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The Bulletin

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

Fed and the election
Elusive American dream

Efraim Chalamish on China investment in US
Richard Koo on European self-financing
John Mourmouras on negative interest rates
Michael Stürmer on the geopolitics of oil
Marsha Vande Berg on stagnating wages

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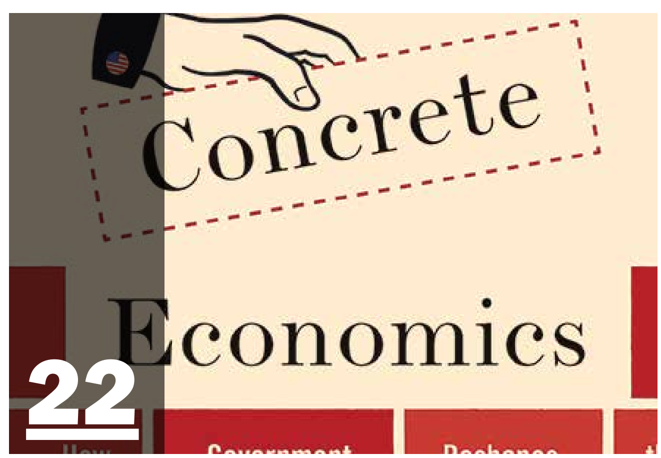

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EDITORIAL

Reviving the American dream in an over-connected world

The tightly fought US presidential race, building momentum just as the UK limbers up for the 23 June European Union referendum, may soon become a factor on financial markets. November's Republicans v. Democrats battle and the British plebiscite on Europe share common characteristics. They feature candidates seeking to allay voters' fears over the negative effects of foreign economic intrusion, inequality and immigration in a world that often appears too connected for comfort. Robert Kaplan, president of the Federal Reserve Bank of Dallas, touched on some of these issues in an OMFIF lecture on 29 April, which we reproduce in an abridged form on p.13. He made clear central banks could be over-extended: monetary policy was 'never designed nor intended to act in isolation'. He added pointedly that the Fed would be trying to stay out of the election race.

In this month's Bulletin, we place under the spotlight the key issues confronting the US electorate on 8 November, in a competition that is developing (almost literally) towards a head-to-head encounter between Hillary Clinton and Donald Trump. Marsha Vande Berg focuses on the all-encompassing background theme of wage stagnation and the nation's somewhat desperate desire to resuscitate (somehow) the American dream. Efraim Chalamish examines one principal source of fear about outside interference: Chinese investment in the US. Darrell Delamaide investigates how the Federal Reserve, in its drive gradually to normalise credit conditions, is signalling allayed concerns about global economic and financial hazards – foreshadowing a rate rise later this summer which, if all goes well, will not overly intrude into the electoral campaign. Ben Robinson looks at another global economic issue reverberating through the electorate: the rising dollar and the effect on emerging market currencies.

OMFIF's monthly review records the nomination of three economic experts from different parts of the world – Kingsley Moghalu, Niels Thygesen and Robert Johnson – as senior advisers, joining a now eight-strong group. We portray international developments including an asset management seminar in Singapore, sessions at the Washington spring meetings of the International Monetary Fund and World Bank, London discussions on central bank investing, and the signing of an accord on the internationalisation of the renminbi with China Construction Bank.

In an essay on 'Putin and the petrostates', Michael Stürmer analyses the geopolitics of oil. John Mourmouras weighs up the pros and cons of ultra-low interest rates after the ratcheting up of Europe's move into negative territory. Richard Koo of Nomura Research Institute outlines radical ideas on improving euro member countries' capacity for self-financing. Brigitte Granville sums up her bleak views on France's political entrapment in monetary union.

Tarisa Watanagase, former governor of the Bank of Thailand, demonstrates how the Asean economic growth engine is ploughing through global vicissitudes. Jorge Vasconcelos shows how the world is moving towards a lower-carbon energy mix, with big implications for investors, as implementation gains ground following December's Paris agreement on combating climate change. George Hoguet reviews a plea for a revival of 'Hamiltonian' industrial policy in the US in a book by Stephen S. Cohen and J. Bradford DeLong. Our advisory board provides their forecast for the US November vote. Overwhelmingly they believe Clinton will clinch it.

Short honeymoon for Brazil leader

Argentinian example beckons after impeachment move

David Smith, Advisory Board

Brazil has entered a political no man's land after the lower house of congress voted to impeach President Dilma Rousseff, with hundreds of thousands of people on the streets denouncing her leadership. The process has moved to the senate, which on 11 May is expected to decide to move forward with impeachment proceedings against the president and suspend her for 180 days, making Michel Temer, Brazil's vice-president, interim leader. Rousseff has vowed to fight on.

Amid the uncertainty, realisation is growing across all parties that change has to come, starting with policies to tackle the country's economic crisis. The fiscal deficit has leapt to close to 11% of GDP, while the economy is expected to contract by 3.8% this year, as it did in 2015. An unsustainable 90% of spending is channelled into subsidies and entitlements.

Temer has said he favours the road taken by neighbouring Argentina under Mauricio Macri, the country's new president. The new government in Buenos Aires has received a significant vote of confidence from global investors prepared to bet on Macri's agenda of deficit reduction, debt settlement and reopening Argentina for business. A $16.5bn bond issue, designed to enable Argentina to settle with hold-out creditors from its 2001 default, was heavily oversubscribed, enabling the government to reduce interest rates on the bond as it went on offer in London and New York.

Temer has indicated that he will carry out economic reforms that follow the manifesto of his centrist Democratic Movement party. 'That means serious spending limits, government debt reduction, free trade, and a smaller role for state enterprises,' according to one of his economic advisers. 'As acting president, Temer will restore investor confidence and reignite the Brazilian economy.'

But beyond Temer's words of serious intent lies the fear that the next government may have a short honeymoon. The acting president is largely unknown to the masses, and almost as unpopular as Rousseff.

'The first two to three months of a new government will be critical,' says one of Brazil's leading commentators. 'If they can avoid mass protest, while implementing change, they have a window to arrest our decline. But it's a big If. They don't have the option of gradualism.'

The rest of Latin America is watching intently. Agents of economic reform in Argentina, Peru, Colombia and Mexico see Brazil's crisis as a sign of change throughout the region. 'In the medium-term, Brazil can yet become the key factor in the region, recognising that our future depends on embracing markets and market forces, not denouncing them,' says a member of Macri's economic team in Argentina. ■

David Smith represented the UN Secretary-General in the Americas for more than a decade.

Advisory Board

OMFIF has appointed Kingsley Moghalu, Niels Thygesen and Robert Johnson as senior advisers. For the full list of members, please see p.20-21.

Kingsley Chiedu Moghalu served as deputy governor of the Central Bank of Nigeria from 2009 to 2014. He is professor of practice in international business and public policy at Tufts University's Fletcher School of Law and Diplomacy, the founder of Sogato Strategies LLC, and a partner in the US law firm Cooke Robotham LLP. He has written four books including the acclaimed *Emerging Africa: How the Global Economy's 'Last Frontier' Can Prosper and Matter* and is preparing a book on global banking reform. He previously worked for the United Nations for 17 years, rising to the rank of director.

Prof. Niels Thygesen is emeritus professor at the University of Copenhagen. He is a member of the board of Nordea Investment Funds SICAV, Luxembourg, a fellow of the Royal Society of Copenhagen, a founder member of the European Shadow Financial Regulatory Committee, and a member of the Euro-50 Group and Trilateral Commission. He was among the 'wise men' on the Delors Committee in 1988-89 that set the path to European economic and monetary union. He is a visiting professor at the European University Institute, Institute d'Études Politiques, and the London School of Economics and Political Science.

Robert Johnson is president of the Institute for New Economic Thinking and a senior fellow and director of the Global Finance Project for the Franklin and Eleanor Roosevelt Institute in New York. He is a consultant to investment funds on issues of portfolio strategy, and recently served on the United Nations Commission of Experts on International Monetary Reform under the chairmanship of Joseph Stiglitz. He received a Ph.D. and M.A. in economics from Princeton University as well as a degree in Electrical Engineering and Economics from the Massachusetts Institute of Technology.

Emerging markets growth challenges

The role of emerging market economies and advanced nations as conduits for trade and investment at a time of slowing world growth was high on the agenda at a seminar of international central bankers and other experts hosted by OMFIF and State Street Global Advisors in London on 12-13 April. The roundtable – 'The world economy at a crossroads – What's next for Global Public Investors?' at Painters' Hall – focused on policy divergences among major central banks, exchange rate movements and the direction of global imbalances, and the effects of quantitative easing and negative policy rates in major economies.

When many official investors are grappling with radical economic uncertainty and low or negative returns on conventional instruments, participants sought to find answers to the economic and institutional challenges of adjusting to lower rates of growth. A particular feature was the emergence of new reserve currencies including the renminbi, triggering questions about China's transition to a new growth model. The meeting discussed, too, the changing global energy landscape, new dynamics of global oil supply and demand, and the impact of the downturn in the global commodity cycle on resource-related investment. A highlight was a dinner debate on a possible UK withdrawal from the European Union, a duel between Quentin Davies of the House of Lords and Gerard Lyons, chief economic adviser to the Mayor of London. Brigitte Granville of Queen Mary College, London, gave delegates an acerbic view of France's role in economic and monetary union. *For further details see p.16*.

Tri-party system 'gives safer financial framework'

Clockwise from top left: José Manuel González-Páramo, Greg Medcraft, Christopher Pullano, Andrej Raczko, Sanjay Reddy, Brian Ruane

A wide-ranging discussion on security-enhancing reforms to the US wholesale bank funding market took place in Washington on 15 April, during the International Monetary Fund-World Bank spring meetings. The exchange of views, organised by Bank of New York Mellon and OMFIF as part of a co-operation series, concluded that the April 2015 reform of the so-called tri-party system had produced a safer and better-functioning framework for the essential 'plumbing' of financial markets, but more work had to be done, particularly in extending international progress to European and other markets.

The audience in Washington's Metropolitan Club comprised around 80 representatives of official organisations, banks, investment managers, treasurers and regulators from around the world, moderated by OMFIF's David Marsh. Topics covered included the role of the Federal Reserve in the repurchase (repo) market, further plans for regulatory changes affecting repo users, and expansion of the availability of cleared repo in the US to systemically important financial institutions.

The discussion featured presentations by BNY Mellon's Brian Ruane, Chris Pullano of PwC, Susan McLaughlin of the New York Federal Reserve Bank, the IMF's Manmohan Singh, Sanjay Reddy of Citi, Andrzej Raczko of the National Bank of Poland, José Manuel González-Páramo of BBVA and Greg Medcraft of the Australian Securities and Investments Commission and IOSCO. Participants agreed that the practical elimination of intraday credit was a major advance, but questions remained on issues such as the role of centralised clearing platforms. The panel also discussed longer term funding reforms, such as the bail-in framework, banking resolution in Europe and elsewhere, and loss-absorbing debt requirements.

Briefings

Discussion on the future growth engines of Asia

As part of the Asean central bank governors' and finance ministers' meetings, OMFIF and Bank of the Lao PDR on 3 April in Vientiane organised a panel discussion on the future growth engines of Asia. Speakers included: Vathana Dalaloy of the Bank of the Lao PDR; Tarisa Watanagase, former governor, Bank of Thailand; Bounthavy Sysouphanthong, Lao vice minister for planning and investment; and Chen Lihong, deputy director, research division, Ministry of Finance, China. For further details see p.18.

Opportunities from a 'low-amplitude' world recovery

Public and private sector asset managers from around the world discussed opportunities and challenges from a 'low-amplitude' world recovery at a seminar on 29 March in Singapore organised with the Lee Kuan Yew school of public policy at the National University of Singapore. The session on 'Risk and yield management for official asset managers in a multicurrency system' deliberated international investment possibilities.

Euro area will 'muddle through' impasse

Participants at an OMFIF discussion at the Metropolitan Club on 18 April in Washington, running alongside the spring meetings of the IMF and World Bank, concluded that there are no realistic solutions to the euro area's impasse. Although some attendees thought that some form of break-up was inevitable, the prospect of an immediate explosion appeared low.

US meetings

Prospects for the American economy
A lecture with Robert Steven Kaplan, newly-appointed president of the Federal Reserve Bank of Dallas.
29 April, London
For details see p.9 and p.13

Inaugural OMFIF City Lecture in Beijing
James Bullard, president of the Federal Reserve Bank of St. Louis, discusses US and international prospects.
23 May, Beijing

Inaugural OMFIF City Lecture in Singapore
James Bullard, president of the Federal Reserve Bank of St. Louis, discusses US and international prospects.
26 May, Singapore

Divergent Europe and US monetary policies
Breakfast with Charles Evans, president of the Federal Reserve Bank of Chicago.
2 June, London

Main Meeting at the St. Louis Fed
OMFIF's third Main Meeting in the US, hosted by James Bullard, will discuss the role of the US in the global economy.
14-15 July, St. Louis

CCB and OMFIF sign strategic partnership

China Construction Bank, the world's second largest bank ranked by assets, and OMFIF signed a strategic agreement in London focused on joint work on the internationalisation of the renminbi and the currency's use on capital markets. The agreement stipulates that CCB and OMFIF will organise joint activities, including OMFIF's Renminbi Liaison Network.

The purpose of the RLN is to provide an informal and confidential information hub to enable global public investors to build up knowledge and improve practices in dealing with the renminbi as an investment and transaction currency. The RLN's work includes collating information on trading and investment practices and regulations, including developments in China's capital account liberalisation; exchanging views on renminbi use in cross-border trade, investment and capital market transactions; and discussing procedures for clearing and settlement.

Fintech 'thriving' in financial services industry

Participants at the second of a series of joint discussions with McKinsey Global Institute held in London on 7 April heard how declining capital flows, digital globalisation and financial technology disruptors have transformed the global financial landscape.

McKinsey Partner Susan Lund (right) explained how one of the biggest changes has been the decline of global capital flows since 2007, largely attributed to the retrenchment of cross-border lending. However, the development of new technologies has increased global cross-border digital flows over the past decade, increasing world GDP by an estimated 10% and now accounting for a larger share than the global trade in goods.

Initially seen as having a negative impact on traditional banking businesses and revenue pools, fintech and financial innovation are now thriving in all areas of the financial services industry, with private and public financial institutions partnering with fintech companies worldwide. One example of this is the development of blockchain technologies, where there is significant potential both in finance and other industries.

Stagnating wages at the heart of politics

Finding a consensus on the American dream

Marsha Vande Berg, Advisory Board

America's economic worries hover like dark clouds over the presidential candidates' campaign trail. Full-blown storms may emerge after the November election.

Following the latest burst of primaries, Hillary Clinton is close to edging out Vermont Senator Bernie Sanders as Democrat standard-bearer. The Republican contest has been closer, but Donald Trump, the real estate mogul, has confirmed his position as frontrunner ahead of Ted Cruz, who withdrew after losing the Indiana primary. Trump, however, remains as controversial as ever.

In past campaigns, candidates could focus on shiny promises of education, a good wage, home ownership and future prosperity for voters' children. This time, wage stagnation is the central issue – reflecting the electorate's fears of losing both income and hopes for the future.

In 2014, a typical American family earned \$53,657, barely \$200 over their income a year earlier. Adjusted for inflation, the federal minimum wage peaked in 1968 at \$8.54 (in 2014 dollars). Congress last raised the minimum wage in 2009 to the current \$7.25, although several states have raised their statewide minimums.

Translated into the political arena, these facts electrify Trump supporters and amplify the *cri de coeur* of Sanders' backers. Emotions run deep, and tend, too, to conceal real differences in the candidates' and their parties' positions over taxes, the budget deficit, interest rates and the economic recovery.

Whoever takes office in January will have to move away from campaign politics and find sound policies that can move America and Americans forward.

The new leader must promote and listen to a national dialogue about how Americans themselves can renew the American dream – and then act on what is said. Special interests in Washington speak with money. Yet, this campaign season, individual interests within the electorate are demanding a change from business as usual. Politicians who ignore this dynamic will earn the scorn and cynicism of the American public.

On the tricky question of how to respond, one answer comes from soundings taken by Edward Lazear, a labour market economist, professor at Stanford university's Graduate School of Business, and former chairman of President George W. Bush's council of economic advisers.

Inviting his students to think unconventionally about tax policy and the presidential campaign, Lazear made the simplistic point that the primary reason for taxes is to raise revenue – and revenue in turn funds key components of the American dream.

However the fundamental purpose of taxes becomes distorted when the tax code – which hasn't been reformed significantly since 1986 – becomes used in a progressively complicated fashion to influence incentives.

One distortion is apparent in the tax pie chart – 37.1% of tax revenues (federal, state and local in 2011) stems from individual taxes, against only 9.4% from corporate taxes. (And yet US corporate taxes are among the highest in OECD countries.) Consumption taxes represent 18.3%; property taxes, 12.4%; and social insurance taxes, 22.8%.

Fairness in the tax system is desirable yet difficult to define. Lazear explains that politicians frequently act with multiple and conflicting policy interests.

The losers in the process scream more loudly than the winners cheer. The greater the need to raise taxes to fund necessary revenues, the more loudly losers complain.

Liberals are trapped by the tax code's complexities. They cannot finance government of the size they want by taxing rich people and business. Yet, if they fail to address entitlement spending, they will face the highly unpopular step of raising taxes on the broad middle class.

Complexities also trap conservatives. Many resent that a significant number of Americans – one half by some estimates – pay no income taxes. Conservatives fear committing electoral suicide if they were to advocate scaling back promises on popular entitlement programmes.

"The new leader must promote and listen to a national dialogue about how Americans themselves can renew the American dream – and then act on what is said.

Lazear asked his graduate school students which of the candidates they believed stood for a winning tax and revenue solution. He described Trump as lowering income tax in general with a top rate of 25%, bringing down capital gains tax for all but the rich, and reducing the corporate tax rate to 15% from 35%. The result would be 12% growth in GDP and a loss in tax revenues over 10 years.

Clinton was seen as making relatively minor changes, supporting a 4% surcharge on the rich as well as higher capital gains taxes (varying between 24% to 39.6%), and limiting deductions. These policies were regarded as producing minimal negative growth – less than 1% over 10 years and roughly revenue neutral.

None of the leading candidates (including Cruz and Sanders) appears to have come up with solutions for slowing worryingly high rises in entitlement growth, notably for Medicare and Medicaid.

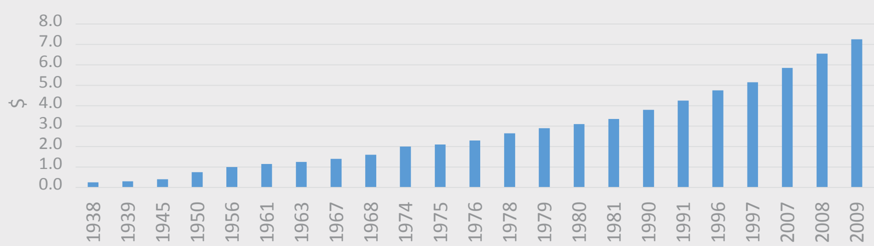
So which candidates did the Stanford students favour? Uncharacteristically for many on campuses today, 28 favoured Clinton's plan; 21, Trump's; 13 voted for Cruz; and surprisingly only three for Sanders.

This inconclusive outcome does produce one clear pointer: on the difficulties the next US president faces in finding consensus on restoring the American dream. ■

Marsha Vande Berg is a Distinguished Career Fellow at Stanford University this year.

Minimum wage growth in the US

Hourly rates, nominal dollars, 1938-2009



Source: US Department of Labour

Undecided whether to sink or swim

Fed treads water amid meandering economic data

Darrell Delamaide, US editor

Still unable to decide whether to sink or swim, the US Federal Reserve continued to tread water. The Federal Open Market Committee barely tweaked its consensus statement following the late April meeting of the monetary policy committee from the previous meeting in March.

The latest statement erased references to the risks 'global economic and financial developments' pose for US economic growth, as members contented themselves with 'closely' monitoring these developments.

Otherwise, it was business as usual – an improving labour market 'even as growth in economic activity appears to have slowed', but inflation stubbornly not picking up – so that the Fed remains noncommittal about proceeding with its gradual upward adjustment in interest rates.

As in the previous meeting, Kansas City Fed chief Esther George was the only voting member to register her disapproval with this consensus, saying she wanted to proceed with a quarter-point hike at this meeting.

Instead, the soonest a rate hike can come is in June, with most market participants still anticipating movement only in the second half of this year – if at all. Robert Kaplan, head of the Dallas Fed, making his maiden international speech at an OMFIF meeting in London on 29 April, held out the possibility of a slightly quicker timetable, depending on the data. Whatever happens, as Kaplan made clear, the Fed wants to put as much distance as possible between its monetary policy decisions and the presidential election.

Inflation is definitely a worry staying the hand of some policy-makers, Fed Chair Janet Yellen first among them. 'The inflation outlook has also become somewhat more uncertain since the turn of the year,' she said in a late March speech in New York, 'in part for reasons related to risks to the outlook for economic growth.'

Not a problem, she continued, because that would mean only a delay in inflation returning to the 2% target – 'provided that inflation expectations remain anchored'. There, in fact, is the rub. 'Lately, however, there have been signs that inflation expectations may have drifted down,' Yellen cautioned.

Market-based measures of inflation compensation 'have fallen markedly over the past year and half', even as longer-run inflation expectations reported in the University of Michigan Survey of Consumers has drifted down. Yellen is not yet ready to push the panic button and conclude that inflation expectations have 'actually' fallen. But this downward drift in the measures 'has heightened the risk that this judgement could be wrong'.

And that would be serious business. As Fed watcher Tim Duy, an economist at the University of Oregon, observed, 'Anchored inflation expectations are the holy grail of central banking. Policy-makers fear that once expectations lose their mooring, they also lose any hope of meeting their target.'

Other members of the FOMC seem less worried about this possibility. Two of the panel's biggest doves have recently been hawking the notion that rate hikes could come sooner than the market expects.

'While I believe that gradual federal funds rate increases are absolutely appropriate,' Boston Fed chief Eric Rosengren said at Connecticut university, 'I do not see that the risks are so elevated, nor the outlook so pessimistic, as to justify the exceptionally shallow interest rate path... in financial futures markets.'

> ***"An improving labour market, but inflation not picking up – the Fed remains noncommittal about proceeding with its gradual upward adjustment in interest rates.***

Federal funds futures, he noted, are indicating markets expect an increase of just a quarter percentage point in each of the next three years.

The US economy is stronger than such a gradual increase would suggest, he said. 'While there have been significant headwinds from abroad, and market turbulence related to those headwinds,' he continued, providing a clue as to why global economic risks were downplayed in the consensus statement, 'I view the US economy as fundamentally sound and likely to perform better than the domestic economies of most trading partners.'

John Williams, head of the San Francisco Fed, seemed unworried about either employment or inflation in the US, but was still concerned about news from abroad. 'The real issue is the global financial and economic developments,' he told CNBC.

Rosengren is a voting member this year, though Williams is not. New York Fed chief Bill Dudley, who is a permanent voter and deputy chair of the FOMC, was more in Yellen's cautious vein.

New York Fed chief Bill Dudley

'Although the downside risks have diminished since earlier in the year, I still judge the balance of risks to my inflation and growth outlooks to be tilted slightly to the downside,' Dudley said in a speech at another Connecticut university.

'Given my outlook and risk assessment, I judge that a cautious and gradual approach to policy normalisation is appropriate,' he said. 'Moreover, caution is also called for because of our limited ability to reduce the policy rate to respond to adverse developments, recognising that we could also use forward guidance and balance sheet policies to provide additional accommodation if that proved warranted.'

Two of the more hawkish policy-makers seemed to be sharing these dovish sentiments. St Louis Fed chief James Bullard, who is a voting member this year, suggested that slower economic growth is a reason for caution.

'The jobs report we got was very strong but the GDP tracking has moved down substantially for the first quarter and to some extent for the second quarter,' Bullard said in an interview with the Financial Times. 'We are on track to continue normalising this year, but it certainly gives us room for manoeuvre and we can be patient and go gradually.'

Dennis Lockhart, head of the Atlanta Fed, cited similar concerns when he said in mid-April he would not be pushing for a rate hike later that month. 'Based on what I have seen, I am not going to be advocating a move in April,' Lockhart said on Bloomberg TV. 'I have changed my view.'

Consumer spending and business investment, he said, 'seem to be softening, and yes that gives me pause'. ■

Darrell Delamaide is a writer and editor based in Washington.

Global repercussions of firmer dollar

Differential effect on countries with US currency pegs

Ben Robinson, OMFIF Economist

Between July 2014 and January this year the dollar appreciated by 18.6% in real terms and over 22% nominally against the Bank for International Settlements' index of 61 currencies and almost 25% against the DXY index of major currencies. Since January the dollar has fallen significantly from its peak, yet it remains over 15% stronger on both the DXY and BIS indices than in mid-2014, signifying the extent of its earlier rise.

Its fall this year reflects, in part, the failure of expansionary European and Japanese monetary policies to satisfy market expectations, causing their currencies to strengthen. Those countries may loosen further as a result. The US by contrast appears likely to raise interest rates again later this year, following its initial rise last December. Divergences in monetary policies thus have a long way further to run and the dollar's strength is not over. Emerging economies caught between these two trends are being pulled in different directions and are facing a range of domestic challenges.

Slowing foreign investment

The strength of the dollar has lowered the foreign currency earnings of US companies (as much as 50% of the earnings of S&P 500 companies are made abroad), contributing to slowing foreign direct investment into emerging economies. This is an important factor behind the reduced capital inflows to emerging economies during 2015 ($293bn gross, down from almost $1.1tn in 2014).

The rapid decline of greenfield investments in particular threatens the growth potential of these countries by reducing the amount of capital spending on new productive capacity. In Africa and Latin America and the Caribbean, greenfield investments declined by 19% and 23%, respectively, in 2015 compared with 2014.

Currency depreciation and capital outflows have contributed to high inflation forecasts for emerging economies with floating currencies. Year-on-year consumer price inflation in 2016 is forecast to be 9% in sub-Saharan Africa, 5.7% in Latin America, 5.2% in the Middle East and 8.4% in Russia. This may result in monetary tightening in the affected countries, with repercussions for credit supply and financial deepening which could stifle growth and consumer demand.

Countries pegged to the dollar have suffered a fall in export competitiveness as their currencies rise. Even countries without pegs have seen the price of business transactions increase, as most international trade is conducted in dollars rather than local currencies.

Regional pressures have built up where currency and exchange rate policies differ between neighbours. In central and western Africa, members of the CFA currency area, which is pegged to the euro, have become less competitive compared with their neighbours, given that the euro has fallen less against the dollar than the unpegged currencies of Ghana, Angola, Zambia and others.

Manufacturers that import high value-added inputs from the US, in particular electronics firms in Asia, have seen their production costs rise. This is most damaging for countries like Japan whose currencies have fallen against the dollar (although the yen has strengthened this year, it remains around 38% weaker than in early 2012). The renminbi, by contrast, remains roughly where it was against the dollar in mid-2011. Thus China's import costs from the US have remained relatively stable.

> ***"While the cost of maintaining a currency peg is expensive and has damaging repercussions, the risks from devaluation or a change to exchange rate policies are also great.***

For commodity and energy exporters, the inverse relationship between the price of their exports and the value of the dollar has meant they have not been able to weather the rising dollar as easily. In sub-Saharan Africa, where the main contributor to growth is commodity exports, the average current account balance fell from a surplus of 0.3% of GDP in 2008 to a projected deficit of 6.2% in 2016. Globally, lower prices could result in a 1 percentage point decrease in the average growth rate of commodity exporters in 2015-17 compared with 2012-14, and a 2.25 percentage point decrease for energy exporters, based on IMF regression analysis.

Commodity producers with floating currencies have seen some currency-based benefits from the rising dollar (in which commodities are priced), which has offset some of the fall in the nominal price of their exports. IMF research however shows that the income effect of a rising dollar and falling commodity prices tends to have a stronger negative influence on GDP than these modest gains, due to higher import costs, lower real income and depressed domestic demand.

For Saudi Arabia, maintaining the peg to a rising dollar, especially in the context of falling commodity prices, has placed a severe strain on its foreign reserves which countries without pegs – notably Russia – have managed to avoid. Some question how long Saudi Arabia can maintain its dollar peg.

The large costs of using reserves to offset the rise of the dollar has meant that other necessary measures to combat falling oil prices, such as recapitalising domestic banks, have become less affordable. This threatens to limit bank lending, reduce funding for businesses and hinder international capital market access for these countries, raising serious risks to their financial systems.

While the cost of maintaining a currency peg is expensive and has damaging financial repercussions, the risks from devaluation or a change to exchange rate policies are also great, making emerging market dollar-denominated debt harder to service. The BIS estimates that total emerging market dollar debt exceeded $3.8tn in mid-2015, raising solvency issues and contagion risks should domestic currency values fall further.

Debt build up since 2010

The build-up of debt since 2010, partly a result of low interest rates and the cheap dollar up to mid-2014, has significantly increased primary bond market issuance in developing countries, raising the risk of a sharp price correction on secondary markets if fundamentals change. A sell-off on emerging market bond markets could spill over to global bond and equity markets, raising systemic liquidity risks.

For the time being however issuance is being stimulated by the further fall in interest rates on developed country bond markets, which is raising the relative attractiveness of emerging market bonds, as seen by the almost $70bn demand for Argentina's bond issue last month.

Diverging monetary policies in advanced countries, combined with fluctuating currency values, add to the strains in emerging economies caused by China's slowdown and the commodity price slump. Given that developing economies make up over 50% of global GDP and are closely interconnected with global financial markets, the international reverberations of a strong dollar and further US rate rise are likely to be substantial. ■

Dilemma over China technology drive

US election campaign complicates investment trend

Efraim Chalamish, Advisory Board

US policy-makers and politicians often refer to commercial relations between the US and China as the main economic challenge facing the US government. Driven by voter sentiment and genuine economic trends and concerns, candidates in the presidential primaries have extensively addressed the 'China problem'. China's role in the US economy requires a better understanding of this love-hate relationship and the potential impact of the November election.

Chinese investment in the US is rising significantly. In 2015, it amounted to $15.7bn, 30% higher than in 2014. Mergers and acquisitions have been an important factor in China's commercial penetration of the US, with 103 transactions worth $14bn in 2015.

Chinese direct investment in the US has had a visible positive effect. A report in April by the National Committee on US-China Relations and the Rhodium Group, an economic research firm, showed that 80% of congressional districts hosted more than 1,900 Chinese-affiliated companies, employing around 90,000 people in the US. This number is growing annually, with significant further potential. The rise of Chinese greenfield investment in the US, estimated at $1.8bn in 2015, supports critical infrastructure projects.

Trade versus investment issues

Public debate over Chinese risks to the US economy often conflates trade and investment issues. Most arguments on the trade side focus on trade imbalances and Chinese subsidies to local companies and state-owned entities. Those on the investment side tend to raise market-access concerns and the quest by US investors and companies for reciprocity in the Chinese market. Mixing the issues often results in lack of clarity and a rise in anti-Chinese sentiment.

Chinese investment has focused on US companies with a technology edge, supported by the direction of Beijing's five-year economic plan. In these cases, almost by definition, and to maintain a competitive advantage in the technology sector (including sensitive sub-industries), US investors are constantly frustrated by limited access to their Chinese counterparties, their know-how and their customers. Washington is seeking to strike a balance between keeping the door open to Chinese investors and protecting US economic and security interests.

Semiconductors a strategic priority

One sector at the centre of this dilemma is semiconductors, one of the fastest growing areas in the high-tech sector.

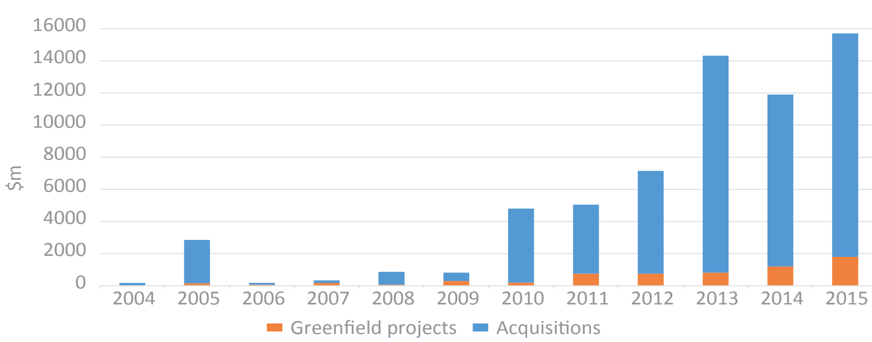
The Chinese government has announced that the semiconductor industry is a strategic priority for China's economy and has set aside $100bn for potential deals. Chinese semiconductor companies have been scouring the globe to acquire companies in this field, primarily in the US as one of the world's leading semiconductor markets.

In 2015, there were 21 Chinese attempts to buy a microchip maker abroad. The dollar value of such transactions tends to be very high.

Since some of the target companies use their technologies for sensitive applications such as drones and maritime intelligence, there are growing calls in US political and military circles to block some proposed Chinese acquisitions. In January US officials blocked a $2.9bn deal under which Chinese investors would have taken a controlling stake in lighting business Lumileds, a subsidiary of electronics multinational Philips.

China's growing direct investment in the US

FDI by greenfield projects and acquisitions



Source: Rhodium Group

Corporate executives and their advisers often decide not to pursue a transaction even before US regulators consider or approve it. Examples of abandoned deals in late 2015 and early 2016 include the proposed takeover of US memory chip maker Micron by a Chinese state-owned firm, and chip pioneer Fairchild Semiconductor International's proposed acquisition by Chinese state-led investors.

> ***"US investors are constantly frustrated by limited access to their Chinese counterparties. Washington is seeking to strike a balance between keeping the door open to Chinese investors and protecting US economic and security interests.***

The market will closely follow future and pending transactions, such as Chinese chip maker Tsinghua Holdings' bid for a stake in US hard-drive producer Western Digital.

The US administration has been closely following the way in which Chinese electronics companies are increasing their global market share while potentially violating sanctions regimes or posing other national security risks. The controversy surrounding ZTE, a Chinese global smartphones company, is a case in point. The US commerce department in March announced that it had banned the company from buying technology from US companies without an export licence because of its commercial activity with Iran.

Rhodium Group in January valued pending Chinese merger and acquisition transactions in the US at more than $22bn, and estimated that total Chinese greenfield investment could amount to $10bn in 2016.

This trend is likely to continue, but political perturbations cannot be excluded. While corporate executives are driven by commercial interest and US officials by the national interest, the election campaign and the general US political debate will have a clear effect on the direction of policy next year and beyond. ■

Efraim Chalamish is an economic law scholar and practitioner, teaching at New York University and IESE Business School.

Oil producers seek new economic models

Lessons of geopolitics for Putin and the petrostates

Michael Stürmer, Advisory Board

Europeans may indulge in Schadenfreude and enjoy low oil prices while they last. But it is unlikely that the shift in markets, demonstrated by the breakdown in the April oil talks in Doha, will persist. Serious conflicts and market disruption are in the offing.

The cartel power of the Organisation of the Petroleum Exporting Countries may be broken for the moment, but no one can tell what will follow. The Near and Middle East, deeply troubled since 2011 by the aftershocks of the Arab revolt, will continue to send migrants from war, persecution and economic malaise to more hospitable places, mostly in Europe and, more specifically, Germany.

The petrostates' economic model was simple: forever rising demand for an ever scarcer commodity, managed at predictably rising prices. The business plan was introduced into geopolitics after the October 1973 Yom Kippur War that saw the Arabs defeated by Israel and, less visibly, by the US. *En revanche*, the Arabs discovered the oil weapon and have used it ever since – though with increasing sophistication, even-self restraint.

The revenue generated by supply maintained a fraction below demand appeared to assure rising incomes. The bounty was transferred into bricks and mortar at London's posh addresses or guaranteed social benefits and a tax-free life to the people at home to keep them quiet. If neighbours created trouble, money could keep unpleasantness at bay through fighter jets and battle tanks.

A fight for market share

The business plan no longer works, killed by worldwide competition and – for the time being – boundless supply in world markets. Oil producers draw daggers, fighting for market share while seeking higher prices: mutually irreconcilable policies. Iran, liberated from United Nations sanctions, and in existential need of much more oil revenue, is prominent among the spoilers.

The US and Russia, whatever their differences, are united in wanting to steady the market: the US at the lowest possible price, Russia at the highest possible. No magic formula short of, God forbid, a major war raging through the Middle East, possibly between Iran and the Saudi Kingdom, Shia against Sunni, is going to change the present uneasy equilibrium.

It is worth dwelling on past turning points. The 1973-74 and 1979-80 oil price hikes were driven not by scarcity but by political turmoil and fears of worse to come. Globalisation as experienced over the last 30-40 years, whether influencing supply or demand or both, turns predictions into a game without rules.

In Germany, in the early 1970s, the oil price rise helped shift the public mood away from technocratic left-wing can-do optimism into a deep pessimism. The high-flying social democratic dreams of Willy Brandt collapsed, replaced by the stern crisis management of Helmut Schmidt.

Western economies entered a spiral of gloom, intensified by the fall of the Shah of Iran and his replacement by Ayatollah Khomeini. The Iranian upheaval sent oil prices sky high, and depressed western and developing economies alike, bringing down governments and triggering war with Iraq.

By July 1986 the theatre of war shifted from the Persian Gulf to the global oil market. As a result of Arab-American joint action the price of oil dropped as low as \$8 a barrel, signalling the death knell for the Soviet Union, by now a petrostate dependent on ever rising oil and gas income and a dominant position in world markets, and the loss and dismemberment of its post-war European empire. The Brezhnev doctrine – that Soviet dominion could never end – was abandoned. Massive oil income from western Siberia and the overstretched Soviet Union both petered out together.

> ***"The petrostates' economic model was simple: forever rising demand for an ever scarcer commodity, managed at predictably rising prices.***

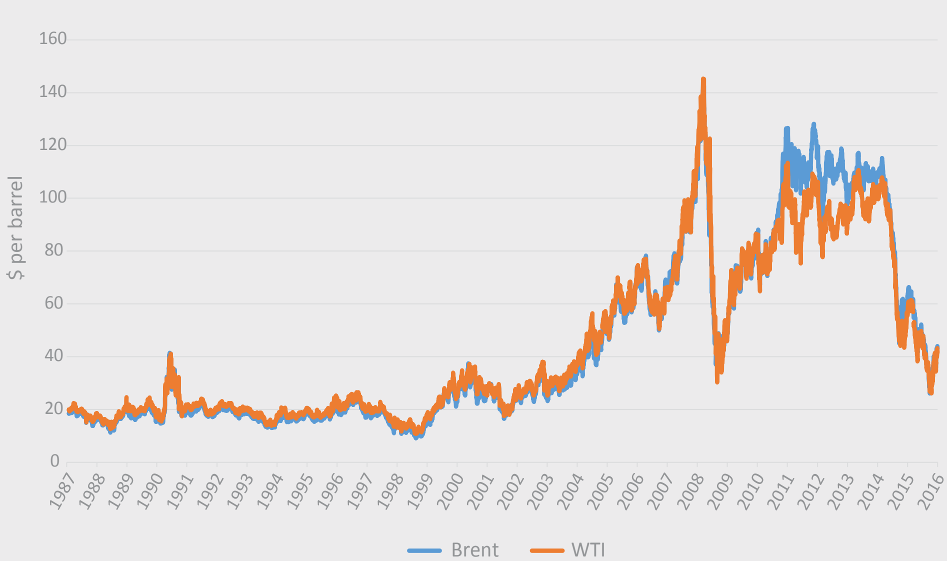
After a decade of energy price setbacks for the Soviets' heirs, Vladimir Putin, master of the Kremlin after 1999, drew advantage from a fresh rise in prices, enabling consolidation of his rule and enhanced public support. At \$150 a barrel, just two years ago, Russia's social contract looked assured.

In late October 2014 Putin told visitors that at \$95 everything was under control. When the oil price continued to fall, as a result of higher US shale production and increased supplies from other parts of the world, the Kremlin began to worry much more seriously about western sanctions imposed after the annexation of Crimea.

As always, markets will not stagnate; they can move either way. Whatever the direction, history is on the move again. As Putin once put it when fortune was smiling at him: 'Everything depends on the price of oil.' ■

Oil price decline following highs of \$120 a barrel

Brent Crude and WTI prices, 1938-present



Michael Stürmer is Chief Correspondent at Die Welt and former adviser to Chancellor Helmut Kohl

Four big issues affecting world recovery

US monetary normalisation will be gradual and patient

Robert Kaplan, Federal Reserve Bank of Dallas

While the US and the world have made good progress in recovering from the economic crisis, we still face a number of significant challenges. Many of these issues arise from four longer-term secular forces taking shape over the past few years. They are likely to exert even greater influence in the future.

First, through globalisation, the world has become much more interconnected. Major companies have become more global and have spread their operations throughout the world to serve customers and improve their competiveness.

Companies increasingly think about their labour, products and services with a global mindset. Economic conditions in one nation have a greater potential to impact economic conditions elsewhere, through trade in goods and services as well as through the labour market. Financial markets have become much more interconnected. Market strains or other challenges in one market have the potential rapidly to affect currency, debt and equity markets globally.

A second major challenge is demographics. The US and other major economies, including Europe, Japan and China, are all facing aging populations. In the US as the baby-boomer generation moves into retirement age, the fraction of the labour force age 55 or older is projected to increase from around 22% in 2014 to almost 25% in 2024 and is expected to rise steadily through 2060.

In the euro area, the working age population, as a percentage of the total, has been declining since 1990. The absolute size of the working age population will decline in coming decades. In the UK, the working age population is projected to grow, but at a slower pace than that of the total population. These demographic trends bear directly on the rates of workforce participation and, in turn, impact rates of potential economic growth in advanced economies.

A third important factor is rising debt to GDP levels in advanced economies. US household balance sheets have improved since the crisis but business debt to GDP is somewhat higher. Government debt to GDP has increased too. While US government debt held by the public is around 75% of GDP, underfunded entitlements are estimated at more than $40tn. These underfunded obligations will increasingly work their way into the annual budget deficit over the next five to 10 years.

This rising entitlements burden, coupled with greater political polarisation, may have impaired the capacity for possible recovery-enhancing fiscal policy action. This, in turn, has put substantial focus on the role of monetary policy to address important economic challenges for which it was neither designed nor intended to address in isolation.

Fourth, the rate of disruption in industry is increasing. Consumers increasingly are able to use technology to rapidly compare prices for goods and services. New business models are emerging which offer products and services in a superior manner to older models.

> ***"We may still have capacity for healthy job growth without overheating the economy or unduly stressing the capacity of the US workforce.***

These trends are encouraging companies to look for new ways to use technology to lower costs, improve productivity and enhance customer service. These changes are reducing the pricing power of companies, putting downward pressure on the prices of many types of goods and services. This affects the way companies think about traditional capital spending and overall resource allocation, with significant implications for future monetary as well as fiscal policy.

International economic conditions

We must consider these four factors in looking at international economic conditions. One important issue is the oil market. Dallas Fed economists estimate that global daily oil production exceeds daily consumption by more than 1m barrels per day. However, they expect that global oil supply and demand will get into some degree of daily balance by early 2017.

Production outside the Organisation of the Petroleum Exporting Countries is expected to decline significantly during the latter half of this year. This estimate is underpinned by our forecast that global demand will grow by around 1.2m bpd in 2016.

Against this background, estimates of US first quarter GDP growth have been disappointing. But based on strong consumer demand economists at the Dallas Fed expect growth will improve over the remainder of this year, with growth of around 2% in 2016. This is sluggish by historical standards but should be sufficient to continue to drive down unemployment below the current 5%.

Robert Kaplan, speaking in London at an OMFIF meeting

Labour market slack needs to be viewed in a global context. The US may be able to achieve lower unemployment than in the past, without creating near-term inflation pressures. The Dallas Fed's trimmed mean personal consumption expenditures measure of core inflation shows that, while headline inflation has been running well below the 2% objective, the 12-month change in the trimmed mean ranged consistently between 1.6% and 1.7% from early 2014 until the end of 2015. This measure has ticked up to between 1.8% and 1.9% in 2016. These readings give us confidence that headline inflation will ultimately increase toward our 2% objective over the medium term as we move toward full employment.

Excess capacity outside the US may dampen US inflation pressures at a given level of unemployment. We may still have capacity for healthy job growth without overheating the economy or unduly stressing the capacity of the US workforce.

From a risk management point of view, the Fed's monetary policies have an asymmetrical impact at or near the zero lower bound. Yet the effort to 'normalise' monetary policy is important; excessive accommodation has a cost in terms of creating distortions in investing, hiring and other decisions which can create unhealthy imbalances. These imbalances are often easier to recognise in hindsight and can be very painful to address.

As the Fed continues to make progress in achieving its dual mandate combining both unemployment and inflation, I will advocate that we take actions to remove some amount of monetary accommodation, but in a gradual and patient manner. ■

Robert Kaplan is President of the Federal Reserve Bank of Dallas. This is an abridged version of a speech given at an OMFIF meeting on 29 April in London. For details see www.omfif.org or www.dallasfed.org

Complex crisis, simple solutions

How to tackle Europe's balance sheet recession

Richard C. Koo, Nomura Research Institute

The root cause of the crisis in economic and monetary union is a balance sheet recession across the euro area – the same disease that has afflicted all post-bubble economies. The problem appears complex, but the solution is relatively straightforward.

It lies in treating the disease by improving EMU economies' self-financing capacity. First, a provision should be added to the European treaties to enable governments to borrow more than 3% of GDP to stabilise the economy when the private sector is saving more than 3% of GDP at near-zero interest rates. Second, governments and regulators should introduce differentiated risk weightings or similar measures to ensure that the excess private sector savings of countries in balance sheet recessions flow into those countries' government bond markets.

I was one of the few who predicted the euro crisis long before it happened. In 2003 I wrote: 'Since fiscal stimulus is the most effective – if not the only – remedy for a balance sheet recession, as soon as the symptoms of balance sheet recessions are observed in Europe, the EC Commission is strongly advised to take action to free the euro economies from the restrictions of the Maastricht treaty. Failure to do so may result in Europe falling into a vicious cycle.'*

Project in danger

More than a decade later, at a time when the European project is in great danger, it is frustrating that those who did not forecast the crisis continue to make things worse. The survival and prosperity of EMU does not require more fiscal union, more structural reform, more European Central Bank monetary easing, more German fiscal stimulus or more money from German taxpayers. After all, it was not a lack of any of these that caused the euro economy suddenly to implode after 2000-08.

When debt-financed housing bubbles burst on both sides of the Atlantic in 2008, the private sectors in affected countries found themselves with huge debt but no assets to show for it. That prompted them to deleverage en masse to eliminate their debt overhang and restore financial health. That is the right corrective action for individual households and businesses. Yet the economy will enter a deflationary spiral if everyone tries to save and no one is borrowing.

In a normal or textbook world, such a spiral is avoided by interest rates rising when there are too many borrowers, and falling when there are too few borrowers.

Since 2008, however, the private sector in the countries affected by the crisis have become massive net savers, in spite of zero or negative interest rates. The US private sector has been saving, on average, 5.9% of GDP since the third quarter of 2008, Spain's private sector 7.3%, Ireland's 8.6%, and Portugal's 4.6%. In view of ultra-low interest rates businesses and households should be borrowing massively, but instead they have been saving aggressively to repair their balance sheets.

If the private sector as a whole is saving 7% of GDP, the public sector must borrow and spend a similar amount to prevent the economy from entering a deflationary spiral and keep the money supply from shrinking.

> ***"In view of ultra-low interest rates businesses and households should be borrowing massively, but instead they have been saving.***

In the euro area, however, policy-makers unfortunately have reached no such understanding. Furthermore, the Maastricht treaty and the subsequent fiscal compact made no provision for a balance sheet recession. Instead, they forbade member states from running deficits above 3% of GDP, regardless of private sector savings.

But if the private sector is saving 7% of GDP and the government is allowed to borrow only 3%, the remaining 4% will become a deflationary gap. And this balance sheet-driven deflationary gap cannot be filled with structural reforms or monetary easing. So one euro member after another fell off the fiscal cliff, with devastating consequences.

With regard to solutions, my first European treaty change would allow Europe to deal with both ordinary downturns and balance sheet recessions. It would maintain the spirit of the original treaty by allowing member governments to borrow more than 3% of GDP only if the private sector is saving more than 3% of GDP at near-zero interest rates.

The second change I advocate is needed because, in EMU, the self-corrective mechanism of economies in balance sheet recessions does not function well.

Elsewhere in the world, government bond yields fall to unusually low levels during this type of recession because investors who had exhausted their foreign exchange exposure limits had no choice but to buy bonds issued by the only domestic borrower left: their own government.

Very low yields encourage governments to administer necessary fiscal stimulus; at such low yields, many infrastructure projects become self-financing. However EMU contains 19 government bond markets, all denominated in the same currency. There is no assurance that Spanish savings will be invested in Spanish government bonds, or that Portuguese savings will be used to buy Portuguese government bonds, and so on.

Fiscal stimulus incentives

This devastating uncertainty robbed many peripheral countries of their 'fiscal space'. If periphery countries in balance sheet recessions had had their own currencies, their massive private sector savings would easily have financed the fiscal stimulus needed to keep them away from the fiscal cliff. One way to meet this problem would be to assign lower risk weights to institutional investors' holdings of domestic government bonds relative to foreign government debt. That would encourage Spain's excess savings to flow into Spanish government bonds, Portugal's into Portuguese bonds. By lowering bond yields, such incentives would give periphery countries the fiscal space they need to engage in necessary fiscal stimulus.

Today the misplaced fear of a negative feedback loop between sovereign and banking risk makes it difficult for peripheral countries to use their excess private-sector savings to finance necessary fiscal stimulus.

That increases pressure on Germany to engage in more fiscal stimulus. Yet instead of forcing reluctant Germany, already at full employment, to do more, Europe should allow peripheral countries to use their own excess savings to restart their economies.

High EMU unemployment, coupled with turbulence over refugees, is straining Europe to its political and economic limits. Amending the European treaties is not easy, but the EU has made numerous technical changes to its procedures to meet EMU challenges. European governments must open their eyes to the reality of balance sheet recessions and take action before it's too late. ■

*Richard C. Koo is the Chief Economist of Nomura Research Institute and was formerly Economist with the Federal Reserve Bank of New York. *Balance Sheet Recession: Japan's Struggle with Uncharted Economics and its Global Implications, published by John Wiley & Sons (Asia).*

The impact of negative interest rates

Opportunities and costs of the new 'global norm'

John (Iannis) Mourmouras, Bank of Greece

Much has happened in central banking since the financial crisis. We live in an era of very low, in many cases, negative nominal interest rates. We now know the mysterious lower-bound rate in monetary policy – some call it 'the twilight of interest rates' – is below zero.

After nine years of low interest rates and large-scale market intervention through quantitative easing, the prospect for normalisation of unconventional monetary policy seems somewhat remote. Some analysts view the new 'QE with a negative interest rate' as a regime shift from quantitative targeting to interest rate targeting, considering negative rates to be the new 'global norm'.

Indeed, most of continental Europe (the euro area, Denmark, Sweden and Switzerland) and, from January also Japan, have introduced negative policy interest rates and/or negative central bank deposit rates. On 10 March the European Central Bank reduced its policy rate further, to minus 0.4% from minus 0.3%.

Nominal interest rates are negative in several European countries across a range from overnight to five- or 10-year maturities. Nearly $2tn of debt issued by European governments is trading at negative yields.

Shifting interest rates to negative territory reduces borrowing costs for firms and households, boosting demand for loans and incentivising investment and consumer spending. This affects the economic outlook and bolsters confidence.

These changes in turn influence investment and saving decisions of firms and households, and should raise demand for domestically produced goods and services. With capital inflows discouraged, downward pressure on the exchange rate will increase, supporting external demand.

There are also effects with regard to holding cash, which involves storage, insurance, handling and transportation fees. This cost is what defines the effective lower bound. Once policy rates fall too far into the negative zone, below the costs of holding cash, people will start to hoard money instead of holding negative-yielding deposits. In such cases, cash will be held by people as a store of value, indistinguishable from bonds. Banks will be left with fewer deposits and the economy with fewer loans.

Avoiding reduced profitability

The underlying question is how far and for how long negative rates can go. There are a number of concerns.

Negative deposit rates impose a cost on banks with excess reserves, so there is enhanced probability that the banks' net interest margins (the gap between commercial banks' lending and deposit rates) will shrink. Banks may be unwilling to pass negative deposit rates onto their customers to avoid an erosion of their customer base and subsequent reduced profitability.

"Persistent negative rates may act as an anaesthetic to euro area governments, especially in the periphery. The fiscal space gained from lower debt service costs may slow enactment of necessary fiscal and structural reforms.

The extent of the decline in profitability will depend on the degree to which banks' funding costs fall too. So far, lenders have been reluctant to pass on the costs of negative rates to customers, and have borne themselves almost all of the burden.

Bank for International Settlements research shows that the impact on profitability becomes more drastic over time as short-term benefits, such as lower rates of loan defaults, diminish.

There are also negative effects on financial markets. Money market funds make conservative investments in cash-equivalent assets, such as highly rated short-term corporate or government debt, to provide liquidity to investors and help them preserve capital by paying a modest positive return.

While these funds aim to avoid reductions in net asset values, this objective may not be attainable if market rates are negative for a considerable period, prompting large outflows and closures and reducing liquidity in a key segment of the financial system. 'Low for long' interest rates, and particularly negative ones, make it harder for insurance companies and pension funds to meet fixed long-term obligations and fulfil guaranteed returns.

Negative rates encourage borrowing

An additional problem is that, with interest rates at negative levels, governments are under no pressure to reduce their debt. Negative rates encourage them to borrow more: a disincentive for fiscal discipline.

Ultra-low interest rates flatter the debt service ratio, painting a misleading picture of debt sustainability. Persistent negative rates may act as an anaesthetic to euro area governments, especially in the periphery. The fiscal space gained from lower debt service costs may slow enactment of necessary fiscal and structural reforms.

The long-term effects of negative interest rates are unknown, as they may change expectations and create distortions, for example, in saving habits. While QE has been tested successfully in the US and the UK, with negative interest rates – if applied for too long – monetary policy is sailing into uncharted waters.

Yet negative rates encompass one inherently positive aspect: they deliver a strong reminder that the time has come to use other policy tools to boost demand, including fiscal and structural ones. ■

Prof. John (Iannis) Mourmouras is Deputy Governor, Bank of Greece, and a former Deputy Finance Minister. This is an abridged version of a speech at the 'Asset and risk management seminar for public sector investors' organised by the Lee Kuan Yew School of Public Policy, National University of Singapore, and OMFIF on 29 March in Singapore.

Resolving the euro drama

Core countries need exchange rate realignment

Brigitte Granville, Advisory Board

Since 2012, the crisis of the euro area, and hence of Europe, has ceased to be a financial market malaise and has instead become a slow-burning political crisis.

For around 24 hours last year – on 15 July – it seemed the crisis could end. Wolfgang Schäuble, Germany's finance minister, proposed Greece should 'temporarily' leave the euro area and gain financial support from euro area members as it returned to its national currency.

François Hollande, the French president, crushed that idea. Of all his mistakes, this is one of the most underestimated. Yet Europe's basic problems lie still deeper than Greece, with countries at the euro area core. Realigning nominal exchange rates between these core countries is a necessary condition for any serious growth upturn.

Schäuble has suggested a controlled euro area dismantling. The alternative will be that electorates take matters into their own hands and opt out. I mean electorates within the core: Italy and France. It is here that this great drama will be resolved.

Damp squib recovery

The European Central Bank forecasts the euro area will grow 1.4% this year against 1.5% in 2015. Growth is slowing despite the oil price windfall and the euro's depreciation following ECB quantitative easing.

This comes against the background of a double-dip recession in the early years of this decade. A strong bounce-back would normally follow such a recession. Instead we have a damp squib, with persistently high unemployment.

'Euro-optimists' point to the well-known global problems of weak demand, with China now a particularly fashionable theme. 'Euro-pessimists' insist the root causes are within Europe. In my opinion, the single currency provides the essential perspective. The euro has a direct negative effect on growth. This exerts an indirect effect on everything else.

The Italian economy's dreadful performance since the euro's launch results from a collapse in labour productivity growth. Alberto Bagnai, the Italian economist, in a paper for the International Review of Applied Economics, demonstrates that only one explanation fits the facts – Italy's membership of monetary union, which has brought real (inflation-adjusted) appreciation of the Italian currency relative to Germany and other similar countries.

"Europe is like a man cast overboard into the sea with his legs tied together. Using his arms, he can just about keep his head above water, but he cannot solve his predicament. Over time, sheer grind and exhaustion will overcome him.

Both devaluation and any change in German policies of domestic demand compression are impossible, so Italy's only choice is internal devaluation. Bearing down on wages cannot generate a positive demand shock: this policy is simply degrading Italy's industrial and social fabric.

So-called anti-austerity policies would not work either. Such an approach would result in Italy violating its balance of payments constraints and soon lead to another financial crisis.

We see degrading of the industrial and social fabric in all other euro members that have become uncompetitive relative to Germany, and above all in France.

The economic effects are explained by the 'cumulative growth model' refined by Tony Thirlwall, the British economist. He warned in the 1990s that, far from making the balance of payments irrelevant, monetary union would make participating countries more vulnerable by accentuating competitiveness divergences. 'Once a country obtains a growth advantage, it will tend to sustain it… but if a country undergoes a negative growth shock, it will be trapped in a low-productivity growth path'.

France is trapped in exactly this way. Or, more accurately, France has trapped itself, as it was the French governing class that forced Germany to accept monetary union in 1990.

The euro-induced absence of growth significantly complicates responses to all Europe's other problems. If European unemployment were on a par with the US, at 5% rather than 10%, the difficulties of handling the migrant crisis would still be great, but they would be more manageable.

Europe is like a man cast overboard into the sea with his legs tied together. Using his arms, he can just about keep his head above water, but he cannot solve his predicament. Over time, sheer grind and exhaustion will overcome him.

Electorates will increasingly want to opt out. The latest example is the Netherlands' rejection of the EU's association agreement with Ukraine in the April referendum. We can expect more such episodes in future. ■

Brigitte Granville is Professor of International Economics and Economic Policy and Director of the Centre for Globalisation Reform at Queen Mary, University of London. This is an abridged version of a speech at the State Street Global Advisors-OMFIF seminar in London on 13 April.

The shape of the new energy era

Investment decisions promoting low-carbon economy

Jorge Vasconcelos, Advisory Board

We have come a long way from the 1997 Kyoto accord, which the US never ratified and binds just 37 industrialised nations to emissions targets. According to a United Nations report published in March, 'Renewable energy set new records in 2015 for dollar investment, the amount of new capacity added and the relative importance of developing countries in that growth. All this happened in a year in which prices of fossil fuel commodities – oil, coal and gas – plummeted.'

At the UN in New York on 22 April, 175 countries signed the Paris agreement, approved just four months earlier to strengthen 'the global response to the threat of climate change, in the context of sustainable development and efforts to eradicate poverty'.

By coincidence, Peabody, the world largest private sector coal company, filed for Chapter 11 bankruptcy protection on 13 April. And some of the largest private and sovereign funds have announced fossil fuel divestments since the start of the year.

Political statements and investment decisions are aligned in a clear direction – both are promoting the transition to a low-carbon economy. The question is no longer whether this is the direction, but whether the transition is sufficiently fast and consistent.

Critical sectors

Three sectors are critical in the energy transition path because they are the largest greenhouse gas emitters. Transport, heating, and cooling in buildings account for the majority of emissions on the demand side.

The energy sector, due to the extraction and transformation processes involved in 'producing' and supplying energy, is the leading emitter. These sectors are interlinked because full decarbonisation of transport, and heating and cooling requires the use of 'green' – namely zero-carbon – electricity.

Key points of the Paris agreement

- Keep global temperatures 'well below' 2C above pre-industrial times
- Limit the amount of greenhouse gases emitted to the levels that trees, soil and oceans can absorb naturally
- To review each country's contribution to cutting emissions every five years
- For rich countries to help poorer nations by providing 'climate finance'

Replacing fossil fuel car engines and boilers with equivalent electric machines driven by green electricity should not be the only – or even the first – measure to adopt. Construction and use of buildings and vehicles should be considered from the viewpoint of energy efficiency: only new architectures and mobility models, combined with better materials, create the conditions for a more efficient urban metabolism. Investing in energy efficiency must be the absolute priority.

Although significant results have been achieved, they remain modest compared with both the existing technical and economic potential, as well as the effort needed to cut greenhouse gas emissions. A combination of more stringent standards, more stable public policies and innovative financial mechanisms to narrow the gap between short-term capital needs and long-term returns is needed.

The rise of green electricity

Electricity is replacing fossil fuels in many cases. At the same time, it is becoming greener: combined wind and solar accounts for more than 25% of total electricity generation in three EU member states, a reality many derided as technically unfeasible a decade ago.

Green electricity is becoming cheaper and green electricity generation is increasingly decentralised – there are more than 1.5m active 'producers' in Germany, for example.

Some states have guaranteed prices through mechanisms such as tax credits, feed-in tariffs, and market premiums, as well as, more rarely, investment subsidies. As a result, electricity generation from renewable energy sources is affordable for small and medium-sized investors, not just institutions with deep pockets.

The renewable energy sector encompasses a diverse range of companies around the world, ranging from high-tech equipment manufacturers to private equity funds and construction businesses. A new and dynamic green energy business universe emerged in the 21st century, and its size and scope – for example in terms of storage – continues to grow.

Low-risk investment opportunities

The 'modern classics' of efficiency and renewables still offer opportunities for low-risk investment. The 'avant-garde' areas such as storage, electric vehicles, and demand management show signs of strong vitality and risk appetite, as demonstrated by the growth of electronic vehicle manufacturer Tesla.

However, these are 'one note' melodies, 'bread and butter' business models based on a single technology. The most significant phase in the new energy era will begin only when several new technologies are digitally interlinked and combined into new business models and resilient (for example, extreme weather, cyber security) infrastructures.

"Political statements and investment decisions are aligned in a clear direction – both are promoting the transition to a low-carbon economy. The question is no longer whether this is the direction, but whether the transition is sufficiently fast and consistent.

Creative businesspeople and investors will bring the digital revolution into the enlarged energy industry. Infrastructure operators, regulators and policy-makers will be obliged to run behind them to limit the damage (stranded investments, incumbent and newcomer crashes, big failures and small incidents).

Decision-makers have two alternatives – either to delay the inevitable transformations, most likely inflicting a competitive disadvantage on their economies, or to ensure that transition is as consistent as possible.

This can be achieved by providing clear and stable guidelines, based on demanding concrete technical choices rather than generous vague principles of political economy. All this requires is a modest amount of know-how and political capital.

Constant policy pressure to maintain the forward path will keep capital costs for investors and energy prices for consumers within reasonable limits, enabling long-term sustainable investments. ■

Jorge Vasconcelos is Chairman of NEWES New Energy Solutions, Lisbon, and was the founder and first Chairman of the Council of European Energy Regulators.

Asia's future engines of growth

Properly functioning financial sector needs supervision

Tarisa Watanagase, former Governor, Bank of Thailand

Since the 2008-09 global financial crisis, cyclical and structural factors have caused growth in both advanced and emerging economies to decline and then stagnate. Cyclically, a number of countries are still dealing with the aftermath of the crisis, with high debt overhangs, high unemployment and weak financial sectors.

Excess supply and capacity in countries such as China will take time to work off to make room for new investments. Structurally, several traditional manufacturing sectors lag behind rapid technological changes and have difficulty making necessary adjustments in their production and products.

These factors are not conducive to investment. In addition, the services sector, which tends to be more labour intensive, has grown, generally resulting in lower levels of investment. Reduced investment and productivity improvement have caused potential growth to decline around the world, a situation that will persist in the near term.

However, China, India and Association of Southeast Asian Countries (Asean) member states – Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam – provide potentially powerful growth engines for the medium term in the form of exports, consumption and infrastructure investment.

Growth factors

China, India and the Asean countries are well integrated into the region and the world. This integration is expected to increase with the expansion of Asean and other free trade agreements, both multilateral and bilateral. Discussions are underway to expand Asean to 'Asean+6', to include China, Japan, Korea, Australia, India and New Zealand, and agree on a framework for a regional comprehensive economic partnership. Other FTAs in the pipeline include those between Asean and Hong Kong and between Thailand and Pakistan. Four Asean countries – Brunei, Malaysia, Singapore and Vietnam – have joined the Trans-Pacific Partnership and more from the region are expected to join. Further trade expansion is likely, along with increased integration.

These are large markets with large populations and high levels of urbanisation. As of 2014, China's urbanisation rate, at 54.4%, exceeded the global average of 53.6% (Chart 1). Moreover, Asean countries and India, particularly the latter, have significant room for further urbanisation. Poverty levels are declining, resulting in a consistently expanding middle class.

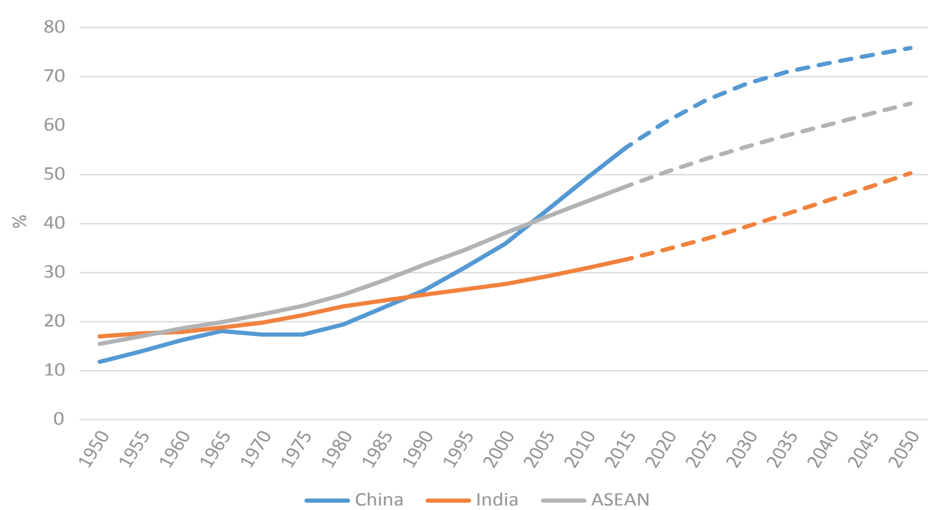
The countries have significant room for consumption growth. Private and government consumption accounts for a lower percentage of GDP in the Asean countries, China and India than in advanced economies (Chart 2). Large populations, continued urbanisation and the expansion of the middle class provide a conducive environment for consumption levels to catch up with those of advanced economies.

Infrastructure in the Asean countries, China and India is grossly inadequate – logistic costs as a percentage of GDP in Indonesia and China in 2012-13 were respectively around 24% and 18%, significantly higher than in the US (at around 9%) and Japan (around 11%). There is substantial room for improvement in areas such as electricity, transportation, telecommunications, water and sanitation. The Asian Development Bank has estimated the need for infrastructure investment in east, southeast and south Asia between 2010 and 2020 at close to $8tn.

> ***"Consumption needs to be based on higher incomes rather than debt creation to be sustainable. Infrastructure investment should cover both traditional and technological infrastructure.***

Chart 1: Growth in urbanisation set to continue

Percentage of total population residing in urban areas, 1950-2050



Source: United Nations

Engines of growth

As noted above, three engines for future growth in the Asean countries, China and India can be identified – exports, consumption and infrastructure investment.

Exports must be technology and innovation driven to keep pace with fast changing consumer preferences. Consumption needs to be based on higher incomes rather than debt creation to be sustainable. Infrastructure investment should cover both traditional and technological infrastructure. But there are significant challenges to ensuring these growth engines work properly.

First, given limited supply side resources, growth must be generated through productivity increases. Infrastructure investment will make an important contribution to this end. It is equally important to build capacity and capability in technology, innovation and human resources with the right skills. This requires educational reforms, as well as efforts to increase research and development, reduce the digital gap both domestically and internationally, and move up the value chain. These are all long-term initiatives that will require patience, resources and policy continuity, all of which could easily be disrupted.

Second, countries have different risks and challenges in respect of consumption growth, depending on the average age of their population. For example, the rapidly aging populations of China and Thailand may have fewer incentives to consume if they believe they have not saved sufficient funds for retirement. Substantial spending on social welfare and safety nets may be needed to care for the elderly and encourage people to consume more if they perceive they need to save less for their retirement. Maintaining fiscal sustainability will be a challenge, given other developmental needs as well.

The young populations of Cambodia, Laos, Myanmar, Vietnam and Brunei may have higher consumption needs. The challenge is to ensure that the seeds of financial instability are not sown through an excessive build-up of consumer debt as a result of lax monetary and fiscal policy and financial institutions' imprudent lending practices.

Third, securing sufficient funding for infrastructure investment will be a challenge. The ADB alone will not be able to support the large funding requirement. With the launch of the Asian Infrastructure Investment Bank, these international institutions need to work together closely to better support these countries' financing needs.

Financial instability risks

While making long-term efforts to ensure these future growth engines function properly, these countries need to be mindful of the significant financial instability risks as a result of developments elsewhere in the global economy, as well as the need to maintain resilience.

Substantial capital inflows result in excessive liquidity, a potential source of financial imbalances. A currency may also appreciate beyond a country's economic fundamentals, weakening its export competitiveness.

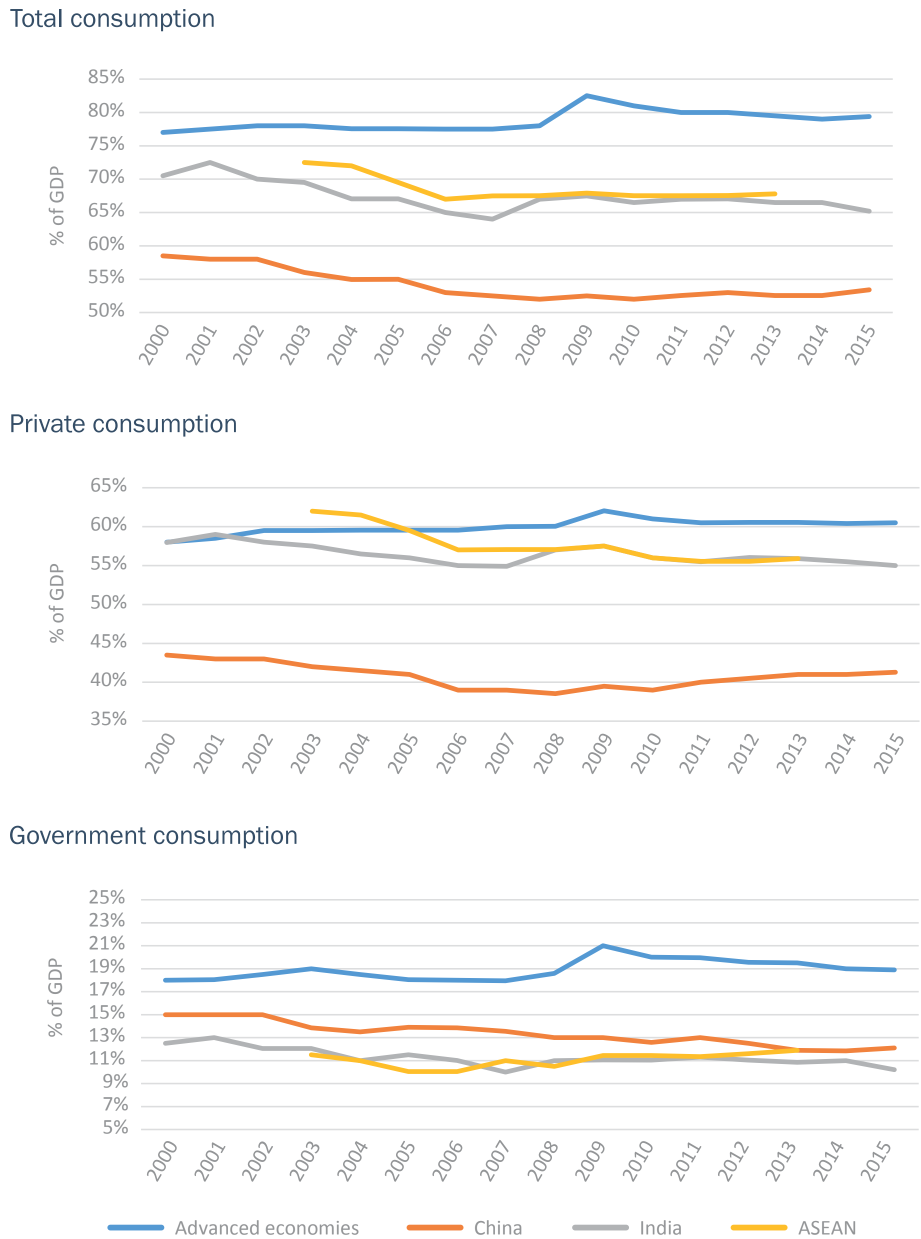
Abrupt and drastic outflows can be an even greater problem if they result in substantial falls in foreign reserves and declining investor confidence.

Asian countries have become much more resilient since the 1997 financial crisis. This is attributable to real and financial sector reforms and also heightened risk awareness and risk management in both the private and public sectors. Foreign reserves are much higher. As a result, the risk of a major crisis at the regional level is currently low.

Regional safety nets have also been put in place. 'Asean+3' countries (the Asean countries plus China, Japan and South Korea) have been working to strengthen the Chiang Mai Initiative Multilateralisation – a multilateral currency swap arrangement between the 10 countries – with greater resources and flexibility in financing for member countries in times of emergencies, though these facilities have yet to be tested.

Chart 2: Asean economies consume less than advanced states

Consumption as % of GDP, 2000-15



Source: Oxford Economics

Amro, the Asean+3 macroeconomic research office, is now an international organisation with full independence for its research, member surveillance, and regional bond and capital markets development.

Guarding against complacency

One cannot be complacent, notwithstanding the lower systemic risk. The global economy remains weak, markets are still highly volatile and investor confidence is fragile. Policy uncertainties and more vigorous policy normalisation will continue to have spillover effects in emerging economies.

It is important for countries to continue to build economic resilience with an appropriate mix of monetary and fiscal policies, and if necessary, macroprudential measures. Areas susceptible to financial imbalances, such as the property market, stock markets, and household and corporate debt, need to be monitored and any build-up of financial imbalances dampened.

Supervision must be adequate to ensure a strong and properly functioning financial sector. Without financial stability in the short and medium term, future growth can only be jeopardised. ■

Tarisa Watanagase is former Governor of the Bank of Thailand. This is an abridged version of a speech given at the Asean central bank governors' and finance ministers' meetings, organised by OMFIF and Bank of the Lao PDR on 3 April in Vientiane.

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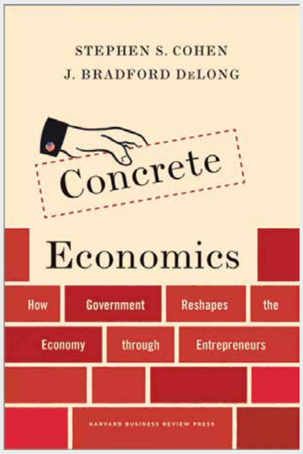
Arguments for industrial policy

The US, Asia and the Hamiltonian way

George Hoguet, Advisory Board



Debate about industrial policy in the US has a long history, going all the way back to Alexander Hamilton, the first US treasury secretary. In *Concrete Economics: The Hamilton Approach to Economic Growth and Policy*, Stephen S. Cohen and J. Bradford DeLong sashay through that history, reviewing multiple government interventions and building the case for a US industrial policy.

The authors – respectively professor emeritus and co-director of the Berkeley Roundtable on the International Economy, and professor of economics at University of California, Berkeley – want the US government to do more to promote US industry, especially manufacturing.

The book is both substantive, reminding us, for example, that for many years American industry benefited from high levels of tariff protection, and timely, given the US primary electorate's evident anger with globalisation. But this slim monograph is as much philippic as careful analysis, and studiously omits counterfactuals. To paraphrase Austrian philosopher Ludwig Wittgenstein, the authors have taken the chess pieces out of the box, but failed to move them around.

Economic policy goes astray

Cohen and DeLong (who served in the treasury department under President Bill Clinton) argue that US economic policy started to go astray in the 1980s, when it became 'ideological and abstract' and not 'pragmatic and concrete'.

The authors fail explicitly to define these terms, but a persistent theme of the book is that, over 200 years, the federal government has played a major role in strengthening the economy via multiple initiatives, including settlement and land development, provision of public goods, financing basic research and development, and enhancing human capital.

The authors celebrate Hamilton's policies of high tariffs, high spending on infrastructure, assumption of states' debts by the federal government, and a central bank. Hamilton wanted to develop and protect the nascent US manufacturing system. He promoted the US financial market, remarking that, 'A national debt, if it is not excessive, will be to us a national blessing.'

The authors argue that among successful 'late developing' countries such as Germany, Japan, Korea and now China, Hamilton's ideas have proved more influential than Adam Smith's. They chronicle the persistence of Hamiltonian policies through successive US administrations. 'Intelligent design' characterised US economic policy. One example was the granting of federal lands to US railroad developers.

Eisenhower presidency

Policy activism continued up through the presidency of Dwight D. Eisenhower, with development of US interstate highways. From 1950 to 1970 federal deficits averaged less than 1% of GDP. High taxes, not high borrowing, paid for big government. More recently the Pentagon, the National Aeronautics and Space Agency, the department of energy and the National Science Foundation funded basic research that led to major innovations such as transistors and semiconductors, the laser, computers and the internet.

In the authors' view, East Asian governments have actively incorporated Hamilton's ideas. Japan and China have undergone stunning transformations, heavily benefiting from protection, subsidies, exchange rate undervaluation and industrial policies. In the Cohen and DeLong narrative, Asia has developed booming manufacturing while the US has produced a dysfunctional financial sector and inefficient healthcare.

Cohen and DeLong provide a useful service in reminding Americans of their economic history including, in the early days of the republic, their lack of respect for foreigners' intellectual property. (Charles Dickens was unable to collect royalties on US sales of his best-selling novels.)

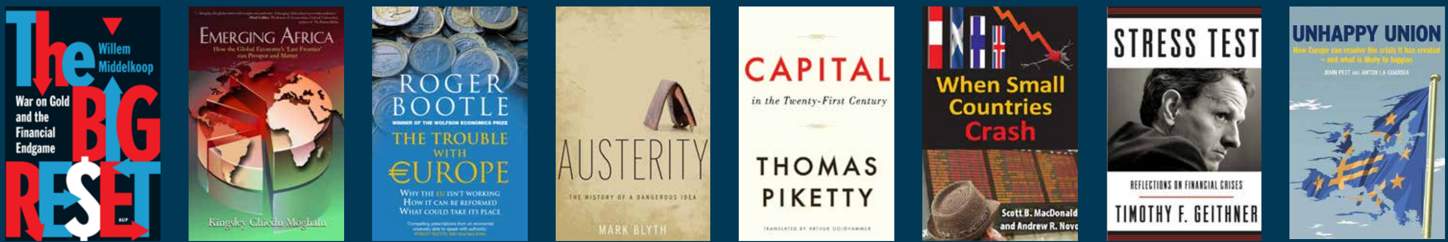
But the authors ignore some inconvenient facts. They forget that in 1980 US inflation stood at 13.5% and that some government policies, such as price controls on oil and gas, had perverse consequences. They fail to consider the long history of 'rent seeking' and corruption. They discuss neither the benefits to US consumers of US trade policy since 1980, nor that manufacturing as a percentage of output has fallen in many advanced countries. From a theoretical perspective, they fail adequately to evaluate the hypothesis that macroeconomic policy should be neutral, letting the market determine winners and losers.

They do not mention that the Asian development model led to the Asian financial crisis of 1997-98. They leave out analysis of Japan's lost two decades. More broadly, they do not acknowledge that, relative to most other developed economies, the US economy has performed well.

Michael Boskin, head of former President George H.W. Bush's Council of Economic Advisors, reportedly once remarked, 'Potato chips, computer chips, what's the difference? $100 of one or $100 of another is still $100.'

The debate goes on. Cohen and DeLong are correct to point out the critical role of the US government in funding research and promoting the commonweal. But this book should be considered an appetiser, not a main course. ■

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



Advisory Board believes Clinton will win

Democrat challenger hailed as better for economy, foreign relations

As the US presidential primaries enter the final furlong, Hillary Clinton is leading the race to receive the Democrat nomination, after victories in four out of the last six states. However Bernie Sanders, the left-wing Democratic contender, has pledged to 'fight on' to the end of the primaries after winning in Rhode Island and Indiana.

From being viewed as an outside contender before the primaries, Donald Trump appears the only contender for the Republican nomination, following the withdrawal of his closest contender Ted Cruz on 3 May.

We put three questions to members of the Advisory Board in April, offering a choice of the then four leading contenders – Clinton, Trump, Sanders and Cruz. The questions were: 1) Who do you think will be the next US president? 2) Which candidate would be most likely to promote sustainable US economic growth in the next two to three years? 3) Which candidate would be most likely to bring about rapprochement with Russia?

Clinton was the runaway winner, with 87% of respondents believing she would win the election. Clinton was regarded as most likely to produce sustainable growth, gaining a 79% support rating, and was also thought most likely to improve relations with Russia (69% of the vote). The sole minor compensation for Trump was that 18% of respondents stated that he was most likely to bring about a rapprochement with Moscow. ■

'Presidents have relatively little influence on the evolution of economic growth which instead depends on the internal dynamics of the economy itself and on external factors. That said, I believe Clinton is the least likely to make a mess than the others.'
Hans Genberg, the Seacen Centre, Kuala Lumpur

'The answer to all of the three questions is of course Clinton. Not because she is such a fantastic candidate but because the others are much worse – for America much as for Europe.'
Michael Stürmer, Die Welt, and a former adviser to Chancellor Helmut Kohl

'There needs to be no rapprochement between the US and Russia. We don't need their friendship, we need their good behaviour. The best person to defend western interests vis-à-vis Russia is naturally Clinton.'
John Kornblum, Noerr LLP, and former US Ambassador to Germany

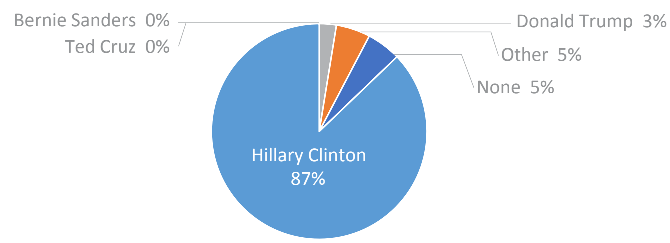
'If the choice is confined to the four names, Clinton has fewer chances of being defeated than Trump, Cruz or Sanders. There is however a significant chance that it will be none of the above, with an open convention on the Republican side, followed a few days later by a difficult one (just possibly also an open one) on the Democratic side.'
Francois Heisbourg, Fondation pour la recherche stratégique

'My answer is Hillary Clinton to each of your questions. She is the most substantively grounded of all the candidates. While I think the question in respect of Russia may prove more challenging, the measure of her success will depend on the quality of the advisers, including the secretaries of state, commerce and national security.'
Marsha Vande Berg, Stanford University

These statements were received as part of the April poll, conducted 12-22 April.
Responses were received from 39 Advisory Board members.

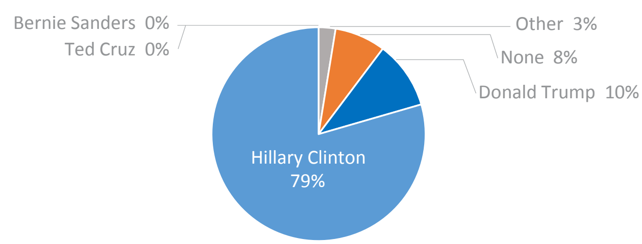
Clinton favourite to become president

Sanders and Cruz not seen as serious contenders



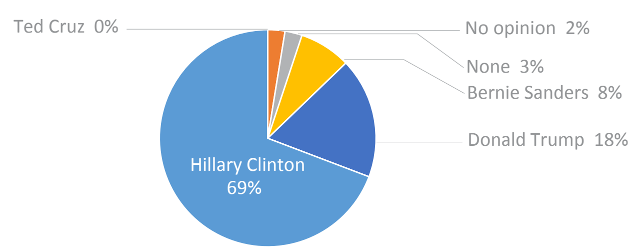
Sustainable growth prospects better under Clinton

Trump lags far behind in economics ratings



Clinton would be best for relations with Russia

Trump and Sanders seen as also-rans in Moscow ties



May questions

Are rising US interest rates likely to pose a substantial threat to the world economy by the end of 2016?

Which areas of the world will be most hit by rising interest rates?

Which areas of the world, judged by the position at end 2016, will have the best and worst economic prospects for 2017-18?