May 2015
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The Bulletin

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

Europe’s pivotal players

Negotiating multiple fronts

Antonio Armellini on Modi’s first year
Lorenzo Codogno on Renzi’s key task
Bronwyn Curtis & William Baunton on Asia
Meghnad Desai on secular stagnation
Gerard Lyons on bringing AIIB to London

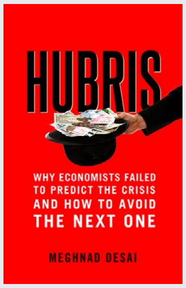
OMFIF

Europe's pivotal players

Angela Merkel, the German chancellor, has emerged even more powerfully as Europe's pivot after the UK election. She must negotiate multiple fronts. She will play a key role in efforts by David Cameron, the British prime minister, to win concessions from Europe before the UK vote on EU membership. And Merkel stands at the centre of a bitter stand-off between debtors and creditors over Greece, which could still result in a major upset for the euro.

Book review

William Keegan evaluates Meghnad Desai's *Hubris*, an ambitious analysis of how the 2008 financial crisis went unanticipated by most economists. In forgetting their history, according to Desai, the economics profession and its disciples in public life forgot business cycles, long and short, as well as the previous occurrence of banking crises and financial crashes. The book ranges over several centuries of capitalism, communism and economic history, before warning the reader to watch out for further crashes and crises.



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Official Monetary and Financial Institutions Forum

30 Crown Place
London
EC2A 4EB
United Kingdom

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

www.omfif.org

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T: +44 (0)20 3008 5262

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

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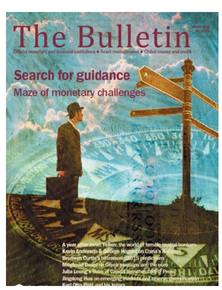
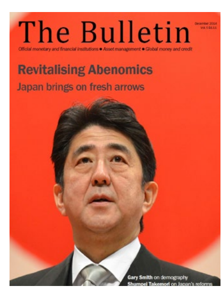
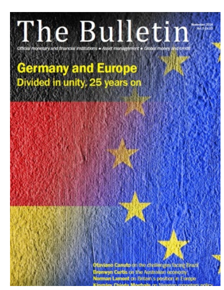
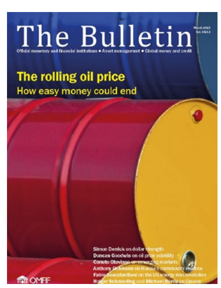








EDITORIAL

Merkel pivotal figure on UK and Greece

Just at the time when the possibility of a major Greek upheaval in the euro area has grown into a real threat, a referendum on whether the UK may leave the European Union has drawn closer following Prime Minister David Cameron's election victory on 7 May. In both cases Angela Merkel, the German chancellor, will play a decisive role. She and her country will do a lot – but not everything – to keep both protagonists as members of a diverse European line-up.

David Marsh analyses the opportunities for an Anglo-German alliance to rescue Europe from instability – and points to often unsuspected convergence between the UK and Germany that might prove crucial in a compromise on Britain's EU membership. Thomas Kielinger and Denis MacShane, from different sides of the camp, warn against giving too much credence to established opinion. Kielinger doesn't believe Brussels protestations that Britain's EU reform requests go too far. MacShane is equally sceptical about the oft-viewed theory that UK voters would never opt to depart. From the advisory board, Antonio Armellini, Bob Bischof, Trevor Greetham, John Kornblum and Gerard Lyons give their views. Armellini spells out the brutal truth that a British exit from the EU would signify Scotland leaving Britain. England could soon start to feel lonesome.

Looking further afield, Meghnad Desai tells us to prepare for secular stagnation, Darrell Delamaide relates how the Fed is inching towards an interest rate rise, while Ousmène Mandeng underscores the importance of refashioning the currency weights inside the Special Drawing Right and introducing the renminbi.

Ryan Shea and Pasquale Urselli warn how the US and other leading countries should get ready for further unconventional measures, while Moorad Choudhry scans inconsistencies in the ECB's monetary stance and warns against over-reliance on quantitative easing. Lorenzo Codogno, recently departed from the Rome Ministry of Finance, surveys some brighter spots for Italy. Francesco Franco focuses on Portugal's problem of a large negative international investment position. Francesco Papadia answers key questions on the ECB's QE.

In our emerging markets section, William Baunton and Bronwyn Curtis explore prospects for Asean countries in the light of possible problems from a rise in US interest rates and the Chinese economic slowdown. Gerard Lyons salutes the positive outlook for international co-operation from the establishment of the Asian Infrastructure Investment Bank. Juan Carlos Martinez Oliva from the Banca d'Italia says expanding the renminbi's role will be internationally beneficial.

Michael Lafferty records the opportunities available from mobile financial services in Africa. Antonio Armellini praises Indian Prime Minister Narendra Modi's first year in office. Jamie Bulgin and Pooma Kimis explore the outlook for the Brazilian real and the Indonesia rupiah. William Keegan reviews Meghnad Desai's book *Hubris*, saying the chairman of the OMFIF advisory board has restored a sense of history to economics. ▪

IMF returns to fray in Argentina

Time for economic truth-telling

David Smith, Advisory Board

The International Monetary Fund is set to play a critical role in Argentina's election campaign that could decide whether the country persists in defying economic logic – or whether it accepts the medicine deemed necessary to return to stability and growth.

In its report 'Economic Perspectives, the Americas', the IMF's regional team chooses words carefully, but the intent is clear. In the words of one veteran Latin American economist at the Fund: 'The leadership, from Madame Lagarde on down, feels it is high time for truth-telling, and reality check, with the Argentine government.'

The headlines from Washington are stark. Argentina needs to devalue, has to cut spending, must curb inflation, and has to confront the growing fiscal deficit. And the kicker lies in a hope expressed by Fund leaders: that there will be 'favourable expectations for investors after the elections' for a new president in October.

The IMF expects an economic contraction of 0.3% this year, and anaemic growth of 0.1% in 2016. The Fund records inflation running at almost 24%, and the fiscal deficit rising to 1.7% of GDP this year.

'What's required are tighter macroeconomic policies, a weaker exchange rate (that is to say, devaluation) and fewer microeconomic distortions, in order to return the country to stability and growth.'

Inevitably, given the stormy history between the Fund and the Argentine government, run by the Kirchner family since 2003, the official response in Buenos Aires mixes sound with fury.

Anibal Fernandez, chief of staff to President Cristina Fernandez de Kirchner, expressed contempt. 'The IMF returns with its familiar agenda, telling us to make a profound adjustment in the economy, and then to devalue our peso – which we have no intention of doing, no intention whatsoever.'

In the October election an anointed successor of the Kirchners, most likely Daniel Scioli, governor of Buenos Aires province, will face an opposition led by Mauricio Macri, the Buenos Aires city mayor. Macri, who comes from the business community, insists Argentina has to return to open markets, fiscal responsibility and flexible exchange rates.

In the battle with Macri's party, President Kirchner wants to make the IMF a major bogeyman. We have seen the opening shots in what could be a bitter campaign. ▪

GLOBAL PUBLIC INVESTOR 2015

REAL ASSETS FOR THE REAL ECONOMY




OMFIF's second annual Global Public Investor report advances understanding of investment behaviour and performance of different categories of public entities owning assets equivalent to 40% of world output. It features global analysis of public sector investment and its impact on the world economy, marked by these institutions' increasing search for 'real economy' investments, including real estate and infrastructure, to counter the impact of low or negative yields in many parts of world capital markets.

GPI 2015 outlines key investment themes in many different sectors, provides data on asset allocation and performance across different regions, indicates projected future portfolio shifts and extends the 2014 ranking table to 500 investment institutions from 180 countries.

Release date: 10 June

ADVISORY BOARD

OMFIF has appointed Pasquale Urselli to the Advisory Board, which has risen to 177 people, subdivided into six groups ranging from Capital Markets & Investment to Economics & Industry. For the full list of members see p.20-21.

Pasquale Urselli is a banking and investment expert who has served in the management of the investment banking arms of Crédit Agricole and of BNP Paribas. Previously, he worked in investment banking at Deutsche Bank, Citigroup and Morgan Stanley. He is a member of The 48 Group Club and Chatham House, and joins the Banking Panel.

BRIEFING

Growing role of the renminbi

During the International Monetary Fund and World Bank Group spring meetings in Washington on 17 April, OMFIF hosted a seminar on gold, the renmibi and the multicurrency reserve system, in association with the World Gold Council. Participants discussed gold and its role in diversifying investment portfolios; the internationalisation of the renminbi, including the possibility of its inclusion in the IMF composite reserve unit, the Special Drawing Right; and possible correlations between gold and renminbi holdings in worldwide central bank reserves.

WORLD GOLD COUNCIL

Takada assesses Abenomics and challenges to fiscal sustainability

Hideki Takada of the Japanese Ministry of Finance discussed his views of Japan's economic prospects at the Embassy of Japan in London on 24 April. He outlined challenges to fiscal sustainability, including Japan's large budget deficit and rapidly ageing population. Nearly 40% of the population will be aged 65 or over by 2060, making pensions and healthcare a growing burden. Takada described programmes to reform the tax and social security systems, and gave an overview of the progress of 'Abenomics' to an audience of Japanese investors and senior government officials.

Visco addresses euro area's economic prospects

Ignazio Visco, governor of Banca d'Italia, addressed monetary policy decisions and economic recovery in the euro area at a reception and dinner in London on 5 May. He outlined various challenges faced by the European Central Bank, including reaching its inflation target and maintaining quantitative easing – most likely until September 2016.Visco explained that the ECB is acting within its mandate, and that QE cannot be equated to monetary financing of debt. He urged Britons not to give up hope on Europe, an issue which is likely to dominate the next parliament.

Schäuble on Germany's long-term investment potential

Wolfgang Schäuble, the German finance minister, discussed long-term investment potential in Germany with an audience of investors from 12 countries over dinner in Berlin on 6 May. The dinner focused on methods of improving possibilities for public-private partnerships in Germany as well as the political barriers that needed to be overcome for greater privatisations in areas like local authority infrastructure. Comparisons were drawn with the experience of many other countries in North America, Europe and Asia.

Impact of QE and Juncker plan on European growth

The outlook for European growth after the European Central Bank quantitative easing measures and the Juncker Plan for capital market integration were the main items discussed at the DZ BANK–OMFIF Global Central Bank Conference in Berlin on 5-8 May featuring 50 speakers and an audience of 150.

From left: Matthias Kollatz-Ahnen, Berlin Finance Senator, David Marsh, Klaus Trömel, EIB Director

Powerful role for Merkel

British PM may soon feel the back-bench heat

David Marsh, Managing Director

In determining whether or not Britain ends up quitting the European Union, Angela Merkel, the German chancellor, will play a pivotal role. The relationship between her and David Cameron, the re-elected British prime minister, could over the next 12 months become crucial to the future of Europe.

Merkel has every interest in playing a waiting game on Cameron's desire to secure concessions from European partners to make more winnable the referendum on Britain's EU membership promised in the next two years.

Merkel, along with a battery of German parliamentarians and a strong selection of politicians from central and eastern Europe, has come out strongly against some key British reform requests. In particular, this applies to watering down European social legislation and freedom-of-movement principles.

Cameron, like Merkel, may also have to show patience. He could take advice to move quickly, heap pressure on the rest of Europe and bring forward the referendum to 2016. On the other hand, if he waits until after the French presidential election in April-May 2017, he may find that the political arithmetic in Europe moves in his favour if a French right-wing candidate beats President François Hollande and reconquers the Elysée Palace.

As they ponder together the future of the EU, Merkel and Cameron may like to reflect on the similarities between the UK and Germany. They have the two largest populations: 81.1m and 64.5m, the IMF says. GDP per capita is almost the same: $47,600 and $45,700. Over the six years 2009-14 affected by the financial crisis, GDP in both countries has grown by an annual average 0.7%. Unemployment is around the lowest in the EU: 5% last year in Germany, 6.2% in the UK (10.2% in France, 12.8% in Italy).

There are differences. In terms of budget deficits (Chart 1) and balance of payments (Chart 2), the countries are mirror images. Most strikingly, Britain's current account deficit last year was 5.5% of GDP, while Germany's surplus was 7.5%. Both figures appear unsustainable. Germany may need a more rigorous approach to state finances. Its ageing and shrinking population and its parlous position as the biggest euro area creditor will ensure that it has to dig deep into savings in coming years.

Indeed, Merkel stands at the centre of a separate stand-off over Greece, a country at the opposite end of the continent, which may end up leaving the euro area if the divergences with its creditors persists. For the time being, a possible combination of introduction of exchange controls coupled with technical default on part of its foreign debt may mitigate the most intense pressure on Greece – and allow it to remain inside monetary union.

Despite the flush of unanticipated triumph, one reason why Cameron may himself be feeling the heat before long reflects the narrow margin of his victory.

Even though he won an overall majority, the prime minister is more vulnerable to back-bench revolts than he was in the last parliament, when the joint strength of the Tory-Liberal Democrat coalition gave him a stronger majority in the Commons – 76 over the past five years against just 12 now.

Another reason for communality between the UK and Germany is that political fragmentation has been taking place at a similar pace in both countries. The 67% of the votes that the Conservative and Labour parties gained in the 7 May poll exactly the same combined proportion as the two main groupings in Germany gained in the October 2013 election (see Chart 3 on p.10).

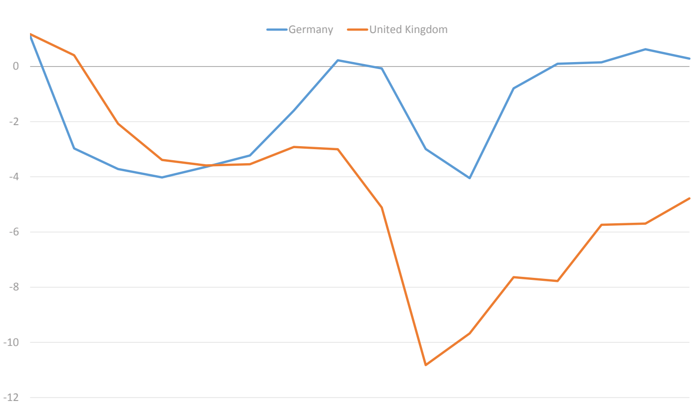
The ebbing of support for the major parties has proceeded at a roughly equal pace. In the four UK general elections this century, in 2001, 2005, 2010 and 2015, Conservatives and Labour have scored a combined average of 68%, the same as for the two German Volksparteien, in 2002, 2005, 2009 and 2013.

Fragmentation has developed for broadly comparable reasons: reunification in Germany, devolution in the UK. Not counting the Federal Republic's first eight transitional years after its establishment in 1949, when splinter parties were jostling for influence, in the 30 years between 1957 and 1987 the two main German parties took 80 to 90% of the votes. Fracturing of the main groupings became manifest in 1983, when the Green party entered parliament, and took full hold after reunification in 1990 with the advent of the east German left-wing Bündnis 90 (now partners of the Greens) and the former communist Die Linke party.

...continued on p.10

Chart 1: Budget positions in UK and Germany

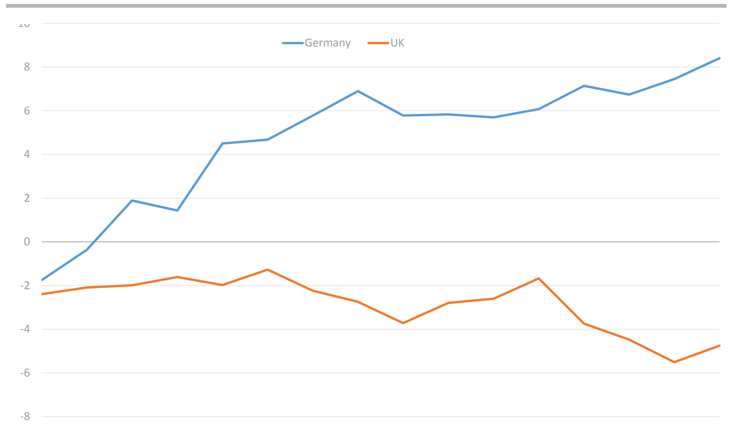
General government lending/borrowing, 2000-15 (% of GDP)



Source: IMF World Economic Outlook Database, April 2015 *IMF forecast

Chart 2: Current account balance

UK and Germany current account balance, 2000-15 (% of GDP)



Source: IMF World Economic Outlook Database, April 2015 *IMF forecast

UK electorate opts for growth

EU exit would make Scottish independence inevitable

Antonio Armellini, Advisory Board

To everyone's disbelief, the British electorate has decided that it prizes stability – with its promise of relative growth, uncertain and unequal though it may be – over change that an inconclusive leader has failed to present as a convincing vision of the future. So, what next?

Cameron will have to spell out very soon what exactly he intends to obtain from Brussels. There is a growing awareness in the EU that a 'Brexit' could cause a trauma, quite apart from its economic implications, and call into question the survival of the EU as a political entity. But Cameron should be advised not to overplay his card, since understanding for his situation is coupled with growing exasperation with the UK's constant shilly-shallying.

Managing his eurosceptics on the way towards the referendum will require a good dose of brinkmanship: Merkel and the rest are prepared to concede the strictures in which his slender majority puts him, but some red lines – such as freedom of movement – will remain non-negotiable. Even in their present diminished position, Cameron could make good use of an alliance with the Liberal Democrats providing a much needed counterweight.

'Brexit' would make Scottish independence inevitable, and the UK would cease to be a country of consequence in Europe; all dreams of a 'maxi Singapore' would also rapidly evaporate. Nothing stops nations from committing suicide, but does sleepwalking into dissolution make any sense?

With world economy growing solidly, 'a good election to win' for UK Conservatives

Gerard Lyons

This was a good election to win, *writes Gerard Lyons*. Despite the problems facing the euro area and inevitable market turbulence as US interest rates rise, the world economy is set to grow solidly in the next five years. The UK will position itself well in this changing global economy. The election outcome is an endorsement of current economic policy as the UK addresses its twin current account and budget deficits and low productivity. Expect steady growth, low inflation and low rates. Expect greater fiscal devolution, to Scotland and to English cities, and a much-needed 2017 referendum on British membership of the EU.

Britain needs to improve 'ineptness of political management' to maintain direction

John Kornblum

Much has been made of Britain's place in the world recently, most of it irrelevant to the facts, *writes John Kornblum*. Britain's role has evolved steadily over the past two decades towards that of a middle-sized country less enamoured with the trappings of power than with the substance of influence.

Britain possesses the world's most diversified financial market. London sits conveniently between America and Asia. London's financial system has been modernised regularly. Add to this the English language, an ever lively cultural and intellectual life and a solid merchant and surprisingly strong industrial tradition and Britain possesses important tools for building a strong future. On the downside is the government itself. Much of the talk about Britain's decline has resulted from the ineptness of its political management. If that does not improve, the UK will seem to bob in the turmoil of change, lacking both strategy and direction.

Sterling seen as suffering from problems on productivity, current account and budget deficit

Bob Bischof

Sterling is moving up in the short term, *writes Bob Bischof*. The problem will come once the euphoria evaporates about the Conservative win. Then the real problems of low productivity, a deteriorating current account balance and the public deficit will have to be addressed in earnest. My prediction is sterling at €1.20 by the end of the year.

Decisive outcome 'positive for business investment and sterling'

Trevor Greetham

Opinion polls suggested that this would be one of the closest contests in memory but in the event the Conservatives will govern with a small majority, *writes Trevor Greetham*. A decisive outcome is a clear positive for business investment and for sterling, which saw its largest one-day jump versus the euro since 2009.

A Conservative victory is likely to be seen as positive for the UK stock market. While a Labour-led administration would probably have offered more support to the economy by way of government spending, the transport sector, utilities and banks would undoubtedly have seen more intervention and tax rates would probably have risen.

Political uncertainty hasn't gone away altogether, however. As a second term prime minister, David Cameron will be at the mercy of every fringe of his party without a large group of Liberal Democrats to hide behind. Moreover, after a year that has seen a closely fought referendum on Scottish independence and a nail-biting general election campaign, investors now have the vote on UK membership of the European Union to look forward to.

Antonio Armellini was Italian Ambassador to India from 2004-08. He is a member of the International Institute for Strategic Studies and Istituto Affari Internazionali. Gerard Lyons is chief economic advisor to the Mayor of London and author of *The Consolations of Economics*, published by Faber&Faber. John Kornblum is a former US Ambassador to Germany and Senior Counsellor to Noerr LLP. Bob Bischof is chairman of the German-British Forum. Trevor Greetham is Head of Multi-Asset at Royal London Asset Management.

Piercing ‘spiral of silence’

Europe’s true views on UK proposals remain hidden

Thomas Kielinger, Die Welt

David Cameron, the British prime minister, may stand a better chance of winning a referendum on Britain staying in the EU than popularly supposed.

We should pay little attention to the British media megaphoning the critical line on Cameron and Europe. I expect an early agreement to bring the referendum forward and get it out of the way before 2017 so it does not collide with elections in France and Germany. In other words: the UK should and will get on with it. The task now is to clear the deck for the real challenge ahead: improving growth and jobs in Europe and completing the single market.

Opinion polls

One of the reasons why opinion polls before the 7 May election underestimated the Tory vote was because people, when canvassed, often give a politically correct answer. In this case that the Conservative-led coalition had not succeeded and that Ed Miliband, the opposition leader, was the coming man. In reality people keep their innermost conviction to themselves, as the election result showed. In Germany this discrepancy between what pollsters pick up and what those polled will not divulge is called ‘the spiral of silence’ (Schweigespirale). The late Elisabeth Noelle-Neumann, founder of the Allensbach polling institute, discovered this studying German election results nearly 50 years ago.

People, she discerned, are governed by a fear of social isolation. When asked their opinion they often go along with ‘received wisdom’, especially when the media keep magnifying how the election of the day will turn out. Privately, however, they are free from such ‘isolation fear’, of jeopardising their social standing. They can and do vote according to their true preferences.

The same phenomenon was at work in the British 1992 election and even more strikingly in the US in 1980. The polling institutions had predicted until the last day of the campaign a neck and neck race between President Jimmy Carter and his challenger, actor Ronald Reagan.

Reagan, so the voters claimed to pollsters, was a trigger-happy cowboy who would start the third world war; he would be untrustworthy as president. So we saw the ‘spiral of silence’. Leading left-of-centre media organisations like CBC and the New York Times had saturated their election coverage with this mantra about the former B-movie actor. A lot of people, when asked, didn’t want to deviate from the established opinion for fear of being called mad.

In fact, Reagan won by a landslide. The blue-collar vote (later called ‘the Reagan Democrats’) had been strongly in his favour. Prime Minister John Major, too, won in 1992 in the face of polling data saying it was impossible.

View from Brussels

The ‘spiral of silence’ applies to Europe, too. Published opinion says Brussels will absolutely resist any British desire for a change in basic European principles, for example over the freedom of movement.

But the European Court of Justice already ruled in November 2014 that EU members need to codify more precisely in law the definition of and barriers against ‘welfare tourism’. On many other fronts, too, the EU will strive to make sure Britain stays in the community.

It is too soon for guarantees. Cameron has not produced his proposals. But I will in future lend no credence to unnamed Brussels sources damning the insufferable Brits for their deviation from the beaten track of Europe. ▪

Thomas Kielinger is London correspondent of German daily Die Welt.

Cameron’s constraints from small parliamentary majority

...continued from p.8

Cameron’s only 12-seat majority will constrain his capacity to introduce legislation that does not command the support of his entire parliamentary party, exposing him to the threat of blockage from backbench rebels that dogged his predecessor John Major after he, like Cameron, won an unexpected victory in the 1992 elections. The disastrous showing of the Liberal Democrats, his previous coalition partners, and the Scottish Nationalists’ near-wiping out the opposition Labour party in Scotland, will add further to complications over European manoeuvring.

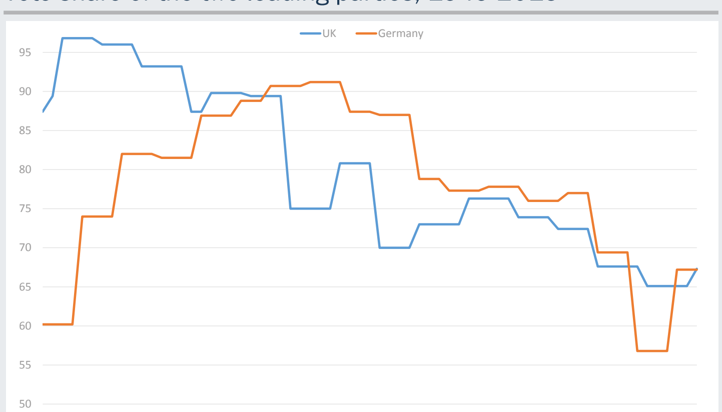
The success of the Scottish Nationalists, which won 56 seats after only six in 2010, while derailing Labour’s chances of a win, has not been an unmitigated blessing for Cameron. He will have to handle the setback, both practically and symbolically, of presiding over a deeply divided nation. The Scots remain much more pro-EU than the English, partly for ideological reasons, partly because they are poorer. In European negotiations, Cameron knows any hard-line stance over Europe would lead to calls for a fresh referendum north of the border on Scottish secession from the UK. If Britain leaves the EU, Scottish departure becomes a near-certainty. England would find itself truly isolated. At the same time as leaving Europe, England would lose Scotland.

The debacle suffered by the Liberal Democrats, down to just eight seats after 57 in 2010, frees Cameron from having to rely on them for support. None the less the pro-European Liberals may be able to exert leverage that could lower Cameron’s freedom of manoeuvre.

However unlikely this may appear, the more his back-benchers rebel, the more Cameron may need even a skeleton army of Liberals. But the party which feels mortally wounded will wish to extract retribution from Cameron for the damage he has inflicted on them while in a coalition. ▪

Chart 3: Voting patterns in UK and Germany

Vote share of the two leading parties, 1949-2015



Source: electionresources.org

Rethinking ‘unlosable’ referendum

Pollsters’ view on Brexit discredited

Denis MacShane, Advisory Board

The forthcoming campaign towards a referendum on possible British departure from the European Union will represent one of Britain’s most difficult two year periods in the post-war era.

The plebiscite, a near-certainty following the victory of Prime Minister David Cameron’s Conservatives, is much more important than the UK’s referendum in 1975 on whether to stay in the European Economic Community Britain joined two years earlier. It eclipses previous votes in other countries on whether to back new European treaties or to join the European single currency.

Major renegotiation

Large sections of the political and business leadership and the press claim there is so much wrong with the EU that only a major renegotiation of the UK’s status can put it right. Cameron’s negotiating demands will be of particular importance. There will be a long list. It will probably include an end to free cross-border movement of citizens, withdrawal from European social legislation applying to UK firms, and removal of some vague-sounding words about ‘ever closer union of peoples’ that have been in the European treaties since 1957.

Other items seem likely to be the right of the UK parliament to reject EU rules or policies it does not like, and special protection for the City so the UK financial industry can opt out of EU regulations.

Such ideas are backed by senior Conservatives like Sir John Major, the former prime minister, and Boris Johnson, the mayor of London, as well as most Tory MPs.

Modest demands

Sensible pro-Europeans have set out more modest demands which they believe the EU can concede and Cameron should seek to obtain. The problem for such recommendations is that the EU question is about raw political emotion not rational balance sheet formulae. Cameron won partly by appealing to English nationalism, including adopting demands for an EU plebiscite made originally by the anti-European Ukip party.

The victory was more comprehensive than anyone could have anticipated, given pre-election polls. Yet Cameron has a smaller majority than achieved in 1992 by Major, who subsequently faced considerable pressure from anti-EU backbenchers. Cameron’s party is full of MPs who were selected as candidates by promising they would oppose the EU.

Many pro-Europeans believe that the British would never vote to quit Europe. This is misguided. Opinion polls to that effect are quoted. But the 7 May outcome has discredited the pollsters. The idea that the referendum is unlosable needs revision.

Jean-Claude Juncker, the Commission president, has made clear he wants to help Britain stay in the EU, but not at any price. Manfred Weber, an influential pro-European politician from Germany’s Christian Social Union, says, ‘Cameron has to put his demands on the table. But the EU freedoms are not negotiable.’ Juncker, too, insists on the sanctity of EU rules on freedom of movement.

A smart move by Cameron would be to lead the Conservative Party back into the European People’s party in the European parliament, showing he wanted to rejoin the mainstream European centre-right. But this would produce a revolt among Tory MEPs and cause general Conservative upheaval, so it probably won’t happen.

One major question is whether the European Commission or Council does the negotiations with Cameron.

Every proposal and any final deal will have to be accepted by the other 27 member states, many with rules about referendums regarding EU changes.

The European parliament will want to have its say. Martin Schulz, its plain-spoken president, will probably not accept any weakening of European social legislation. The same is true of left-wing leaders like François Hollande in France or Matteo Renzi in Italy.

Cameron, in the aftermath of an unexpected victory, is on the crest of a wave. But no one should be fooled into thinking that his European task will be anything but a bitter struggle on several fronts. ▪

Denis MacShane, a former Minister for Europe and an Advisory Board member, is author of *Brexit: How Britain Will Leave Europe*.

‘Different currents – political, economic, cultural – are coming together into one powerful confluence’

In July 2014, Jacques Lafitte, one of the sharpest Brussels insiders, told a City seminar that from the point of view of Brussels ‘a referendum on Brexit was now unavoidable and unwinnable’, ***writes Denis MacShane.***

Lafitte was the French technocrat with fluent German who was the key European Commission official who helped bring the euro to its birth in 1999. Now in the private sector, he is a keen Anglophile but like many in the heart of European decision-making he is fearful of a new populism in Britain.

Different currents – political, economic, cultural – are coming together into one powerful confluence. The economic attraction of Europe which generated support in the years between 1950 and 1990 has faded as the euro area has become associated with slow or no growth economies. The press mocks and scorns the EU whenever it can. There is negligible media coverage and comment in favour of Europe. The mass arrival of central and east European immigrants has fused with euroscepticism to convert anti-immigrant passions into anti-European emotion.

A new anti-European front has been opened with relentless attacks on the European Court of Human Rights which stands accused of preventing British judges from deporting harmful terrorists and ordering British MPs to alter laws on issues like prisoner voting rights which unite Tories and Labour against Europe. David Cameron says he will renegotiate a new deal for Britain. Even if he is sincere, it is hard to see how he can renegotiate a major rewriting of Britain’s EU rule-book to satisfy his mainly eurosceptic MPs.

The European Commission has said firmly to Switzerland it cannot make concessions on free movement of people which the Swiss signed up to in order to obtain full market access, even though the Swiss in a referendum in February 2014 voted to rewrite the Swiss constitution to bring in such EU immigration caps. Now the Swiss political leaders have said there will have to be a second referendum in two or three years to reverse last year’s decision. The Swiss experience shows the illusory nature of the idea that Brussels can or will alter core rules. ▪

Prepare for secular stagnation

Low growth fits into Kondratieff's 50-year cycle

Meghnad Desai. Advisory Board

This time last year secular stagnation was a new idea. In fact, it dates back to the Harvard doyen of American Keynesianism, Alvin Hansen. He was pessimistic about US growth prospects beyond the mid-1950s.

John Maynard Keynes himself had been worried that in rich countries there would be excess savings and investment opportunities would dry up.

Hansen agreed with this. He used the notion of Kondratieff cycles, which are 50-year cycles named after the Soviet economist Nikolai Kondratieff (see OMFIF Bulletin, September 2013). The US, Hansen conjectured, was on the down-swing of a Kondratieff cycle, which would mean low growth and low inflation for 25 years.

'Lo-flation'

He was wrong then. When Larry Summers, former director of the US National Economic Council, revived the idea couple of years ago, no one thought it would catch on.

Yet Christine Lagarde, managing director of the International Monetary Fund, has confirmed that 'the new normal' will be lower growth than we had got used to.

Low rates of inflation or 'lo-flation' are becoming reality. Around the world, central bankers are trying to increase the rate of inflation to their target of 2%. No one would have dreamt during the 1970s when Keynesians were battling Monetarists on the issue of inflation that central bankers would be praying for higher inflation. Low inflation is here to stay.

Anaemic growth

For 75 years between 1939-2014, we had persistent inflation. Now the cycle has reversed itself.

Oil prices, which have been a persistent worry since 1973, have fallen. Despite quantitative easing there seems to be negligible inflation, whatever the monetarists told us during the 1970s.

But growth is also low. In the euro area growth has been anaemic. The depreciation of the euro may revive European economies a bit, but no one expects growth at the old rates.

Of the Brics countries, Brazil, Russia and South Africa are foundering. China is slowing down. India, under Prime Miniuster Narendra Modi, is the only Brics economy people are looking at hopefully to accelerate growth.

The US and UK have recovered from the recession to growth rates comparable to their previous levels. They have better demographics than Europe or Japan.

But even in those countries, there seems to be no innovation happening which could lift the global economy as successive rounds of innovation have done over the last 250 years.

The last innovation cycle was triggered by Silicon Valley. Since the dot com boom collapsed, nothing else has turned up.

Demography and clusters of innovation were two factors mentioned by Kondratieff as causes of long, 50 year cycles. He included wars and political movements as other factors.

No systematic tests of the Kondratieff theory have been carried out. But his cycles are possible to observe.

Downward phase

Beginning in the 1780s he traced out four 50 year cycles. In the post-second world war period is a boom phase from 1940-45 till the early 1970s and a downward phase from the 1970s to the mid-1990s.

Then there was an upswing from the early to mid-1990s till 2007-08 as the next boom phase. Now we are in the down phase.

If Kondratieff were to be an accurate guide, this down phase would last till the late 2020s. To reinforce these ideas, one should add that interest rates are not only low but negative for the first time in memory.

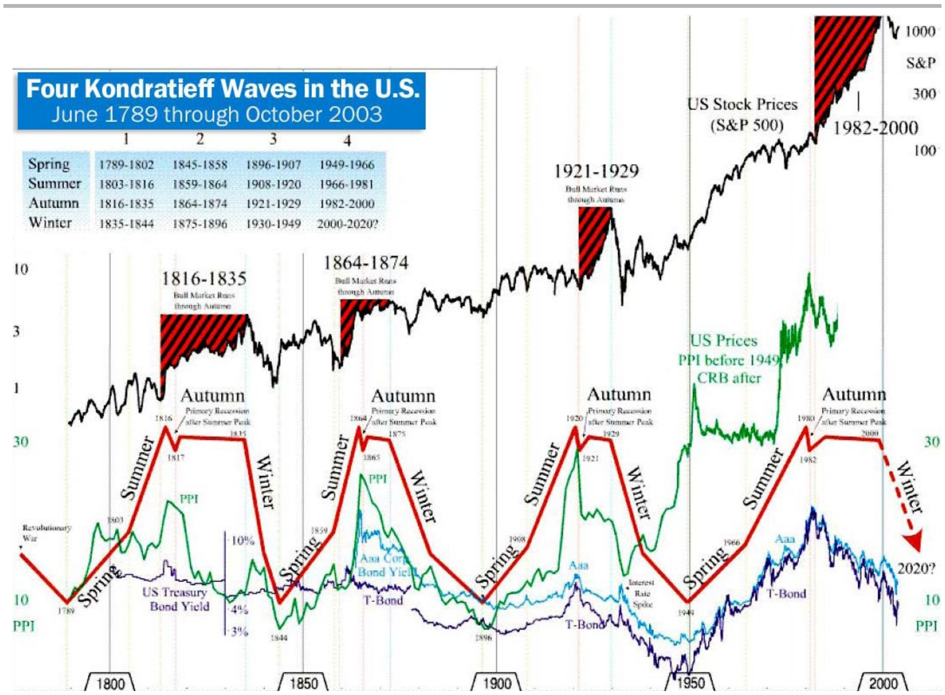
There are no hard laws in economics, just pointers which may help. There is no doubt that there has been shrinkage in middle class jobs thanks to rapid progress in information technology.

Low productivity growth has become endemic. It could be argued, as former US Federal Reserve Chairman Ben Bernanke has, that these are temporary trends which would be removed if a recovery is sustained.

For that to be true, recovery would have to be maintained at reasonable levels in the US and UK and sped up in Japan and the euro area. And then the emerging economies would have to regain their dynamism of 10 years ago.

None of this is impossible. But to imagine it will happen stretches credulity a little too far for my liking. In 10 years, Kondratieff may be celebrated in economic circles as a man whose time, once again, has come. ▪

Four Kondratieff cycles in the US
1789-2003



Source: longwaveanalyst.ca

Meghnad Desai is Emeritus Professor of Economics at the London School of Economics and Politics, Chairman of the OMFIF Advisory Board, and author of *Hubris*.

Fed likely to delay lift-off

Inflation remains stubbornly low and growth sluggish

Darrell Delamaide, US editor

Even as sluggish first-quarter GDP growth in the US seemed likely to keep monetary policy-makers patient, the Federal Reserve tested a media conference line that might make it more nimble.

The late-April test was to provide a technical means for Fed Chair **Janet Yellen (voter)** to hold a briefing with the press at short notice.

Market participants largely believe the Fed will take its first action to raise interest rates at one of the four meetings with a press conference scheduled afterwards, so that Yellen can explain the move and respond to questions.

For her part, Yellen has maintained that the Federal Open Market Committee could and would take action at any of its scheduled eight meetings, or for that matter, at any time, using round robin or conference calls as it has in the past.

By adding the media teleconference to its panoply of communication tools, the Fed reinforced the possibility it would act between press conferences if it wanted to.

As it is, the late April report of US GDP growth at a sluggish 0.2% annual rate in the first quarter led most investors to believe that a June lift-off for Fed rates was now off the table, with the expectation that it would come in September at the earliest.

That meeting is to be followed by a press conference, as is the one in December, but the FOMC would clearly be able to take action in July or October and have Yellen get on a conference call to explain it.

Reasons to wait

The statement from the April meeting, approved without dissent, was a catalogue of reasons for the committee to wait on monetary tightening.

'Economic growth slowed during the winter months,' the committee noted, while the 'pace of job gains moderated' and a 'range of labour market indicators suggests that underutilisation of labour resources was little changed.'

Household spending declined, the panel noted, even as real incomes rose strongly and consumer sentiment remains high. Business fixed investment softened, the litany continued, the recovery in the housing sector remained slow, and exports declined.

And of course inflation continued to run below the Fed's 2% target, reflecting earlier declines in energy prices and decreasing prices of non-energy imports. Keeping interest rates near zero, the panel concluded, was appropriate until there was movement on all these fronts.

The personal consumption expenditures price index – the inflation measure preferred by the Fed – rose just 0.3% in March from a year earlier, the 35th month in a row it was below the targeted 2%. Even the core index, stripping out energy and food prices, rose only 1.3%.

Boston Fed chief **Eric Rosengren (non-voter)** went so far as to suggest that an inflation target of 2% might be too low, as it has lowered interest rate expectations and constricted central banks' room for manoeuvre in applying monetary stimulus.

'The zero lower bound constraint on policy interest rates has been more than an academic concern of late, as most developed countries' central banks have experienced difficulty in providing sufficient monetary stimulus to spur a robust recovery in their economies,' Rosengren said in a speech at Chatham House in London. 'This may imply that inflation targets have been set too low. After all, a higher inflation target would mean a higher longer-run policy rate, which brings with it a lower chance of hitting the zero lower bound.'

Unemployment rates

New York Fed President **William Dudley (voter)** put his outlook on monetary policy in the simplest terms. 'The unemployment rate is still too high and the inflation rate too low,' he said in citing US progress on the economic front at the Bloomberg Americas Economic Summit in New York.

Speaking ahead of the FOMC meeting and the release of the March inflation rate, Dudley said the impact of lower energy prices was 'likely over,' expressing optimism that the inflation rate would 'begin to firm later this year.'

Dudley concluded that 'hopefully' data on employment and inflation would support a decision to raise interest rates 'later this year' – hardly an endorsement of an imminent hike.

Taking part in a panel discussion at the IMF meeting, Fed Vice Chair **Stanley Fischer (voter)** said that lower fuel prices and a stronger dollar had pushed forecasts of when inflation would return to 2% further into the future.

'I think most of us thought we were going to get to 2% quite soon, possibly by next year,' he said. While the oil price and dollar rate effects should be temporary, policy-makers now expect inflation 'to come back and move towards 2% over a couple of years.'

For **Narayana Kocherlakota (non-voter)**, president of the Minneapolis Fed, that inflation outlook is reason enough to postpone any rate hikes until next year at the earliest.

'Right now, personal consumption expenditures inflation is running well below 2%, and my current outlook is that it will continue to do so for several years,' Kocherlakota said in introductory remarks for a town hall meeting in Winona, Minnesota. 'Based on this outlook, raising the Fed funds rate in 2015 would be inappropriate, because such an action would serve to further delay the return of inflation to target.'

Atlanta Fed chief **Dennis Lockhart (voter)**, a centrist, suggested that the weaker-than-expected economic performance in the first quarter might prompt the Fed to wait some more before raising interest rates.

'I think waiting a while longer improves the chances of seeing confirmation from incoming data that the economy is on the desired path,' Lockhart said at a business luncheon in Palm Beach, Florida.

'The more solid the data evidence underpinning lift-off,' he said, 'the more predictable the subsequent rate path can be, in my opinion.'

Rebounding economy

Nonetheless, some of the more hawkish FOMC members continued to push for lift-off in June. Speaking to reporters after a speech in Charleston, South Carolina, Richmond Fed chief **Jeffrey Lacker (voter)** brushed off concerns about first-quarter economic weakness, saying that 'a strong case can be made that short term interest rates should be higher right now.'

St. Louis Fed President **James Bullard (non-voter)** said that economic weakness should be short-lived. With an economy on the rebound and unemployment declining, 'Now may be a good time to begin normalising US monetary policy so that it is set appropriately for an improving economy over the next two years,' Bullard said at the Hyman Minsky economic conference in Washington. ▪

Darrell Delamaide is a writer and editor based in Washington.

Reaching for the unthinkable

Why world may need Outright Monetary Financing

Ryan Shea and Pasquale Urselli, Advisory Board

For the first time in almost a decade the US Federal Reserve is poised to raise its key policy rate.

Despite very careful signalling, US interest rate futures have implied interest rates below the Federal Open Market Committee's 'dot plot' – a diagram setting out members' expectations for the funds rate (see Chart). Consequently, there is concern about a possible replay of the 1994-95 bond market accident, when the Fed sparked a damaging yield surge through an unexpectedly rapid increase in its benchmark interest rates.

In the light of these imponderables, it is time for governments and central banks around the world to consider radical policy options including further unorthodox interventions on the bond market.

Further complicating the Fed's task of achieving a smooth exit is the substantial divergence in monetary policy stance with the other major economies. Since the start of 2015 more than 20 central banks have eased policy, prompted by the significant decline in crude oil prices which generated a disinflationary impulse. In several instances this has required central banks to take interest rates into negative territory.

In the International Monetary Fund's 'World Economic Outlook', the global recovery was described as 'moderate' and 'uneven', and one of the downside risks outlined was Fed policy normalisation.

Several prominent investors have voiced fears that, if the Fed raises interest rates prematurely, we could see a repeat of 1937 when the post-Great Depression US recovery faltered as the Fed tightened policy. The problem is that, given the extremely low level of short-term interest rates, the scope for orthodox monetary stimulus is minimal.

Moreover, for pure arbitrage reasons, there is a limit on how negative short-term interest rates can become. Investors can always convert bank deposits into cash.

In the event of a global downturn, a resumption of quantitative easing is possible. However, as these policies have failed to deliver a self-sustaining recovery, there seems little point in repeating them.

Bond yield cap

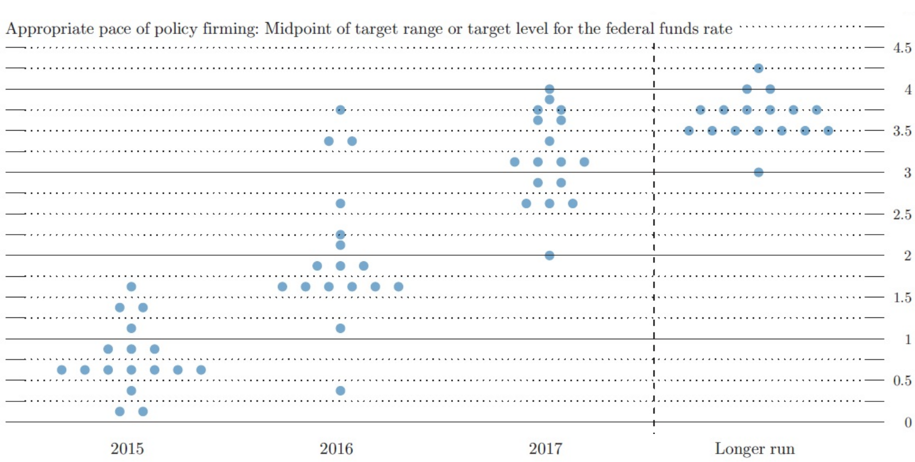
A radical rethink is another, more likely option, with even greater central bank participation in their respective government bond markets one policy that the authorities should be considering. A nominal bond yield cap could be introduced. This might sound highly unorthodox but there is an historical precedent. The US adopted such a policy during the second world war and it remained in place until the 1951 Fed-Treasury Accord that restored independence to the Fed.

Such a change would constitute a necessary condition for reflation, removing the threat of higher government bond yields in response to investors demanding a greater inflation risk premium. But it might not be sufficient.

There is already concern that many advanced economies are either close to, or possibly beyond, their fiscal limit. Government debt in the advanced economies exceeds 105% of GDP, considerably higher than in 2008.

Fed dot plot

Interest rate expectations of the Federal Open Markets Committee



Source: Federal Reserve Bank

As a result of this, governments might have to go still further in the direction of unorthodox policies. We have become accustomed to governments financing budget deficits via sovereign bond issuance. But there is no reason why this should be the case.

Governments can finance themselves via the issuance of money, as has been shown repeatedly in the past. Under such Outright Monetary Financing operations the government gives money to the non-bank private sector and funds these payments by selling debt to the central bank.

This should not trigger so-called Ricardian equivalence (when debt-financed government spending leaves demand unchanged, as people expect future tax increases to pay off the debt and so save any excess money).

Neither does it put upward pressure on interest rates crowding out private investment. Consequently, OMF constitutes an effective stimulus tool.

What is important is that the central bank holds the newly created debt in perpetuity, providing a one-off 'irreversible' increase in base money. This is a key differentiation with QE, where central bank purchases of government bonds are potentially reversible.

Such policy proposals would be a radical departure for central banks. They imply a loss of operational independence. Opposition would be considerable: some would say this is reaching for the unthinkable.

Yet in the event of a global downturn, a combination of OMF to reflate nominal GDP, combined with an interest rate cap on existing government bond yields to avoid a spike in interest rates, seems a logical next step.

Unfortunately, this policy option is ruled out within the euro area as OMF is explicitly banned in the European Central Bank statutes. An alternative needs to be found.

One possibility would be the creation of a pan-European Monetary Union infrastructure investment project, something which is already under consideration within the Eurogroup.

The aim should be to deliver better macroeconomic results accompanied by improved opportunities for long-term investors such as sovereign wealth funds, eventually leading to higher foreign investment in the euro area. ▪

Ryan Shea is Managing Director, Black Swan Economic Consultants and Pasquale Urselli is a member of the Advisory Board.

Why IMF must reform the SDR

Renminbi inclusion would strengthen multilateralism

Ousmène Mandeng, Bretton Woods Committee

The Special Drawing Right has failed as a reserve asset, and never gained ground as a financial instrument. However, it may succeed as a framework for international currency diversification.

In April, the International Monetary and Finance Committee, the IMF's steering body, called for collective efforts to strengthen the international monetary system and facilitate further integration of dynamic emerging markets.

The 2015 quinquennial SDR valuation review offers an important opportunity to assess how the SDR, currently composed of dollars, euros, sterling and yen, may serve emerging markets currency integration. It would signal the IMF's willingness to engage directly in fostering change in the international monetary system.

Renewed interest

The SDR, which is the unit of account of the IMF and some other international organisations, slid into obscurity from the early 1980s. The relatively large increase in the allocation of SDRs in 2009 to $280bn (SDR204bn) reignited interest.

So too did proposals by the Chinese and Russian authorities and in 2011 by the French authorities for a broader role for the SDR. In 2015, China voiced its intention to have the renminbi included in the SDR basket of currencies, following rejection in the 2010 review. SDR valuation reviews have been guided by the objective that the SDR should serve as a substitute for reserve assets. But the unit never took off. SDRs outstanding are very small compared with $12tn in foreign exchange reserves.

They have remained confined to operations within the IMF, are not determined by market forces, have no market impact and have not been adopted by the private sector.

The restrictions on the SDR make it unlikely that it will ever play a major role and previous attempts to increase its appeal have failed. Yet the SDR remains the closest thing to an international currency and it does have certain signalling power.

China's aim to include the renminbi echoes widespread apprehension that the international economy is too dependent on too narrow a set of currencies. While greater emphasis on the SDR would not address this concern directly, it could help raise proliferation of other currencies to advance recognition that the international economy has evolved.

More currencies will soon play an increasing role in promoting more diversified sources of international liquidity.

Changing the rules

The inclusion of the renminbi in the SDR would require a modification of the existing inclusion principles or allowing a rather flexible interpretation of the rules.

Currency inclusion depends on the size of a country's exports, and whether the currency is freely usable, widely used to make payments for international transactions, and widely traded in the principal exchange markets. The latter remains in doubt for the renminbi.

Changing the rules would be the best solution. They address the wrong objectives and reflect the very different concerns of a different era. Squeezing China past the existing rules when there is doubt about its qualification risks undermining the transparency and verifiability of the inclusion principles and would set the wrong precedent.

Rethink

The SDR valuation review offers an important opportunity for the IMF to rethink the role of the SDR. It could serve as a transition framework towards a more diversified international monetary system, echoing earlier concerns among IMF member countries about too great a concentration of international monetary power with the largest IMF members.

The review should therefore not be about whether to include the renminbi but on currency diversification in general. Other currencies such as the won, Brazilian real, Canadian dollar, Mexican peso, Turkish lira and Saudi riyal could equally qualify.

The IMF's prime monetary denominator should be made more representative of the global economy. This seems long overdue. A positive outcome to the SDR review would recognise the increasingly multilateral nature of the world monetary and financial system. ▪

Ousmène Mandeng is a member of the Bretton Woods Committee and senior fellow of the Reinventing Bretton Woods Committee.

Puzzling logic on euro money

ECB contradictions on market liquidity

Moorad Choudhry, Advisory Board

The European Central Bank holds somewhat contradictory views of market liquidity. The baffling logic at the heart of European monetary policy raises questions over the durability of the euro area's recovery.

Last year the ECB introduced negative interest rates on deposits placed with it by commercial banks. Its stated rationale was to encourage banks to lend money to customers. Logically, a central bank must think that there is surplus liquidity in the system if it introduces a negative rate. It wants banks to lend this surplus to individuals and companies, rather than deposit it at the central bank.

Then in January the ECB introduced its quantitative easing programme, following a similar approach to that adopted by the Federal Reserve and Bank of England. Euros are created at the click of a mouse button and used to buy sovereign government bonds. The stated principle for the introduction of QE was to engineer the flow of funds out to banks which can then lend these funds to customers.

Logically, a central bank must think that there is a shortage of liquidity in the system if it introduces QE. If there was a surplus it wouldn't need to make money available to banks by printing it electronically.

So, which is it? Either the system is short of funds or it is long of funds. It can't be both. From this point of view, euro area policy is mind-boggling. It's as if someone were to play for both teams in a game of football, at the same time – as a forward for one team and a goalkeeper for the other.

This is monetary policy on a last-resort basis because there are no more easy options. QE will do very little to generate sustainable growth in the euro area.

What it has done is boost market confidence – of the short-term, artificial kind – because the private sector sees yet again that here is a public sector entity willing to underwrite the economy.

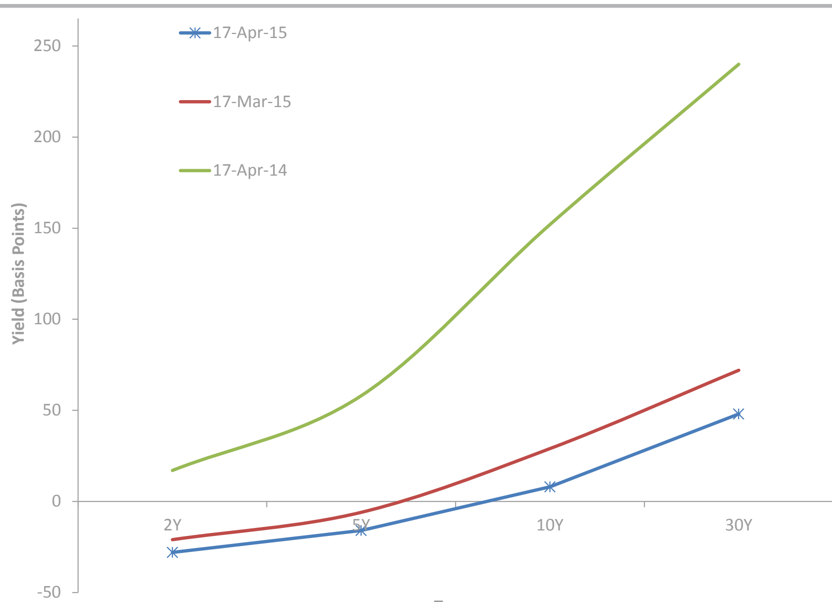
Market reaction

Markets rose energetically when the ECB announced its QE programme, but markets will always enjoy cheap money and plentiful liquidity. As US and UK experience has demonstrated, when markets sell off, the central bank pumps in more liquidity, and when markets rise they don't unwind the easy monetary policy. It's a winning proposition for equity investors.

Governments appreciate QE and loose monetary policy even more, because it lowers pressures on them to make difficult decisions needed to stabilise budgets, including reducing public expenditure and restructuring economies to focus on countries' most competitive sectors.

Bund yields have slipped below zero

Yield curves of German sovereign bonds, 2014-15



Source: Bloomberg

Negative rates

If monetary policy wasn't incoherent enough, there is a serious risk in the form of persistent negative interest rates. The Chart shows how German government bond yields have dipped into negative territory, compared to a healthily positive curve only a year ago. This has been a predictable outcome of QE, but there is something ominous about this development. With the 10-year German bond yielding only 0.08%, it seems only a matter of time before German sovereign long-term debt follows the Swiss sovereign 10-year yield into negative territory.

Governments and central banks need to start taking this seriously and engineer a return to normal positive interest rates. QE is turning from a curing medicine into a life-threatening addictive drug.

A long-term period of negative rates for the benchmark issuer will turn finance on its head. Sovereign yield curves are the baseline for all other asset pricing, so this creates a valuation problem right away. But if this environment persists, this has worrying medium-term implications.

Institutional investors can't hoard their cash under the mattress, but they see little point in holding long-dated assets when the rate is negative. Even if these assets are 'risk-free', the loss incurred is likely to exceed the expected loss risk from holding risky assets. The problem rises in proportion to the maturity of the asset in question.

If this phenomenon carries on for anything beyond the short term, governments will find it difficult to issue long-dated debt. Corporate long-dated financing will dry up, with damaging consequences that will extend well beyond financial markets. An economy built on the back of endless low interest rates and trillions of dollars of QE is fragile indeed.

Governments and central banks need to wake up to the severity of the problems they are creating before it is too late. ▪

Moorad Choudhry is a professor at Brunel University London and author of *The Principles of Banking*.

Implementation is key task for Renzi

Need to tackle reform backlog and spending cuts

Lorenzo Codogno, London School of Economics

There are no major breakthroughs and plenty of continuity in Italy's latest Economic and Financial Document, an update on Italy's stability and reform programmes and public finance issued by the Treasury. It features structural reforms, growth-friendly and gradual fiscal consolidation, and support for private and public investment.

Italy struggled through years of recession and budget measures dictated by emergency situations or external pressure, often with unstable political majorities in parliament – a question addressed by the electoral reforms decided by parliament on 4 May.

The government headed by Matteo Renzi, who came to power in February 2014, has had the opportunity to shift to a medium-term approach. It could focus on delivering reforms and economic growth. The question now is whether it has succeeded.

On the budgetary side, the key targets are in line with those presented in October. GDP growth is projected to be 0.7% this year and 1.4% next year, and interest expenditure is lower. But public debt is hovering at around 132% of GDP. This makes it difficult to argue against the accelerated structural adjustments required by Brussels.

Yet a still-fragile economic environment and a large output gap would argue for flexibility and a more gradual approach. The government has effectively asked for a more gradual path towards a balanced budget, aiming for equilibrium in 2017 rather than early 2016. This would mean a 0.1 percentage point reduction in the structural balance in 2016, yet to be approved in Brussels.

Spending cuts

The government plans to use the 0.4 percentage point projected difference in net borrowing in 2016 (from -1.4% to -1.8%) to reduce spending cuts that were due to be 1% of GDP (€16bn). One aim is to avoid the projected increase in VAT. Spending cuts are now projected at €10bn or 0.6% of GDP.

The government appears to be running out of easy ways to reduce expenditure. Deep reforms of public administration are needed, along with restructuring the way services are provided to citizens. These take time and are politically difficult, and most of the past reform initiatives in the public sector exist only on paper.

In addition, Renzi flagged a 'tesoretto' – some 'money left aside' for future initiatives equivalent to one decimal point of GDP, mainly achieved through lower interest payments. But without further reduction in structural spending, the financing of new initiatives is in danger.

Renzi's government has defeated scepticism by delivering major labour market reform combined with reduced tax on workers and firms, product market reform initiatives, and deep constitutional reform which is likely to improve law-making and stability. Impressively, he managed far-reaching reform of co-operative banks, when previous attempts had repeatedly been blocked by powerful lobbies.

The road to salvation is paved with a lot more reform initiatives. There are at least three areas where urgent and costly intervention is needed.

Further reforms

First, a sharp improvement is needed in the business environment. With recovery still tentative, it is crucial to introduce the right incentives and send a clear message to businesses that it is time to start investing and hiring again.

Italy ranks 56th in the World Bank's 'Doing Business' report. Improvement has to come from streamlining bureaucracy, improving public administration, simplifying the tax code, reducing the many layers of regulation and procedures, reducing corporate subsidies and unjustified welfare spending, and further liberalising and reforming product markets.

Reforming the public administration and reviewing the tax system may well require sizeable additional financing, at least in the transition phase.

Second, the government must address the lack of credit growth, which is mostly due to a build-up of non-performing loans on banks' balance sheets. It will not be politically popular to help banks after such a severe recession, but it is necessary to re-establish proper credit flows to support economic activity and investment.

This can be done in a variety of ways, including introducing tax breaks to increase banks' provisioning, reforming insolvency and recovery procedures, increasing guarantees to reduce risks for banks, especially related to loans to small and medium-sized enterprises, and considering one-off ways to incentivise the cleaning-up of balance sheets while respecting state aid legislation (so-called 'bad banks').

Not addressing this last point is likely to result in slow credit growth, hold back economic recovery and reduce the effect of the credit channel opened by the European Central Bank's quantitative easing. The Economic and Financial Document does not say much on this.

Third, immediate attention should be given to active labour market policies and measures to reduce extreme poverty, such as refinancing the already existing social card and assistance programmes.

Youth unemployment reached 42.6% in February. One in eight households are in relative poverty and one in thirteen in absolute poverty, according Istat's estimates for 2013, which are likely to have increased significantly since then.

There is a risk of producing a lost generation and the already evident deep social problems may endanger social cohesion and impinge on reforms. The government has promised to unveil initiatives to fight poverty in June.

To finance them, the government should further reduce public expenditure and not ease the pressure on spending cuts.

It is time to move from one-off spending reviews to a fully-fledged performance budgeting approach, to give certainty and stability to public spending plans and flexibility to budgeting, and allow a value-for-money reassessment of all spending.

Backlog in parliament

The Renzi government made implementation of reforms legislated by previous governments a priority.

Yet the backlog of measures still to be put into practice is large. Some need secondary legislation, regulations and the public administration actually delivering on the ground. Final approval in parliament is urgently needed for further labour market reforms.

The reforms introduced in just a year are impressive. But the job is not yet done. Structural spending cuts are needed to allow essential spending on improving the business environment, facilitating the transmission of monetary policy through the credit channel, alleviating extreme poverty and improving employability. The implementation of these reforms is crucial to Italy's recovery. ▪

Lorenzo Codogno is Visiting Professor at the European Institute, London School of Economics, and was Director General of the Italian Treasury from 2006-15.

Portugal must rebalance economy

Negative external investment position is a threat

Francesco Franco, Nova School of Business and Economics

Portugal must rebalance its economy from the non-tradable to the tradable sector. This is essential to deal with a very large negative net external investment position.

Portugal is not alone in experiencing a net negative external position (See Chart 1). In 1997, as financial markets became certain of the creation of the euro, long-term nominal interest rates of euro member countries rapidly converged towards German levels. The ensuing capital inflows to peripheral countries financed consumption and investment, but regrettably were not efficiently allocated and did not translate into the higher productivity that was expected to produce economic convergence.

This popular narrative requires both a qualification on the role of the euro and, in the case of Portugal, an acknowledgement of the historical peculiarity of its external balance.

General rate convergence

The nominal interest rate convergence in the second part of the 1990s happened during a generalised decline in interest rate differentials (see Chart 2). The UK, which had not adopted the euro and maintains a floating currency, also saw its interest rate converge with Germany's.

Chart 3 shows the current account as a share of GDP for four peripheral euro area countries: Greece, Ireland, Portugal and Spain. The large inflow of capital that coincides with the adoption of the euro is evident in the cases of Greece, Spain and Portugal. There is an idiosyncrasy in the Portuguese case. Portugal has run current account deficits at least since the balance of payments statistics began (the only exceptions are small current account surpluses in 1969 and last year).

Trade deficit

Chart 4 gives a more detailed view of the Portuguese current account and shows the net transactions in goods, services, primary incomes and in transfers. Portugal did not once achieve a surplus in the trade balance of goods during the 54 years shown in the sample.

Its trade balance in services is almost always positive. The primary income mostly reflects payments on the net international investment position. When the latter improves the net primary income also improves.

The balance on current transfers was an important source of financing for Portugal in the past, reaching a peak of 10% of GDP at the beginning of the 1980s. This reflected the worker remittances of a sizeable number of Portuguese citizens who migrated to other countries.

Although capital transfers are not part of the current account they matter for the net lending or financing position of a fiscal jurisdiction. Since joining the European Community in 1986, Portugal has benefited from large inflows of capital that have partially compensated the inevitable decrease in current transfers.

During the last economic adjustment programme (2011-14) the balance in goods improved rapidly. This strong performance is mainly due to a 13% nominal increase in exports. Imports of goods, after a sharp fall in 2012, are now back to pre-intervention levels. It is not yet clear if the velocity of the improvement in exports of goods can be sustained or mostly reflects one-off events including the utilisation of spare capacity in particular industries such as fuel refining.

Nevertheless, the pace of the increase is noticeable given the overall unfavorable external environment. Services are the most promising component of the trade balance. Tourism has increased both in quantity and quality and transport will become increasingly important if Transatlantic Trade and Investment Partnership negotiations are agreed between the EU and US.

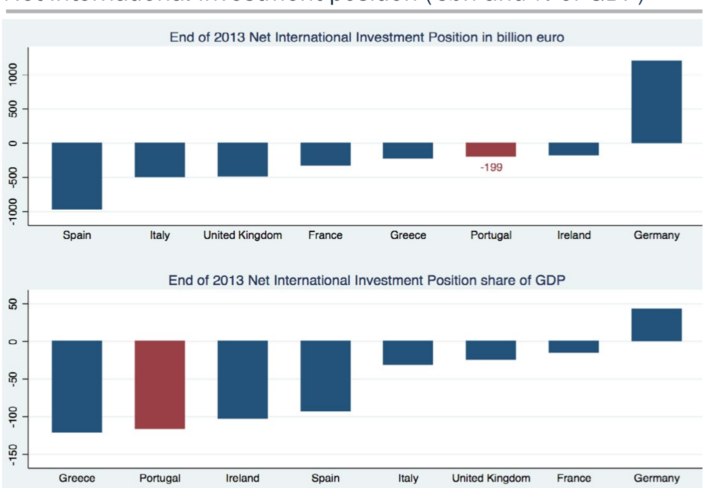
The adoption of the euro has amplified the accumulation of external imbalances in the euro area and eliminated its members' freedom to devalue.

Structural issue

Nominal convergence and large capital flows also happened in non-euro core countries. In the past, large nominal devaluations or depreciations would improve the trade balance. Yet in Portugal the persistence of current account deficits points to a structural dimension of the issue. Activity must be focused in the tradable rather than non-tradable sector. This transformation must rest more on policies that favor a structural change and less on the short-term reallocation that a nominal devaluation, of the sort that took place before monetary union, could achieve.

Chart 1: Portugal's balance sheet

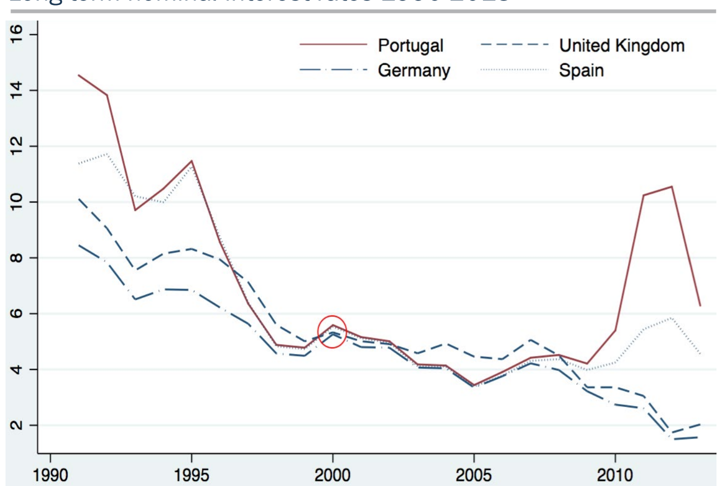
Net international investment position (€bn and % of GDP)



Source: Eurostat

Chart 2: Portugal interest rate fluctuations

Long term nominal interest rates 1990-2013



Source: European Commission

In the face of external financing shocks a nominal devaluation is typically less difficult than the internal devaluation adjustment that Portugal is currently going through.

The latter requires both a coherent set of policies at the euro area level and well-functioning markets which permit adjustment through the demand-supply mechanism and deliver competitive outcomes.

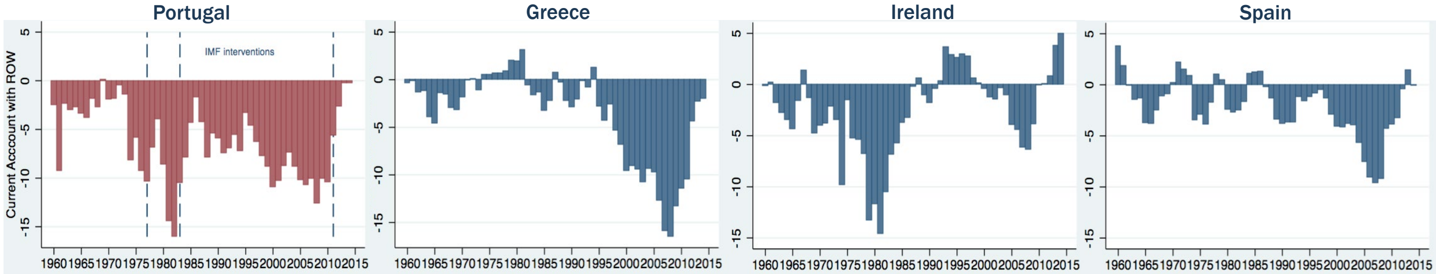
Ireland, for example, appears to have better functioning markets than Portugal. This did not protect Ireland from the consequences of a tremendous banking shock, but it helped to quicken the adjustment relative to Portugal.

The sustainability of the external position is a long-term issue that requires the capacity to generate surpluses. This long-run capacity appears to be at least partially disconnected from nominal depreciations. When the escudo existed, it depreciated massively against its trading partners. In the words of economic historian Charles P. Kindleberger, 'The extra degree of freedom which a country obtains by adopting its own currency does not come full-blown like Athena from the brow of Zeus.' ▪

Francesco Franco is Assistant Professor at Nova School of Business and Economics.

Chart 3: Swings in peripheral countries' balance of payments

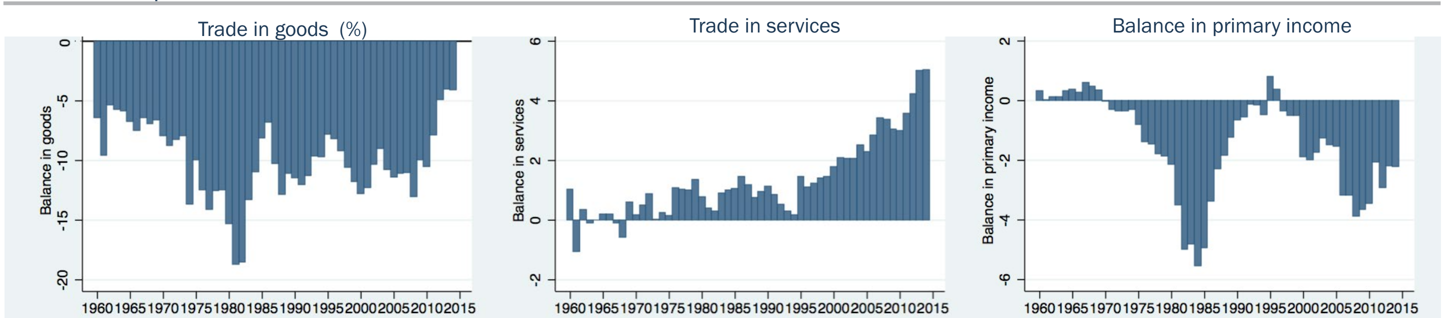
International current account positions (% of GDP)



Source: European Commission

Chart 4: How Portugal has been living beyond its means

Different components of current account balance as a share of GDP



Source: European Commission

ECB seen as adding further measures if quantitative easing needs extending

Francesco Papadia

How can the ECB quantitative easing programme's impact on financial variables be measured? One gauge is the spread between 10-year German government bonds (Bunds) and 10-year Italian government bonds (BTPs). When the spread was 310 basis points in November 2012, Banca d´Italia estimated that the fair spread was around 200 basis points, and has since reduced this to 180 basis points. The spread is now around 120 basis points, so the overall effect of QE can be estimated at around 60 basis points. Adding the effect of the lower Bund yield, the overall impact of QE is around 80 basis points.

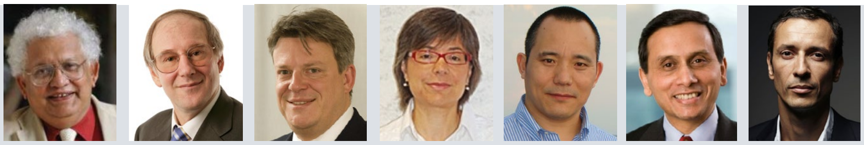
Will the ECB be fully able to implement its programme? Sufficient flexibility has been built into the programme to avoid early implementation problems – for example the possibility of purchasing agency as well as international institutions' bonds. If problems appear in implementation, the ECB governing council could incorporate other elements of flexibility, such as adding corporate bonds to the eligible pool, which could add another €1.4tn.

Will the ECB stop the programme before September 2016, or prolong it afterwards? The ECB would stop or taper its programme before September 2016 only if it is convinced that there is a risk of inflation exceeding its target – for example if inflation in 2017 was expected to be higher than 2.5%. By the same logic, the ECB would prolong QE only if its projection of a recovery of price stability was not fulfilled.

Was QE the last weapon in the ECB panoply of measures? The ECB said in a statement that 'the governing council has now deployed *almost* the full range of instruments at the disposal of monetary policy.' It is not clear which additional instrument the ECB has in mind. I know, however, what I have in mind: interventions on either the inflation swap market or the market for inflation options. The ECB could, for example, offer contracts whereby it would pay a given sum to its counterparty if inflation was lower than a certain strike price.

How can the effectiveness of the programme on macroeconomic variables be measured? The ultimate test will be whether the ECB manages to move the European economy back to 2% inflation. ECB monetary policy is more than just QE, and exogenous, non-monetary shocks will have an impact on inflation. Still, if the ECB substantially misses its 1.8% inflation projection in 2017 there would be serious doubts about the effectiveness of QE. ▪

Francesco Papadia, a member of the Advisory Board, is Visiting Fellow at Bruegel.



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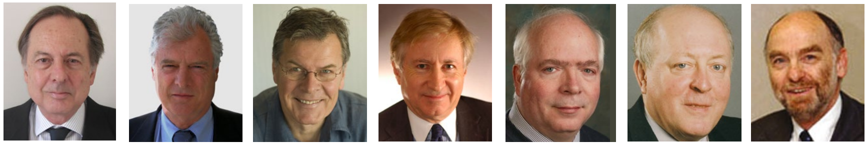

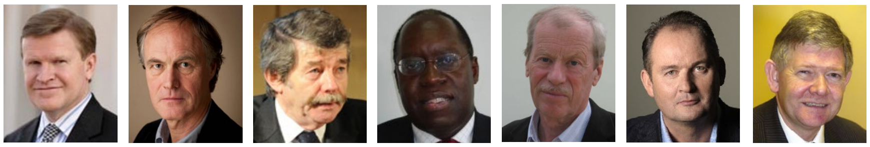

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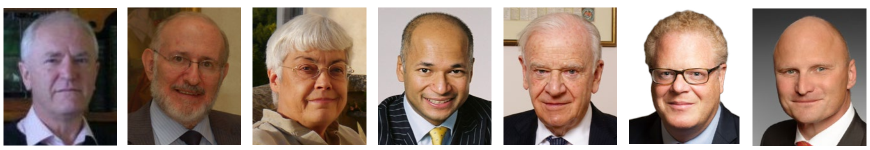

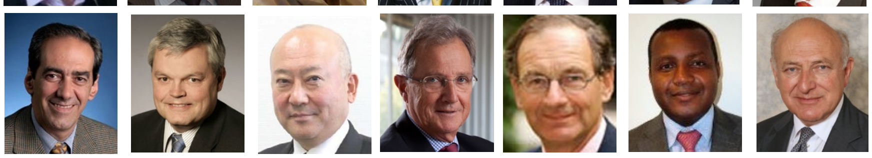

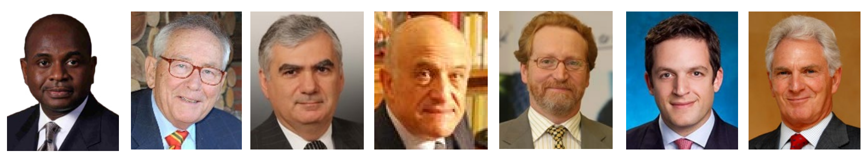

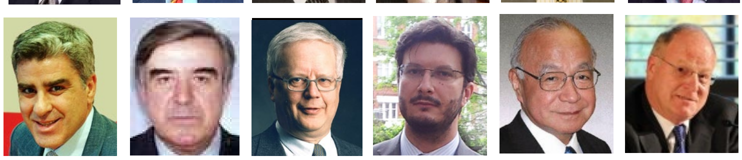

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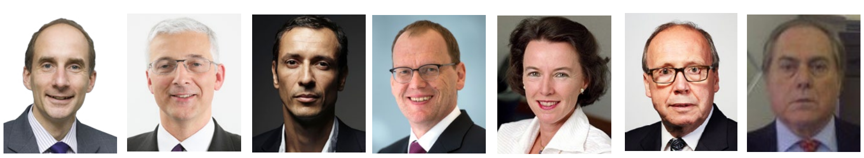

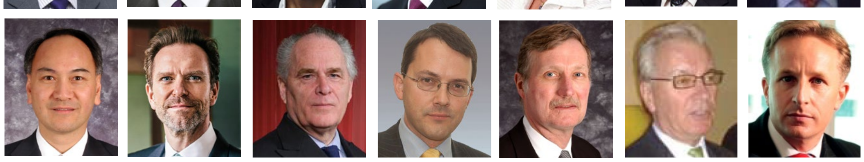

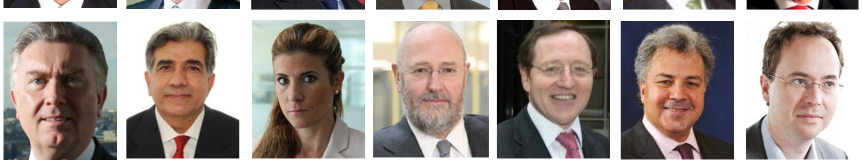

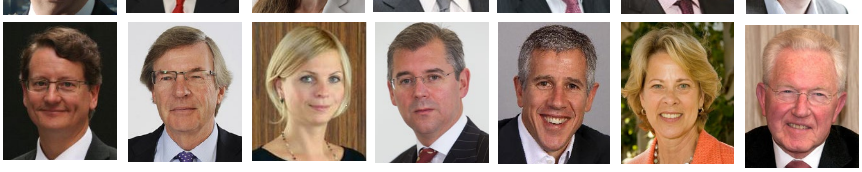

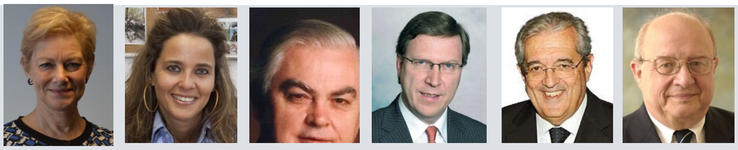

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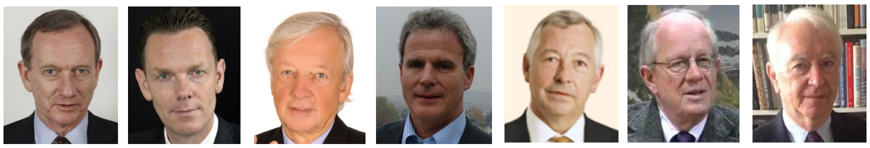

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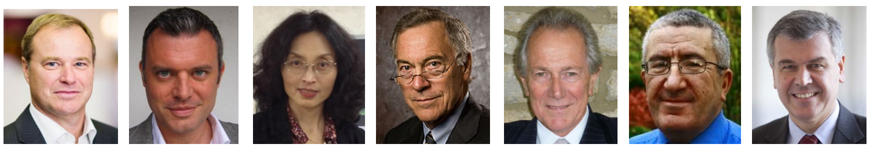

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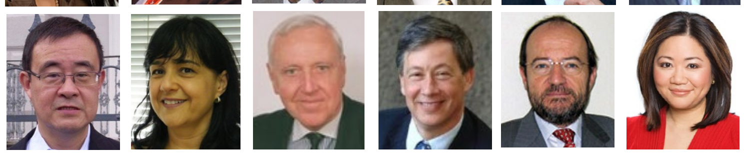

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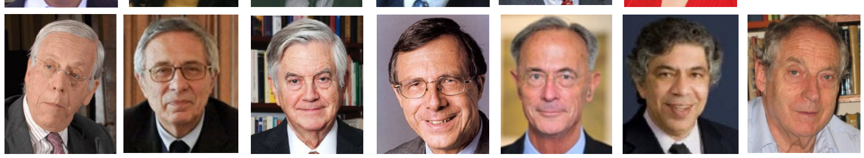

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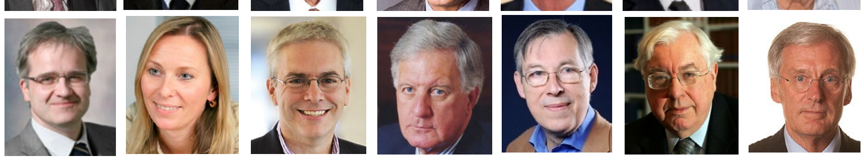

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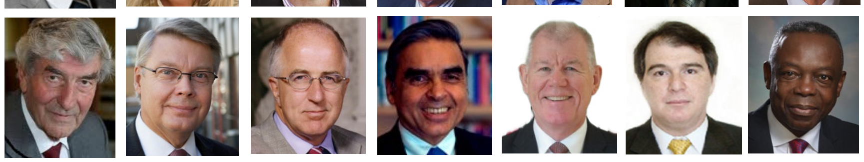

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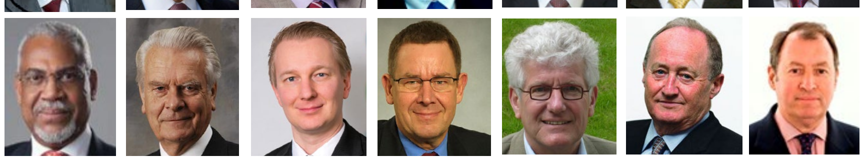

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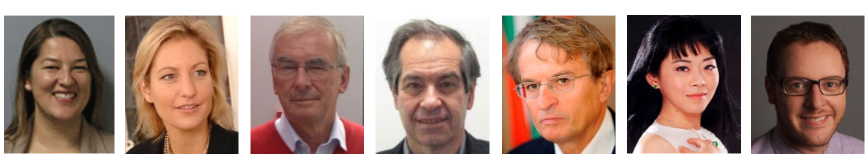

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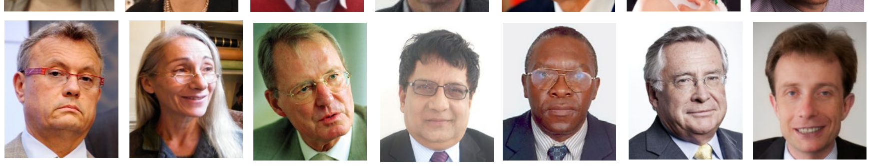

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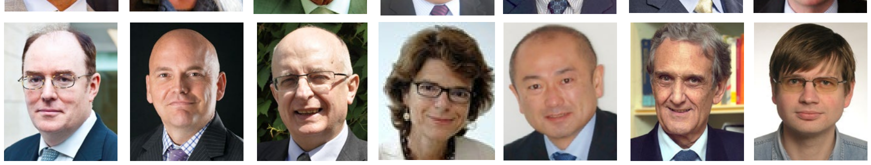

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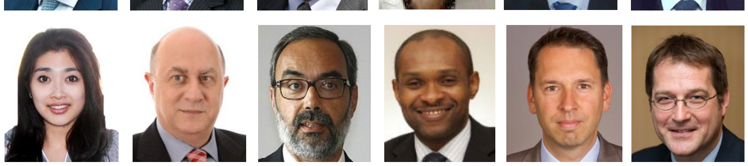

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Asean shaping up for 'double hit'

Headwinds for Asian economies from Fed and China

William Baunton and Bronwyn Curtis

The 10-country Association of Southeast Asian Nations is one the world's brighter regional growth areas. The IMF forecasts GDP growth at 5.2% in 2015, against 4.6% in 2014, well above the world average of 3.5%, as Chart 1 shows.

In spite of the generally positive outlook, the region is having to weather potential damage from a combination of the impact of the strengthening dollar on investment and capital flows and the slowdown of Chinese growth. Combating the implications of these 'twin hits' from the world's two biggest economies will be a major task for Asean finance ministries and central banks in 2015-16.

Infrastructure expansion

Low oil prices have exerted a positive impact, reducing Asean inflation, as Chart 2 shows, and giving the region's central banks more manoeuvring room in their monetary policies.

Like China, with which Asean carries out 14% of total trade (a figure that stood at 9% in 2005, as Charts 3 and 4 show), Asean is shifting the emphasis of economic expansion efforts away from undue reliance on exports to more domestically and regionally generated growth and a build-up in much-needed infrastructure.

Two landmark developments further enhance the medium- to long-term outlook. The establishment at end-2015 of the Asean Economic Community is intended to form a common market for goods, services and investment among the 10 member states. The establishment of the Asian Infrastructure Investment Bank, when it gets going, will add much-needed support to infrastructure efforts by other international institutions.

Dollar drawback

One potential difficulty comes from the strengthening dollar, which is both drawing capital away from the region and raising the value of dollar-denominated debt for corporate borrowers. The strong dollar was one of the key causes of the 1997-98 Asian financial crisis, raising debt payment costs for over-indebted enterprises and ultimately breaking exchange rate regimes pegging Asian currencies to the dollar.

Asean members have greatly improved their ability to withstand such shocks by raising the flexibility of their economies, modifying currency pegs and amassing sizable foreign exchange reserves for use in currency defence, as shown in Chart 5 on p.23.

Overseas dollar-denominated credit to overseas non-bank borrowers stands at $9tn worldwide according to the BIS, an increase of $3tn since the financial crisis. This creates potential debt service problems when the debt is unmatched by foreign currency receivables or existing assets. According to Morgan Stanley, Asian firms' foreign currency debts have tripled since the financial crisis from $700bn to $2.1tn, finding that roughly 22% of their debt is dollar-denominated.

Somewhat reassuringly, a similar percentage of their earnings are dollar-denominated. China is the exception, with 25% of corporate debt denominated in dollars versus just 8.5% of earnings in dollars, exposing a significant currency mismatch.

This may provide one of the reasons why the Chinese authorities have been keeping the renminbi steady against the generally appreciating dollar.

Taper tantrum

When the US Federal Reserve finally raises interest rates, currencies in the region will be exposed – a factor that has already sent destabilising ripples across the region when the first indications of the Fed's reduction (and ultimate ending) of its government bond-buying programme surfaced in May 2013, with a particular effect on the Indonesian rupiah and Indian rupee.

As Chart 6 shows, some countries have allowed their currencies to fall since that time, although the rupee and rupiah have stabilised. A significant accompaniment to this is that some countries (Malaysia , Thailand, Singapore) have lost reserves as their central banks have sold dollars to damp the effect of their currencies' decline, while others (Indonesia,

Chart 1: Uneven expectations

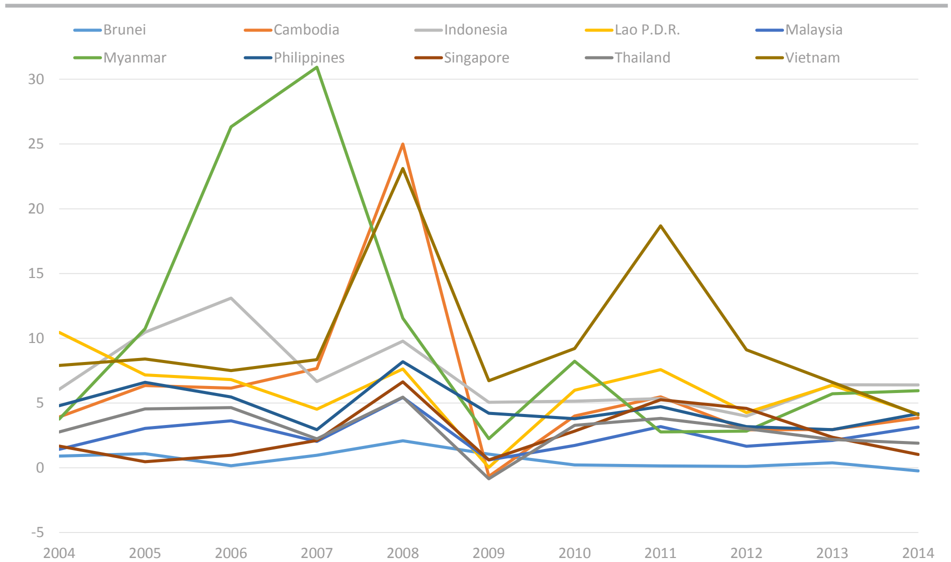
IMF growth forecasts (% change GDP)

Country	2014	2015	2016
China	7.4	6.8	6.3
India	7.2	7.5	7.5
Indonesia	5.0	5.2	5.5
Thailand	0.7	3.7	4.0
Malaysia	6.0	4.8	4.9
Philippines	6.1	6.7	6.3
Bangladesh	6.1	6.3	6.8
Vietnam	6.0	6.0	5.8
Asean	4.6	5.2	5.3
World	3.4	3.5	3.8

Source: IMF World Economic Outlook Database, April 2015

Chart 2: Asean inflation stabilises

Inflation rates of Asean economies, 2004-14 (%)



Source: IMF

India, Vietnam) have stabilised or gained reserves as their central banks have tightened foreign exchange to mitigate the effect of their currencies' recovery. Central banks throughout the region can be expected to show a similar flexible response in 2015-16 in reacting to a probable further dollar rise and capital outflow.

China's slowdown

Another potential headache stems from slower economic momentum in China. GDP grew at 7.4% in 2014, the slowest rate in 24 years. The Asian Development Bank believes this trend will continue, with growth projected at 7.2% in 2015 and 7% in 2016. The IMF predictions are even lower.

Asean will certainly benefit from higher US and European growth but Chinese headwinds need to be taken seriously in view of the strong trade links with the world's second largest economy flowing from China's rising demand in recent years for the region's raw materials and semi-finished goods.

China faces rising deflation risks, with widening negative output driving real GDP growth to a six-year low and the GDP deflator to below zero. Nominal GDP was 5.8% in Q1 2015 (year-on-year) while real GDP grew 7%, marking the first time since the financial crisis that nominal GDP growth has fallen below real GDP growth. More decisive monetary easing is needed to contain these risks.

China's trade with Asean tripled from 2005-13 to $350.5bn according to Asean figures (Chart 3). However, indications that China's demand has peaked increase Asean's need to explore alternative sources of economic expansion, especially since domestic dynamism in these countries is starting to flag as a result of maturing growth patterns, ageing populations and lower productivity.

China has increasingly developed an integrated approach to managing supply chains with its trade partners, and the goods it needs for a domestically driven economy are less import-intensive than in the past.

There are similar structural changes afoot in Asean trade with the US. Before the financial crisis a strengthening dollar would have led to a flood of cheap Asian imports into the US, producing a fillip for Asian growth.

However, as Chart 3 shows, Asean reliance on US trade has fallen significantly and imports to developed countries in North America and Europe are less capital-intensive. In the US, for example, investment is being channeled into new areas like shale mining, where machinery and equipment is needed, and where Asean companies have less skill and expertise.

Chart 3: Asean exports and imports

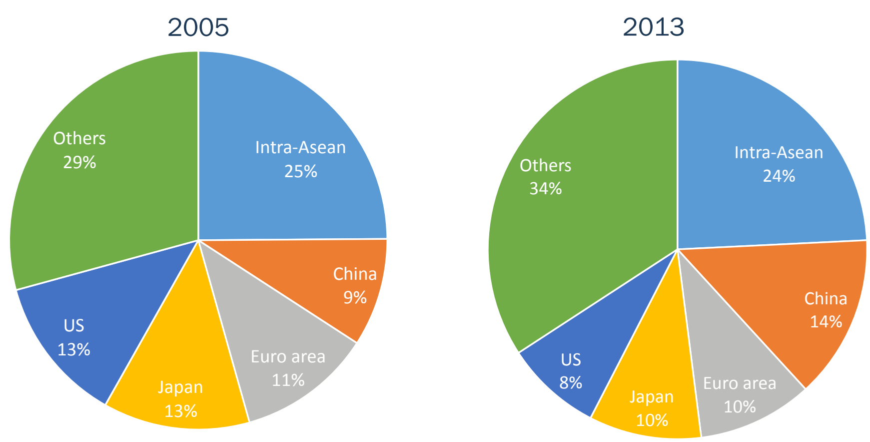
Asean trade with partner countries ($bn)

	1993	2000	2005	2011	2012	2013	1993-2013 average growth
Intra-Asean	82.4	166.8	304.8	598.4	602.0	608.6	10.5
Australia	9.1	17.6	31.2	59.7	69.5	68.0	10.6
Canada	3.5	4.8	6.0	10.8	12.3	13.5	7.0
China	8.9	32.3	113.3	280.1	319.5	350.5	20.2
EU-28	63.2	102.8	140.7	234.6	242.6	246.2	7.0
India	2.9	9.7	23.0	68.2	71.8	67.9	17.0
Japan	86.7	116.2	153.8	273.9	262.9	240.9	5.2
Korea	13.3	29.6	48.0	124.4	131.0	135.0	12.3
New Zealand	1.3	2.2	4.1	8.2	9.2	9.8	10.7
Pakistan	1.0	3.5	2.3	6.8	6.3	6.1	9.4
Russia	0.4	1.4	4.7	13.9	18.2	19.9	21.3
US	75.7	122.2	153.9	198.8	200.0	206.9	5.2
Others	81.5	149.9	238.7	510.7	531.0	538.1	9.9
Total Asean	**429.9**	**759.1**	**1224.6**	**2388.4**	**2476.4**	**2511.5**	**9.2**

Source: Asean trade statistics database

Chart 4: Asean trade

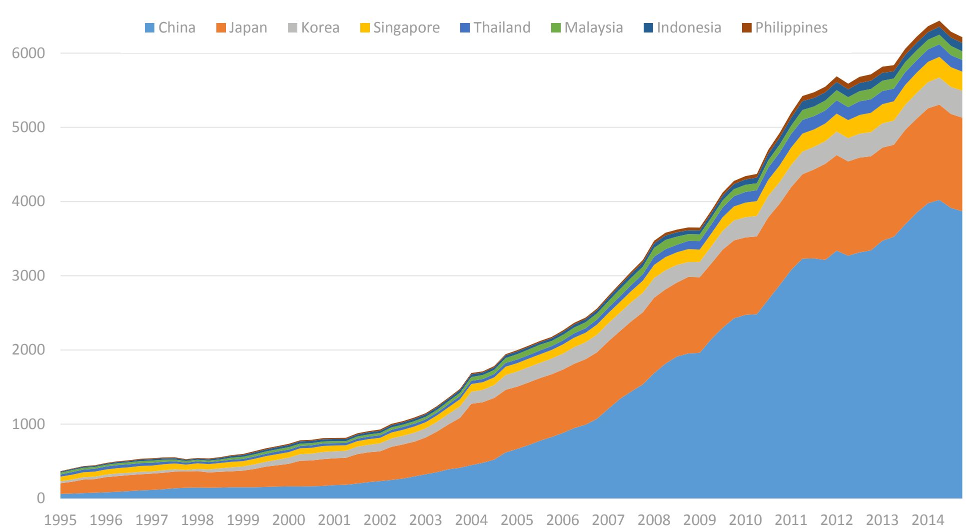
Asean trade with partner countries (% of total trade)



Source: Asean trade statistics database

Chart 5: Mounting defences against currency shocks

Asean countries' total reserves including gold, 1995-2014 ($bn)



Source: IMF

Despite Asean's smaller dependence on the US and Europe than in the past, the region will profit from recoveries in these areas driven by lower oil prices and interest rates. If the fall in oil prices is sustained, global growth could be 0.5% to 1.0% higher according to the IMF. Growth potential has fallen across the world, but there is plenty of upside for Asia if countries in the region can improve business conditions with better infrastructure and a reduction in other bottlenecks.

Oil impact

The significant drop in oil prices is a mostly welcome development for economies in Asean, reducing inflationary pressure and costs for local businesses, offsetting the effect of the 'two hits', particularly in Thailand, Vietnam and the Philippines. Steady progress in disinflation (see Charts 7-8) has led to a lowering of inflation differentials across the region, providing favourable conditions for economic integration.

Producer prices

Although producer prices in parts of the region have been falling (mainly as a result of falling commodity prices and negative consumer inflation rates in Singapore, Taiwan and Thailand highlighted in Chart 8) there appears no threat of sustained deflation. Singapore briefly entered a period of threatened deflation at the end of 2014, partly due to measures to cool the property market.

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

Prospects for the region remain positive. The Asian Development Bank forecast emerging Asian economies to grow 6.3% in both 2015 and 2016, and has set it hopes on India, forecast to grow 7.8% in 2015 up from 7.4% last year.

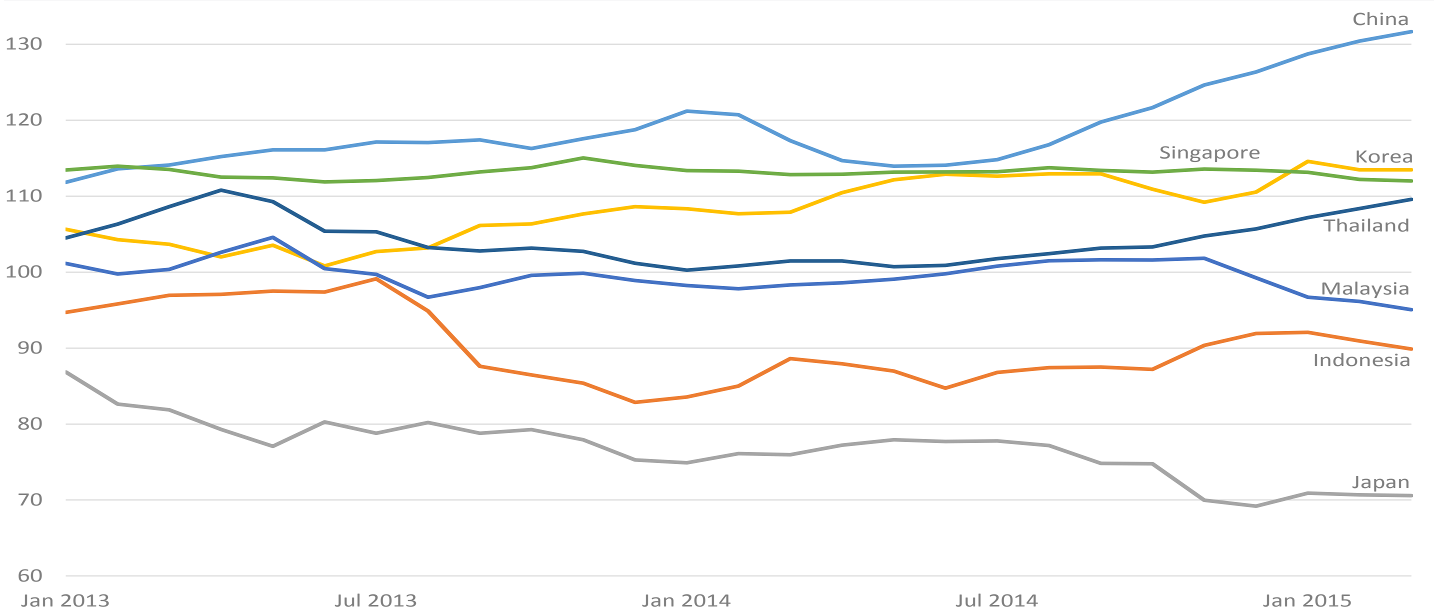
A rebound in Indian growth together with moves for greater trade and investment co-operation and low oil prices represent healthy antidotes to lower Chinese growth.

Yet Asean countries will still need all their reserves of greater flexibility as well as their defensive mechanisms implemented since 1997-98 as they find the right tools to balance Chinese deceleration and Fed tightening in 2015 and beyond. ▪

William Baunton is Economist and Bronwyn Curtis is Chief Economic Adviser, OMFIF.

Chart 6: Renminbi strengthens while yen and ringgit weaken

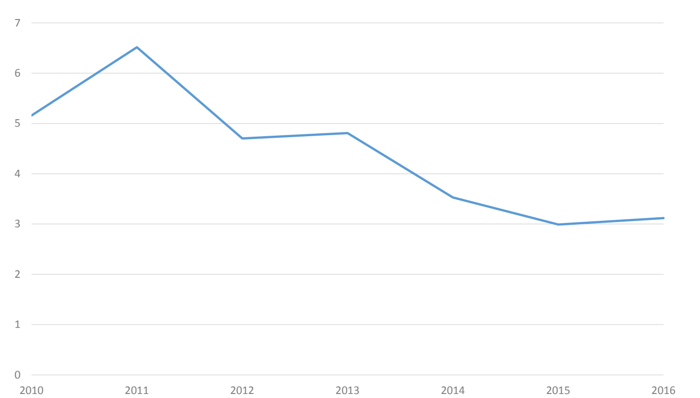
Trade-weighted exchange rates, 2003-15 (monthly averages, 2010=100)



Source: BIS

Chart 7: Asian inflation subsides to 2% level

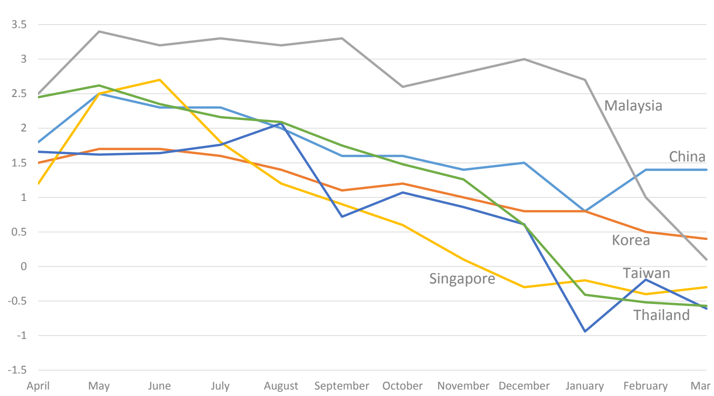
Inflation rate of emerging and developing Asia, 2010-16 (%)



Source: IMF

Chart 8: Negative inflation in Singapore, Taiwan, Thailand

Monthly inflation rates, April 2014-March 2015 (% change)



Source: National Sources

Why AIIB should choose London base

Funding Asian infrastructure presents huge opportunity

Gerard Lyons, Advisory Board

The Asian Infrastructure Investment Bank is a new institution whose time has come. Its progress to date has been impressive.

Although officially proposed by China only in 2013, it was launched in October 2014 and is set to be fully operational within the next year, with $50bn in working capital and a host of countries signed up as members.

The AIIB is the latest evidence of the changing face of the global economy. The significance of its formation and the potential impact it may have should not be underestimated.

The formation of the AIIB highlights the way in which global policy institutions are evolving. The financial crisis has already seen the evolution of G20 alongside the G7. The AIIB looks set to co-exist alongside established multilateral organisations such as the International Monetary Fund and Asian Development Bank.

Although some of the current global institutions are changing, this is a slow process. It takes time to change the operation and governance of institutions like the World Bank and IMF, set up immediately after the second world war.

Perhaps far better to create new institutions from scratch, such as with the AIIB, particularly as its remit is clear: to fund infrastructure investment across Asia.

Asia's growing needs

At its 2010 annual meetings, the ADB unveiled its estimate that Asia would need $8tn in infrastructure investment over the next decade, far more than the amounts then being financed. Funding such infrastructure provides a great opportunity, not only in terms of its direct economic impact but also because it will fulfil the need across Asia to channel the region's huge savings into much-needed investment. This will help generate necessary deepening and broadening of Asian capital markets so that they may eventually mirror that of the US.

China has already shown at a national level how infrastructure can be used as a force for good. The Victorians did the same in Britain in the 19th century and many others have followed suit in between.

Yet too heavy a political hand can produce unnecessary and expensive projects, as shown by examples in China. Thus the AIIB's importance will be as an enabling institution that provides the finance and the tools for necessary infrastructure, and in doing so hopefully adds some market discipline.

Help not hinder

The creation of regional development banks such as the ADB and the European Bank for Reconstruction and Development has not diluted the influence exerted by existing multilateral organisations such as the World Bank. In the same way, the creation of new institutions such as the AIIB and the New Development Bank, the so-called Brics Bank linking Brazil, China, India, Russia and South Africa, should help, not hinder, existing institutions.

The AIIB and the ADB should collaborate, cofinance and complement one another. The AIIB is likely to provide an additional source of focus and funding and also reinforce pressure on the ADB to do more, in terms of a much-needed enhanced lending capacity and financing more infrastructure investment, including through public-private partnerships.

The location of the AIIB has yet to be decided. While its headquarters will be in Asia, there is a case for it to have a significant regional presence in London. This would make sense given the AIIB's multilateral role, Asia's growing economic significance and London's position as the world's leading international financial centre.

It has proven its ability to connect west and east, its position as a centre for internationalisation of the renminbi, and its commitment to the best standards in global regulation and governance.

Ill-founded concerns

Some of the concerns expressed about the AIIB are likely to prove ill-founded. The US is worried about areas such as governance and transparency. Perhaps the probable focus on these issues, as well as on efficiency, will increase the likelihood that they will be addressed head on.

Likewise, there is the wider question about China's future regional and international role. Naturally there are geopolitical concerns across Asia, but China's rise in economic and financial terms should be a force for good.

At the ADB annual meeting in Baku in May, I was struck by the 'Governor's Statement' of Lou Jiwei, Chinese finance minister, who talked about the need for vision in addressing sustainable development, escalation of regional lending, innovation in meeting investment needs and co-operation among multilateral agencies. His comments were refreshing and constructive.

A lot has been said and written about the AIIB. We need now to see how the set-up of the new institution progresses, and what it will actually do. There are many reasons to be positive. ▪

Gerard Lyons is chief economic advisor to the Mayor of London and author of *The Consolations of Economics*.

Renminbi expansion a stabilising influence

Building an East Asian economic community

Juan Carlos Martinez Oliva, Banca d'Italia

The rapid rise of the renminbi as an important world currency reflects a deliberate series of well-engineered actions by the Chinese authorities. The currency is increasingly used in foreign trade and financial transactions, and is present in the foreign exchange reserves of a large number of central banks across the world.

But we need greater clarity about China's motivations. When trying to quantify the benefits of currency internationalisation, economic literature usually limits the analysis to measurable factors such as the reduction of transaction costs and uncertainty deriving from a third country's currency fluctuations, and the benefits accruing from seigniorage (the difference between the value of money and the cost to produce it).

Yet recent academic literature concludes that a monetary hegemon such as the US derives little financial benefit from the international role of its currency. Some, including C. Fred Bergsten in 'The Dollar and the Deficits' in Foreign Affairs, have even claimed that downsizing its role would be economically beneficial.

So geopolitical and power considerations instead provide insight into China's strategy. Renminbi internationalisation fits into the country's involvement in regional economic and financial initiatives, and its exercise of soft and hard power.

Virtuous circle

If the international use of a currency is pushed far enough, it can trigger a virtuous circle based on cross-feeding effects. A powerful country can create incentives for a more intense use of its currency by its clients and partners.

Conversely, being the issuer of a powerful currency allows extracting benefits, both economic and strategic, from other countries, thus increasing a country's power. A monetary hegemon can internalise benefits from a widespread use of its currency while network externalities create compelling reasons to perpetuate its monetary dominance across its area of influence.

Xi's dream

The process of renminbi internationalisation can be viewed as part of a strategy to create an east Asian economic community with China at its centre – working towards President Xi's Asian Dream of an 'Asia for the Asians'.

China's regional strategy consistently looks to win neighbouring countries' support and friendship while keeping a leader's posture on strategic issues such as territorial sovereignty and maritime rights and interests.

Meanwhile, China's continuing soft-power offensive is evident in its pouring money into the Asian Infrastructure Investment Bank and the New Development Bank, and pushing ahead the initiative for a Maritime Silk Road Bank.

Other elements of soft power include establishing renminbi offshore centres around the world. New centres outside Hong Kong have been created in Singapore and London, as well as in Bangkok, Doha, Frankfurt, Kuala Lumpur, Luxembourg, Paris, Seoul, Sydney and Toronto. Many more will follow.

In addition, a fast-growing network of swap lines is intensifying the use of renminbi as a trade settlement currency across the world. China's swap lines may be viewed as a cross-section of its geopolitical interests ranging from key Asian partners to oil-exporting countries and strategically relevant neighbours. In addition, China encourages new renminbi-based regional financial institutions. The late Singaporean leader Lee Kuan Yew suggested that 'the Chinese will want to share this century as co-equals with the US'.

While the US might find it hard to surrender parts of world leadership to China, the recent US diplomatic failure in the Asian Infrastructure Investment Bank confrontation demonstrated that times have changed.

Multilateral approach

Many countries, including historical allies of the US, seem less prone than in the past to adhere to an old-fashioned cold war model based on US hegemony. They are more inclined towards a multilateral approach to global economic issues.

The rapid rise of the renminbi as an international currency shows how fast global economic relations can change. If that trend is to continue, the Chinese currency might eventually sit beside the dollar as a world reserve currency. Deliberations over including the renminbi in the IMF's reserve unit, the Special Drawing Right, could be a step in that direction.

What matters in the short run is that the renminbi has a very high chance of becoming the main regional currency in east Asia, and a powerful vehicle for trade and investment across the area.

Such an outcome should be viewed not as a threat but as helpful and desirable at the regional level, and a source of stability for the overall international monetary system. ▪

Juan Carlos Martinez Oliva is a Principal Director in the Directorate General for Economics, Statistics and Research, Banca d'Italia. The views expressed here are solely those of the author in his private capacity and do not in any way represent the views of Banca d'Italia and the Eurosystem.

Africa's financial services revolution

Big opportunity for mobile products across continent

Michael Lafferty, Lafferty Group

Africa has led the world with the roll-out of mobile money but the big opportunity in mobile financial services lies in the provision of loans, deposits and insurance products to telephone users over mobile phone networks. While the amounts involved are relatively small, at least initially, the sheer scale of the business opportunity is vast.

Substantial benefits are within reach across the continent, which by 2050 is projected to have a population equivalent to that of India and China combined. 80% of Africa's adults are unbanked.

The chance to bring banking and financial services to Africa is a rare opportunity for banks and mobile network operators (MNOs).

Every country is different and there is no single dominant player across the continent. The story of mobile money is much more about regions. East Africa and Tanzania are setting the pace. West Africa is still nascent because MNOs are not allowed to provide mobile money wallets to subscribers. Southern Africa is looking for a business case, and north Africa is focused on just mobile payments.

Collaboration

Despite the extraordinary potential, experience shows that neither banks nor MNOs can seize this unprecedented opportunity by themselves. The MNOs have neither the capital resources nor the financial expertise to go it alone. And financial regulators are reluctant to give MNOs licences to operate by themselves beyond the narrow area of payments.

African banks, on the other hand, lag far behind the MNOs in the size of their customer bases, which are generally tiny. Traditionally corporate-oriented in their business activities, banks have been slow to embrace the consumer opportunity. Regulators are partly to blame for this, though many are now staunch retail banking advocates.

Partnerships between banks and MNOs are the obvious way ahead, as both parties have weaknesses. 'The MNOs are slow, technically weak and have transient management teams that are mainly focused on high margin business,' according to one expert.'The banks, on the other hand have no concept of unsecured lending. They take six weeks to approve a mortgage and they only seem to want to do business with people who work for large companies.'

One of the most fascinating players is AFB, a non-bank financial institution that is forming MNO alliances at great speed across the African continent, particularly in East Africa, the home of mobile money.

To understand what AFB is doing, imagine an office block in Nairobi. At one end of the large office sits a group of staff running a traditional revolving credit cards business and at the other end is a group handling mobile loans.

Credit card group

The credit card group is focused on consumers making point-of-sale purchases in supermarkets, while the mobile loans are provided to micro, small and rural businesses.

Here are two seemingly separate types of business and both are being conducted by a South African-managed, Mauritius-registered consumer lender that is showing banks in Africa how to make unsecured loans to ordinary people. Led by Karl Westvig, former chief executive of RCS, a Cape Town-based credit cards company that is now part of France's BNP, AFB moves very fast.

'Regulators welcome us everywhere because we are bringing financial services to the unbanked. We are a consumer lender and do not require a banking licence', says Johan Bosini, who heads AFB's mobile division.

Apart from the management team, AFB investors include two UK private equity players – Leapfrog Investments and Gemcorp – and IFT, a European investor.

Supermarkets, mainly South African, are AFB's allies in the credit cards business while airtel, the India-based mobile phone company that is also big in Africa, is its partner in the mobile loans business. By all accounts both activities are enjoying explosive growth.

How does it work? Forget stories about the need for sophisticated phones to do mobile lending. Airtel's clients are primarily of the basic prepaid variety.

All that AFB needs is simple consumer contact data like a phone number to start the process moving, which it does by offering people nanoloans of as little as $5 and $10. The interest rates seem extraordinary by western standards but most people pay back their loans on time and are gradually offered higher amounts.

In this way AFB creates its own scorecard in an adaptation of the powerful risk-management system pioneered by France's Cetelem (now part of BNP), among others.

Entrepreneurial player

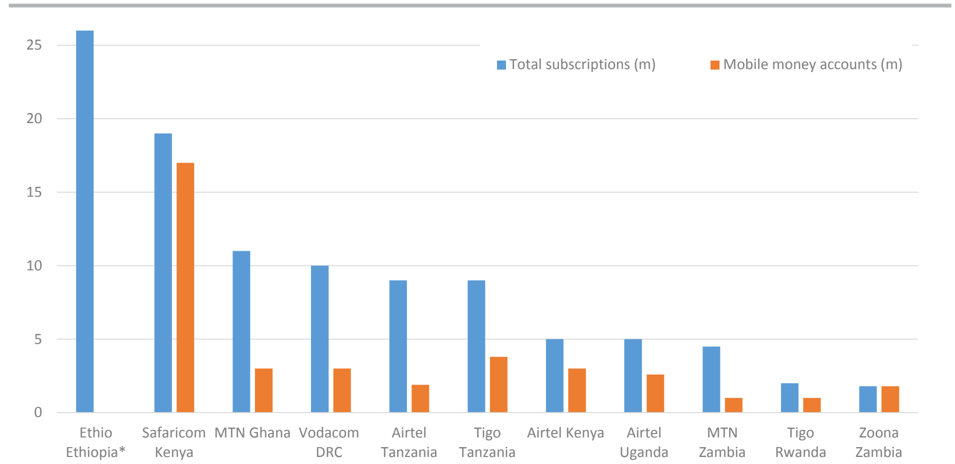
Another highly entrepreneurial player in the African mobile money apace is Zimbabwean Strive Masiyiwa's Econet, which is a significant player in the MNO space across several African counties. It owns a bank in Zimbabwe where it provides a range of mobile financial services and does not need bank partners.

In many ways mobile financial services in Africa are still in their infancy. But a combination of technological innovation and rapid demographic and economic advance will, before too long, bring them to the forefront.

Michael Lafferty is Chairman of Lafferty Group.

Ethiopian subscribers lead the way

Leading mobile network operators in Africa's mobile money market



Source: Lafferty Group

Note: not all mobile money accounts are active, inactive accounts not disclosed

Modi embarks on growth path

India's prime minister confident after year in power

Antonio Armellini, Advisory Board

Nearing one year in power on 26 May, Indian Prime Minister Narendra Modi is confidently in control.

His first full-year Budget on 28 February was a carefully balanced act, which reflected the government's determination to accelerate the modernisation of the country. But it could not hide the many difficulties that lie ahead.

It was relatively weak on fiscal consolidation, and contained pro-growth measures welcomed by business but criticised by the opposition as discriminatory and 'anti-poor'.

Tax reform took pride of place, starting with the promise to introduce a nation-wide tax on goods and services by 2016, without which India will never become a single market.

Whether India can achieve its optimistic GDP growth projection of 8.5% this fiscal year will depend largely on improving physical infrastructure, the appalling condition of which is a serious impediment to turning the country into a manufacturing giant. Plans for this were left undefined, as were those for structural reforms, including subsidies, bureaucracy and 'black money'.

Beating corruption

Tackling the complex web of vested interests and encroached privilege has proved more complex than expected. The Modi government has succeeded in coaxing (most) bureaucrats to get to the office on time – in itself quite a revolution – but making public sector undertakings truly efficient is another matter.

This remains a fundamental point in Modi's programme of renewal, for which he received an overwhelming mandate from voters tired of the cronyism and corruption that welded together an inefficient corporate world and a corrupt and arrogant bureaucracy.

Modi's personal appeal as perhaps the single Indian politician immune from any hint of malpractice is being tested by the sometimes lacking operative capabilities of his government. The strains are starting to show.

The unexpected success of the Aam Admi anti-corruption party at the elections for the New Delhi Government showed that exasperation with corruption has spread wide in Indian public opinion. Some say Aam Admi is likely to become a real danger, but its leadership is fractious and divided. Arvind Kejrival, chief minister of Delhi, is no intellectual or political match for Modi. In fact, by focusing attention on corruption, Aam Admi could turn into an unwitting prop for Modi, contrasting their own empty rhetoric with Modi's hands-on approach in attacking the roots of the problem.

The demise of the Indian National Congress party, together with the persistent weakness of the regional and caste-based parties, has cleared the deck of any real adversaries. It is difficult to predict if and when Sonia Gandhi's party, that of the Nehru-Gandhi dynasty, will revive.

The Congress party and the Bharatiya Janata Party both suffer from an ageing leadership, which has effectively prevented a new generation of qualified politicians coming to power. Modi was able to puncture the BJP, eliminating in one fell swoop all possible competition, and took on board the best among the rest. Modi has more to fear from his own weaknesses and from internal conflict than from adversaries.

Foreign policy

Foreign policy, an area in which few expected Modi to shine, has proved one of his more considerable successes. Starting from the surprise invitation to his inauguration ceremony of the leaders of all neighbouring countries – including Pakistan – he has strived to provide the country with a proactive international dimension befitting its role and ambition.

Gone is the pattern of poor relations with all neighbours, as is the supercilious distance from the region's different international organisations.

The Near East Policy has been re-invigorated and Modi has embarked on a series of visits to Southeast Asia. In redefining the country's geopolitical equation as a major regional power with global aspirations, India has established new links with Japan and Australia as the lynchpins of a future transpacific security arrangement. In addition, Modi carried out a charm offensive vis-à-vis the US.

Many problems remain. Rationality and mutual self-interest in India's relations with Pakistan are unlikely to prevail for another generation.

China is the main of India's foreign policy, both in terms of security and competition for global influence and trade. The two countries do not have an agreed border and the possibility of open conflict cannot be ruled out for good.

The increase in economic relations could favour the emergence of a pattern in which growing interdependence is set in the context of areas of respective influence, from Myanmar to Afghanistan, making open conflict less plausible. Asian stability will ultimately depend on the emerging relationship between India and China, in which the US will be a powerful but increasingly external partner.

What, if any, are Modi's present and future weaknesses? He has so far been strong on declarations, weaker on delivery. Support from aspiring business interests and wider public opinion wanting overall change cannot survive on promises alone.

Modi has often stated that he views his government programme over a period of 10 years, and he will need at least that. But some results in terms of building a more liberal business and economic environment and enhancing the fairness and effectiveness of government machinery will have to come soon; otherwise Modi risks losing support.

There is a further, darker, issue. Modi the prime minister is a pragmatic, flexible statesman. But Modi the Indian political leader is a lifelong member and former national leader of the extremist Hindu nationalist movement, Rashtriya Swayamsevak Sangh, that advocates Hindu supremacy and has been accused of intolerance and violence against Muslims, Christians and other minorities.

Extremist trap

Modi owes part of his electoral clout to the RSS and has given some of its leaders positions of responsibility. They have on occasion spoken irresponsibly, giving credit to rumours of growing harassment and persecutions of minorities. Modi has tried to distance himself from such positions, but not always convincingly. The risk of inter-community strife is ever present in India, and the last thing any stable government should do is align itself, albeit indirectly, with extreme views.

Modi may well, deep in his heart, be at one with the RSS on Hindu supremacy; he is at the same time too astute a politician, and too ambitious a prime minister, not to realise that this could be the unmaking of his power. Out of self-interest rather than conviction, he is likely to steer clear of traps of this kind. ■

Antonio Armellini was Italian Ambassador to India from 2004-08. He is a member of the International Institute for Strategic Studies and Istituto Affari Internazionali.

Kickback cloud over real

Brazil holds breath ahead of US move

Jamie Bulgin, Markets and Institutions

A kickback scandal at Petrobras, Brazil's state-owned oil company, epitomises the country's fall from grace as a member of the once fast-growing Brics club.

Although Indian growth is now moving ahead of China's, Brazil is one of the remaining trio, along with Russia and South Arica, where the economic picture has become a lot less rosy.

The end of a favourable commodity cycle between 2003-11, linked to China's earlier growth, as well as general concerns about the economic stewardship of President Dilma Rousseff, have added to the sense of malaise.

Corruption affair

When Petrobras, the state-controlled oil company, announced in April losses totalling R$51bn in 2014 – partly due to a major corruption affair – the real appreciated 3% against the dollar, mainly on relief that it had managed to declare audited results and that it avoided a technical default on debt. With its dual budget and current account deficits as well as high dollar-denominated corporate debt, Brazil is highly exposed to probable US monetary tightening in coming months.

Under pressure from lower growth and the problems at Petrobras, the real - which was R$2.24 to the dollar a year ago – weakened to R$3.31 in March before rising in recent weeks.

Political stability

President Rousseff and Joaquim Levy, the new finance minister, have used the respite to try to improve political stability amid warring factions in Congress and to take sustained measures to deal with the country's budget problems and stave off the threat of losing Brazil's hard-won investment-grade credit rating.

Levy's orthodox policies to set the economy back on track seems to have helped regain the confidence of some previously dubious investors. He has abandoned the price controls and fiscal ill-discipline of Rousseff's first term. Yet problems persist. Inflation was at an 11-year high in April and unemployment has begun to creep up again. The big test will come when US interest rates rise, an episode that has already led to numerous preliminary tremors. Like other emerging markets, Brazil is standing guard. ▪

Jamie Bulgin is Deputy Director, Markets and Institutions.

How Brazil compares with the Brics

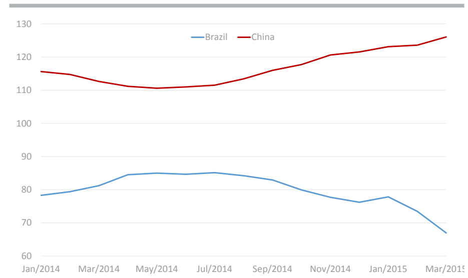
Fall and rise of the real

Brazil's exchange rate, 2014-15 (real per $)

Source: FRED

Renminbi revalues, real devalues

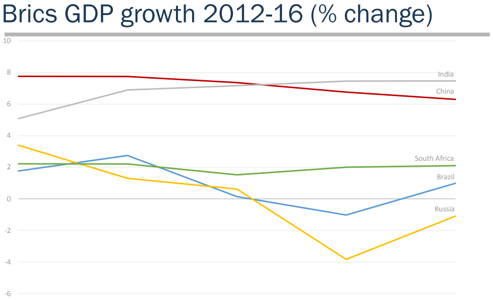
Trade weighted exchange rate (2010=100)



Source: BIS

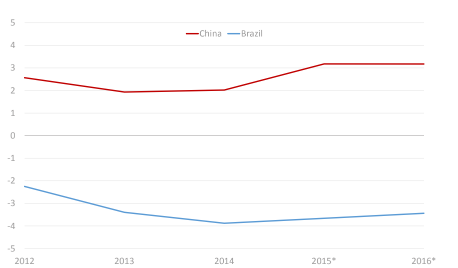
Brazil lags China and India

Brics GDP growth 2012-16 (% change)



China surplus, Brazil deficit

Current account 2012-16 (% of GDP)



Source: IMF World Economic Outlook, April 2015 *IMF projections

SOVEREIGN NOTES

Central banks in many emerging market economies need to prepare themselves for reversals of popular 'consensus trades' - when international investors retreat from large-scale commonly held positions.

One example has been the fashionable moves in the last few months to buy European equities on hopes that the European Central Bank's quantitative easing will generate sufficient liquidity for semi-permanent financial market buoyancy. In a sense, this may already be happening, seen in the early-May reversal of the yield declines on longer-dated European government bonds as worries re-emerge about higher European inflation at the same time as US credit tightening.

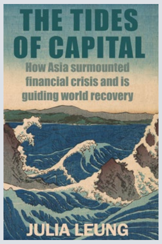
Emerging markets will be prone to capital flight and the authorities need to be prepared. In the absence of any thoroughgoing reform of the international financial system, these countries may need recourse to the 'capital flow management measures' now endorsed by the International Monetary Fund.

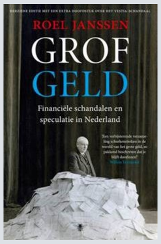
Indonesia provides a case in point where the central bank has been trying to engineer a rebound in investor confidence after earlier years of pressure on the rupiah. President Joko Widodo has had only limited success in pushing through reforms. Investors are considering allocating more capital to the country, but the Jakarta stock exchange has risen only 2.4% since Jokowi (as the president is known locally) assumed office in October 2014.

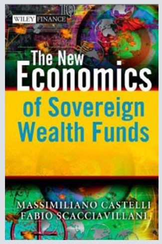
One reason for relative optimism is the belief among investors that the central bank has maintained its independence despite political pressure. The bank has made efforts to improve its communication policies, using social media and other devices to explain its measures to investors.

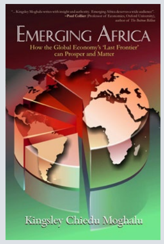
Indonesia needs to pay attention to strengthening local institutions and pension funds (both public and private sector), with capacity to absorb some possible strain brought by foreign investor selling. State pension funds, for example, can be crucial market stabilisers, as seen in other southeast Asian countries. Building domestic investment institutions forms a crucial part of necessary deepening of Asian capital markets as the region extends its general economic progress.

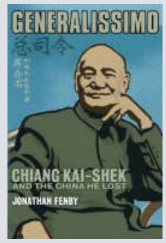
Pooma Kimis is Director, Markets and Institutions.

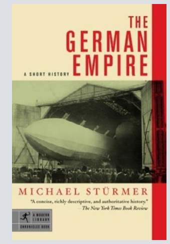












Expect more crises

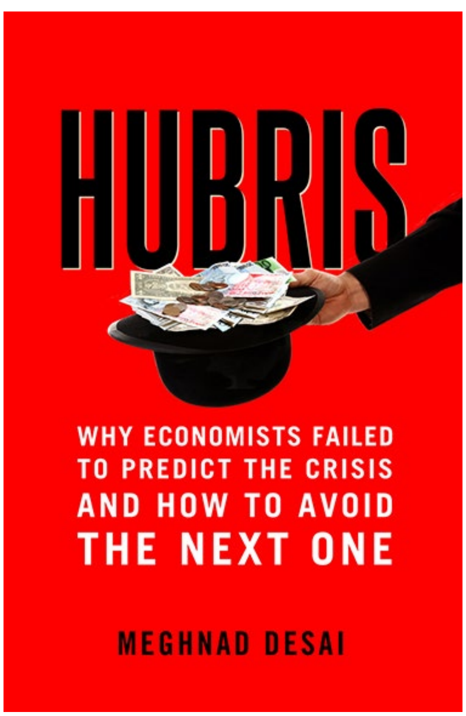
Restoring a sense of history to economics

William Keegan, Advisory Board

There have been countless casualties of what Dominique Strauss-Kahn, when managing director of the International Monetary Fund, termed The Great Recession. Among those casualties that *can* be counted is the economics profession, which is generally considered to have failed miserably to foresee the financial crisis and its aftermath.

It is by now a commonplace that the economics profession got bogged down in mathematical models and lost its sense of history. One of the most resonant comments of the era was made by Her Majesty Queen Elizabeth the Second who, as Lord Desai reminds us in this very ambitious work, famously asked about the onset of the crisis: Why did nobody notice it?

As Desai acknowledges, there were warnings. The present governor of the Bank of India, Raghuram Rajan, when still chief economist at the IMF, tried to alert the economics establishment in 2005 at the central bankers' annual gathering in Jackson Hole, Colorado, to the dangers inherent in newly fashionable financial 'products'. He was howled down.



A similar fate befell William 'Bill' White – former economic adviser at the Bank for International Settlements, another name familiar to members of OMFIF – when he issued a series of prescient warnings, albeit in central bankers' familiarly guarded language.

He too was largely ignored, although both Martin Wolf in the Financial Times and your present reviewer, in the Observer, tried to publicise his message.

In J.K. Galbraith's famous phrase, the 'conventional wisdom' ruled, and the conventional wisdom was that, instead of spreading risk, sophisticated-sounding financial instruments were reducing it.

Asking bankers

I well remember asking bankers if they understood what was really going on, and they would say, the lawyers did. And the lawyers? Surely the bankers did...

But it was not just the investment banks. Conventional retail banks were leveraged up to the hilt and taking enormous risks.

In addition to his undoubted technical skills in economics, Desai brings a sense of history to the party. My wife, who attended his lectures at the London School of Economics and Politics, recalls that they were so mathematical that they were known only half jokingly as 'Marx by Matrix'.

Desai understands capitalism, communism and economic history. Indeed, he provides a potted history of the subject in his attempt to answer the question of where it all went wrong.

His essential message is that in forgetting economic history the economics profession and its gullible disciples in public life forgot business cycles, long and short, as well as the previous occurrence of banking crises and financial crashes. It was, as the present permanent secretary to the Treasury Sir Nicholas Macpherson pointed out not long ago in a public lecture, 'a collective failure'.

In thinking they had conquered inflation, policy-makers took their eye off the financial risks. As Desai says, the entry of China and other Asian countries to the world market had a depressing impact on the prices of goods which the central bankers and their champions attributed to 'the Great Moderation or astute central bank policy rather than the real conditions of manufacturing supply.'

Asian monetary reserves went west: 'this was an amazing situation, with low inflation, low interest rates and plenty of credit.'

So, far from the equilibrium sought by modern economists, we returned to a world of 'dynamic disequilibrium' of which earlier economists had warned.

Keynesian stimulus

This is all very interesting stuff, but where I part company with the good Lord and Emeritus Professor is in the way he himself has parted company with Keynes.

He argues that Keynesian economics had no solution to the crisis. In fact, it was a massive Keynesian stimulus that 'saved the world'. And it was policies of austerity, favoured by Lord Desai, that delayed the recovery.

As Keynes said, the time for austerity was when the boom returned.

Desai is pessimistic about this, and flirts with the latest vogue, 'secular stagnation'. As for the promise on the cover about 'how to avoid the next one' – publishers always push their authors too far. Desai reminds us that 'capitalism is a dynamic system but it works through creating cycles and crises.' You have been warned. ▪

William Keegan is Senior Economics Commentator at the Observer.

Building momentum for adding renminbi

OMFIF Advisory Board expect Chinese currency to join SDR

The Special Drawing Right is an international reserve asset created by the IMF in 1969 to supplement member countries' reserves. Its value is based on a basket of four international currencies, the dollar, euro, pound and yen (the weightings are currently 41.9%, 37.4%, 11.3% and 9.4%), equivalent to $1.4 at the time of printing. There are several criteria for a currency's inclusion in the SDR basket. A crucial condition is that it is deemed 'freely usable' – widely used for international payments and widely traded, as measured by transaction volume in foreign exchange spot and derivatives markets. In addition, it must be included in central banks' reserves, and its interest rates must be seen as market-based.

The IMF long viewed the renminbi exchange rate as undervalued, but now sees it 'moving towards equilibrium' as a result of liberalisation by the People's Bank of China. Zhou Xiaochuan, governor of the PBoC, hinted that China may eliminate the administrative cap on bank deposit rates – the last interest rate in China subject to government control – by the end of this year.

The Chinese authorities made no headway over the renminbi joining the SDR in the 2010 review, but the 2015 review, now in its initial stages, may result in a different outcome. Joining the SDR would have no immeditae practical benefits for the renminbi, since the IMF unit is not a real currency, but adhesion would give a powerful symbolic boost to China's ambitions to help generate a more multilateral world financial system.

The question put to the Advisory Board was, 'As a result of the 2015 review process, do you believe the renminbi will be included in the currency basket in January 2016?'

Over half of those polled expect the renminbi to be included in the SDR, with 27% anticipating that it will be given a significant weight of 15%-20%, and the same number expecting its weighting to be smaller at around 10%. Many remained sceptical, with 42% expecting the renminbi to be passed over this year but included in 2020, and 4% expecting it not to meet the criteria.

At present the reminbi is not a currency freely traded in foreign exchange markets and China maintains capital controls that are at odds with the international role of its currency. It will take at least another five years for full convertibility and more importantly a demonstration that the free float of the renminbi will not be subject to political interference.
- **Fabio Scacciavillani**

Admission of the Chinese currency to the SDR club looks very much on the cards in the 2015 IMF review process. However, I believe the issue of the currency's convertibility on the capital account and the need for greater transparency and disclosure of the breakdown of China's foreign currency and gold holdings would be important determinants in the weight attached to the Chinese currency in a reconstituted SDR basket.
- **Hemraz Jankee**

It can't be included now because of the convertibility issue, but it will be if and when that issue is resolved.
- **David Cameron**

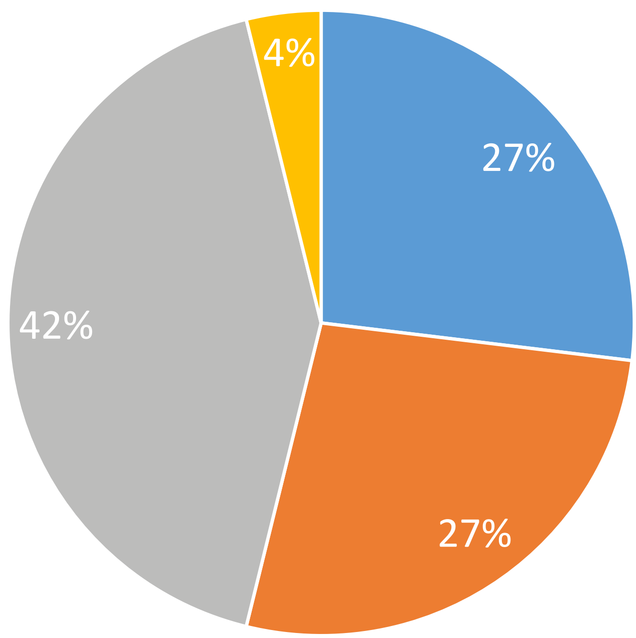
It must surely be only a matter of time before the renmimbi is accepted into the basket, but perhaps 2015 is too early.
- **Boyd McCleary**

The renminbi is likely to meet resistance. The US will do all it can to reduce the growing influence of the Chinese currency.
- **Laurens Jan Brinkhorst**

The renminbi is likely to pass the review. The mood music in the US is becoming more positive towards China.
- **Paul Newton**

Renminbi seen as likely to join IMF reserve asset

Over half of respondents believe renminbi will join SDR in 2016



- Yes – the Chinese currency passes through the review, possibly after China takes further steps to improve the currency's convertibility on capital account, and will be given a significant weight in the basket of 15-20%.
- Yes – but the renminbi meets resistance, particularly from the US, on the grounds that it is not sufficiently convertible. The methodology is reviewed so the renminbi's weight is less substantial, at around 10%.
- No – but the IMF signals strongly that it will almost certainly be included after the review in 2020.
- No – the IMF decides it is not appropriate for the basket.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