OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

May 2013

German riddle over lucky Lucke

New party should spell out what it wants to do

Meghnad Desai, Chairman, Advisory Board

Prof. Bernd Lucke of Hamburg university has founded the Alternative für Deutschland (AfD) party just in time for Germany's September elections. His aim is to prise open the stifled debate about the euro's future.

His party hopes to get the minimum 5% of votes required to win seats in the Bundestag. It's more likely he will not pass the 5% hurdle, but will divert votes away, all the same, from Angela Merkel's Christian Democrats.

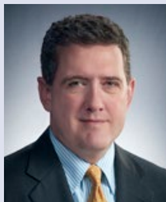
So, win or lose, the professor is making waves. The question is: Will Lucke get lucky?

Prof. Lucke is wary of spelling out how he sees the euro system being reformed, renewed or reneged upon. He sees the tensions within the system: northern versus southern Europe, German taxpayers against the rest, difficulties of a preannounced exit becoming a rout etc.

Yet in dwelling on the euro's future, he has not spelt out the transition dynamics from here to there. Like any good night club stripper, he thinks his strength is in keeping people guessing and teasing them without revealing too much. Thus he says he favours 'gradual phasing out and replacement of the euro'. He also proposes 'a controlled exit for Germany from the euro phased out over a number of years'. Finally he expresses the hope that, while Merkel could adopt his alternative solution, she should take care that the 'information is subtly and carefully released' to contain 'the risk of volatile financial markets.'

Lucke is a professional economist, but it seems that either he is too coy to reveal his real intentions, or, worse, that he is naive enough to believe what he tells us. Exit from the euro can never be gradual, any more than you can leap across a chasm in two steps.

(continued on page 14...)



St. Louis hawk Bullard flies low in reaction to dip in US inflation

Darrell Delamaide, US Editor

James Bullard describes himself as an inflation hawk in the tradition of the regional Federal Reserve Bank he heads in St. Louis, but he is worried now that inflation, running at 1.3% year-on-year on the price index used by the Fed, is too low. 'I'm actually a bit concerned that it's low and been moving lower,' Bullard told the OMFIF Bulletin in a wide-ranging interview. **SEE ARTICLES ON P. 3, 18-23**

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Retreat from bonds

Fixed income turbulence

Special correspondent

Public sector asset managers are increasingly examining a retreat from bonds in reaction to plummeting yields on benchmark fixed income assets and worries about a sharp fall in prices once interest rates normalise.

A search for alternative sources of return combined with the traditional priorities of safety and yield was a highlight of the First Annual OMFIF-ASEAN+3 Reserve Management Seminar held with Bank Indonesia and other Asian central banks in London on 25 April.

A major topic of the seminar exchanges was the desire for higher yields through emerging market debt. One manager said he was actively advising reserve-holders to buy equities to lower risk. Many central banks around the world, including in developed countries, are looking to build up stocks of renminbi bonds as reserve assets in a diversification excercise.

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Three-speed march

Credit easing still the watchword

David Marsh, Chairman

The May edition of the OMFIF Bulletin, with articles by 11 Advisory Board members, pays ample regard to the three-speed pace of the world economy. Europe is stuck in recession, the US is picking up speed but still beset by doubts, and the emerging market economies are registering a reduced but steady performance.

Pride of place goes to a wide-ranging interview with James Bullard by our US editor Darrell Delamaide in which a self-confident St. Louis Federal Reserve president spans a wide selection of topics from the US economy and the leadership style of Fed chairman Ben Bernanke through to Europe and China.

In addition, Delamaide gives us his usual monthly summary of Fed developments, where many US economy watchers now join Bullard in believing that quantitative easing is now less likely to taper off. Gabriel Stein analyses continuing credit easing by the world's leading central banks.

Despite the slowdown in China, Asia is still showing considerable signs of life. Hon Cheung surveys how countries across the continent are trying to overcome fragmentation of financial markets. Trevor Greetham dwells on the hitherto positive results of Abenomics in Japan.

Darmin Nasution, Governor of Bank Indonesia, writes on challenges for reserve asset managers in the region and beyond, stemming from the low yield environment for most fixed income benchmark assets – a key theme of the First Annual OMFIF-ASEAN+3 Reserve Management Seminar in London in April.

We report on the overall impact this is having not just on central banks but also on sovereign funds. Among central banks, there seems to be a new interest in fixed income products from more exotic jurisdictions, including demand for renminbi assets. Gary Smith and Pooma Kimis contribute their thoughts on sovereign funds' move into property assets, which they say is more than just a fashionable change in behaviour, but heralds a long-term trend.

Europe provides more food for thought. Meghnad Desai recommends Germany's new anti-euro party to be more transparent in its prescriptions. Robert Bischof and Denis MacShane provide contrasting views on the damage to confidence after the Cyprus imbroglio. Stefan Bielmeier asks why European Central Bank credit easing isn't feeding through to the real economy.

Still more searching questions require answers. Colin Robertson points to anomalies in gauging the underlying rate of inflation priced into bond markets. John Kornblum gloomily states that the American and Europeans have lost the art of knowing how to talk to each other.

William Keegan ponders the statistical pitfalls that have befallen the American academic duo Kenneth Rogoff and Carmen Reinhart, comparing this with egregious post-war errors committed by Keynes' most ardent followers.

This is a just the kind of historical perspective that readers require in attempting to deduce whether the world economic situation will get worse before it gets better. The answer is, of course, that we don't know, but we will find out in due course.

David Marsh

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Bullish on US, vexed about Europe

Bullard points to possible ECB bond politicisation

Darrell Delamaide, US Editor

James Bullard, president of the Federal Reserve Bank St. Louis, expresses optimism about US economic growth this year, along with slow and steady improvement in employment. But he is less optimistic about Europe. Above all, he is concerned that the European Central Bank's focus on Outright Monetary Transactions, as apparently its prime method for shoring up the euro area, risks politicising central banks by involving them in matters which are better left to elected officials in a democracy.

'The ECB has not really reacted to the recession all that much,' Bullard said.

Bullard believes the contingency plan, highly controversial in Germany, for possibly purchasing weaker countries' sovereign debt has kept the ECB from implementing the unconventional measures that enabled the Fed to stabilise the economy in the US.

In the best traditions of St. Louis, Bullard says he's a hawk on price rises. So his statement that inflation, running at 1.3% year-on-year on Fed's personal consumption expenditures price index, is too low is an eye-opener. 'I'm actually a bit concerned that it's low and has been moving lower,' Bullard told the OMFIF Bulletin. 'I'm predicting it will turn around and move back toward 2% this year, but I'd like to see that happen. If it continues to go lower I'd be more concerned about it.'

Speaking before the ECB lowered its benchmark interest rate by 0.25 percentage points to 0.5% on 2 May, Bullard made plain that we would prefer to see more action from Europe to get the economy moving. 'The ECB has not really reacted to the recession all that much – no rate cut, no QE, no forward guidance,' Bullard said. 'OMT has distracted everybody so much that they decided they weren't going to do any of these other unconventional monetary policies.'

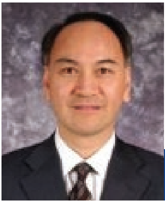
As president of the St. Louis Fed, Bullard takes part in the deliberations of the Federal Open Market Committee, which sets US monetary policy. This year he is one of regional bank chiefs who get to vote on policy on a rotating basis. Though he has been at the helm of the St. Louis bank only since 2008, Bullard, a native of Minnesota, has been on staff there since 1990. 'I've been in the Fed longer than most of these other people, even Chairman Bernanke or some of the other people,' Bullard said. 'I enjoy it; I like the intellectual challenge. The intellectual challenge has been outstanding in the last five years because the world has been upside down.'

Bullard earned a doctorate in economics from Indiana University and has published scholarly papers in many professional journals. He is active on the conference circuit and has participated in more than 150 conferences, symposia and lectures around the world.

It is not unusual for presidents of the Fed regional banks to come out of the economic research departments, but it is rare for someone to join a bank straight out of graduate school and work their way up through the ranks. Bullard's predecessor, William Poole, had been an economist at the Board of Governors in Washington and a professor at Brown University before beginning his 10-year tenure at St. Louis in 1998.

Bullard, who generally aligns with the consensus in the Bernanke Fed, is seen as occupying the middle ground on the FOMC and is something of a weather vane for which way the policy winds are blowing. While sticking to St. Louis hawkish tradition, he has been more pragmatic than Poole. Now a senior fellow at the conservative Cato Institute, Poole has been quite critical of the Fed's unconventional measures under Bernanke.

During the interview in an April visit to Washington, Bullard spoke on US monetary policy and economic prospects, on the euro crisis and on global monetary developments. He also commented on how Chairman Ben Bernanke runs a different Fed than Alan Greenspan and where the ECB has gone wrong. **SEE REST OF BULLARD ARTICLE ON P.18-22.**



Overcoming fragmented markets

Asia accelerates efforts for more integration

Hon Cheung, Advisory Board

In much of the western world, the key concern is the maintenance and overhaul of fragile financial systems. In contrast, the pressing issue in Asia is to buttress the considerable advances in the build-up of financial markets by enhancing regional financial integration and collaboration.

Asia has avoided the worst effects of the global financial crisis, but it now faces the challenge of overcoming the relatively fragmented state of its financial markets.

While the concept of monetary union in Europe is under severe strain, the foundation of the European common market – the single market – continues to be an unqualified success. In the single European financial market, the process of transferring capital from European savers, through European intermediaries, into European capital markets and, ultimately into the hands of those requiring capital seems relatively seamless, efficient and unimpaired. In contrast, a picture of this process in Asia would be highly fragmented with significant barriers to cross-border activity.

The cross-border barriers that exist in Asian financial markets create many inefficiencies, for example:

- Local savers have access mainly to products offered in their own local markets – this reduced competition pushes up the cost for consumers of financial services.
- Asian barriers for cross border retail intermediation act as an incentive for using non-Asian intermediation devices. An example of this is provided by the European UCITS funds that are widely used across Asia due to their broad acceptance by regulators in the region.
- Inefficient intermediation also restricts investors' product choice – basically, local intermediaries will tend to be expert in their domestic markets, but access regional markets more inefficiently. This flies in the face of investment diversification.
- Borrowers also face similar cross-border issues – they mainly have access to their domestic markets.
- In turn, this limited cross-border access to regional markets forces borrowers to look into more liquid, scalable markets. In particular, it encourages borrowing of dollars – why should we be surprised that the Asian local currency corporate bond markets have yet to expand significantly?
- Finally, to add insult to injury, involuntary extra-territorial regulations also create additional overheads that act as a disincentive to participating in cross- border activity.

The global financial crisis has shown that this fragmentation of Asia's financial markets is a potential weakness. The reliance on developed markets as a way to offset and act as a buffer to regional capital flows is no longer a panacea.

Asia needs to encourage cross-border investing, and developed economies will also benefit if, as a result, global capital imbalances begin to reach a sustainable equilibrium.

The good news is that Asian policy makers recognise these threats and, ever since the 1997 Asian financial crisis, have gone to great efforts to address the underlying issues.

The global financial crisis has shown that this fragmentation of Asia's financial markets is a potential weakness. The reliance on developed markets as a way to offset and act as a buffer to regional capital flows is no longer a panacea.

Various fora have been created to facilitate market integration under the auspices of Asia's leading players: Association of Southeast Asian Nations (ASEAN) and ASEAN+3; Asian Development Bank; the 11 leading central banks in the region under the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) grouping; Asia-Pacific Economic Cooperation (APEC) and the APEC Business Advisory Council. However, more can be done, and ideas continue to be discussed on further improvements.

Asia's financial market development is not an end but a means: financial markets exist to ensure that Asia's schools, roads and other infrastructure needs can be financed, and that real trade can be settled and hedged effectively.

For example, in the area of cross-border intermediation, discussions are under way to permit the sale of collective investment schemes across ASEAN by 2015, and an Asia Region Funds Passport (ARFP) is being pursued within the broader APEC group.

In the area of cross-border access by borrowers, the ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) currently under discussion will allow for a system of mutual recognition by market regulators to allow local currency bonds issued in a home jurisdiction to be offered in another host jurisdiction.

In the area of extra-territorial regulatory impact a proposal is underway to create an Asia-Pacific Financial Forum (APFF) that can provide a single, louder regional voice.

There are challenges to market integration. First and foremost is the plethora of different fora and initiatives across the region – this increases the risk of unnecessary duplication. A list of the different groups in the Asia-Pacific looking into regional market integration would include the following:

- Various initiatives under the ASEAN and ASEAN+3
- Asian Bond Markets Initiative (ABMI) under ASEAN+3 and ADB
- APEC
- Pacific Economic Cooperation Council (PECC)
- The 11 EMEAP countries
- Financial Stability Board (FSB) Asia Pacific Committee
- International Organisation of Securities Commissions (IOSCO) Asia-Pacific Committee

This clearly implies that there is a need for coordination and collaboration among the different initiatives to ensure efficient development of the programmes.

Another potential challenge to market integration is the need for mutual recognition among the region's regulators – this was the common prerequisite for the ASEAN Collective Investment Scheme and the ARFP funds passport programme, as well as the ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) and the recently announced China and Hong Kong collective funds initiative.

The reason why mutual recognition has proven intractable in the past is the sheer diversity of Asia's economies; by any measure – GDP per capita, credit rating, market size, savings rates – Asia represents a huge variety that makes European markets seem absolutely uniform.

Creating a system of mutual recognition is by no means easy, but can no longer be put off. Asian economies have already done much to improve the integrity of their domestic markets through the development of financial regulation and market infrastructure. Mutual recognition between markets is now required to lock in cross-border regional investing.

In summary, the objective of greater financial integration in Asia is challenging but not infeasible and new initiatives are underway, particularly in the area of mutual recognition, that will build on previous achievements.

At its core, Asia's financial market development is not an end but a means: financial markets exist to ensure that Asia's schools, roads and other infrastructure needs can be financed, and that real trade can be settled and hedged effectively. Perhaps this is the most important lesson to be learned from Asia's market development programme.

Stronger in the long run

US, emerging markets will steer Europe from doldrums

Robert Bischof, Advisory Board

The euro will do more than simply survive. It will emerge stronger from a crisis it did not cause but which has shone a light on its latent weaknesses. These are being dealt with patiently and effectively – although too slowly for many Anglo-Saxon observers.

The crisis had many causes. Around the world, they include indebted governments as well as private households and over-leveraged corporates, supplied by greedy banks and bankers, and ever-growing inequality in national economies and globally.

The decision by 17 countries in Europe to have a unified currency had little to do with this, although with hindsight the European Central Bank could have acted earlier to dampen the boom. The ECB's remit, however, like that of the Bundesbank, was to watch over inflation. It fulfilled its mandate of keeping annual price rises just below 2%. Actually, that wasn't that difficult. Nobody noticed that the old inflation dragon was already dead, slain by globalisation.

Wages were static and many jobs disappeared to the emerging markets. To avoid deflation arising from lack of demand, a doctrine which might be called the Greenspan/ Wall Street model began to dominate the last decade before the crash of 2008. The basic principle was to counter the missing wage rises necessary for growth by increasing credit for the masses in the form of higher lending limits, more credit cards and ever-increasing mortgages. This kept demand up and provided the feel-good factor to win elections.

Gordon Brown's famous words 'no more booms and busts' provided the perfect epitaph for this fantasy. However, the crisis created a new dragon, seemingly worse than the old one, namely debt – in public and private households alike. While governments were still in reasonable shape before the crash, the rescue of the banking sector added colossal new debt burdens.

Particularly in the US, UK, some southern European countries and Ireland, the situation got out of hand through the combination of public and private household debt. Whether countries were in or out of the euro made no difference. Banks failed particularly spectacularly in the Anglo-Saxon world, where borrowing is more culturally ingrained. The UK outside and Spain and Ireland inside the euro area all finished up in the same mess.

Banks failed particularly spectacularly in the Anglo-Saxon world, where borrowing is more culturally ingrained.

Both the euro-ins and outs have to take the same medicine. Their citizens and governments have to learn again how to live within their own means and deleverage. This is a long and painful adjustment. There are no silver bullets or deep German pockets to change that process. Lean years follow the good years as night follows day. Some say the British benefited from being outside the euro, allowing them to devalue. This led immediately to imported inflation and an erosion of internal purchasing power. It didn't help exports one iota. The trade balance got worse. As for the 'one size fits all' argument regarding interest rates, it is equally irrelevant. We no longer have national business cycles, but world business cycles. So interest rates are low everywhere. They will stay that way for some time.

National economies can no longer blaze their own trails. They are tied into the global cycle. They have to become competitive, in a niche area, if necessary. The answer is to learn to live within your means, lower your costs and work for less or increase productivity.

Europe led by Germany can emerge strengthened, as it can export itself out of trouble with the BRICS countries playing a key role. The US, too, will provide a good market, with growth buoyed by the Fed's printing presses and trillion dollar deficits. Demand from emerging markets and the Americans will help Europe's high tech companies overcome the recession and make the euro attractive for newcomers like Poland and the Baltic states.

Freudian transference by French

Attacking Germany won't create French jobs

Denis MacShane, Advisory Board

The French Socialist Party has launched a bizarre broadside against Germany. In a draft resolution ahead of a party conference, the party directed an attack on Chancellor Angela Merkel with an accusation that she is personally responsible for Europe's austerity malaise. Waiting for Germany to provide the answers to Europe's collective economic misery, like Waiting for Godot, is simply Freudian transference – finding anyone other than oneself to blame for economic difficulties.

Blaming the German chancellor for the failure of the French economy is not adult politics. And it won't create French jobs. New pro-growth reformism is now a priority for the intelligent left as well as the centre-right.

There is a wider, politically-driven European problem. The austerity ideology that dominates Europe is the product of conventional thinkers who run most European governments and control the European Commission, the Council of Ministers, and the European Parliament. The conservative-liberal and centre-right dominant ideology put into operation by politicians who grew up in the early days of globalisation and worshipped at the Alan Greenspan shrine of deregulated debt-driven growth no longer works.

No one appears to have an alternative apart from blaming the euro or calling for EU withdrawal. The centre-left has its own worried electorate who reject reforms that challenge public sector, labour market and welfare state provisions. In France, President François Hollande and his smarter ministers like Pierre Moscovici and Michel Sapin know this. But they remember the fate of former Chancellor Gerhard Schröder who lost to Merkel in 2005 when his reforms hit voters hard.

It is true that Germany rebounded more strongly than most after the 2008-09 recession. But German growth has slowed markedly. Average real wages in Germany have stagnated since 2000. German media have highlighted a finding from the European Central Bank that, in terms of household wealth, Cypriots and Spaniards are richer than Germans. This is a false statistic based on higher levels of home ownership in southern Europe than in Germany, where renting an apartment is the norm. Wages, pensions, and healthcare access are better in Germany but German TV is dominated by demands that Germans should send no more tax money to Cyprus.

Jean-Claude Juncker, the savvy Luxembourg prime minister, once remarked 'Every leader in Europe knows what to do. They just don't know how to get re-elected once they've done it.' Schröder did what was needed by loosening the labour market, and launching the conditions for an effective pay freeze for industrial workers. It was great for German capitalism – but spelled disaster for the social democratic-led government.

Merkel doesn't want to make the same mistake ahead of the German election in September. Telling her core electoral base, the German Mittelstand of small and medium firms, that they should boost demand by increasing wages is the same as telling them to cut profits. An Obama- or Clinton-style economic renaissance based on importing millions of low-paid immigrants or fracking beneath American soil to produce gas and oil will not work in Germany. The country is getting older. It is happy to rely on Russian energy to keep the old people's homes warm in years to come. Gemütlich, cosy Germany simply wants to avoid experiments and be left alone to export Mercedes and Porsches to the rest of the world.

The country is getting older. Gemütlich, cosy Germany simply wants to avoid experiments and be left alone to export Mercedes and Porsches to the rest of the world.

No British prime minister or French president ever thanked the Germans for the personal sacrifices and hard work needed to overcome the division of West and East Germany. It Is hardly likely that the rest of Europe can keep asking German taxpayers to pay for the serial mismanagement and lack of government supervision of banks and financial institutions in other EU member states.

Governments feel the pressure

Consolidation efforts are weighing on the economy

Michael Holstein, DZ Bank

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
US	1.8	2.2	2.0	3.0
Japan	-0.5	2.0	1.7	1.6
China	9.3	7.8	8.0	8.5
Euro area	1.5	-0.5	-0.5	1.1
Germany	3.0	0.7	0.4	2.2
France	1.7	0.0	-0.2	0.8
Italy	0.5	-2.4	-1.2	0.4
Spain	0.4	-1.4	-1.9	0.9
UK	1.0	0.3	0.6	1.4
Addendum				
Asia excl. Japan	7.3	5.7	6.6	7.2
World	3.7	2.8	3.0	3.9
Consumer prices (% y/y)				
US	3.2	2.1	2.1	2.7
Japan	-0.3	0.0	-0.1	1.5
China	5.4	2.7	3.0	4.0
Euro area	2.7	2.5	1.8	2.0
Germany	2.5	2.1	1.9	2.4
France	2.3	2.2	1.4	1.8
Italy	2.9	3.3	1.9	2.0
Spain	3.1	2.4	2.2	1.7
UK	4.5	2.8	2.6	2.7
Current account balance (% of GDP)				
US	-3.1	-3.0	-2.9	-3.0
Japan	2.0	1.0	1.1	1.5
China	2.8	2.6	2.4	2.1
Euro area	0.1	1.4	1.9	2.1
Germany	5.6	6.3	6.0	5.6
France	-2.6	-1.9	-1.7	-1.8
Italy	-3.3	-0.7	0.0	0.5
Spain	-3.7	-0.8	1.0	2.0
UK	-1.4	-3.7	-3.1	-2.3

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The economic situation in the euro area's southern periphery has continued to worsen over the last few months. The plight of the labour markets in these countries is becoming ever more desperate. Spain's jobless rate now stands at over 27% and Greece's is similarly high.

The policy approach of combined fiscal consolidation and reforms, which from an economic viewpoint offers the only way out of over-indebtedness, is putting pressure on European governments. Despite the first signs of a gradual improvement in economic conditions, supporters of essential reforms in several countries are manifestly losing ground.

Yet these latest problems do not appear to have done any lasting harm to the financial market confidence. Spanish government bond risk premiums have not been this low in more than a year, and Italy still has no problem raising funding in the market even though it struggled to form a government. The ECB's guarantee to act as a buyer of last resort appears to be enough to satisfy investors.

Overall, hard and soft economic indicators in the euro area paint a mixed picture. Budget consolidation is depressing public sector construction investment and the private sector is also reluctant to spend on building projects. On the other hand, real retail sales have made an encouraging start to the new year and are running ahead of the fourth quarter of 2012 based on the first two months. The balance of trade surplus has also widened, however this is owing to reduced imports of goods rather than expanded goods exports.

Survey-based indicators, such as the EU Commission's business confidence poll and the purchasing manager indices, are signaling a further dip in the euro area's GDP in the first quarter – though this should be smaller than the 0.6% decline recorded in the fourth quarter of 2012. Another small contraction is expected in the second quarter before the economy starts gradually to pick up in the second half of this year. Our prediction for 2013 is a further GDP contraction of 0.5%. We then expect 2014 to bring growth of 1.1%.

In Germany, disappointing growth figures stem not so much from weakness of demand from the rest of the euro area, but from the decline of trade with non-European customers since last summer, owing to the weaker global economy. We expect international demand to pick up only over the course of the second half of this year, with the prospect of subsequent positive effects on Germany's export sector and domestic economic growth during 2014.

The limits of ECB policy

Smaller businesses burdened by new credit squeeze

Stefan Bielmeier, Advisory Board

The European Central Bank has tried for more than four years to counter the effects of the financial and debt crisis, not only with extremely expansionary policy on key interest rates but also with numerous unconventional measures.

Yet questions remain as to the effect on the real economy. Evidence suggests the benefits are limited. Recent disappointing sentiment indicators for the European economy suggest that monetary policy has failed to stimulate the real economy.

One of the hurdles facing economic recovery seems to be that bank loans – the lubricants of the real economy – are either not in demand or are hard to get, or both. It remains to be seen what impact the latest ECB interest rate cut will have.

Many European central bankers in recent weeks have been clear in their views that cuts in interest rates near the zero bound cannot be expected greatly to stimulate lending. From this point of view, the ECB rate cut is an experiment, where we are all eagerly awaiting the outcome.

Lending in the euro area has collapsed since spring 2012. Lending to euro area residents, on ECB figures, is shrinking at an annual rate of 2.6%. The year-on-year change, compared with the long-term average of 5.7% growth, raises the question whether European banks are putting the brakes on credit as an act of policy – or whether this is more the result of a fall in demand caused by the sluggish economy.

Lending to euro area residents is shrinking at an annual rate of 2.6%, compared with the long-term average of 5.7% growth.

An ECB survey on access to finance for euro area small and medium-sized enterprises (SMEs) indicates that stricter demands on loan applications are one of the reasons for falling lending volumes. European SMEs are complaining that it is becoming increasingly difficult to secure bank loans.

On the other hand, banks' growing reticence to extend loans also reflects an increase in defaults. The five-year phase of economic weakness has resulted in a growing number of borrowers struggling to service their debt. An IMF survey for the euro area shows the ratio of non-performing loans relative to all outstanding loans has increased significantly in recent years.

As well as the growing number of loan defaults, another explanation for the lending fall reflects the higher minimum capital requirements for banks under Basel III. As a result, the banks have been tending to reduce their total assets to improve their capital ratios.

Against this backdrop and in the light of the economic importance of SMEs for the euro area, there is growing talk about ECB efforts to take further measures to improve the monetary policy transmission process.

Among other things, the central bank might be tempted to accept SME loan packages as collateral for their tender operations. Collateral conditions have been already eased significantly for a number of months. The proposal for easing these further overlooks the actual problem. The lack of central bank liquidity is not a stumbling block for lending, but rather this is being held back by insufficient bank capital or by the banks' desire to reduce risks on their balance sheets under Basel III.

It would be more effective if the ECB were to buy SME loan portfolios, in a type of quantitative easing. This would relieve the pressure on the banks and offer them more scope for new lending operations. The central bank is fundamentally prepared to resort to unconventional measures, and the issue is still open on how it uses the leeway it undoubtedly has.

Retreat from bonds *(... continued from page 1)*

News that Norwegian government pension fund NBIM, the world's biggest sovereign fund, has cut allocations to bonds to the lowest-ever level indicates the overall pressures on asset managers.

Assets that display growth-related characteristics (linked to the overall resources and economic capability of issuing countries) are likely to come into their own. However, asset managers caution that the search for exotic currencies and assets should not be taken too far. The intrinsic priorities of safety, liquidity and return imply a continuing role for benchmark bonds from the west (including inflation-linked bonds). There is general consensus that the role of the dollar will be maintained thanks to the prospective move in coming years to US oil and gas independence.

Shifts in asset managers' preferences were underlined by separate announcements from two of the world's best-respected official investors. The Reserve Bank of Australia announced that it will build up its share of renminbi in its foreign exchange reserves to 5% in coming years, in recognition both of the Chinese currency's growing status on world markets and the importance of trade between China and Australia.

This follows announcement in 2011 that the National Bank of Austria had become the first European central bank to own renminbi reserves, acquired through the onshore Chinese interbank bond market. Other developed country monetary authorities, including the UK, are considering owning renminbi reserves, following work carried out by the Treasury and the Bank of England on building up London's activities in renminbi trading and plans to open a renminbi-sterling swap line between the Bank and the People's Bank of China.

The other announcement, from NBIM, revealed that the fund held only 36.7% of its $726bn assets in bonds at the end of March, the lowest proportion since it first started building up assets 17 years ago. Its equity holdings were close to a record high, accounting for 62.4%. The fund underlined in separate comments that the reallocation reflects above all dissatisfaction with low yields on mainstream western government bonds, which have also caused a slide in return on emerging market securities, rather than significant optimism about equities. This explains why NBIM and other sovereign funds have been focusing increasingly on real estate, which it expects to make up 5% of holdings in coming years.

The fund has been shifting both its bond and equity holdings away from dollar, yen, euro and sterling assets to those of emerging markets. But the fund is noticeably more positive on US Treasuries than other western government bonds. As part of the search for return, NBIM has announced plans to become a more active investor, with its chief executive joining the nomination committee of Swedish truckmaker Volvo, thus helping guide selection of board members.

Photos from the First Annual OMFIF-ASEAN+3 Reserve Management Seminar, London, 25 April 2013. *Left to right:* ***Songzuo Xiang****, Chief Economist, Agricultural Bank of China and* ***Dian Ediana Rae****, Chief Representative, Bank Indonesia London;* ***David Marsh****, Chairman, OMFIF,* ***Dr. Darmin Nasution****, Governor, Bank Indonesia,* ***Ernst Welteke****, former President, Deutsche Bundesbank,* ***Philipp Hildebrand****, Vice Chairman, BlackRock;* ***Darmin Nasution****, Governor, Bank Indonesia.*

Quote of the month

'Some of our worst expectations of 2012 did not materialise. We did not see a Greek exit from the euro, a Spanish default, the break-up of the euro area, a US double-dip recession, or a hard-landing for China. But the fundamental problems remain.'

Dr. Darmin Nasution, Governor, Bank Indonesia

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Coping with volatility

Difficult environment for reserve managers

Governor Darmin Nasution, Bank Indonesia

Since the global financial crisis of 2008, the world economy has seen diverging trends in economic growth. The sluggish performance of developed economies has been complemented by robust growth in emerging markets. Nevertheless, developing countries have been exposed to negative spillover effects. In addition, we have seen record low interest rates among the developed economies stemming from unprecedented monetary stimulus measures. These conditions present both challenges and opportunities for real money investors, particularly central banks as reserve managers.

US Treasury and German bonds are strengthening their status as global safe haven assets, while the outlook for several other major economies roles looks gloomy.

The European sovereign debt crisis continues as a disquieting factor. Banking problems and heightened risks from major political events, especially in Italy, Spain, Portugal, and Cyprus, have increased uncertainties in the global financial market. This situation is unprecedented. There is an urgent need for a more harmonised fiscal and monetary policy framework to ensure the euro bloc's stability.

Political risk has become a very important tail risk not only in Europe and the US, but also in the Korean Peninsula, Africa and in other regions, as the various episodes of the Arab Spring reminds us. We need to recall, too, that the European sovereign debt crisis took centre stage not long after the US subprime mortgage crisis hit the global financial market in 2007-08, triggering some leading banks to collapse and other to get bailed out.

To prevent another banking crisis and avoid severe defaults, the European authorities will have to resort to unconventional and unprecedented measures. Fortunately, some of our worst expectations of 2012 did not materialise. We did not see a Greek exit from the euro, a Spanish default, the break-up of the euro area, a US double-dip recession, or a hard-landing for China. But the fundamental problems remain. The recent case of Cyprus revealed the persistent vulnerabilities of the euro area while the US economy continues to struggle to overcome its unemployment and debt problems.

Broadly speaking, financial market participants have welcomed coordinated measures by financial authorities in the US and the euro area. We have witnessed the Federal Reserve's injection of liquidity into the market by conducting seemingly unlimited quantitative easing. The European Central Bank followed a similar path with the Long-Term Refinancing Operation (LTRO) and the Outright Monetary Transactions (OMT) facility.

Revitalising efforts in Asia have also provoked positive responses from market participants. The election of Shinzo Abe as Japan's prime minister last year signalled a break with past policies and the introduction of radical quantitative easing measures. In China, economic reform and financial deregulation helped avoid the widely expected hard-landing.

Formidable challenges lie ahead as uncertainty in the global market lingers. US Treasury and German bonds are strengthening their status as global safe haven assets, while the outlook for several other major economies roles looks gloomy due to the increasing downside risk related to possible sovereign rating downgrades.
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This low yield environment has been further exacerbated by the monetary stimulus implemented by their monetary authorities. Coupled with the uncertainty in the global markets, this warrants central banks, as reserve managers, to seek alternative sources that provide opportunities for yield enhancement given the accepted risk level. Against this backdrop, I raise these questions: Is it the time for us to be optimistic? Or, can we see an even worse situation ahead? These questions need to be addressed, as we are likely to face different kinds of challenges and volatility in the year 2013 and beyond.

This is an edited extract of Dr. Darmin Nasution's speech at the First Annual OMFIF ASEAN+3 Reserve Management Seminar, London, 25 April 2013. Nasution steps down as governor of Bank Indonesia in May.

Pricing inflation expectations

Dangers of misinterpretation when QE ends

Colin Robertson, Advisory Board

Policy-makers and investors alike are invariably interested in the long-term inflation expectations priced into financial markets, especially in view of large-scale quantitative easing being adopted globally. Increased inflation expectations could awaken bond market vigilantes from their slumbers, triggering policy action, while pension funds would be likely to accelerate purchases of assets considered inflation-proofed.

The problem is gauging what level of long term inflation is actually priced into bond markets. Typically, the difference between yields on fixed income and inflation-linked bonds of comparable duration (break-even inflation) is taken to represent long-term expected inflation. However, this spread in bond yields includes what investors are prepared to pay for protection from inflation, in addition to expected inflation itself. Commonly, this is thought of as an inflation risk premium (IRP), which varies over time and from region to region. Research shows that over the long term the IRP has averaged around 0.5% in the UK, generally ranging from 0% to 1.5%, and 0.25% or slightly less in the US, Canada and the euro area.

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An important characteristic of the IRP is that it is pro-cyclical; it rises as the expected level of long-term inflation increases. This is hardly surprising as human nature leads to a greater desire to take out insurance when the insurable event appears more likely. The important point is that this means break-even inflation usually overstates inflation expectations to an increasing extent as inflation rises.

However the desire to buy (or sell) fixed income relative to inflation-linked bonds depends on more than just the desire to take out protection. Notably, in times of market panic, investors flood into fixed income bonds, rather than very much less liquid inflation-linked bonds. This leads to break-even inflation temporarily collapsing, by a great deal more than can be justified by changes in expected inflation. For example, during the credit crisis, US break-even inflation on 10 year Treasuries fell from 2.5% to close to zero in around 6 months.

An outstanding feature of supply/demand in current bond markets is the purchases of bonds by central banks under quantitative easing programmes. As these are focused on fixed income, not inflation-linked markets, these act to depress break-even inflation. This is liable to lead to an apparently contrary development when quantitative easing ends: greatly reduced demand for fixed income should lead to break-even inflation increasing at a time when the central bank has become less dovish.

An issue is the measure of inflation implicit in break-even inflation which is that defined in the terms of the inflation-linked bond. This is most obvious in the UK where index-linked gilts use RPI but policy is set with regard to CPI. Indeed the discrediting of the statistical basis of RPI and the conjecture over whether the authorities would change the construction of the index have led to movements in break-even inflation quite unrelated to the path of underlying inflation.

Economic surveys and investment bank research indicate that long-term inflation expectations are currently broadly in line with break-even inflation in the US and UK. In effect there is no IRP, which might be considered an opportunity for pension funds to buy inflation protection at no cost.

The danger is that policy-makers and others overestimate the 'market view' of long term inflation when the IRP reappears as a result of quantitative easing being reduced or ceasing or because investors become more concerned about the risk of future inflation. Conversely, a sharp equity market correction and severe 'risk-off' period in markets are likely to lead to an exaggerated view of the reduction in inflation expectations.

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Japan leads the way

Dollar strength and positive domestic policies

Trevor Greetham, Advisory Board

After an eight month upswing in lead indicators a cooling off in the rate of global growth is to be expected. We trimmed risk asset exposure last month but stocks remain our preferred asset class. Japan is now our favourite market. A trend of dollar strength is a headwind for commodities and emerging market equities but it is good for Japan and domestic policy settings are very positive.

The Investment Clock is in the equity-friendly disinflationary recovery phase of the global business cycle with growth indicators positive and inflation indicators pointing downwards on the back of continued commodity price weakness.

However, after an eight month upswing, lead indicators are close to peaking and US economic data have surprised negatively. We reduced our large overweight in risk assets in March, primarily by selling commodities.

Return indices for global stocks and property are at or near all time highs but broad commodity indices are back to their mid-2012 lows. Commodity weakness is a side effect of dollar strength rather than global economic weakness. The fact gold has been hit particularly hard shows this is not a 'risk off' move.

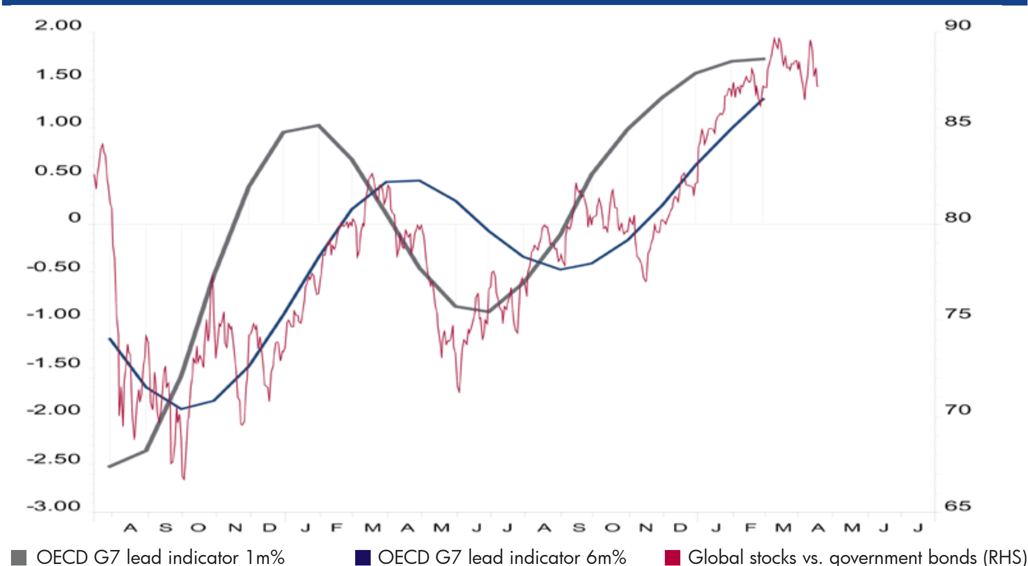
Improvements in the US property market make it possible to imagine a rise in US interest rates in the next two or three years and this is supporting a trend of dollar strength that we expect to continue. Irrespective of our overall position on cyclicality, this leads to a favourable assessment of stocks over commodities.

Dollar strength is also a headwind for emerging markets equities and we would use a bounce to reduce exposure further. Japan is our favourite equity market. Japan benefits from dollar strength and it has very positive domestic policy settings from an equity investor's point of view.

The Bank of Japan has announced aggressive Fed-style QE with the aim of doubling the monetary base by late 2014. Moreover, Japan will also implement fiscal expansion so there is no danger that this money lies dormant. Signs of a recovery in confidence are already evident.

Japan is now our favourite market. Signs of a recovery in confidence are already evident.

OECD lead indicator and global stocks vs. bonds



Source: Datastream, April 2013

Looking ahead – 2013 diary dates

The future of the international monetary system
Lecture with Dr. Jaime Caruana, General Manager, Bank for International Settlements
16 May, London

America in the aftermath of the crisis
Lecture with James Bullard, President, Federal Reserve Bank of St. Louis
23 May, London

Rebalancing of monetary and fiscal policy after the financial crisis
Lecture with Prof. Charlie Bean, Deputy Governor, Bank of England
29 May, London

Mauritius: the financial crossroads of the world
Lecture with Rundheersing Bheenick, Governor, Bank of Mauritius
30 May, London

Croatia's place in the international monetary system on the eve of EU accession
Lecture with Boris Vujčić, Governor, Croatian National Bank
4 June, London

OMFIF Future of the International Economy Dinner
Gala dinner with Gerhard Schröder, former Chancellor, Germany
6 June, London

German riddle over lucky Lucke (... continued from page 1)

The markets are not stupid and will pick up the slightest hint from Merkel if she changes her mind about the single currency's survival.

Lucke is throwing away an advantage he has as an outsider. He should issue detailed scenarios for euro realignment while he is still new on the political scene. One possibility would be a break-up of the euro area between north and south. The best way to do this would be for the south to stay in and for the north to leave the euro and let its currency ('neuro' would be a good name) float upwards. Thus the liabilities of the weaker southern countries would remain in the old euro while the neuro's appreciation would benefit their trade.

A second-stage alternative would be to reintroduce the exchange rate mechanism (which still exists for potential entrants to the euro) for the neuro and euro constituent countries.

This can solve the French problem. France can join the neuro to save face and then slide down using the ERM. It can also help other northern countries to distinguish themselves from the Germans by floating their currency upwards (Finland may like to do this) or downward.

The various southern nations can also place themselves above or below the euro as they wish. The markets can then make their judgement.

None of this can be done gradually or in the open. These two steps may have to be taken simultaneously, and hopefully without a treaty to implement them. If the euro area members can manage to decide this over a long weekend, shut down banks for the next few days and implement their plans, the saga may yet have a happy end. We would then all be able to look forward to a second, longer currency soap opera: 'Backwards to the Future'.

Maybe Prof. Lucke can take up these ideas and spell them out while there is still time before September. He may not get elected, but he will still be 'Lucky Lucke' – and a grateful European public will thank him for it.

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Gary Smith, Global Head of Official Institutions, BNP Paribas Investment Partners

World central banks still easing

Diverging economies, diverse reactions

Gabriel Stein, Chief Economic Adviser

The world's leading central banks are showing diverse reactions to varied circumstances. But the main common denominator is easier monetary policy across the board.

The Federal Reserve has indicated that it may increase its $85bn-a-month of asset purchases in response to weak economic data and falling inflation in the US. The Bank of Japan has stepped up the fight against deflation under its new leadership, significantly blurring the lines of central bank independence under what has been on the whole a welcome change of Japanese monetary stance since the election of prime minister Shinzo Abe.

The European Central Bank has joined in the action, cutting its benchmark interest rate by 0.25 percentage point to 0.5% on 2 May, with Mario Draghi, ECB president, saying the bank remained 'ready to act if needed' to cut rates further – including the possibility of a fall in the ECB's deposit rate into negative territory. However the ECB remains a special case in view of widespread doubts whether the reduction will really help the hard-hit peripheral states in economic and monetary union (EMU).

Additionally, the ECB has to take heed of strong opposition to further interest rate cuts in Germany in view of fears that easy ECB money may be provoking an asset bubble in parts of Europe that could turn out similar to the circumstances earlier in the 2000s that have subsequently caused havoc across EMU. A more likely development is therefore an attempt to improve the transmission mechanism, rather than a further cut in interest rates.

In other parts of the world, we have seen unchanged policies by the Reserve Bank of Australia, the Bank of England, the Swedish Riksbank and the Bank of Canada. In contrast to the institutions in the developed countries, the most important emerging market central bank, the People's Bank of China, is now in tightening mode, although the pace of change may be somewhat subdued.

The table below shows the main factors behind the policy thinking among the main central banks. Behind the uneven pace of policies and action lies divergence in the world economy.

The US is firmly set on a recovery path, even if this is patchy and weaker than previous post-recessionary phases. Japan seems to be responding well to treatment, but longer-term doubts remain, particularly what will happen if more fundamental measures proposed by the new government of Abe dissipate after the upper house elections in July. The euro area, despite successive effort to talk up growth prospects, is still mired in stagnation if not recession, with unemployment now above 12% and the economic outlook dismal.

The US is firmly set on a recovery path and Japan seems to be responding well to treatment. The euro area is still mired in stagnation if not recession.

Central bank policy

Central bank	Move	Time	Comment
Federal Reserve	Taper QE	2013	Uncertain
Federal Reserve	Hike	2014	Uncertain
ECB	Cut	2013	End of cycle
Bank of England	Extend APP?	2013	After Carney comes
PBoC	Tighten	2013	Raise RRR more likely than rate hike
BoJ	Ease	2013	Less effective short-term than expected
BoC	Hike	2014	Year-end
RBA	Hike	2014	Year-end
Riksbank	Hike	2014	Year-end

One problem when attempting to forecast policy is the difference between what should be done and what will be done. This is particularly true in the case of the Federal Reserve. The outlook for the US economy is reasonably benign. While recent data have shown some weakness, the American economy should grow near trend in the first half of 2012 and possibly at an above-trend rate in the second half and into 2014. The Fed's markers for policy change (chiefly an unemployment rate of 6.5%) should be achieved by mid-2014, subject to how quickly previously discouraged workers return to the labour force.

In principle, this should mean a tapering off of quantitative easing (QE3) this year, with a first interest rate increase next year. If all goes well, the Federal Open Market Committee's statement on 1 May that it is 'prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labour market or inflation changes' may turn out to be academic. On the other hand, if the US economy hits a further roadblock, or if US inflation (currently at 1%) shows an unexpected fall, then we may see a further upward adjustment in asset purchases.

The dovish composition of the FOMC next year may mean that both QE and current interest rate are maintained for longer than previously anticipated. Judging by recent speeches by FOMC members, as well as FOMC minutes, there is a reasonable likelihood that QE3 could be discontinued in late 2013 or early 2014, while interest rates remain unchanged into 2015. That would risk prolonging a bond bubble.

In the case of the ECB, there is some uncertainty about whether the cut has brought the bank to the end of the interest-rate cutting cycle. As the ECB well knows, there isn't much room to cut interest rates. The ECB, as other central banks, recognises that ultra-low interest rates begin to lose their power when extended indefinitely. On the other hand, Draghi's comments on 2 May make clear that a significant minority on the bank's Council favours further action – even if this risks a showdown with the German members of the decision-making body. More importantly, the ECB has spoken of possible measures to boost lending, notably to smaller businesses. But, apart from the fact that concentrating on credit rather than money is a conceptual mistake – and even more so in a debt-induced downturn – the experience of similar programmes elsewhere (such as the Bank of England's Funding for Lending Scheme) shows that the effect is marginal at best.

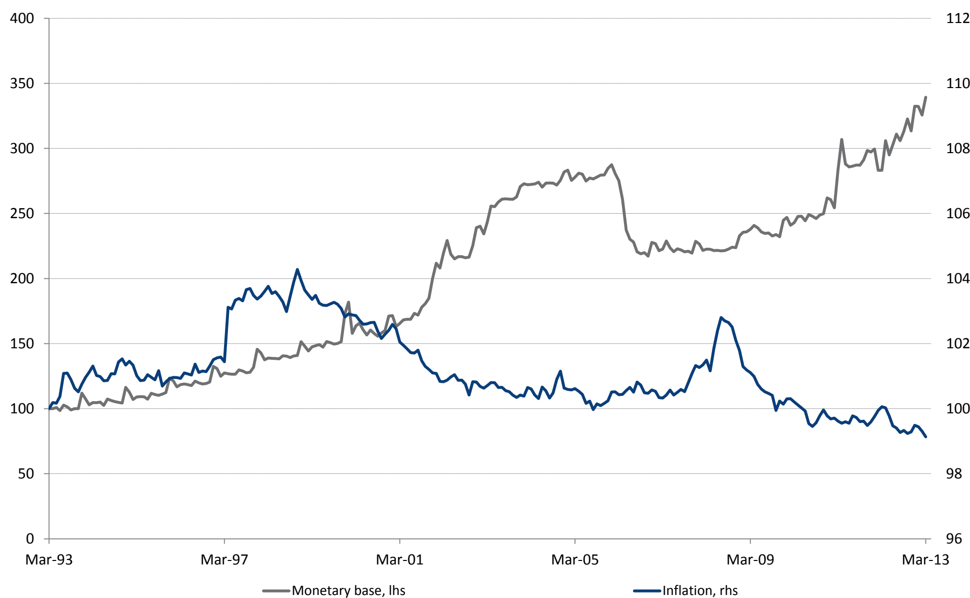
Talk of changing the Bank of England's mandate (for example, to nominal GDP targeting) has temporarily ceased after the UK Treasury in March gave the central bank more flexibility by allowing it to loosen monetary policy by focusing on growth as well as its inflation target. However, such speculation may restart once Mark Carney, governor of the Bank of Canada, takes over at the helm on 1 July. If the Bank extends its asset purchase programme (an idea which the incumbent Sir Mervyn King favours but where he has been outvoted twice), that would probably also take place after the change of governor and in conjunction with other changes, such as the introduction of Fed-style forward guidance.

If the Bank of England extends its asset purchase programme it would probably take place after the change of governor and in conjunction with other changes, such as the introduction of a Fed-style forward guidance.

The three smaller economies in the table – Canada, Sweden and Australia – have different issues. All three weathered the 2009 recession relatively well. All three have issues with high and rising household debt. All three also have strong currencies, underpinned by policy interest rates on the high side by current standards: 3% in Australia, 1% in both Canada and Sweden. The only one of the three where there has been any hints of a tighter monetary policy is the Bank of Canada. But these hints have since receded, not least because of fears of what this would do to the housing market.

The Riksbank has two pronounced doves on its board who will resist any repo rate hike; and in Australia the talk over recent months has been more about cuts than about hikes. Nevertheless, based on recent data and on the improving global outlook, all three are likely to have reached the end of the cycle, meaning that the next move in interest rates should be up. However, that move will not come until 2014, perhaps only by the end of the year. By contrast, the Chinese authorities are already in tightening mode, perhaps somewhat dampened but not banished by weaker growth in the first quarter. The People's Bank of China has not moved officially yet, but every week seems to bring notification of another attempt to cool down the housing market with some form of restriction on mortgages, on second homes or in some other way.

Japanese monetary base and headline CPI, index March 1993=100



Banks' willingness to lend is one factor determining the growth of money and credit. Other factors are the level of interest rates and the willingness of non-banks to borrow.

On the other hand, consumer price inflation is slowing and there is outright producer price deflation. The PBoC is therefore less likely to raise interest rates this year. Instead, it will probably raise the reserve requirements ratio.

The major central bank firmly in easing mode is the Bank of Japan. Under its new governor Haruhiko Kuroda, the BoJ has announced plans to double the monetary base, raised its inflation target to 2% and introduced a date – 2015 – for reaching it. The yen appears to be falling gradually further towards 'parity' (that is, 100 yen per dollar). The weak yen may – indeed should – help to boost activity and inflation. However, the main chosen method of the BoJ is to ramp up its quantitative easing by buying more government securities. Here, the outlook is clear. Like the Fed, the Bank of Japan concentrates on the monetary base. The theory is that if you stuff the banking system with cash, banks will eventually lend that out, which will create faster activity and, ultimately, inflation.

Banks' willingness to lend is one factor determining the growth of money and credit. Other factors are the level of interest rates (already low in Japan) and – most importantly – the willingness of non-banks to borrow. Judging by the BoJ's most recent senior loan officers' survey, this willingness is not high in Japan – although, if the BoJ's policy change does induce a lasting shift in the mindset of non-banks, that could change, and hopefully will.

Not surprisingly, the relationship between changes in the monetary base and eventual inflation is not particularly close, either in Japan or elsewhere. Over the past 20 years, the Japanese monetary base has multiplied 2.5 times; the level of prices over the same period has fallen. Inflation has accelerated or decelerated irrespective of what previous monetary base developments have been (see chart above.) So a good deal of the Japanese reflationary effort now under way is experimental. Practitioners of monetary policy in other countries, as well as at the International Monetary Fund, need to bear this in mind.

The BoJ is committed to its easier policy. It may succeed – but not in the way it thought it would. A rough and ready estimate of the pass-through rate of foreign exchange movement to consumer prices over the past three years gives a 5% effect. The yen has already depreciated by 22% from its January 2012 peak (measured by monthly average, rather than daily or intraday numbers). Another 20% fall in the level against the dollar to ¥117 would be enough to inject 2% imported inflation. In fact, if the weak yen is perceived to be the only way to achieve inflation, the rate may well overshoot. The problem is that, for the Japanese authorities and the rest of the world, inflation brought on by higher import prices is not as desirable as inflation caused by overheating domestic demand. So the Japanese experiment will continue, as the world watches in hope mixed with trepidation.

Bullard's view of global economy

The St. Louis view: US providing international uplift

Darrell Delamaide, US Editor

James Bullard

The interview with James Bullard encapsulated a large number of points on worldwide monetary and financial issues. Here are the highlights.

US monetary policy

While Bullard is monitoring US inflation closely for any further movement downwards, he expects it to resume an upward trend in the course of 2013.

'Our aggressive QE programme is likely to send inflation and inflation expectations moving higher,' he said, noting that the Fed's latest round of asset buying has only been in place since December after a hiatus of more than a year from the end of QE2.

The interim Operation Twist programme of swapping out shorter term assets for longer term was less effective, Bullard said.

'Our policy is more aggressively easy right now than it has been since QE2,' he said. While this should push inflation higher, he acknowledged that 'we haven't seen it yet.'

Nonetheless, Bullard is pleased with the impact of the Fed's unconventional measures in the wake of the financial crisis.

'As far as monetary policy is concerned, we have been able to keep the inflation rate from drifting down into negative territory,' he said. The fact that inflation has remained close to the 2% target shows that it's possible to have a reasonable monetary policy in place even when interest rates are zero, he said.

'If it was just that we were sitting on our hands,' he said, 'then I think we would have had a big deflation during this period.'

For Bullard, it is an affirmation that the traditional reliance on monetary policy for short-term stabilisation and on fiscal policy for longer term balance is the right way to go.

'It's hard for fiscal policy to react that quickly,' he said of dealing with a crisis. Politicians need to debate fiscal issues and set tax and spending plans over the medium and long term. Then they should stick with them, because people don't like a lot of change.

US economic prospects

In recent weeks, Bullard has been suggesting that the Fed should begin tapering off its asset purchases, currently running at $85bn a month, and he reiterated this position even in the wake of a disappointing jobs report for March.

'It's just one data point,' he said of the report, 'and it could easily get revised.' And in fact the jobs report for April released after the interview not only showed stronger growth for that month but substantial upward revisions for employment both in March and February.

The main news, Bullard said in the mid-April interview, is that first quarter GDP growth seemed to be fairly strong. Even though the Commerce Department data released at the end of April put first-quarter growth below economists' forecast of 3.2% at a preliminary 2.5% annual rate, it was still much stronger than had been anticipated earlier in the year.

Prior to the release of this data, Bullard said he was not convinced by the March jobs report alone that the US economy is poised for a spring 'swoon' like it experienced last year. 'I don't think it's a good model to say that it's happened a couple of times and therefore it might happen again,' he commented. 'We need to wait for more data.'

Bullard doesn't share the concern of some economists that automatic government spending cuts mandated by the so-called 'sequester' that went into effect earlier this year will significantly dampen growth.

'I actually don't think the sequester is going to be a very large negative for the US,' he said. For one thing, he noted, the cuts will end being spread out more than people anticipate.

Bullard blames the slow recovery in employment on the magnitude of the economic shock from the financial crisis. 'The shock was so huge – gigantic – it displaced a lot of workers,' he said.

Even so, the jobless rate has gone down by nearly 0.8 points a year and he expects the decline this year to be about the same, going from 7.9% in January to the 'low 7s' by the end of the year.

As for overall economic growth, Bullard said in mid-April he is expecting an increase of 3% or more in US GDP for the year.

'It's not a great number for us but it's going to feel great,' Bullard said, in comparison to recent years and to immediate rivals.

Greenspan vs Bernanke

When Bullard read Alan Greenspan's memoir on his tenure as Fed chairman, The Age of Turbulence, he felt like he saw his whole life passing in front of him because he was working at the Fed for virtually the entire time.

'He liked obfuscation,' Bullard said of Greenspan. 'He did not want to be too obvious about what the Fed was doing.'

Bernanke noted that this reflected an 'older view' within the Fed that a more secretive central bank can be more effective.

'There's been a sea change in thinking on that,' Bullard said. 'Chairman Bernanke has been the opposite of that. For him, there isn't really much of a case to be made for being clandestine in policy.' A view, Bullard quickly added, that he shares.

While the attitude toward transparency in policymaking is probably the biggest difference between Bernanke and his predecessor, the current chairman also has sought to depersonalise Fed policy, to show it clearly as the policy of an institution and not a particular person.

'Chairman Bernanke is extremely intellectually secure as the Princeton professor,' Bullard said. 'He can listen to a lot of viewpoints and it doesn't ruffle his feathers.'

But Bullard declined to speculate as to whether Bernanke would take the ultimate step in depersonalising the monetary policy he has put in place by stepping down when his second term as chairman ends in January.

No one has said anything to him in this regard, Bullard said. 'My suspicion is that the people who are directly involved aren't sure what they are going to do,' he said.

Bullard also declined to comment on possible successors. However, he did think it very unlikely that the Fed would follow the example of the Bank of England and appoint someone from outside the country as chairman.

'The US has lots of great economists of many different stripes,' he said. This makes likely there'll be plenty of competition for the job without the US having to go abroad to find a suitable candidate.

'Chairman Bernanke is extremely intellectually secure as the Princeton professor. He can listen to a lot of viewpoints and it doesn't ruffle his feathers.'

Europe and the debt crisis

For Bullard, the most significant development in the global economy recently was that the US has kept growing but Europe went back into recession. 'It's really the tragedy of the last two years,' he said.

He blames the economic downturn in Europe on the underlying debt crisis in several euro area countries.

'It's absolutely a debt problem,' Bullard said. 'You're borrowing too much, you lost credibility in the markets.'

Too much of standard Keynesian analysis about borrowing your way out of a crisis posits a pristine condition – the country has never borrowed before. 'That's not where Europe started from,' he commented.

There are limits to how much a country can borrow and for the markets that is reached when the perception is it might be to country's benefit to default rather than pay back loan. That's an endogenous debt limit, and once Greece reached that point there was concern that other southern European countries would get there, too.

Bullard says he is not dogmatic, and describes himself as 'iconoclastic.' He feels it is not so easy to categorise economists any more.

'I do like new Keynesian literature,' he said, referring to Michael Woodford at Columbia University and his co-authors. 'They put a model on the table fully worked out in detail. You can learn a lot from that – here's how monetary policy could work.'

ECB and the euro

Bullard said a trip to Europe last summer raised his concern about the situation there. 'My feeling was that at that point the debate was chaotic,' he said. 'I wasn't sure where European sovereign debt crisis was going to go at that point.'

And he was sceptical when ECB President Mario Draghi gave his famous 'whatever it takes' speech in London, presaging the announcement on the Outright Monetary Transactions programme (which hasn't been used) later on.

'There have been a lot of attempts in the last few years to play the bazooka card,' Bullard said. 'But it has worked – so far. OMT has created an unusual equilibrium in Europe that I would not have predicted that so far has held its own.'

However, Bullard remains wary. 'It's an uneasy equilibrium,' he commented. 'I would have said it was fragile but so far it's held its own.'

This central banker expects the equilibrium will hold at least through the German elections in September. While the main thing for US policymakers is that Europe has avoided some sort of meltdown, Bullard is concerned that OMT has set a dangerous precedent, not only for the ECB but for central banks in general.

Thoughts of President Bullard

On Fed monetary policy...

'As far as monetary policy is concerned, we have been able to keep the inflation rate from drifting down into negative territory. If it was just that we were sitting on our hands, then I think we would have had a big deflation during this period.'

On his forecast for US growth of 3% this year...

'It's not a great number for us but it's going to feel great.'

On playing a policymaking role at the Fed...

'I enjoy it; I like the intellectual challenge. The intellectual challenge has been outstanding in the last five years because the world has been upside down.'

On central banks getting pulled into political battles...

'We should not have technocrats making decisions that elected officials should be making. So I hope this isn't the start of a trend – the new method of central banking in the next couple of decades is about central banks intervening in individual markets in exchange for something they want.'

'The ECB was the only pan-European institution with credibility to do something about the sovereign debt crisis,' he said. 'As a result, it got pulled into a political battle, politicising the ECB in an unfortunate direction.'

OMT, in effect, after all the caveats and conditionality, is a promise to intervene in a particular market and to monetise that country's debt to the exclusion of all others, Bullard said.

'It's as if we said to Illinois or California that we would monetise their debt in exchange for certain concessions on their fiscal programmes,' Bullard said. That would pull the Fed into fiscal policy, which is something that an elected body should handle in a democracy.

'We should not have technocrats making decisions that elected officials should be making,' he said.

Trends in world central banking

While he understands the ECB was under tremendous pressure, OMT was an unprecedented step. 'I see it as a worrisome trend in global central banking that you would start to have the idea that a central bank is going to negotiate with a local territory about intervening in their particular markets,' Bullard said.

'What I'm concerned about is the sense that this is how central banks are going to behave globally going forward,' said Bullard. 'There has been this notion that is tightly circumscribed about what central banks are supposed to do and not supposed to do.'

And, Bullard made clear, intervening in a quid pro quo manner was on the 'not supposed to do' list. 'That's a way of politicising central banking,' he said. 'So I hope this isn't the start of a trend – the new method of central banking in the next couple of decades is about central banks intervening in individual markets in exchange for something they want.'

Bullard declined to characterise the difference between Draghi and his predecessor, Jean-Claude Trichet. However, he said, 'the ECB generally up until the time of the OMT has been less innovative than the Bernanke Fed.'

For instance, the ECB has confined its monetary easing to the discount window function, which the Fed has largely stopped.

'It's very instructive,' Bullard said. 'The US balance sheet is big, and the European balance sheet is big, but for different reasons.'

The difference is significant, Bullard feels. The ECB's collateralised loans amount to one scenario: We print money, you give me collateral, I give you back the collateral, you give me back the money and we burn it.

By contrast, he said, under QE the Fed buys an asset, and the money is 'out there' and stays out there.

The ECB may yet find it necessary to adopt some of the unconventional measures used by the Fed and other central banks in coping with the crisis, Bullard said.

On when or if the ECB will adopt unconventional measures used by the Fed...

'Europe has not faced the deflation threat – yet. Proof will come now if inflation does start to move persistently below target and the ECB would have to take some kind of action. What would they do at that point?'

On whether any country will leave the euro...

'No one really wants to be outside the euro. You're on your own, you're outside.'

On his scepticism on President Mario Draghi's 'whatever it takes' speech last year...

'There have been a lot of attempts in the last few years to play the bazooka card. But it has worked – so far. OMT has created an unusual equilibrium in Europe that I would not have predicted that so far has held its own.'

On whether China or other BRIC countries will create the conditions to serve as a reserve currency...

'To become the world's reserve currency you have to check all those boxes and you have to be better than everyone else on all those boxes. I don't think these countries are at that point yet.'

'Europe has not faced the deflation threat – yet,' he said. 'Proof will come now if inflation does start to move persistently below target and the ECB would have to take some kind of action. What would they do at that point?'

Longer term, Bullard feels, Europe simply needs more political integration. Rather than government ministers wrangling into the wee hours of the morning on successive weekends, these debates should be hashed out in a European parliament with wider powers than the current elected body has.

Europeans are already negotiating all the time, he said, so they should be more organised about it. While countries clearly love their freedom, Europe as a whole would be better off with more political integration.

'As far as I can tell,' Bullard acknowledged, 'this has zero chance of happening.'

Nonetheless, Bullard believes that the probability of a country leaving the euro has gone down, after Cyprus, which was small enough that an exit would probably have been manageable, elected to stay.

'No one really wants to be outside the euro,' Bullard said. 'You're on your own, you're outside.' Besides, the European Commission appears to have created a further disincentive by suggesting that if you leave the euro, you also have to leave the EU.

So Bullard believes 'the odds are good at this point' that the euro will still be around in 10 years. But he doesn't think it will be in a position to take on a wider role as a reserve or trade currency.

'Right now, the euro is not making any progress on being a world's reserve currency,' Bullard said, 'so I think the dollar is in great shape for the near term.'

The problem for euro going forward is that European growth does not look good, not only in the short term, but over the next five to 10 years.

China, the dollar, and the global monetary system

Nor does Bullard see much chance that currencies of China or other emerging markets will take on a significant reserve function in the foreseeable future. 'The Chinese have often said they want to move in that direction, but I think they have a long way to go,' he said.

China would have to move to full convertibility of the renminbi and capital mobility. 'China doesn't seem to be a country that is open to the idea of wide open capital mobility,' Bullard said. 'I just don't see China in the near term being a threat on the reserve currency front.'

Nor does he see much chance for the currencies of the other BRIC countries – Brazil, Russia, India – to play a big role internationally despite moves among these countries to do more of their trade in their own currencies.

For a currency to play a significant role in the world monetary system requires not only the credibility of the monetary policy behind the currency, but also the political stability and economic strength of the country.

'To become the world's reserve currency you have to check all those boxes and you have to be better than everyone else on all those boxes,' Bullard said. 'I don't think these countries are at that point yet.'

Bullard acknowledged that 'there are a lot of advantages to being a reserve currency.' Not least, he said, is that in a crisis your interest rates automatically go down as international investors flee to safety.

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Lew loses listeners in Europe

US cannot communicate with the Old Continent

John Kornblum, Advisory Board

When President Barack Obama's new Treasury Secretary Jacob Lew made his first visit to Europe in early April, he delivered exactly the same message which the President, the Vice President, the National Security Advisor and Lew's own predecessor had issued and failed to get across so many times over the past four years.

Europe needs to let up on austerity, stimulate its economies and contribute to global growth. German Chancellor Angela Merkel rejected this idea in April 2010 and has done so regularly since then. Other than a friendly suggestion that his German interlocutors call him by his first name, Lew seems to have had nothing new to offer.

Repeating his mantra for perhaps the 5,000th time, Wolfgang Schäuble briefed the press with Lew sitting beside him: 'Nobody in Europe sees this contradiction between fiscal consolidation and growth. We have the common position of a growth-friendly process of consolidation, or sustainable growth.'

Whatever he said he private, Schäuble made clear in public to his top-level American visitor: 'I am not listening to you.'

This continuing trans-Atlantic dissonance seems to demonstrate that the divergences are so great that the two sides can no longer really talk to each other. If the climate stays this bad, chances for the much heralded trans-Atlantic trade and investment negotiations do not seem bright, even though it is clear to many countries that such a pact would be in Europe's best interests.

Lew's maladroitness suggested that Washington's massive bureaucracy had not been able to give the freshman secretary even the most rudimentary new thoughts to break the impasse. Lew didn't seem to understand that, from the beginning, European leaders have not been talking about the banking system or deficits — or really about money at all. The compromise over the Cyprus rescue deal should have finally have made clear that sticking plasters are the tool of choice.

The compromise over the Cyprus rescue deal should have finally have made clear that sticking plasters are the tool of choice.

Twenty years after the end of the Cold War, American leaders seem to be losing the ability understand what motivates their European colleagues. The US will have no influence on the debt crisis until it grasps the basic fact: Europeans care most about maintaining the existing methods and structures of 'Europe'. Taking steps to solve, rather than plaster over, the causes of the crisis are much lower on their agenda.

Thus, instead of acting decisively, European governments are limited to taking small steps that will not endanger the balance within the EU. Doing nothing is better than risking hard-won stability. To agree to American demands would require changes in this carefully constructed world which the current generation of European leaders could not even begin to accept.

But there is a big problem: this mutual deafness is starting to become dangerous. If they don't like Treasury Secretary Lew, the Europeans should listen to the International Monetary Fund, whose French director is becoming increasingly vocal in her warnings. Or the president of the European parliament, Martin Schulz, who told the Financial Times on 27 April: 'The EU is really threatened by failure. We should not underestimate the dramatic reality ... The consensus on Europe is in a kind of freefall.'

And the Americans might heed the advice of former Federal Reserve chairman Paul Volcker, who has suggested that now is the time to consider far-reaching changes in the global financial system to head off even worse problems in Europe and elsewhere. A policy based excessively on banging the austerity drum might not be the best way to get results.

Talk of tapering off QE tapers off

Fed wary of 'spring swoon'

Darrell Delamaide, US Editor

A slew of mixed economic data has suspended talk of tapering off Federal Reserve asset purchases as policymakers wait to see if the US is headed for another 'spring swoon' like the one last year that slowed down progress on employment and growth.

A disappointing jobs report for March, when unemployment remained stuck at 7.6%, was followed later in April by a preliminary report that first-quarter GDP grew at an annual rate of 2.5%, well short of the consensus 3.2% forecast by economists. The policy statement from the Federal Open Market Committee meeting at the end of April did not downgrade the economic outlook but spoke again of expectations of a 'moderate' pace of growth.

Though Chairman **Ben Bernanke (voter)** had spoken before of the panel's flexibility regarding asset purchases, the statement from the most recent meeting mentioned for the first time a possible increase from the current pace of $85 billion a month. 'The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labour market or inflation changes,' the statement said.

Inflation hawk **James Bullard (voter),** head of the St. Louis Fed, has been concerned lately more about the threat of deflation and went so far to suggest that he would push for increased asset purchases if US inflation fell further below the Fed's 2% target. 'If inflation continues to go down, I would be willing to increase the pace of purchases,' Bullard told reporters after a speech at a mid-April conference in New York.

Bullard discussed his concern about the US tipping into deflation more at length in a wide-ranging interview with the Bulletin (see front page, p.3 and p.18-21). In fact, data released in late April showed that the personal consumption expenditures price index used by the Fed declined in March, so that the year-on-year rise was only 1%, compared to 1.3% in February.

To taper or not to taper, that is the question

The new caution about asset purchases marked a shift from the mid-March meeting of the FOMC, where, according to the minutes released earlier in April, 'a number' of participants thought the pace would be tapered down starting around mid-year, and only 'a few' saw purchases continuing through the third quarter and another 'few' through the end of the year.

Sandra Pianalto

FOMC members ranging from the hawkish **Sandra Pianalto (non-voter)** at the Cleveland Fed to the dovish **John Williams (non-voter)** at the San Francisco Fed talked at the beginning of the month about the Fed tapering off its purchases soon.

At an early April economic conference in West Palm Beach, Florida, Pianalto noted that the Fed's balance sheet was on course to hit $4tn this year at the current pace of purchases, an unprecedented size that could present its own risks and uncertainties.

'Given our limited experience with our asset purchase programs, slowing the pace of purchases could help minimise the potential risks associated with our large and growing balance sheet,' she said. 'Even continuing asset purchases at a reduced pace, and limiting the size of the overall programme, would enable the Federal Reserve to continue adding accommodation and providing meaningful support to economic growth and job creation.'

The week before, with the caveat that positive news would have to continue, Williams was optimistic enough about the economy that he thought there would be substantial improvement in employment by the summer. 'If that happens, we could start tapering our purchases then,' Williams said in a speech in Los Angeles. 'If all goes as hoped, we could end the purchase program sometime late this year.' By mid-April, New York Fed chief **William Dudley (voter)** was sounding a more cautious note. He said at an event in Staten Island that the current level of purchases seemed appropriate given the sluggish improvement in the job market.

At some point, he acknowledged, 'I expect that I will see sufficient evidence of improved economic momentum to lead me to favor gradually dialing back the pace of asset purchases.' But even before the disappointing GDP report, Dudley expected only sluggish economic growth of 2-2.5% this year. So while he might 'dial back' asset purchases when the economy improves, 'any subsequent bad news could lead me to favour dialing them back up again,' he added.

Eric Rosengren

One policymaker who was not ready to talk about tapering off asset purchases at any point in April was Boston Fed chief **Eric Rosengren (voter)**. For him, the fact that the Fed was falling short on both aspects of its dual mandate was reason enough to maintain its aggressive monetary stance.

'With inflation at 1.3%, and with my own forecast that inflation will remain well below our 2% target over the next two years, one could argue that consistently missing our inflation target alone would justify a highly accommodative policy,' he said.

'However, coupled with persistently high unemployment, the justification for continuing highly accommodative policy by large-scale asset purchases is clear.'

'With inflation at 1.3%, and with my own forecast that inflation will remain well below our 2% target over the next two years, one could argue that consistently missing our inflation target alone would justify a highly accommodative policy,' Rosengren said.

Exit, stage right

Charles Plosser

Meanwhile, Philadelphia Fed President **Charles Plosser (non-voter),** who opposed the new round of asset purchases, suggested it is time for the Fed to revisit its exit strategy.

Echoing the concerns expressed by Pianalto about the swollen Fed balance sheet, he noted that the plan for winding down the balance sheet has not been revisited since it was formulated in June 2011.

It's not too soon to start thinking about a return to normalcy with a step-by-step plan that is clearly communicated to the market, he suggested.

'The specific timing and sequence of the steps detailed in the exit strategy may require some adjustments in light of the larger, and still growing, size of the balance sheet,' Plosser said in Beijing.

'Of course, an important precursor toward normalisation is to stop purchasing more assets.'

Keeping an eye on risks

Janet Yellen

Fed vice chairman **Janet Yellen (voter)** spoke to some of the risks and uncertainties from the central bank's accommodative policy at an IMF discussion in Washington.

The concern that Fed policies encouraging a return to prudent risk-taking can backfire as institutions go too far is a legitimate one, she said.

'Low interest rates may induce investors to take on too much leverage and reach too aggressively for yield,' she acknowledged. 'I don't see pervasive evidence of rapid credit growth, a marked buildup in leverage, or significant asset bubbles that would threaten financial stability. But there are signs that some parties are reaching for yield, and the Federal Reserve continues to carefully monitor this situation.'

She added, however, that monetary policy is 'a blunt tool for addressing financial stability concerns.'

Her own preference, said the Fed official widely considered to be the frontrunner to succeed Bernanke as chairman in January, is to rely on micro- and macro-prudential supervision and regulation.

As one of the main bank regulators in the US, the Fed has been working with other agencies to improve supervision and mitigate systemic risk, she said.

'It's not my expectation that financial stability concerns will rise to the level where that becomes the dominant factor that should control our policy,' Yellen said in response to a question from the audience.

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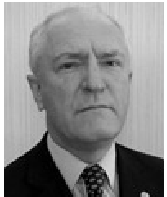
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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome two new members to the Advisory Board, taking the total number of members to 135. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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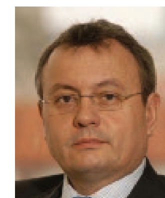
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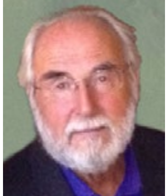
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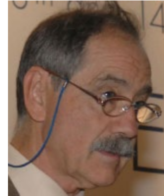
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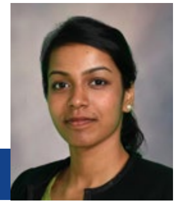
The role of the Advisory Board

The OMFIF Advisory Board is made up of 135 experts from around the world and a range of sectors, including financial services, policy and editorial areas. The OMFIF Advisory Board includes people who contribute to OMFIF's output in many ways, and contains a wide-ranging group of active participants who take part in a cross-section of OMFIF's activities. They can be called upon to provide a variety of services to OMFIF members, including speaking arrangements and bespoke advice on specific subjects. They also take part in the OMFIF International Academy of Central Banking. Please contact Edward Longhurst-Pierce at the OMFIF secretariat for further details.

The lure of real estate

Global shift in asset allocation preferences



Gary Smith, Advisory Board and Pooma Kimis, OMFIF

Sovereign funds from many jurisdictions are showing increased interest in real estate investments, underlining a worldwide shift in asset allocation preferences. Appetite for real estate, partly driven by very low yields on developed country government bonds, to some extent is supplanting appetite for public equities when compared with the stylised investment models used by many funds.

A good example is SOFAZ, the Azerbaijan sovereign fund, which has embarked on a programme to invest in real estate before diversifying into equity markets. A simple marketing point perhaps, but a picture of a real estate investment can be placed on the website of the fund, providing comfort to domestic stakeholders. An image of a share certificate wouldn't work in the same way.

Other explanations for this general trend include the memory of the 2008-09 equity market slump, and the pain that public daily mark-to-market equity valuations can create in the minds of investors.

Many sovereign funds – the Norwegian pension fund, Norges Bank Investment Management (NBIM) is a notable exception – did not rebalance into equity holdings in 2009 market lows, and so have already missed a significant equity market bounce.

Many sovereign funds did not rebalance into equity holdings in 2009 market lows, and so have already missed a significant equity market bounce.

Since some of the largest funds have grown very quickly, there may be a realisation that they have in the past placed too much emphasis on liquidity. Real estate is illiquid, but this is not entirely relevant if a fund is investing for future generations. As funds become larger, their appetite may grow for less liquid but higher-yielding alternative investments.

A stylised model of sovereign fund investment strategy evolution has an investment preference progression that begins with short dated fixed income, continues to other fixed income classes, before reaching public equities. Thereafter, for large funds, or for funds that have grown quickly, historical observation and theory suggest a move into alternative, less liquid, asset classes that offer the potential of higher yields.

The traditional model ranks assets by their liquidity, as well as by yield. Recent evidence suggests that liquidity and safety of investment are perhaps being reassessed in terms of their relative ranking in the investment allocation process. Real estate has characteristics similar to fixed income; rents are akin to coupons, and while entry and exit at a price of par might not be guaranteed, downside potential compared with equities will usually be smaller.

A fundamental reason for the portfolio reassessment may be due to low yields on fixed income assets which no longer meet many funds' relatively high return targets. The Australian Future Fund for example has a government-mandated target of 4.5%-5.5% above inflation, requiring portfolio adjustment. The Future Fund reported property allocation of 6.6% of its portfolio, up from only 1.3% four years ago.

Others acquiring strategic property assets include funds from Malaysia, China, Korea and Norway. The trend is reflected by NBIM, which was given a mandate in March 2010 to increase real estate holdings to 5%, specifically by reducing its fixed income exposure.

In the six months to March, NBIM stepped up growth in its property assets by more than 10-fold from the same period a year ago, with deals including a $600m investment in US offices, taking over Credit Suisse's headquarters complex in Zurich, buying a stake in Sheffield shopping centre Meadowhall and spending €2.4bn on European warehouse and industrial property.

NBIM now has about NKr37.6bn ($6.5bn) of property assets, or 0.9% of the $720bn fund, up from NKr26.7bn at the end of last year and NKr11.2bn last September, when property represented only 0.3% of the fund.

Yngve Slyngstad, the fund's chief executive, told the Financial Times that NBIM would still need a few years to reach its 5% property-to-assets target, given the pace of the fund's inflows. It added NKr366bn in the first quarter through a mix of inflows from Norway's oil revenue, currency moves and returns on its assets.

Slyngstad said most of the sellers in recent property deals – such as Credit Suisse, ProLogis and life insurance companies – were 'long-term owners changing assets', not short-term owners as many had expected.

The various nations that own sovereign funds often have little in common from a macroeconomic perspective. So variations in their investments are driven by many factors, including the demographic profile of the host nation.

The various nations that own sovereign funds often have little in common from a macroeconomic perspective. So variations in their investments are driven by many factors, including the demographic profile of the host nation.

None the less, there is clear evidence that they do emulate each other. Nations as diverse as Singapore, Korea, Abu Dhabi and Qatar all invested in western financial institutions at the same time; it is difficult to believe that this was pure coincidence.

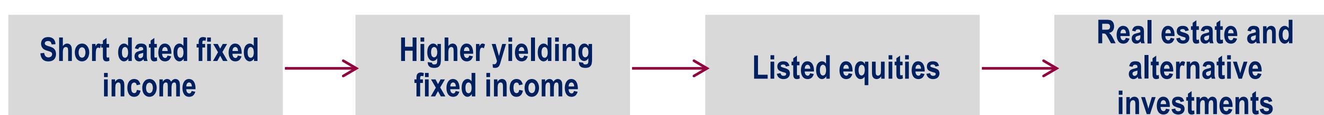
The overall transition by sovereign funds into the property field is time-consuming and relatively expensive in terms of additional resources, requiring among other things specialised investment in building up real estate teams.

But the funds are probably now following a more appropriate fashion than they did when taking part in other shifts in investment preference such as investing in western bank stocks in 2008-09.

Assets under management are now larger. Asset preferences have shifted and become more sophisticated in some ways. The core characteristics of real estate should suit sovereign funds better than western bank investments were ever likely to do.

Traditional SWF model of product evolution; questions for the future

Traditional model



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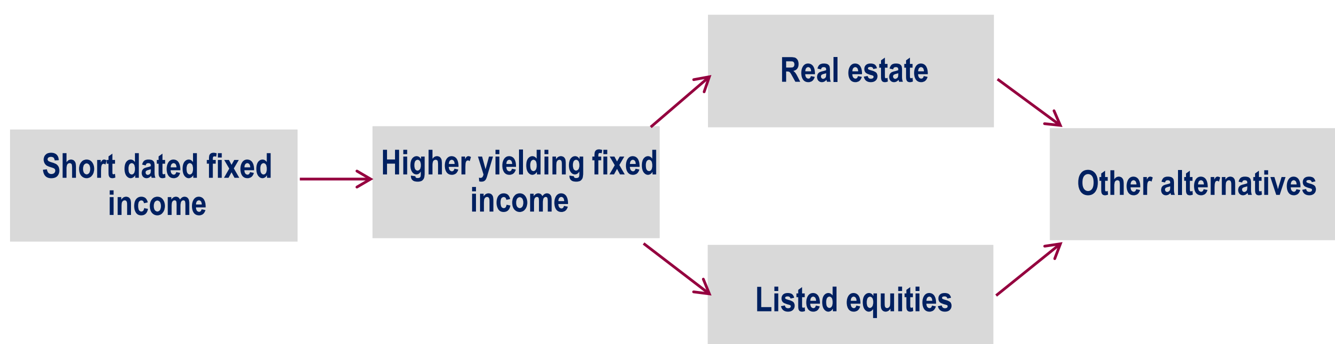
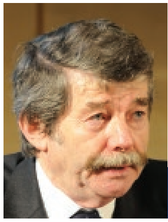


A regular round-up on international monetary affairs



How causality became a casualty

Reinhart-Rogoff error sets a landmark

William Keegan, Chairman, Board of Contributing Editors

I have met the Harvard economist Kenneth Rogoff several times and found him most engaging. When he was at the International Monetary Fund, Rogoff could be relied upon for a good turn of phrase. There was the time, some years ago, when he quipped about a burgeoning world economic recovery that the Europeans would not be participating but 'watching it on television'.

In their bestselling This Time is Different Rogoff and Carmen Reinhart warned that 'policymakers must recognise that banking crises tend to be protracted affairs'. From the UK's point of view this was an important reminder to those who were looking at the experience of the 1930s for useful comparisons, because in the UK, unlike the US and the European continent, there were no banking crises in the1930s.

In that book the authors were more judicious than in a much-hyped academic paper which has now been discredited for its dubious manipulation of data to produce the conclusion that rising public sector debt, especially above the 90% of gross domestic product level, causes slow growth.

Having established in the book that 'fiscal finances suffer mightily as government revenues shrink in the aftermath of crises and bail-out costs mount' they conceded that 'our extensive coverage of banking crises, however, says little about the much-debated issue of the efficiency of stimulus packages as a way of shortening the duration of the crisis and cushioning the downside of the economy as a banking crisis unfolds'.

This did not stop them from questioning how far governments should go fiscally to offset the consequences of a crisis that was not, even according to their own research, originally a fiscal one.

And then, in the aftermath of the success of their book, they went way over the top in transforming an observed association between high public sector debt and slow growth into a causal relationship. They put the cart before the horse: it is slow growth that aggravates the deficit and debt problem.

Excellent news that rival economists at Massachusetts University have discovered massive holes in the Rogoff/Reinhart research which 'supported' the above thesis. How rich that causality has become a casualty! But it's bad that both Chancellor George Osborne in the UK and policy-makers in the euro area were able to place so much emphasis on Rogoff and Reinhart in pseudo-justification of their own austerity policies. Alas, in the real world there have been casualties aplenty as a result of unnecessary policies of austerity dreamed up in academic towers.

It is a major landmark that Rogoff and Reinhart have been 'found out'. Indeed, this could be as important for economic policy as two other landmarks in post-1945 economic history. One was when the 'Keynesian Establishment' became overconfident, and began to ignore the cautionary teachings of their master. The second, and closely related, was when in his latter days Milton Friedman effectively disowned the monetarism he had so ardently preached – a doctrine for which the over-confidence of the Keynesians (I am a Keynesian myself) had opened up a gap.

The Keynesian over-confidence problem arose when disciples who had absorbed the importance of 'not digging deeper' during a slump, and of using fiscal policy to counteract the consequences of private sector retrenchment, began to overdo 'expansionary' and 'growth' policies, thereby aggravating inflation.

In came Friedman with his simple message that inflation was always a monetary phenomenon and that all would be well if governments refrained from most activities and the central bank controlled the supply of money.

Attempts to control the money supply caused excessive damage to the British economy in the early 1980s. In one of the most interesting exchanges in the Financial Times's weekly 'Lunch with the FT' Friedman blithely confessed (7 June 2003), 'The use of quantity of money as a target has not been a success … I'm not sure I would as of today push it as hard as I once did'. At a stroke, he more or less confirmed the wisdom of his old sparring partner J.K. Galbraith: 'Milton Friedman's misfortune is that his economic policies have been tried.'

Rogoff and Reinhart are not nearly as well-known to the general public as Friedman was. But they may not be insensitive to the reaction against them. Writing in the International Herald Tribune of 27 April they maintained: 'Our consistent advice has been to avoid withdrawing fiscal stimulus too quickly, a position identical to that of most mainstream economists'.

Unfortunately, that is precisely what their policy-making disciples in the UK and the euro area have been doing. By treating the issue of deficit-reduction more flexibly to allow for the impact of the economic cycle in increasing fiscal shortfalls rather than lowering them, governments already started to draw the necessary conclusions from the poor economic outcomes of the past two years. It would have been better if Rogoff and Reinhart had never made their mistake. But, if politicians of all stripes guard against making over-hasty decisions on the basis of dubious data, the academic duo's embarrassment may turn out to have salutary consequences.