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OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

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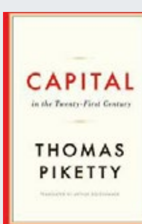
Cover story

Brazil under President Lula, whose term of office came to end in 2010, has been an iconic nation in world development. Without the Brazilians, the 'BRICS' connotation would never have come into common parlance. The country is running into severe headwinds before hosting the World Cup – a development mirrored by other emerging market economies. Some factors, such as the ending of quantitative easing in the US, are external. Some are home-grown. We look at the tensions overshadowing the up-down Brazilian economy. See p.24.

Bulletin



Meghnad Desai praises a monumental book by French economist Thomas Piketty, *Capital in the Twenty-First Century,* in the review section. See p.30.

Misery index

Outlining his international misery index to assess economic circumstances in different countries, Steve Hanke on p. 10-11 outlines in particular the links between economic wellbeing and US political cycles over several decades of American presidents. He outlines how some countries have failed - especially Venezuela.

International monetary policy

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Draghi outlines how ECB will follow Fed example

Mario Draghi, governor of the European Central Bank (ECB), is looking to remodel the way the institution makes decisions. Draghi, who spent many of his formative years in the US, is leaning towards the example of the Federal Open Markets Committee (FOMC) as a way of setting monetary policy. Draghi is pondering shifting the number of ECB governing council meetings to eight a year, in line with FOMC practice, from the present 12, as part of a new policy for releasing minutes of ECB policy discussions. See p.15.

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OMFIF's 152-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars and other OMFIF activities. See p.22-23.

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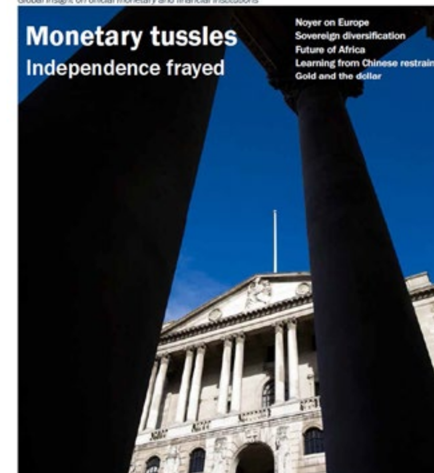


OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

World markets in holding pattern

Suspense on political-economic issues damps growth prospects

David Marsh, Managing Director

International capital markets are in a holding pattern. Several sources of political and economic tensions – ranging from now-unwinding American quantitative easing and the danger of major corporate earnings downgrades in Europe, through to Japan versus China disputes and war threats in Ukraine – keep the world in thrall. Yet, on financial markets, underlying buoyancy remains. In the May edition we look at the suspense, and ask how long it will last. Unless the fog dissipates, world economic growth will remain below par.

The cover story is on Brazil, Latin America's biggest economy, the focus of much pride, hope and worry ahead of June's World Cup. Maria Antonieta Del Tedesco Lins describes the on-off state of economic growth and the decline of the Brazilian economic model. Elsewhere across the emerging markets Meghnad Desai dwells on the Indian elections, where the count in mid-May seems likely to lead to the election of Narendra Modi, the charismatic and controversial chief minister of Gujarat. Jonathan Fenby outlines new question marks over the renminbi. Desai describes, too, how leadership of the International Monetary Fund – embroiled still in a long dispute with the chief paymaster, the US, over a much-needed reordering of quotas and voting strengths – should pass to a non-European when Christine Lagarde's mandate runs out in 2016. We put forward the name of Tharman Shanmugaratnam, the Singapore finance minister, as a possible candidate – and highlight the need for a genuinely open-minded competition.

In our European section, Gabriel Stein highlights a key problem of economic and monetary union: many countries with which Germany should theoretically be forming an optimum currency area are not euro members. William Keegan ponders the perils of central banks' 'forward guidance'. Klaas Knot reflects on De Nederlandsche Bank's 200-year-old history. John Nugée puts forward an alternative strategy for winning Scottish voters to the cause of remaining in the UK.

Frank Westermann cautions against drawing the wrong conclusions from improved Target-2 balances at the heart of the euro's financial imbalances. Ruud Lubbers and Paul van Seters emphasise how the UK is backing Europe's green energy plans. We focus, too, on how Mario Draghi is leading a revamp of the European Central Bank's decision-making processes on monetary policy.

With regard to the US, Desmond Lachman writes that, on the future of the world's premier reserve currency, prophets of the dollar's fall from grace will once again be proven wrong. In similar vein, John Kornblum says the US will emerge strengthened from latest geopolitical tussles, whereas Russian President Vladimir Putin is one of the losers. Darrell Delamaide, in his monthly Banknotes feature on the Federal Reserve, sums up the debate on whether the US faces inflation or deflation. Steve Hanke updates his 'misery index', putting US experience into an international context. Our review section describes books by Thomas Piketty and John Peet and Anton La Guardia.

I write this as Managing Director. John Plender has taken over as a Chairman. OMFIF has strengthened its shareholding structure, board and management team. The world remains uncertain. This is not necessarily a hindrance to further expansion. ▪

David Marsh

Bittersweet quest for philosopher's stone

Adventures of British chancellors end in tears

William Keegan, Advisory Board

After the kind of banking crisis that was never supposed to happen again in the wake of the Great Depression, we were given 'forward guidance' as the panacea to provide the economy with 'escape velocity'.

To judge from the confusion within and outside the sacred portals of the Bank of England as to what this means, and the array of mystified (and mystifying) comments about its real significance, I am inclined to rename the latest economic philosopher's stone 'forward misguidance'.

The Bank of England, having seen its plans to delay interest rate increases dissolve in a statistical welter, seems to have concluded that a housing bubble is indeed a fundamental danger. Sir Jon Cunliffe, one of the bevy of deputy governors arrayed around Mark Carney, says with cinematographic relish (is he thinking of 'Jaws'?) that property price signals resembled 'a movie that has been seen more than once in the UK'.

I have been thinking a great deal lately about economic miscalculations. One of the many diversions from my work on my memoirs – where, I hope you will be glad to hear, I am making considerable progress – was writing a book called *The Prudence of Mr Gordon Brown*. Prudence with Britain's finances, you may recall, was to be the panacea under the previous Labour government to avoid the old phenomenon of boom bust.

It didn't quite work out like that – although, in a second diversion, I wrote another book called *Saving the World? Gordon Brown Reconsidered* in which I attempted to demonstrate that Brown's 'imprudence' was not as serious as his critics made out. (Meanwhile, a third diversion from memoir-writing is a book I am writing with the working title of *Mr Osborne's Economic Experiment,* on which I have certainly been given plenty of forward misguidance.)

....continued on page 16

ADVISORY BOARD

OMFIF welcomes three new members, David Smith, Volker Wieland and David Badham. Their appointments take the number of Advisory Board members to 152. For full list of members see p.22-23.

David Smith is a writer, professor and adviser to non governmental organisations based in Latin America. From 2004-10, he represented the United Nations Secretary-General in Washington, working with the White House, State Department and US Congress. From 2010-14 he headed the UN's office in the Southern Cone, based in Argentina, where he now lives.

Prof. Volker Wieland is a member of the German Council of Economic Experts and the Scientific Advisory Council of the German Ministry of Finance and also belongs to the Kronberger Kreis, the Scientific Council of the Market Economy Foundation. Furthermore, he is a Research Fellow at the Centre for Economic Policy Research (CEPR).

David Badham is a financial services strategy, marketing and communication specialist. Previous roles include head of investment marketing in Europe for the World Gold Council. Prior to that, he worked for 26 years for NatWest and the Royal Bank of Scotland, leading global divisional business strategy, marketing, research and communications functions.

EXPERT SEMINARS

Central banks discuss gold in Washington

A group of central bankers and other public officials discussed 'Gold and central banks' during the World Bank Group and International Monetary Fund spring meeting in Washington on 11 April. A reception hosted by the World Gold Council and OMFIF provided the forum for discussions on gold and central banks at which Richard McCormack, former US assistant secretary of state for economics and business, gave an address on perspectives for renewal of the Central Bank Gold Agreement, due to expire in September 2014.

Knot presides over De Nederlandsche Bank bicentennial

Klaas Knot, President, De Nederlandsche Bank (DNB), presided over a conference in Amsterdam on 24-25 April commemorating its 200th anniversary, at which the main speaker was Mario Draghi, European Central Bank president. (For an account of Draghi's ideas on monetary policy communication, see p.15). David Marsh spoke in a panel on the future role of monetary policy, together with Lucas Papademos, former ECB board member, Frederic Mishkin, Columbia Business School, Paul De Grauve, London School of Economics and Job Swank, member of the DNB governing board.

POLICY GROUP

Office for Budget Responsibility outlines UK challenges

Robert Chote, head of the Office for Budget Responsibility, spoke about fiscal sustainability in the UK at an OMFIF policy group meeting on 10 April. Chote focused on Chancellor George Osborne's austerity policies, their effects on the UK economy and the OBR's projections for Britain's tax and spending in the long-term. Chote expounded on the growing robustness of the OBR's work in verifying governmental assumptions on the British economy and on the need for independence in its verification and forecasting work. International comparions were another point of discussion.

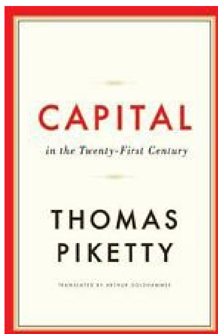
BRIEFINGS

Asian Development Bank outlook for 2014 and beyond

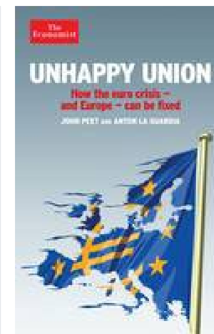
At a briefing in London on 3 April, hosted by OMFIF, Juzhong Zhuang, Deputy Chief Economist, Asian Development Bank (ADB), gave his outlook for the Asian economies for 2014 and beyond. The ADB sees 'steady growth' for Asia over the coming years, supported by the improved outlook in advanced economies. However he noted that gains may be offset by slowing GDP growth in mainland China. Overall political and economic risks are fewer in number and more manageable than in previous years. Asian economies are in a much better position to handle any future crises, having built more resilient frameworks, according to the ADB.

BOOKS & THE ADVISORY BOARD

Inequality and Europe hold centre stage



Meghnad Desai praises a monumental book by French economist Thomas Piketty, *Capital in the Twenty-First Century*. Piketty, a professor at the Paris School of Economics, observes that, since 1980, income inequality has surged and is unlikely to fall without substantial government intervention. While Desai points out that Piketty has no short-term answers, the reviewer says the Frenchman has produced a rare economics book – a bestseller – which will be read for years to come. Meanwhile, Graham Hacche reviews *Unhappy Union: How the euro crisis – and Europe – can be fixed* by John Peet and Anton La Guardia. Both are journalists at The Economist and their work is a succinct primer on how the euro came about, prospered in the initial years and then fell into years of crisis and restructuring. Their conclusion about next steps in Europe's passage is not optimistic. 'Though the financial panic is in abeyance, the economic and political crises are far from over, and may well deepen.' See p.30-31.



GOLDEN SERIES

EBRD's Chakrabarti on reigniting growth reforms

Suma Chakrabarti, President of European Bank for Reconstruction and Development (EBRD), analysed the international monetary system for a Golden Series Lecture on 29 April in London. Chakrabarti, the first British head of the EBRD, outlined his views on international finance from the perspective of a development bank. Chakrabarti's theme was whether countries in the EBRD's wide area of operation, several of them 'stuck in transition', could kick-start their economies through additional spending measures. His conclusion was that only three countries, Estonia, Georgia and Bulgaria, were in that position and there was no alternative to painful structural reforms. He outlined his vision for the changing role of the EBRD in the light of its move towards financing projects in the Middle East and North Africa, and discussed how the EBRD's role as an investor had changed since it was founded in 1991. See p.29.

EXPERT SEMINARS

The pros and cons of UK austerity policy debated in London

John Redwood, MP (standing) speaks at OMFIF debate on UK austerity

Four intellectuals grappled with the subject of whether austerity has worked in the UK at a seminar on 30 April in London. Lord (Meghnad) Desai, Emeritus Professor of Economics, London School of Economics, Lord (Robert) Skidelsky, Emeritus Professor of Political Economy, University of Warwick, John Redwood, MP for Wokingham, and William Keegan, Senior Economics Commentator at The Observer, exchanged views on government austerity measures. The debate ended with a vote. The Desai-Redwood team claiming that austerity had worked, although clearly a minority view, was judged to have won over a small proportion of additional support from the opposing side of Skidelsky and Keegan.

Prophecy of dollar doomsayers will fail

Status of dollar as reserve currency is safe in uncertain times

Desmond Lachman, American Enterprise Institute

Some years ago, I attended a small luncheon at which Paul Volcker, the former Federal Reserve chairman, was the guest of honour. In response to Cassandras who argued that the US economy's all too apparent weaknesses would lead to an inevitable dollar collapse, Volcker made a simple observation.

For the dollar to depreciate, he said, it would necessarily have to depreciate against another currency. In Volcker's view, it was far from obvious that the US economy was fundamentally any weaker than those of its major industrialised country competitors.

Volcker's logic

Volcker's logic would seem equally pertinent today in responding to those who believe that the Fed's unprecedented quantitative easing will eventually lead to the dollar's demise as a reserve currency. More than 60% of the world's foreign exchange reserves and more than 85% of world trade is still denominated in dollars. If the US currency were to lose its pre-eminent position, some other unit would need to replace it. And yet no other money encompasses the liquidity, the depth of financial markets and the store of value that the dollar still offers.

Viewed in isolation, many questions about the dollar's long-run future come to the fore. The US economy is only now emerging from its worst economic and financial crisis since the 1930s. Its dysfunctional political system has yet to come to grips with the country's long-term budget issues. The Fed has been forced to more than quadruple its balance sheet to around $4tn to get the economy moving again.

Ex-Federal Reserve chief Paul Volcker

Yet the US economy's recent performance has been considerably brighter than that of the other major industrialised countries. Not only has the US economy recovered the most strongly from the 2009 recession, but its economic outlook for 2014 and 2015 remains among the brightest of the industrialised countries, as acknowledged by the IMF's latest World Economic Outlook. The non-partisan Congressional Budget Office forecasts that the US budget deficit will be as low as 2.75% of GDP in 2014 and 2015.

There appears to be no sign of any resurgence in US inflation, despite all the dire warnings about the expansion in the Fed's balance sheet. Indeed, US inflation is running at around 1%, or half the Fed's desired target. Long-term US inflationary expectations appear to be very firmly anchored.

Prospects for dollar's reserve currency role look all the brighter when one considers the currencies that could conceivably challenge that status. This is most evidently the case with regard to the euro, which accounts for almost 25% of international reserves.

Despite financial markets' current optimism about Europe, the euro's long-term prospects are fraught with political and economic risks. These centre on Europe's record high unemployment, which is around 12% for the region as a whole and as high as 27% for countries like Greece and Spain. The European Central Bank forecasts that, despite a gradual recovery, European unemployment will not decline below 11.5% by 2016.

The European sovereign debt crisis has been partly responsible for a disturbing fragmentation of European politics. In France, Marine Le Pen of the National Front is now ahead in the polls for the May European parliamentary elections. Together with Geert Wilders of the Dutch far-right Freedom Party, she is campaigning on an anti-European platform. Meanwhile in Greece, the two centrist parties which commanded 70% of the vote in 2010 now command barely 30% of public support, while in Italy the populist Five-Star movement still polls 25%.

Unless unemployment unexpectedly falls sharply, Europe's political climate is likely further to deteriorate. Europe's political commitment to the euro could still face tough tests. There is now the spectre of Japanese-style deflation in Europe. Over the past year, Europe's average inflation rate has decelerated to 0.5% while peripheral countries are either experiencing outright deflation or are on the cusp of deflation. Deflation not only constitutes a major headwind to the economic recovery but also greatly complicates the task of restoring public debt sustainability. Sadly, much like the Bank of Japan (BoJ) before it, the ECB behaves much of the time as if it were oblivious to the deflation risk.

Serious challenge

If the euro is unlikely to pose a serious challenge to the dollar, the yen is certainly not going to do so. The Japanese government is drowning in debt at a time when it still runs an outsized budget deficit. The country's very poor demographics have led to a plunge in the domestic savings rate. There is every prospect that the BoJ will have to step up its massive quantitative easing to avert a relapse into deflation, which will lead to a prolonged period of yen weakness. This is hardly the stuff of which a strong reserve currency is made.

In contrast to the yen, the renminbi is a currency that could eventually pose a real threat to the dollar, particularly if China were to continue to grow at anywhere near its recent rate. However, for that to happen, China would need to engage in serious financial reform, making the currency convertible by lifting capital controls, developing its domestic bond market, cleaning up its shadow banking system and making the financial system more transparent and more based on the rule of law.

Judging by other countries' experience, it would seem fanciful to think that these reforms could be successfully implemented in less than a decade.

Since the collapse of the Bretton Woods system in 1971, many have predicted that the dollar's reserve currency days were numbered. Yet more than 40 years on, the dollar's position is yet to be seriously challenged. This reflects less the dollar's inherent strengths, more rival currencies' intrinsic weaknesses. For better or for worse, there is every reason to expect that this state of affairs will persist. In the decade ahead, the long-run dollar pessimists again will be proved wrong. ▪

Desmond Lachman is a resident fellow at the American Enterprise Institute.

Why Singapore's Tharman must run for IMF

Time for a non-European to take charge

Meghnad Desai, Chairman, Advisory Board

Christine Lagarde is more than halfway through her tenure as the managing director of the International Monetary Fund (IMF). She is the 11th consecutive European in the job. There is no shortage of talent as to who will succeed her in July 2016.

This time, ample notice is required to prepare an open and transparent selection process. There must be no European monopoly on the post. I would like Tharman Shanmugaratnam, the Singapore finance minister, to be a candidate. He is thoughtful, technically competent, well respected – and he would hit the ground running.

The IMF needs a managing director with equal doses of technocratic and political skills. When Dominique Strauss-Kahn, the overly high-flying previous incumbent, departed in May 2011 because of extra-curricular activities, a feeble attempt was made to open up the appointment to a global contest, but the outcome was a foregone conclusion.

A Frenchwoman followed a Frenchman. A French politician with presidential ambitions (sadly thwarted) was followed by another French politician with similar ambitions (always denied of course).

French dominance

For 38 of the 68 years in which the IMF has had a managing director, a French person has been at the helm. I love the French. And I am all for women in top positions. But sometimes you can go too far.

In the previous round, OMFIF backed as a candidate Zeti Akhtar Aziz, the highly-accomplished governor of Bank Negara Malaysia, but she showed no inclination to join the contest. Tharman is an IMF insider, the chairman (since 2011) of the International Monetary and Financial Committee, whose first chair was Gordon Brown, the former UK chancellor of the exchequer and prime minister.

Tharman is Singapore's deputy prime minister and a previous chief executive of the Monetary Authority of Singapore (before he entered politics). He's a member of the prestigious Group of Thirty. You cannot get a better CV than that for the job.

In the past, when asked about the possibility that he might go for the position, Tharman has shrugged his shoulders or murmured something self-deprecating. But if the possibility came into view, the Singapore government would no doubt take it very seriously.

The IMF has just had its spring meeting in Washington. The world economy is in better shape than when Lagarde took over. Losing Strauss-Kahn was a shock. The IMF is now on a more even keel. Its analysis of the world's experiments with austerity has been criticised, as has been its forecasting record. But that is not new.

The IMF has often got its macroeconomics wrong. Yet it faces challenges, as does the global economy. The US Congress, in its usual erratic manner, is holding up long overdue reforms, including quota rebalancing agreed by the rest of the world. The refusal to vote funds for reforms is entirely due to quarrels between President Barack Obama and Congress. Any movement is unlikely before November's mid-term elections.

The US needs some stiff talking to, now and in the future. This is where people like Tharman Shanmugaratnam can play a role. Someone has to tell the US that its days of hegemony are over in the global financial field, just as they are in the international political arena. Syria and Crimea have shown that the US lacks clout. The world may, or may not, be a better place for it, but that's a fact.

The IMF affords Christine Lagarde a bully-pulpit to tell the world how irresponsible the Americans are, in the hope of inspiring some activity in Washington. Thus far she has held her fire. This may be a shrewd calculation as to timing.

In the case of Strauss-Kahn, his refusal to crack the whip at the Greek government in 2010 and his softly-softly approach on the euro were attributed to a desire to keep his presidential hopes bright for the 2012 election eventually won by François Hollande.

Lagarde's relative hesitancy may reflect desire to keep on the right side of an important French ally. France and the US are having an unusual honeymoon since the British failed to march into Syria. An old friendship has been revived. It may be that Lagarde does not want the opprobrium of disrupting the mood music. Perhaps, at a time of her choice, she will act decisively.

Equally likely, time for IMF reforms may run out. Whatever the case, the IMF and its friends must begin thinking about the succession. The reasons why the managing directorship should no longer go automatically to a European are even more obvious than three years ago.

Finance Minster Tharman Shanmugaratnam

The emerging economies have traversed the 2009 recession and are in better shape than the developed countries. They had better financial regulation. But they have been subjected to asymmetric shocks due to quantitative easing from the industrialised countries.

Quantitative easing

First QE and now tapering have convulsed the emerging market economies. As Brazil has complained, the trade wars of earlier decades have given way to exchange rate protectionism.

Raghuram Rajan, the new governor of the Reserve Bank of India, has urged developed countries' central banks to take the emerging economies into their confidence and alert them to forthcoming policy shifts.

This appears unlikely. The IMF has not been as alive to the problems of the majority of its members as it should have been. It continues to be a US-Europe club.

Let's hope that, as the horse-trading starts on Lagarde's successor, there will be other candidates from around the world. The important thing is to begin the global discussion on how the IMF can be better run – and who should run it.

Summer 2014 offers the right opportunity. This discussion should start now. ▪

Meghnad Desai, Chairman of the OMFIF Advisory Board, is Emeritus Professor of Economics at the London School of Economics.

Measuring misery around the world

Data show that free market societies are happier than others

Steve Hanke, Advisory Board

The 2009 recession and its aftermath grind on and politicians of all stripes ask, usually behind closed doors, 'Just how miserable are our citizens?' The chattering classes offer a variety of opinions. As it turns out, there is a straightforward way to measure this question. It is termed the misery index.

The late Arthur Okun, a distinguished economist who served as chairman of the President's Council of Economic Advisers, during President Lyndon Johnson's administration, developed the original misery index for the US. Okun's index is equal to the sum of the inflation and unemployment rates.

Harvard Professor Robert Barro amended the misery index by including the 30-year government bond yield and the output gap for real GDP. Barro used his index to measure the change in misery during a president's term.

From these metrics, one would anticipate that if there were a high level of misery in a country, and the current politicians increased that level of misery, then this increase would be borne out by looking at opinion polls. In other words, it is expected that citizens are aware of misery, and approve or disapprove of their leaders accordingly.

The data in the misery index chart are revealing. Contrary to left-wing dogma, the 'free-market years' during the presidency of Ronald Reagan were very good. And the Clinton years of Victorian fiscal virtues – when President Bill Clinton proclaimed in his January 1996 State of the Union address: The era of big government is over' – were good ones as well.

The misery index pours cold water on the current critique of free markets and fiscal austerity – a critique that has taken on the characteristics of a religion embraced without investigation. Indeed, it makes one wonder whether the critics ever bothered to subject their ideas to a reality check.

But does the misery index accurately measure misery? When looking at the relationship between a president's approval ratings and the misery index, the truth comes in to sharp focus. If the economy is doing poorly during a president's term, the likelihood for this president to have a low approval rate is high, and vice versa (correlation of -0.54).

Ranking presidents

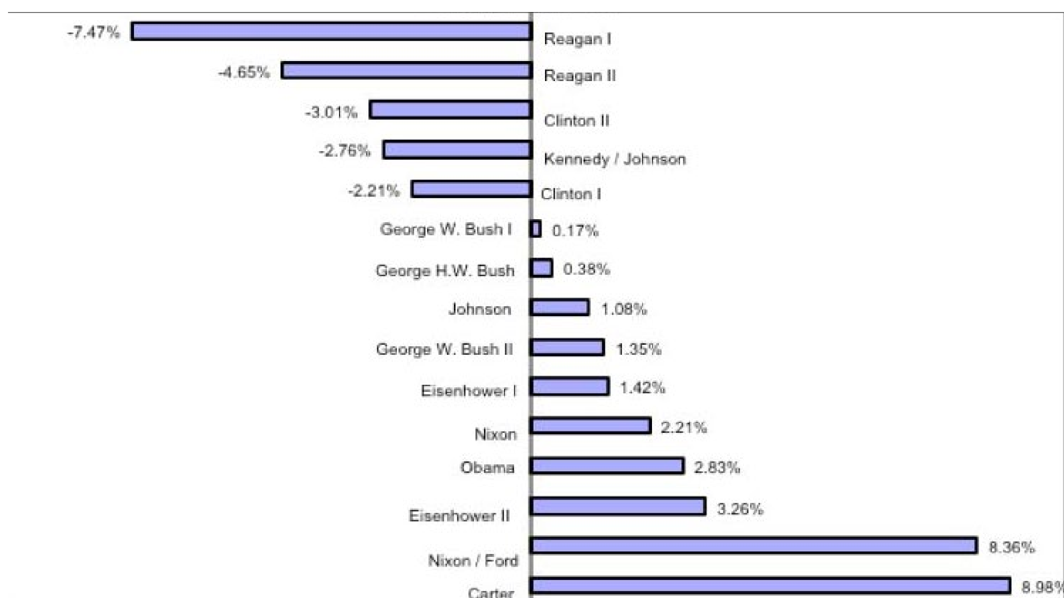
By examining the misery index ranking and the the poll ratings of US presidents, the correlation becomes apparent. (See Charts 1 and 3.) For most people, their quality of life is important. Constituents prefer lower inflation rates, lower unemployment rates, lower lending rates, and higher GDP per capita. By combining the poll rankings and the misery index, one can calculate a standardised ranking from one president to another.

This type of analysis is not limited to the US. The misery index concept can be applied to any country where suitable data exist. A misery index — a simple sum of inflation, lending rates, and unemployment rates, minus year-on-year per capita GDP growth — is used to construct a ranking for 89 countries (see Chart 2.)

When measured by the misery index, Venezuela holds the ignominious top spot, with an index value of 79.4. But that index value, as of 31 December 2013, understates the level of misery because it uses the official annual inflation rate of 56.2%.

In fact, I estimate that Venezuela's annual implied inflation rate at the end of last year was 278%. That rate is almost five times higher than the official inflation rate. If the annual implied inflation rate of 278% is used to calculate Venezuela's misery index, the index jumps from 79.4 to 301, indicating that Venezuela is in much worse shape than suggested by the official data.

Chart 1: Misery index – changes during terms of US presidents



Sources: Bureau of Labor Statistics, CPI-U Index; Bureau of Labor Statistics, Current Population Survey; Bureau of Economic Analysis; U.S. Federal Reserve; International Monetary Fund, World Economic Outlook; Congressional Budget Office; Federal Reserve Bank of St. Louis and calculations by Prof. Steve H. Hanke, The Johns Hopkins University.

Note: The misery index presented is the sum of the following four metrics: the difference between the average inflation rate over a president's term and the average inflation rate during the last year of the previous president's term; the difference between the average unemployment rate over a president's term and the unemployment rate during the last month of the previous president's term; the change in the 30-year government bond yield during a president's term; and the difference between the long-term trend rate of real GDP growth and the real rate of growth during a president's term.

The question needs to be put why such a huge gap exists between the official inflation rate and my estimate of the true inflation rate. After all, Venezuela imposes a complex web of government price controls.

In fact, when one observes prices for the items that comprise Venezuela's price index, many of the prices will be those mandated by the government, not the market. So the inflation rates for the basket will be artificially low. The official inflation reading will be for what is termed 'suppressed' inflation. And that's not the end of the story. Indeed, with binding price controls, many goods in the official price index basket are nowhere to be found.

Friedman's adage

Furthermore, when it comes to price control-induced shortages, there is no better authority than Milton Friedman: 'We economists don't know much, but we do know how to create a shortage. If you want to create a shortage of tomatoes, for example, just pass a law that retailers can't sell tomatoes for more than two cents per pound. Instantly you'll have a tomato shortage. It's the same with oil or gas.'

The figures confirm Friedman's observation. In Venezuela, 28% of basic products are not available.

When price controls and shortages prevail, how can the true rate of inflation – 'open' inflation – be measured? Binding price controls spawn black markets. Many of the goods and services subject to controls migrate to black markets. For example, in German-occupied Poland during the Second World War, price controls prevailed and the black market flourished.

Everything from basic food and industrial goods to foreign exchange traded on black markets. There was even an illegal stock market. The scale of the black markets was impressive, with 80% of all food being supplied via illegal channels.

Venezuela's inflation

One way to estimate the rate of true, open inflation, in cases such as Venezuela's, would be to track down the free-market prices – including the black-market prices – for all goods in the official basket. But such a procedure would be very difficult, if not virtually impossible, to implement. That is why no country has ever accomplished such a herculean task.

As an alternative, I have developed a procedure for estimating the true, open inflation rate for an economy in the grip of high inflation and price controls. While it is impractical to determine the free-market (read: black-market) prices for all items in an official basket, it is often quite easy to observe the free, black-market exchange rate.

Since this is the most important price in the economy, changes in the free, black-market exchange rate can be used to estimate the true, open inflation rate for an economy.

By using the most important free-market price in Venezuela – the bolivar/dollar rate – one can accurately estimate Venezuela's annual open inflation rate. At the end of 2013, this true, open inflation rate was five times higher than the official rate. And the associated true misery index was 301, not 79.4.

It's not surprising that President Nicolás Maduro's popularity has plunged 16 percentage points since he took office in April 2013. And if that wasn't bad enough, politically-motivated street violence has claimed 39 lives since mid-February 2014. ▪

Steve Hanke is a Professor at Johns Hopkins University and Director of the Troubled Currencies Project at the Cato Institute.

Chart 2: Global misery index

Rank (Worst to Best)	Country	Misery Index	Major Contributing Factor	Rank (Worst to Best)	Country	Misery Index	Major Contributing Factor
1	VENEZUELA	79.4	Consumer Prices	46	ALGERIA	16.8	Unemployment
2	IRAN	61.6	Consumer Prices	47	MOLDOVA	16.7	Interest Rate
3	SERBIA	44.8	Unemployment	48	SLOVAKIA	16.5	Unemployment
4	ARGENTINA	43.1	Consumer Prices	49	ICELAND	16.3	Interest Rate
5	JAMAICA	42.3	Interest Rate	50	CZECH REPUBLIC	15.0	Unemployment
6	EGYPT	38.1	Unemployment	51	SRI LANKA	15.0	Interest Rate
7	SPAIN	37.6	Unemployment	52	CHILE	14.6	Interest Rate
8	SOUTH AFRICA	37.4	Unemployment	53	HUNGARY	14.3	Unemployment
9	BRAZIL	37.3	Interest Rate	54	VIETNAM	14.0	Interest Rate
10	GREECE	36.4	Unemployment	55	FINLAND	13.9	Unemployment
11	MACEDONIA	35.7	Unemployment	56	FRANCE	13.9	Unemployment
12	PALESTINIAN TERRITORY	32.9	Unemployment	57	ESTONIA	13.8	Unemployment
13	TURKEY	32.7	Interest Rate	58	MOROCCO	13.3	Unemployment
14	CYPRUS	30.7	Unemployment	59	AUSTRALIA	13.3	Interest Rate
15	CROATIA	30.5	Unemployment	60	LITHUANIA	13.0	Unemployment
16	DOMINICAN REPUBLIC	29.8	Unemployment	61	MEXICO	12.9	Unemployment
17	TUNISIA	29.5	Unemployment	62	UNITED KINGDOM	12.9	Unemployment
18	GEORGIA	27.7	Unemployment	63	BELGIUM	12.9	Unemployment
19	NICARAGUA	27.0	Interest Rate	64	ECUADOR	12.7	Interest Rate
20	HONDURAS	26.8	Interest Rate	65	EL SALVADOR	12.4	Unemployment
21	COSTA RICA	25.6	Interest Rate	66	ROMANIA	12.2	Interest Rate
22	INDIA	25.6	Interest Rate	67	PHILIPPINES	11.7	Unemployment
23	JORDAN	25.3	Unemployment	68	KAZAKHSTAN	11.7	Interest Rate
24	UKRAINE	24.4	Interest Rate	69	NETHERLANDS	11.5	Unemployment
25	PERU	23.9	Interest Rate	70	NEW ZEALAND	11.4	Unemployment
26	URUGUAY	23.8	Interest Rate	71	UNITED STATES	11.0	Unemployment
27	PORTUGAL	23.5	Unemployment	72	ISRAEL	11.0	Unemployment
28	BARBADOS	22.9	Unemployment	73	SWEDEN	10.5	Unemployment
29	PAKISTAN	21.9	Interest Rate	74	CANADA	10.5	Unemployment
30	INDONESIA	21.6	Interest Rate	75	LATVIA	10.3	Unemployment
31	BANGLADESH	20.8	Interest Rate	76	HONG KONG	10.1	Interest Rate
32	SLOVENIA	20.8	Unemployment	77	DENMARK	9.88	Unemployment
33	BOLIVIA	20.2	Interest Rate	78	GERMANY	9.08	Unemployment
34	ITALY	20.1	Unemployment	79	AUSTRIA	9.03	Unemployment
35	AZERBAIJAN	20.0	Interest Rate	80	NORWAY	8.75	Unemployment
36	RUSSIAN FEDERATION	19.9	Interest Rate	81	PANAMA	8.24	Interest Rate
37	POLAND	19.8	Unemployment	82	CHINA	7.90	Real GDP Growth
38	COLOMBIA	19.6	Interest Rate	83	MALAYSIA	7.80	Interest Rate
39	PARAGUAY	19.1	Interest Rate	84	QATAR	7.39	Interest Rate
40	SAUDI ARABIA	18.9	Unemployment	85	THAILAND	6.83	Interest Rate
41	MYANMAR	18.4	Interest Rate	86	KOREA, REP. OF	6.77	Interest Rate
42	MAURITIUS	18.2	Interest Rate	87	SINGAPORE	6.38	Interest Rate
43	TRINIDAD & TOBAGO	17.9	Interest Rate	88	TAIWAN	6.13	Unemployment
44	IRELAND	17.6	Unemployment	89	JAPAN	5.41	Unemployment
45	BULGARIA	17.2	Unemployment				

Sources: Economist Intelligence Unit (including estimates), IMF, calculations by Prof. Steve H. Hanke, The Johns Hopkins University.

Notes: The misery index score is the sum of the unemployment rate, the lending rate, and the inflation rate (consumer prices; end-of-period) minus the percent change in real GDP per capita. Only countries where all four data series were available from the Economist Intelligence Unit were included (2013 lending rate in Tunisia estimated at 8%).

Chart 3: Measuring US presidents

Rankings of US presidents compared with misery index performances: a correlation is confirmed

Presidents	Years in Office	Poll Ranking	Misery Index Ranking	Standard Rankin
Reagan	1981-1988	1	1	1
Clinton	1993-2000	3	2	2
Kennedy/Johnson	1961-1963	2	3	3
G. Bush	1989-1992	4	4	4
Carter	1977-1980	5	8	5
G. W. Bush	2001-2008	8	5	6
Nixon/Ford	1969-1976	6	7	7

Calculations by Prof. Steve H. Hanke, The Johns Hopkins University. Notes: Ranking transformed according to their relative position on the interval between the lowest and highest score ([min, max]) and to their relative position on the interval [0, 1].

In order to calculate the ranking during Johnson's terms, an average of Kennedy's approval rate and Johnson's approval rates during both terms was used. Likewise, an average of the approval rates of both Ford and Nixon were used.

This is due to the fact that the misery index values of Kennedy or Ford alone are not available.

Fed debate turns towards deflation

Policy-makers increasingly worried about hitting inflation target

Darrell Delamaide, US Editor

As Janet Yellen (voter) hits her stride as chairman of the Federal Reserve and the Federal Open Market Committee continues to reduce its asset purchases, the monetary policy discussion in the US is turning to that central bank bailiwick par excellence – inflation.

While some Fed policy-makers and other economists worry that the Fed's bloated balance sheet from years of quantitative easing is a powder keg just awaiting a spark to ignite inflation, Yellen clearly lines up with those who are more worried that the current low rate of inflation is likelier to tip into deflation.

'The FOMC strives to avoid inflation slipping too far below its 2% objective because, at very low inflation rates, adverse economic developments could more easily push the economy into deflation,' Yellen said last month in her debut policy speech at the Economic Club of New York.

Labour market slack

Much of the discussion has centred on how much 'slack' there is in the labour market and how much push might come from wage inflation if indeed there is less slack than the doves think.

In her speech, Yellen said that the best indicator of slack is the unemployment rate itself, which at 6.7% is still far away from the maximum employment the Fed is legally mandated to achieve. But there may be even more slack that indicated, Yellen added, because the number of part-time workers remains exceptionally high and some of them may be seeking full-time employment. By the same token, the low level of labour market participation might be obscuring the full amount of slack, she said.

As for the actual impact of more or less slack on inflation, Yellen was hesitant. 'During the recovery, very high levels of slack have seemingly not generated strong downward pressure on inflation,' she said. 'We must therefore watch carefully to see whether diminishing slack is helping return inflation to our objective.'

In the question period after her speech, Yellen responded to a question from Harvard's Martin Feldstein about whether short-term unemployment, rather than total unemployment, might be a better indicator of slack in the labour market and the risk from wage inflation.

Feldstein noted that Princeton's Alan Krueger, like Yellen a former chairman of the Council of Economic Advisers, has made the case that many of the long-term unemployed are marginal and won't return to the labour market.

'It is conceivable that that line of thinking is right,' Yellen conceded generously in her response. But she added, 'I think it's premature, frankly, to jump to that conclusion, that that argument is correct.'

Yellen acknowledged that for whatever reason there is a risk that inflation could rise above the Fed's 2% target. 'At present, I rate the chances of this happening as significantly below the chances of inflation persisting below 2%,' she said, 'but we must always be prepared to respond to such unexpected outcomes.'

Fed governor **Daniel Tarullo (voter)** came down in the Yellen camp in a speech at the annual Hyman Minsky conference in Washington. 'In the face of some uncertainty as to how best to measure slack, we are well advised to proceed pragmatically,' he said.

The Fed obviously will remain watchful whether labour markets tighten to the point that they create inflationary pressure, even though inflation currently lags its 2% target. 'But we should not rush to act preemptively in anticipation of such pressures based on arguments about the potential increase in structural unemployment in recent years,' Tarullo said.

His remarks reflected the debate at the FOMC meeting in March, according to the minutes released last month. 'Several participants' expressed sentiments similar to Yellen's in her speech, the minutes recorded. 'A couple of other participants, however, saw reasons to believe that slack was more limited, viewing the decline in the participation rate as primarily reflecting demographic trends,' the minutes continued.

Chicago Fed chief **Charles Evans (non-voter)** is also more worried about inflation, currently at about 1%, being too low. 'Given today's unacceptably low inflation environment and the wealth of inflation indicators that point to continued below-target inflation, I think we need continued strongly accommodative monetary policy to get inflation back up to 2% within a reasonable time frame,' he said at the same Hyman Minsky conference.

He amplified his position in remarks to reporters after the speech. 'I'm not quite sure why we would want to raise interest rates with a 1% inflation rate, no matter what the unemployment rate is,' he said. He added that the Fed would probably begin raising rates sometime next year, but that he personally would prefer keeping them near zero into 2016.

Low inflation concern

Charles Plosser (voter), head of the Philadelphia Fed, doesn't share Evans's concern about the low rate of inflation. In remarks to reporters following a speech in Philadelphia, Plosser said he thinks inflation expectations remain well-anchored and that inflation will get back to 2% target. 'In the short run, I'm not terribly concerned,' he said.

In the speech itself, Plosser weighed in on the subject of banking regulation and financial stability, where he argued for greater simplicity. He cited the example of increasing complexity in the Basel risk-weighting classifications, which can create incentives to minimise the use of capital in a way that results in risks becoming hidden in opaque structures.

'There is merit in developing simpler, more transparent regulatory solutions designed to work reasonably well in a wide range of situations,' Plosser said. 'For example, higher capital requirements based on the leverage ratio, as opposed to overly complex risk-weighting schemes, might lower both compliance and enforcement costs while achieving similar or better outcomes in terms of the safety and soundness of individual institutions as well as overall financial stability.' The Fed joined with other US bank regulators in April in adopting a supplementary leverage ratio for large institutions, requiring Tier 1 capital of at least 5% on total assets, regardless of risks. ▪

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

Power of spontaneous combustion

In a difficult environment, the US is again defining the future

John Kornblum, Advisory Board

As leaders in Russia and China demonstrate, some large 'emerging powers' still seem to believe that 19th century authoritarian methods provide the best means of managing radical change in the 21st century. Determined authoritarian leaders can make western nations appear weak and indecisive. But democracies usually succeed at mastering challenges much more successfully than controlled societies.

Russian President Vladimir Putin's hopes of building an alternative to the west will in the end be judged on his ability to profit from democratic change rather than keeping it from happening. There will be no middle ground.

US far ahead

In this race, the US is already far ahead. So much so, that America is likely to define the global future, much as it has influenced the history of the last seven decades. In fact, a new type of American leadership is already emerging. Beyond the fog of National Security Agency revelations or congressional disarray, it is already possible to see the outlines of what we might call a post-industrial American approach to its role in the world.

President Barack Obama is often criticised when he exhibits such tendencies. But, over the longer term, new generations of American leaders will find his more balanced approach well-adapted to the increasingly dynamic technological society they are managing.

Russian President Vladimir Putin

Obama would be the first to admit that America's ability to manage change has been severely tested. Over the past decade or so it underwent the worst foreign attack since Pearl Harbor, became embroiled in two nasty, ill-conceived wars, and was confronted by numerous vicious crises around the world. Battered by the most severe economic collapse since the great depression, the US has suffered from the impression that its power and influence are steadily waning in the face of competitors such as China and India.

Post-Cold War

All this was accompanied by a post-Cold War turn inward similar to that which has followed every major US foreign success since the First World War. American leaders at times seem to have jettisoned the careful practice of diplomacy in favour of a sort of cyber age crisis management. We now have cameramen in helmets, rather than the good old gunnery sergeant urging his troops to take yet another hill.

Both at home and abroad, US society often appears to be engulfed in chaotic and even damaging confrontation with itself. Such disorder invites scepticism about America's ability to provide any sort of leadership in a multidimensional system. But conflict of this sort is as much part of the American tradition as the Royal Family is to the English.

We are leaving an era characterised by a stable, but inflexible, world order, and entering one of growing pluralism and transparency, accentuated by unsettling change. At first glance, such situations seem ready-made for reactionary or planned societies. Recall western infatuation with Japan 30 years ago.

In reality, however, this is where the US has always showed its strengths. America as a disruptive society can always navigate irrationality more easily that centrally-controlled, planned societies.

US influence is not based solely on the talents of its leadership, or even on its power, but on a form of spontaneous combustion which arises from within its national life. The unique American mix of peoples, cultures and geography somehow enables the US to break from the moulds of the past more easily than others.

Becoming part of American society does not take years, as is often the case in other parts of the world. Instead, the contradictions, disorganisation and narcissism of what early 20th century German travel writer Arthur Holitzer called an 'irritating country' repeatedly opens new avenues for innovation and imagination.

Barely 10 years ago, Joschka Fischer, then German foreign minister, declared that one of the most important goals of European and German diplomats lay in anchoring the European Union's multilateralism in their foreign policies.

European Union

Today this recipe seems out of date. The EU appears to be risking the fate of the Soviet Union. The euro crisis demonstrated how hard it is to fit countries and issues into neat organisational boxes required by the EU's old fashioned multilateral system.

Anyone who doubts this fact should heed Timotheus Höttges, the new Deutsche Telekom chief executive, who on 13 April told the Bonn newspaper General Anzeiger that US companies were dominating 'digitalisation', which he sees as the key to the world's business and economic future. 'Anything and everything which can be expressed in binary code will be digitalised. And everything which can be networked, will be networked.

Höttges asked: 'Are any German, or European companies leaders in this field? The companies which dominate, for example Google or Facebook, are located in the US.' Google's market capitalisation, he noted, is greater than that of all European telecommunications companies combined.

Visionary business leaders often have a better instinct than politicians for the scale of real power shifts. Spontaneous combustion may be irritating, but it creates space for creative people and new ideas – and this continuously draws other into America's circle. President Putin should take heed. The race is already over. He is not among the winners. ▪

John Kornblum is a former US Ambassador to Germany and Senior Counselor to Noerr.

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Mario Draghi's change of rhythm

ECB chief aims to make monetary policy simpler

David Marsh, Managing Director

Mario Draghi, the European Central Bank (ECB) president, has launched a move to cut down the annual number of monetary policy-setting meetings of the 24-member governing council to eight from the present 12. This would mirror the pattern of the Federal Open Market Committee (FOMC) that sets interest rates in the US.

Draghi, a former managing director of Goldman Sachs, as well as governor of the Banca d'Italia and man who has been strongly influenced by US monetary policy concepts during his career, believes less is more. He rarely says too much when too little would be better.

Over the 2½ years since he took on the job in November 2011, Draghi has made 80 statements or speeches, according to the ECB website (not counting his monthly set-piece press conferences after governing council meetings). This compares with 153 in the 2½ preceding years by his loquacious predecessor Jean-Claude Trichet.

A slower pace of policy meetings would signal a more mature phase in the ECB's development, away from a central bank that hyperactively insists on always being at the frontline of communication, towards one that follows a less frenetic information policy. Draghi revealed the shift in an address in Amsterdam on 24 April at a conference marking the 200th anniversary of De Nederlandsche Bank (DNB).

The modification is closely tied up with plans for the ECB to issue minutes of its decision-making sessions, which seem likely to be released (like in the US) three weeks after policy-setting meetings – a pace that would be out of kilter with the arrangement of monthly monetary meetings.

Unlike the FOMC, the ECB seems unlikely to publish the names of council members who vote for or against certain policy decisions. This is on the grounds that this could damage the independence of individual country members. The change in rhythm would reduce further the number of occasions that Draghi has to meet the press. This would mark the biggest single alteration to the central bank's communication since it was set up in 1998.

Draghi indicated the new stance in a phrase that was not contained in the official version of the speech published on the ECB's website. As a result, much media coverage of his Amsterdam address failed to note the change in tack. Draghi's tilt in favour of FOMC practice reflects his strong US affiliations. His links with his Italian homeland are arguably more distant than those with America.

He earned a PhD in economics from the Massachusetts Institute of Technology in 1976, and in 1984-90 was Italian executive director at the World Bank. In 2002-05, a formative time for the euro, when much was going wrong in the councils of European power, Draghi was conveniently away from the European action, as a managing director of Goldman Sachs.

Draghi has not yet informed his council of any plans for a change in dates. At present, council members – the 18 central bank governors of the euro area, plus the six-person executive board – meet in Frankfurt twice a month. This includes a monthly session on administrative affairs – a frequency that many governors who travel from wide-ranging locations find irksome.

Now that the ECB, through the still-under-construction European banking union, has entered fully into the mainstream of financial stability as well as monetary stability, Draghi feels it is time to retreat somewhat from the parapet. He has shown signs of being bored with too much communication and is happy to make fewer statements and let his listeners work out for themselves what he means. ▪

Support builds for EU green growth

Incongruously constructive role for the UK

Ruud Lubbers & Paul van Seters, Advisory Board

The European Council has taken the road to green growth, underlining the importance of an informal network of 13 European ministers and state secretaries responsible for climate and energy, which was inaugurated at the Green Growth Summit in Brussels in October last year.

The origin of the so-called 'Green Growth Group' remains a mystery, but it appears that the initiative was taken by UK Energy Secretary Ed Davey, seen by many as the group's informal leader.

Apart from the UK, other countries in the group are Belgium, Denmark, Estonia, Finland, France, Germany, Italy, Netherlands, Portugal, Slovenia, Spain and Sweden.

The UK's leadership in this field is somewhat incongruous, given Britain's general scepticism about the European Union and the referendum plan (which could take place in 2017) announced by Prime Minister David Cameron last year. For the time being, however, it is good news that 'perfidious Albion' appears to be exerting positive influence and playing a constructive approach on one of the most pressing EU policy issues – The 'Going for green growth' report agreed at the October 2013 meeting is not the first time the EU has shown it is taking the subject seriously.

But, as demonstrated by the most recent European Council meeting on 20-21 March, never before has Europe demonstrated such commitment to a programme to counter carbon depletion and climate change. The report recommends three priority actions for the EU.

First, it should offer investors and the private sector an ambitious, target-based low carbon policy for the longer term, especially after 2020. period. Second, it should reform the structure of the EU's Emissions Trading System by increasing the price of carbon, with the aim of cutting emissions and stimulating low carbon investments. Third, it needs to put a formidable EU emissions reduction offer on the table for United Nations climate change summits in 2014-15.

The Green Growth Group deserves praise for its splendid work. Along with the Eurogroup, it is here to stay. The crisis in Ukraine has been overshadowing other European developments, but Europe's progress on the environmental front is a source of optimism that we should salute. ▪

Ruud Lubbers is a former Dutch Prime Minister and Paul van Seters is Professor at Tilburg University.

Westminster must win hearts and minds

Unionists can win referendum campaign with right strategy

John Nugée, Board Member

In the campaign for the Scottish independence referendum in September, it is hard to disagree with Alex Salmond, Scotland's first minister and Scottish National Party (SNP) leader, that the SNP has so far made all the running. The pro-independence Yes campaign has built up substantial momentum.

It is fairly easy to see why. A message of change, with all its promise of a new beginning, is inherently more powerful than the message of the status quo. One does not need to be among society's less advantaged to feel that life could be better with a change of circumstances, that the grass is greener on the other side.

But there is a still stronger reason why the defenders of the union, the Better Together campaign led by Alistair Darling, have not found their message easy to get across. The fundamental problem of the pro-union side is that they have no authority for anything they say. Salmond can say, 'Vote for me and I will do X, Y and Z.' But Darling cannot: He has no constitutional position to promise anything at all.

The result is that only Salmond can describe what greater powers Scotland will get if the electorate votes for him. Although a Yes vote is, in reality, more of a step into the unknown, Salmond can present it as delivering the more certain of the two outcomes. A No vote may lead to greater devolved powers – but then again it may not, and even if it does, no one has any idea what those new devolved powers might be.

To remedy this, an all-party campaign for the union is required, with the power to make good on its promises. Westminster must play a central role.

What is needed is a trilateral agreement among the three main UK parties that, if Scotland votes to stay in the union, it will be offered a defined list of extra powers.

Only then can the unionists argue two important points.

First, a Yes victory means that the Scots will get independence and may or may not keep much of what they hold dear (the Queen, the pound, the BBC, the armed forces, the university system, the financial system, the National Health Service).

Second, by staying with the union, they will keep all they hold dear and will also get a set array of extra devolved powers.

And then the unionists can start to give positive reasons why Scotland should stay in the UK. They can start to claim that a No vote delivers certainty and aspiration, whereas a Yes vote delivers uncertainty and isolation.

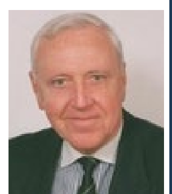
This would be a major about-turn – in effect a declaration that the Better Together campaign so far, with its emphasis on warnings of what will happen if Scotland goes it alone, has proved too negative and not sufficiently compelling. That message is important – there are consequences of voting for independence, and not all are favourable – but it needs to be leavened with a more positive argument for retaining the union.

If this is not done, England may find it is sleepwalking towards a future it does not expect and will not like. The Westminster politicians do not have long left to keep their country together. ▪

John Nugée is a Board Member of OMFIF.

Scottish independence from a European and monetary viewpoint

OMFIF gathers a panel of distinguished experts in Edinburgh to discuss Scottish independence from a European and monetary viewpoint on 9 June 2014. Prof. Wilhelm Nölling, a former member of the Bundesbank Council (left), and Prof. Niels Thygesen, a member of the Delors committee in 1988-89, will take part in the seminar. The debate will draw on previous European experience of monetary unions over two centuries.



Bittersweet quest for philosopher's stone

...continued from p.5

During what was in other respects considered a disastrous premiership, Brown made a huge contribution to the 2008-09 G20 rescue operation for the world economy. Yet the strict budgetary rules with which Brown began his chancellorship in 1997 were just one example in a long line of polices that initially raise hopes, only to be dashed later.

Since the days of Reginald Maudling's chancellorship (1962-64), the UK has seen a series of would-be panaceas: dashes for growth; national economic plans; incomes policies; monetarism (which I christened 'sado-monetarism'); exchange rate targets (including 'shadowing the D-Mark' and joining the European exchange rate mechanism).

And, of course, inflation targets. Belief that they were the new lodestar beguiled policy-makers in the UK and elsewhere into taking their eyes off the asset price ball, with devastating consequences.

With regard to memoirs, the best one can say is that writers are prone to tergiversation. As the old joke goes: two authors meet, and the first says to the second: 'Which book are you not working on at the moment?' I vividly recall two friends of mine suggesting a good 10 years ago that it was time to get down to it. One was Robert Chote, then a fellow financial journalist and now the director of the UK's Office for Budget Responsibility; the other was someone very familiar to OMFIF, the good Lord Desai.

Sometimes one feels like the character Casaubon in George Eliott's novel *Middlemarch*. Readers of that 19th century masterpiece will recall that Casaubon does endless research, but never quite gets down to it.

But I have advice for those readers with lives interesting enough to tempt them to do what my generation would describe as 'putting pen to paper' but nowadays involves hitting the computer, the iPad or the latest version of the smart phone.

This advice is simple. and easy to implement. Stop talking about it and start writing. I find that 500 words a day, surprise, surprise, add up! ▪

William Keegan is Chairman, Editorial and Commentary Panel.

Protecting independence is paramount

Lessons and old truths from 200 years of history

Klaas Knot, Governor, De Nederlandsche Bank

The role of central banks has changed over time. How central bankers have moved with the times becomes clear if we look at the 200-year history of De Nederlandsche Bank (DNB).

In the first decades after its establishment in 1814, DNB was a mainly Amsterdam-oriented credit institution that performed commercial activities. Over time, however, it gradually evolved into a nationwide, non-commercial institution. Towards the end of the previous century, the Treaty of Maastricht, which established economic and monetary union (EMU) and the introduction of the single currency, paved the way for DNB, and 17 other central banks, to become part of the European System of Central Banks, and thus to become a truly pan-European institution. The most recent milestone was the European Council's decision in 2012 to create a European banking union, which is still under construction.

In the first decades after Maastricht, there was a consensus on the role of central banks. It was generally found that (1) central banks served society best if they focused primarily on price stability; that (2) central banks played a relatively narrow role in financial stability, and (3) that central banks should leave microprudential supervision and regulation to other independent parties.

While during the Great Moderation, this consensus on monetary policy seemed adequate, the 2009 recession and euro area crisis have shown that central banking must be redefined comprehensively. These events were a painful reminder that financial instability can severely damage the broader economy.

Governor Klaas Knot and President Mario Draghi at 200th anniversary of De Nederlandsche Bank.

In seeking to secure financial stability, monetary policy-makers have to avoid two well-known pitfalls. One is that of reacting too late. The other pitfall is reacting too early. To avoid these traps, two preconditions must be met.

First, the independence of central banks in monetary policy matters should be protected in all circumstances. The 19th century economist David Ricardo explained that governments would almost certainly abuse their power to issue paper money if, for instance, they were forced by war into creating money.

The second precondition is to stay clear of the pitfalls of either reacting too late or too soon. It must never be forgotten that central banks are exceptional institutions owing to their ability to lend and so to create liquidity for banks.

Management of liquidity

In normal times, this may just mean day-to-day management of liquidity in the financial system. But in times of financial stress, it may mean having to act as lender of last resort.

Being the 'bank of banks' means central banks have always been at the heart of the payment and settlement process. But here, too, central banks will continue to face major challenges in keeping up with innovation and technological change. The difficulty here is that payments systems have characteristics of a public service, while most of them are actually operated by private agents.

Given the overall economy's reliance on the payment system, these private sector activities require a certain degree of public policy guidance. And so, as well as preserving their independence, central banks also need to continue to support and improve the safety, the reliability and the efficiency of the privately-operated payments and settlement systems.

So has the recent financial crisis resulted in a paradigm shift for central banks? I believe so. And I think there are three major lessons that can be drawn from the crisis which challenge the pre-crisis consensus.

The first lesson is that price stability alone is not enough to ensure macroeconomic stability.

The second lesson is that central banks are on the front line when the financial system comes under stress. Since central banks are the only parties with enough information to decide whether lending on exceptional terms is reasonable, the crisis may have reversed the pre-crisis tendency to separate microprudential supervision and central bank regulation. An example close to home is the European Central Bank's preparations for taking on new banking supervision tasks as part of the Single Supervisory Mechanism.

The third lesson is that price stability alone is not enough to ensure financial stability. Central bankers now understand that the key factors in the euro area crisis were the links between financial institutions and sovereigns.

This perspective places the financial system as a whole under constant scrutiny. Unfortunately, this scrutiny was clearly lacking in the pre-crisis framework. There is also some acceptance of a key role for central banks here, given that monetary and macroprudential policies are very much interdependent.

In the Netherlands, DNB has indeed been entrusted with this role. From 2014 enhancing financial stability is explicitly embedded in DNB's mandate. The financial crisis has brought the core functions of central banks closer: monetary and liquidity policy, micro- and macroprudential regulation and supervision, stability and reliability of payment and settlement systems all complement each other.

However, there are several concerns that central banks must take into account. Giving central banks a larger role in financial stability may blur the lines between different policies. The fact that financial stability involves so many different actors makes things even more complicated. Finally, central banks may end up becoming more political than they were in the decades before the crisis.

How can we preserve our independence with regard to price stability, while at the same time broadening our responsibilities? For one, by fostering a clear understanding of what central banks can and cannot do in each of their responsibilities and in each of their roles. Not until then can central banks avoid unreasonable expectations about what they can – and cannot – achieve. The aftermath of the crisis challenges central bankers to look into their role over the next two decades. The task will be to bring core functions more closely together, while preserving independence where required. ▪

This is an abridged version of a speech on 'The changing role of central banking', by Governor Klaas Knot at DNB's conference celebrating its 200th anniversary in Amsterdam on 24 April.

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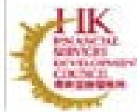

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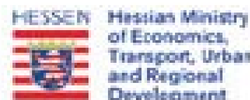
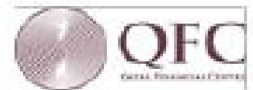




AN OMFIF PUBLICATION

Where Germany's interests lie

Monetary union has been bad for intra-union trade

Gabriel Stein, Chief Economic Adviser

Economic and monetary union (EMU) was always about much more than economics. The stated aim was political. However, the political and economic directions of the euro area are diverging.

The appetite for further political integration is crumbling. Economic arguments against the euro have strengthened during recent years. The May elections for the European parliament are likely to show a substantial backlash against mainstream pro-European parties in key euro area countries, particularly France.

Analysis purely of trade data since the euro started in 1999 raises questions about whether Germany should really be in a monetary union with many of the other members. Countries such as France, the Netherlands and Austria seem appropriate. But, elsewhere, Greece, Portugal or even Finland do not appear to fit. The UK, possibly the US, Russia and China, would arguably be better partners.

In the debate about optimum currency areas, one of the arguments used in favour of EMU has been that it would boost the growth of trade between states sharing the same currency. By definition, this would have to be at the expense of trade with the rest of the world.

A further often-made point is that Germany benefits from having the periphery countries inside the euro area as it can export to them. However, both these arguments are contradicted by the evidence. The single currency did not boost intra-union trade relative to extra-area trade. When it comes to boosting a country's foreign trade, fixed exchange rates do not appear to have any advantage over floating exchange rates. Goods exports alone tell an intriguing story. In 1999 Germany's biggest export markets were (in order of magnitude) France, the US, the UK, Italy and the Netherlands. These countries together took 44% of total German exports. Adding in Austria and Switzerland brought the total to 54%. Two of Germany's top five trading partners, and three of the top seven, were not euro area members.

By 2013, German trade had diversified further. The top five were roughly the same, except that Italy had been replaced by Austria and the order had changed to France, the UK, the Netherlands, the US and Austria. But the top five took only 36% of total exports, with the shares of France, the UK and the US falling.

The question needs to be raised whether Germany and other euro members benefit from the current set-up. The answer is uncertain.

Looking at the global picture, world goods exports have grown by 216% since 1999, according to the International Monetary Fund. Avoiding the distortions caused by the 2009 recession and looking solely at the period from 1999 to 2007, world trade grew 144%. Over the same periods, euro area exports grew 134% (1999-2013) or 86% (1999-2008).

So euro area export growth was weaker than total world export growth. But intra-euro area exports – i.e. the trade that should have grown faster due to the sharing of a single currency – developed even less strongly, rising by 69% over from 1999 to 2008 and by 73% over the from 1999 to 2013.

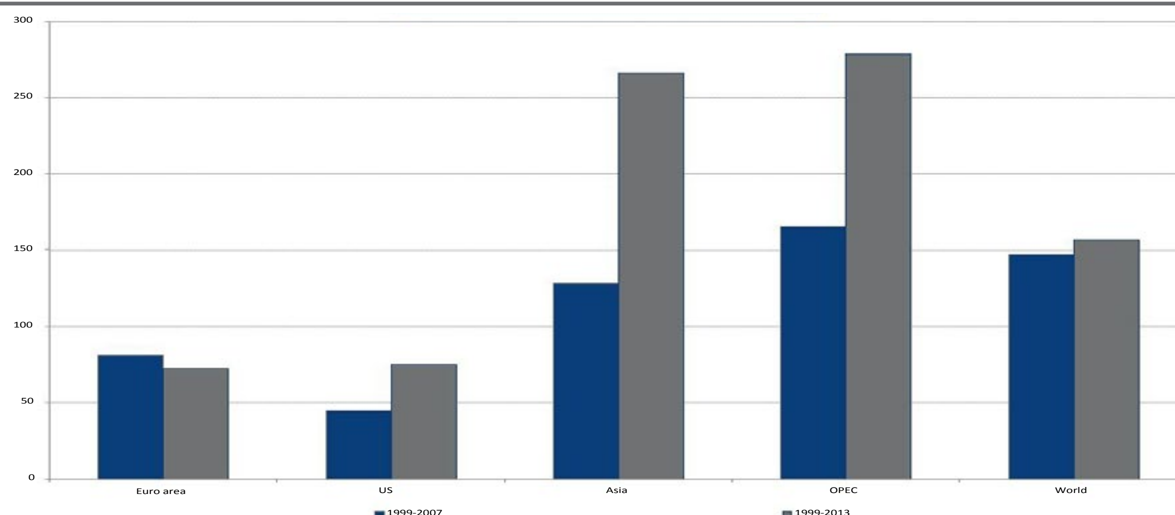
The pattern of trade with Germany is particularly striking. According to the Bundesbank, German goods exports to the rest of the world grew 147% from 1999 to 2007 and 157% from 1999 to 2013. Exports to the euro area grew 81% in 1999-2007 and 72% from 1999 to 2013, showing the impact of the euro area recession on overall German exports. (See Chart below.) Here too, the impression is that sharing the same currency as the rest of the euro area has not helped German exports .

The severity of Europe's sovereign debt crisis can be blamed for these poor figures. But, even for the period from 1999 to 2007, German exports to the rest of the euro area grew more slowly than German exports to Asia, to the OPEC countries and to the world as a whole. This impression is reinforced by the geographical distribution of German exports. In 1999 the other 17 countries now in the euro took 47% of total German exports. By 2013, this number had slipped to 37%.

Intra-euro trade may regain dynamism as the region's recovery picks up and other parts of the world such as the emerging markets weather their own problems. But the data raise the question whether Germany and the single currency area as a whole really benefit from bringing in ever more countries and, indeed, from the current members remaining in the euro area. Clearly, the euro is supposed to bring political as well as economic advantages. As time goes by, it is becoming more difficult to discern what these are. ▪

Gabriel Stein is OMFIF's Chief Economic Adviser.

German exports to different regions, % change by period



Central bank flows indicate vulnerability

Falling Target-2 balances are not the whole story

Frank Westermann, Advisory Board

Up to summer 2012, capital flight in Europe was clearly visible in rising Target-2 balances, measuring the central bank refinancing of private banks beyond domestic liquidity needs.

They are akin to loans made by the European System of Central Banks to finance euro area payment deficits in weaker countries. Since the announcement of the ECB's (not-yet-used) Outright Monetary Transactions (OMT) programme for potential purchases of government bonds, these balances have been declining again.

However, we have not returned to the old 'good equilibrium' of the pre-2008 period. The returning capital has facilitated the purchase of new government bonds, rather than private investment. Risks for the euro area have changed in shape and scope, but they have not gone away.

Mario Draghi, ECB president, has regularly described the fall in Target-2 balances as a positive sign and a signal of 'enormous progress', a view shared by many researchers and analysts. Clearly, there was renewed interest in investing in southern Europe after the OMT announcement.

The key question is what kind of investment has been undertaken, an issue illustrated by comparing the two countries with the largest changes in Target-2 balances, Germany and Spain.

The decline in Germany's Target-2 balances is a mirror image of the Spanish improvement. Both series have been converging since their peak in September 2012. The fall in Target-2 balances coincides with a decline in banks' deposits at the Bundesbank (see Charts 1a-d). The returning money has partly been used to repay short-term refinancing operations.

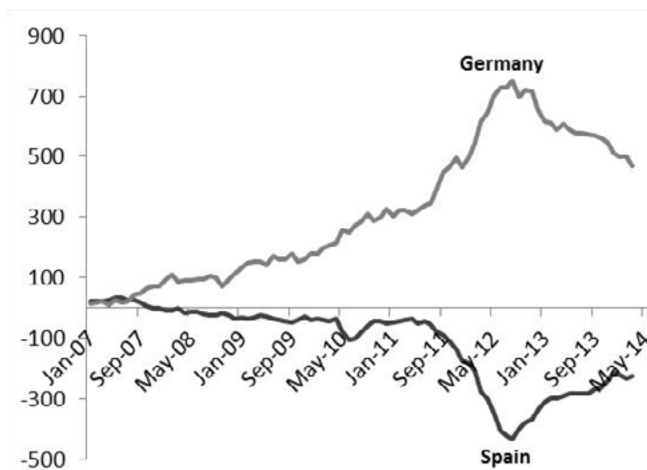
German banks' levels already dropped to nearly zero by end-2011. Banks in Spain, too, repaid most of their short-term loans to reduce levels back to about €20bn, in line with the period before the pre-crisis.

The remaining flows were used to repay long-term refinancing operations (LTROs). From a peak of €320bn in June 2012, they fell to nearly half in February 2014. This has clearly been a process of market stabilisation.

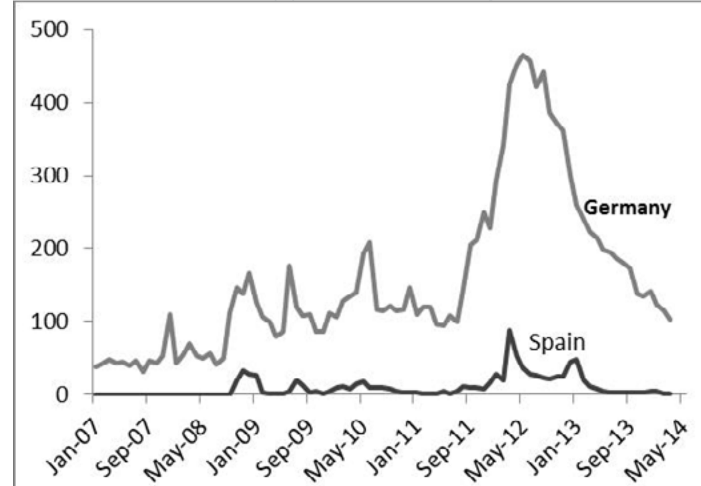
The most favourable accompaniment to repayment of central bank loans would be a resumption of lending to private firms and

Chart 1: Balance sheets of the Bundesbank and the Bank of Spain

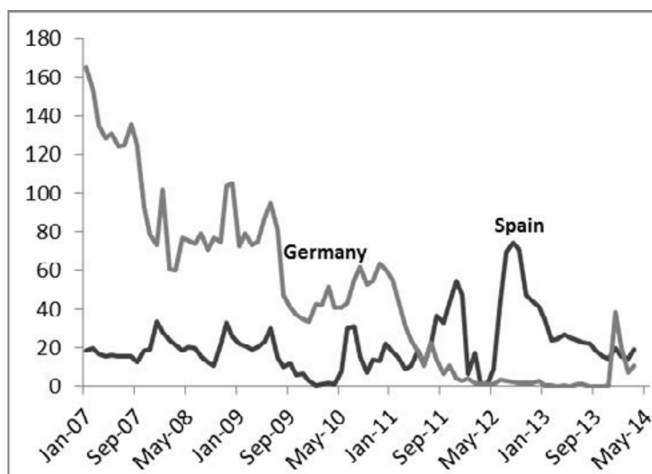
(a) Target-2 balances



(b) Central bank deposits



(c) Main refinancing operations



(d) Long-term refinancing operations

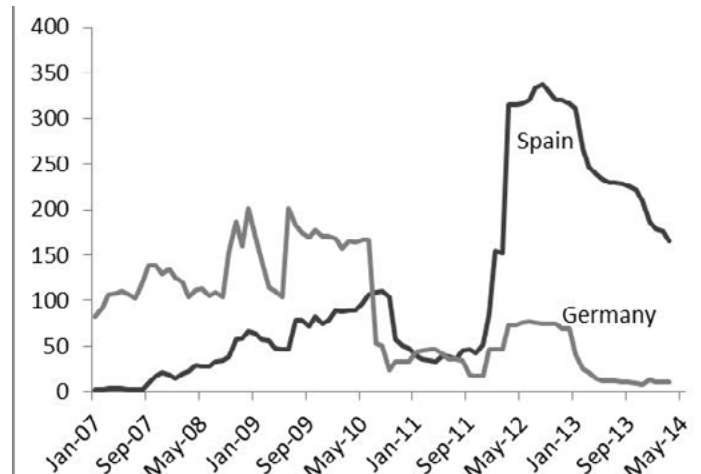
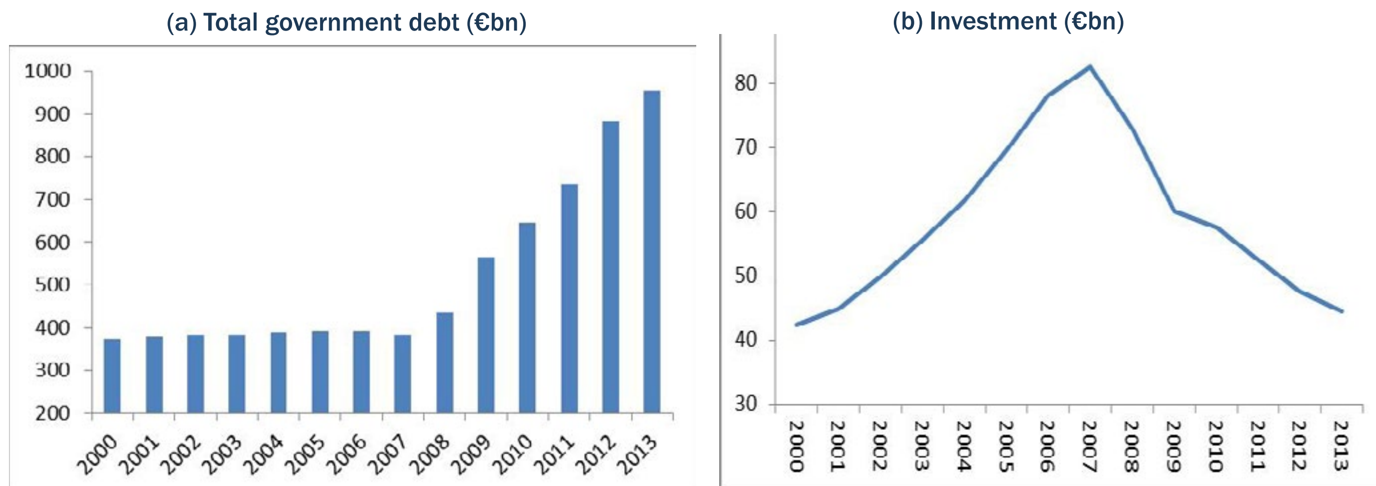


Chart 2: Gross government debt and real investment



enterprise that would stimulate growth and a general European turn-around.

However, as the data from Spain's aggregate bank balance sheets show, in 2012 and 2013, Target-2 balances and private loans fell together, the latter declining €400bn, more than 20% down from the peak. Recent monthly data show no reversal in the trend.

Total investment, shown in Chart 2, has been falling continuously since the crisis. In an economic upswing, lending typically precedes investment and growth, so the latest figures indicate that the recovery under way will be highly anaemic.

While loans to private enterprises are falling, Spanish government bond issues are rising. The central government has issued new bonds of €250bn in 2012 and €238bn in 2013, with €242bn projected for 2014.

Some of these issues are used to roll over expiring old debt, but there has also been new net issuance of €97bn in 2012 and €72bn in 2013. The new issuance total of €169bn is of a similar order of magnitude to the Target-2 decline of €202bn from its September 2012 peak to end-2013.

Adding other levels of government, total public sector debt in Spain has increased around 150% from €383bn at end-2007 to €954bn at end-2013. Government bond maturities have declined during this process, matching the ECB's announcement that, under the OMT, it would buy only government bonds with a less than three year maturities.

In 2012 the average maturity of Spanish government bonds (not including loans from the European Stability Mechanism) fell from 6.55 to 6.05 years. Issues of more than 10 years maturity made up less than 25% of total issuance in 2013.

Replacement of Target-2 balances by a build-up of government debt in other fields may have represented some form of stabilisation, but it does not indicate an end to Spain's fundamental problems.

Competitiveness, measured by Spain's producer prices compared with Germany, has hardly changed since the beginning of the crisis. The cumulative current account deficit has flattened out, but still adds up to €600bn since the euro's introduction in 1999.

It is also worth recalling that the average quality of collateral in the euro area seems to have declined. LTROs that were issued immediately after the reduction of collateral standards have only partly been repaid.

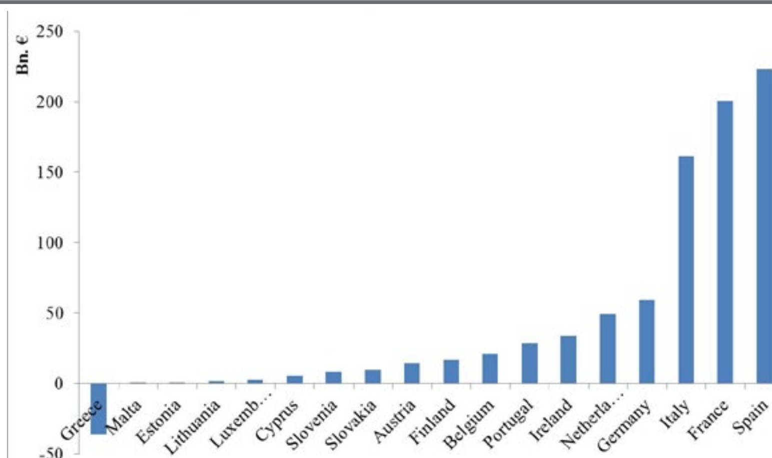
So, in the process of repayment of central bank credit, the ECB may be left with the weakest collateral items, covering the loans that will be the last to be repaid.

Issuance of new government debt, with a parallel shortening of maturities and no categorical improvement of fundamentals, might lead to the risk of new capital flight. Also Spain is not the only country with similar problems. Chart 3 shows that the increase in gross debt in Italy and France is nearly as large.

In total, the euro area countries have increased their gross government debt by €1.4tn in the years 2012 and 2013. Government bonds are eligible collateral for fresh banking credit from central banks – providing plenty of ammunition for future build-up of intra-euro area Target-2 balances should underlying conditions deteriorate again. ▪

Frank Westermann is Professor of Economics at Osnabrück University.

Chart 3: Change in government gross debt 2012 and 2013 (€bn)



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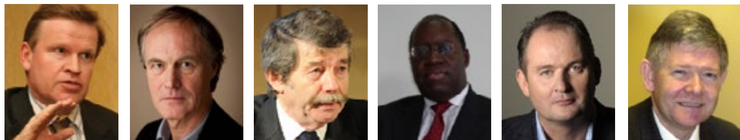

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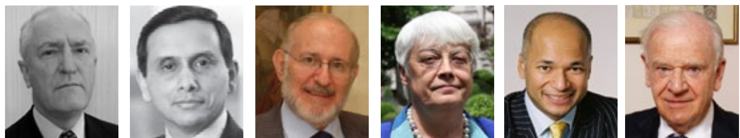

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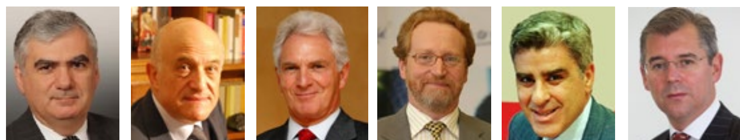

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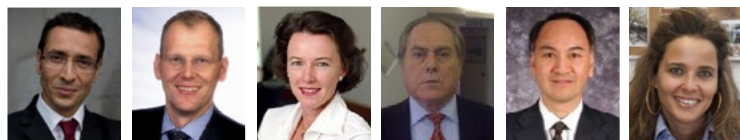

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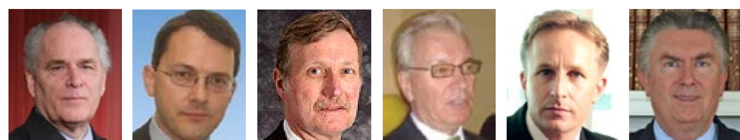

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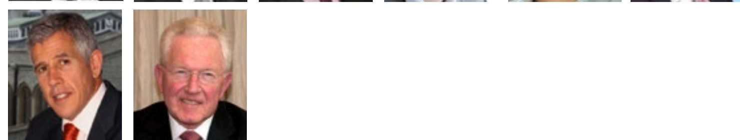

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Brazil veering off track in election year

How Latin America's largest economy has lost will to reform

Maria Antonieta Del Tedesco Lins, Advisory Board

Brazil's impressive economic growth over the last decade has dwindled to a much more sluggish pace. The health of the economy has become a major theme in the general election in October that will choose the president, national congress, state governors and state legislatures.

The decline of Brazil's economy since 2012 is reflected in falling growth, rising inflation, a worsening budget deficit, a deteriorating current account, depreciation of the real, and serious loss of policy credibility. Just weeks before the start of the football World Cup in June, the economic benefits of the competition seem questionable, while the drawbacks of international attention on Brazilian shortcomings may start to loom larger.

In late March, Standard & Poor's downgraded the country's debt rating. This much-anticipated move allowed Brazil to hold its investment grade position. But the downgrade reflects the reality, in the eyes of much of Brazilian society and the foreign investment community, that Brazil's economic model has now been badly tarnished.

Following the 2009 recession, official arguments favouring a model of economic policy and the institutional framework that proved so successful in the previous decade remained the same. However, economic policies have been changing profoundly with negative results.

Contrasting leaders

There is an intriguing contrast between the policies of President Dilma Rousseff, who took office in January 2011, and those of her predecessor Luiz Inacio Lula da Silva. The Workers' Party (PT), from which both presidents stem, marked 10 years in power last year – a useful yardstick.

Rousseff's inauguration was a time of optimism. In 2010, just as Lula's second term was ending, the economy grew by 7.5% and Brazil was close to full employment. Since then, however, confidence has evaporated as structural problems in Brazil's economy, combined with the long-term effects of the 2009 recession in the industrialised world, interrupted Brazil's previously excellent growth record.

When President Lula came into office in late 2002, Brazilian public opinion and global markets anticipated a radical break in economic policy. Many people were concerned that Lula would reframe policy and align his government's goals with the PT's socialist ideology.

In some quarters Lula was even compared to Venezuelan President Hugo Chavez. In fact, there was striking continuity between the Lula government's first term, and the policies of his predecessor, Fernando Henrique Cardoso.

Against expectations, Lula's first economic decisions were pragmatic. He aligned himself with policy prescriptions from international organisations such as the International Monetary Fund, in contradiction, some might argue, to the PT's socialist roots.

In 2002 as the inflation rate peaked and the currency depreciated, rebuilding the country's economic credibility was an urgent task. Lula recognised this and implemented tough measures including an interest rate increase and deep cuts in government spending, achieving a rise in the government's primary budget surplus.

Government rhetoric has remained focused on maintaining the three pillars of macroeconomic stability – a flexible exchange rate, inflation targeting and fiscal discipline. Yet each pillar has gradually eroded. In August 2011, the Central Bank of Brazil initiated a round of monetary easing, which, given elevated inflation, reduced the real interest rate to just 1.5%.

Already in 2009, during Lula's second term the target for the primary budget surplus was reduced. Since then, the government has found it difficult to meet its goal, often resorting to obscure accounting practices. Similarly, the central bank's independence and credibility have been falling.

It is seen to be adjusting monetary policy and targeting the exchange rate according to the whims of the president and finance minister. Furthermore, the failure (or unwillingness) of the central bank to maintain inflation close to its 4.5% target has damaged its reputation.

Rousseff extended policies from Lula's time in office, but also refashioned them according to her different vision for the economy. Finance Minister Guido Mantega, who worked for the Lula administration in the same job and had a rather tense relationship with the central bank, has strengthened his position under Rousseff.

At the same time, a group of economic experts who are developmentalist in their thinking have become influential in government. Economic thinking has changed markedly – and this has had big consequences for economic policy.

Brazil bounced back from the 2009 recession but unfinished reforms and structural weaknesses, combined with deteriorating global conditions in the world economy, have slowed Brazil's growth. Brazil has experienced a sharp deterioration in its current account deficit and greater volatility in foreign exchange markets.

In March, it posted a current account deficit of $6.2bn, down from $7.4bn in February. Meanwhile the IMF estimated Brazil would grow 1.8% in 2014 according to its latest growth forecast.

Economic slowdown

The factors that previously fuelled emerging economies' growth and gave them strength in the post-2009 recovery have now faded. Chinese growth, rising commodity prices and loose US monetary policy all favoured Brazilian dynamism, but the international environment no longer supports primary goods demand that drove Brazilian exports in previous years.

For Brazil and many other emerging market economies, potential growth has fallen compared with five years ago. This sharpens the question of how much longer Brazil can delay the implementation of vital reforms. The health of the economy is a major theme in the election. But it is highly unlikely that the government will address these structural problems in the months before the poll, particularly if they threaten lower income groups and so risk alienating the PT's electoral core.

Rousseff's leadership is closely identified with improved living standards and high welfare spending to help the poor, held in high regard by much of the population – the main factor behind Rousseff's desire to win a second term. As a sign of her resolve in this sphere, the president announced on 1 May that she will increase payments under the bolsa familia programme by 10%. It is still too early to say what will happen next. The sobering economic prospects do not yet appear a serious threat to Brazil's international status, in terms of its stature as a foreign investment or as a holder of a respectable credit rating.

However, there is no shortage of warning signals. Robust reforms are needed to improve Brazil's economic performance. Long-term policies that are sadly overdue must be implemented sooner rather than later – before time starts to run out. ▪

Prof. Maria Antonieta Del Tedesco Lins, Institute of International Relations, University of São Paulo.

New renminbi strains for Sino-US relations

Chinese currency's decline and banking pressures

Jonathan Fenby, Advisory Board

The renminbi is no longer a one-way appreciation bet. Its gradual but steady springtime decline against the dollar risks bringing renewed currency tension with the US, especially with mid-term elections looming.

These often produce a bout of China-bashing from congressional candidates. They claim that the last major nation ruled by a Communist party is stealing jobs by holding down the renminbi and see it as reneging on undertakings to appreciate the currency.

While not branding the China as a currency manipulator, the US Treasury said in mid-April that the recent renminbi depreciation could 'raise particularly serious concerns' if it proves to be a reversal in Beijing's commitment to a more free-floating renminbi. In its twice-yearly report to Congress, it added that the renminbi remains 'significantly undervalued' and that market pressures suggest it could easily move upward if it was more freely traded. The rise in China's foreign exchange reserves to nearly $4tn was excessive and pointed to action by Beijing 'to impede market determination,' the report said.

Trading band

The movement has accelerated since the People's Bank of China (PBoC) widened the daily trading band for the currency in mid-March to 2%. That was another small move towards liberalisation and evidence of the faith authorities have in the stability of the economy, meaning that there is less need for micro-management of the renminbi. But companies are facing greater challenges in hedging against currency risks given the increased volatility.

The PBoC said it would 'continue to increase the two-way flexibility of the renminbi exchange rate, keeping the exchange rate fundamentally stable within reasonable and balanced levels'. It views the depreciation of the currency this year as a signal that it can move both ways to dispel the expectation of continued appreciation.

Chinese banks and companies, as well as rich individuals, have been diversifying out of renminbi this year to spread their assets holdings. Chinese firms have been turning increasingly to foreign investors as domestic credit has become harder to raise. Loans by foreign banks to Chinese enterprises reached $610bn, according to the latest figures. This is only 5% of all corporate loans but is up some 70% on the end of 2011. The top Chinese issuers placed just over $10bn in bonds in the first quarter of this year. This trend of internationalisation – and the risks that come with it as the currency fluctuates – have to be placed in the broader context of the ambitious economic reform programme announced at the Communist Party Plenum last November.

Despite the depreciation this year, it is possible that an appreciation will set in once the PBoC has made its point and policy-makers take a longer-term view which will almost certainly include strengthening the renminbi as they seek to broaden its internationalisation.

In the Chinese political-economic system, everything is connected. The final decisions on issues such as currency liberalisation have to be approved at the top level of the Party Politburo. The finance minister and PBoC governor are bound to decisions taken by top party figures headed by General Secretary Xi Jinping.

The 60-point reform programme, to be implemented up to 2020, aims to modernise the economy and make it more efficient through use of market mechanisms while preserving the power of the Party State with the public sector remaining dominant. Xi and Prime Minister Li Keqiang speak of the need for reform to cope with China's challenges – from the environment to excess capacity – but Xi, in particular, insists that China must not take the risk of going the way of the former Soviet Union.

The question is whether economic reform and preservation of the political status quo will come into conflict. If they do, there can be little doubt from Xi's statements that the second will take precedence over the first. This is a huge, long-term process – the biggest economic transformation in on earth – in an economy made up of multiple moving parts. Some move in contradictory directions as change threatens the position of entrenched vested interests. There will be plenty of speed bumps along the way, the recent default of a couple of small wealth management products being but an example of what happens when protected sectors are exposed to market pressures.

Few things are more sensitive than the currency, given its key role in China's relations with the rest of the world and, in particular, the attention paid by US politicians to the value of the renminbi. The record shows little correlation between the currency's value and trade flows. However, internationalisation of the renminbi has been a big theme of the past couple of years with Frankfurt joining London as a hub at the end of March. But the volume relative to dealing in dollars and other major currencies is still very small. The renminbi represents around 1% of foreign exchange trading in London.

True globalisation will have to wait until liberalisation of the capital account, but that can only come after domestic reform to produce a more robust financial system that can be integrated into open global dealing. This will bring major strains for key parts of China's economy – for instance by requiring state-owned enterprises to pay market rates for loans, by ending financial repression of households and by turning the big banks from policy institutions into commercial operations.

Deposit insurance

There is evidence of progress in plans to introduce a deposit insurance scheme and liberalise interest rates. The growth of shadow banking has meant the introduction of freer rates with tacit official approval. The decision to allow selected debt defaults has widened spreads between private and public sector bonds though defaults are likely to be allowed only for private firms in non-strategic sectors or where the government wants sectoral restructuring.

However financial reform may be impeded by growing deflationary signs. Inflation measured by the producer price index has remained negative on a yearly basis for 24 months. The consumer price index has been below market expectations since late last year. Financial strains on borrowers and lenders point to potentially explosive debt dynamics. The outcome may be a flow of funds from shadow banking into bank deposits.

That may be what the PBoC wants, but the process will not be easy. This will buttress the leadership's caution about altering a financial system which, reflects quite accurately the political control that the Party leaders regard as key to China's continuing success. Whether that can continue to be the case in an increasingly complex economic and monetary context is the big question for the coming decade. This has enormous implications for the currency and its potential for strains in the all-important relationship with the US. ▪

Jonathan Fenby, a member of the OMFIF Advisory Board, is China Director of the research service Trusted Sources (www.trustedosources.co.uk) and author of seven books on China, most recently Will China Dominate the 21st Century?

Ukraine crisis shapes market sentiment

Impact of crisis has been moderate so far

Michael Holstein, Advisory Board

DZ BANK Economic Forecast Table

GDP change (%)	2011	2012	2013	2014	2015
US	1.8	2.8	1.9	3.2	3.0
Japan	-0.4	1.5	1.5	1.4	1.5
China	9.3	7.7	7.7	7.5	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.4	2.3	2.6
France	2.0	0.0	0.3	0.8	1.3
Italy	0.6	-2.4	-1.8	0.4	1.3
Spain	0.1	-1.6	-1.2	0.8	1.5
UK	1.1	0.3	1.7	2.6	1.7
Addendum					
Asia excl. Japan	7.6	6.0	5.9	6.2	6.3
World	3.8	3.0	2.7	3.4	3.6
Consumer prices (% y/y)					
US	3.2	2.1	1.5	1.9	2.3
Japan	-0.3	0.0	0.4	2.4	1.8
China	5.4	2.7	2.6	2.9	3.6
Euro area	2.7	2.1	1.4	1.1	1.8
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	0.8	1.6
Italy	2.9	3.3	1.3	0.6	1.3
Spain	3.1	2.4	1.5	0.0	1.3
UK	4.5	2.8	2.6	2.0	2.7
Current account balance (% of GDP)					
US	-2.9	-2.7	-2.3	-2.3	-2.5
Japan	2.0	1.1	0.7	0.6	0.8
China	1.9	2.3	2.0	2.0	1.6
Euro area	0.1	1.4	2.2	2.3	2.3
Germany	6.2	7.1	7.0	7.2	6.5
France	-2.5	-2.1	-1.9	-2.1	-2.2
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.2	1.1	1.8	2.3
UK	-1.5	-3.8	-3.8	-4.3	-4.0

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Although developments in the Ukraine crisis are keeping the financial markets in a state of nerves, the actual impact has been moderate. Market participants do not expect the conflict to escalate further. The base economic scenario, presented in this table (left), assumes a gradual calming of the situation, especially once the Ukrainian presidential elections have been held at the end of May.

However, the risk of the crisis worsening cannot be excluded. If the west is forced to deploy further economic sanctions ('level 3'), a drag effect on the European economy is expected. One has to factor in both the direct impact of the sanctions (bans on specified exports) and indirect consequences (higher energy prices, damage to confidence, second-round economic effects).

In Europe, the current economic indicators are signaling a stable recovery at the beginning of the second quarter even if the upturn lacks dynamism in several euro area countries. Germany still has the strongest economic momentum.

The first quarter of 2014 will probably reveal decidedly strong growth, supported by this winter's mild weather. While it follows that the spring will probably bring a perceptible slowdown, there is little risk of a break in the positive trend.

One thing that is causing the financial markets concern is the persistence of low inflation, which could motivate the European Central Bank to loosen monetary policy further. In Germany, provisional estimates show the harmonised consumer price index (HICP) rising by 1.1% in April compared with a year earlier.

Although inflation has picked up slightly compared with March (+0.9% year on year), it remains low. The 'Easter effect' (hikes in the prices of seasonal goods such as holiday travel) has been especially weak this year and has barely lifted the price level.

Energy prices remain below their year-ago level and are still exerting downward pressure on the price level. With inflation remaining subdued, even in the face of good economic data and income growth, the risks of 2014 inflation forecast are on the downside.

The US economy remains on a stable upwards trend despite the latest disappointing GDP growth numbers. Macroeconomic output was barely essentially flat in the first quarter of 2014 compared with the previous quarter.

Although expectations were already depressed after the cold winter weather that started the year, one of the negative factors was the bigger-than-expected decline of investment activity in the quarter. On the positive side, the stable growth of personal consumption expenditures in the first three months confirms the financial health of US households. Overall, the forecast is roughly 3% GDP growth for 2014 and 2015. ▪

Michael Holstein is Head of Macroeconomics at DZ BANK.

Chinese liberalisation will change global economy

China's moves to open up its financial markets will have implications for the country's investors and large-scale repercussions for the world economy, *writes Stefan Bielmeier in Frankfurt.*

Most analysts focus on foreign investment in China, but the potential flow into markets outside is huge. Much is known about the foreign investments of the People's Bank of China (PBoC) but these amounts could be dwarfed once Chinese private investors gain full access to foreign markets. The very high savings rate in China (nearly 50% of GDP), restrictions to invest internationally and the closed nature of domestic markets have potential to create pools of capital ready to move. According to a recent IMF paper, full capital account liberalisation may lead to an increase in Chinese assets abroad of up to 15-25% of GDP. Similarly, a smaller increase in foreign assets held in China in the order of 2-10% of GDP is also possible. ▪

Stefan Bielmeier is Divisional Head of Economics and Research at DZ Bank.

Modi can revive India's position

Potential BJP victory could unleash capital inflows

Meghnad Desai, Chairman, Advisory Board

As Indian voters go to the polls this month in the world's most populous democracy, many commentators expect Narendra Modi, the charismatic and controversial chief minister of Gujarat, to become the nation's next prime minister.

Some critics voice concerns about Modi's character and style, similar to the worries over India's economy – but I believe the overall outlook is relatively optimistic.

Right man

Modi is the right man at the right time to inject the reforming zeal needed to put India back among the first rank of expanding powers on the world stage. India has not lived up to advance billing in terms of attracting foreign direct investment, and some money has left the country.

A great deal of money is waiting in the wings, both at home and abroad, ready to invest in India, given the right conditions. In view of the uncertainties overhanging other parts of the world economy, a reforming Indian government backed by business, and with an able governor at the helm of the Reserve Bank of India (RBI) in the shape of Raghuram Rajan, can play its part in creating a more buoyant international economy.

High inflation, a growing current account deficit and anaemic growth by Indian standards have all been holding back the nation's development.

Unfortunately, the incumbent United Progressive Alliance (UDA), consisting of the Congress party and its allies, has become impotent in the last three years. Prime Minister Manmohan Singh has not lived up to expectations

While chief minister of Gujarat, Modi acquired the reputation as a reformer who excelled at job creation by attracting investment from abroad. A Bharatiya Janata Party (BJP) government, which is more liberal economically than Congress, combined with a possible landslide victory, would give Modi the necessary platform to reinvigorate India's fortunes.

India needs a stable government to ensure a return to higher growth. I believe that in 2015, India's growth rate could hit 6.5% and move higher afterwards.

However, Modi and the BJP do have a public relations problem with Muslims who make up the country's largest minority group. Modi attracted criticism during his reign as chief minister of Gujarat during communal riots in 2002.

However, I believe that Modi's party would not pursue a hard-line brand of Hindu nationalism, as it would have to rule from the middle ground to maintain power.

Any reform programme under Modi would be painful in the short term, but the discomfort would be worthwhile. The prize is the longer-term reward of curbing inflation, shrinking the current account deficit, creating jobs and boosting growth. This certainly justifies some initial hardship. ▪

Meghnad Desai, Chairman of the OMFIF Advisory Board, is Emeritus Professor of Economics at the London School of Economics.

Narendra Modi might be the leader to revive India's economic fortunes

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Re-energising growth in EBRD countries

Fiscal policy can be used to boost growth in some cases

Suma Chakrabarti, President of EBRD

Economies are suffering from the effects of low demand in the aftermath of the financial crisis. Former US treasury secretary Larry Summers has brought back the idea of 'secular stagnation' from the late 1930s to describe this permanent loss in demand and many agree with him.

In the countries where the European Bank for Reconstruction and Development (EBRD) operates, some growth is returning. But it is anaemic and, according to the International Monetary Fund, likely to remain so. In the aftermath of the crisis and the euro area's existential struggle, potential growth has fallen significantly both in advanced and in emerging market economies.

Fiscal policy action

The EBRD, as major investor in our countries of operation, asks if these countries have any room for fiscal policy action.

Our overall conclusion is that the task of re-energising growth largely falls to governments, which need the political will, courage and leadership to take on vested interests and implement structural reforms. That said, there is some limited room for specific fiscal action.

At the outset we should note that there is no clear consensus on the effect of looser fiscal policy on economic growth. Among other things, the size of the fiscal multiplier is a subject of continued debate.

However fiscal stimulus can work under certain circumstances. We have identified twin conditions for this: First, when countries can afford fiscal stimulus; and, second, when they can efficiently absorb it.

'Can countries afford it?' means that the stimulus does not endanger debt sustainability and trigger counter-productive rises in interest rates. Indeed, increasing government borrowing over a certain limit runs the considerable risk of losing investor confidence in the sustainability of fiscal health. This might lead to markets demanding higher returns on sovereign debt investments.

The current fiscal health of transition countries varies substantially. But most transition countries have public debt levels below 60% of GDP and deficits below 5% of GDP – both favourable figures relative to many euro members, though rather high when compared to levels markets may consider healthy for emerging economies.

The second condition is the existence of good absorptive capacity. Countries that are struggling to recover are likely to be better in absorbing a stimulus as they are likely to have a surplus of production capacity, idle labour and possibly funds available for investment. Therefore an increase in aggregate demand is more likely to lead to a supply response. Government borrowing is also less likely to increase interest rates and result in crowding out the private sector. Poorer countries tend to grow faster as they catch up and enjoy comparative advantages in terms of labour costs.

Likewise, absorption capacity will be weaker in countries with high propensity to spend additional income on imports. Therefore a high ratio of imports to GDP would generally indicate that the fiscal multiplier could be smaller.

Analysing the above factors we have found that the largest group of transition economies is somewhere in the middle ground. They may have some, but limited, fiscal space or absorptive capacity. Overall they probably should not resort to fiscal stimulus. There is room for a more activist fiscal policy only for a few countries – which we identify in our sphere as Georgia, Bulgaria and Estonia.

This does not mean there is no room for fiscal policy action in support of growth.

Even if in most cases there is little or no room for fiscal stimulus, we do know that certain expenditure items have higher effect on growth than others – their so-called 'multiplier effect' is higher. For instance, infrastructure spending and targeted assistance to liquidity-constrained consumers have been shown to have higher growth-generating effects. Even without additional fiscal demand, i.e. increasing the fiscal deficit and debt, there could be a positive stimulus from shifting spending, within the existing fiscal framework, towards higher domestic demand-generating items such as infrastructure.

The EBRD's task is to put to use our project and sector based experience to engage more wholeheartedly in policy advice to support the reformers. In the process we can help build independent, market-supportive institutions and market structures and as such help cement the system of checks and balances and good governance. And with our projects in infrastructure and other growth-enhancing areas we can help support growth from the demand side.

Largest investor

In the majority of our countries of operations, we are the largest non-oil and gas investor and the biggest foreign investor. In eastern Europe, our success was very much linked to our intimate knowledge of local markets. We have an operating model that requires strong teams on the ground in our countries of operation. This model has proved its value so far and was one of the reasons why we were able to operate quite quickly in Tunisia, Morocco, Egypt and Jordan in opening and staffing local offices. This model allows us to provide tailor-made project financing.

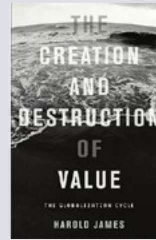
Since 1991 we financed around 4,000 projects with cumulative investment volume of €90bn in our countries of operation. We work across a very wide range of sectors, including issues such as privatisations and large corporate restructuring. We have strong expertise in financing smaller and medium-sized businesses, which are very important for re-energising growth.

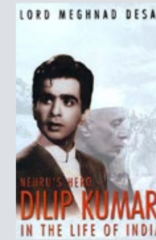
We have remained true to our original vocation of financing projects and promoting reforms. Our overall message, in today's poor growth climate, remains unchanged. If countries do restart reforms, annual long-term growth can be increased between 0.8 to 1.5%. In other words the growth dividend of reforms is high. Fiscal action can complement supply-side reforms primarily through shifting expenditures towards more demand-generating spending within existing fiscal envelopes.

Only a handful of countries may be able to afford additional fiscal stimulus. The overall policy implication is clear. To re-energise growth and prevent countries being 'stuck in transition' in the end, there is no other way: Governments must accelerate structural reforms and take on vested interest in the way of reforms. ▪

This is an abridged version of Suma Chakrabarti's Golden Series lecture on 29 April.

Books & the Advisory Board section features books written by members of the OMFIF Advisory Board, across finance, economics, history, arts and culture.





Inequality ebbs and flows

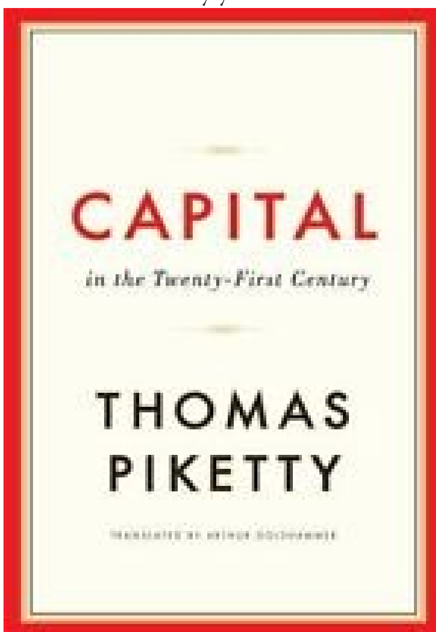
French economist's ground-breaking tome

Meghnad Desai, Chairman, Advisory Board

It is rare for a book on economics, a technical one full of diagrams and tables, to become a runaway success. Thomas Piketty, a bright young French economist, in his early 40s, trained in the UK at the London School of Economics and in the US at the Massachusetts Institute of Technology, has managed to attract the attention of major newspapers all over the world.

Given the current concern about rising income inequality, his book could not be more timely. It is based on years of hard work in archives and with statistical offices and probate records that Piketty has made his life's chosen mission.

Piketty currently heads the prestigious Paris School of Economics. His first interest was in understanding and charting income and wealth distribution in France going back to the Revolutionary years. He then extended his net wider and has taken in the US, UK, and other major western economies and done voluminous amounts of hard work to map the history of income and wealth distribution. His book of 577 pages of text plus 105 pages of footnotes and index is backed up by a technical appendix available on line.



While his prose is lucid and beguiling, weaving in references to Balzac and other literary master, do not be fooled. This sort of book requires monumental amount of work.

So what is the message? Over the last 300 years, the centre of gravity in the world economy has shifted from Asia to the west and is just lately turning a bit back towards Asia. Global inequality in terms of inter-country differences of per capita income widened between 1700 and 1990 and has just turned down a bit since.

Modern economies were born in the second half of the 18th century but per capita output growth reached 0.9% only during 1810-1912. It nearly doubled over the next hundred years 1913-2012 to 1.6%. (The Rule of 72 says that if you divide 72 by the annual growth rate, it will tell you how many years it takes to double the income. In the 19th century it took 80 years, in the 20th century only 45 years).

Capital growth

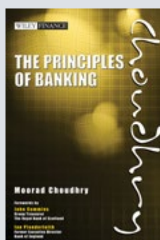
Piketty then traces the growth of capital, both public and private, in housing, land and machinery over the centuries for the western economies. Capital was seven times national income in 1870-1910 and fell to just three times during 1910-50 (reflecting wartime destruction and also more productive capital in the 20th century), but has risen steadily since then to between four times and six times in Europe. In US, it rose from three times in 1770 to five times in the 1920s, slumped to below four times and is now 4.5. One reason for this has been the financial revolution of the last 40 years. The market value of corporations as a ratio of book value (Tobin's Q) has risen from around 35% to 60% in the 1970s to 100% to 120% in the last 15 years.

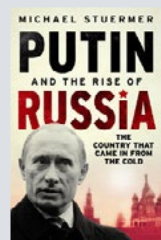
Income inequality as between people has followed a similar trend – high in the 19th and early 20th centuries, falling in the 1930s and then staying low for 50 years until 1980 and then rising again back to its old levels by the end of the 20th century.

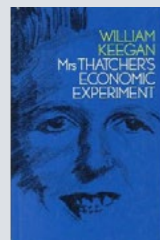
The reason behind this trend is the contrasting fortune of labour and capital. Labour's share in total income stuck around 60% (UK), 70% (France) from 1770-1910, then rose in both countries over the next 60 years to 80% and then has been declining in the last 40 years back to where it was in 1910. By contrast the rate of return on capital as well as its share have been rising.

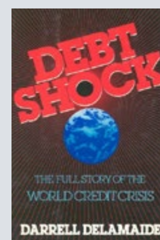
Piketty tells a fascinating story of the course of income inequality in France which was the starting point of his researches. The top income decile had 40-45% of total income during the years 1910-40 but has been confined to between 30% and 35% since the Second World War. In the US, the story is similar for 1910-40: around 40-45% for the top decile. It falls as in France by around 10-15 percentage points between 1940 and 1980 but then rises sharply unlike in France back to its pre-1940 values by 2000-10.

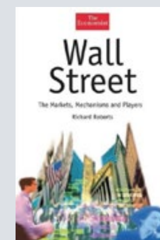
The bottom line is that over the last 40 years, capital has been grabbing a higher share of income relative to salaries. This is a result of the financial markets being more innovative, higher corporate salaries and











a variety of ways in which the wealthy can evade taxes and lobby to have them lowered (the US being the best example.) Piketty manipulates a couple of simple identities to accompany his descriptive tables. Thus the capital output ratio β is a ratio of the savings rate s and the output growth rate g. Then the share of capital in income α can be expressed as the product of the rate of return r and the capital output ratio β. Savings are higher and the rate of return on capital, too, is higher lately; hence the rise in the share of capital and by implication of the top decile who own most of the capital.

This is a monumental book yet at the end one yearns for a more analytical explanation. A number of important questions remain. Is it not the case that globalisation and the new technology and have put a premium on the educated as against the manual skilled worker? Has the middle class not benefited from free or at least below cost higher education at the expense of the poorer people?

Piketty would like to see a global tax to reduce inequality but he has not traced the effect of globalisation sufficiently to make case for a feasible tax. But he is bright and young and will no doubt come up with some more answers. Rare enough for an economics book to be a bestseller, but here is one. ▪

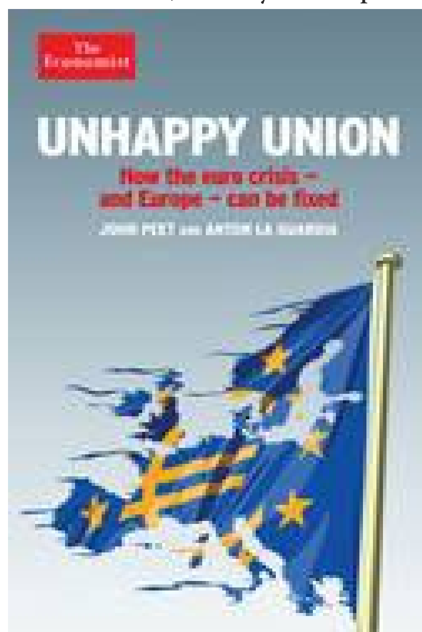
Meghnad Desai, Chairman of the OMFIF Advisory Board, is Emeritus Professor of Economics at the London School of Economics.

Past crises and current challenges

New study of euro area difficulties offers little comfort

Graham Hacche, National Institute of Economic and Social Research

The return to growth in the euro area and marked narrowing of sovereign spreads have encouraged hopes that the crises are over. However, as John Peet and Anton La Guardia of The Economist put it in this excellent guide to the single currency and its problems, 'Though the financial panic is in abeyance, the economic and political crises are far from over, and may well deepen.'



The first half of the book provides a concise yet comprehensive history of the euro from its origins through the sovereign debt crises and the policy responses to them, up to the March 2014 agreement on steps towards a banking union.

The monetary union was designed with major flaws, as the book's analysis shows, which became apparent in the build-up to the crises. Policy surveillance focused mainly on budget discipline, with too little attention to divergences in competitiveness, external imbalances, and banking problems.

Moreover, there was little recognition of the need to create the structures necessary for a monetary union to work such as flexible markets, but also a system of stabilising fiscal transfers, and a banking union. The authors provide a well-informed account of the crises that began with Greece, the policy responses and their shortcomings.

The second half of the book shows how the European Union has been damaged by the crises.

The EU has become more divided, between north and south, and ins and outs. The crises have preoccupied policy-makers and caused other EU work to stall. They have 'sapped the EU of much of its broader influence in the world'. And public support for the EU has plummeted. In sum, 'the single currency has been a terrible folly. Its failings have brought misery to many parts of Europe and gravely damaged the post-war European project.'

So what should be done? The authors reject a break-up, citing the costs of redenomination and the likely threat to the single market and the EU as a whole.

Instead, the euro should be refitted during the current lull, before the next storm, which, as the authors suggest, may well brew from political pressures arising from high unemployment.

The authors set out a list of needed reforms, including restoring a no bail-out rule for member countries, completing the banking union with a public backstop, more burden of adjustment on surplus countries, and so on. These proposals are generally very sensible, but as the authors admit, they face formidable political obstacles: 'Reform will have to be done in stages that build confidence.' The question is: Will there be time? ▪

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