The Bulletin

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

Turkey turns
A president thwarted

Korkmaz Ilkorur on Turkey's potential
Willem Middelkoop on waning US influence
Vicky Pryce on the Greek debt saga
Kevin Rudd on US-China common ground
Michael Stürmer on revanchist Russia
David Tonge on Turkish reforms

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Turkey turns

Turkey's election on 7 June, in which voters rejected proposals for a wide-ranging expansion of presidential powers, underlines the conflicts between effective government and the need for voter support for unpopular action. Turkey, like other economies anticipating the onset of US interest rate rises, needs major changes in its economic and social system – but lacks the means to push them through without damaging a delicate network of social consent.

Book review

William Keegan discusses John Hills' *Good Times, Bad Times: The Welfare Myth of THEM and US*, a 'meticulously researched study' of the UK's welfare system.

The combination of the government's obsession with 'cutting the deficit' and what the author sees as myths about the true cost of welfare had led to growing vulnerability for the poorest sections of the population, subject to the bulk of the cuts. As Hills says: 'What was once a national safety net, albeit not a very generous one, now has substantial holes in it.'

Turkey

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

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A full list of past and forthcoming meetings is available on www.omfif.org/meetings

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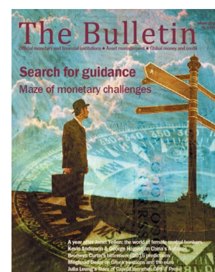
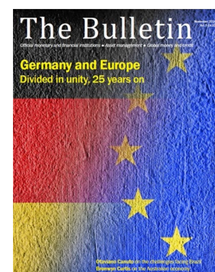




EDITORIAL

Greece and Turkey in the headlines

Not for the first time in Europe, Greece and Turkey are occupying the headlines. As the drawn-out Greek dispute with its creditors spirals towards yet another climax, Turkey has held an election that raises as many questions as it answers.

Vicky Pryce says the four-month interim accord between Greece and its creditors has produced little apart from leeway for the European Central Bank to bring in quantitative easing which could protect other euro members from contagion after a Greek exit. The fundamentals of the euro area economy and Greece's place within it, she says, remain much as they were before Alexis Tsipras' January election victory.

In Turkey, electoral developments throw up a different set of uncertainties. As our long-standing Istanbul-based advisory board member David Tonge explains, Turkish voters have rejected the expansionary ambitions of President Recep Tayyip Erdoğan, but have opened the way to a period of fraught coalition-bargaining that, at least temporarily, will damp the economy. Korkmaz Ilkorur, a new member of the advisory board, recommends financial service reorganisation as one of a series of reforms to improve the economy.

Gündüz Fındıkçıoğlu says need for reforms is so pressing that whatever government takes power will have no alternative but to decide them.

Surveying another European hotspot, over the Ukraine, Michael Stürmer urges a new round of east-west diplomacy to overcome cold war-style fault lines. He calls for new models of self-restraint and mutual self-respect of the sort displayed by the US and the Soviet Union in the 1960s.

Willem Middelkoop analyses the reasons behind US opposition to the Asian Infrastructure Investment Bank and says it shows how the US is losing world influence. In the UK, after the May general election and David Cameron's surprising win, Gerard Lyons says the Conservatives stand ready for reforms – and private sector investment will be the decisive test.

An overriding influence on the world economy remains the likelihood that US interest rates will rise later this year for the first time since the financial crisis. This will have notable effects on countries like Turkey which need to finance large current account deficits – and could come at just the wrong time for a euro area still struggling with the Greek dilemma and its aftermath.

As Darrell Delamaide explains, weak US first-quarter data have strengthened the Federal Reserve doves, with the unusual support of Christine Lagarde, managing director of the International Monetary Fund. However the robust US non-farm payroll release on 5 June has added to pressure for the Fed to move sooner. To the south of Washington lies another problem country – Venezuela. A veteran of Latin American monetary disputes, Steve Hanke, says dollarisation is Venezuela's best hope – with Ecuadorian experience providing a sound template.

William Keegan rounds off June's coverage with a review of *Good Times, Bad Times: The Welfare Myth of THEM and US* by John Hill, which explores the extent to which the UK welfare net has been damaged by recent policies. Across the developed world, as well as in emerging market economies, budgetary discipline will need to be accompanied by new thinking on welfare and social support for the underprivileged.

Time for real IMF reform

Congress delay could provide an opening

Desmond Lachman

Over the past five years, the US Congress has been repeatedly browbeaten by the Obama administration as well as by a chorus of international leaders for its opposition to IMF reform proposals agreed by the G20 nations in 2010. However, over the same period, there have been a number of major developments that must raise serious questions as to the appropriateness of the IMF reform package on the table. This could offer the opportunity for crafting a new IMF reform proposal that would be both more palatable to the US Congress and more suited for the effective operation of the IMF.

Two principal factors motivated the G20 in agreeing to a basic overhaul of the IMF. The first was the recognition of the increased relative importance of major emerging market economies like Brazil, China and India. The second was the belief that in the aftermath of the Lehman crisis, the IMF needed additional permanent lending resources to fulfil its mandate of promoting external financial stability.

The essence of the 2010 IMF reform proposals was to increase the relative representation of the emerging market economies. This was to be achieved by trebling the overall lending capacity of the IMF – from $250bn to $750bn – and by having the emerging market economies make a disproportionately large share of the country quota contributions to achieve that result. The US relative IMF voting position was to be little changed, which would allow Washington to maintain its effective veto power on key IMF decisions.

Over the past five years, the case for greater emerging market representation has become stronger, not least to arrest the trend towards the formation of regional financial institutions. Yet the case for a bigger IMF has become considerably weaker. In 2010, at the start of the European sovereign debt crisis, it could be argued that a very much larger IMF was needed to support Europe's beleaguered economic periphery, since Europe did not have the financial instruments in place to provide that support.

However, much has changed since then. In June 2012, Europe established a €500bn European Stability Mechanism to support euro area member countries. Still more important, in September 2012, the European Central Bank introduced its so-called outright monetary transaction mechanism to enable the ECB to do 'whatever it takes' to save the euro.

Europe is now in a better position to take care of its own problems. Asian and Latin American countries are still highly reluctant to submit themselves to IMF loan conditionality after their respective crises in the late 1990s. So it is extremely debatable whether the IMF really does need an extra $500bn in lending capacity.

...continued on p.10

ADVISORY BOARD

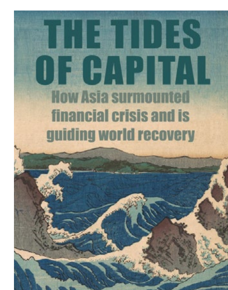
OMFIF has appointed Louis de Montpellier Deputy Chairman of the Advisory Board, and Korkmaz Ilkorur to the Banking Panel. The board has risen to 177 people, subdivided into six groups ranging from Public Policy to Banking. For the full list of members see p.18-19.

Louis de Montpellier is global head of the official institutions group at State Street Global Advisors (SSGA), the US-based investment management company. Before joining SSGA in 2013, de Montpellier was for eight years deputy head of the banking department at the Bank for International Settlements. De Montpellier's 30-year career spans public debt management, public asset management and private sector finance at Morgan Stanley, the Belgian Ministry of Finance, European Bank for Reconstruction and Development and Crédit Suisse. He becomes a Deputy Chairman.

Korkmaz Ilkorur is vice-chair of the Finance Task Force of the Business and Industry Advisory Committee to the OECD, having served as chairman of the BIAC Regulatory Reform Committee from 2002-10. After a career in banking, Ilkorur was senior adviser to Oliver Wyman from 1998–2014. He is on the supervisory board of Crédit Europe Bank, Netherlands and was a member of the board of directors of the Turkish Businessmen and Industrialists Association and chairman of its Corporate Governance Committee in 2002-09. He joins the Banking Panel.

LAUNCHES

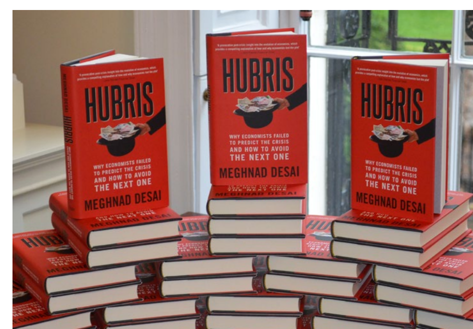
Leung discusses Asia's standard-setting financial regulation



Julia Leung, executive director of the Hong Kong Securities and Futures Commission, discussed *The Tides of Capital: How Asia surmounted financial crisis and is guiding world recovery* at the Fung Global Institute on 18 May, hosted by the group's chairman Victor Fung. The book, written while Leung was senior adviser to OMFIF, details how Asia surmounted two spells of financial crisis – in 1997-98 and 2008-09 – with economic and financial measures that are increasingly setting standards in the US and Europe. Hong Kong-born Leung has been a public servant in the financial sphere for two decades. She was executive director (external) of the Hong Kong Monetary Authority and worked on crisis prevention with international financial organisations and central banks. Her book is the first account by a senior Asian policy-maker of sometimes acrimonious financial manoeuvrings between the west and Asia.

Beware conventional economic theory, says Desai

At the launch of *Hubris: Why economists failed to predict the crisis and how to avoid the next one* at Yale University Press in London on 14 May, Lord (Meghnad) Desai, Chairman of the OMFIF Advisory Board, told an audience to beware of conventional economic theories. Desai said the 2008 financial crisis erupted because mainstream economists and financial market operators were not communicating. Academics failed to see that markets would not always return to equilibrium, while traders were too busy making money through asset bubbles, which he warned were likely to recur. In *Hubris*, Desai makes a persuasive case for the profession to re-engage with the history of economic thought, dismissing the notion that one over-arching paradigm can resolve all economic eventualities.



Detailed analysis of global investment community unveiled

Building on the 2014 Global Public Investor report, the 2015 edition, launched on 21 May in Beijing, is a comprehensive publication devoted to public-sector asset ownership and management cross official institutions around the world, including central banks, sovereign wealth funds and a multiplicity of other public asset funds, especially in the pension sector. GPI 2015 goes into greater detail on big investment themes by providing macroeconomic data on countries' net foreign investment positions and the proportions held by official institutions in each case. GPI 2015 assesses who the world's most efficient investors are by looking at metrics on institutions' staff numbers and their deployment and the efficiency of individual institutions' asset management.

SEMINAR

Advance of the renminbi

The possible inclusion of the renminbi in the Special Drawing Right, the IMF's composite reserve currency, was the focus of the World Reserves System seminar on 22 May in Beijing. Co-hosted by the International Monetary Institute of Renmin University, the seminar involved participants from 17 countries.

The renminbi has gained significant traction as a trade currency over the last few years, and is expected to make significant progress as an investment currency, and in the future, as a reserve currency. The criteria for inclusion in the IMF's currency basket are sufficiently ambiguous, and China's advances sufficiently impressive, that the various metrics were considered likely to be viewed as fulfilled in the forthcoming review.

The discussion moved on to the need for a greater volume of renminbi assets on international markets to satisfy potential pent-up demand. China's trade deficit with countries with large monetary reserves (including Japan, Germany and Korea) could provide an opportunity for China to issue these countries renminbi-denominated bonds that would encourage circulation of renminbi assets.

Zhang Jie, director of IMI, and Wei Benhua, former deputy administrator of SAFE

BRIEFING

Rudd urges US-China unity

(From left): Tim Rigby, Toby Clark, Chris Harrison, James Whitelaw, Pooma Kimis, David Marsh, Joyce Zhou, Kevin Rudd, Bao Mingyou, Grant Lewis, Jacopo Moretti

China and the US should put aside antagonism over security and economic issues and join forces in defending common values in areas like global investment and anti-terrorism initiatives, Kevin Rudd, the former Australian prime minister, told an OMFIF meeting in London on 2 June. He spelled out common ground in a range of policy areas between the US and China, which he said should overshadow issues of divergence that have emerged in military and security areas in recent years. Rudd also outlined the findings of his Harvard Kennedy School paper 'US-China 21: The future of US-China relations under Xi Jinping'.

OBITUARY

Robert Koehler (1949-2015)

Born in Munich in 1949, Robert Koehler was chief executive of the Wiesbaden manufacturer SGL Carbon for over 20 years, from 1991 until his retirement at the age of 65 last year. He joined the OMFIF Advisory Board two years ago after being previously associated with OMFIF for several years. His lively contributions to meetings and insights into international business life made him a popular figure in high demand for international seminars and company boards alike. He died on 17 May after a period of hospitalisation.

After completing a commercial apprenticeship, Koehler studied Business Administration at Mainz University of Applied Sciences before joining Hoechst Group where he worked from 1971-91. From 2011 Koehler was Chairman of the Supervisory Board of Heidelberger Druckmaschinen. He held several non-executive directorships, including chairmanship of the supervisory board of Lanxess, Klöckner & Co and Benteler International. He was a member of the supervisory board and the shareholder committee of Freudenberg and member of the board of directors of Baring Russia Fund.

Turkey seeking to unleash potential

Reorganisation needed to leave economic crises behind

Korkmaz Ilkorur, Advisory Board

Assessing the future of the Turkish economy is no easy task, particularly after the inconclusive result of the 7 June election. Some economic indicators have improved, but Turkey has failed to unleash its real potential.

Growth is falling, unemployment is high and persistent, domestic savings are too low. Income distribution is unsatisfactory. Growth is insufficient to promote welfare, quality of development is low, and inflation continues to be volatile and unpredictable.

Since the 1960s the Turkish economy has gone through several major crises. The origins have been diverse: lack of foreign exchange (current account imbalance), excessive public borrowing (wrong fiscal policies), political mismanagement (wrong macroeconomic policies) and banking sector failures (lack of institutions). In between these, there have been ups and downs of lower magnitudes.

Turkey has been able to derive some benefits from this chequered history. First, the lessons learnt in each crisis helped to prevent further mistakes. Second, repeated financial instability made clear the importance of sound macroeconomic management at the political level. These lessons helped increase the resilience of the economy.

From 2010-14, the budget deficit fell from 3.6% of GDP to 1.3%. Public debt declined from 43.1% of GDP to 34.9% and is expected to stay at this level in 2015. Exports increased from $114bn to $158bn, despite the weak recovery in the European Union which is Turkey's most important export market (and the reason that exports are not expected to show much improvement in 2015).

Challenges remain

Turkey's challenges outweigh these positive indicators. Inflation rates, though much lower than the average of the last two decades, have remained stubbornly higher than the central bank's targets, rising from 5.5% to 7.5%. Inflation remains a big problem this year, and will be exacerbated by the fall of the lira.

On the more positive side, the current account deficit has remained stable at 5.7% last year, according to the IMF, and is due to fall further this year. Unemployment, however, has not improved from 2014's 10.4%.

The biggest worry is Turkey's growth rate, which has shown a persistent decline from 9.2% in 2010 to 2.9% in 2014. The OECD Economic Outlook Report estimates Turkey's growth rate for 2015 to be slightly higher at 3.1%. Domestic demand is sluggish, real sector confidence is declining and gross fixed capital formation sliding with a substantial slowdown in the private sector. All of these factors will be made worse if political uncertainty continues.

Several steps must be taken to unleash Turkey's potential. It must establish a workable growth strategy based on competitive and value-added industrialisation, innovation, research and education. It should recognise the vital importance of institutions, rule of law, regulatory governance and structural reforms. And Turkey must reorganise its financial services industry to accommodate the fast-changing and growing needs of the economy and the international environment. ▪

Korkmaz Ilkorur, a member of the Advisory Board, is vice-chair of the Finance Task Force of the Business and Industry Advisory Committee to the OECD.

New government must ensure comprehensive economic reform

At a critical juncture for Turkey's economy, the 7 June poll brings into view a possible coalition government, *writes Gündüz Fındıkçıoğlu*. This could prove to be much more effective than most people envision. The need for a comprehensive reform programme involving endogenous growth and institutional change is so clear that whatever government is formed will have to bring it about.

The economy has been locked in a middle-income trap since the collapse of Lehman Brothers in 2008. GDP growth is much higher than in the 1990s, but the loss of momentum is worrying. Turkey has been growing at 3% per annum over the last four years. This is sub-optimal, since the most conservative potential growth estimate is 4%.

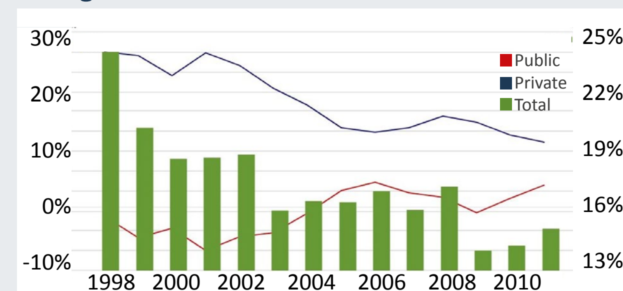
After Turkey's crisis of 2001, a programme designed by Economics Minister Kemal Derviş altered the course of the economy. Public debt-to-GDP fell as primary balances improved, inflation and interest rates fell, and growth resumed. Openness to trade increased and Turkey quickly developed a legal framework for attracting foreign direct investment. Banking reforms followed, which improved asset quality. Loan growth reached unprecedented levels. For the first time in Turkish banking history, consumer lending – including housing loans – became an important activity. Until 2007, it was a success story. Global liquidity helped greatly. The lira appreciated to the point of overvaluation.

Much has changed over the last 14 years. Overall savings have fallen significantly, mainly due to a build-up of private debt (see Chart 1). Behind this has been a big increase in consumption. In the 1990s, fiscal deficits and a soaring public debt were the main reasons for chronically high inflation. In the 2000s, budget discipline ensured that both the public debt-to-GDP ratio and the inflation rate fell sharply. But this was accompanied by a large current account deficit, requiring Turkey to maintain the confidence of foreign investors needed to import large quantities of capital.

By end-2011, the current account hit 10% of GDP and growth fell to 2.2% – necessitating a change of course and a fall in the lira, which after the election seems to be continuing. The worrying effects on inflation will probably make further interest rate increases necessary. Investments are on hold and the growth rate is falling. Confronting these difficutl issues is a far from enviable task for the new government.▪

Chart 1: Public saving replaces private

Saving as % of GDP



Left: public and private saving, % of GDP; right: total saving
Source: Turkey Data Monitor

Gündüz Fındıkçıoğlu is Chief Economist at Türkiye Sınai Kalkınma Bankası.

Voters reject Erdoğan's ambitions

Difficult balancing act in Turkey

David Tonge, Advisory Board

By rejecting the overweening ambitions of President Recep Tayyip Erdoğan, the Turkish electorate has opened the way to coalition-building that spells further uncertainty for the hard-pressed economy. June may prove a long month in Turkish politics.

But the autumn may prove still more arduous with Minister of State Ali Babacan no longer around to reassure investors and Erdem Başçı, the central bank governor, under pressure from a probable rise in US interest rates.

Following the 7 June elections, no party in the Grand National Assembly has a majority. The pro-Kurdish HDP (People's Democratic Party) has entered parliament. The Islamist-rooted AKP (Justice and Development Party), over which Erdoğan retains dominance, is still the most important constituent of the assembly, with 258 seats, 18 short of a majority of the 550-strong chamber. The traditional Republican People's Party has 132 seats, the nationalist MHP (Nationalist Movement Party) 80 and HDP 80.

Several outcomes are possible. The AKP could form a minority government, with HDP abstaining. It could establish a coalition with one of its opponents such as the MHP, even though these parties, for the moment at least, refuse to countenance the idea. The opposition might attempt to form a coalition, although there are doubts whether Erdoğan would allow it. Another possibility is a fresh general election. Whatever happens is likely to spell bad news for the Turkish economy, at least in the short term.

The 59% of Turks who voted against the AKP may have been happy with the result, but the negative impact on the lira and on the stock market showed how investors have been unnerved. The heated election campaign does not augur well. It culminated in a bomb attack on an HDP rally two days before the voting which left four people dead and 100 injured. This was one of some 70 attacks on the HDP.

Unfair process

The election process was far from fair. The president flaunted Article 101 of the constitution which requires him to sever relations with political parties and campaigned tirelessly for AKP. But, helped by 200,000 distrustful volunteer monitors, the count seems to have been relatively unbiased and the results were clear. AKP's share of the vote fell from 49.9% in 2011 to 40.9% (see Chart 2). HDP vaulted the 10% threshold, winning 80 seats which would otherwise have mostly been awarded to AKP.

In the municipal elections of March 2014, the Turkish electorate seemed to set little store on the corruption allegations which forced the resignation of four ministers and cast a shadow on Erdoğan himself. AKP still won 43.9% of the votes. The further fall on 7 June marked a response to the slowing economy as well as voters' distaste at Erdoğan's boorish, hectoring demands for more powers for his Presidency.

It also reflected the hopes engendered by HDP and its charismatic leader, Selahattin Demirtaş. This cool-headed 42-year-old lawyer gathered the votes of many religious Kurds and others disturbed by Erdoğan's long refusal to help the Kurds in Syria. Demirtaş has become a focus for the many 'white Turks' – traditional secularists, social democrats and leftists – who wanted to deny Erdoğan the chance to reinforce presidential powers, seeing him more as a putative Putin than an Obama or Hollande. Memories of the feared Abdullah Öcalan, the imprisoned leader of PKK (Kurdistan Workers' Party), were buried – though Demirtaş was to thank him in his own post-election speech.

The initial statements by the parties about their willingness to enter a coalition are all negative. Erdoğan will not facilitate these negotiations, sensing that his role will be strengthened by drawn-out coalition discussions and political stalemate. AKP may face its own internal battles, with Erdoğan possibly seeking to displace his anointed successor, Ahmet Davutoğlu, and Abdullah Gul, the former president, perhaps emerging from the shadows.

All this will further hamper the economy. Growth has slowed to around 3%, with the International Monetary Fund forecasting 3.6% for 2016. Prospects are better than for the European Union, but well below the 5.3% of Erdoğan's golden years from 2003-10.

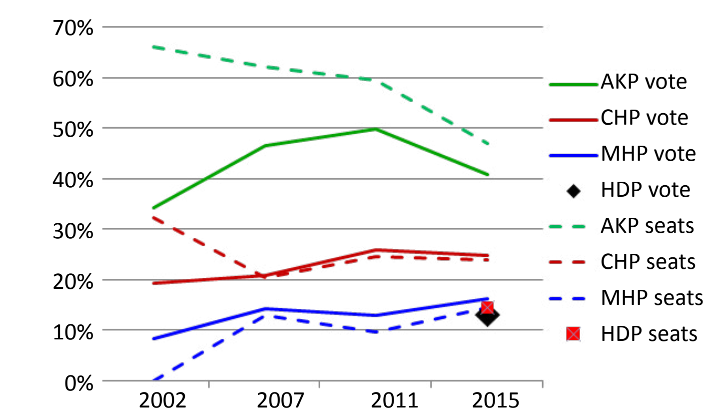
True, the construction industry has benefited under Erdoğan, but other sectors have fared less well. The current account deficit has grown and bodies such as the IMF and World Bank warn that preventing a further worsening requires a reduction in Turkey's future growth.

Whoever is in charge in Turkey faces a difficult balancing act. ▪

David Tonge, a member of the OMFIF Advisory Board, is managing director of IBS Research & Consultancy.

Chart 2: Electoral mismatch

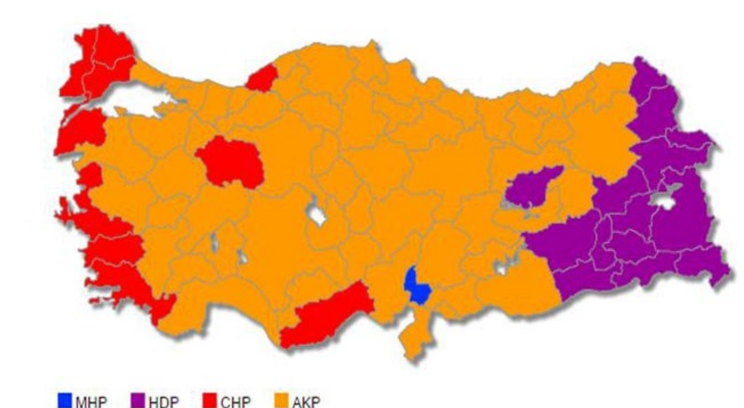
General election votes and seats, 2002-15



Source: Official and, for 2015, initial election results.
Note: Forces now represented by HDP stood as independent candidates before 2015.

Chart 3: AKP retains heartland

Provinces by winning party, 2015



Source: milliyet.com.tr/secim/2015

AIIB shows US is losing influence

China forging ahead with infrastructure bank

Willem Middelkoop, Advisory Board

The launch of the China-led Asian Infrastructure Investment Bank has been a landmark event.

The bank is starting without US involvement but with the participation – against US wishes – of staunch traditional American allies such as Britain, Germany and Australia.

Waning power

Larry Summers, a former US Treasury secretary, commented that the AIIB's establishment 'may be remembered as the moment the US lost its role as the underwriter of the global economic system. I can think of no event since Bretton Woods comparable to the combination of China's effort to establish a major new institution and the failure of the US to persuade dozens of its traditional allies, starting with Britain, to stay out.'

This British decision was highly criticised by the US, with an unnamed official telling the Financial Times, 'We are wary about a trend toward constant accommodation of China, which is not the best way to engage a rising power.'

US economic power has been dealt a blow. Summers rightly criticised the strategy of the Obama administration: 'The US misjudged the situation tremendously.'

And he rightly linked it to the failure of the US Congress, largely because of resistance from the Republicans, to ratify International Monetary Fund governance reforms that Washington itself pushed for in 2009 and which were agreed in 2010.

'By supplementing IMF resources, this change would have bolstered confidence in the global economy,' Summers said. 'More important, it would come closer to giving countries such as China and India a share of IMF votes commensurate with their increased economic heft.'

For the first time since the end of the second world war, the US is not in the driving seat during the foundation of a significant global institution. This will not change the world economic system overnight, but when we look back in five, 10 or 15 years, spring 2015 may be remembered as a turning point in economic history.

It might be remembered as the start of an open Chinese confrontation with the US over the world's economic leadership. As Summers points out, this has taken place because Beijing has had to wait five years for a change in the IMF voting structure.

Potential rival

China floated first ideas for an AIIB in 2013. The Chinese wanted the AIIB to work cooperate closely with the IMF, the World Bank and the Asian Development Bank. The US, however, saw the AIIB as a potential rival for these US-dominated organisations.

In 2014, China invited India to participate in the AIIB's foundation of the AIIB. In October last year that year, 21 mainly Asian countries signed a memorandum of understanding to set it up. The US tried to keep Australia and South Korea from signing up, but by summer 2015, almost all Asian countries and most major countries outside had pledged to join the AIIB – a total of 57 as of May 2015. The main exceptions are the US, Japan (which still has a strong hand in the ADB, by design of the US) and Canada. North Korea's and Taiwan's applications were rejected. The Chinese want the AIIB to be fully established by the end of 2015.

Infrastructure investment

The AIIB will be used to finance large infrastructural investments mainly in Asia. The ADB estimates that the region requires up to $9tn in infrastructure investments in coming years. Although China is the largest investor in the region, it has only 5% of ADB voting rights, while Japan and US have 13% each.

In the IMF, the most important decisions require a special majority of 85%, giving the US with over 17% of the votes, an effective veto. France, with just over 65m people, has more voting rights (4.3%) than 1.3bn-strong China (3.9%). Belgium, with just over 10m people, has more voting rights (1.9%) than Brazil (1.7%), with more than 200m.

Another frequently heard complaint is that the post-1980s move to neoliberalism and global capitalism has led to a change in IMF functions. Critics claim US allies receive bigger loans with fewer conditions. China and many other emerging market economies are frustrated by US defence of the status quo. The AIIB will provide a test of how much may be about to change. ▪

Willem Middelkoop is co-founder of the Commodity Discovery Fund and author of *The Big Reset*.

IMF 'exceptional access' lending policy ripe for termination

...continued from p.5

Further substantially weakening the case for a larger IMF has been the way in which the IMF has abused its 'exceptional access' lending policy over the past five years. This policy, which effectively removes any reasonable limit on the amount that the IMF can lend to an individual country, has allowed the IMF to lend very large amounts without precedent to countries with dubious economic fundamentals. As a result of such exceptional lending, we now have a situation where three countries with a questionable ability to repay (Greece, Portugal and Ukraine) account for two-thirds of the IMF's loan portfolio.

The IMF will have to fight to get its money back on time from Athens. No one knows how a worsening of the Greek imbroglio would impact the safety of IMF loans to other problem countries in Europe. A new IMF reform package should not be achieved through an increase in the IMF's lending capacity. Indeed, there is the strongest of cases for the IMF's 'exceptional access' lending policy to be terminated and the IMF to return to its original role of a catalytic lender. Such a reform package would offer the IMF a much better chance of getting the US Congress on board than the package now on the table.

Realistically, there is little prospect that IMF reform will be approved by the current US Congress. Rather, it would seem that US approval will need to await the November 2016 US presidential and congressional elections. By that time, the IMF might have in place a new managing director, who might be chosen from outside Europe and who might have the mandate to make a fresh attempt at far-reaching IMF reform. ▪

Desmond Lachman is resident fellow at the American Enterprise Institute and former deputy director in the IMF's Policy Development and Review Department.

Weak US data bring out Fed doves

Policy-makers question inflation assumptions

Darrell Delamaide, US Editor

Monetary policy-makers in the Federal Open Market Committee expressed concern that the weakness of the US economy in the first quarter may not be just a temporary, weather-related phenomenon but could herald slower growth for the entire year.

The weak data encouraged doves on the Federal Reserve panel to urge delay on action to raise interest rates, a move now expected to come in September at the earliest.

The sentiment was echoed in an unusual and surprising intervention by International Monetary Fund Managing Director Christine Lagarde, who urged the Fed to wait until the first half of next year to act. Lagarde made her remarks a day before the release of robust US non-farm payroll data that made some analysts consider a September hike more probable.

'What we are seeing on the data, particularly on inflation, is that the pick-up is very slow and we believe that there is a good argument to actually defer until early 2016 any rate hike,' Lagarde said on Fox Business News. She was repeating recommendations contained in the IMF's annual assessment of the US economy released in early June, but her comments threw a spotlight on a possible collision between the IMF's cautious forecast and the views of the more hawkish members of the FOMC.

The protracted course to interest rate normalisation prompted some policy-makers to question the assumptions behind current policy. They suggested the inflation target of 2% may be too low, or the 5% unemployment now considered a 'natural rate' may be too high.

Winter weakness

Boston Fed chief **Eric Rosengren (non-voter)** was among the doves urging that weak data should mean 'continued patience in monetary policy'. Speaking in Hartford, Connecticut, Rosengren acknowledged that severe winter weather, especially in New England, had impacted the economy as record snowfall prevented people from getting to work, from shopping and even from going out to eat.

'However, the data were not just weak during the worst of winter,' Rosengren said. 'They were also weak before the storms and have been weaker than expected ever since. So economic growth for the first half of this year looks to be well below what was expected, even correcting for some temporary disruptions.'

Newly installed Federal Reserve Governor **Lael Brainard (voter)** positioned herself firmly among the doves with her first major policy speech, sounding many of the same notes.

Speaking in Washington at the beginning of June, the former Treasury official cautioned against dismissing the contraction of the US economy in the first quarter as a temporary aberration.

'The limited data in hand pertaining to the second quarter do not suggest a significant bounce-back in aggregate spending, which we would expect if all of the weakness in the first quarter were due to transitory factors,' she said.

For one thing, the decline of gasoline prices has not led to the uptick in consumer spending that was expected, as households seemed to prefer paying down debt to added consumption.

In addition, the decline in net exports due to the rising dollar has been greater than expected, and may be holding back investment in areas sensitive to foreign demand.

'Given the softness in the data we have seen so far this year and some uncertainty about how much to attribute to temporary or statistical factors, I think there is value to watchful waiting while additional data help clarify the economy's underlying momentum in the face of the headwinds from abroad,' Brainard concluded.

She was willing to concede nonetheless that if the labour market continues to strengthen and inflation readings continue to improve, 'lift-off' – the term of choice for the first action to raise interest rates in more than six years – could still come in 2015.

It was Fed chair **Janet Yellen (voter)** who affirmed that lift-off this year was still probable.

'I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalising monetary policy,' she said in late May. Her remarks came after release of the minutes from the April FOMC meeting indicated that a rate hike was effectively off the table for the June meeting.

Those minutes related that 'many' at the meeting 'thought it unlikely that the data available in June would provide sufficient confirmation that the conditions for raising the target range' were satisfied. These were opposed to a 'few' who thought there might be enough data by June that 'conditions for beginning policy firming had been met'.

Richmond Fed chief **Jeffrey Lacker (voter)** made it clear in remarks to reporters at an event in Baton Rouge, Louisiana, that he was among those 'few'.

In his view, economic data has in fact suggested that the weakness in the economy is transitory. 'What I've said is that a case might be strong in June. I still think that's possible.'

But even **James Bullard (nonvoter)**, head of the St. Louis Fed, who has been urging earlier action, acknowledged that market expectations of a delay were probably 'appropriate' given the weak economic data.

'I would like to move on the back of good news, basically, and I think it's very difficult to say that you're trying to normalise interest rates just at the moment where the economy looks a little bit weaker,' he told reporters in St. Louis. 'I think this is all transitory, but that's where we are.'

Inflation assumptions

The minutes from the April meeting revealed that policy-makers were beginning to question their assumptions about inflation and employment.

In a discussion about the persistence of low equilibrium real rate of interest (the rate consistent with achieving maximum employment and price stability), 'one participant' suggested the panel 'should discuss the possibility of increasing its longer-run inflation objective'.

A 'few others' thought such a discussion could be useful but worried that such a change might undermine the Fed's credibility.

The staff economic outlook reported in the minutes suggested the unemployment rate, then at 5.5%, would continue to decline only very slowly because of remaining slack in the labour market.

Chicago Fed chief **Charles Evans (voter)**, a long-standing dove who (like Lagarde) has urged delaying lift-off until 2016, said in a speech in Munich that research by his staff indicates the 'natural' unemployment rate in the US could be lower than the 5% currently assumed in Fed policy. 'If we've got a natural rate below 5%, we might not see inflation pick up until we go even further,' he said, according to a report in The Wall Street Journal. ▪

Darrell Delamaide is a writer and editor based in Washington.

Greece on the brink

Handling of debt will shape European order

Vicky Pryce, Advisory Board

Greece is moving perilously near to running out of cash to continue paying for wages, pensions and the provision of basic public services, let alone to repay its external debts and keep banks solvent. So the disputes over debt payments to the International Monetary Fund and the European Central Bank have taken centre stage.

The Greek government reached a deal to delay the €300m due to the IMF on 5 June, bundling all four June payments into a lump sum of €1.5bn payable at the end of the month. But the government also needs to find billions of euros to meet repayments of maturing short term Treasury Bills.

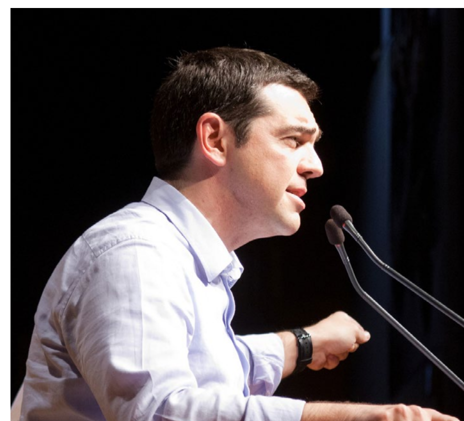
Greece has no chance of meeting further payments to the ECB of €3.5bn in July and again in August unless it receives the final €7.2bn due from its second international bail-out. Respite could come, provided Alexis Tsipras' government reaches accord on reforms demanded by creditors.

One source of funding is the €11bn remaining from the bank re-capitalisation fund which the Greeks have not been able to use. Athens could also use some ECB profits from earlier Greek bond purchases, all so far frozen.

Despite the potential for modest recycling of earlier aid, Greece may still need an interim additional loan, and maybe even a third bail-out. This would probably no longer involve the IMF, which is unlikely to want any further exposure.

The Greeks would relish an end to the uncertainty though they will not see the end of austerity for a while to come. The international financial markets would breathe a sigh of relief.

However, in spite of occasional optimisim about a possible compromise, very little progress has been made over several months to bridge the gap between the IMF, the ECB and the European Commission and the Greeks.



Greek Prime Minister Alexis Tsipras

The Greeks want a cut in the expected primary surplus, excluding debt servicing, to give them some breathing space after the 25% reduction in GDP over the last six years. They also wish to renegotiate their huge and unsustainable debt. On the other hand the list of conditions from the 'institutions' (a term now preferred to 'troika') have included further pension and labour reforms and, astonishingly to many Greeks, primary surpluses of 3.5%. After Tsipras' visit to Brussels on 3 June, the institutions did however appear prepared to ease that condition.

Fear of contagion

It is questionable whether anything has been gained from the four-month 'review' period and extension of the Greek bail-out granted to the Syriza-led coalition after the January election. Some cynics might argue that the interim agreement allowed the ECB to start quantitative easing, producing a positive impact on lending conditions in Europe – therefore shielding the rest of Europe from any contagion from a Greek default or even exit from the euro.

The interim accord has not however changed the fundamentals of the euro area economy or eliminated the possible negative impact of Greek negotiations with creditors breaking down entirely.

The prolonged period of negotiations has not been good for euro area confidence and growth. The risks of 'Grexit' have been sufficiently worrying to have warranted several interventions from the US. This has included President Barack Obama and Jack Lew, US Treasury secretary who, mindful of geopolitical uncertainty in the region, called for the Europeans to show less 'brinksmanship' and seek early resolution to the crisis.

The impasse has proved disastrous for Greece. After recovering for most of 2014, GDP fell by 0.4% in the last quarter of 2014 and a further 0.2% in the first quarter of 2015. The primary surplus, excluding debt interest payments, that Greece was forecast to achieve in 2015 has now effectively disappeared.

Unemployment, which had fallen slightly last year, is now back to 26%. Youth unemployment remains at around 55% and the 'brain drain' from the mass exodus of young Greeks has alarmed policy-makers and will constrain future growth. Growth for this year, rather than the 2.9% forecast earlier, is likely to be flat at best, supported mainly by what are likely to be record tourist arrivals this summer as the tensions in the Middle East and Africa make Greece's relative tranquillity more attractive.

By now, Greece should have started to see the benefits from the improved euro area economy. But the impact has been tiny. Instead the threat of default and 'Grexit' has paralysed the economy, encouraging massive deposit withdrawals, amounting to some €40bn since late 2014. The Greek banking system has been kept going by the ECB's Emergency Liquidity Assistance. Lending to businesses has been declining and investment, both domestic and inward, has stagnated.

The euro area is bad at solving crises. It takes a long time to appreciate the dangers inherent in its policies. The building of the institutional framework to help with crises including the role of the ECB has been too slow.

Compounding this, the institutions involved have an unsatisfactory record in learning from mistakes. The IMF package for Greece was poorly conceived and implemented. The huge cut in salaries has had only a small positive impact on the country's exports and competitiveness. The substantial reduction in the budget deficit from 15% in 2009 to around 2% of GDP is due less to improved tax collection, far more to government cut-backs on paying contractors and supplying public goods like healthcare.

Almost one-third of the population, and half of Greek pensioners, are either on the brink of poverty or below the poverty line, with hospitals short of medicines and basic necessities like bedsheets.

Eventually Europe will have to address the large and unsustainable Greek debt. This will remain a constraining factor on Greek growth – and is an issue for many other countries too. For different reasons, Greece's debt crisis impinges on other heavily indebted countries such as Ireland, Portugal, Italy and Spain. Greece's problems, and any solutions that it reaches with its creditors, resonate far beyond its borders. ▪

Vicky Pryce is Chief Economic Adviser at the Centre for Economics and Business Research and author of *Greekonomics*.

UK Conservatives ready for reforms

Private sector investment will be the test

Gerard Lyons, Advisory Board

The new Conservative government has unveiled a packed legislative agenda following its 7 May election victory. Led by Prime Minister David Cameron it is trying to seize the initiative and think radically following his unexpected victory.

The overall stance of macroeconomic policy remains key. The economy faces a twin deficit problem, with a high but declining budget deficit and a stubborn current account deficit.

Shrinking state

The fiscal shortfall occupies centre stage. The aim is to curb the growth of government spending, both to help lower the budget deficit and to reduce the size of the state. This latter aim, together with reforming public services, could become as important a focus for the government as lowering the budget deficit. It may be seen in five years as the true measure of how radical the Conservatives have been.

The implication is that the economy will face fiscal headwinds. The impact on growth is uncertain. The UK recovery in recent years highlighted the combined benefits of an accommodative monetary policy, a flexible labour market and a resilient private sector. Wage growth has been subdued, so per capita incomes are still below their pre-crisis level. Despite this, in the years after the financial crisis, the UK created more jobs than the rest of the EU combined, the majority of which were full-time.

This leads to the big issue of coming years: the debate on Europe. The UK is committed to an in-out referendum on membership of the EU before the end of 2017.

The prime minister's aim is to achieve far-reaching, radical reforms. These are designed to change the EU from a system that has seen power become centralised at the expense of national governments. In addition, the EU's basic economic model is backward-looking. Unfortunately, the early signs are that any reforms may be limited in nature. As was the case in 1975 when the UK last voted on this topic, the country is likely to be encouraged to vote in favour of continued EU membership with little reform having been achieved.

The UK must reposition itself in a growing and changing global economy. Ideally it should do so from within a reformed EU.

Some international observers wonder why the UK would want to leave the bigger EU, particularly if one consequence is that Scotland could then leave the UK. All this would be seen to weaken the UK's international role.

Yet the whole of Europe would be disappointed if the UK initiative failed to achieve meaningful EU reforms. Europe needs to reposition itself to succeed. If it doesn't, then the UK should have no hesitation in leaving. If, after all we have seen in recent years, Europe does not realise it needs to reform now, then when will it?

Not only the regional relationship with Europe, but also domestic regional issues, will absorb much UK attention. Increased powers were granted to Scotland in the wake of last year's independence referendum. Now the focus is on devolving more powers to English cities.

Interest rates

Monetary policy is likely to have to remain accommodative. The message so far in the UK is that interest rates will have to stay low, rise gradually and peak at a low level. At some stage the Bank of England will feel it should raise rates, but it needs to tread carefully. The economy's resilience to higher rates is not clear. Furthermore, the economy needs increased bank lending to business.

There are still worrying aspects to the UK recovery. It is coinciding with a rise in personal debt. House prices and rents are high. The latter point to the need for large-scale house building. There is also scope for increased infrastructure spending. One source of frustration in recent years is that, despite the high budget deficit, the government has not taken advantage of very low borrowing costs to undertake much-needed infrastructure spending.

On a wider social level, the election raised issues linked to living wages and inequality. The government must create a business-friendly environment in which those in work on low incomes receive higher wages, while paying low taxes. Immigration, too, figured as an election issue, highlighting public concern about the growing numbers of migrants and the pressure they put on housing, wages and other services.

The challenge for the UK is addressing some of these intractable issues without weakening its openness and attraction to inward investment.

A key issue is the UK's long-term growth rate. The economy is growing below its pre-crisis trend, yet spare capacity is seen as small. This goes to the heart of the debate about low UK productivity, which lowers future growth.

The UK is a service sector economy and has a large number of both low and high skilled jobs. While a higher skilled workforce would be a welcome focus, measures of productivity may not always reflect the benefit of having a low skilled job as opposed to no job, and also may not reflect the potential upside to productivity in the UK if demand recovers more strongly. Perhaps, given all this, the true measure of this government's success will be if the private sector gives its vote of confidence, by increasing the scale of its investment. ▪

Gerard Lyons is chief economic adviser to the Mayor of London

Boosting growth in Europe

Sixth Main Meeting in Europe co-hosted with Czech National Bank

19 October 2015, Prague

Healthier bank balance sheets, low interest rates and low oil prices have helped generate growth momentum which is being supported by the European Central Bank's quantitative easing programme and an easing of fiscal austerity. However, even with this modest growth, the European economy is still likely to be below its pre-Lehman peak by the end of the year. OMFIF's sixth Main Meeting in Europe brings together senior representatives from official institutions and select private sector organisations to discuss economic and monetary policy initiatives.

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Towards a new ECB role in shadow banking

Capacity constraints and possible conflicts raise question marks

The financial crisis has shown that the financial sector needs wider and more comprehensive financial supervision. The former belief in 'light touch' regulation was proved wrong. After more than five years of updated regulation and supervision, for example through Basel III and EMIR, European policy-makers have reached the next stage.

The European Central Bank is expanding the reach and scope of the single supervisory mechanism that grants it the right to monitor all systemically relevant banks in the euro area (and in some other non-member countries).

Another step will be to develop a framework for non-banking financial supervision. The ambition to develop new tools and instruments of regulation aims to test the ability of banks to overcome liquidity crises. It is also designed to integrate the European financial market into a comprehensive framework that will ultimately be a part of the banking union. As Vítor Constâncio, deputy president of the ECB, outlined at an OMFIF City Lecture on 8 May, this is part of a comprehensive policy on macroprudential supervision and regulation that has far-reaching repurcussions across the financial field.

Stronger supervision

A key part of this approach, as Constancio explained, is stronger supervision of the non-banking financial market. Indeed, the shadow banking sector has almost doubled in the last decade to about €23.5tn, largely because tighter rules on the banking sector have squeezed major banks out of certain markets, which are now being taken over by non-banking financial entities.

Constâncio explained how shadow banking entities are vital providers of credit to the real economy and can help companies to diversify their funding requirements. However, these entities can take on too much risk and may 'too big to fail'.

This could have a direct effect on the financial sector and on the wider economy. The ECB is proposing to expand its supervisory framework to shadow banking entities. This would require it to create tools and instruments similar to those found in the banking sector, such as stress tests and capital requirements. Alongside these extra instruments, the ECB wishes to promote a stronger institutional base in the euro area, through implementing a capital market union.

The introduction of the SSM is an important first step towards the banking union, which would strengthen the financial capacity of the euro area and would provide businesses with better access to capital.

The SSM, however, covers only part of the EU. Apart from creating a two-speed integration process, this could create the danger of insufficient supervision and failures of banks outside the SSM.

It is difficult to imagine how the ECB can extend its capacity to supervise the entire European financial sector, including the non-banking area.

Direct insight

The ECB has direct insight into the credit worthiness of and the collateral used by commercial banks. It is in a unique position to monitor banks. This however creates a potential conflict of interest between its role as a market participant and its position as an independent institution controlling monetary policy.

The information the ECB gains from supervising 130 systemically relevant banks can have a major influence on its monetary policy. For example, if the ECB intends to increase interest rates in line with its inflation target, but believes this would negatively affect the financial sector, this might dissuade it from monetary action. This issue also affects Constâncio's proposal to expand supervision to the non-banking sector, which would would greatly strain the ECB's resources.

National level

Delegating this responsibility to the national level would probably result in a divergent regulatory framework, negatively impinging on the prospects for genuine banking union.

The best outcome would appear to be increasing still further the SSM's independence from the ECB, giving it more resources to supervise both the banking and the non-banking sectors. Without doubt, macroprudential supervision of the banking and non-banking sector is an important part of anticipating and preventing future financial crises. It remains uncertain however whether the ECB is the best institution to take the lead on this development, considering both possible conflicts of interest and the strong capacity constraints that at present are all too visible.

The ECB has vital access to market information that can be crucial to its supervisory actions. The challenge for the future lies in using this access in the best possible manner to create a supervisory institution with powers over banking and non-banking activities in the euro area and the wider EU. ■

ECB Vice President Vítor Constâncio flanked by David Marsh and José Manuel Gonzáles-Paramo, 8 May, London

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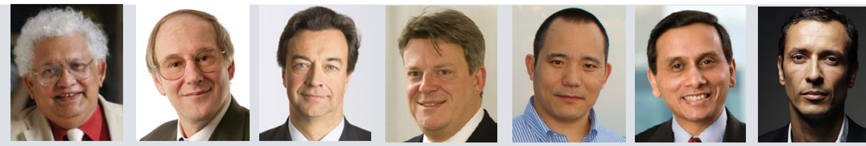

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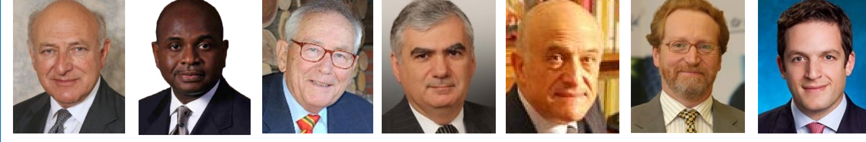

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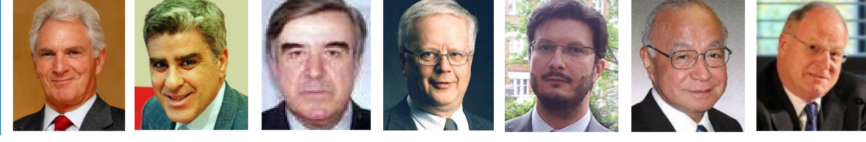

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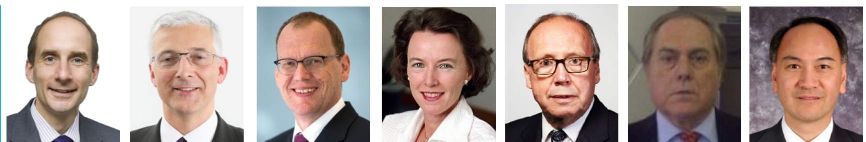

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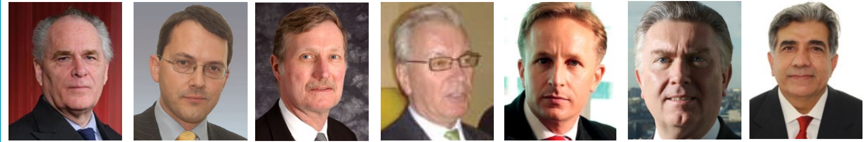

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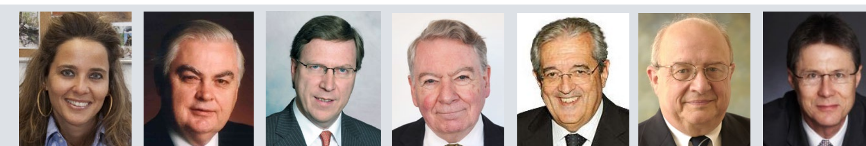

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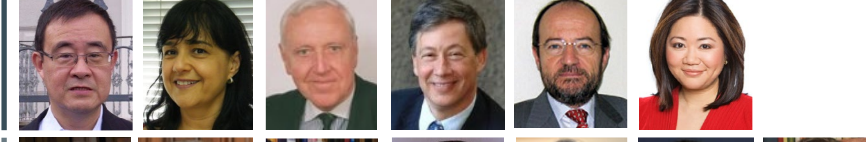

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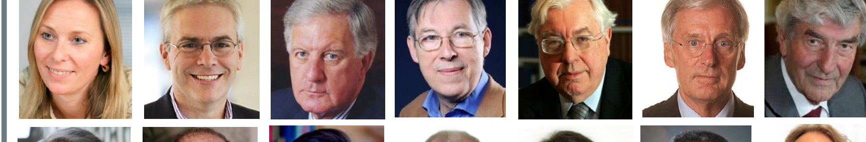

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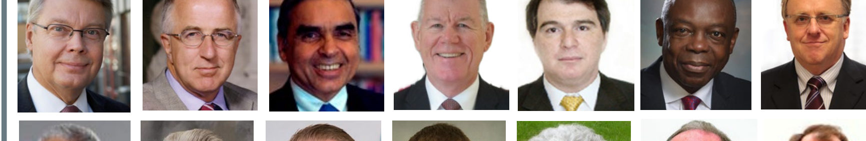

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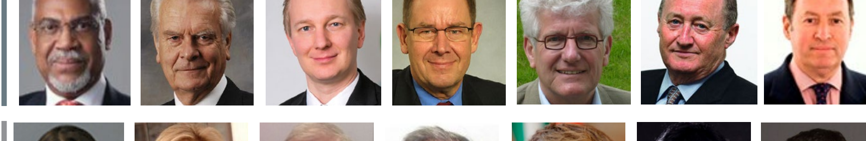

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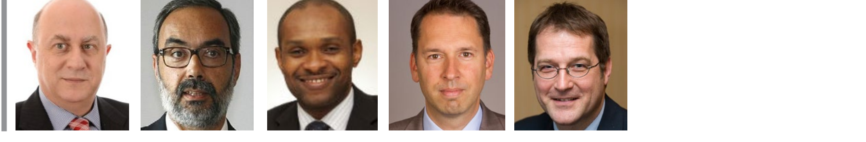

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Dollarisation is Venezuela's best hope

Ecuador provides a template

Steve Hanke, Advisory Board

Venezuela has at best a tenuous grip on the rule of law. This is nowhere more visible than in the monetary sphere. The country's foreign exchange reserves are falling like a stone (see Chart 1). The bolivar has plunged 47% against the dollar since the start of the year (see Chart 2).

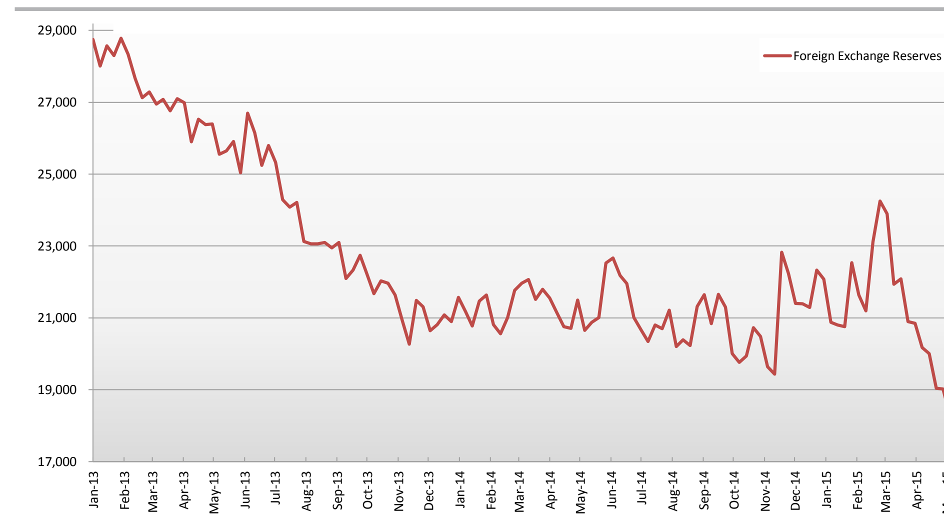
Venezuela's worsening financial situation can be glimpsed in the government's approaches to Wall Street. On 24 April, it secured a $1bn loan from Citibank, with 3,500 gold bars (worth $1.7bn) as collateral.

In line with the bolivar's decline, inflation has soared to an estimated annual 335% (see Chart 3), the highest in the world. For those holding bolivars, it amounts to: 'no rule of law, bad money.' Facing this inflationary theft, Venezuelans have voted with their wallets. Indeed, they have begun to unofficially dollarise the economy. The only way to reestablish the rule of law in the monetary sphere is to take this development further and officially dollarise the economy by dumping the bolivar and replacing it with the dollar, following the pattern of Ecuador which swapped its sucres in 2000.

In general terms, the rule of law subjects the state to a fixed set of rules that limits the scope of its coercive powers. When properly applied, the rule of law guarantees freedoms in the economic, political, intellectual and moral spheres. In the economic sphere, money constitutes an important element.

Chart 1: Dwindling reserves

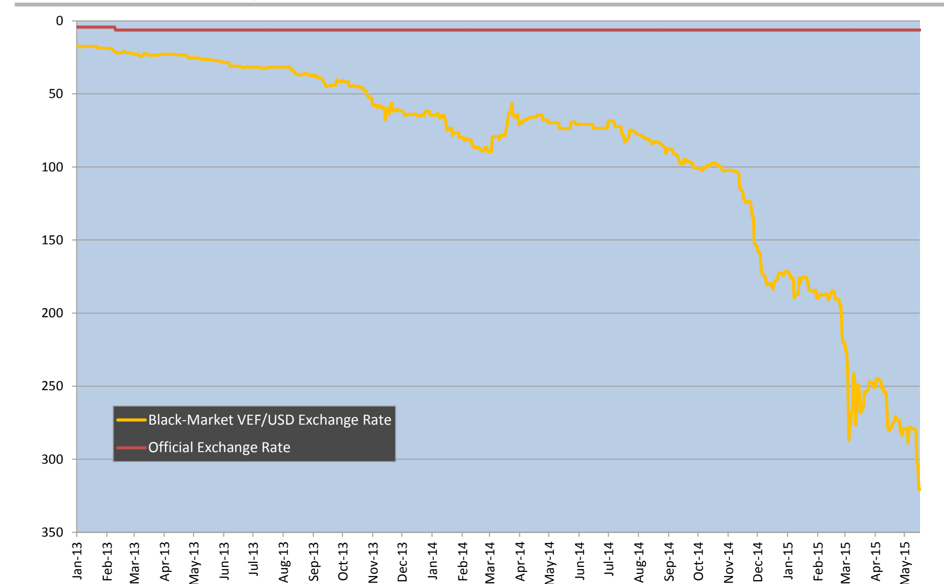
Venezuela's foreign exchange reserves, 2013-15 ($m)



Foreign exchange reserves ($m).
Source: Banco Central de Venezuela weekly data, and calculations by Prof. Steve Hanke, The Johns Hopkins University.
Note: Reserve data after March 2015 are provisional.

Chart 2: Bolívar falls 47% against the dollar

Black market exchange rate for bolívar



Bolívar/$ exchange rate. Source: Banco Central de Venezuela, Dollar.nu, Dolar Paralelo, International Monetary Fund, Paralelo Venezuela. Prepared by Prof. Steve Hanke, The Johns Hopkins University.
Note: For purposes of illustrating the declining value of the Venezuelan bolívar, relative to the dollar, the y-axis is inverted.

Sound money

The Austrian economist Ludwig von Mises dealt at length with this issue in *The Theory of Money and Credit* published in 1912: 'It is impossible to grasp the meaning of the idea of sound money if one does not realise that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments.'

It is worth noting that currency debasement and inflation robbery were not always the order of the day in Caracas. During the decade of the 1950s, Venezuela's average annual inflation rate was only 1.7%, not much above Switzerland's. In the 1960s, inflation fell to a 1.2% average annual rate. It wasn't until the 1980s that Venezuela experienced a decade of double-digit annual inflation. Today, inflation, contrary to the official numbers and amateur estimates, has soared well into triple-digit territory.

When inflation rates are elevated, standard economic theory and reliable empirical techniques allow us to produce accurate inflation estimates, using free market exchange rate data (usually from the black market) and the principle of purchasing power parity (PPP), which links changes in exchange rates and changes in prices. My estimate of a 335% inflation rate stems from black market exchange rates that The Johns Hopkins-Cato Institute Troubled Currencies Project has collected over the past year.

Ecuador, where I served as the chief adviser to the finance minister during the dollarisation episode, offers some lessons. Ecuador represented a prime example of a country that was incapable of imposing the rule of law and safeguarding the value of the sucre. The Banco Central del Ecuador was established in 1927, with a sucre-dollar exchange rate of 5.

Until the 1980s, the central bank periodically devalued the currency. Then, devaluations became more frequent. By the end of 1998, the sucre traded at 6,825 per dollar. A year later, the rate was 20,243. During the first week of January 2000, it soared to 28,000.

Moral beliefs

The inability of the Ecuadorian government to abide by the rule of law was, in part, a consequence of traditions and moral beliefs. Ecuadorian politics have traditionally been dominated by elites who are uninhibited in their predatory and parochial demands on the state. Special interest legislation was the order of the day. For example, in 1999, laws were passed that allowed bankers to make loans to themselves. In addition, state guarantees for bank deposits were introduced. These proved to be a deadly cocktail, one that allowed for massive looting of the banking system's deposit base.

With the rule of law (and the sucre) in shambles, President Jamil Mahuad announced on 9 January 2000 that Ecuador would abandon the sucre and officially dollarise the economy. The positive confidence shock was immediate. On January 11 – even before a dollarisation law had been enacted—the central bank lowered the rediscount rate from 200% a year to 20%.

But this newfound ray of hope was threatening to some, and on 21-22 January, a coup d'état ensued. While the Mahuad government was toppled, the coup was bungled. Gustavo Noboa, a former vice president, assumed the presidency and honoured Mahuad's dollarisation pledge. Congress passed the so-called Ley Trolebus, containing the dollarisation provisions, which became law on 13 March. Ecuador became the world's most populous dollarised country on 13 September.

The critics of dollarisation condemned it as something akin to voodoo economics, but have been proven wrong. The so-called misery index shows how well dollarisation has worked. The index is equal to the sum of the inflation rate (end of year), banks' lending interest rates and unemployment rate, minus the actual percentage change in GDP per capita. A high index means higher misery.

In pre-2000 Ecuador the country sustained a misery index of over 120. After dollarisation, high inflation was stifled and misery drastically fell (see Chart 4). From 2003 to 2014, the misery index in Ecuador has been remarkably constant at around 20 – one of the lowest in Latin America. Dollarisation has allowed Ecuadorians to import a vital element of the rule of law – one that protects them from the grabbing hand of the state. That's why recent polling results show that 85% of the population embrace dollarisation. It's time for Venezuelans to take note and follow suit. ■

Steve Hanke is professor of Applied Economics at Johns Hopkins University.

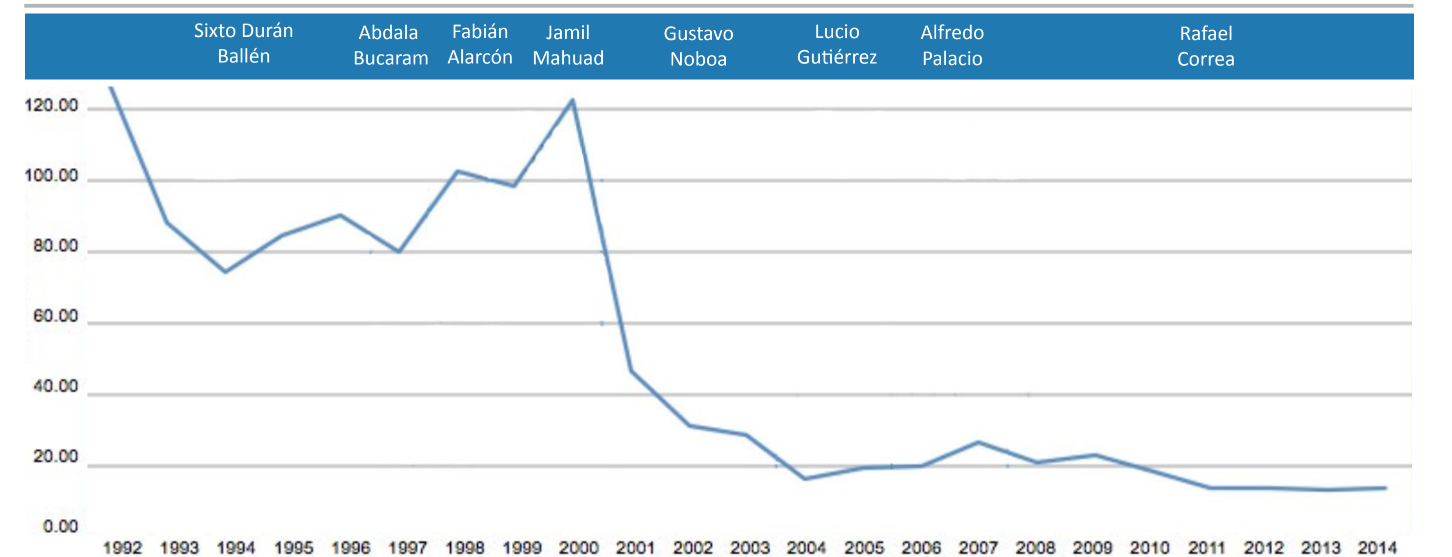
Chart 3: Inflation soars to 335%

Venezuela's annual inflation rates, 2013-15

Annual inflation rate. Source: Banco Central de Venezuela, Dollar.nu, Dolar Paralelo, International Monetary Fund, Paralelo Venezuela, and calculations by Prof. Steve Hanke, The Johns Hopkins University.
Note: These annual inflation rates are implied from the black market bolívar/$ exchange rate. When the annual implied inflation rate drops below 25%, the estimate is unreliable.

Chart 4: Ecuador cheers up

Ecuadorian 'misery index' under successive presidents, 1992-2014



Source: World Bank, International Monetary Fund, and calculations by Prof. Steve Hanke, The Johns Hopkins University.
Note: Misery Index = Inflation Rate (End of Year) + Bank's Lending Interest Rates + Unemployment Rate - Actual % Change in GDP per capita.

Challenge to west from Russian revanche

Great effort required to overcome cold war fault lines

Michael Stürmer, Advisory Board

Russia sees the annexation of Crimea and its aftermath as a turning point from weakness to strength, and from a US-led world system to a new competition for global power. The stark message portrayed by President Vladimir Putin and his supporters is that the world will either move to a new form of order, in which the US role is downgraded, or there will be no order.

The challenge will not soon go away. It will force western countries into a new mode of realpolitik, a sizeable strengthening of their defences both military and non-military, and a return to policies of containment inaugurated after the second world war.

Putin is playing a long game. We are witnessing not just a brief moment of discomfort but a long and strenuous contest between the transatlantic way of life and the Russian claim to set the rules. Future policy will be guided by three questions: how we reached the present troubled state of affairs, what is at stake, and where we go from here.

Soviet disintegration

The disintegration of the Soviet Union sheds light on the tensions in Ukraine. The unravelling started with the Baltic states which, after 50 years of occupation, declared independence. Then on the last day of 1991, all the constituent parts of the Soviet Union declared independence, notwithstanding their political, financial and economic links to what had been the Russian centre of power.

The most important standard bearer in this exodus was Ukraine. Once the Soviet Union was gone, the Warsaw Pact followed. The more than 15,000 nuclear warheads of the Soviet arsenal became the chief object of concern for the west and especially Washington.

Hundreds were deployed in Ukraine. Nuclear arms control continued, up to a point. It took on a new, co-operative aspect with the Nunn-Lugar amendment for joint nuclear deactivation and the Budapest protocol. This guaranteed Ukraine's territorial integrity in return for giving up every nuclear warhead stationed within its borders – with the exception of the Russian-leased, Ukrainian-owned port of Sevastopol.

A lasting settlement on the new map of eastern Europe seemed underway. The west proceeded with the eastern enlargement of Nato while Russia reminded western politicians that during the 'Two plus Four' diplomatic negotiations on German unity they had been given to understand that in the foreseeable future the new status quo would not be challenged. Not an inch – as the then US Secretary of State James Baker had allegedly assured his Soviet counterpart – would change hands and loyalty.

Despite serious differences, Moscow accepted the eastward movement of Nato and was compensated through the Nato-Russia Founding Act. While the Russians had assumed that they would have a right of inspection over Nato policy, something akin to a veto, the view in Brussels was different. When communication was most needed over Kosovo and Nato's war against Serbia in 1999, the telephones fell silent.

Since then, as the oil price recovered throughout the 1990s, Russia regained negotiating power. In 2007, Putin, in no uncertain terms, gave notice at the Munich Security Conference that the time of weakness was over and that the west should recognise that Russia had serious grievances. One year later, after Georgia's ill-judged excursion into disputed territory, Russia annexed South Ossetia and Abchasia.

While the west celebrated the outbreak of democracy in Georgia and Ukraine, the Kremlin resented the political upheaval escalating in 2013 on Kiev's main square, the Maidan. In a preemptive action, Russia annexed the Crimea peninsula. Even worse than this breach of international law was the violation of the 1994 Budapest Protocol and the challenge to accepted standards of behaviour. Putin's breaches extended all the way from unhinging military confidence and security-building measures to flouting well-established rules of civil aviation.

Ukraine has the potential to split the western alliance. German Chancellor Angela Merkel has ruled out any military solution. In contrast, the US concept of low-level arms supply and deployment of military-technical advisors amounts to war by proxy. It could escalate into more substantial military engagement, strategic misunderstanding and, ultimately, the threat of nuclear war.

For the time being the fighting over Lugansk and Donetsk conforms to the Russian doctrine of hybrid or non-linear war. This is a war that Russia cannot lose and Ukraine cannot win.

The future of the rebel regions in the Donbass remains an open question. If they return under the jurisdiction of Kiev they will forever be a thorn in the side of Ukraine, a fifth column, incapacitating any authority in Kiev.

But if these regions are not returned to Ukraine, this sets an ominous precedent and confirms Russia's claim that the Kremlin is the overlord of any former Soviet dominion. The only chance to pacify these war-torn regions seems to be to give them a statute of limited autonomy inside Ukraine, generous help in reconstruction from the EU as well as Russia, plus an equitable settlement on energy supply.

Overcoming fault lines

The EU's chosen counter-measures are economic and financial sanctions against the stalwarts of Putin's regime. While these measures are hurting Russia's economy, they have failed to curb its policies. The track of escalation – military and strategic by Russia, economic and financial by the west – is bound to end in huge losses to both sides.

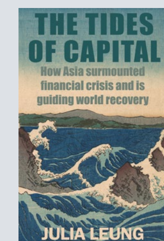
Better use should be made of formats and institutions that have proven their usefulness in overcoming the fault lines of the cold war, such as the Helsinki Process or the Organisation for Security and Co-operation in Europe.

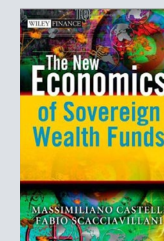
Conventional arms control is in urgent need of repair; so is nuclear arms control in the face of proliferators old and new. The Nato-Russia Founding Act is still on the statute books and can be revived and put to good use.

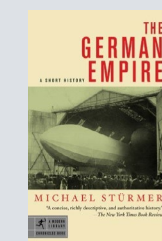
Displays of military prowess should be reduced to a symbolic minimum. Political grandstanding should be suspended for the duration of the stand-off. Self-restraint and face-saving should once again be part of the diplomatic toolbox. To find common ground, both sides will need to find a sense of history and to show mutual respect. Both sides will need back channels, commercial, cultural and diplomatic.

The present stand-off resembles the crises over Berlin and Cuba half a century ago. When the nuclear superpowers went to the brink, they saw in front of them the ashes of their own destruction, and crafted a new balance of power, embodying arms control and self-restraint. The stakes now are as high as ever. A new order may be found, at best a rough balance, at worst a mix of confrontation and co-operation. ■

Michael Stürmer, a member of the Advisory Board, is a historian and author of Putin and the Rise of Russia.







UK social safety net full of holes

Myth of scroungers has led to damaging welfare reductions

William Keegan, Advisory Board

It was US Secretary of State and political scientist Henry Kissinger who, when asked why academic disputes were so fierce, liked to say 'Because the stakes are so low.'

I could not help calling this to mind when reading *Good Times, Bad Times: The Welfare Myth of THEM and US*, a fascinating work by John Hills, professor of Social Policy at the London School of Economics and Politics. If ever there was a need to counteract popular myths with serious research it is in the field of 'welfare'.

Conservative cuts

Urged on by the Daily Mail and the Murdoch press, and encouraged by occasional one-sided television 'exposés' of supposed 'benefit scroungers', the re-elected Conservative government has made an attack on 'welfare spending' into a major feature of its policies for the next five years.

Yet, as Prof. Hills explains in this meticulously researched study, the actual financial stakes are low, and blown out of all proportion by propagandists. This said, the political stakes are much higher.

By making a mountain out of a molehill, the Conservative party in Britain has demonstrably secured huge dividends. It frightened supporters of former Labour leader Ed Miliband into backing mean-minded plans for reducing social security benefits, which are low by European standards, even further.

The 'them' in the title of this book are the putative 'welfare scroungers' and people who would allegedly rather live off the taxpayer than take up paid work.

The 'us' are the rest of the population of the United (or, these days, not so united) Kingdom. What Prof. Hills explains so vividly is that the welfare state is very important to 'us', the majority of the population, over the course of what he calls our 'life cycles' and that a veritable minimum of welfare spending actually goes to the recipients of social 'benefits' who are so vilified in the tabloids.

Smoothing income variation

The origins of the welfare state go back to Otto von Bismarck, the 'Iron Chancellor' who unified Germany in the 19th century and established national healthcare (1883), accident insurance (1884) and old age pensions (1889). The trend continued in Britain under Lloyd George's Liberal government, which introduced free medical care, sick pay, pensions, labour exchanges and free school meals before the first world war.

A fundamental concept of the welfare state is, as Hills states, that 'The incomes people get from the "market" – mainly from earnings – vary greatly across their life cycles. The living standards they can afford from market incomes vary even more, after allowing for periods when they have larger families.'

He sees one of the main functions of the welfare state as to smooth out some of these variations. In fact, allowing for important services like healthcare and education as well as benefits such as pensions, the *large majority* of what the welfare state does is 'life cycle smoothing'.

This is because it is dominated by universal entitlements (pensions, education and healthcare), not by stigmatised 'welfare benefits' for the poor.

Myth and misinformation

Pensions actually dominate the costs of social security. Benefits for the unemployed – most of whom are genuinely unemployed – account for less than 4% of the British social security and tax credit payments.

But myths are strong. Hills notes that 'This is a tenth of the proportion most people think goes to unemployed people'. Moreover 'Just 0.7% of all benefits was overpaid as a result of fraud'.

Prof. Hills rounds up his argument by concluding that: 'Many more people benefit from the operation of the welfare state than are affected by narrowly selected parts of it at any one time.' Indeed, there is no 'them and us', just 'us'.

The tragic thing is that in the UK, the combination of the government's obsession with 'cutting the deficit' and the myth about the true cost of welfare for the poorest had led to a situation where the most vulnerable in society are subject to the bulk of the cuts.

As Hills says: 'What was once a national safety net, albeit not a very generous one, now has substantial holes in it.' ■

William Keegan is Senior Economics Commentator at the Observer.

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