June 2016
Vol. 7 Ed. 6

The Bulletin

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

Storm-tossed currencies
Steering through volatility

Claudio Borio on dollar dominance
Mojmír Hampl on activist central bankers
George Hoguet on Fed political pressures
Ravi Menon on Beijing's debt vulnerabilities
Gary Smith & John Nugée on reserves growth

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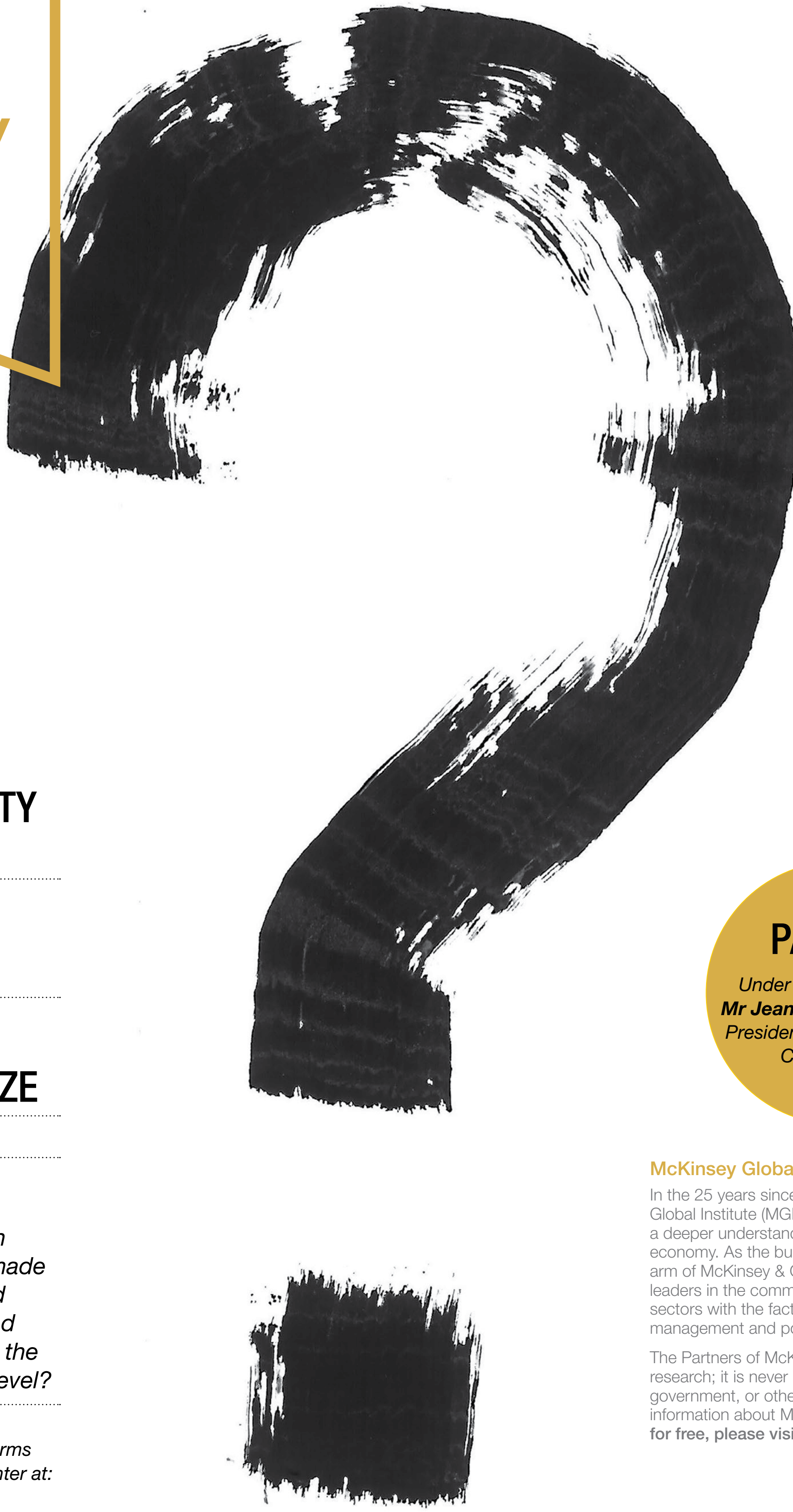

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The Official Monetary and Financial Institutions Forum is an independent platform for dialogue and research. It serves as a non-lobbying network for worldwide public-private sector interaction in finance and economics. Members are private and public sector institutions globally. The aim is to promote exchanges of information and best practice in an atmosphere of mutual trust. OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries.

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EDITORIAL

Volatile currencies, storm-tossed waters

Each of the world's major trading and transaction currencies – the dollar, euro, sterling, yen and now the renminbi – is beset by policy uncertainty and doubt. Volatile currency cargoes are heading towards cloudy horizons on storm-tossed seas. The Federal Reserve is on the horns of a familiar dilemma about when to carry out only the second interest rate rise since 2006. Concern about Britain voting to leave the European Union on 23 June is just one of the anxieties staying the Fed's hand ahead of its monetary policy meeting on 14-15 June.

Japan and Europe are weighed down by debt worries. It seems increasingly likely that Haruhiko Kuroda and Mario Draghi, the respective central bank chiefs, will complete their spells in office (in 2018 and 2019) without tightening credit. China is sticking to its contention that its economy will avoid a 'hard landing' and the renminbi will remain reasonably strong on a complex trade-weighted basis combining indices from the CFETS foreign exchange system, the Bank for International Settlements and the International Monetary Fund.

Given nervousness about world economic health, asset managers are adopting caution as their watchword. Central banks, despite the undoubted costs of maintaining high reserves, believe it is even more costly and unpleasant not to have adequate stocks when times are tough. Demand for, and competition between, reserve currencies will persist. These themes are covered by Gary Smith and John Nugée, two long-standing sovereign asset specialists, in an OMFIF paper on this subject. And they were high on the agenda at a seminar 'Towards a system of multiple reserve currencies', organised by the IMF and the Swiss National Bank in Zurich on 10 May. We reproduce some of the introductory thoughts on the challenge to dollar 'dominance' spelled out to the meeting by Claudio Borio of the BIS.

On US monetary policy, Darrell Delamaide and George Hoguet weigh up the pressures on the Fed. Ravi Menon of the Monetary Authority of Singapore, Martin Taylor of the Bank of England, James Bullard of the Federal Reserve Bank of St. Louis and Andrea Enria of the European Banking Authority – who along with Chicago Fed chief Charles Evans all spoke to OMFIF audiences in the past month – expound their views.

Peter Warburton explores the tangled links between ECB policy and European inflation expectations. Mojmír Hampl of the Czech National Bank writes in defence of 'active central bankers'. Frédéric Samama delivers a further instalment of how a decarbonisation drive among asset managers can support government climate change policies. Backing Ravi Menon's line that fears of a China 'hard landing' are overdone, Juan Carlos Martinez provides some historical parallels to China's One Belt One Road initiative. Kingsley Chiedu Moghalu urges African policy-makers to shake off the shackles of economic orthodoxy. Eduardo Borensztein explains how Brazil must replace its broken economic model.

This month yields a bumper crop of book reviews, linked to febrile European politics. William Keegan gives a bittersweet verdict on Gerard Lyons' book, *The UK Referendum: An Easy Guide to Leaving the EU*, while David Marsh lends a sympathetic ear to *Let's Stay Together: Why Yes to Europe* by Denis MacShane. Alex Saeedy reviews *The Euro Trap* by arch-critic Hans-Werner Sinn, while Meghnad Desai is disappointed by Tom Bower's *Broken Vows: Tony Blair – The Tragedy of Power*. We end on a positive note: 83% of respondents in the May advisory board poll say rising US interest rates are unlikely to pose a substantial threat to the world economy by the end of 2016. We must hope they are right.

Reserves and safety nets

Towards a further rise in global foreign exchange

Gary Smith and John Nugée, Advisory Board

After almost 15 years of unremitting growth to mid-2014, foreign exchange reserves totals have declined, in some countries rather rapidly. China's foreign exchange reserves, after peaking at around \$4tn in mid-2014, have fallen to \$3.2tn, a 20% decline. Global reserves, as measured by the International Monetary Fund, have fallen from around \$12tn to just under \$11tn over the same period.

Some commentators have extrapolated a forecast of a continual decline in official foreign exchange holdings of the emerging market economies that dominate global reserves holdings. But these forecasts are unlikely to be correct in our view. There has not been much change in the underlying economics of emerging markets, and in the strategies adopted to meet their challenges.

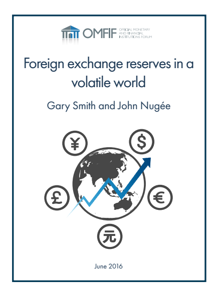
Trends are still firmly in place that provide longer-term structural support for growing foreign exchange reserves. The global reserves surge in the 15 years to 2014 is unlikely to go into full reverse.

Reserves have become too important to be run down rapidly, as this would risk compromising a range of objectives. Holding reserves can be costly, but the benefits should not be underestimated.

China illustrates some important lessons. In little more than a year the country went from having a 'very big problem' with the burgeoning size of its reserves (to quote Li Keqiang, China's premier, in May 2014), to speculation (for example in September 2015) that its reserves levels were inadequate. The absolute level of reserves is now less important as an indicator of the health of a central bank and underlying economy than their rate of change. Rapid use of reserves is likely to be perceived as a sign of weakness. This is a key problem for central bankers as they seek to defend their accumulation strategy.

For many countries, the definition of excess reserves is constantly changing and may prove elusive. The natural bias of central bankers and finance ministers for 'more not less' has probably not ended. Politicians cling to the sentiment that reserves are a national safety net, so a sustained decline would be unpalatable for many nations.

Two trends appear inescapable. Developing economies will, over time, continue to take a growing share of global GDP. And emerging nations will continue to have more foreign exchange reserves per unit of GDP than developed countries. As the global financial system expands much more quickly than world output, central banks may feel the need to bolster their reserves faster than global economic growth. ■



Gary Smith is Head of Sovereign Wealth Funds and Official Institutions at Barings Asset Management. John Nugée is a Director of OMFIF. This is an edited extract from the authors' OMFIF paper, '[Foreign exchange reserves in a volatile world](omfif.org)', published on 14 June.

Advisory Board

OMFIF has appointed Karl Kaiser to the Advisory Board. For the full list of members, please **see p.20-21.**

Karl Kaiser is adjunct professor of public policy at the Harvard Kennedy School and senior associate in transatlantic relations of the Weatherhead Center for International Affairs. He was a director of the German Council on Foreign Relations, Bonn/Berlin and an adviser to chancellors Willy Brandt and Helmut Schmidt. He serves on the Board of Asia-Pacific Review, Internationale Politik, Russia in Global Affairs, the Advisory Board of the American-Jewish Committee, Berlin, and the Board of the Centre for International Security and Governance, Bonn. He holds a Ph.D. from Cologne University.

Tighter jobs market 'pushing rates hike'

A tightening labour market, abating international economic tensions and gradually increasing inflation make a rise in US interest rates more likely, James Bullard, president of the Federal Reserve Bank of St Louis, told OMFIF audiences in Beijing on 23 May and Singapore on 26 May.

Bullard, who this year holds a voting position on the rate-setting Federal Open Market Committee, has taken a somewhat more hawkish position on interest rates than some of his peers in recent months. In his Asian speeches – where he was speaking at the Dalian Commodity Exchange in Beijing and the DBS Auditorium in Singapore – Bullard made clear he was giving precedence to tightening in the labour market in recent months over the still relatively lukewarm picture of higher inflation moving slowly towards the Fed's 2% target.

Bullard was speaking before financial markets reacted badly to 3 June US jobs data showing hiring slowed sharply in May, a signal that will probably dissuade the Fed from raising rates in June. Referring to the minutes of the Fed's latest policy meeting in April, Bullard said on 26 May, 'I think they read the minutes correctly.' Global investors had earlier assumed the Fed was in no rush to raise interest rates. But they were taken aback by the April minutes, which suggested most policy-makers felt the US economy could be ready for another rate increase in June. Ahead of the May jobs figures opinion had been moving to expect a rate rise when the FOMC next meets on 14-15 June. *See Darrell Delamaide on p.13.*

Challenges and opportunities for China

China is encountering challenges and opportunities in its transition to slower growth and a shift from an investment- and export-led economy to one based on services. These were the main themes of an OMFIF discussion with Ravi Menon, managing director of the Monetary Authority of Singapore, in London on 5 May.

China faces vulnerabilities in its economy and financial system, Menon said. The chief risk is leverage — both its level and its growth. According to the Bank for International Settlements, China's credit to GDP ratio stands at around 250%, having risen by 100 percentage points since end-2008. Nearly 70% of that increase is attributable to corporate debt.

Menon termed the road to addressing China's debt vulnerabilities as 'long and fraught with risks'. But if recent efforts are sustained and economic growth does not slow dramatically, the MAS chief said prospects are good for an orderly and gradual deleveraging. China has taken the important step of liberalising interest rates. But it needs to develop deeper and broader capital markets. This will help better price risk capital and ensure that financing flows to more productive economic activities. Menon added, 'China has proceeded with capital account liberalisation in a careful and systematic way. But opening up the capital account amid a slowing economy, a still developing domestic financial system, and a debt overhang, is no easy task.' *For a fuller account of Ravi Menon's speech, see p.16.*

Enria calls for regulation transparency

A strong call for more transparency in banks' financial reporting as well as in regulatory and resolution decision-making was made at an OMFIF lecture in London on 4 May by Andrea Enria, chair of the European Banking Authority, stating that 'opaqueness is a powerful crisis accelerator'.

Enria pointed out the traditional view on the disclosure of supervisory decisions is that this may generate instability and possibly lead to a bank run. The disclosure of sensitive information concerning supervisory assessments – such as, for instance, additional capital requirements under Pillar 2 – may indeed trigger self-fulfilling processes. However, he said, his experience at the EBA had made him aware of the drawbacks of insufficient transparency. 'If market participants are unable to compare and contrast the situation of banks vis-à-vis a specific risk, they are naturally inclined to think the worst of each and every bank. The market grinds to a halt.'

If authorities act in an unpredictable way, for instance by taking different courses of action in apparently similar cases or by concealing the information that formed the basis of their decisions, volatility was likely to increase, with the risk of destabilisation. He underlined how the EBA is focusing efforts on increasing the quantity and quality of bank disclosures. *For a fuller account of Andrea Enria's speech, see p.14.*

Briefings

Economic representatives reject Anglosphere notion

Participants at a meeting between OMFIF and the Association of Economic Representatives in London on 17 May reacted with scepticism to claims that Britain outside the European Union could form a new Anglocentric trade alliance with Australia, Canada, New Zealand and the US. The meeting discussed different post-referendum options, but concluded that reconstructing the 'Anglosphere' for economics and investment was unlikely.

World Bank's Levy seeks private sector co-investors

Joaquim Levy, the World Bank Group's managing director and chief financial officer, told an OMFIF briefing in London on 25 May that the group wanted to bring in more private investors to co-invest with its various arms to help reach its development goals more quickly. He described this as a 'huge agenda' for the group, particularly to improve funding for infrastructure.

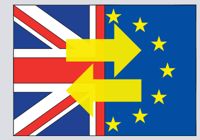
European Commission director foresees turbulence

Olivier Guersent, the European Commission's director-general for financial stability, financial services and capital markets union, told an OMFIF briefing in London on 31 May that declining reserves in emerging markets meant another period of market turbulence was likely.

The need for further strengthening of Europe's banking sector is more pressing than ever and development of insolvency laws would be critical to help spur cross-border investments.

Referendum meetings

Referendum debate



An OMFIF Westminster EU debate agreed Britain should stay in. But in electronic voting the 200-strong audience shifted towards 'Brexiteers' Gerard Lyons and John Redwood arguing for UK control over European policies against Remain backers Andrew Adonis and Vicky Pryce.
1 June, London

Lunch discussion with Lord Lamont

Lord (Norman) Lamont, the former UK chancellor of the exchequer and pro-Brexit campaigner, told an OMFIF lunch meeting that Prime Minister David Cameron would face turbulence after the referendum but would have a good chance of staying in office.
8 June, London

Discussion with German family companies

David Marsh, OMFIF managing director, told German family companies that Britain on balance was likely to vote to stay inside the European Union, but the neck-and-neck finish would be disruptive to UK politics.
11 June, Berlin

Catalonia's future and UK EU referendum

The different options facing Spain and Catalonia following the British referendum on 23 June on membership of the European Union were discussed on 13 May at a meeting in London between Carles Puidgemont, the Catalonian government chief, and OMFIF members.

Catalonia has made an active case for full-scale independence from Spain, but the overall sentiment at the meeting was that some form of compromise might be possible, partly hinging on the outcome of the rerun of the Spanish general election on 26 June, where Prime Minister Mariano Rajoy is bidding to hold on to power, possibly with a new governing coalition.

Puidgemont, a former journalist who has been head of the Generalitat of Catalonia since January, made clear that the British plebiscite could play a major role in the Catalonian imbroglio. However, the Madrid government was unlikely to show its hand for the moment.

Achieving banking sector resilience

The UK's settlement on bank capital is aimed at correcting banks' chronic undercapitalisation at the time of the financial crisis and achieving resilience without unreasonable costs, Martin Taylor, external member of the Bank of England's Financial Policy Committee, told an OMFIF City lecture on 25 May in London.

Taylor said periods of anaemia among banks can cause damage to the economy as a whole just as surely, if less dramatically, than periods of mania. His lecture centred on two kinds of difficulties facing banks at the moment: the struggle for financial returns, and the structural problems banks face in rebuilding a relationship of trust with their customers.

When pressed to find a title for the talk, Taylor said he came up with, 'Banking in the tundra' because 'it's quite cold out there, the landscape is very flat, and trees do not even pretend to grow to the sky. Luckily the bankers are wrapped up warm, in highly resilient anoraks with contingent-convertible hoods, but the huskies have not been fed for a while, and are getting tired and rebellious.' *For a fuller account of Martin Taylor's speech, see p.14.*

Quest for global 'rules of the game'

Recipes for policy coordination on booms and busts

Claudio Borio, Bank for International Settlements

The dollar's dominance in the international monetary and financial system is indisputable, even though it not quite a monopoly. Its role has not declined much over the past decade or so, despite the waning US share of world output, which is now down to only one quarter.

The dollar's gravitational pull, in turn, has a deep influence on the denomination of countries' assets and liabilities and, hence, also on foreign exchange reserve composition, as it determines a portfolio's sensitivity to exchange rate fluctuations.

There is a clear positive relationship across countries between these shares and the degree to which currencies co-move with the dollar. The dollar is involved in around 90% of all foreign exchange transactions and accounts for some 60% of official reserves as well as debts and assets outside the US.

It has a similar weight as a gravitational force for other currencies, and only a slightly smaller one as the currency of choice in the denomination of trade. The euro is a distant second, with weights ranging between one fifth and one third, and has a more regional character (see Chart 1).

This dominant role, coupled with the depth and breadth of US financial markets, underpins the well-documented asymmetric influence of US monetary and financial conditions on the rest of the world. US asset prices, such as bond yields, tend to lead those in other economies. Furthermore, US monetary policy tends to have an influence on monetary policy elsewhere, over and above domestic conditions.

Two related concerns

One currency's international dominance gives rise to two related concerns. The first is that the 'asymmetries' involved may exacerbate the tension between the interests of the dominant country, on the one hand, and those of the system as a whole, on the other. That is, the country appears to project its influence on the rest of the world, which cannot in any sense insulate itself.

The other, more central, problem could be called the Achilles heel of the international monetary and financial system: it does not have an effective anchor for monetary and financial stability. The system is thus unable to prevent the build-up and unwinding of hugely damaging financial imbalances through outsize financial cycles – circumstances reflecting what has been called excess financial 'elasticity'.

More pluralism does not seem the answer to the main problem. True, it may impose greater discipline on the dominant country. Greater choice must surely help. But more pluralism, per se, does not address the absence of a global anchor.

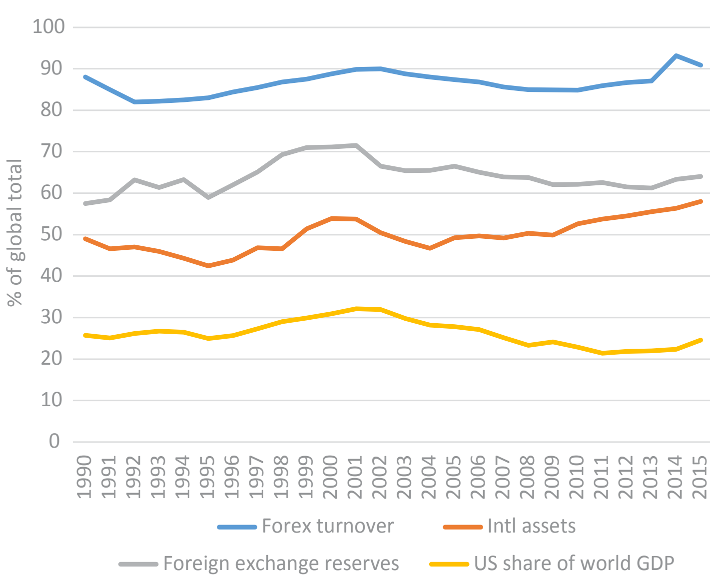
Take the IMF's special drawing right as an example. Even if the SDR was placed at the system's centre, what would anchor the SDR? Short of creating a supranational central bank that operated in SDR, this would require an explicit link to national monetary policies; otherwise, the SDR would simply remain an additional instrument with but a limited impact on global financial conditions, at least in tranquil times.

> ***"The dollar's dominant role, and the breadth and depth of US financial markets, underpin the asymmetric influence of US financial conditions on the rest of the world.***

We should note, for instance, that the European currency unit acted as a common reference for exchange rate adjustments in the European Monetary System, the forerunner of economic and monetary union, although even then the system was far from symmetrical, with the D-mark playing the main anchor role.

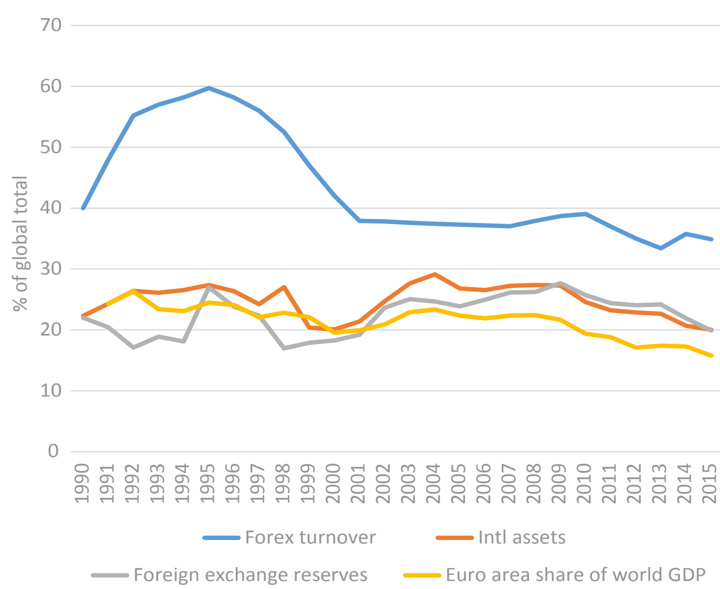
Chart 1: US currency remains dominant in international transactions

Dollar's share of world trade and transactions, 1990-2015



Source: BIS

Euro's share of world trade and transactions, 1990-2015



Source: BIS

Solutions to the possible destabilising effects of the present international constellation need to focus less on addressing current account imbalances and more on financial imbalances. That is, they need to focus more on gross capital flows (and the corresponding stocks) than on net flows (see Chart 2). In any case, gross capital flows dwarf current account balances.

Net flows are the tip of the iceberg. A focus on current accounts could be counterproductive. In particular, one should beware of recommending expansion in surplus countries exhibiting signs of financial imbalances. This is what happened in Japan in the late 1980s, contributing to the subsequent crisis. More recently, the international community encouraged China's post-2008 credit-fuelled expansion – an expansion that lies at the heart of some of the debt challenges the country is now facing.

As these examples indicate, strong credit booms, including some of the most disruptive ones, have also occurred in current account surplus countries. Further back in history, the experience of the US ahead of the great depression is a famous example.

One further element of a solution is the requirement for stronger anchors for domestic regimes and their interaction. There is scope to improve international crisis management arrangements. But an ounce of prevention is worth a pound of cure. And, while putting one's house in order is essential, it is not enough; there's a need to put the global village in order.

Domestically, this means more systematic tackling of financial booms and busts through monetary, prudential and fiscal policies, strongly supported by structural policies.

The key is to have policies that are more symmetrical over booms and busts, mitigating these extremes without the risk of running out of policy room for manoeuvre. This means better internalising the possible international repercussions of national policies (including those reverberating back to the originating country).

> ***"The key is to have policies that are more symmetrical over booms and busts, mitigating these extremes without the risk of running out of room for policy manoeuvre.***

The international community could envisage three possible sets of action for a more stable international system, ranked on a scale of increasing ambition.

At a minimum, enlightened self-interest, based on a thorough exchange of information, should be feasible. This would mean that, when setting domestic policies, countries would individually seek to take international repercussions more systematically into account. Large jurisdictions that are home to international currencies have a special responsibility. Going one step further, co-operation could extend to occasional joint decisions, on both interest rates and foreign exchange intervention, beyond the well-honed responses seen during crises. The third, most ambitious possibility would be to develop and implement new global rules of the game that would help instil greater discipline in national policies.

Monetary regimes

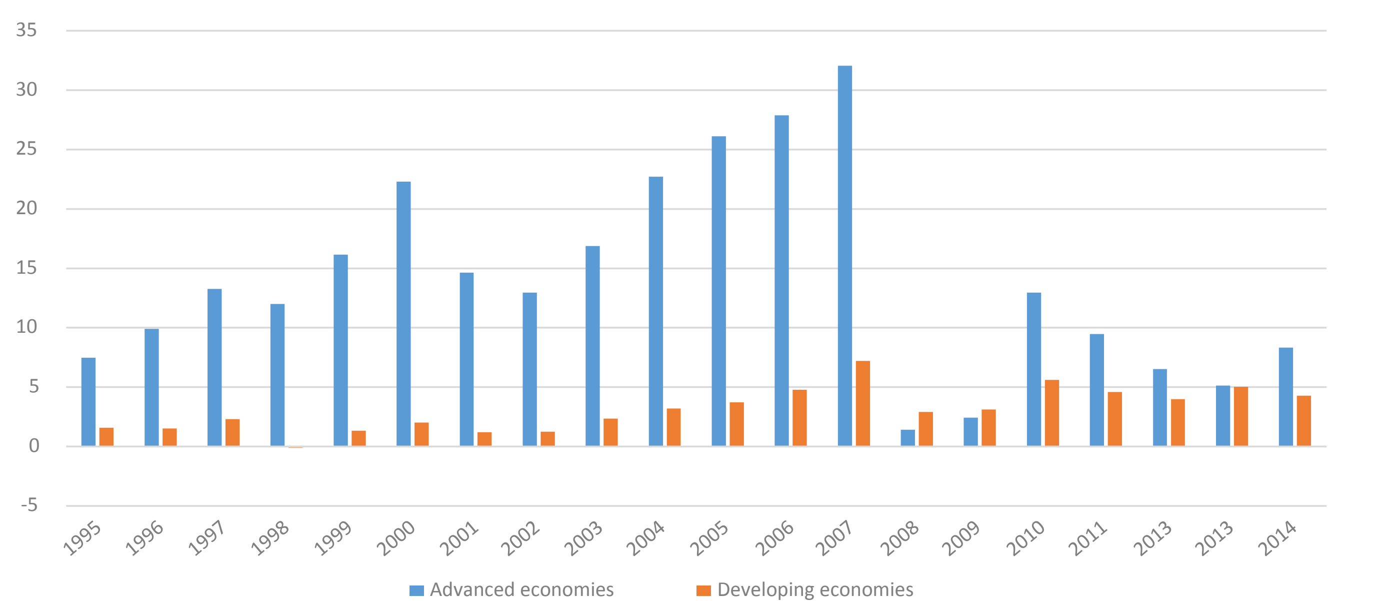
Based on this analysis, the international community is still a long way from finding adequate solutions. Progress has been substantial in the prudential domain. But much more is needed regarding monetary regimes. Even at the national level, it is difficult to incorporate systematically financial stability considerations, which are generally left to prudential policy. These problems are compounded at the international level.

The preconditions for progress are consensus on diagnosis, which would put financial imbalances at the heart of the problem, as well as a strong sense of urgency and shared responsibility internationally. At present, neither precondition is met. ■

Claudio Borio is Head of the Monetary and Economic Department at the Bank for International Settlements. This is an abridged version of the author's introductory speech at the Swiss National Bank-IMF conference 'Towards a system of multiple reserve currencies' in Zurich on 10 May.

Chart 2: Gross capital flows dwarf current account balances

Comparison of advanced and developing economies, % of global GDP, 1995-2014



Source: BIS

ECB riddle on inflation expectations

Misplaced emphasis on five-year, five-year swap rate

Peter Warburton, Economic Perspectives

Over the past two years, a seemingly innocuous difference in terminology has assumed great significance in the conduct of monetary policy. Whereas the US Federal Reserve is careful to describe forward inflation rates derived from the interest rate swap curve or from Treasury inflation-protected bonds as 'inflation compensation', the European Central Bank has opted for the stronger term 'inflation expectations'.

This subtle distinction can be summarised as follows. 'Inflation compensation' refers to the pay-off from selling inflation protection or the cost of buying inflation protection. The accompanying narrative is bland and non-committal: the market is pricing an unknown outcome relating to future inflation expressed as a specific consumer price index.

Deeper meaning

'Inflation expectations', by contrast, has a deeper meaning. It infers the market has formed a collective view of the central expectation of inflation over a specific time horizon, taking account of all known information. This definition carries connotations of statistical efficiency. It is a small step from here to the elevation of the inflation swap or break-even rate, to the status of an independent barometer of central bank performance. The result is a riddle over the ECB's chosen benchmarks.

Under Mario Draghi's leadership, the ECB appears to have fallen victim to this illusion. In numerous speeches and policy statements, the five-year, five-year inflation swap has been described as a market inflation expectation. When this swap rate plunged in 2014 as the latest instalment of the Greek crisis unfolded, the ECB invited the interpretation that the financial markets were losing confidence in its ability to achieve its declared objective of inflation 'below, but close to 2%'. In other words, the weakening of this market indicator represented a call to action. By implication, to have ignored such a clear market signal would have brought risks for the ECB's credibility. The central bank did not disappoint, launching its quantitative easing programme in January 2015.

The ECB's strong interpretation of the five-year, five-year forward swap rate (see Chart) ensured a repeat performance in early 2016. Indeed, this measure of future inflation dipped beneath its previous lows, and despite an initial rally after the eventful 10 March meeting has headed lower once again. The problem is that the policy actions open to the ECB – interest rate cuts, long-term repos and augmented QE – appear to have little traction with its policy objective. ECB council members questioned the wisdom of extending QE for this very reason.

> ***"The underlying problem is that the policy actions open to the ECB – interest rate cuts, long-term repos and augmented QE – appear to have little traction with its policy objective.***

Meanwhile, the ECB's inflation forecasting has been woeful. In March and June last year, it projected a rebound to 1.5% inflation for 2016. In March, this forecast was reduced to 0.1% in recognition of oil price weakness. The ECB is in danger of appearing impotent in the face of these inflation setbacks.

A misplaced emphasis on the inflation swap rate as a representation of medium-term inflation expectations is all the more remarkable in view of the good work the ECB staff carried out as early as 2007. In 'Working Paper 734', the authors concluded that 'the break-even inflation rate is a noisy measure of expected inflation, because it can include an inflation risk premium component.' Moreover, 'our results suggest that fluctuations in the raw break-even rate have mostly reflected variations in the inflation risk premium, while long-term inflation expectations have remained remarkably anchored since 1999'.

Comprehensive valuation

In 2015, Bank of England researchers comprehensively evaluated the informational content of market-based measures of inflation expectations. The authors found that liquidity premia in gilt break-even inflation rates explained a large part of the total risk premium during certain periods, especially in the post-2008 crisis period. 'The results suggest that the negative sign of the risk premium in break-even inflation rates during these periods was, to a large extent, the result of negative liquidity premia, which we conclude were driven by bouts of illiquidity in the market for index-linked gilts.'

Many commentators have highlighted the extraordinarily strong direct correlation between inflation break-evens, or inflation swap rates, and the crude oil price during the past two years. It is important to note that this correlation is relatively recent and used to be entirely absent. This is a correlation that has its roots in financial risk management, not economics.

Research by Economic Perspectives confirms that oil prices from five to 10 years ago have no explanatory power for today's inflation rate. The monetary and real forces that will determine CPI inflation rates in five years have themselves not yet been settled.

The ECB has allowed itself to be chastised by a noisy market indicator with threadbare credentials as a predictor of inflation. Either the ECB must change its inflation language or it will need to change its inflation target to rescue a semblance of credibility. People have expectations. Markets have only prices. ■

Sharp decline in ECB inflation swap rate

Five-year, five-year swap rate, %, Dec 2012-Apr 2016

Source: Thomson Reuters Datastream

Peter Warburton is Chief Economist at Economic Perspectives.

In defence of active central bankers

Why the critics are fashionable but wrong

Mojmír Hampl, Czech National Bank

Sweeping criticisms of central banks have become fashionable. The main line of attack goes something like this: central banks have been too activist since 2008, and their actions are harmful to the economy. This narrative is equally popular among libertarians and neo-Marxists, otherwise irreconcilable adversaries.

The critics fail to understand monetary policy and the modern monetary system. Central banks strive to maintain long-term price stability. It's a bit like a doctor trying to keep a patient's body temperature at the ideal level – not too hot and not too cold, since either extreme can cause serious complications or even death.

Central bankers are just as 'activist', regardless of whether they are fighting inflation or deflation. Both scenarios imply price instability, albeit with opposite signs. And they can pose serious threats to the health of the economy.

The battle is symmetric, but the public assessment of it is bafflingly asymmetric, especially in countries with financially conservative populations.

This includes my home country, the Czech Republic, a nation of small savers where the loan to deposit ratio is still well below 100%. Czechs still fear inflation even though it hit a 13-year low last year, and the Czech National Bank has been mitigating the effects of deflation since 2013.

Monetary policy critics

Critics say monetary policy has redistributive effects, taking from one and giving to another. It certainly does, but that is true at all times and in all circumstances.

An interest rate hike pleases savers not borrowers, whereas a rate cut is welcomed by borrowers not savers. Importers prefer a strong exchange rate, exporters a weak one. Monetary policy actions always redistribute wealth.

To make any sense, monetary policy must have different impacts on different groups of people at different times. That is not a failure, but the definition of monetary policy.

> ***"Central banks are just as activist whether they are fighting inflation or deflation. Both scenarios imply price instability, albeit with opposite signs.***

These critics of excessive activism then repeatedly and illogically add that central banks are failing to hit their inflation targets anyway, so their efforts are futile and monetary policy is ineffective. Some even manage to say both these things at once.

The reality is different. Central banks in the developed world have succeeded in maintaining price stability and the purchasing power of money during and after the financial crisis. They have averted catastrophic deflation, severe asset price slumps and financial and economic meltdown. This is what would have happened otherwise.

In a system of elastic money with no intrinsic value, the quantity of money changes over time. It has to change if the purchasing power of money is to stay broadly constant over the cycle. Price stability, not the quantity of money, is what matters. Central banks' ballooning balance sheets are merely evidence of the sheer depth of the problems faced by many economies after 2008.

Central banks did so much to maintain purchasing power and price stability not because they were 'activist', but because they stuck more or less successfully to their permanent mandate.

If, by failing to act, central banks had not kept the purchasing power of money stable after 2008, consumers would spontaneously have sought substitutes for their home currencies (other currencies, precious metals or alternative forms of saving). Yet this rarely happened in the developed world.

Central banks below inflation targets

Central banks in many countries are undershooting their inflation targets (defined at around 2%). This is unpleasant, but not disastrous. Part of the decline in prices is due to cheap oil: a supply shock, not a demand shock. That supply shock has positive effects and poses no threat to price stability, at least in countries that are net importers of oil.

A comparison with the world of business shows whether central banks have been successful in meeting their objectives. Would you rate a firm as unsuccessful if its sales rose by just 1%, instead of the planned 2%, two years in a row? Hardly. You would probably say it was just a minor deviation.

The planned and actual profits and turnovers of private companies can easily differ by tens of percent. Such firms operate in a simpler environment with fewer variables than central banks.

Of course, central banks should try to achieve their objectives. And they should not allow inflation expectations to destabilise.

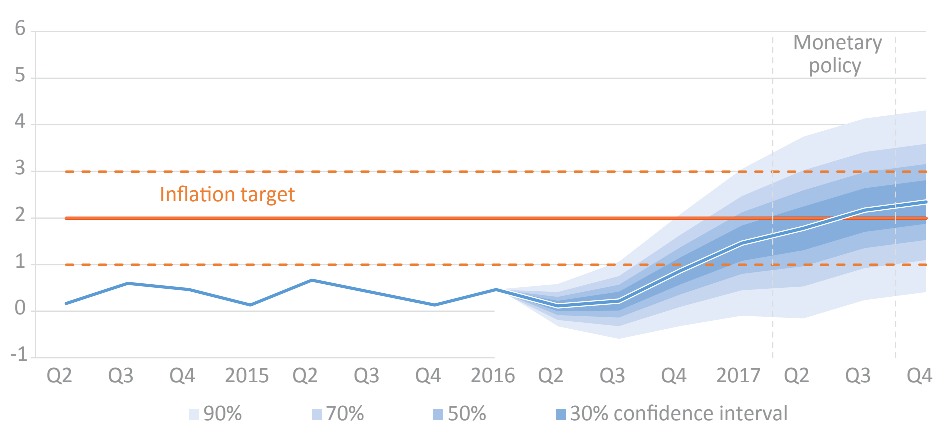
People just need to keep a sense of proportion when judging central banks. They should not say things that aren't true: for example, that the monetary policy arsenal is exhaustible and reaching its limit, as some commentators have again been claiming.

It is about time we said 'enough' to this ignorant criticism of central banks. Not one of our critics has explained clearly and credibly why price stability is a bad thing, what other key objectives central banks should pursue in the present monetary system, and what central banks should have done differently after 2008. ■

Mojmír Hampl is Deputy Governor of the Czech National Bank.

Czech Republic inflation forecast

Q1 2014-Q1 2017 Q4, %



Source: Czech National Bank

Mastering the political business cycle

Summer rate rise could be less controversial than later

George Hoguet, Advisory Board

The Federal Reserve's monetary policy reaction function will remain data-dependent for the remainder of 2016, but the US presidential race may bring forward the timing of the next increase in the federal funds rate.

At the margin, it is easier for the Fed to raise rates in the summer, rather than September or November, when the presidential election campaign will be in full swing.

The Fed must garner support from four primary constituencies: Congress, 'Main Street', Wall Street, and the executive branch of government. To these must be added several others – disenfranchised groups seeking access to cheap credit, populists suspicious of large banks, and other vocal interest groups.

The Fed must be especially attentive in a presidential election year to avoid alienating the prospective chief executive, one of whose principal powers is the power of appointment. And, as a creature of Congress, it must closely follow developments on Capitol Hill.

Constantly evolving Fed

Since the Fed's creation in 1913, Congress has amended the original legislation – or otherwise modified the Fed's breadth of control – several times. For example, the Dodd-Frank Act of 2010 reduced its discretionary emergency lending powers (widely used during the global financial crisis) under Section 13(3) of the Federal Reserve Act.

In terms of the presidential campaign, the Fed's critics still accuse former Fed chair Arthur Burns of running an overly lax monetary policy in 1972 to facilitate Richard Nixon's re-election.

Since the 1970s, a rich academic literature has developed on the 'political business cycle'. Proponents suggest that the cycle results from politicians manipulating policy tools to stimulate the economy just prior to an election in the hope of improving their own party's re-election prospects.

> ***"The Fed must be especially attentive in a presidential election year to avoid alienating the prospective chief executive.***

In their view, economic booms and busts can result from over-stimulus in an election year, with the resulting inflation leading to retrenchment after the election.

The Federal Open Market Committee will meet four times before the 8 November elections: on 14-15 June, 26-27 July, 20-21 September, and 1-2 November.

Both the Republicans and Democrats will hold their conventions in July, early by historic standards. The July FOMC meeting coincides with the Democratic convention and comes a few days after the Republican convention.

Coming into the conventions and the general election cycle, the Fed is below its inflation target and faces an improving labour market but weak output growth. The economic data appear to be giving mixed signals; market expectations of a further rate hike in 2016 are well below the most recent 'dot plot'.

Should the data improve in the coming weeks, raising rates in June or July may be less controversial than doing so in September or November.

Candidates would comment

While low interest rates since the global financial crisis have penalised savers, interest rate cuts from a political standpoint generally remain more popular than interest rate increases.

The candidates would be sure to comment on a hike in September or November, with some arguing that a rise is a sign of an improving economy and others that Fed action was premature. Savers and the banks would like to see rates rise, while other constituencies are less enthusiastic.

Given the sell-off in global stock markets following the Fed's interest rate 'lift-off' in December and recent conflicting signals, the Fed must be particularly astute in the timing of its next hike.

The presidential election is a further complicating factor in FOMC decision-making. But it will not be an explicit policy variable, or a principal determinant of policy. ■

George Hoguet retired on 1 June as Global Investment Stategist in the Investment Solutions group of State Street Global Advisors.

Jobs data dampen rate rise prospect

Fed opinion swinging as May hiring slows

Darrell Delamaide, US editor

To hike or not to hike, that is – or rather was – the question. Financial markets had been moving towards the belief that the 14-15 June meeting of the Federal Open Market Committee was 'live' and that a new hike in the federal funds rate could be imminent. But this was before 3 June US jobs data showing hiring slowed sharply in May, and before Chair Janet Yellen on 6 June described Fed monetary policy as 'generally appropriate'.

A key passage from the minutes of the April meeting, released in mid-May, led to the shift in market opinion: 'Most participants judged that if incoming data were consistent with economic growth picking up in the second quarter, labour market conditions continuing to strengthen, and inflation making progress toward the committee's 2% objective, then it likely would be appropriate for the committee to increase the target range for the federal funds rate in June.'

'Most participants' and 'likely... increase' jump off the page here. Less attention, however, was paid to the many qualifiers that followed this statement and lowered the probability of a rate hike.

Namely, there was 'a range of views' about whether all the conditions for a likely rate hike would be fulfilled. 'Several' worried the incoming information would not be clear enough, while only 'some' were confident it would. 'Some' also worried the market had become too complacent in thinking there would be no rate hike in June.

Political risks

What did not appear in the minutes and was virtually absent from policy-makers' public comments was the political jeopardy of taking action now. If a June rate hike turned out to be precipitous and impacted the economy negatively, a Democratic candidate campaigning on the economic success of the Obama administration – as frontrunner Hillary Clinton has done – could blame the Fed for sabotaging his or her chances.

Another political factor that was mentioned in the minutes was the UK's 23 June referendum on its membership of the European Union.

In the discussion about economic expectations, the minutes stated, 'Some participants noted that global financial markets could be sensitive to the upcoming British referendum on membership in the European Union or to unanticipated developments associated with China's management of its exchange rate.'

New York Fed chief William Dudley, vice chair of the FOMC and a permanent voting member, commented briefly after the April minutes were released that 'we are on track to satisfy a lot of the conditions' set by the committee for a rate increase.

However, he qualified his remarks by pointing out that the FOMC meeting was just a week before the British referendum. 'We'll have to think about that in terms of... whether it makes sense to go in June or wait a little bit later,' he said.

But the longer the Fed waits, the closer it gets to election day in the US and exposes itself to criticism of playing political favourites.

Later in May, St. Louis Fed chief James Bullard noted labour market data for April had been favourable for a rate move. But, he said, 'there's no reason to prejudge June.'

> ***"The longer the Fed waits, the closer it gets to election day in the US and exposes itself to criticism of playing political favourites.***

In fact, the early May report that the US economy had added only 160,000 jobs, leaving unemployment at 5%, was seen as many as a weak report – an interpretation confirmed by the 3 June jobs data.

Bullard hinted that a decision might wait until July, which, unlike June, is not scheduled to have a press conference afterwards. 'I think on the issue of press conferences, we have made many moves over the years without press conferences,' he told CNBC. 'So I think you can make a move without press conferences in this circumstance.'

Election impact

With regard to the presidential campaign, he said, 'The Fed has moved during political cycles in the past,' recalling that the Fed started a tightening cycle during the 2004 presidential election year. 'Monetary policy is largely independent of the political process. And one of the things I think is you can't win an election by talking about whether the Fed should move right or move left.'

But, as Jimmy Carter found out to his sorrow in his 1980 re-election bid, you can lose one if Fed action negatively impacts the economy. Historians have blamed Fed chair Paul Volcker's aggressive action to break inflation for the steep recession that year, which contributed to Carter's loss in a landslide to Ronald Reagan.

San Francisco Fed chief John Williams

San Francisco Fed chief John Williams rejected the notion that the presidential campaign would have any influence on Fed timing. 'We're about as apolitical as you can imagine,' Williams told Fox News. Any rate decision 'would be based on the data, based on our analysis,' he said.

While Williams could cite rate hikes in previous presidential election years, the key factor is the second part of the equation – a negative impact on the economy – and that could give policy-makers pause.

Atlanta Fed president Dennis Lockhart echoed his Fed colleagues on the possibility of a June hike. 'I wouldn't take it off the table,' he said at a meeting in Washington.

Dallas Fed chief Robert Kaplan told an OMFIF event in April that markets could be underestimating the Fed's willingness to act.

'We'll see how the second quarter unfolds but I think the market may well be underestimating how soon we might move next based on what I have seen,' he said.

Kaplan told Bloomberg Television that he would back a June rate hike based on current data, but he warned that the Brexit vote could be a factor if it looks like it would roil markets.

'I'm going to have to make an assessment on 15 June what the likelihood is,' Kaplan said. 'Right now it's unclear, and if it's still unclear on 15 June it is going to be a factor. ■

Darrell Delamaide is a writer and editor based in Washington.

Case studies in banking distortions

Oligopoly, leverage and cyclicality – the consequences

Martin Taylor, Bank of England

The banking industry has a tendency, driven perhaps by its combination of oligopoly, leverage and cyclicality, to get itself into ghastly collective jams from which extrication is very difficult.

One example is the free-in-credit current account. In the 1970s, bank customers (much fewer in number than today) paid for transactions unless they kept a minimum of £100 on average in their account – say £1,000 in today's money. As interest rates rose, and unremunerated liabilities became very valuable to the banks, this fell to £50, and then the Midland dropped the requirement altogether. The whole industry followed suit. The contortions the industry has put itself through to maintain this overriding of the price mechanism have been very damaging, not only to the most vulnerable consumers who, through penalty charges subsidise the better-off (they used to be known, revealingly, as 'delinquents'), but also, I believe, to banking in general. Perceived necessity has been the mother of mis-selling.

A second example stems from the so-called teaser rates. In the mid-1990s the idea emerged that you should treat people who were not your customers better than those who were. The habit of giving what are effectively disloyalty discounts has turned into a cynical and corrosive negative-sum game. Many recipients of pre-crisis teaser mortgage rates are now marooned on the standard variable rate and unable to refinance.

A third case focuses on overpaid investment bankers. City pay was always high relative to professional pay in general, but it really took off in the late 1990s, accompanied and facilitated by sharply increasing leverage in the industry. I suspect pay rose even faster than leverage and has come down a good deal more slowly. Keynes' dictum that wages are 'sticky downwards' seems to apply to salary-plus-bonus too. It appears to be easier to fire people than to pay them less; it may even be easier to go out of business altogether.

Fourth is the issue of regulatory arbitrage. The practice of 'optimising' returns on risk-weighted capital by exploiting the gap between regulatory risk weights and underlying risk has become more difficult now that banks have rules for both risk weighted capital and gross leverage to contend with: the noughts-and-crosses game has become three-dimensional. The habit of arbitrage has encouraged forms of balance sheet construction that overlay financial engineering on whatever mix of assets and liabilities naturally arises from the banks' day-to-day business operations. The firm might almost as well be run by an algorithm.

All four practices have two things in common. First, however uncomfortable the distortions they produce, bankers fear to abandon them, since first-mover disadvantage can be severe; collusion, meanwhile, is forbidden.

Second, in different and sometimes subtle ways, they are all mechanisms that promote customer alienation. I have no easy solutions to offer, but feel that until issues like these are confronted, customer trust will continue to elude the industry. ■

Martin Taylor is an External Member of the Financial Policy Committee at the Bank of England. This is an edited extract from an OMFIF City Lecture in London on 25 May.

Open approach to financial stability

How shortcomings in transparency can accelerate crises

Andrea Enria, European Banking Authority

The financial crisis has significantly affected my thinking about transparency. Two pieces of the new regulatory framework introduce a new dimension in the discussion on transparency in banking.

First, one of the main implications of the crisis on banking regulation is that the cost of bank failures should be borne first and foremost by shareholders and creditors. Support with taxpayers' money should be used only as a last resort, when there is a proven concern for systemic stability. Bail-ins of private investors are largely expected to substitute bail-outs financed by governments.

Second, the new macroprudential framework has introduced the principle of 'capital conservation' which requires banks to restrict payouts – in terms of dividends, coupons and bonuses – to a 'maximum distributable amount' if they are unable to meet the cumulative macroprudential buffers above Pillar 1 and Pillar 2 requirements.

The shift from bail-out to bail-in and the MDA concept have important implications for market dynamics, since the decisions of the supervisory authorities directly affect the payoff of several banks' stakeholders. The question is whether supervisory decisions on, for instance, Pillar 2 requirements and actions possibly triggering the suspension of payments to stakeholders should be transparent. Unquestionably, increased transparency reduces the magnitude and frequency of bank problems, as it allows market participants to impose market discipline earlier and more effectively.

Transparency cannot prevent banks' failures, but it may force prompt recognition of losses, the dismissal of assets, and potentially a quicker recovery. Disclosure also forces the closure of clearly insolvent institutions, thus contributing to reduce overcapacity following a boom-and-bust cycle.

However, the traditional view on the disclosure of supervisory decisions is that it may generate instability and possibly lead to a bank run. The disclosure of sensitive information concerning supervisory assessments – such as, for instance, additional capital requirements under Pillar 2 – may indeed trigger self-fulfilling processes. My experience at the EBA has made me acutely aware that opaqueness is a powerful crisis accelerator. If market participants are unable to compare and contrast the situation of banks vis-à-vis a specific risk, they are naturally inclined to think the worst of each and every bank. The market grinds to a halt.

If authorities act in an unpredictable way, for instance by taking different courses of action in apparently similar cases or by concealing the information that is at the basis of their decisions, volatility is likely to increase and any shock can easily destabilise the system.

This is why we at the EBA have consistently focused our efforts on increasing the quantity and quality of bank disclosures, enhancing the comparability and accessibility of bank data, and recommending greater disclosure of authorities' assessments. ■

Andrea Enria is Chair of the European Banking Authority. This is an edited extract of an OMFIF City Lecture in London on 4 May.

Hedging climate change risk

Index decarbonisation can support green policies

Frédéric Samama, Amundi Asset Management

Investors and financial markets cannot continue to ignore climate change. The effects of rising temperatures, the increasingly extreme weather events climate change generates, and the climate change mitigation policy responses it could provoke may have dramatic consequences for the economy and thus investment returns. Financial innovation should be explored so the power of financial markets can be used to address one of the most challenging global threats faced by humankind.

Governments have focused mostly on introducing policies to control or tax greenhouse gas emissions and build broad international agreements for the global implementation of such policies.

Index decarbonisation can boost support for such policies among a large section of the investor community. As more and more funds are allocated to decarbonised indexes, stronger market incentives will materialise, inducing the world’s largest corporations – the publicly traded companies – to invest in reducing greenhouse gas emissions.

Encouraging climate risk hedging can have real effects on reducing greenhouse gas emissions even before climate change mitigation policies are introduced. The mere expectation that such policies will be introduced will affect the stock prices of the highest greenhouse gas emitters and reward those investors who have hedged climate risk by holding a decarbonised index. Anticipation that climate change mitigation policies will be introduced will create immediate incentives to initiate a transition to renewable energy.

Mandatory disclosure

A simple, costless policy in support of climate risk hedging that governments can immediately adopt is to mandate disclosure of the carbon footprint of their state-owned investment arms (public pension funds and sovereign wealth funds). Such a disclosure policy would have several benefits.

As climate change is a financial risk, disclosure provides investors (and citizens) with relevant information on the nature of the risks to which they are exposed.

Some pension funds have already taken this step by disclosing their portfolios’ carbon footprint – in particular, Erafp, the public service additional pension scheme, and Fonds de Réserve pour les Retraites in France; KPA Pension, the Church of Sweden and the AP national pension funds in Sweden; APG in the Netherlands; and the Government Employees Pension Fund in South Africa.

Given that citizens and pensioners will ultimately bear the costs of climate change mitigation, disclosure of their carbon exposure through their pension or sovereign funds helps internalise the externalities of climate change. Investment by a public pension fund in polluting companies generates a cost borne by its government and trustees, lowering overall returns on investment. China Investment Corporation, China’s sovereign wealth fund, has already made statements in this direction.

> ***“As more and more funds are allocated to decarbonised indexes, stronger market incentives will materialise, inducing the world's largest corporations to invest in reducing greenhouse gas emissions.***

Disclosure of the carbon footprint of a sovereign fund’s portfolio can be a way for sovereign funds of oil- and gas-exporting countries to bolster risk diversification and hedging of commodity and carbon risk through their portfolio holdings.

Diversifying investments

The basic concept underlying a sovereign fund is to diversify the nature of the country’s assets by extracting the oil and gas under the ground, thereby ‘transforming’ these assets into ‘above-ground’ diversifiable financial assets.

A more direct way to support investment in low-carbon, low-tracking error indexes is to push public asset owners and their managers to make such investments. Governments could thus accelerate the mainstream adoption of such investment policies.

In this respect, it is worth mentioning the precedent of the policy of Prime Minister Shinzo Abe’s administration in Japan to support the development of the JPX-Nikkei Index 400 – comprising companies providing high returns on equity and with high standards of corporate governance. The Abe administration sees this index as an integral part of its ‘third arrow’ plan to reform Japan’s companies.

Japan’s Government Investment Fund, by far the largest Japanese public investor with more than $1.2tn of assets under management, has adopted the new index. This shows how combining a newly designed index with a policy-making objective and the adoption of that index by a public asset owner can be a catalyst for change.

Financial innovation

Climate change has mostly and appropriately been the bailiwick of scientists, climatologists, governments, and environmental activists. There has been relatively little engagement by finance with this important issue.

Robert J. Shiller, in his 2012 book *Finance and the Good Society*, advances a refreshing perspective on financial economics. Finance is not about ‘making money’ per se – it is a ‘functional’ science in that it exists to support other goals, namely those of society. The better aligned society’s financial institutions are with its goals and ideals, the stronger and more successful the society will be.

It is in this spirit that Amundi has pursued its research into how investors can protect their savings from the risks associated with greenhouse gas emissions and their long-term impact on climate change.

Our basic working assumption is that to foster financial markets' engagement with climate change, it is advisable to appeal to investors’ rationality and self-interest. Our argument is simply that even if some investors are climate change sceptics, the uncertainty surrounding climate change cannot be used to dismiss it and related mitigation policies as a zero probability risk.

Any rational investor with a long-term perspective should be concerned about the absence of a market for carbon and the potential market failures that could result from this incompleteness. A dynamic decarbonised index investment strategy seeks to fill this void, offering an attractive hedging tool even for climate change sceptics.

The decarbonisation approach we have described for equity indices can also be applied to corporate debt indices. Although the focus in fixed-income markets has been on green bonds, corporate debt indices – decarbonised along the same lines as equity indices (screening and exclusion based on carbon intensity and fossil fuel reserves while maintaining sector neutrality) – could be a good complement to green bonds. ■

Frédéric Samama is Deputy Global Head of Institutional & Sovereign Clients at Amundi Asset Management.

Asia's equivalent of Marshall plan

Historical lessons from China's One Belt programme

Juan Carlos Martinez Oliva, Banca d'Italia

China's One Belt One Road initiative, a pan-Asian development strategy based on economic co-operation and infrastructure building, portrays relevant parallels to the European reconstruction plan enacted in 1948-52, named after George Marshall, the US secretary of state.

The Chinese plan offers numerous countries the chance to participate in a broad market, and to benefit from improved connectivity and trade networks. The potential advantage is significant for countries still in the early stages of industrialisation, with weak development and poor infrastructure.

The Marshall plan teaches us that the success of a grand initiative like the OBOR will depend on the capability of the proponent and on the collaboration of its partners. The success of the 'one belt' plan will depend on China's ability to achieve common and beneficial goals with its partners.

The European Union represents a crucial partner for the OBOR programme. The trade links between the EU and China are among the largest in the world, and there is great potential to increase them further. Railway connections in place between the two economies represent a cheaper and greener alternative to airfreight.

A large number of projects underline China's engagement in enhancing European infrastructure. China is gradually shifting its activity in foreign direct investment from the US to the EU, which is seen as a more hospitable business environment.

Economic issues take precedence

The comparison between OBOR and the Marshall plan is sometimes criticised because the latter is viewed as a geopolitical device meant to control western European nations and contain the Soviet Union. On the other hand, China's OBOR is intended as an alliance where economic issues take precedence, with no political strings attached.

Observers stress that the OBOR is based on 'open co-operation' to assist the development needs of China's neighbours, regardless of their relations with China. The Marshall plan, on the other hand, placed political conditions on its beneficiaries and contributed to Europe's geopolitical split. As during the Marshall plan, today's debate on OBOR places a good deal of attention on geopolitical and security issues.

Specifically, some countries involved in OBOR are still in a transitional stage, and therefore prone to political instability and terrorism. Like the US 70 years ago, China today faces a potential dilemma in choosing the right response when security issues that threaten the functioning of OBOR emerge.

The Marshall plan was meant to 'help Europe to help itself'. The strength and enthusiasm of the European nations in taking the opportunity to build new co-operative institutions, pursue common interests, and accelerate moves towards better living standards represented essential ingredients for the US programme's success.

The same can be true, 70 years later, of the Chinese plan. ■

Juan Carlos Martinez Oliva is a Principal Director in the Economics, Research, and International Relations Department of Banca d'Italia. He writes in a personal capacity.

Overcoming Beijing's debt vulnerabilities

Why China 'hard landing' fears are overdone

Ravi Menon, Monetary Authority of Singapore

The slowdown in the Chinese economy and volatility in its financial markets have sparked fears that the Chinese economy is headed for a 'hard landing' and that it will drag down much of Asia with it. These fears are understandable but overblown.

China faces three necessary but significant challenges at the same time.

First, the Chinese economy is adjusting to a lower rate of growth. Managing this moderation without major dislocation is a key priority for China's policy-makers. Second, China is addressing risks and vulnerabilities in its economy and financial system. Doing this without triggering a crisis of confidence is another key priority. Third, China's economy is undergoing perhaps the most comprehensive and ambitious structural reform programme of any country in modern times.

Slower growth does not mean anaemic growth. China may no longer grow at 8 to 10%, but it is well positioned to grow by 6 to 6.5% for the next five years.

With the right mix of structural reforms, there is substantial scope for China to achieve faster catch-up in terms of productivity and income levels.

China's per capita GDP is modest by international standards and labour productivity remains well below the frontier. But the economy's large size means that, at even more moderate rates of growth, incremental demand from China will be quite substantial in absolute terms. This is what matters for the global economy.

Leverage risk

China faces vulnerabilities in its economy and financial system. The chief risk is leverage — both its level and its growth.

According to the Bank for International Settlements, China's credit to GDP ratio stands at around 250%, having risen by 100 percentage points since end-2008. Nearly 70% of that increase is attributable to corporate debt.

The road to addressing China's debt vulnerabilities is long and fraught with risks. But if recent efforts are sustained and economic growth does not slow dramatically, the prospects for an orderly and gradual deleveraging are good. At the same time, the outcome of ongoing structural reforms effort will be decisive for the economy's long-term prospects. The Third Plenum reform blueprint of 2013 provides a comprehensive roadmap for China's full transition to a market economy, and is a thoughtful, coherent, and well-conceived plan.

China has taken the important step of liberalising interest rates. But it also needs to develop deeper and broader capital markets. This will help better price risk capital and ensure that financing flows to more productive economic activities.

China has proceeded with capital account liberalisation in a careful and systematic way. But opening up the capital account amid a slowing economy, a still developing domestic financial system, and a debt overhang, is no easy task. ■

Ravi Menon is Managing Director of the Monetary Authority of Singapore. This is an edited extract of an OMFIF City Lecture in London on 5 May.

A plea for 'smart protectionism'

Africa must shake off shackles of orthodoxy

Kingsley Chiedu Moghalu, Senior Adviser

Optimism on Africa has declined along with commodity prices. This is a good time to challenge the conventional wisdom that Africa's path to salvation lies through emulating economic precepts that work in the West but are not suitable for many developing countries.

For capitalism to work for Africa, just as it has for China and much of east Asia, policy-makers must shake off the shackles of orthodoxy.

We must confront the shibboleth that prosperity and growth depend on governments getting out of the way of business. On the contrary, governments must lead, by setting policy that creates an enabling environment for market-based job-creating growth.

'Smart protectionism'

African nations must reject the misleading notion that they can join the West by becoming post-industrial societies without having first been industrial ones.

One route to manufacturing-based, inclusive growth is 'smart protectionism' — temporary tariffs that would protect nascent industries from the cheap imports that have rendered African economies uncompetitive. This can be achieved within the rules of the World Trade Organisation.

A relatively small number of entrepreneurs have prospered on the continent in the past decade, the positive side of a continent where the fundamentals for improving jobs and lives have indeed changed for the better. But hundreds of millions remain poor and unemployed, lacking electricity, good schools and access to adequate healthcare.

I am not arguing for a heavy-handed statist approach stifling productivity and competition. Yet a strategic role for governments remains essential. The question is whether African governments are capable of making the right policy choices. Ethiopia and Rwanda offer hopeful examples.

African countries need to remove incentives for systemic corruption. The Nigerian government under President Muhammadu Buhari has rightly withdrawn subsidies and deregulated the importation of refined petroleum products. Next, it should review its policy of maintaining an artificially fixed exchange rate, in the face of depressed income from crude oil. This has bred corrupt arbitrage in currency markets and hurt productivity.

Self-sufficiency

Africa should be striving for self-sufficiency and to become part of the globalised production value chain. This requires the consistent development of skilled labour, linking innovation to industrial production, as well as investment in infrastructure and manufacturing. Governments must keep a careful eye on market actors with regulation and oversight that has wider social objectives in view.

Markets must work for society and not the other way round. That, surely, is one of the lessons of the financial crisis. ■

Prof. Kingsley Chiedu Moghalu is a former Deputy Governor of the Central Bank of Nigeria. He teaches international business and public policy and is a senior fellow in the council on Emerging Market Enterprises at The Fletcher School of Law and Diplomacy at Tufts University, Boston.

Rebuilding Brazil's broken model

Vigorous reforms needed to stabilise economy

Eduardo Borensztein, Advisory Board

Brazil's new administration faces daunting challenges. Interim President Michel Temer has assumed power with conditional support in Congress and little popular support. His term is uncertain – the senate may exonerate Dilma Rousseff, impeached over corruption allegations, and reinstate her as president.

An ambitious economic reform programme might be regarded as impossible under such conditions. But the opposite is true. Only by launching a vigorous reform initiative can the government afford to adopt a looser short-term macroeconomic stance, generate positive economic expectations and stabilise the economy.

Brazil is experiencing the worst recession in its modern history. At the same time, macroeconomic imbalances have widened.

The newly appointed economic team displays talent and professionalism. Henrique Meirelles, the finance minister, is a former central bank president who consolidated the inflation-targeting regime and helped establish confidence under the previous administration of Luiz Inácio Lula da Silva. The new central bank chief, Ilan Goldfajn, has an outstanding career in the private sector, government, and academia.

The new economic administration has set more realistic budget projections, and started discussion of fiscal and pension reforms.

All this is needed because Brazil has run out of fiscal room for manoeuvre. Public debt has climbed to around 70% of GDP. Brazil's sovereign credit rating continues to be downgraded. The government mostly borrows domestically and in local currency securities. But persistent inflation means real interest rates will remain high.

There is similarly little space for expansionary monetary policy. As the central bank's credibility has eroded, inflation expectations have become more entrenched. So monetary expansion would result in price increases rather than stimulate growth.

A macroeconomic adjustment is necessary. But with double-digit unemployment and increasing credit delinquency, Temer and his team cannot risk exacerbating the recession.

Thus, Brazil should focus on ambitious reforms to revive investment and productivity, and ensure long-term macroeconomic sustainability. Fixed investment is on a path to decline a cumulative 20% by end-2016, and productivity growth contributed just 0.5% to GDP growth over the past decade.

Brazil needs to open up its economy to international and domestic competition, and improve a business climate overwhelmed by bureaucracy and high taxes. Macroeconomic policies should be guided by reforms that ensure long-term fiscal sustainability and central bank credibility.

Tangible progress in deep reforms will reduce the need to tighten fiscal and monetary policy in the short run.

These are formidable tasks. But there is hope of a viable economic policy, even if the fluid state of Brazilian politics could produce more turbulence. ■

Eduardo Borensztein is a consultant, and a former member of senior staff at the IMF and the Inter-American Development Bank.

Lyons' cavalier approach to 'Brexit'

The fallacy of an easy renegotiation

William Keegan, Advisory Board

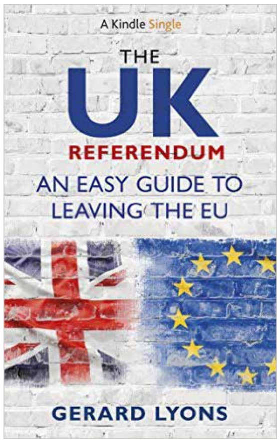
Gerard Lyons is a City economist who three years ago made the somewhat challenging career move to become economic adviser to Boris Johnson – a leader of the 'Brexit' camp.

Lyons, the author of an ebook *The UK Referendum: An Easy Guide to Leaving the EU,* presents the book as a 'balanced view' explaining the referendum's issues. He avoids 'eurospeak' and writes with commendable clarity. In easily digestible chapters he offers a history of the European Union and pithy summaries of the single market's workings. He explains issues such as the cost of the UK's EU membership, the economic pros and cons of migration, Brexit's impact on the City of London and the debate on trade.

However, as the title implies, this is not really a balanced account. Lyons is strongly pro-Brexit, and seems to minimise the problems that might arise in renegotiating trade and other arrangements from what most of the Remain camp would regard as a position of weakness.

Much of what he says is perfectly sensible. For instance, some of the more passionate Remainers overstate their case by giving the impression that half the UK's trade would halt if it left. This kind of exaggeration is an easy target for Lyons, as are the EU's obvious imperfections, let alone the euro area's design. But he becomes quite cavalier in claiming, 'Presumably if the UK were to vote to leave in the 2016 referendum – and if the EU proved successful – then there is nothing to stop the UK voting to rejoin.' Oh no? And what is to stop our former partners saying, 'Allez-vous-en!'?

Lyons concedes there might be a short-term cost. But why incur one in pursuit of speculative long-term gains? Recent economic statistics seem to indicate that the very prospect of that short-term cost is already damaging investment.



Lyons and others seem to underestimate the economic importance of the UK's EU membership for the investment decisions of multinational corporations. They ignore the degree to which so many firms spread their operations throughout Europe in complex networks which Brexit would severely disrupt.

George Soros was right when he said that, by being members of the EU but not the euro area and the Schengen agreement, the UK has the best of both worlds. When my wife and I arrived in Barcelona at the beginning of a bank holiday weekend, there was a queue of hundreds at passport control. As EU citizens we sailed through. Much that we, especially the younger generation, take for granted in the EU would disappear after Brexit.

One last word. My contemporaries are divided into two camps: those who take easily to Kindle and ebooks and those who don't. I am firmly in the latter category. It matters not that one of the contemporary economists I most admire, Paul Krugman, not long ago light-heartedly castigated me for the environmental impact people like me have on the destruction of Scandinavian trees. Long live the real book and proper newspapers! ■

William Keegan is Senior Economics Commentator at The Observer.

Only a genuine political solution will free the euro

Something has definitely gone wrong in Europe, as Hans-Werner Sinn, the well-known German economist, says in *The Euro Trap*, writes Alexander Saeedy. Despite encouraging growth figures from some debtor countries that have emerged from rescue programmes, the crisis is far from over.

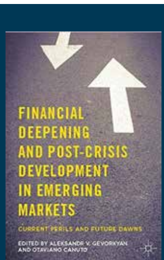
Sinn's book, perhaps the best articulation of the fiscal ideology guiding the German finance ministry, fixates on macroeconomic fundamentals in the euro area and the austerity required to keep the monetary union in balance.

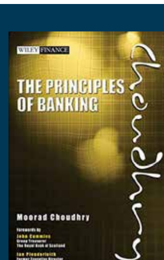
Sinn reminds us that credit-fuelled growth can be dangerous and that macroeconomic logic is often unrelenting. This logic may even point to the euro's eventual dissolution. *The Euro Trap* provides a necessary dose of brutal honesty, expertly diagnosing the euro area's many illnesses.

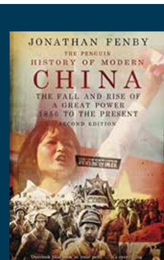
Reflecting a false belief that all euro area governments and banks were equally safe borrowers, converging interest rates were a self-fulfilling consequence of the Maastricht treaty. A credit boom took hold in peripheral countries. However, capital inflows did not finance productive investment, but instead increased prices without an accompanying rise in labour or capital productivity.

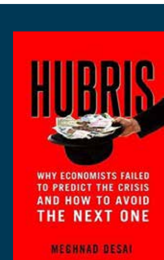
Within the euro area, there are only two solutions. Wages and prices must deflate in the south, or they must inflate in the north. Both are politically difficult, but the latter is perhaps legally impossible, given the ECB's mandate of price stability, Sinn reminds us.

Deflation in the debtor countries is a trap. As Sinn writes, 'Firms, private households, and governments are overburdened with debts… that make it impossible for them to accept a significant real depreciation even if prices and incomes could all be cut









In defence of a love affair

Why Britain must avoid 'wanton signal' on Europe

David Marsh, OMFIF

Denis MacShane, the former Labour MP and British Europe minister, has a nose and an ear for a good story.

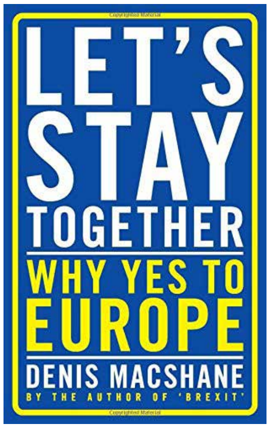
At a time when others (myself included) believed the chances of a UK referendum on European Union membership were slim, he spotted the possibility that this could exert a convulsive shock on the British and European system – and wrote a book on the issue in February 2015 entitled *Brexit: How Britain will leave Europe*.

Now he has produced another book – short, readable and pointed – *Let's Stay Together: Why Yes to Europe,* demonstrating what he calls his 'love affair' with Europe and why the UK should carry on the community of 'hope and solidarity' after 23 June.

MacShane underlines that the debate is more about emotion and judgement than hard-and-fast fact. For MacShane, an urbane polyglot, the continent's appeal lies in the history of peace and co-operation since 1945. In particular, he cites with feeling the freeing of Poland (from which his father hails) and other central and eastern European states after the fall of the Berlin wall.

MacShane approvingly quotes Charles de Gaulle's welcome to the reawakening of free speech after the liberation of Paris in 1944 – even though the General turned out to be no great defender of liberal media when he regained power after 1958.

Minor quibble – MacShane says Paris was liberated by the Free French, whereas he might have mentioned the role of American and British arms. He does however rightly place emphasis on the importance of the EU and Nato working together, saying that Britain's membership of the Atlantic alliance embodies a greater derogation of national sovereignty (for example, the obligation to go to war with any belligerent against a Nato member) than anything in the EU treaties.



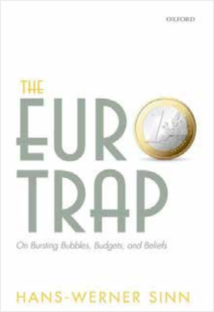
Down-to-earth arguments

With a level-headed style that protagonists on both sides of the EU battleground would do well to emulate, MacShane eschews rhetorical overkill and keeps his arguments simple and down-to-earth. He scotches a few myths along the way.

The phrase to which many Brexiteers take exception, 'ever-closer union', was inscribed in the preamble to the Treaty of Rome signed in 1957, referring not to states but, more innocuously, to 'peoples'. MacShane reports how, when he was Europe minister, British officials helped remove the essentially symbolic phrase in the European constitutional treaty that was voted down in 2005, but it reappeared in the Lisbon treaty that took its place.

MacShane unrepentantly reprints his list of '50 reasons to love the EU' , which first appeared in the Independent newspaper in 2007, including such choice findings as 'Making the French eat British beef again' (No.14), 'British restaurants are now much more cosmopolitan' (No.47) and (No.50) 'Lists like this drive the Eurosceptic mad'. Reason No.36 is 'Britons now feel a lot less insular'. On 24 June we may find out whether this is true. ■

David Marsh is Managing Director of OMFIF.



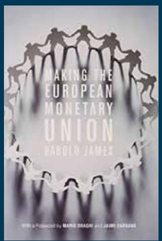
simultaneously and in proportion.'

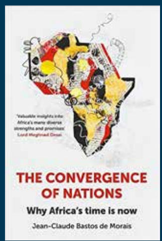
Much of *The Euro Trap* critiques the ECB's unconventional monetary policy since 2008. According to Sinn, the ECB's accommodative monetary policy has helped perpetuate the imbalances at the heart of the crisis. This, combined with what Sinn calls the ECB's 'stealth bail-out' through the notorious Target-2 balances, has prevented a painful but necessary market correction. Mario Draghi, the ECB president, may have restored investor confidence, Sinn says, but he has done little to nurse the euro area back to health.

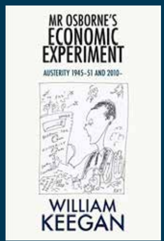
Despite Sinn's crystal-clear intelligence, he struggles to see beyond the constraints of his own discipline. He clings to the primacy of rule-based law, yet international law and foreign relations are ultimately based on relations of power. Rules are valuable only if they can be enforced. If Sinn believes stricter rules would put the euro area right, his calls for political federalism should be much stronger. Likewise, his support for countries to depart from the monetary union is an expression of straightforward macroeconomics, but lacks political nuance. Leaving the euro, particularly for a country with vulnerable borders like Greece, would throw the European balance of power into complete disorder. It would further undermine the pursuit of 'common peace and prosperity' that Sinn sees at the heart of the European project.

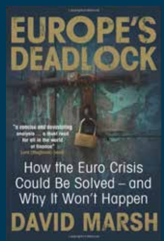
The euro area and the EU result from a coalition of political will to pool forces in the common cause. That understanding is now under great strain. Genuine political solutions are required. Otherwise, the euro area will remain caught in a trap of its own making. ■

Alexander Saeedy is Head Policy Researcher for SMP Policy Innovation.









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Gladstonian, not Bushman

Dull book on the man who made Labour popular again

Meghnad Desai, Advisory Board

Broken Vows: Tony Blair – The Tragedy of Power by Tom Bower is a surprisingly dull book. Bower is known for forensic investigations into the great and good. But with Blair he fails for the simple reason that much of what he reveals is already known.

I met Blair soon after he came into parliament. He was open and friendly. Very much like his friend Bill Clinton, he never forgets a face or name, and can retrieve it the minute he gives you a vigorous handshake. When he was shadow home secretary, he told us people in the constituency parties to stop being anti-police and remember that the poor suffered more from burglary and petty crime than the rich. He knew how to make Labour popular again.

Credible party of government

The day in 1994 my secretary at the London School of Economics and Political Science told me the shocking news that John Smith, the Labour party's then leader, had died, my first thought was that Blair would be his successor. There was never any doubt. He was an outstanding leader, winning the Labour party three successive general election victories with a large majority. We may be nostalgic about Clement Attlee or Harold Wilson. But Blair made Labour a credible party of government.

Bower starts with 1997 and the advent of the New Labour administration. He relentlessly tries to portray the government as faltering, lost and confused. Except for Margaret Beckett and Jack Cunningham, no one in that first Cabinet had experience of holding office.

Yet they were young and eager to pursue their modernising agenda. If Margaret Thatcher had modernised the economy by jettisoning the nationalised industries, New Labour would modernise the political system and society. New Labour also thought the civil service would be a roadblock to its crusade. It is easy to think of the civil service as villains for a generation reared on the popular television programme *Yes Minister*.

Much of what Bower describes is New Labour's learning experience. Blair knew that whatever happened or did not happen would be blamed on him, not his Cabinet colleagues. Bower finds this peculiar, but Blair was right. He was in a hurry to implement his vision. As with many previous prime ministers, he discovered that change takes time and requires herding a disparate collection of civil servants, members of parliament, Cabinet colleagues and even sympathetic journalists – the worst prima donnas of them all.

As always the National Health Service proves difficult to reform. No matter who is in power, the NHS is 'in crisis'. Nurses' morale is low and doctors are overworked. The Labour party thinks of the NHS as its private property, but its supporters want unlimited funding with no reform. Bower does not see the significance of the good reforms, such as that overseen by Alan Milburn, health secretary between 1999 and 2003, establishing the National Institute for Health and Care Excellence.

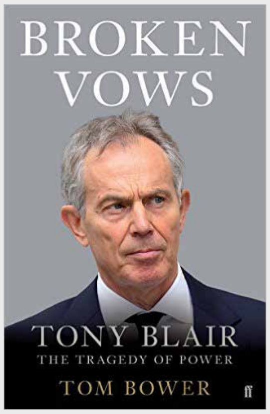
Iraq invasion

Blair was a Gladstonian 'liberal interventionist' and it is wrong to think of him as being dragged along by President George W. Bush. He was convinced of the need to tackle Saddam Hussein from the day he took office. There was much unfinished business stemming from Iraq's 1990 invasion of Kuwait and Operation Desert Storm, launched to liberate the Gulf state.

The 2003 invasion of Iraq lost Blair millions of friends. But fast forward to today and listen to the demands for the removal of Bashar al-Assad, the Syrian president, if there is to be peace in Syria, and you see Blair's point.

While Bower spills much ink on the subject of Iraq, he barely mentions Blair's biggest positive achievement – the Northern Ireland peace process. A dispute harking back to the 1960s, if not the 1920s, was resolved permanently.

Nor does Bower say much about the constitutional reforms Blair achieved – incorporating European human rights legislation into UK law, freedom of information, reform of the judiciary and the House of Lords, devolution for Scotland and Wales, gay rights, and disability rights. All these together merit just one page. Nor does he mention the introduction of the minimum wage, perhaps the New Labour government's most welcome achievement.

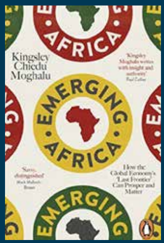


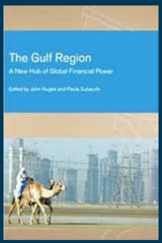
The fascinating saga of the feud between Blair and Brown is rehashed here. It is amazing the government did not disintegrate, with No.10 and No.11 Downing Street permanently at daggers drawn. Of course, once Brown became prime minister he lost all credibility and then the general election.

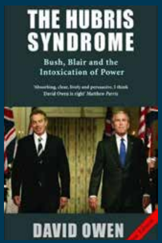
As to Blair's money-chasing activities, there is nothing to reveal that we do not know already. John Major, Blair's Conservative predecessor, is the ideal to follow. He has done high-level work with lucrative clients, but quietly. Blair does not just want wealth: he is still hungry for power and high office.

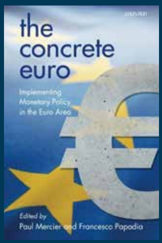
Bower has read the open book that is Blair. But as his subject said himself, no one will ever be able to settle the score with Blair. He will be talked about and discussed when many of his rivals and detractors are forgotten. ■

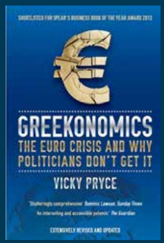
Meghnad Desai is Emeritus Professor of Economics at the London School of Economics and Political Science and Chairman of the OMFIF Advisory Board.











Limited threat from rising US rates

OMFIF Advisory Board says emerging markets to bear brunt

The May poll focused on rising US interest rates and their impact on the global economy. As George Hoguet and Darrell Delamaide discuss elsewhere in this month's Bulletin, expectations that the Federal Reserve will increase rates in coming months remain in place, despite unexpectedly weak jobs data for May, as the presidential race approaches its denouement.

We put two questions to members of the Advisory Board in May: 'Are rising US interest rates likely to pose a substantial threat to the world economy by the end of 2016?'; and, 'Which areas of the world are most likely to be affected by rising US rates?', with possible answers of 'Europe', 'Asia' and 'emerging economies'.

A substantial majority of respondents to question one, 83%, said rising US rates were unlikely to pose a substantial threat to the world economy by the end of the year. An even higher proportion – 87.5% – of respondents to question two said emerging markets were most likely to be affected by rising US rates.

A further 8% said that no area of the world was most likely to be hit by rising interest rates – on the basis that interest rates were unlikely to rise much, if at all, in a US election year or that China's handling of its currency could have a greater impact. ■

'Rising interest rates will stimulate consumer demand in Europe, re-establish a real risk-free rate and probably eliminate the zombie companies that are using up resources but will never be profitable or enhance productivity.'
Caroline Butler, Walcot Partners

'I do not believe interest rates will be raised substantially, and hence rising US rates will not be a problem. In my view the main problems for the world economy lie elsewhere, principally the risk of further slowdown or credit-related problems in China.'
Hans Genberg, the SEACEN Centre, Kuala Lumpur

'My sense is the Fed will hike once, maybe twice, this year starting in September. The impact on the global economy will be minimal as Janet Yellen has made plain spoken announcements about the likelihood of a rise.'
Marsha Vande Berg, Stanford University

'There are differences between emerging market countries in their ability to weather the impact of higher US interest rates. For many, the projected rise in US interest rates poses the risk of capital outflows and currency weakness amid anticipated US dollar strength.'
Hemraz Jankee, formerly Bank of Mauritius

'Rising US rates, in the circumstances in which they are likely to rise, will not pose a threat to the world economy because there will be positive as well as negative effects. Higher US rates will boost banks' margins, provide some relief to Europe and Japan through weaker currencies and, if translated to somewhat higher bond yields, reduce pension deficits.'
Colin Robertson, independent asset allocation consultant

These additional statements were received as part of the May poll, conducted 16-27 May, with responses from 24 Advisory Board members.

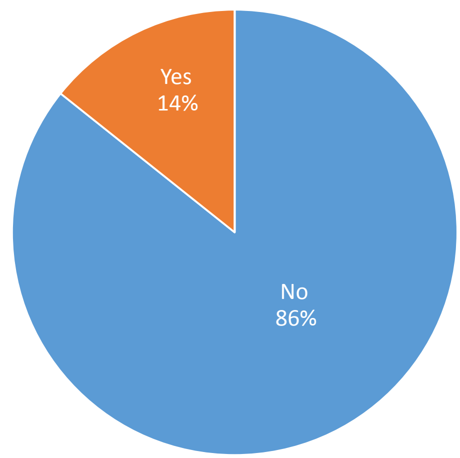
June question

When do you expect fundamental problems over the Greek economy to re-emerge?

a) By the end of 2016 b) 2017 c) Later d) Never

Optimism on impact on world economy

Percentage of respondents believing in negative impact



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

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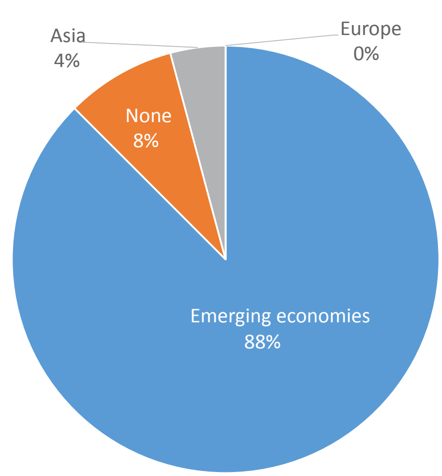

Which areas of the world are most likely to be hit by rising interest rates?