The Bulletin

April 2017
Vol. 8 Ed. 4

Shock and renewal
Challenges for Europe

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Brigitte Granville on Le Pen's popularity
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Dialogue on world finance and economic policy

The Official Monetary and Financial Institutions Forum is an independent think tank for central banking, economic policy and public investment – a non-lobbying network for best practice in worldwide public-private sector exchanges. At its heart are Global Public Investors – central banks, sovereign funds and public pension funds – with investable assets of $30tn, equivalent to 40% of world GDP.

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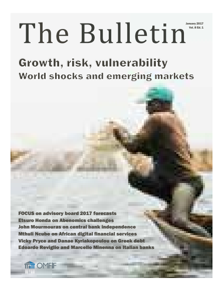
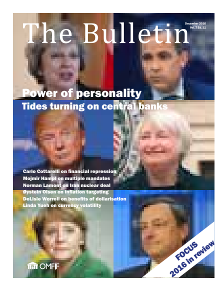
The 179-strong OMFIF advisers network, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors: Monetary Policy; Political Economy; Capital Markets; and Industry and Investment. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership changes annually owing to rotation.





EDITORIAL

Europe's challenges: shock, renewal and a variable future

Europe's leaders gathered on 25 March to celebrate the 60th anniversary of the signing of the Treaty of Rome. It would be easy to dismiss the occasion as lacking any cause for cheer. There are plenty of shadows over Europe: the terrorist attack in London on 22 March, uncertainties over the French and German elections, renewed concerns about the Greek and Italian economies, and worries over the UK's exit from the European Union. This month's Bulletin attempts to summarise the risks and challenges for Europe as it moves on from commemorating the past towards examining priorities for the future and attempting to renew structures and objectives.

Roel Janssen argues that populism's loss of momentum in the Dutch elections will influence other European polls. The most immediate one is the presidential election in France. Jean-Jacques Barbéris and Brigitte Granville reflect on the concerns of voters and the candidates' economic policies. Victory for Marine Le Pen, leader of the anti-euro, anti-immigrant National Front (FN), is deemed doubtful. Yet her standing in the opinion polls and the FN's electoral success so far put pressure on elites to adapt to a new political environment.

Regulation, reforms and monetary policy remain key tenets as the European Community, now the EU, enters its seventh decade. Felix Hufeld highlights the need for balance between rules and principles in financial regulation. Hans Blommestein draws attention to the negative side-effects of easing policies on bond market liquidity, while Gary Smith presents the challenges for central banks in the context of future demographic shifts. Lorenzo Codogno focuses on the issue of minority shareholder protection and its importance in Italy's efforts to attract foreign investment.

The shock waves emanating from Britain's decision will mingle with further perturbations stemming from expected political acrimony in the exit negotiations and a wider economic reordering as nations within and beyond the EU adjust to the consequences for trade, business and finance. The European Commission's surprisingly (and, for some, disappointingly) broad set of options for the future in its 'five scenarios' 60th anniversary document emphasises the lack of certainty over the journey's direction and destination. The phrase 'variable geometry' – popularised during the 1990s – remains the best description of the continent's present and future set-up. The British economy so far has been relatively undisturbed by the referendum result – but shocks may still be in store. The British chancellor may need to reassess his plans and impose new cuts, argues Vicky Pryce in her review of Philip Hammond's first Budget. David Marsh draws attention to the political repercussions of a prospective second referendum on Scottish independence. Our monthly Advisers Network poll focuses on the likely outcome of the two-year negotiation period, with a small majority of those polled concluding that a deal acceptable to both the UK and EU27 will materialise.

Outside Europe, Carlos Giraldo argues that, despite vulnerability to difficult external conditions, the economic backdrop remains positive for Latin America. One external risk is monetary tightening in the US. Darrell Delamaide states how steady improvement of the domestic economy is making the Federal Reserve more confident about raising interest rates twice again this year. The choices are less obvious for the Bank of Japan: Sayuri Shirai reflects on the dilemma between short-term, large-scale monetary accommodation and a more restrained pace of easing that may last for longer. On Africa, Mthuli Ncube highlights the importance of interoperability for models of mobile banking.

We close with three book reviews. John Nugée surveys the reflections of Yanis Varoufakis on the euro area and Greek crises in *And The Weak Suffer What They Must?*. Danae Kyriakopoulou compares them with those of another former Greek finance minister, George Papaconstantinou, as revealed in *Game Over*. Lord (Meghnad) Desai reflects on the history of monetary theory and policy-making of the past 50 years through Sebastian Mallaby's biography of Alan Greenspan, *The Man Who Knew*.

Renminbi vulnerable to debt, lower growth

Trump could spark devaluation, harm US competitiveness

Adam Cotter

RENMINBI LIAISON NETWORK

President Xi Jinping has focused on an anti-corruption campaign and extensive foreign policy innovations against a background of geopolitical tension and slowing growth. Some observers have noted Beijing's apparent hesitancy to implement economic reforms. Commitment to reform is central to the party's desire for stability and predictability.

The People's Bank of China is trying to manage asset bubbles while not unduly cutting credit growth. China's leaders are still placing their faith in Governor Zhou Xiaochuan – now well beyond his official retirement age. He has helped steer the nation through the global financial crisis, overhauled monetary policy tools and overseen the renminbi's elevation to reserve currency status. China's $9.15bn trade deficit in February (although partly due to seasonal factors), alongside the lower China 2017 growth target, appears to show the export giant's trade status in a difficult position. Challenges may grow further in the light of protectionist US rhetoric and the European Union's efforts to curb cheap Chinese steel imports. If President Donald Trump levies import tariffs on Chinese goods, Beijing will point to its spending of well over $1tn trying to stem the renminbi's fall. Pan Gongsheng, director of the State Administration of Foreign Exchange, says the foreign exchange market will remain stable.

The country's foreign exchange reserves saw a modest rise of $6.9bn in February, reflecting the success of efforts to curb capital outflows. This will help improve confidence in the renminbi. Exchange rate fluctuations in the second half of 2016 were exacerbated by China's accelerated outbound investments and the US presidential election result. However the renminbi remains vulnerable to high and growing Chinese debt. If Washington does impose protection measures, the renminbi is likely to fall further – increasing China's competitiveness and worsening the position of the American enterprises Trump is trying to shield. The irony of a possible renminbi devaluation is likely to be lost on the Trump administration, but not on the Chinese leadership.

Adam Cotter is OMFIF's Head of Asia and Chief Representative of the Asia office in Singapore.

OMFIF Advisers Network

OMFIF has appointed Johannes Witteveen as honorary chairman and David Suratgar as a member of the OMFIF advisers network. For the full list of members, see p.24-25.

Johannes Witteveen was managing director of the International Monetary Fund from 1973-78. Before joining the IMF he was the Dutch minister of finance from 1967-71, a role he combined with that of deputy prime minister. Between 1958-73 Witteveen served alternately as a member of the Netherlands' Senate and House of Representatives. He first held the role of finance minister for two years from 1963. After leaving the IMF he spent five years as chairman of the Group of Thirty, the Washington-based economics body.

David Suratgar is chairman of BMCE Bank International. He is a former vice-chairman of Deutsche Morgan Grenfell and senior adviser to the president of the European Investment Bank. He served as a senior attorney in the World Bank's legal department and has acted as legal adviser to the Bank of England, UK Treasury, the EIB and the European Commission. Suratgar was adjunct professor of international financial law at Georgetown University, lectured at NYU Law School and the Hague Academy of International Law, and was visiting professor at the University of Georgia School of Law.

Gender diversity improves decisions

Men's propensity for risk-taking and women's for risk-aversion make gender balance in decision-making key to building dynamic but stable financial markets, participants were told at the launch of the 2017 OMFIF Global Public Investor Gender Balance Index on 8 March in London. The index was launched on International Women's Day by a panel including women leaders from central banks, government and the private sector. It revealed that the world of central banking is highly unbalanced when it comes to gender, and the disequilibrium seems to be getting worse.

Attendees heard from Emma Howard Boyd, chair of the Environment Agency; Kate Glazebrook, co-founder and head of insight at Applied; Sandra Boss, external member of the Prudential Regulation Committee of the Bank of England; Joanna Place, executive director, Human Resources, at the Bank of England; Vicky Pryce, board member at the Centre for Economics and Business Research; Sam Reinhardt, minister-counsellor (economic) at the Australian Treasury; and Anna Stupnytska, global economist and team leader – market research at Fidelity. Danae Kyriakopoulou, head of research at OMFIF, presented the results of the Global Public Investor Gender Balance Index.

Women in central banking remain a very small but powerful minority. Alongside well known cases such as Janet Yellen of the US Federal Reserve and the Bank of Russia's Elvira Nabiullina, only 6.5% of central banks are headed by women. This corresponds to 12 institutions, down from 15 last year.

Transferring Asia experience to Africa

African countries can learn from Asian experience by maintaining prudent macroeconomic policies and flexible exchange to boost sustainable growth. That was one of the main conclusions from an Asian Development Bank-OMFIF conference on policy for emerging markets on 22 March in Tokyo.

Takehiko Nakao, president of the Asian Development Bank, outlined best practice in emerging markets to strengthen financial stability and the needs for infrastructure development. The conference convened 60 participants from China, Germany, India, Indonesia, Japan, Korea, Malaysia, Mauritius, Nepal, the Philippines, Romania, South Africa, Sri Lanka, Thailand, the UK and the US. It was held 50 years after the formation of the Asian Development Bank and 20 years after the Asian financial crisis, to compare experience between different parts of the emerging market world.

Subbarao says India needs 8-10% growth

India needs growth of an annual 8-10% in coming years to overcome unemployment in a growing population and avoid a 'low income trap', Duvvuri Subbarao, former governor of the Reserve Bank of India, said at an OMFIF-Japan Center of Economic Research City Lecture on 23 March in Tokyo.

Subbarao outlined the main themes of his book *Who Moved My Interest Rate?: Leading the Reserve Bank of India Through Five Turbulent Years*. Eisuke Sakakibara, former Japanese vice finance minister, also spoke at the lecture.

Sustainable growth in Nigeria

Investors should look to pensions and sovereign funds to help mitigate risk when investing in Nigeria, said Chinelo Anohu-Amazu, director general of the Nigerian National Pension Commission, at an OMFIF briefing on 8 March in London.

Anohu-Amazu added that addressing the perceived risks in Nigeria, as well as highlighting positive steps by public investors, help the country unlock its potential and expedite its economic recovery. Too often observers perceive risks and misconceptions that hinder external investments. With the drop in global oil prices acting as a catalyst for economic diversification, Nigeria is looking to green energy and infrastructure to help it move out of recession. Mthuli Ncube, head of Quantum Global's research lab, former chief economist of the African Development Bank and OMFIF board member, outlined concrete steps foreign investors were taking to spur growth.

Economic forecasts for Ghana

Though consumer sentiment shows renewed optimism, fiscal and external sector pressures remain key challenges for Ghana, said Johnson Asiama, deputy governor of the Bank of Ghana, at an OMFIF discussion on 14 March in Singapore.

The conversation, which focused on the monetary policy and macroeconomic developments in Ghana, highlighted the need for a commitment to ensure fiscal prudence.

Opportunities remain in agriculture and extractive industries. However, given its high degree of openness to trade and commodity price fluctuations, Ghana is looking to further diversify the economy into banking services, including digital financial services.

The medium-term prospects of the economy remain bright, and there is a strong commitment to preserve macroeconomic stability.

Forthcoming meetings

Implications of the French elections
A discussion with Dominique Moïsi, founder and senior adviser at the French Institute for International Relations, on the French presidential elections and the consequences for French politics, Anglo-French relations and the future of Europe.
6 April, London

Building confidence in Canada's economy
City Lecture with Bill Morneau, minister of finance, Canada, discussing Canada's policy priorities to promote inclusive growth and build an economy that works for all citizens.
7 April, London

On the cusp of a new relationship
A discussion with Joachim Wuermeling, board member of Deutsche Bundesbank, responsible for markets and information technology. Topics include the direction of European monetary policy and implications of the UK decision to leave the EU.
18 April, London

The future of the Fed
OMFIF and McKinsey Global Institute convene a panel of speakers, including Sebastian Mallaby of the Council on Foreign Relations, exploring future US monetary policy, the effects on the world economy, changes in international financial regulation and cross-border capital flows.
20 April, Washington

For details visit www.omfif.org/meetings.

Outlook for the euro and Europe

Hans-Olaf Henkel, former member of the European parliament for Alternative for Germany (AfD), the right-wing anti-euro party, predicted AfD will score 10% of the vote and win seats in the German parliament in the September elections. In an OMFIF telephone briefing on 7 March, Henkel – an OMFIF advisory board member, who has switched allegiances in parliament – emphasised progressive AfD radicalisation.

Fed 'has hardened its rhetoric'

'The Fed has hardened its rhetoric, changed market expectations, and will fulfil those expectations. If there is a U-turn in monetary policy later in 2017, it will be because Trump disappoints in his reforms,' said Chris Probyn of State Street Global Advisors in an OMFIF briefing on the FOMC's March meeting on 15 March. The briefing also featured Ebrahim Rahbari of Citi and Frank Sansone of China Construction Bank.

Future of trade policy in Asia under Trump

Japanese relationships with the US, UK, China and the EU, including the imminent EU-Japan Free Trade Agreement, were the focus of an OMFIF briefing on Japanese trade policies in the post-Brexit environment on 14 March in London. Professor Yorizumi Watanabe, professor of policy management at Keio University and former deputy director-general for economic affairs at Japan's Ministry of Foreign Affairs, led the discussion.

China's role in world markets

OMFIF held discussions and bilateral meetings on 9 March in London to share knowledge on China's economic development and place in world markets. Attendees at the meetings, including Tang Xiaodong of China AMC, discussed China's expansive infrastructure programmes, including the Belt and Road initiative, its relationship with the UK, and prospects for foreign bond and equity investors in China.

French candidates' economic visions

Hamon, Fillon, Macron: choices in presidential race

Jean-Jacques Barbéris, Amundi

One thing that stands out in the French presidential campaign is how little attention is being paid to the candidates' economic policies. This is a first in modern times.

In 2012, François Hollande's call for a 75% tax rate got everyone talking. Five years earlier Nicolas Sarkozy won with his slogan 'work harder to earn more'. In 2002, the electorate witnessed the great battle of the assessment of the 35-hour working week. In 1995, Jacques Chirac won the election on the promise of healing France's 'social fracture'. In 1988, the 'No-No' of François Mitterrand (no nationalisations and no privatisations) was the omnipresent slogan.

In 2017 there has been virtually no comment or headlines on the economic programmes of the candidates. The lone point that has caught the attention of investors has been the risk of leaving the euro area, as proposed by Marine Le Pen, leader of the right-wing National Front. No one seems interested in what the other candidates are offering, even though they have a greater chance of being elected and being able to implement their policies.

Yet, according to a poll by the French Institute of Public Opinion, economic challenges are among the top issues for French voters (54%). On top of this, it is mainly the economic reforms that France does or doesn't bring to the table that will determine whether the European Union and the euro area are able to revisit the idea of deeper EU unification.

Economic growth in line with potential

The pace of economic growth over the past two years (1.1% and 1.2%) may appear disappointing, but is in line with the French economy's potential.

In terms of competitiveness, the French economy has improved, as evidenced by improved performance of French corporates, but not enough. Foreign trade figures for 2016 show that increased household purchasing power and consumption resulted primarily in increased imports. The main driver of French growth remains domestic consumption.

The rate of growth remains too low to have a lasting effect on unemployment, notably due to France's strong demographics.

Notwithstanding this mixed performance, the level of inequality in France is a lot lower than in other western democracies that have been affected by populist politics. Tax breaks and social transfers associated with public spending account for more than 56% of GDP and thus act as a de facto buffer. Over the past decade, all Italian households and 70% of Dutch households have seen their income, after tax breaks and benefits, stagnate or decrease. This compares with only 10% in France, illustrating how the French model has remained extremely income-protective.

> ***"The lone point that has caught the attention of investors has been the risk of leaving the euro area, as proposed by Marine Le Pen. No one seems interested in what the other candidates are offering.***

Growth close to its potential, improving competition, still high unemployment, and unceasing inequality: this is the economic landscape with which the presidential candidates must contend.

Candidates' economic solutions

Against this backdrop, the candidates that have the best chances of success – centre-right François Fillon, social-liberal Emmanuel Macron and left-wing Benoît Hamon, although the latter is least probable – offer three solutions.

Hamon has a programme that falls within the 'economy of sharing'. He believes that growth will remain low, in particular because of heightened environmental constraints, and that technology will gradually replace labour as a factor of production for some processes. He proposes introducing a universal income and a new allocation of working time.

At the European level, this programme would be extended by a new budgetary treaty that readdresses the rules of the 1992 Maastricht treaty, instituting a euro area parliament with budgetary power, and establishing debt solidarity. Hamon is planning to create a minimum European salary and introduce a €1tn investment plan. Overall, his programme is characterised by the will to share value added on a national level and to implement a European-level Keynesian stimulus programme.

Fillon's programme is, as he says, one of 'liberal rupture'. He believes that France needs a dramatic reduction in public spending and a boost in competitiveness. His drastic economic measures include: cutting 500,000 civil service jobs; reducing social contributions and taxes on production by €25bn; increasing the retirement age to 65; raising value added tax by 2%; and abolishing the wealth tax and the 35-hour working week. These measures should enable France to meet the European challenges within the context of a new relationship with Germany; using intergovernmental methods, meaning relying on heads of state rather than EU institutions, and major projects, such as the convergence of corporate taxation, to strengthen the euro area.

Macron has a programme that follows the Nordic model of social democracy. He proposes a €60bn savings plan and a €50bn investment plan over the five-year presidential term, accompanied by a 6% decrease in social contributions.

The wealth tax would be limited to tax on real estate while the council tax would be discarded. In the social sphere, Macron is proposing to nationalise the unemployment benefits system, introduce a points based retirement system based on the Scandinavian model, and make statutory working time more flexible. On Europe, he is for immediate compliance with the Maastricht treaty and supports the strengthening of the euro area, specifically through the creation of a euro area budget overseen by a minister of finance. Minimum social rights would be implemented on an EU-wide basis.

Clear choices for voters

These three programmes present clear choices for French voters.

Hamon has opted to divorce from France's past economic policy and is proposing to break with European policies introduced over the past 10 years.

Fillon wants to see an intergovernmental relaunch of the EU with negotiations to include structural reforms (like those recommended by Germany and the European Commission).

Macron is proposing a European revival by continuing to leverage European institutions coupled with the introduction of a reform programme inspired by social democracy.

One of these three, probably Fillon or Macron, is likely to defeat Le Pen and win the May election. So scrutiny of their economic policies is crucial – for the sake of the French electorate and, indeed, of the rest of Europe. ■

Jean-Jacques Barbéris is Global Head of Central Banks and Sovereign Wealth Funds at Amundi Asset Management and a Member of the firm's Executive Board.

Unemployment spurs Le Pen phenomenon

Economics, not identity politics, define French election

Brigitte Granville, Advisory Board

Commentators on the French presidential elections and related political risks in Europe are blaming a range of issues for the strength of the protest against the political establishment. In France the debate hinges on whether identity politics or economic discontent – above all, chronically high long-term unemployment – is mainly influencing the growing appeal of Marine Le Pen, head of the right-wing National Front (FN).

Marine Le Pen, president of the National Front

I see France's poor growth performance – its causes and effects – as the most powerful explanation for the FN's popularity. The party is on course to exceed, by a large margin, its share of votes in previous presidential elections.

Putting emphasis on the economics is justified when looking at Jean-Luc Mélenchon, the second most effective anti-establishment candidate after Le Pen, from the opposite end of the political spectrum. He draws his support from economy-related grievances rather than public concerns about immigration.

The need to pay attention to France's economic situation is highlighted by a comparison of Le Pen's prospective first-round vote share of around 25% with the relatively modest 15% achieved in the Dutch election by Geert Wilders. The far-right politician, Le Pen's counterpart in the Netherlands, campaigned overwhelmingly on identity issues, without emphasising the economy.

The prominent FN economic agenda – including a commitment to take France out of the euro – is an important part of its platform and reflects the inferior performance of the country's economy.

Social costs of weak economy

An alternative approach to explaining the FN's strength might be to stress the links between the two elements of its appeal – economic grievances and identity (anti-immigrant) politics.

This argument suggests that the failure of immigrant communities from North Africa to integrate into French society would never have been so deep had the labour market performed better. Put another way, the social costs of unemployment – which extend far beyond the problem of immigration – are a core driver of the anti-establishment protest vote.

There is an additional underlying cause of the FN phenomenon which goes deeper than these surface economic and identity issues. This is the alienation of a large portion of French society from the country's oligarchic elite. This oligarchy monopolises state power and the economic rents derived from what, by European standards, are still extensive state asset holdings.

This group – formed from a web of connections and vested interests among no more than a few thousand individuals – is resistant to external input. Instead, policy initiatives emanate from the rigid world view of this hermetic core. Their unquestioned way of thinking is disseminated, articulated and entrenched thanks to the 'public intellectuals', journalists, pollsters and lobbyists who are drawn into the elite thicket.

> ***"In France, high levels of distrust stimulate demand for regulation. Pervasive regulation is the government activity most associated with corruption.***

The result is widespread policy blockages that have entrenched high unemployment and the relentlessly expanding share of value added recycled through state budgets. Broader public attitudes echo the rigidity of the elite. In a series of surveys conducted by the polling firm GlobeScan since 2005, France emerges as the most hostile of all developed countries to free enterprise and the free market economy.

This French distrust of free markets is paired with a low level of trust in others, compared with the country's European peers. Herein lies part of the explanation for the poor performance of the French economy. Kenneth Arrow, the eminent US economist who died in February, illustrated in his work how trust is the cornerstone of a properly functioning market economy.

In France, high levels of distrust stimulate demand for regulation. Pervasive regulation is the government activity most associated with corruption. All major measures of corruption show France as performing considerably worse than high-trusting nations such as Nordic and Anglo-Saxon countries.

Shock or relief

Unless the French elites adapt to the enhanced transparency and exposure of privilege which social media engenders, Le Pen will continue to make progress. While all candidates promise to reduce unemployment and poverty, she can highlight – to good electoral effect – the failures of her rivals.

The French and international media have played down Le Pen's chances. They will be discredited if she wins.

However, in the event of her defeat in the second-round run-off on 7 May, the sense of relief felt by the establishment and media will prove hollow. The underlying realities in France make it impossible that the probable victor Emmanuel Macron, who is in practice the continuity-candidate from the François Hollande presidency, could govern any more effectively than his dismal predecessor. ■

Brigitte Granville is Professor of International Economics and Economic Policy and Director of the Centre for Globalisation Research at Queen Mary University of London.

Hammond leaves Brexit setback margin

Britain relying too much on rescue by consumers

Vicky Pryce, Advisory Board

Philip Hammond on 8 March presented his first Budget since taking up the mantle of Britain's chancellor of the exchequer in July 2016. Some onlookers were disappointed with his frugal and cautious Budget, which failed to address the worries related to the uncertainty over Britain's exit from the European Union.

This was Hammond's first and the last spring Budget – from now on the Budget will be presented in the autumn, with spring reserved for a shorter statement on the country's finances. One reason why the March Budget was a disappointment was because it may be incomplete. Plainly more can be done later in the year if developments – both with the EU and domestically – do not turn out quite as planned.

Optimistic OBR forecasts

However, while the economic analysis by the independent Office for Budget Responsibility reflected the considerable uncertainty around the terms of Britain's exit from the EU, the chancellor was helped by better-than-expected economic growth.

The economy grew by 1.8% in 2016. The rate of growth accelerated throughout the year, helped by an interest rate cut in August. This, together with temporarily low inflation and high employment levels, encouraged record levels of borrowing and increased consumer spending.

The ratio of personal savings to disposable income turned negative in the last quarter of 2016 for the first time since 2008. Other indicators such as investment and net trade were negative contributors to growth.

Higher corporation tax receipts and the rescheduling of some expected payments to EU institutions have resulted in borrowing likely to be just £51.7bn in 2016-17 – maybe even lower in 2016-17, compared with the £68.2bn predicted in November, when the last OBR report was published. This has enabled a net £3.1bn of giveaways for 2017-18 and more the following year, partly for adult social care.

> ***"The economy is unlikely to react well to what may be protracted and acrimonious UK-EU negotiations following 29 March's triggering of Article 50 of the Treaty of Lisbon.***

The OBR expects 2% growth in 2017, but a slowdown afterwards, with cumulative GDP by the end of the forecasting period slightly weaker than was forecast in November. Public finances reflect this and the year-to-year path remains volatile.

The deficit is projected to fall from 3.6% this year to 0.9% in 2021-22. The debt-to-GDP ratio is expected to peak at 88.8% in 2017-18. But over the forecast period the chancellor would still need to borrow around £100bn more than was projected in November.

This is all without the OBR factoring any EU 'divorce payments' into its analysis. On the positive side, the research assumes that any savings in EU contributions once Britain leaves will be recycled back into the economy. But even these forecasts may prove too optimistic.

The worry is that British consumers may not oblige the politicians by spending more of their savings. Retail sales have begun to show some weakness, suggesting that shoppers are prioritising essential items which are increasing in price, partly due to sterling's depreciation. Manufacturing input costs are rising at the fastest rate in years. At the same time, Brexit uncertainty is constraining investment.

Eliminating the deficit

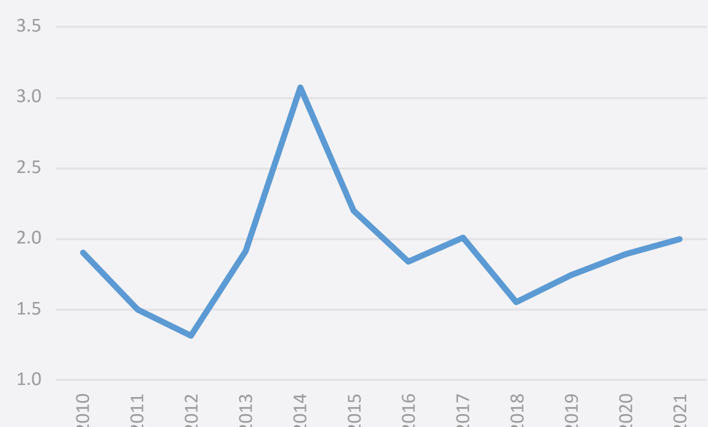
Hammond has played it safe. Austerity continues with further cuts in day-to-day departmental spending and welfare through the term of the current parliament. But the chancellor's new, more lax fiscal rules demand a structural deficit of below 2% in 2020-21 and eliminating the deficit early in the term of the next parliament. With the OBR projecting a structural deficit of 0.9% for that year, it gives Hammond some margin to ease any Brexit pain.

However, the economy is unlikely to react well to what may be protracted and acrimonious UK-EU negotiations following 29 March's triggering of Article 50 of the Treaty of Lisbon. By the autumn, the chancellor may have to reassess whether the funds he has reserved for the impact of Brexit setbacks are enough to see him through. ■

Vicky Pryce is a Board Member at the Centre for Economics and Business Research, a former joint Head of the UK Government Economic Service.

Chart 1. OBR expects 2% growth in 2017

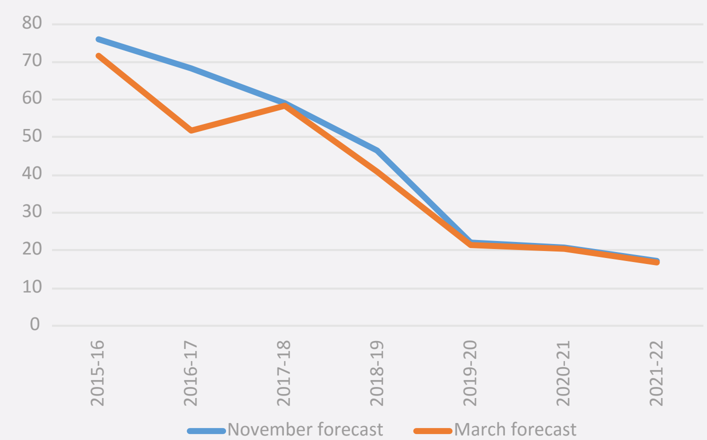
Real GDP growth forecasts, %, March 2017



Source: Office for Budget Responsibility

Chart 2. Lower budget deficit expected, 2017-20

Public sector net borrowing, £bn



Source: Office for National Statistics, Office for Budget Responsibility

May off guard over Scottish conundrum

Nationalists learn lessons from 2014 referendum

David Marsh

L-R: Theresa May, UK Prime Minister; Nicola Sturgeon, Scottish First Minister

UK Prime Minister Theresa May and her government, fighting a battle on many fronts over Britain's European Union exit, have been caught off guard by the sudden upsurge in support for a new referendum on Scottish independence.

Part of this is due to the British government's actions in overdoing the bid for a 'hard Brexit', which would cut ties to the single market. This is anathema to the European-minded Scots – and has directly incited a campaign for a second plebiscite following the September 2014 independence vote that maintained Scotland's union in the UK.

When May became prime minister in July, she made initial efforts to forge links with Nicola Sturgeon, leader of the independence-seeking Scottish National Party and first minister in the devolved Scottish government. May promised Sturgeon that the British government would adopt an EU exit path aligned with Scotland's own special interests. To many SNP supporters, May's decision, sealed at the beginning of the year after months of prevarication, for Britain to quit the single market as well as the EU contravenes that undertaking.

Transitional currency arrangement

There are signs that the SNP has learned lessons from 2014 and is taking a more considered view of currency and financial matters in a post-independence Scotland.

The SNP's somewhat naive belief in 2013-14 that Scotland could leave the UK but keep sterling – flying in the face of the lesson of monetary unions over the ages: political and monetary integration go together – greatly handicapped the party's attempt to win credibility 30 months ago.

The SNP now says that Scotland would use the pound in a transitional arrangement but would then need to adopt its own currency rather than joining the euro or relying on the Bank of England. Adhering to the European single currency would be technically and politically problematic for both Scotland and for present euro members.

Yet setting up an independent Scottish currency, too, would be a massively complex operation. The new money would need to be backed by a central bank equipped with monetary reserves as well as arrangements for supervising Scottish banks. It would have to cope with problems for the Scottish economy caused by an oil price that will probably stay relatively low for longer than was considered in 2014-15.

Latest EU developments, igniting nationalist feeling in Scotland after the previous referendum which was supposed to lay the question to rest for a generation, have massive potential to disrupt UK financial markets and sterling, already vulnerable to the multiple vicissitudes of the EU withdrawal talks.

A difficult decision for Scotland

Politics is much more confused, and the choices even less straightforward, than in 2014. Should a referendum take place in the next few years, Scottish voters will face a much more difficult decision over which route to take.

> ***"The SNP's somewhat naive belief in 2013-14 that Scotland could leave the UK but keep sterling – flying in the face of the lesson of monetary unions over the ages: political and monetary integration go together – greatly handicapped the party's attempt to win credibility 30 months ago.***

In the 23 June EU referendum, Scotland chose by 62% to 38% to stay in the EU, ending up on the losing side of the overall 52% to 48% UK vote against EU membership. In the 2014 referendum, the option of staying in the UK – which the Scottish electorate then backed by 55% to 45% – appeared the more secure choice.

Now that the UK has decided to leave the EU, some pro-Europeans on both sides of the Scottish-English border believe a safer choice might be to seek to stay in the EU as a separate state when the other parts of the UK leave.

Referendum timing under discussion

Sturgeon told an SNP party conference last month that a new independence referendum would take place soon. But she left open how she could force a second vote – which requires UK government approval to attain constitutional validity – and when it would be held.

On 28 March the Scottish parliament approved a formal request to Westminster for the power to hold a referendum. Sturgeon has said it should take place by spring 2019 at the latest. May has already ruled out a vote until much later, saying that an earlier plebiscite would badly interfere with the exit process and would anyway require the Scots to vote on the basis of incomplete information about the UK's post-Brexit arrangements.

The SNP's struggle is favoured by a lack of credible figures who could lead any anti-independence campaign. Gordon Brown, the former prime minister and chancellor of the exchequer, and Alistair Darling, former chancellor, who campaigned decisively against independence in 2014, both stepped down from frontline politics shortly afterwards. Whatever happens in the next few years, the path to a new Scots independence vote will be an arduous journey. ■

David Marsh is Managing Director of OMFIF.

Dijsselbloem's Eurogroup role in jeopardy

Long wait before next Dutch government is formed

Roel Janssen, Advisory Board

The leadership of the Eurogroup of finance ministers is in doubt following the results of the Dutch election, which are being felt beyond the country's borders.

Jeroen Dijsselbloem, the Dutch finance minister and Eurogroup chairman, saw his Labour party (PvdA) lose 29 of its 38 seats in the election on 15 March. Though Dijsselbloem was re-elected, he will have to relinquish his post as finance minister once a new government is formed because his weakened party is not expected to be part of the ruling coalition. He had hoped to see out his five-year term as chairman of the Eurogroup, which ends in January 2018.

That ambition was put in doubt when he faced calls to resign over remarks he made to the German daily Frankfurter Allgemeine. Dijsselbloem told the paper that countries in the northern euro area had shown 'solidarity' with the south during the crisis, but that solidarity came with 'duties'. He went on: 'I cannot spend all my money on liquor and women, and beg for help afterwards.'

Spanish, Portuguese and Italian politicians and media were quick to condemn him. They felt he had confirmed northern prejudice against southern euro countries, insinuating that the latter were freespending Mediterraneans. The Portuguese prime minister Antonio Costa called Dijsselbloem's remarks 'racist, xenophobic and sexist' and demanded his resignation from the Eurogroup.

As chairman, Dijsselbloem's defence of austerity policies has put him at odds with the Italian and Portuguese governments. The Spanish, who have long campaigned for the baton to pass to a southern European country, are thought to be keen to replace him with Luis de Guindos, the Spanish minister of economy.

Loss of momentum for European populism

The priority for Mark Rutte, the Dutch prime minister, is to pull together a coalition, a task that could take months. To achieve a majority in parliament he needs the support of three other parties. Although Geert Wilders' far-right Party for Freedom (PVV) holds the second highest number of seats, no other party will work with it. This appears to leave two options for forming a coalition: both would include Rutte's People's Party for Freedom and Democracy (VVD), the Christian Democrats and the Social Liberals. The fourth party could either be the progressive Greens or the small Christian Union.

Unlike the period after the 2012 Dutch elections, when action was needed to tackle the effects of the financial crisis, the economy is booming and the budget is in balance. After four years of austerity, there is fiscal room to loosen the budgetary reins and this may ease Rutte's task.

The prime minister, having consolidated VVD as the largest party and halted the advance of Wilders, will undoubtedly use his renewed political clout in Brussels and could be inclined to be more strongly pro-EU than before. The loss of momentum for the populism that had appeared to be sweeping Europe may well have implications for this year's elections in France and Germany. ■

Roel Janssen is an author of economic and financial affairs books. He covered economics and finance for Dutch newspaper NRC Handelsblad for more than 30 years.

Italy must protect minority shareholders

Corporate governance is good, but enforcement is poor

Lorenzo Codogno, London School of Economics and Political Science

The lack of protection for minority shareholders in Italy has become increasingly apparent in recent months, and not just in the case of the troubled Banca Monte dei Paschi di Siena (MPS). This issue may become a serious difficulty for the country when attracting foreign investment.

On paper, Italy has some of the most advanced legislation for the protection of minority shareholders. Even in the Anglo-Saxon world, requirements and corporate control to protect minorities are not as stringent as in Italy. However, there is a gap between the rules and their application. The Italian Securities and Exchange Commission (Consob) is attracting most criticism for this failure. The treatment of small shareholders in relation to MPS, the struggling banks in the Veneto region and in several other cases goes beyond ordinary mistakes. Most striking is the lack of public explanation about Consob's actions, or inaction.

In January international investment fund Elliott, frustrated by the lack of response from Consob, published information on its website that it had sent to the regulator about the sale of Ansaldo STS, operating in high technology for railway and urban transport, to Hitachi. The evidence it presented suggests that deliberate actions were taken to the detriment of minority shareholders, in which Consob only partly intervened.

Safeguarding independent directors

At issue is corporate governance and the safeguarding of independent directors whose duty it is to protect the interests of minority shareholders. Ansaldo STS's shareholders voted at the request of Hitachi, the majority shareholder, to remove an independent director accused of 'excessive diligence' for challenging some majority shareholder decisions. This sets a dangerous precedent in which the so-called 'action of responsibility', meant to serve as an effective means of protecting all shareholders, was used by the majority shareholder to eject a particularly diligent director appointed by the minority. Consob remained silent on the matter.

A paper by Mauro Guillén of Wharton University and Laurence Capron of Insead business school shows that countries with effective legal frameworks to protect minority shareholders tend to have more robust financial markets. This is because investors are more willing to take risks. It is not enough the law, but what matters is enforcement, and for that, the administrative ability to implement rules. In Italy, the mirror effect of this phenomenon is the relatively high value of the private benefits of control. There are many reasons why the culture of equity investment is still underdeveloped in Italy, but this problem is certainly part of the story.

Given that bank credit channels tend to improve slowly, and domestic savings are diversifying into other countries' assets, it becomes essential for Italy to be able to attract foreign investment to support economic growth. Proper enforcement of minority shareholders' protection is central to this. ■

Lorenzo Codogno is Visiting Professor at the London School of Economics and Political Science, and Chief Economist at LC Macro Advisors.

Fed reaffirms gradualism as it raises rates

Yellen curbs expectations of aggressive tightening

Darrell Delamaide, US editor

The only surprise from the mid-March meeting of the Federal Open Market Committee was that US Federal Reserve policy-makers remained slightly dovish despite following through on their clearly stated intention of raising rates for the third time since the global financial crisis.

Market observers had believed that the Fed's decisiveness about a March increase meant it was ready to move aggressively to avoid any potential overheating of the economy. But Janet Yellen, the Fed chair, quickly curbed those expectations at a press conference after the meeting.

'We continue to expect that the ongoing strength of the economy will warrant gradual increases in the fed funds rate to achieve and maintain our objectives,' Yellen said. 'That's based on our view that the neutral nominal fed funds rate – that is, the interest rate that is neither expansionary nor contractionary and keeps the economy operating on an even keel – is currently quite low by historical standards.'

Gradual tightening

In questioning afterwards, Yellen could not be drawn into a more hawkish stance. Asked about what she would consider a 'rapid' rate of increase if the Fed felt obliged to abandon the 'gradual' increases, she demurred. 'I'm not sure that I can tell you what a rapid rate of increase is,' she said. 'I think the trajectory that you see is the median in our projections which, this year, looks to a total of three increases. That certainly qualifies as gradual.'

The Fed's dot plot graph, which charts the expectations of FOMC members, showed little change. Of the 17 members, 12 are looking for just two more rate rises this year, or fewer, even though some who had previously expected fewer are looking for two more.

The March consensus statement dropped the qualifying word 'only' in front of 'gradual,' saying that the committee 'expects that economic conditions will evolve in a manner that will warrant gradual increases in the fed funds rate'. Some analysts read into this that the FOMC is open to the idea of moving ahead at a more rapid pace if data suggests this is desirable.

For the moment, at any rate, Fed policy-makers think the gradual increases are appropriate given the macroeconomic outlook. 'Overall, we continue to expect that the economy will expand at a moderate pace over the next few years,' Yellen said.

Another dovish note was the lack of any indication as to when the Fed would start reducing its balance sheet, swollen to over $4tn after its quantitative easing. The Fed said it would continue its current accommodative policy of reinvesting principal of maturing bonds and rolling over maturing US government bonds. It anticipates doing so until 'normalisation of the level of the fed funds rate is well under way'.

"Yellen could not be drawn into a more hawkish stance. Asked about what she would consider a 'rapid' rate of increase if the Fed felt obliged to abandon the 'gradual' increases, she demurred.

Yellen said this did not mean that there was a strict cut-off level for the fed funds rate. What will be decisive 'is confidence in the economy's trajectory'. She explained that policy-makers wanted to feel that the economy would make progress without too much worry about downside risks or adverse shocks that could force the Fed to reverse its position and have to add accommodation right after shrinking it.

Forecast failures

Neel Kashkari, Minneapolis Fed chief and a voting member of the FOMC for the first time this year, dissented from the consensus statement and the decision to raise rates. He had spoken out against a rate increase beforehand, so it was no surprise.

'I dissented because the key data I look at to assess how close we are to meeting our dual mandate goals haven't changed much at all since our prior meeting,' Kashkari said. 'We are still coming up short on our inflation target, and the job market continues to strengthen, suggesting that slack remains.'

'Once the data do support a tightening of monetary policy, I would prefer the next policy move by the FOMC to be publishing a detailed plan that explains how and when we will begin to normalise our balance sheet.'

Kashkari, who was a key Treasury department official when the global financial crisis started in 2008 and later ran for

Neel Kashkari, president, Minneapolis Fed

governor of California, said markets have not been good at forecasting political developments, such as the widespread anticipation of a fiscal stimulus under President Donald Trump.

'Financial markets are good at some things, but, in my view, notoriously bad at forecasting political outcomes,' he said. Further uncertainty surfaced later when Charles Evans, Chicago Federal Reserve Bank president, in previous years a prominent dove, told an OMFIF-DZ BANK Frankfurt audience that coming interest rate rises reflected positive growth and unemployment news and a gradual rise in inflation towards 2%.

Diversity at the Fed

The Atlanta Fed has announced the appointment of Raphael Bostic to succeed Dennis Lockhart as president, the first African American head of a regional bank in the Fed's history.

There have been three African American members on the Fed's Washington board of governors, and Bostic, who has been teaching at the University of Southern California, previously served as senior economist for the board. The Fed has been under pressure to increase diversity in its top ranks. Though each regional bank's board appoints its own president, some of that pressure no doubt filtered through to the Atlanta board. ■

Darrell Delamaide is a writer and editor based in Washington.

Fall-out from less liquid bond markets

Adverse 'flash events' occurring more frequently

Hans Blommestein, Advisory Board

Liquidity in government bond markets appears to have suffered since the financial crisis as a result of new regulations, unconventional monetary policy and investor sentiment.

A study published in the Journal of Financial Regulation and Compliance suggests that regulatory changes, such as Basel II and III, Solvency II, CACs, MiFID and the Dodd-Frank Act, are having an adverse impact on liquidity. New regulations are reflected in tighter balance sheet constraints for dealers that seem to impede market-making. These developments may be having an adverse impact on liquidity.

The conclusion of the report is supported by research among public debt managers and the International Monetary Fund. The Fund has said that structural changes, such as a decline in market-making, 'appear to have reduced the level and resilience of market liquidity'.

In contrast, the UK Department for Business, Innovation & Skills noted in its annual report that most market liquidity indicators, such as bid-ask spreads and average transaction size, do not show a significant structural decline of liquidity in fixed income markets. A 2015 report on the US market showed that average levels of liquidity in benchmark government bonds were generally good by historical standards.

While the latest report concluded that new regulations were leading to lower liquidity, it recognised that, in many jurisdictions, negative yields and quantitative easing are adversely affecting government bond markets.

Traders warn that the European Central Bank and the US Federal Reserve are draining liquidity from these markets by reducing the number of bonds available for trading, having swallowed unprecedented amounts through their purchase programmes. The Fed is now the largest owner of US government bonds, with a total of $2.5tn, and is expected to reinvest the proceeds from $216bn of those securities that mature this year.

Innovative responses to change

One difficulty in identifying the overall impact of regulatory changes on liquidity is the need to take account of the reactions of policy-makers, notably debt managers, and financial institutions. Innovative responses from market participants, which aim to counter the adverse impact of the regulatory changes, may improve liquidity over time. In the US, government bond market firms have been established to match more efficiently buyers and sellers of less liquid bonds.

In the short term, however, the reaction of market participants may be making market dynamics more complex, with a greater number of intense and disorderly price movements. Stanley Fischer, the vice-chair of the Fed, has acknowledged that these 'flash events' – tail events in which liquidity unexpectedly evaporates – seem to be happening more frequently.

> ***"In the short term, the reaction of market participants may be making market dynamics more complex, with a greater number of intense and disorderly price movements.***

At an OMFIF City Lecture on 24 January Chris Salmon, executive director for markets at the Bank of England, said, 'We need a deeper understanding of the potential for flash events to have longer-lasting consequences than has been the case so far.'

While increased regulation does appear to be having an impact on liquidity, more research is needed into the relative influence of all the contributing factors, not least unconventional monetary policy. ■

Hans Blommestein is Associate Director of Vivid Economics.

Subtle shift in ECB monetary guidance

Nederlandsche Bank chief sees rate rise at start of 2018

David Marsh

The European Central Bank has changed its approach to interest rates, jettisoning the idea of further cuts in already negative rates and boosting expectations of a rise in both its lending and deposit rates over the next year.

At the same time, a debate has started within the ECB governing council about scaling back its monthly bond purchases from January – possibly sooner if European recovery and inflation pick up faster than expected.

In view of general uncertainties, the ECB is sticking to the 'make haste slowly' approach on interest rates and quantitative easing. Klaas Knot, president of the Nederlandsche Bank, the most vocal of the ECB's 'hard money' faction, has reaffirmed that interest rate increases should come only after bond purchases have been adjusted downwards, calling this 'a logical order'. Knot said markets now expect the ECB's first interest rate rise at the beginning of 2018, adding, 'That is much closer to my own expectation.'

A subtle change in the ECB's 'forward guidance' came at the 9 March meeting of the governing council. The ECB excluded from its statement its previous reference to using all the weapons in its policy arsenal to defeat deflation — recognising that inflation is starting to rise towards 2%.

The council repeated that it expects key ECB interest rates to remain 'at present or lower levels for an extended period, and well past the horizon of the net asset purchases'. But Mario Draghi, the ECB president, added, 'There is no longer that sense of urgency in taking further actions while maintaining the accommodative monetary policy stance including the forward guidance.'

Although he played down the prospects of a rate increase before the end of the present scheduled programme of monthly central bank bond purchases in December, Draghi stated, 'The probability of a rate cut has gone down.'

The first monetary tightening since Draghi took over in November 2011 would be an important landmark. A faster rise in German inflation to beyond 2% has irked German policy-makers, who accuse him of abandoning traditional German beliefs in the primacy of currency sanctity – but pressure on Draghi has relaxed after annual price rises fell back below 2% in March. ■

David Marsh is Managing Director of OMFIF.

Regulation as science and art

Markets should be given room for innovation and failure

Felix Hufeld, Federal Financial Supervisory Authority of Germany

Financial regulation, like investing in the stock market, is as much an art as a science. No one doubts that regulation requires quantitative analysis, but there are questions that rely on human judgement. The answers to these will not come from algorithms.

Financial markets cannot be viewed in isolation from their often volatile political and social environment. In unusual conditions, regulators must find similarly unusual solutions. While showing steadfastness and continuity in their principles, regulators must be pragmatic and flexible on individual issues.

It is neither desirable nor possible for the regulator to exclude every risk and any conceivable uncertainty. On the contrary, it is part of the regulatory mandate to give financial markets the necessary freedom for innovation and, indeed, failure. That is why it is important to seek the best possible balance between responsibility and liability, which are inseparable. Liability and the prospect of a bail-in should be the best friend of financial supervision. Banks and their customers are likewise entitled to expect dependability from regulators.

Nuance on risk sensitivity

On the relationship between financial stability and profitability, one issue is the extent to which banks must be curbed by capital, liquidity, and other requirements. Opposed to this, there is the financial institution's need to generate profit and offer investors appropriate returns on the risk capital they provide.

Experience has shown that when this pressure becomes strong, banks seek to improve or maximise their business model. This is neither illegal nor illegitimate. It even contributes to some extent to making banking more profitable, and possibly, resilient.

But there is a limit. Some politicians might say that this limit is reached at the point where profit is distributed to shareholders but heavy losses have to be borne partially or completely by taxpayers. This would disrupt the unity of responsibility and liability. Regulation should ensure that taxpayers' money is not used, or that it used only in limited and extraordinary circumstances.

Some may ask why proceedings must be so complicated, when it would be possible to make banks just as resilient by introducing a much higher leverage ratio or comparable tools. The premise for such a question is flawed.

Experience shows that a crude capital approach kills all risk sensitivity. Additionally, if institutions have to protect their banking and trading books with flat-rate capital requirements, they are left with no alternative but to take on maximum risk in order to recoup high capital costs. I am convinced that, rather than guiding credit institutions towards a less risky way of doing business, a leverage ratio of 10% or beyond would make many financial institutions act in a riskier way.

Mitigating procyclical effects

There is a conflict between the objectives of risk sensitivity and procyclicality. In recent years, the greater market orientation of the valuation of assets and liabilities has made the risk situation of financial actors and markets more transparent.

In banking regulation, this has happened gradually with the transitions from Basel I to Basel III, while in the insurance sector the launch of Solvency II was a milestone.

The market-value orientation is intended to reduce companies' assumption of risks and strengthen their solvency, among other things. In addition, the loss-absorbing capacity is supposed to be increased.

> ***"It is part of the regulatory mandate to give financial markets the necessary freedom for innovation and, indeed, failure.***

Risk sensitivity, if not appropriately limited, can turn long-term movements into excessive short-term volatility. It can promote the tendency towards too much credit expansion in boom phases and more restricted lending in recession phases – with potential repercussions for the real economy.

Much has been done to mitigate procyclical effects. In banking regulation, the countercyclical capital buffer was designed so that institutions should accumulate an additional capital cushion during periods of excessive credit growth.

However, ultimately it will not be possible to avoid the regulatory linking of capital and risk with market valuation to go along with some degree of procyclicality. A balance must be struck between market-value orientation and prudence which enables a risk-based regulation with the least possible procyclical effect.

The dynamic nature of the markets can only be kept on track when regulation does not spell out everything to the last detail. Regulation ought to restrict itself to forming a framework of principles within which some leeway and freedom from day-to-day supervision is granted.

> ***"It is the mix of principles and a rules-based approach which makes for robust regulation.***

Crises breed demand for regulation

Working according to principles demands a close relationship between companies and supervisors. It is important that supervisory authorities can get a full picture of whether an institution has appropriately established its risk management system. Institutions, for their part, have a right to supervision which is fair and comparable, and yet essentially individual.

Calls for greater rules-based regulation become louder if something goes fundamentally wrong: real estate crises, sovereign debt crises, and mis-selling scandals are pertinent examples.

An abundance of rigid rules cannot do justice to dynamic financial markets and individual risk profiles. Too much principles-based regulation, on the other hand, reduces predictability and the harmonisation of the legal application of supervisory measures across individual institutions and countries. It is the mix of both – a principles and a rules-based approach – which ultimately makes for robust regulation.

Models and statistics alone cannot live up to the reality of financial markets, which are inconceivable without risk. Good regulators are characterised by their ability to balance differing policy and economic goals, even in situations of extreme crisis.

Even regulation itself is exposed to volatility. Proportionality, differentiation, and lessons learned are always important and welcome; full-fledged deregulation should be avoided. ■

Felix Hufeld is President of BaFin, Germany's Federal Financial Supervisory Authority. This is an abridged version of an OMFIF City Lecture on 1 February in London.

Scope for reversing balance sheet expansion

Rising inflation creates incentives for tighter policy

OMFIF and National Bank of Poland analysis

The central banks of advanced economies responded to the financial crisis by expanding their balance sheets at an extraordinary pace. Nine years on, some are assessing the risks and benefits of exiting such policies and reversing this balance sheet expansion. In this new Bulletin series, prepared jointly by OMFIF and the National Bank of Poland, we will be looking at the development of the balance sheets of key central banks, and analysing the latest challenges facing their policy-makers. This edition profiles the European Central Bank, Bank of Japan, US Federal Reserve, and the National Bank of Poland.

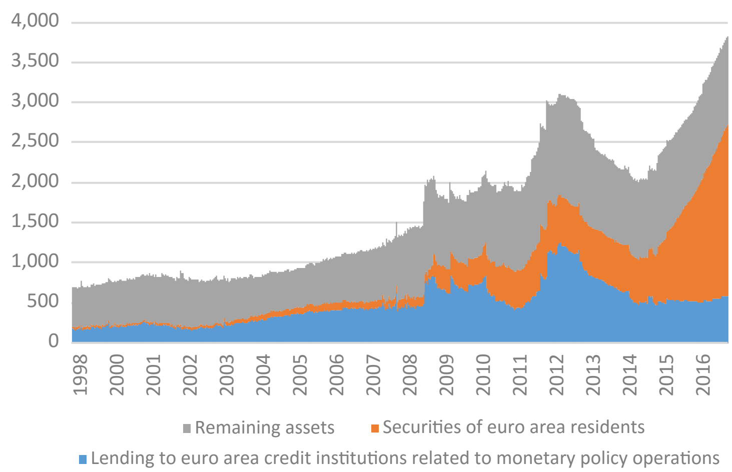
Dipping March inflation lowers prospects for ECB tapering

In March the euro area's annual inflation dropped to around 1.7% from 2% in February, but in some member countries the fall was more pronounced. In Spain the rate fell to 2.1% from 3%, while in Germany it dropped to 1.6% after having reached 2.2% in February (the highest since August 2012). Energy and food prices were responsible for the fall, just as previously they had pushed inflation up. Core inflation for the euro area fell to 0.7% from 0.9%, while the market's '5y5y inflation' expectations fell below 1.6%. After this, the market became less sanguine about the chances of a speedy beginning to 'tapering' – adjusting downwards monthly bond purchases.

The volume of asset purchases is close to €1.7tn, with the share of public sector purchases, at €1.4tn, representing more than 82% of the programme. The relaxation of the rules of the public sector purchase programme in December – along with a worldwide increase in yields – led to a fall in the bank holdings' remaining weighted average maturity. In February, their average maturity fell to 8.2 years, the lowest since June 2016.

The M3 aggregate in March grew at an annual 4.7% (4.8% in February and 5% in January). This slowdown mainly reflected falling net external assets. M1 is still the key generator of this growth. Meanwhile, the M2-M1 aggregate – after dropping in December to its lowest level in more than nine years – reached €3.5tn. The effect of negative rates is widely felt, with longer-term financial liabilities of other euro financial institutions falling below €6.9tn in February for the first time since March 2010. Some of this lost ground was recovered in March.

European Central Bank balance sheet, assets €bn



Source: European Central Bank, National Bank of Poland, OMFIF analysis

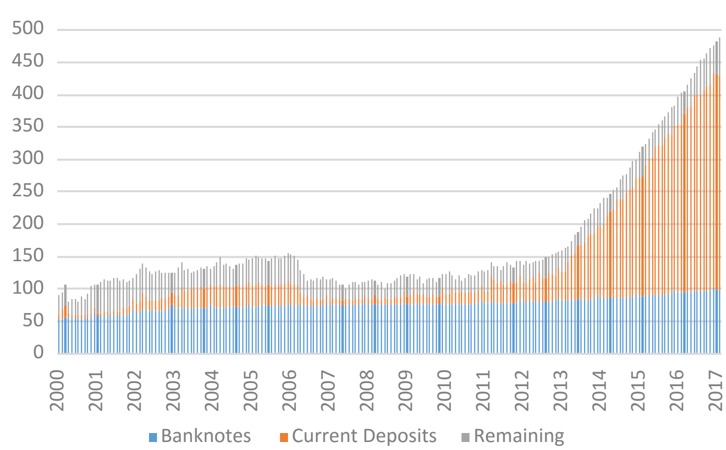
Japan's new yield curve target: flexibility and transparency

After implementing yet another innovation on yield curve targeting in September (which Sayuri Shirai describes in further detail on p.18), the Bank of Japan published further details on its purchase of Japanese government securities. As a result, the Bank has started to disclose data – on a monthly basis – regarding the volume and type of bonds to be purchased, the frequency of purchases, and a method for auctions.

Subsequently, the BoJ has announced that it will buy in April between ¥6.3tn-¥9.8tn (around $57bn-$88bn) of government bonds. The announcement forms part of the Bank's efforts to enhance transparency. Market participants have greeted the measure positively. In particular the new details have lowered uncertainty about the scheduling of auctions.

Market participants have welcomed the clarity of the BoJ's commitment to yield curve control. By offering a range (and not a single numerical target) of bonds to be purchased, the Bank has gained valuable operating flexibility. As a result, its programme should be less susceptible to swings in market sentiment.

Bank of Japan balance sheet, liabilities, ¥bn



Source: Bank of Japan, National Bank of Poland, OMFIF analysis

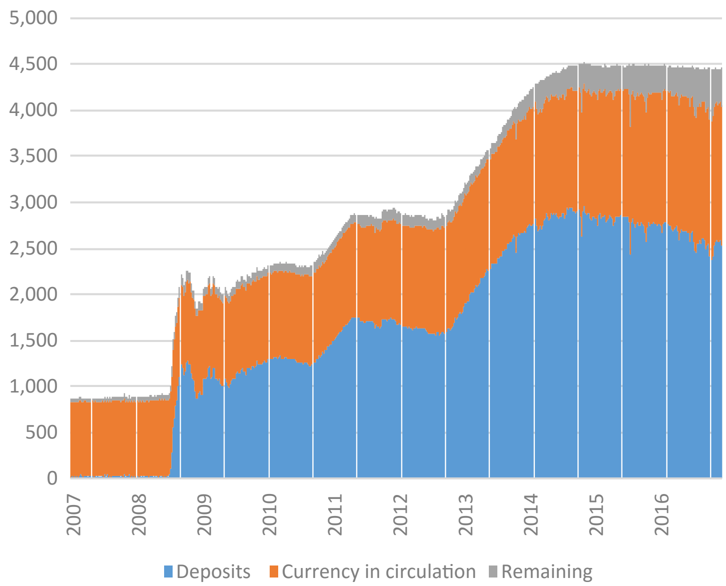
More interest rate clarity, but balance sheet uncertainty

On 15 March the Federal Open Market Committee raised its target range for the fed funds rate to 0.75%-1%, indicating that this is likely to be the first of three increases in 2017. The relative certainty over the expected future path of interest rates stands in some contrast to mounting uncertainty over the outlook for the balance sheet. The Fed emphasised its willingness to continue reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities. It is also prepared to continue rolling over maturing Treasury securities at auctions. The Fed expects to continue this policy up to the time when it starts 'normalisation' of of the fed funds rate in earnest.

James Bullard, president of the Federal Reserve Bank of St. Louis, gave more specific indications about the balance sheet. He expressed the view that current Fed policy is distorting the yield curve. If actual and projected movements in the policy rate are putting upward pressure on the rate, the current $4.5tn balance sheet is exerting downward pressure. According to Bullard, even if the Fed ended reinvestment now, that would still leave the balance sheet at a very large level for years to come. It seems likely that the Fed will opt for what Bullard describes as 'policy space' – giving it considerable room for manoeuvre, especially if a further downturn starts to loom on the horizon.

One point is clear. The Fed cannot set a future benchmark for the balance sheet. The Fed's balance sheet as a proportion of GDP is now around three times as large as before the financial crisis, when it hovered at levels below 7%. Some of the increase is no doubt structural. In the light of a sharp increase in demand for money worldwide (and considering the role of the dollar as the world's reserve currency), cash and banknotes in circulation alone amount to more than 8% of GDP.

Federal Reserve bank balance sheet, liabilities, $bn



Source: Federal Reserve, National Bank of Poland, OMFIF analysis

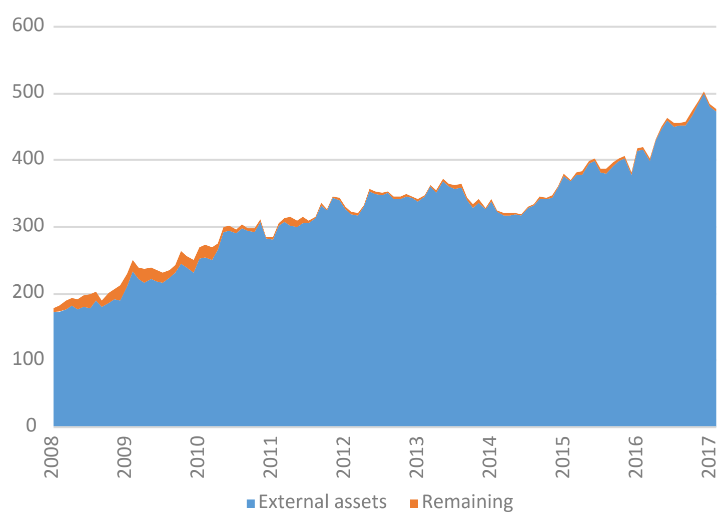
Warsaw leaves interest rates unchanged

The National Bank of Poland left its interest rates unchanged at the last meeting of its monetary policy council. The rate has been held at 1.5% for more than two years. This is the longest period without change since 1989, when Poland moved from a planned economy to a free market system. The MPC at its most recent press conference implied that interest rates may not be altered before 2019.

Inflation in Poland fell to 2% in March from 2.2% in February, close to the NBP target of 2.5% with a 1 percentage point deviation. Inflation has been fuelled mainly by higher energy prices and the base effect. The increase in base inflation remains subdued, at 0.3% in February. This may go some way to explaining the MPC's dovish tone. Market participants are behaving cautiously in assessing whether momentum is strong enough to ensure Poland reaches the 2.5% inflation target on a sustainable basis.

In the MPC's opinion, after a considerable increase at the start of the year, inflation will stabilise at a moderate level. This is the dual result of the fading effect of past increases in commodity prices, accompanied by a gradual increase in inflationary pressures stemming from improving domestic economic conditions. As a result, the risk of medium-term inflation running persistently above 2.5% is limited. This view has been supported by the latest reading of 'flash' inflation for March (pointing at inflation of 2%). Low interest rates are affecting the M3 monetary aggregate (the broadest measure of a country's monetary supply) compared with M1 (grouping the most liquid components of the money supply), with M1 reaching a high of almost 65% of M3. The NBP's foreign exchange reserves, having peaked at $109.5bn at the end of 2016, dropped in the first two months of 2017 to $105.7bn, because of valuation effects.

National Bank of Poland, assets, Pln bn



Source: National Bank of Poland, OMFIF analysis

This analysis was led by Pawel Kowalewski, Economic Adviser in the Bureau of Monetary Policy Strategy at the National Bank of Poland, with contributions from Danae Kyriakopoulou, Head of Research at OMFIF.

New problems from yield curve control

Bank of Japan needs more time to hit 2% inflation

Sayuri Shirai, Keio University

In September the Bank of Japan shifted its primary monetary policy instrument from the monetary base to the control of the yield curve, pegging the 10-year bond yield 'around zero'.

Notwithstanding the de facto monetary tightening, the markets reacted positively to the BoJ action. This was reflected in a shift towards short positions in the yen and long positions in stock prices.

By implementing yield curve control, the BoJ abandoned the guideline for the average remaining maturity of Japanese government bond purchases. This was in the target range of seven to 12 years.

The intention of this guideline was to prioritise exerting downward pressure on longer-term bonds – reflecting greater monetary accommodation generated through flattening the yield curve.

Instability risk

Since the BoJ announced it would maintain annual government bond purchases of ¥80tn ($550bn) in 2017, yield curve control has implied fewer bond purchases for longer-term yields and more purchases for shorter-term yields.

By pegging the 10-year yield at around zero, the BoJ appeared to have prevented long-term government bond yields from falling excessively and prevented the yield curve from becoming too flat. These phenomena intensified after the BoJ adopted negative interest rates in January 2016.

This suggests that there is a threshold below which a further cut in government bond yields (and lending rates) no longer has a noteworthy impact on credit demand, aggregate demand, inflation, and inflation expectations.

Instead, smaller lending-deposit interest rate spreads became a growing cause for concern among banks. This is especially the case in the absence of strong credit growth with a low loan-deposit ratio (below 70%).

> ***"Central banks stress that monetary policy should prioritise price stability over financial instability risk.***

Low returns on government bonds also worried banks, given that they had opted to hold government bonds to fill the gap between loans and deposits. Insurance firms and pension funds likewise suffered from low returns and higher liability due to a declined discount factor.

If such policies continue for a long time, the financial instability risk may rise. Yield curve control may therefore be viewed as the BoJ's admission of potential adverse effects.

The Chart shows the yield curve at three specific dates: 27 January 2016, just before the announcement of a negative interest rate; 27 July 2016, just before the announcement of expanding purchases of exchange traded-funds; and end-February 2017.

The 10-year yield achieved its lowest level on 27 July. After this, the yield curve began to rise as markets anticipated the change in the monetary policy framework from volume-focused to yield curve control.

Macroprudential and monetary policy

Generally, central banks stress that monetary policy should prioritise price stability over financial instability risk. The latter should be dealt with by macroprudential policy, with monetary policy as a second line of defence. While desirable in theory, such a clear division may no longer be possible.

Central banks may no longer be able to monitor risks adequately – such risks may not be traceable or foreseeable, given the dominant impact of monetary easing on markets.

Although yield curve control deals with some adverse effects, it generates new potential problems. If the 10-year yield is kept at a rate that cannot be justified for too long from a credit risk perspective, the risk rises of undermining financial intermediation functions and delaying corporate sector restructuring. The government bond market has been distorted because price information is largely suppressed. The BoJ's balance sheet risk is higher given that it may commit to buying government bonds in excess of ¥80tn annually in a phase of upward pressures on yields.

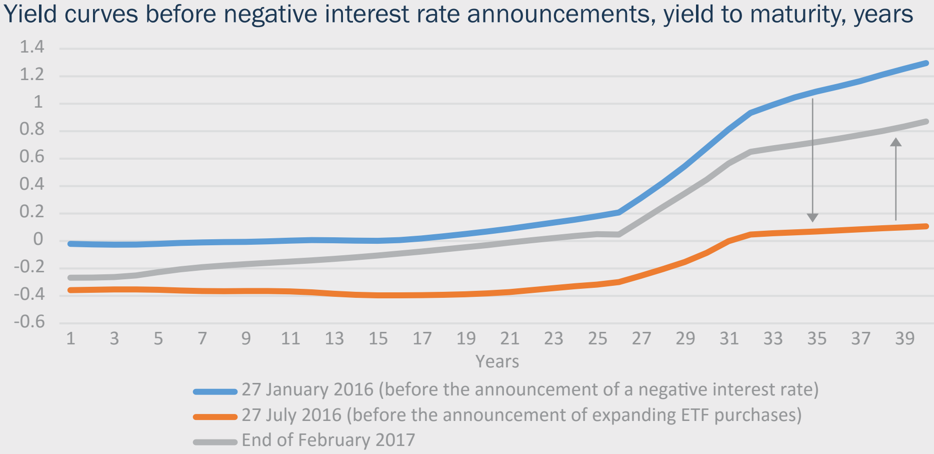
Eventually, the BoJ must choose between two options. The first is maintaining large-scale monetary accommodation for what is likely to be a shorter period. The second is reducing the degree of monetary accommodation somewhat and instead focusing on maintaining the new level of monetary accommodation for a longer period.

Since Donald Trump was elected president, higher US yields in anticipation of higher economic growth and inflation, together with yield curve control, have caused the yen to depreciate against the dollar. Japanese stock prices have risen, suggesting the markets consider yield curve control to be more effective than negative interest rate policy.

Nevertheless, it is important to recognise that monetary policy is overstretched and its impact on domestic demand has not been strong. By resisting higher prices, the public has shown that it does not support the 2% price target. It will therefore take more time for the BoJ to achieve inflation of around 2% and anchor long-term expectations at that level. In the light of this background, the BoJ should consider providing more reasonable projections for when it can achieve 2% and present a more sustainable monetary policy framework to meet this goal. ■

Depressed bond yields raising financial stability risk

Yield curves before negative interest rate announcements, yield to maturity, years



Source: Japan Ministry of Finance, OMFIF analysis

Sayuri Shirai is a Professor of Keio University, a former Policy Board Member of the Bank of Japan and an author of Mission Incomplete: Reflating Japan's Economy.

Monetary policy is feeding populism

Low growth, low interest rates, low hopes of improvement

Gary Smith, Advisory Council

A December paper from the US National Bureau of Economic Research concluded that 'children's prospects of earning more than their parents have faded over the past 50 years in the US'.

McKinsey, the management consultancy, calculated that between 1993-2005 just 2% of households in 25 developed nations experienced flat or falling market incomes. In contrast, for the period 2005-14 that figure was estimated at a startling 65% to 70%. This equates to more than 500m people across 25 countries who fear that they are 'poorer than their parents'. This will be the first generation since the second world war to suffer such a setback.

Middle income earners: economic losers

Critically, this phenomenon is not about the gap between those at the bottom and the top, but about what is happening to middle income earners. These people have been shocked at becoming economic losers.

This newly disaffected group is where modern political populism has taken root, and populist sentiment has arguably been fertilised by a vicious circle of low interest rates, disappointment with pensions, and demographics. Low interest rates and poor market returns are two factors behind weak incomes. The 'baby boom' generation, born between 1945 and the early 1960s, created a bulge in the working age population. In terms of the traditional savings/investment model of the economy, this gave a significant boost to savings as boomers reached their peak earning years, leading to a lowering of the natural rate of interest.

> ***"Middle income earners criticise low interest rates and quantitative easing in the same way they criticise the bail-out of failing banks and borrowers. This fuels popular resentment of the political elite.***

The low rate environment has contributed to lower returns on pension savings, which is creating pressure to work and save for longer to improve pay-out prospects; the demand for savings feeds back into more downward pressure on interest rates.

Data compiled by the Bank of England suggest that over the past 20 years demographic effects have exerted a larger downward pressure on the natural rate of interest than the slowing of global growth. This demographic effect should reverse when savers (workers) become spenders (retirees). However, we don't know when precisely that reversal might begin, because retirement is being delayed.

Growing phenomenon of elderly workers

Between 2006-16 the UK labour market participation rate for over-65s jumped to 10.4% from 6.6% – and this ratio is likely to rise further. Japan's labour market participation rate for the same group is 20%, and for men alone it is around 30%. In the US the participation rate for over-65s is around 20%. The elderly worker looks increasingly like a growing global phenomenon for advanced economies.

The conventional assumption that the switch from saver to spender occurs at 65 needs to be amended – we can only speculate on what the correct age assumption might now be. It could be that 75 is the new 65. Beyond the precise number, the trend of workers staying in jobs to an older age will sustain the downward pressure on the natural rate of interest.

A key issue with a falling natural rate is that nominal interest rate adjustments can become constrained by what used to be described as the zero lower bound. A further consequence is that this downward pressure on the natural rate of interest has accelerated the deployment of unconventional monetary policies.

Middle income earners criticise low interest rates, quantitative easing and other measures for punishing savers in the same way that they criticise the bail-out of failing banks and borrowers. This fuels popular resentment of the political elite.

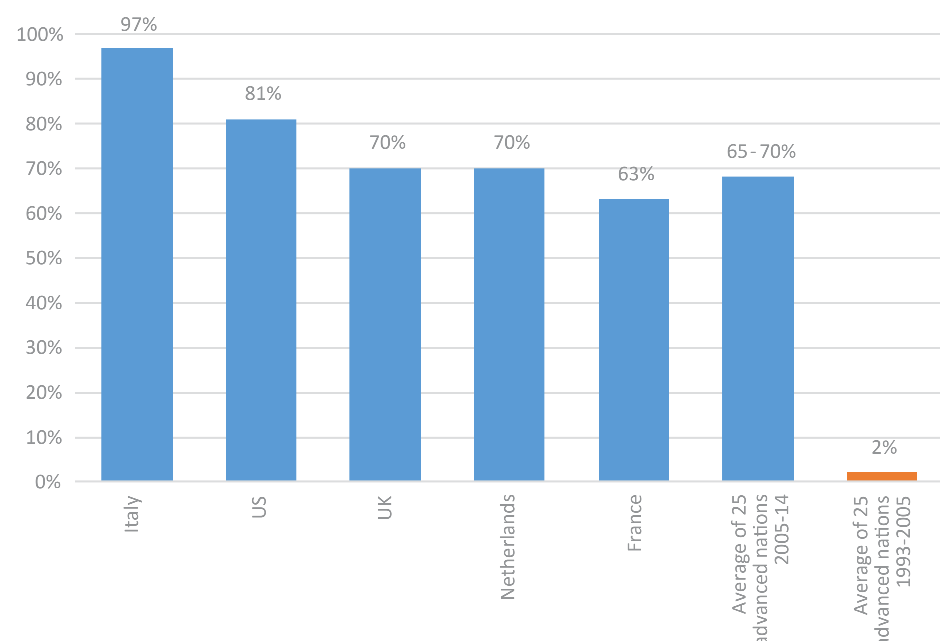
It is difficult to incorporate demographic effects into interest rate forecasts, but it is reasonable to argue that demography will be a structural factor weighing on the longer-term outlook for interest rates It may offset some of the potential for cyclically driven interest rate hikes by central banks.

Arguably, a low return world will prove difficult to leave behind, fuelling further the appetite for asset class diversification. Low growth, low interest rates, and poor prospects for improvement: the key elements that spawned the growth of political populism may prove durable. ■

Gary Smith is a Member of the Strategic Relationship Management Team, Sovereigns, at Barings.

Advanced economies experience deteriorating income growth

Share of population in groups with flat or falling market income, 2005-14, %



Source: McKinsey Global Institute, Barings

Model future for mobile banking

Interoperability essential to market growth

Mthuli Ncube, Quantum Global

For successful mobile banking systems, it is essential that everyone using them – customers, retailers, mobile network operators and financial institutions – feel they benefit.

Finding technology and business models that work for all parties is challenging because of the different objectives of those involved. Customers want convenience, easy access and fair pricing, while retailers are looking to improve customer service and attract new business by offering additional payment channels. Financial institutions and mobile network operators, too, aim to offer more options for making payments, and thus increase customer satisfaction.

Failure to meet any of these expectations may result in the collapse of the mobile banking business model. These partnerships often require parties to compete and work together simultaneously.

Models of co-operation

Mobile banking partnerships can follow a number of models with varying levels of co-operation. One model is 'light-touch' with minimal co-operation among providers such as banks, network operators and other businesses involved in digital payments services.

In models that are mobile phone-centred, network operators lead the mobile payments service, and there is minimal co-operation with banks and other parties. A further option is to have services that are bank-led, where there is minimal co-operation with network operators and other parties.

In yet another model – partial integration – banks and network operators have a high level of co-operation but there is little interaction between them and others providing digital payments services. The alternative to this is full-integration, where there is strong co-operation among all parties.

Regulatory implications

Under a functional approach to regulation of mobile banking, central banks have to maximise financial inclusion as well as focus on price stability, the growth of the network and payment system stability.

The regulator should adopt a risk-based approach to supporting financial inclusion. This is based on the risk that an activity poses to the individual participant and to the stability of the financial system. Equally, the regulator must find a balance between initial regulation, which defines the rules of the game, and intervention in response to the evolution of markets.

Regulators such as central banks and governments need to ensure that the environment is competitive and that monopolies are curtailed. Easy entry to and exit from the market should be encouraged. It is also important to develop the capacity for phone users of one telecommunication network to make calls and communicate with those of another.

Such interoperability is equally necessary in mobile banking, to ensure that users of one financial service's digital network can transact with those on another. This deepens the penetration of mobile money, lowers the cost of transactions, broadens customer choice, and encourages competition.

The GSM Association, the body that represents mobile operators worldwide, has been promoting interoperability across Africa and the Middle East. In April 2014, the association announced that nine mobile network operators in the two regions were to work together to accelerate the implementation of cross-network mobile money services. These operators have 582m mobile connections across 48 countries in Africa and the Middle East.

> ***"Barriers to expansion must be broken down if mobile networks are to continue transforming banking in emerging markets.***

Africa's first interoperability arrangement was announced in June 2014 when the telecommunications company Tigo, which has 6.2m customers in Tanzania and 3.4m users of its Tigo Pesa system, said it would be linking with rivals Airtel and Zantel. Interoperability was extended further last year when Vodacom, Tanzania's fourth mobile money provider, connected with Airtel and Zantel. This allows over 16m people to send money by mobile to each other in Tanzania, regardless of network. By contrast, in Uganda users of mobile money services are forced to use multiple mobile providers as the country has no interoperability.

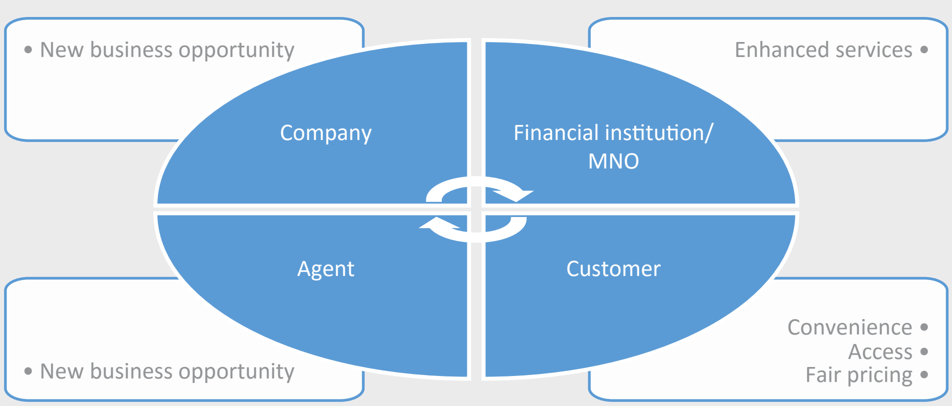
Equal access to infrastructure

The final aspect of regulation, and one that is critical to the success of mobile banking services, is that there should be equal access to infrastructure. This refers to the right of providers to access on identical terms the infrastructure that underpins their services.

For mobile network operators, such infrastructure includes telecommunications lines, fibre optic networks, the power grid, and water supply. For providers of digital financial services, the required infrastructure includes the telecommunication system, and network services for payment and settlement credit bureaux.

Both providers and regulators have important roles to play in breaking down barriers to expansion. That is the crucial condition for ensuring mobile networks continue to transform banking in emerging markets. ■

Architecture and partnership ecosystem for mobile banking



Source: Ncube (2016), African Economic Research Consortium

Mthuli Ncube is Visiting Professor at the University of Oxford, Head of Research at Quantum Global Group, and a Director of OMFIF.

Promising dawn for Latin America

Future is positive, but vulnerable to external risks

Carlos Giraldo, Latin American Reserve Fund

After two difficult starts to the year in 2015 and 2016, Latin America has experienced a promising dawn in 2017. External variables that most influence the Latin American economy are turning upwards, as are the region's economic growth expectations (Chart 1).

These indicators suggest that the worst of the past few years' external shocks has passed. All the same, we must recognise that uncertainties in the international environment still pose the greatest risk for a reversal of the continent's improving fundamentals.

A series of interconnected factors (Chart 2) supports the firmer tone for the region in early 2017. The outlook for 2017 and 2018 has improved for several advanced economies, including the US and China, linked to improved economic performance in the second half of 2016 and expectations of positive effects of stimulus policies.

External financing for Latin America

Latin America has significantly improved access to international financing in both quantity and cost terms in the past few months. This has reflected increased capital flows toward emerging economies, as illustrated by high-frequency indicators such as the capital flow tracker prepared by the Institute of International Finance. Latin American economies have managed to secure necessary external financing for various funding programmes in a timely manner.

Commodity prices have recovered in past months, especially for oil and metals, resulting from Chinese investment, US fiscal stimulus, and supply reductions among the main oil producers.

Latin American inflationary pressures have fallen, accompanied by signs of well-anchored inflation expectations in line with targets in most countries in the region. This has been a welcome change from past years' episodes of sharp currency depreciation and supply shocks – and has provided the regions' central banks with 'monetary space' to cut interest rates where necessary.

Risks for 2017

Despite these fundamentally positive ingredients in the 2017 economic scenario, we must be aware that the climate during 2017 may become less sunny if a range of external risks starts to materialise.

One important danger emanates from a possible hard landing of the Chinese economy. China is the main export market for several countries in the region, as well as the main public financing source for some economies. In 2016, Chinese loans approved to countries in the region equalled $21.2bn, compared with $4.8bn in 2008. So any Chinese downturn would hit Latin America.

Even though the greatest negative impact on the terms of trade for the region has passed, the commodity price recovery could start to fade, as a result of global factors affecting the supply and demand of raw materials.

Another potential problem comes from a possible acceleration in US Federal Reserve monetary policy tightening resulting from demand and price pressures in the US economy, tied to the expectations of President Donald Trump's stimulus measures. However, the base scenario remains a moderate increase in the federal fund rates, even in a scenario of aggregate demand stimulus.

Uncertainty over policy changes

A final dampener: the positive effect of increased US economic activity could be outweighed by uncertainty over possible changes in US trade and migration policies, particularly for Mexico and Central America.

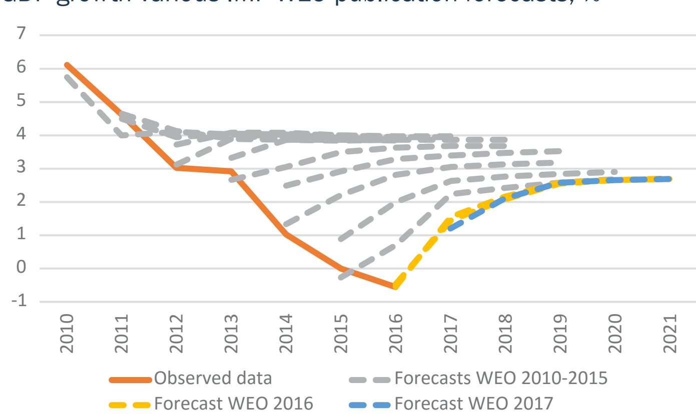
> ***"Latin American inflationary pressures have fallen, accompanied by signs of well-anchored inflation expectations in line with targets in most countries in the region.***

As a result of all these factors the position for Latin America is positive but not free from risks. The key to prolonging Latin America's promising dawn lies in vigilance as to the international environment – and willingness to take action where necessary to ward off any downturn that occurs for reasons beyond the region's control. ■

Carlos Giraldo is Director of Economic Studies at El Fondo Latinoamericano de Reservas. The opinions, interpretations and conclusions expressed in this article are those of the author and do not necessarily reflect the view of FLAR or its board of directors and assembly.

Chart 1. IMF projections historically optimistic

GDP growth various IMF WEO publication forecasts, %



Source: International Monetary Fund, OMFIF analysis

Chart 2. Financial conditions above long-term average

Financial conditions index, Dec 2009=100

Source: Bloomberg, JP Morgan, International Monetary Fund, FLAR-DEE Calculations

Wielding power in post-war West

Varoufakis: finance minister returns as historian

John Nugée

Yanis Varoufakis appeared abruptly on the political scene in early 2015 when he was plucked from academia to become Greece's finance minister. He subsequently became the protagonist in negotiations over the country's endless struggle for survival.

For five months he dominated the stage, and it is fair to say that the European Union has never seen a finance minister like him: a committed Marxist, a learned historian, and a passionate believer that the whole of Europe needed Athens to be offered a better deal on its debt.

And then he was gone. He will admit that he failed in his political aims. But Varoufakis clearly used his time as a minister to study his peers and think deeply about what was propelling Greece's, and Europe's, crisis. In this he was much more successful. His book, *And the Weak Suffer What They Must?*, is the result.

Disbelief and despair on austerity

The book is classic Varoufakis – nothing is simple or straightforward, and everyone always has ulterior motives for their actions. There is no sense of a linear timeline or a progression through history, as the book jumps between the pre-second world war era, the Bretton Woods era, and the last decade and a half of economic and monetary union.

There is much – perhaps more than the non-Greek reader really needs – on Greece's past, the influence of the civil war in the 1940s, and the consequences of the country's period of military rule between 1967-74.

The one thing there is not much of is analysis of the state of the Greek economy today after nearly seven years of enlightened guidance from EU powers. There is little on the practical effects of austerity on the long-suffering Greek people. Nor is there much thought on the role of democracy in the EU and how Greece, the cradle of democracy, finds that the will of its people is routinely ignored, if not flouted.

Perhaps Varoufakis feels that others have already written at length on how austerity, which was intended to make Greece lean and competitive, has merely emaciated and bankrupted the country. Maybe he feels the same about how the construction of the euro decrees that all the adjustments in the imbalances in the currency bloc have to be made by the weakest members.

Perhaps he assumes, having lived through it, that we do not need further descriptions of the impact on real people's lives of grandiose policies emanating from Berlin, Brussels and Frankfurt. These are excellent theories which

> ***"The book is classic Varoufakis – nothing is simple or straightforward, and everyone always has ulterior motives for their actions.***

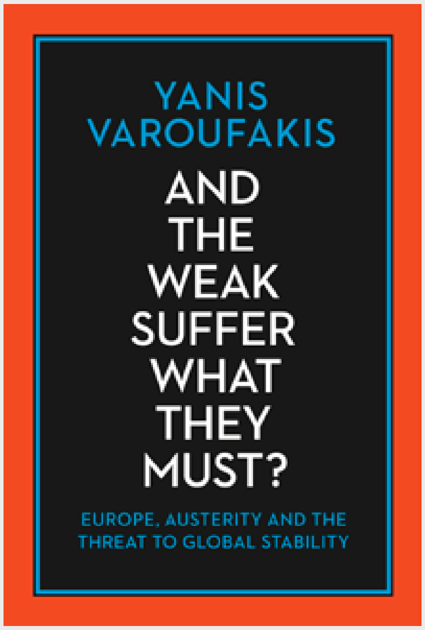
all have the main advantage that the people proposing them do not have to experience their effects.

Perhaps, like so many of his countrymen, Varoufakis has simply been angry for so long that the anger has turned to disbelief and despair.

Rescuing a bankrupt post-war Europe

And then things become clear. This is not a book about Greece and its debt problems, but a much deeper and wider-ranging treatise about the exercise of power in the reconstruction of the post-second world war West.

The book is about the challenges that the US faced in rescuing a bankrupt Europe and holding the USSR at bay; the choices that the US, Germany and France made in the 1950s and 1960s as the EU began to take shape; and America's struggles to persuade surplus nations to recycle their savings.

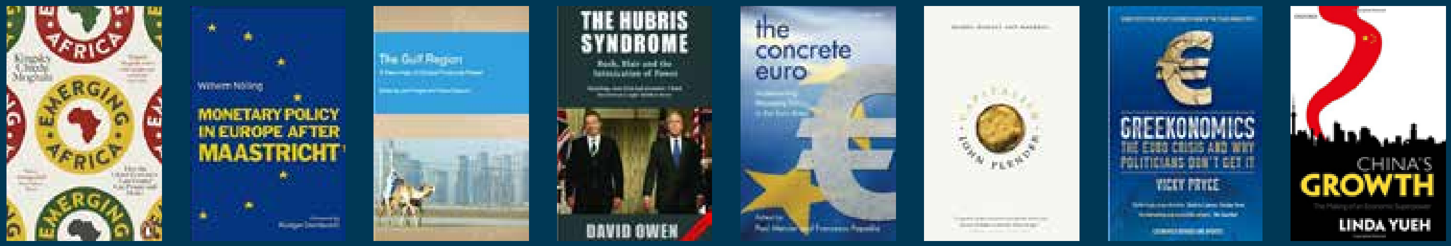


> ***"This is not a book about Greece and its debt problems, but a deeper and wider-ranging treatise about the exercise of power in the reconstruction of the post-second world war West.***

Varoufakis the finance minister came and went in five short months. He achieved little for his country while in office and left nothing as a political legacy. Varoufakis the historian, the Marxist, the writer, has resurfaced.

This book offers a fascinating insight into how he sees history and his explanations for how, 70 years after the second world war ended, the spectre of division and national antagonism is again stalking Europe. ■

John Nugée is a Director of OMFIF and a former Chief Manager of Reserves at the Bank of England.



Idealist and pragmatist seeking reform

End of the Greek party: two ministers, two accounts

Danae Kyriakopoulou

George Papaconstantinou and Yanis Varoufakis have a lot in common. Both are economists educated at Anglo-Saxon universities, and were born in the same year, in the same city. Both served as finance ministers for Greece, the first in 2009-11, the second in 2015, during an extraordinarily turbulent period. Yet they differ greatly in their account of the Greek crisis as narrated in their respective books.

Game Over takes us back to 2009, when Papaconstantinou began administering the Greek economy as finance minister. The title sets the scene: It is a direct quote from an exasperated Jean-Claude Juncker – then prime minister of Luxembourg and Eurogroup head – in response to the continuous 'revisions' of Greek statistics, which revealed the circumstances under which Papaconstantinou took office. For years, the country had been living beyond its means but had done a good job (with Europe's help) of covering up the resulting huge debt pile.

The author does not spend much time on the causes: a flawed common currency that created the wrong incentives, weak institutions that gave rise to profligate governments, and the pressure on northern European banks to lend. He probably did not have the time to do so in office either – the narrative unfolds quickly, with revelations of new statistics revisions, strikes and demonstrations, and Eurogroup meetings adding pressure for one difficult decision after another.

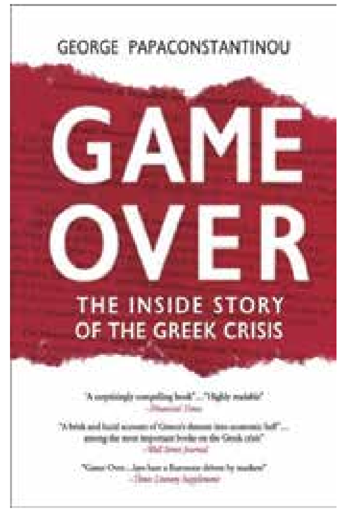
Irrespective of the causes, his mandate was clear: this was the time for hard work and reforms. Reforms that, according to Papaconstantinou – and many Greeks, including this reviewer – should have been implemented years ago. At the pace implemented, the reforms were painful: the economy shrank by a quarter, and with it went the minister and his party, reduced from dominant half in Greece's former two-party system to the fourth party in the last election of September 2015, behind even neo-Nazi Golden Dawn.

'I was the one who turned the lights on and told everyone the party was over – nobody likes that guy,' writes Papaconstantinou. He recalls being asked by a journalist, 'How does it feel to be Greece's most hated man?'

Flawed foundations

His reaction – 'the question had never occurred to me' – is characteristic of his attitude and the environment in which he operated: the harsh realisation that there was no alternative and a sense of commitment to doing the right thing given the circumstances.

In *And The Weak Suffer What They Must?*, Varoufakis, who became Greece's finance minister in the radical-left Syriza-led government in 2015, takes issue with the premise of 'given the circumstances'.



> ***"Leaders do not respond to the circumstances; they shape them.***

His grandiloquent volume is about much more than Greece. 'Borders are scars on the planet' for Varoufakis. The real struggle is not between one country and another, between 'Calvinist ants and Mediterranean grasshoppers', but between the world's weak and the powers that be. He maintains that the Greek rescue programme 'was not a bail-out'. It was a convenient way to transfer losses from over-exposed French and German banks to European taxpayers via the Greek state.

Leaders do not respond to the circumstances; they shape them. 'A smart eight-year-old would have seen that such a bail-out could not end well,' he writes, implying that Papaconstantinou should have tried harder for a better deal. A 2010 report by Olivier Blanchard, then chief economist of the International Monetary Fund, was leaked in February revealing that the fund's economists had been sceptical about the bail-out.

The benefit of hindsight is powerful, but the lack of counterfactuals makes its application dangerous as well as misleading. Varoufakis's mantra is that leaders shape their times. That may well be true but, as he and the Syriza government showed, they don't always shape them for the better when they try.

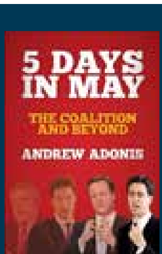
Balance in actions and ideals

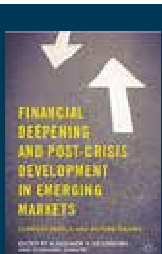
Seven years and eight finance ministers later, the Greek crisis lingers. The books are recommended for anyone seeking insight into what got us here, as well as a glimpse into two individuals' attempts to respond.

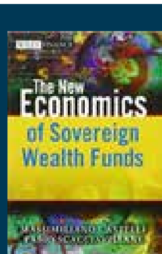
Read together, they highlight the complementarity of their authors' approaches. A pragmatic attitude and a spirit of 'getting on with the job' are essential for implementing reforms. Diplomacy, patience, and respect towards established institutions help with winning the confidence and support of markets. But, for many Greeks and other Europeans, there also needs to be a vision, a commitment to being part of a community that can offer a better answer than 'there is no alternative'.

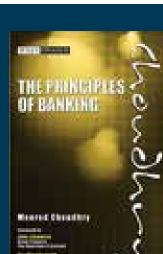
As Raphael's fresco The School of Athens beautifully depicts, idealism and pragmatism go side by side. In the former ministers' birthplace, modern-day politicians need to strike a balance between the two. ■

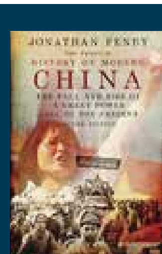
Danae Kyriakopoulou is Head of Research at OMFIF.

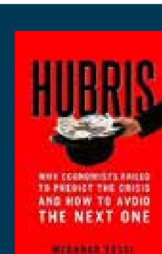












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Hans Genberg, The SEACEN Centre
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Hans-Olaf Henkel, University of Mannheim
Mumtaz Khan, Middle East & Asia Capital Partners
Joel Kibazo, JK Associates
Jürgen Krönig, Die Zeit
Oscar Lewisohn, Soditic
Boyd McCleary, 39 Essex Chambers
Luiz Eduardo Melin, International Economic Synergies
Willem Middelkoop, Commodity Discovery Fund
Célestin Monga, African Development Bank
Danny Quah, Lee Kuan Yew School of Public Policy
David Smith, formerly United Nations
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Hans Eichel, former German Minister of Finance
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Thomas Kielinger, Die Welt
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Christopher Tugendhat, House of Lords
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Linda Yueh, St Edmund Hall, Oxford

Financial mastery and flawed theory

A man who couldn't let go of Randian fundamentalism

Meghnad Desai, Advisory Council

Sebastian Mallaby's biography of Alan Greenspan is a massive book: vast in its ambitions, scholarly in its research, and deserving of the many honours it has garnered.

Mallaby has written the history of monetary theory and policy-making of the past 50 years with an enviable eye for contemporary politics. This is an intellectual history but a social history, too, tracing the rise of an immigrant family in two generations.

The Man Who Knew: The Life and Times of Alan Greenspan contains a detailed account of Greenspan's lengthy tenure as chair of the US Federal Reserve. It also deals with the sad interlude in which his reputation was destroyed after his retirement by the 2008 financial crash.

His faith in the theory that free markets would always correct themselves and that regulation was therefore unnecessary turned out to be seriously misguided.

Market competition for a sound economy

Mallaby's account of the rising importance of monetary theory and policy in the US begins in the 1950s with a few robust intellectuals like Milton Friedman, winner of the 1976

> ***"Mallaby spells out Greenspan's mistaken belief as an advocate of free markets that stock market bubbles cannot be curbed, and that policy-makers cannot, and ought not, interfere.***

Nobel prize for economics, who was chief among those who ignored economic fashions and stuck to their beliefs.

Greenspan started out as a good student of Arthur Burns, Fed chair between 1970-78, who had pioneered detailed measurement of the microeconomic industrial and commercial data to monitor macroeconomic movements.

Greenspan was always a political conservative, but the influence of the philosopher Ayn Rand gave him a faith. He became a libertarian and took market

> ***"Greenspan knew that markets were not always vigilant against excesses, but he could not admit it to himself or base his policy on the likelihood of markets being wrong.***

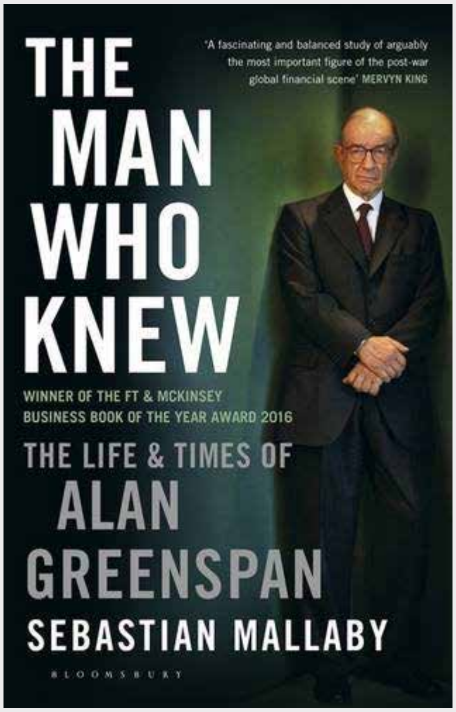
competition as the basis for a sound economy. From that point on there was always tension between the man who looked at data and the faithful libertarian. He often let his faith overcome the warnings from data.

Mallaby traces Greenspan's climb to become a global financial master through his involvement in the back rooms of the Republican party. He showed sound instincts as a reader of political currents, but his well-known insistence on hard monetarism often got in the way when it came to high office.

Maintaining mistaken beliefs

Regardless, Greenspan did get to the top of the Fed and stayed there under four US presidents. At this point, Mallaby spells out Greenspan's mistaken belief as an advocate of free markets that stock market bubbles cannot be curbed, and that policy-makers cannot, and ought not, interfere.

There is a similar refusal on Greenspan's part to see that controlling inflation is insufficient. Financial stability is a different problem. Even with low inflation, it is possible



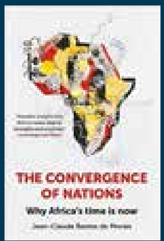
for markets to go berserk as they did – to Greenspan's regret.

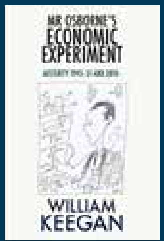
He could not let go of his Randian fundamentalism until the very end of his career. He knew that markets were not always vigilant against excesses, but he could not admit it to himself or base his policy on the likelihood of markets being wrong.

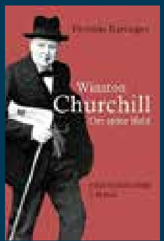
In *The Man Who Knew*, Mallaby covers the debate among the economists and the policy-makers. He has waded through an enormous amount of literature to capture the mood as well as the gritty details of what has been happening in the US since the early-1950s.

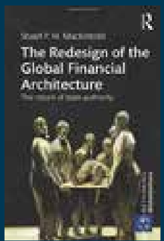
This is an indispensable book if you want to know how we got to where we are. There is a lot more than just Greenspan. It is a history of our times. ■

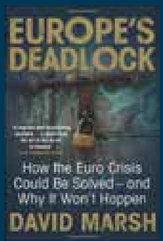
Lord (Meghnad) Desai is Emeritus Professor of Economics at the London School of Economics and Political Science.









Narrow majority expects ‘acceptable’ EU deal

Tough talking: 53% of advisers expect result acceptable to both

This month’s advisers network poll focused on the possible outcomes of the UK government’s formal notification to leave the European Union. Members of the advisers network were asked: ‘As Theresa May triggers Article 50, what are your expectations for the result of the UK’s negotiations with the EU over the coming two years?’ The four choices were: a deal acceptable to both the UK and EU27; a deal acceptable only to the UK; a deal acceptable only to the EU27; and a deal acceptable to none.

David Davis, the UK’s secretary of state for exiting the EU, said, ‘The government is clear in its aims: a deal that works for every nation and region of the UK and indeed for all of Europe – a new, positive partnership between the UK and our friends and allies in the EU.’

But the exit process is haphazard and the rules contained in Article 50 are brief. The government expects to secure a positive outcome but acknowledges the possibility of no formal agreement at the end of the two years. The prime minister has stated, ‘No deal is better than a bad deal.’

Of those polled, 53% believe a deal acceptable to both the UK and EU27 will be achieved; 44% expect to see a deal acceptable to none; and 3% presume a deal acceptable only to the EU27 will be the outcome. None expects a deal acceptable only to the UK.

‘I believe that a deal acceptable to both the UK and the EU will be achieved. There is lots of chest-beating before negotiations, but something as important as this is doomed to succeed.’
John Kornblum

‘It is impossible that 27 countries will agree on a deal which favours the UK. It is most probable that the negotiations will never end because to forge a consensus among 27 countries is a Sisyphean task, especially on controversial issues.’
Fabio Scacciavillani

‘In my opinion both sides will come to the conclusion that a velvet divorce is the only way out of the mess in which we find ourselves. The multitude of crises may even help to bring home to the actors on both sides what is really at stake in a world out of joint.’
Michael Stürmer

‘In the time available it will not be possible to get any deal that delivers a clean break for the UK from the EU which all sides will be happy with. The only question is what sort of fudge will be acceptable to both in order to prolong the negotiations beyond the two-year timetable of Article 50.’
Stewart Fleming

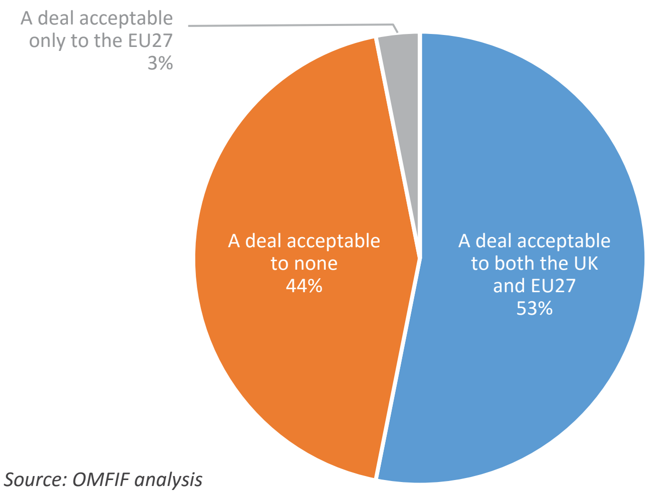
‘The EU is faced with such strong anti-EU sentiments that the leader of each member state is struggling to re-establish the case for the union. In these circumstances, I am afraid there is little room for concession on either the UK or EU side on, for example, immigration and fiscal-burden sharing.’
Akinari Horii

‘I think a deal acceptable to neither is probable. Recent comments from EU Commission, Council leaders and heads of individual continental governments like France, have strongly evidenced that a desire to punish the UK is their priority.’
Jack Wigglesworth

These statements were received as part of the March poll, conducted between 6-20 March, with responses from 32 advisory network members.

Small majority expects mutually acceptable deal

Percentage of responses



Source: OMFIF analysis

As Theresa May triggers Article 50, what are your expectations for the results of the UK’s negotiations with the EU over the coming two years?

‘The UK government and the EU sound like two age-old friends turned foe, now speaking different languages, one Latin, the other Greek. The result is a dialogue of the deaf.’
David Smith

‘I do not expect any deal to be achieved, so find it very difficult to choose an option. There are 27 EU members wielding a veto, which is too many to reach a compromise.’
Miroslav Singer

May’s question

Will Donald Trump be impeached before his presidential term ends?

- **Yes, in the first half of his presidency.**
- **Yes, in the second half of his presidency.**
- **No**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