency Risk and Corporate Balance Sheets', in 14 major emerging market economies, the share of government debt in local currency held by foreigners went from 12% in 2003 to 58% in 2012.

The proportions vary: local currency foreign-owned debt of the Colombian government was 15% of the total, while for Thailand the share was 98% in 2012. But overall most of these countries' $1tn in sovereign debt owed to foreigners was in local currency. They had apparently been absolved of original sin.

Liability mismatches persist, but now they are largely in the private sector. While emerging market governments owe well over $1tn abroad, most of it in local currency, emerging market private corporations owe over $2tn to foreigners – and 90% of this is in foreign currency.

This leaves the typical emerging market acutely exposed to currency movements that can dramatically increase the private sector's debt burden. This exposure in turn can hamstring national policy. While the ideal response to a terms-of-trade or other negative shock might be to loosen monetary policy and depreciate the currency, if households or corporations are heavily indebted (and, as is typical, unhedged) in foreign currency, the government may come under major pressures to avoid a depreciation.

This dynamic was on display in eastern Europe in 2008-10. In the Baltic states, some 80% of bank loans were in foreign currency – mostly mortgages – which made it politically virtually impossible to contemplate a depreciation, desirable as that might have been.

In Poland, where the proportion of bank loans in foreign currency was under a third, there were few political barriers to depreciating the currency by 40% when the crisis hit. This meant that Poland avoided a recession, in contrast to a GDP fall of 20% in the Baltic states.

Hungary went in a different direction. With most of its mortgages denominated in Swiss francs, the Hungarian government effectively bailed out households and pushed the losses onto creditor banks, most of which were foreign-owned.

Real economy

There are good reasons for exchange rates to move, especially to reflect trends in the real economy. But most governments must now be sensitive to the impact of currency movements on the balance sheets of both the public and private sectors. A depreciation that is eminently justifiable on macroeconomic grounds can cause major, countervailing financial disruptions. And emerging market currencies can be buffeted by other forces – such as expectations of policy changes in the major financial centres – that threaten the solvency of important segments of the local economy.

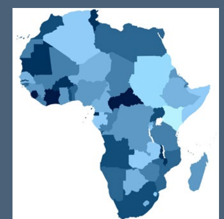
Two of the central features of today's international economy are global financial integration and exchange rate volatility. These can interact to provoke and magnify debt problems, especially in the emerging markets.

Without more systematic international macroeconomic policy coordination – which is unlikely in the near future – the dangerous nexus between international currency movements and international debts will continue. ▪

Jeffry Frieden is professor of government at Harvard University, and author of Currency Politics: The Political Economy of Exchange Rate Policy.

Inaugural African Public Investors Meeting (APIM)

15 September 2015, London



The African continent is becoming an increasingly integrated economic area and a growing force in the global economic system. OMFIF, in partnership with Quantum Global Group, is initiating the African Public Investors Meeting. The inaugural meeting will bring together international and regional public and private sector bodies to examine key issues relating to the African investment landscape.

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

Braking China's debt surge

Navigating a turning point to curb vulnerability

John West, Advisory Board

Only a few years ago Wen Jiabao used his position as Chinese premier to scold the US for its responsibility in the debt-driven financial crisis, appealing to the Americans to safeguard the value of Chinese holdings of US government debt.

In the meantime, China's total debt has risen from $7tn in 2007 to $28tn by mid-2014, according to the McKinsey Global Institute. And with a strong dollar and a resurgent American economy, Premier Wen's successors have much less to worry about regarding China's holdings of US government debt.

Debt build-up

China accounts for more than one-third of the growth in debt globally. At 282% of GDP, China's debt is now even larger than that of America (269%) or Germany (258%).China's rapid debt build-up is roughly double that in the US before the global crisis or in Korea before the Asian financial crisis.

If the pace of debt build-up continues, China's debt would reach 400% of GDP by 2018. This debt surge is the result of the government's stimulus programme in response to the 2008 bankruptcy of Lehman Brothers, which led to an explosion in directed bank lending, mainly to state-owned enterprises and local governments. More recently, this was followed by a boom in shadow banking finance.

China's debt is concentrated with the SOEs. At 125% of GDP, China has one of the world's highest levels of corporate debt. While China's government debt is more modest, this could change quickly if the government were obliged to bail out SOEs or to recapitalise financial institutions.

China's debt binge has created vulnerability. Unregulated shadow banking has accounted for nearly half of new lending since 2008. Some local government infrastructure projects are not capable of generating financial returns to enable debt repayment. And nearly half of China's total debt is directly or indirectly related to the volatile real estate sector.

Real estate prices in China skyrocketed over the past decade, increasing 500% from 2004 to 2013. Some analysts have described Chinese real estate developments as forming the world's biggest bubble. A price correction has already begun. In fact, a slump in the housing market seems to be accelerating, as housing prices have fallen in each of the past six months.'A plausible concern is that the combination of an overextended property sector and unsustainable finances of local governments could result in a wave of loan defaults in China, damaging the regular banking system and potentially creating a wave for investors and companies that have put money into shadow banking vehicles,' the McKinsey report argues.

'Don't worry, China won't crash', was the message from Premier Li Keqiang at the end of the 5 March National People's Congress. But even Li acknowledged that the Chinese economy faces a long period of adjustment.

Addressing problems

At this stage, the Chinese government has the financial wherewithal to deal with its debt challenges and stave off a full-blown financial crisis. And Li indicated a willingness to continue propping up the economy, if necessary.

But as highlighted by Japan two decades, public finance can quickly get out of control unless the government promptly addresses financial problems. And to prevent a recurrence, the government must implement necessary structural reforms to enable the financial system to allocate finance more efficiently and to empower provincial governments to raise sufficient tax revenues to finance their expenditures.

Some observers have argued that China could use its large foreign exchange reserves of close to $4tn to solve its debt problem.

But it's not as simple as that. Such an approach would require selling foreign currency-denominated investments and converting the proceeds into renminbi.

This would push up the renminbi exchange rate, with the potential to harm exports at a time of economic weakness. Clearly this is a danger. Yet there are signs that this may be the strategy that the Chinese authorities have been following.

Development trajectory

China must navigate a major turning point. A period of slower growth lies ahead. Most important, China must unlock productivity as a generator of growth and industrial upgrading, now that the demographic dividend of cheap labour has come to an end.

This will require urgent implementation of the commitment of the 2013 Third Plenum to allow market forces to take over as the decisive factor in resource allocation.

In the past, China's economic policy-makers have been adept at navigating treacherous waters. But introducing more market forces into China's still state-dominated economy brings the risk of considerable creative destruction.

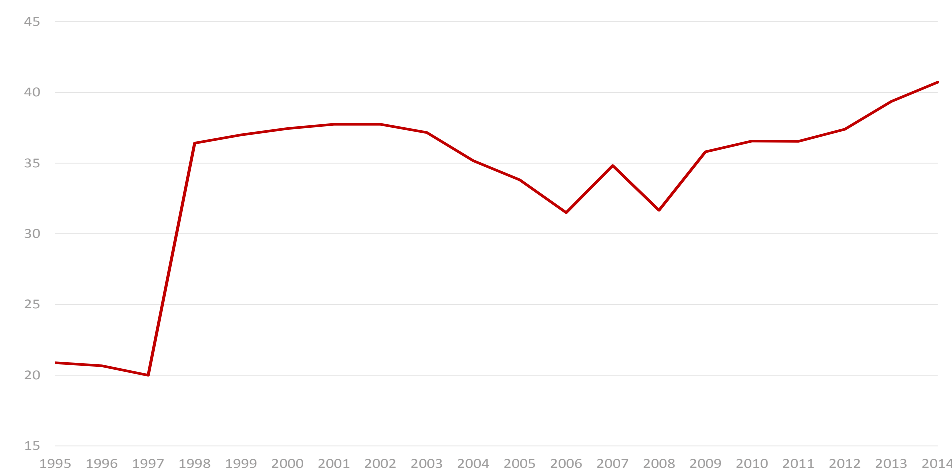
At the same time China must escape the danger of financial instability.

Finding the appropriate route forward will require still more skilful policy-making than in the past. ▪

John West is Executive Director of the Asian Century Institute.

China's debt surge

Total gross government debt of China 1995-2015 (% of GDP)



Source: IMF World Economic Outlook database, October 2014

Virtuous circle for east Africa

Regional capital market integration is the only option

Staci Warden, Milken Institute

Over the past decade, the major economies of east Africa – Kenya, Uganda, Tanzania, and Rwanda – have enjoyed annual growth rates of well over 5%. But unlike in Latin America and east Asia, where economic growth has spurred impressive growth in capital markets, in east Africa capital market development has lagged considerably.

With the exception of Kenya, the East African Community, made up of Burundi, Kenya, Rwanda, Tanzania, and Uganda, has among the smallest and least developed capital markets in the world, even as a share of GDP.

Market capitalisation

Equity market capitalisation is low, secondary market liquidity is paltry, benchmark domestic currency yield curves show major shortcomings, and corporate bond markets are virtually non-existent. Even Kenya's equity market capitalisation, at about 35% of GDP, is much smaller than what typically counts as a 'liquid market', both in terms of size and daily turnover. Nigeria's stock market, for example, is about three times larger than Kenya's.

East Africa has huge public and private financing needs, but corporates raise money almost entirely through bank loans, and small and medium-size enterprises in particular have limited access to reliable finance of any kind. Likewise, domestic savers have few retail savings products beyond bank deposits.

Given the financial repression and low levels of credit allocation caused by an over-reliance on banking systems, capital market development has become a priority for governments in the region. Kenya, for example, has just completed a comprehensive capital markets master plan and has undergone a number of important reforms, including the demutualisation of the Nairobi stock exchange. Rwanda has distinguished itself for its openness and its rapid approval process of licenses and new issue applications.

But a country's capital market development is related to the size of its economy, and in particular to the level of domestic savings on the supply side and the size of the corporate sector on the demand side. Apart from, perhaps, Kenya, the countries of east Africa are arguably too small economically to develop viable capital markets even if individually they put in place the right macroeconomic policies and institutions.

Rather, regional capital market integration is the only viable option for deep, well functioning capital markets for the EAC countries. Until recently, though, rather than pursue the scale opportunities that come with regional integration, each country has tried to develop its market in parallel, with modest success and at considerable cost.

For example, each country in the region has spent millions of dollars on trading and clearing and settlement systems, each one of which has the capacity to handle more trades per second than the turnover on the combined exchanges annually. To their credit, EAC governments have recognised both the error and the opportunity and have made some important progress towards integration in recent years, in particular regarding the harmonisation of their regulatory environments and in encouraging the cross-listing of stocks on national exchanges.

Required reforms

The recent automated linkage of the inter-depository mechanisms between Kenya and Rwanda is a significant step, and serves as a pilot for a regional system. But more work needs to be done on the standardisation of listing and other requirements, the harmonisation of tax and fee regimes, and the linkage of trading and clearing and settlement systems.

These reforms are required before capital can move freely across the EAC, with issuers raising money in any market and intermediaries providing services across the region from their home countries. Progress has been slow in part because of the fear on the part of some countries – Tanzania in particular – that liquidity will be consumed entirely by the Nairobi stock exchange.

But the benefits of EAC integration for the member countries far outweigh the risks. For companies, the harmonisation of listing requirements will significantly reduce the administrative burden of raising capital; for investors, a regional market will enable better diversification of risk; and a greater opportunity for (and competition from) intermediaries will reduce transaction costs and improve liquidity in all markets.

Kenya has the most sophisticated market intermediaries, the only well-developed fund management sector, and the largest institutional investors. Therefore, the other EAC countries, by leveraging Kenyan market infrastructure, should benefit disproportionately.

Economic growth

Despite their different levels of financial sector development and integration readiness, the participation of all EAC members should be the ultimate goal, not least because of the marketing opportunity. Combined, the EAC region is home to 135m people and has a GDP of $120bn.

This is a golden opportunity to promote the EAC as an asset class to international investors, with regional debt instruments as well as collective investment vehicles such as mutual funds or ETFs on offer. Capital market integration enables joint promotion of regional-level FDI opportunities, especially with respect to infrastructure.

There are other self-feeding benefits too. Not only does liquidity generate liquidity: capital markets create a virtuous circle for economic growth. Deeper capital markets attract more robust foreign investment flows that can finance large-scale infrastructure and export-oriented companies.

Better infrastructure and integrated capital markets facilitate intra-regional trade. Improved trade and larger regional companies drive economic growth. And richer economies generate greater savings that, in turn, facilitate deeper capital markets.

Both Asia and Latin America have already displayed this virtuous circle over the past 10 years. This is something east Africa can emulate in the coming decade. ▪

Staci Warden is Executive Director of the Center for Financial Markets at the Milken Institute and Chair of the Rwandan Capital Markets Authority.

East African Community

Established in 1968, revived in 2008

Qatar's resilience to falling oil prices

A welcome support for diversification

Abdullah Saud Al-Thani, Qatar Central Bank

The sharp fall in crude oil prices and slower-than-projected global growth have substantially altered the economic context for countries in the Middle East and north Africa. While lower oil prices have weakened the external and fiscal balances of oil exporters, including members of the Gulf Co-operation Council, it provides much needed breathing space for oil importers in terms of reduced oil import bills and lower energy subsidy bills.

Against this backdrop, stock markets in GCC countries declined sharply in late 2014. Energy-related firms and banks with large exposure to the oil sector are facing more difficult refinancing conditions. Capital flows to the GCC have slowed, though they remain broadly in line with trends for other emerging markets.

Consequently, most GCC countries have revised downward their near-term economic growth. However, large buffers in the form of foreign assets and available financing should allow most GCC oil exporters to avoid sharp cuts in government spending, limiting the impact on near-term growth and financial stability.

Strong GDP

Despite a fall of over 55% in global crude oil prices between June 2014 and January 2015, reflecting weak demand and ample supply, Qatar has maintained strong GDP growth at about 6% over the past two years, driven by double-digit growth in the non-hydrocarbon sector. The large public investment spending to diversify the economy and prepare for the FIFA World Cup 2022 has resulted in a significant inflow of expatriate population, adding to aggregate demand and supporting growth. Falling global commodity prices have helped contain inflation.

The budget continues to post surpluses and growth is expected to accelerate in 2015 reflecting solid expansion in non-hydrocarbon activities propelled by investment spending, expansionary fiscal policy and population growth.

Despite its reliance on hydrocarbon exports, Qatar may not be affected as severely as expected by the oil price fall, given the dominance of liquefied natural gas in hydrocarbon exports and relatively lower decline in global LNG prices, which were down only by 10-35% in the June-January period. LNG prices in the Asian market, which is the most relevant for Qatar given its dominant share in exports, fell only 14% over the same period. Qatar's LNG exports are expected to increase somewhat when production from the Barzan gas plant comes on stream in 2015. Moreover, global crude oil prices are projected to recover in 2015 and stabilise, which should have a steadying impact on gas prices.

How this works depends on the links between the world economy and oil demand, subject to multiple risks. Another risk lies in falling investment spending by oil companies, which could begin to have an impact on production by 2016-17, adding upward pressure to prices as the supply glut is cleared.

Managing risks

Mindful of the risks associated with falling oil prices, including related financial sector vulnerabilities, the Qatari authorities have taken steps to prioritise public investment while raising efficiency. The Qatar Central Bank for its part is actively managing systemic liquidity, closely monitoring emerging risks to the financial system, and implementing macroprudential measures to sustain growth while maintaining price and financial stability.

So far, the banking sector continues to be resilient despite the fall in global oil prices and associated uncertainties. This reflects strong macroeconomic performance as well as sound policies. Total assets of the banking system continue to grow robustly, driven by credit to the private sector and a rise in Islamic finance.

As of December 2014, credit quality improved, with Tier I capital ratio well above the regulatory minimum required under the Basel III framework and the non-performing loan ratio falling below 2%. Profitability levels remained high with return on assets above 2%.

If lower oil prices persist for a prolonged period, most GCC countries may need to re-assess medium-term spending plans. Some countries that do not have significant buffers or borrowing capacity will need to adjust more quickly, with adverse consequences for growth.

In all oil-exporting countries, deepening reforms aimed at diversifying economies away from oil, and encouraging growth and job creation, would help mitigate any adverse effects of fiscal consolidation on growth.

Gulf Co-operation Council

Established in 1981, six member states

In reference to my previous OMFIF Bulletin article in November 2013, 'Wide range of Gulf influence: A region that looks beyond oil and gas', I can only repeat that lower oil prices emphasise the need for GCC countries to speed up their structural reforms. The objective must be to propel private sector activity and foster a diversified, competitive and inclusive economy.

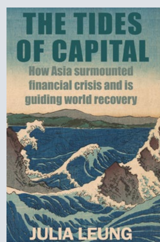
In the case of Qatar's economy, non-hydrocarbons sector growth is significant. This led GDP growth in 2014. The development of a diversified and more resilient economy is at the core of the QCB's Strategic Plan for Financial Sector Regulation 2013-16.

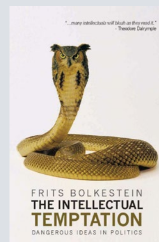
As envisaged in the strategic plan and conforming to international standards, QCB has been moving to risk-based regulation, expanding macroprudential oversight, enhancing transparency, strengthening market infrastructure, and improving consumer and investor protection.

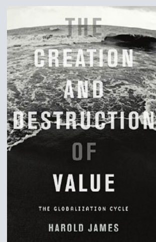
Progress achieved under the QCB's regulatory agenda has opened up the financial market as part of steps to develop the financial industry and to provide a stable environment to a broad range of businesses.

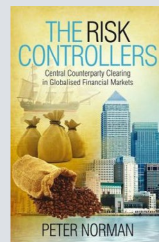
Other supportive influences include Qatar's upgrading to emerging market status by leading rating agencies, an increase in foreign investors' activity, and more recently the establishment of Qatar as the region's first renminbi clearing centre. ▪

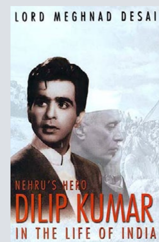
Abdullah Saud Al-Thani is Governor of the Qatar Central Bank.











How to find skilful money managers

A guide to the art and arithmetic of the investment process

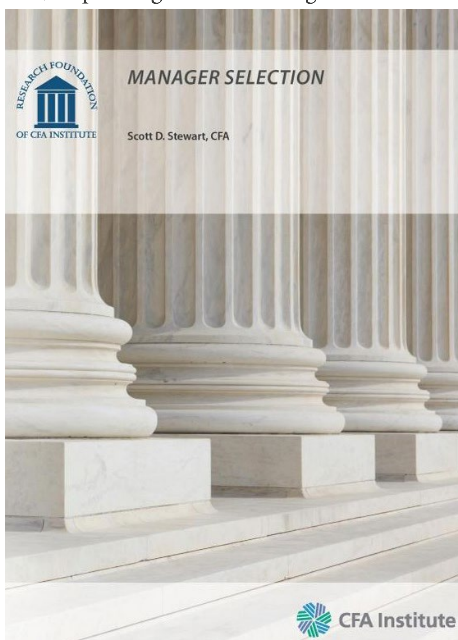
George R. Hoguet, Advisory Board

Scott Stewart, formerly a portfolio manager at Fidelity Investments and currently a professor of finance and accounting at Cornell University, has written a useful book for anyone charged with selecting investment managers and trying to 'beat the market.'

Stewart's admirably slim monograph, *Manager Selection*, is published by the CFA Institute Research Foundation, a not-for-profit organisation seeking to bridge the gap between academia and practitioners. Stewart provides a theoretical and empirical analysis of manager selection. The book is intended for investors: it contains both quantitative and qualitative metrics, and an up-to-date bibliography.

Active risk

The good news is that, despite very strong evidence that the vast majority of active managers underperform their benchmarks over seven years, Stewart confirms that skilful managers do in fact exist. The bad news is that, depending on the manager's active risk (deviation from the index), it may take more than 20 years to determine whether a manager's performance is due to skill or simply luck.



So the question is how to identify skilful managers. In choosing an active manager, an investor is implicitly making the statement that markets are not fully efficient from an information point of view and that exploitable anomalies (such as investor herding) definitely exist.

In selecting an investment manager, investors believe that skilful managers exist; that skill will persist; that investors are capable of identifying skill; and that investors can build a portfolio of managers to deliver asset class exposure in an effective way and capture superior performance after costs.

Stewart reviews the arithmetic of active management which stresses the importance of costs and its zero-sum nature. Risk-adjusted outperformance (alpha) is a random variable. Therefore investment process is key.

Stewart lists six key characteristics of successful investment managers: intelligence, knowledge, focus, long-term thinking, independent thinking and alignment of interests. He then suggests ways to measure each of these attributes. While one might question Stewart's narrow definition of intelligence (performance on IQ tests and selectivity of undergraduate and graduate schools), he cites a number of studies linking the six attributes above to investment performance.

Stewart discusses the importance of fee minimisation, governance and portfolio manager compensation. He then provides various equations to evaluate manager performance.

The analysis then describes quantitative techniques to set weights for active managers. Stewart provides several equations to optimise manager allocations, complete with an Excel template.

Evaluation of investment manager performance and detailed attribution is key, and Stewart discusses various techniques. He also discusses manager selection for non-US mandates and alternative asset classes.

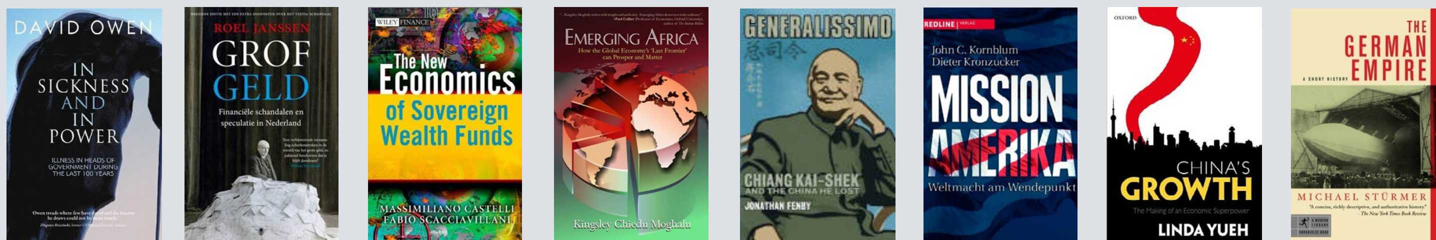
The final chapter outlines key recommendations and best practices. To begin with, investors should know their limitations and recognise that manager selection is an art, not a science. To improve the odds, investors should formulate a manager selection process. Investors should include this process in an Investment Policy Statement, periodically evaluate the success of this process, not overreact to short- and medium-term fundamentals, and understand that certain things are beyond the investor's abilities and control.

Stewart addresses an important topic. 'Investigate before you invest' may be a necessary but not a sufficient condition to pick a manager capable of beating an index. Continuous advances in computing power, risk models, and analytical techniques should make it easier for investors to identify superior managers. Persistence in performance, however, is elusive and advanced beta techniques, which seek to replicate active manager style tilts, continue to blur the line between active and passive management.

Stewart could have spent more time on which asset classes, such as non-US small cap stocks, presumptively offer better odds for active management, but the book is a good introduction to the art of manager selection.

Academics disagree whether markets are fully informationally efficient, citing for example, limits to arbitrage. In picking managers, investors need to think of the world in probabilistic, not deterministic, terms. This book will help improve the odds. ▪

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



UK at mercy of centrifugal forces

Pro-Europeans must make their case or risk exit

William Keegan, Advisory Board

There is a breed of Labour politicians and left-inclined journalists who entered public life as extreme left wingers, often as members of a group whose members styled themselves international socialists. Denis MacShane is one of many I have known and liked over the years.

One of the most prominent characteristics of former international socialists is that they tend, or tended, to be rebels with a cause.

For many, when the workers of the world failed to unite, that cause became Europe – and, for some, the putative importance for Britain of joining the euro area, which they advocated with religious devotion.

Operating forces

Both Michael Foot and Neil Kinnock became passionate 'Europeans'; Lord Kinnock actually served in Brussels as a Commissioner. Denis MacShane has an extra ancestral dimension to his Europeanism, having been born in Poland and spent five years as Tony Blair's political envoy to Europe.

He speaks several European languages and spent many years on the Continent before being elected to parliament in 1994 and serving almost 20 years as an MP.

MacShane is so passionately pro-European that I confess the title of his latest book came as something of a shock. But it is important to know that MacShane has a wicked sense of humour. I take it that he and his publishers settled on a title that was intended to shock – and to sell.

For the real message of the book is not that Britain will definitely leave the European Union, but that there are so many forces operating in that direction that the odds on the pro-Europeans winning a referendum have narrowed markedly since the 1975 referendum, when there was a two to one majority in favour of staying in.

The very term Brexit makes this correspondent shudder. MacShane hints that he may have coined it himself, as an obvious derivation of the term 'Grexit'. But Grexit referred to the possibility of Greece leaving monetary union, not the EU.

European construction

Brexit implies that Britain would leave the entire European construction. The UK would not be leaving the euro area, which it did not join. But the country would undo the good work of all those British statesmen and civil servants who spent decades trying to overcome French resistance to UK membership of what was once known as the Common Market.

Ironically, it was British accession, and an act of the eurosceptic Margaret Thatcher, that proved the decisive influence in the EU's adoption of the single market in goods, if not in services, in 1986.

In his preface MacShane explains: '*Brexit* seeks to argue that different tributaries – political, economic, much of the press, cultural, identity, historical – are coming together in one powerful confluence that – unless Britain awakes to the danger of where we are heading – will take Britain out of Europe.'

In the subsequent chapters MacShane does this magnificently, combining a historical and contemporary sweep which, to my mind, puts this beautifully written and carefully argued book into the 'must read' category.

As they discover MacShane's passionately held views in favour of resisting what he terms 'A centrifugal Europe', eurosceptics will find that what is inside the book is not what it says on the cover. However, the author undoubtedly worries that the eurosceptics are winning the battle at present.

While suitably angry about the blatant anti-Europe propaganda of the Murdoch press and the Daily Mail, MacShane criticises the pro-European press for being supine when it comes to counterattacks.

His principal ray of hope seems to lie in the economics. Just as British policy-makers were attracted towards the European Economic Community in the 1950s by observing its superior economic performance, attitudes may change if the euro area pulls itself out of the economic mire – where there have been some encouraging signs – and the British economic recovery begins to come under strain.

MacShane fears that, whatever the strength of the Labour party opposition ahead of the general election on 7 May, the centrifugal forces are such that, if elected, Ed Miliband, the Labour party leader, would have to hold a referendum.

I am not sure about that. And I would hope that the natural conservatism of the British people would militate against UK departure from the Union. ▪

William Keegan, member of the Advisory Board, is Senior Economics Commentator at the Observer.

Singapore: city of the Asian century

Need for vigilance after Lee Kuan Yew's death

Kishore Mahbubani, Advisory Board

A sea of opportunities awaits the sturdy city-state of Singapore after the death of Lee Kuan Yew, its first prime minister, undoubtedly one of the 20th century's greatest leaders. Just as London and New York were the capital cities of the European and American centuries, Singapore can serve as the capital city of the Asian century.

It has perhaps the best airport and seaport in the world. Its financial centre is poised to serve Asia's middle classes. Singapore is Asia's No.1 wealth management centre. The country has the best ranked university in Asia, the National University of Singapore.

Despite the withering criticism of the western media, world leaders respected Lee because he was a geopolitical genius. In his brutally candid manner, he would dissect the key global trends of the day and suggest wise courses of action.

Vernon Walters, an American ambassador, once quipped: 'Thank God that Lee Kuan Yew is the leader of a small state; otherwise, [Richard] Nixon and [Leonid] Brezhnev would hug each other for comfort.'

Lee Kuan Yew transformed Singapore. He inherited a fledgling ex-British colony that apparently faced doom in 1965 after expulsion from Malaysia. Most expected Singapore to become a failed state. Yet, in less than 30 years, he took it (as the title of his book put it) 'from third world to first'. Starting in 1965 with a per-capita income the same as Ghana's, Singapore has become a rich economy that earns more, in proportion to the size of its population, than the UK.

He built strong institutions. People in the know respect Singapore's defence capabilities.

The military can deploy up to 250,000 troops. The civil service, too, is a strength. Sir Michael Barber, the British government and education expert, has said: 'The Singapore civil service sets a standard of quality that in my experience is rarely matched.'

Challenges remain. A big influx of foreigners into Singapore has generated anti-immigrant sentiment as public transport and housing failed to keep up with the surge. Inequality has grown. Hence the latest budget introduced some new social transfer measures; for example, schemes to share more of the benefits from economic growth with low and middle income households.

A geopolitical contest between America and China would put Singapore in a very awkward position, torn between its close

Former Singapore Prime Minister Lee Kuan Yew, May 2002

defence ties with the US and ethnic affinity with China. Singapore cannot afford to be complacent. This may be its biggest strength. Lee Kuan Yew's son Lee Hsien Loong, the prime minister, is fond of quoting the statement of former Intel chief executive Andy Grove: 'Only the paranoid survive.'

The leaders of Singapore are aware of the big lesson of history: small city-states rarely survive a century or more. Constant vigilance was a hallmark of Lee Kuan Yew's personality. It is the trait he has embedded in Singapore. ▪

Kishore Mahbubani, member of the Advisory Board, is a professor at the National University of Singapore, and author of *Can Singapore Survive?*

Executive opportunities

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Asian Infrastructure Investment Bank impact

OMFIF Advisory Board expects new bank 'co-existence'

The Asian Infrastructure Investment Bank, initiated by the Chinese government, looks likely to have more than 50 founder members. OMFIF asked its Advisory Board for their views about the bank's impact in the next five years. In the poll over the second half of March, 60% of respondents viewed the bank as having only a limited impact, although they agreed it would 'co-exist with and complement' existing institutions such as the World Bank and the Asian Development Bank. Only 6% said that it would have a negligible impact, whereas 31% said that it would be a significant rival to the IMF, World Bank and ADB.

The question to the Advisory Board was, 'Over 70 years after the creation of the IMF and World Bank and nearly 50 years after the formation of the Asian Development Bank, China has initiated the establishment of the Asian Infrastructure Investment Bank. Will the AIIB over the next five years significantly rival the influence of these existing institutions dominated by the US?'

The US has badly bungled the diplomacy. China invested in the IMF response to the 2007-08 financial and economic crises, but it got little in return as the US congress refused to deliver on the agreed deal of Chinese cash for voice and voting reforms. So China looked elsewhere to exert its influence, outside the World Bank and IMF. A declining hegemon has been outwitted by a rising power. Former allies have shifted, leaning towards the Chinese. Over time this institution will extend China's power over and influence in Asia. China can play the long game. America has lost out because internal domestic posturing by a Republican congress replaced sensible policy-making with foolish gestures.

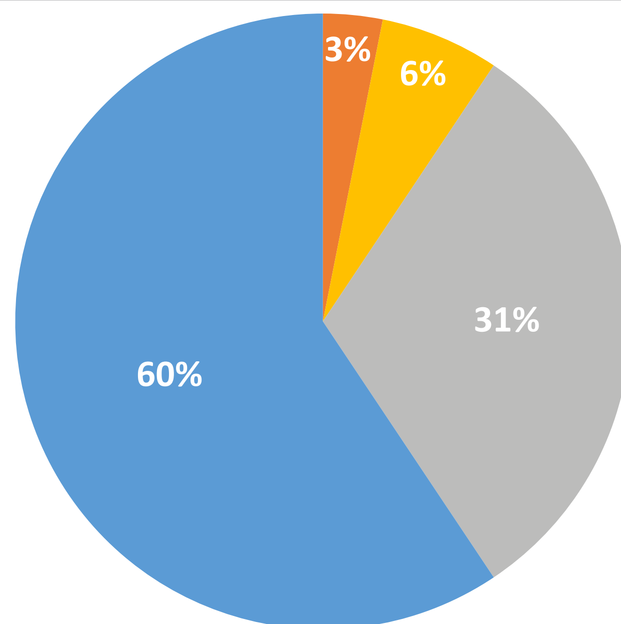
– Stuart Mackintosh

The decision by the UK, Germany, France and so many other western countries to join the AIIB as founding members is a direct blow to the US, which has been so well in control of the world's financial system since 1944. The full repercussions will be known only in another 10 or 20 years, but one can be quite sure this development one day will be seen as the beginning of the end of the dollar supremacy. The sympathy voiced by Christine Lagarde, the IMF managing director, for the renminbi to join the SDR, is another important step in this long and important process.

– Willem Middelkoop

Questioning the role and impact of the AIIB

60% of those polled believe that the AIIB will have limited impact



Developments will largely depend on the position of the US. The adhesion of major European countries to the AIIB is above all the result of US non-ratification of the change of IMF statutes and voting rights negotiated with US consent. In that sense the US is an exception. As a result the AIIB may gradually become a competitor to the traditional financial institutions, something I would regret.

– Laurens Jan Brinkhorst

It will take about 10 years to set up the AIIB, establish its governance and deploy funds in an efficient manner. Most likely the AIIB will be under pressure to lower lending standards and take into account political factors.

– Fabio Scacciavillani

The AIIB's impact is uncertain. It depends on whether or not China aims to use it as an instrument of its foreign policy, as the US has in the past used the World Bank and the Fund. It also depends on whether China recognises that, in a changed world, such hegemony is certainly not an option for a rising power like China, which is both politically and economically unstable.

– Stewart Fleming

The AIIB's establishment would seem a natural development against the background of the lack of progress in ratification by the US Congress of the reforms which would have given emerging market countries a greater say in the running of the IMF.

– Hemraz Jankee

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