OMFIF BULLETIN

Global Insight on Official Monetary and Financial Institutions

July-August 2013

A time of tests and experiments

Central bank shake-ups bring pressures for markets

David Marsh, Chairman

Testing experimental change has broken out among the world's leading central banks. Each one of the world's leading monetary institutions – in the US, Europe, Japan, China and UK – is facing either new leadership or an important change in the monetary regime, or both.

A growth slowdown in emerging markets, along with improvement in the US and UK and continued uncertainties over euro rescue measures and September's German elections, represents a highly disparate picture for the world economy, bringing diverse pressures for financial markets.

The comment by Sir Mervyn King, former governor of the Bank of England, that euro economies face 'hell' reminiscent of the 1930s Gold Standard may be regarded as unhelpful in Frankfurt and Brussels.

But it sums up the risks that the euro area will slip into a self-perpetuating depression as a result of the well-known 'asymmetry' of the crisis-management response, under which deficit countries are forced to take radical demand-cutting action while the creditors (led by Germany) feel under no compulsion to take compensatory reflationary measures.

Mario Draghi's intelligent manoeuvre to bring in modified 'forward guidance' at the European Central Bank as a way of reassuring bond markets about possible shifts towards higher interest rates is a sensible way of heading off imminent difficulties caused by expectations of tighter US credit.

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Latin America emerges as net positive force for world economy at OMFIF meeting

After years when Latin America was frequently a problem for the world economy, the balance of forces has now changed for the good, according to Meghnad Desai, Chairman, Advisory Board, speaking at OMFIF's Inaugural Main Meeting in Latin America at Central Bank of Brazil on 17-18 June. Ernst Welteke, former president of Deutsche Bundesbank, pictured right with Eduardo Loyo, Chief Economist, BTG Pactual, spoke positively about the European outlook, despite general euro gloom. As part of a new focus on emerging markets, the OMFIF July-August Bulletin features 14 pages of coverage on Asia, Africa and Latin America, including on the OMFIF Mission to China on 24-28 June. SEE P.28-41.

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ENABLING PUBLIC-PRIVATE LEARNING

Beijing slowdown

Shadow of debt burden

Special correspondents in Beijing

The risk of a sharp slowdown in Chinese growth in the next two to three years seems to have risen dramatically, even though imminent danger of a 'hard landing' has been averted after an apparent monetary policy U-turn in Beijing.

Behind the fears of a fall in GDP growth to well below 6% from the 7-8% currently targeted lie several explanations. These range from the debt burden of China's regional and local governments to the authorities' desire to rebalance the economy through an increase in domestic consumption, weakening the traditional forces of exports and investments behind GDP expansion. Under-performance in key export markets, especially in Europe, is another depressive factor.

(continued on page 20..)

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RR Donnelley | 279881 | February 2013

Emerging markets to the fore

Expanding content in line with world economic shifts

David Marsh, Chairman

Welcome to the July-August edition of the OMFIF Bulletin, the biggest-ever at 48 pages, grouped into six sections with two dozen contributors.

That illustrates the wider-ranging format and more international content that OMFIF wants to bring into its activities. All this is part of wider world economic shifts that we are endeavouring to track (and encourage).

Some of you may have noticed that we have redesigned the logo as part of a general revamp of our marketing and communications activities, with a new website coming online soon.

We introduce a new feature, the Monthly Review, containing news from the recent past and outlining forthcoming highlights. International Monetary Policy brings contributions by Stanley Fischer, Gabriel Stein, Richard Fisher, Jaime Caruana and the latest round-up of Federal Reserve developments from Darrell Delamaide.

The euro and its problems have not gone away. We record the thoughts of Holger Fahrinkrug and Stefan Bielmeier on the imbroglio facing Germany over the constitutional court's hearings on potential bond purchases by the European Central Bank.

Willem van Hasselt provides a historical perspective to Britain's famed tergiversation on Europe. We outline Dave Ramsden's account of the lessons learned by the British Treasury over the analysis of possible UK membership of the euro, completed 10 years ago. Lars Rohde introduces a Danish perspective into the debate on banking union. Michael Burda describes how the constituency boundaries of the ECB could be redrawn.

In our Emerging Markets section, we record the views of Rundheersing Bheenick, Atiur Rahman, Kishore Mahbubani, John Adams, Carlos Hamilton Araújo, Lucas Abaga Nchama, Roland Holst and Christopher Probyn. Forrest Capie and Michael Lafferty provide reflections on tighter banking capital regulations. William Keegan rounds off, once again, in bittersweet fashion.

David Marsh

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GOLDEN SERIES LECTURES

'We, in Mauritius, have always rejected the tax-haven label as we are a jurisdiction of substance, which comes with a real, diversified and thriving economy attached.'
– Governor Rundheersing Bheenick, Bank of Mauritius, 30 May, see p.30-32

'More substantial structural reforms are the key factor to increase competitiveness and growth; EU accession will definitely help, but is not the key.'
– Governor Boris Vujčić, Croatian Central Bank, 4 June

'The Bank of England approach is probably the most coherent way of dealing with [coordination problems] — namely, the creation of a Financial Policy Committee in the Bank of England.'
– Governor Stanley Fischer, Bank of Israel, 13 June, see p.6-7

'The moment I became a governor, I thought it was a blessing in disguise that I now have the opportunity to direct credit to the underserved.'
– Governor Atiur Rahman, Bangladesh Bank, 21 June, see p.28-29

'Even if we reach a situation this year where we dial back [monetary stimulus], we will still be running an accommodative policy.'
– President Richard Fisher, Federal Reserve Bank of Dallas, 24 June, see p.10-11

ADVISORY BOARD

OMFIF welcome a new member of the Advisory Board, Dr. Winston Moore, Latin America social and political risk analyst, corporate communications and community relations consultant. Dr. Moore has over 20 years of experience working for international oil and gas, and mining companies. He advises the Alliance for Responsible Mining that sets standards for artisanal and small-scale mining communities. Moore's appointment takes the number of Advisory Board members to 141. For full list of members see p.42-45.

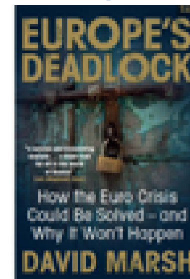
MAIN MEETINGS

Inaugural Main Meeting in Brasilia, 17-18 June

David Marsh and Luiz Pereira da Silva — Jai Arya — Ernst Welteke, Ava Nouripour and Meghnad Desai

INTELLIGENCE

Europe's Deadlock



In this short yet devastating analysis, David Marsh asks why five years of continuous crisis management have not only failed to resolve the euro area's problems but actually made things worse. Marsh argues that constructive dialogue has collapsed as EU decision-making descends into a state of terrified paralysis, and that although there are potential paths out of the impasse, all are blocked by indecision and timidity at the top. See details at Yale University Press: www.yalebooks.co.uk.

The book will be launched in London on 24 July: please contact dina.patel@omfif.org.

Renminbi report

Peter Norman's report, *'China's challenges in clearing and settlement: Helping the renminbi become a world currency'*, looks behind the headlines of China's drive for reform and analyses a less-explored yet vital part of the financial system. This is the 'plumbing' that makes finance work: the post-trade infrastructures that provide services, commonly described as clearing and settlement. This is an essential part of China's advance towards economic modernisation. Norman, member of the OMFIF Advisory Board, has been writing on post-trade infrastructures since 2005.
Please contact nikolai.blackie@omfif.org for a copy of the report.

FORTHCOMING

New website launch on 24 July

CEREMONIES

Dinner with Gerhard Schröder

OMFIF and the German British Forum co-hosted a gala dinner with guest of honour, Gerhard Schröder, former German Chancellor, on 6 June in London.

Schröder's speech, *'Britain, Germany, Europe and the new world economic order'*, focused on the euro crisis, the upcoming German elections and European integration. The photo shows Schröder with OMFIF Advisory Board chairman Meghnad Desai shortly after accepting a framed facsimile of the Daily Mirror of 8 April 1944, the day after he was born.

Central banking in transition

Support for flexible inflation targeting

Report on Golden Series Lecture with Stanley Fischer, Governor, Bank of Israel

Stanley Fischer, Governor of the Bank of Israel, delivered a Golden Series Lecture on 13 June in London, chaired by Gabriel Stein, OMFIF Chief Economic Adviser. Fischer underlined that, in a financial crisis, central banks show increased willingness and propensity to undertake extreme measures. Fischer discussed the aftermath of the crisis, focusing on lessons learned about monetary policy and central banking in transition.

The Bank of England approach is probably the most coherent way of enabling coordination — namely, the creation of a Financial Policy Committee in the Bank of England

'In a foxhole, there are no atheists'

Fischer explained that before the financial crisis, textbooks would explain that, once interest rates reach zero, the authorities must turn to fiscal policy. However, the crisis has shown that monetary policy – broadly defined – can still influence the economy, even when the zero lower bound has been reached. Empirical evidence shows that quantitative easing efforts to increase liquidity indeed had an impact on asset prices, including the exchange rate. Furthermore, central banks have operated as market-maker of last resort in particular financial markets.

Systemic financial stability, not 'macroprudential'

Fischer said that, while Friedman and Schwartz attributed the Great Depression to the failure to keep the money supply growing, Ben Bernanke, in his work, highlighted the breakdown of the credit mechanism. This underlines the crucial dimension of keeping the credit side working. Regulation has been strengthened, notably with Basel III and the Financial Stability Board replacing the Financial Stability Forum. However, it remains to be seen how effective these changes will be in the event of future financial crises.

Fischer called attention to the overuse and misuse of the term 'macroprudential'. While the notion of macroprudential policy was directed at systemic interactions and how to deal with them, many measures described as macroprudential are instead more like regulations of the 1960s and 1970s, aimed at particular markets for reasons of micromanagement of the financial system. This in turn may mask the underlying core issue of central banks addressing systemic financial stability.

Greater coordination among regulators

Greater coordination is needed among regulators; for Israel, this refers to the Banking Supervisor, located in the Bank of Israel, the Israel Securities Authority, and the Supervisor of Capital Markets and other non-bank financial institutions – the latter a department of the Treasury. The main challenge lies in regulators operating under different rules, as well as a structural and general reluctance to forego certain privileges for the good of the system. For Israel, cooperation between the central bank and the Israel Ministry of Finance in particular would pave the way for progress in maintaining financial stability.

Fischer referred to the Bank of England's new supervisory model as promising, with a relatively greater ability to reach agreements and willingness to share information. According to Fischer, the ensuing diminution of central bank independence with regard to maintaining financial stability is near-inevitable, and does not bring particular problems, so long as the central bank maintains its independence in the setting of monetary policy – a distinctly minority view among central bankers.

Fischer noted that the financial crisis has also clarified the relationship between financial and fiscal crises. Sometimes fiscal problems lead to problems in the banking sector. But in many cases, a financial crisis leads to difficulties in public finances, as governments intervene to prevent the collapse of financial institutions which would otherwise cause major losses to depositors.

Several instruments have been designed in an attempt to sever this connection and lower the likelihood of similar destabilisation in the future. In a sense, the private sector has been brought in as lender of last resort. This was most obvious in the case of Cyprus, where uninsured deposits were bailed in to reduce the call on the public finances. Much thought is being given to the strengthening of resolution mechanisms, in particular by establishing a strong presumption as to the seniority of different classes of creditors.

While clarifying the seniority of different bank creditors will help reduce the burden on the public finances, it is unlikely that public sector interventions can be reduced to zero without damaging financial stability. Further, as in the Iceland and Cypriot cases, it may be necessary to use capital controls to mitigate the effects of a financial crisis. But we can certainly do better in managing financial crises than has been done in many cases in recent years.

Flexible inflation targeting

It is often argued that since central banks have only one instrument – the interest rate, or the quantity of money – they should have only one target of policy – the rate of inflation. That has never been true in practice, as every central bank, whether an inflation targeted or not, also takes into account the impact of its policies on output and employment. That fact was taken into account by the development of the flexible inflation targeting approach.

Central banks in practice are choosing time paths for inflation and output (or employment) so that the difference between the Fed's dual mandate approach and flexible inflation targeting is relatively small. In both cases, policy-makers operate on a two to three year horizon, with a watchful eye on the future.

Fischer argued that the flexible inflation targeting approach, built around a tripartite set of goals of monetary policy – first, maintenance of price stability, as defined by the government, second, contributing to other goals of government policy, particularly growth and employment, and, third, contributing to financial stability – remains the way forward for monetary policy.

Stanley Fischer on 13 June in London

FRONT LINE VIEW

After the great recession

Gabriel Stein, Chief Economic Adviser, OMFIF

Governor Fischer's Golden Series lecture gave considerable food for thought. Some of his arguments challenge what is already received wisdom about the crisis – beginning with the widely-held view that nobody saw it coming (also known as 'the Queen's question'). As Fischer noted, the correct question should have been: why were the multitude of warnings ignored?

Another point he mentioned was the – again oft-repeated – claim that central banks concentrated too much on inflation targets and price stability and ignored the consequences for output growth. According to Fischer, all central banks are conscious of the trade-offs between growth and price stability and take them both into account when setting monetary policy.

But that is the past. What was more interesting was what Fischer had to say about the future. One thing was made clear at the beginning: there will be future financial crises. Whether the efforts we have made to increase regulation – e.g. through the Basel III accords or the Financial Stability Board – will be enough to reduce the probability of these future crises we cannot know. This is regardless of stress tests or other exercises attempting to gauge future risks. Nor will we know if new instruments, designed to reduce bank vulnerability, such as contingent convertibles (CoCos), really work until they are exercised.

This view has consequences for the general approach to macroprudential policy. This has become one of the buzzwords of the post-crisis financial architecture. However, as Fischer pointed out, macroprudential supervision and regulation are not problem-free. First, because the interaction with the financial system can in itself give rise to instability. Second, because there is a strong temptation to use the word 'macroprudential' in a Humpty-Dumpty way, so that it means anything we want it to mean – notably to justify detailed interventions which may not have much, if anything at all, to do with financial stability.

Does this mean that central banks and financial authorities should abstain from trying to regulate and stabilise markets? It does not. It does mean that they must have a certain amount of healthy humility towards what can and cannot be achieved through regulation and prevention, as well as an awareness of inevitable unintended consequences. Further, it does not mean that central banks and financial authorities should refrain from action when there is a crisis. On the contrary, among the criticisms levelled against Sir Mervyn King is that his concerns about giving rise to 'moral hazard' inhibited the Bank of England's actions when the crisis erupted. As Fischer put it, don't be a purist in extremis. How well the world weathers the next financial crisis will very much depend on how much these lessons are taken to heart.

On the web

See Bloomberg's video of Stanley Fischer's full speech at www.omfif.org

Diverging money trends

Sluggish euro area broad money growth

Gabriel Stein, Chief Economic Adviser

Global broad money provide a highly mixed picture of the international economy. In the US, latest data and household and company behaviour – readiness to take on more debt, rising consumer confidence and so on – imply that broad money growth will accelerate through 2013.

The soft spot indicated by other data for the second quarter of this year should be shallow and brief. The message from US broad money developments is that the US recovery remains on track and should accelerate in the autumn and into 2014.

US broad money is growing at a healthy, if unspectacular rate. Contrasting with the previous surge in broad money growth in spring 2011, which presaged good GDP growth from Q4 2011 to Q3 2012, credit to the non-bank private sector is expanding. The growth of credit is positive news – even though broad money growth is more important than credit growth, partly because an expansion in broad money is near-permanent.

As Chart 1 shows, the US Financial Accounts released in early June show US broad money was growing at a 12-month rate of 6% in May. ('Broad money' here refers to my own recreation of the broad money measure M3 that the Fed ceased to publish in 2006. This is constructed using the Financial Accounts; between the publication of the Financial Accounts, it is updated with the seasonally adjusted monthly change in the deposit liabilities of US commercial banks).

Historically, the rate of US broad money growth consistent with trend rate GDP growth over the medium term is in the 5-7% range, allowing for 2-3% real GDP growth, 2% inflation and a long-term average fall in the velocity of money of just under 1%. So the latest number – and the above-5% growth in US broad money since March – is positive.

However, three months is not long enough to call a change in monetary trends. Moreover, since the US economy is still in a weak recovery phase, broad money should ideally grow well above the 5-7% range for six to nine months, before falling back to that range.

Monetary developments in the euro area are much more worrying. For an avowedly monetarist central bank, the European Central Bank (ECB) has been remarkably complacent about broad money developments. As Chart 2 shows, M3 growth is nowhere near the ECB's medium-term reference value of 4.5%, meant to be consistent with medium-term trend output growth. Nor has M3 growth been anywhere near that number since spring 2009. The latest growth rate is 3.2% in the year to April and the three-month moving average is 3%.

There are several reasons why euro area broad money growth is so sluggish. One is that credit – the most important counterpart to broad money – is contracting. Though frequently blamed on banks for not lending enough, this is much more the result of households and companies not wishing to borrow.

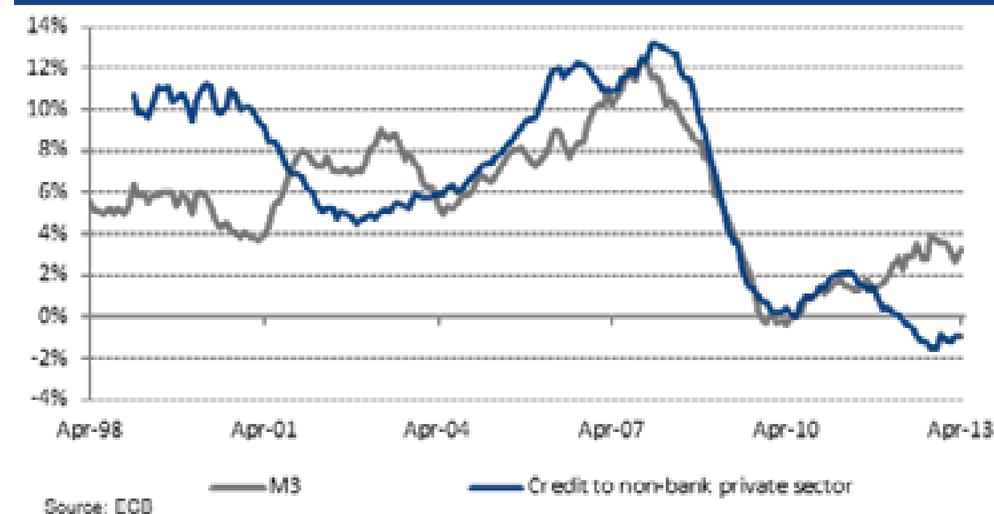
European banks are under pressure to shore up their balance sheets and improve their capital to asset ratio. This is being carried out by increasing capital or shrinking assets, striking directly against broad money growth.

The troika's handling of the Cyprus crisis and clear signs that, in future bank rescues, senior bondholders are likely to be bailed-in, is discouraging investors form contributing. The issuance of senior bank debt in Europe has fallen to the lowest since 2002.

Chart 1: US broad money and credit, 12-month change, %

Source: Federal Reserve, Stein Brothers (UK)

Chart 2: Euro area broad money and credit, 12-month change, %



Source: ECB

While the US banking system balance sheet has expanded since June 2010 and is now 20% larger than in September 2008, that of the euro area is up only 12% over this time, and smaller than a year ago.

The German banking system balance sheet is contracting after a surge in 2010-11, tying in with other recent data pointing to German below-trend growth in 2013, and dampening hopes for a stronger German recovery. German M3 growth is moving sideways at a reasonable rate of around 5%. French broad money growth is weaker (3.9% in the year to April) but is rising year-on-year.

The most surprising development is the acceleration in Italian broad money growth, from zero in April 2012 to 4.1% in April 2013. While it's difficult not to be pessimistic about Italian prospects, Italy doesn't have to do well in order to surprise on the upside — only less badly than expected.

When we turn to Japan, the question remains whether Bank of Japan's (BoJ) 'quantitative and qualitative' easing – 'Abenomics' – will work.

The BoJ policy is based on the idea that the money multiplier is holding and that lending enough money to the banks to cause their reserves with the BoJ to double over two years will boost broad money, credit growth and hence activity, eventually leading to overheating and inflation moving to 2% by 2015.

The relationship between developments in the monetary base and broad money – which was reasonable in the 1970s and 80s and somewhat better in the 90s – is not good. The weak growth and deflation dominating the Japanese economy over the past 20 years have led to an apparently limitless propensity by banks' willingness to hold extra reserves.

With the monetary base growing by close to 32% in the year to May (up from -0.2% in March 2012), the M2 broad money measure is growing at 3.4% (up from 2.2% a year earlier) and the somewhat broader M3 is growing by 1.8% – the slowest rate since October 2011. As seen in Chart 3, both growth numbers are slightly higher than average over the last three years (2.7% for M2; 1.6% for M3), but not by so much to spur confidence that Abenomics can boost domestic demand.

The prime minister's failure to launch convincingly the structural reforms that were meant to be the 'third arrow' of Abenomics adds to concerns that his policy may not drag the Japanese economy out of its two decade slump.

Chart 3: Japanese monetary base, M2 and M3 — 12-month changes, %

Stronger dollar shows confidence

Aftermath of the June FOMC meeting

Report on Golden Series Lecture with Richard Fisher, Federal Reserve Bank of Dallas

Richard Fisher, President and CEO of the Federal Reserve Bank of Dallas, delivered a lecture as part of the OMFIF Golden Series in London on 24 June. The lecture was chaired by Meghnad Desai, Chairman of the OMFIF Advisory Board, and a panel discussion was led by Christopher Jeffery, Senior Economist at BNP Paribas Investment Partners. Fisher's lecture, 'US monetary policy in the aftermath of the June FOMC meeting', focused on responses to the policy announcements on 19 June, that the Federal Reserve Bank would scale down its programme of liquidity injections under 'quantitative easing' (QE3).

Fisher believes the time has come for central banks to adjust monetary policy to address underlying economic problems. This action must be complemented by politicians in order to stimulate a global recovery. In light of the policy announcement on 19 June, Fisher underlined that he is not surprised by recent asset price volatility. Markets are 'manic depressive mechanisms' and it is expected for investors to test the resolve of central banks.

Last week, the Fed signalled that it would begin dialing back when conditions were right, but has yet to reduce purchases. The Fed's statement and subsequent press conference were meant to prepare markets for a gradual end to central bank support. Fisher has long been a sceptic about the Fed's efforts to spur faster growth in the US with the purchase of $85bn of securities a month. He warned markets that the Fed would not prop up the economy indefinitely, or be pushed to continue buying Treasuries and mortgage-backed securities at the same pace and, in so doing, possibly inflate asset price bubbles. Fisher affirmed that gradually reducing the volume of assets purchased by the Fed is the right direction for monetary policy in the US.

The strengthening of the dollar shows that financial markets are increasingly confident about US economic prospects. Bubbles have developed in a number of financial markets, including real estate investment. The US housing market, the decline of which helped spark the beginning of the global financial turmoil, has been recharged by the Fed's extraordinary monetary stimulus. This has seen the central bank expand its balance sheet fourfold, as it has acquired Treasury and agency-backed securities. Further, companies issuing bonds with a triple C rating can borrow for less than seven per cent.

Though comfortable with the rise in US Treasury yields, Fisher cautioned that a major spike would demonstrate a risk of financial instability. Fisher is hopeful that Japan's three-pronged assault on its economic problems through fiscal stimulus, monetary stimulus and structural reforms will be successful at returning the country to growth. He emphasised that structural reforms are most important, and lamented their absence in the US, maintaining that congressional inaction lies at the heart of US economic difficulties.

Fisher emphasised that structural reforms are most important, and lamented their absence in the US, maintaining that congressional inaction lies at the heart of US economic difficulties.

Eugene Nxumalo and Richard Fisher

Meghnad Desai, Desmond Cecil and Christopher Jeffery

FRONT LINE VIEW

Carnivorous message from Fed hawk

Christopher Jeffery, BNP Paribas Investment Partners

FOMC-watchers like nothing more than characterising policy-makers on a simple avian scale: hawk or dove. Given Richard Fisher's voting record, we came to the Armourers' Hall expecting a perspective on US monetary policy from the more carnivorous end of the spectrum. We were not disappointed.

President Fisher spoke with élan in an unscripted forty minute address. Coming just a few days after the FOMC had rocked the markets with its intentions to dial back the flow of asset purchases, his first hand perspective on policy deliberations was invaluable. With detours via Shakespearean comedy and Greek mythology, President Fisher expressed candid views on US monetary and fiscal policy, the regulatory framework and global financial markets. In short, the raptor held us in rapture.

As a long-standing internal critic of the Federal Reserve's quantitative easing programme, it was particularly interesting to hear his perspective on the (very) recently announced plans to dial back the rate of asset purchases by the end of the year. Listening to President Fisher, it was hard not to think of the famous line from William McChesney Martin (Federal Reserve Chairman: 1951-70) that the central bank's job is to 'take away the punch bowl just when the party is getting good'.

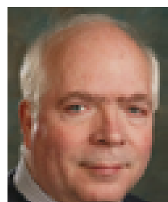
Fisher spoke of the dangerous and complacent behaviour in financial markets (noting in particular, recent exuberance in high yield corporate debt and private equity buyers in US residential real estate). Comparing financial market participants to adolescents on prescription drugs, he expressed little surprise or discomfort in the substantial repricing across bond, equity, currency and commodity markets since the FOMC meeting.

However, the address was not entirely red in tooth and claw. In recent weeks, the FOMC has struggled to convince the markets that the stock of purchased assets, rather than the monthly flow, is the appropriate measure of the policy stance. The recent repricing of short-dated interest rates suggests that they have also struggled to convey the 'separation principle' between asset purchase and interest rate policy.

Like Chairman Bernanke himself, Fisher was at pains to stress these points: policy will remain extremely accommodative for an extended period, the FOMC was committed to keeping interest rates low at least until unemployment dropped below 6.5%. It is hard to imagine the Federal Reserve Chairman referring to the dangers of going from 'Wild Turkey to cold turkey' in quite the same way, but the substantive message was essentially the same.

Echoing recent comments from the Bank for International Settlements, one of Fisher's main points was that we are close to the limits of what monetary policy can be expected to achieve in support of the economy. Making the analogy with Abenomics in Japan, Western (and indeed emerging market) economies need to unsheathe their 'third arrow' of structural reform to succeed in the long-run. Without a clearer fiscal and regulatory framework, and without long-term fiscal sustainability, private enterprise would continue to stumble along in the policy-induced 'fog of uncertainty' that had impeded growth during the recovery.

The implicit message was that it is time for central bankers to do less, and politicians to do more, to underpin the economy. He may be a hawk on monetary policy but, when it comes to relations with the political classes, this central banker is clearly not afraid to ruffle a few feathers.



Officials fight to calm markets

Tapering does not mean tightening, Fed insists

Darrell Delamaide, US Editor

It was inevitable that markets would overreact to the first whispers of a reversal of course on quantitative easing by the Federal Reserve. For the time being, the Fed's counteroffensive to damp the market's excessive behaviour appears to have worked, but there will almost certainly be more squalls to come.

Ben Bernanke

Fed Chairman **Ben Bernanke's (voter)** affirmation at his June press conference that the central bank might reduce the volume of its monthly bond purchases later this year from $85bn currently led to a global sell-off in stocks and bonds and sent Fed officials to the barricades to correct what they see as a misreading of their policies.

The barrage of statements appeared to help calm the markets, but the experience showed that Bernanke's policy of forward guidance is work in progress.

Bernanke said that if the economy progresses as the Fed anticipates, the central bank could begin reducing its asset purchases later this year and end them by mid-2014, when unemployment is expected to be in the 7% range, compared to 7.6% in May.

William Dudley

New York Fed chief **William Dudley (voter)**, vice chairman of the policy-making Federal Open Market Committee, was in the forefront of the fray, reminding markets that the amount of purchases would be reduced only if positive economic trends continue.

'This means that the policy — including the pace of asset purchases — depends on the outlook rather than the calendar,' Dudley said at a press briefing in New York. 'Even if this scenario were to occur and the pace of purchases were reduced, it would still be the case that as long as the FOMC continues its asset purchases it is adding monetary policy accommodation, not tightening monetary policy.'

A rise in short-term interest rates has led some analysts to suggest 'that market participants now expect the first increases in the federal funds rate target to come much earlier than previously thought,' Dudley said.

'Let me emphasise that such an expectation would be quite out of sync with both FOMC statements and the expectations of most FOMC participants.' Dudley spelled out what this means: 'A rise in short-term rates is very likely to be a long way off,' he said. 'Most FOMC participants currently do not expect short-term rates to begin to rise until 2015.'

Jerome Powell

Fed governor **Jerome Powell (voter)**, who joined the board last year, added his voice to the flurry of speeches in the last week of June, echoing Dudley's remarks.

'I want to emphasise the importance of data over date,' Powell said in a speech in Washington. 'The path of purchases is in no way predetermined; we will monitor economic data and adjust our purchases as appropriate.' He agreed that a rise in short-term interest rates is out of step with the Fed's forecasts and intentions. 'Market adjustments since May have been larger than would be justified by any reasonable reassessment of the path of policy,' Powell said.

Jeremy Stein

Another newcomer to the board, **Jeremy Stein (voter)**, portrayed Bernanke's remarks as an evolution in the Fed's communication of its intentions as the economic outlook becomes clearer. The central bank has always said it would wind down its quantitative easing when there is 'substantial progress' in the economy. Bernanke's remarks at the press conference, Stein said, were 'an effort to put more specificity around the heretofore less well-defined notion of substantial progress.'

Atlanta Fed chief **Dennis Lockhart (non-voter)** reinforced this view in remarks to a local group. Bernanke's comments did 'not constitute an enormous shift' regarding the asset purchases, which, in any case are a supplement to the Fed's primary monetary policy tool of the federal funds rate. 'Nothing has changed as regards that policy position,' Lockhart said. 'The timing of the first move to raise the policy rate will depend on overall economic conditions, but I would estimate 'liftoff,' as it is called, to come sometime in 2015.'

Jeffrey Lacker (non-voter), head of the Richmond Fed, took a more sanguine view of the market volatility. 'The chairman's statement forced financial market participants to re-evaluate the likely total amount of securities the Fed would buy under this open-ended purchase plan,' Lacker noted.

'This type of volatility is a normal part of the process of incorporating new information into financial asset prices.' In fact, Lacker added, 'As market participants gain additional insight from the words of Federal Reserve officials or by policy actions in coming quarters, further asset price volatility seems likely.'

Dennis Lockhart

San Francisco Fed chief **John Williams (non-voter)** emphasised that the Fed is continuing its monetary stimulus regardless of when and if it reduces the pace of asset purchases. 'Reducing or even ending our purchases does not mean the Fed will be tightening monetary policy,' he told a California audience.

'Not at all. The amount of stimulus our purchase program creates depends on the size of our securities holdings, not the amount we buy each month.'

Jeffrey Lacker

The Fed's balance sheet will continue to grow even with reduced purchases. 'As long as we are adding to our holdings of assets, we are adding monetary stimulus to the economy,' Williams said.

Part of the confusion has resulted from the Fed's maintaining a specific target of 6.5% unemployment before it will even consider raising rates again, and not giving any targets for winding down asset purchases until the June press conference.

Even as he indicated that the Fed could end asset purchases when unemployment was at 7%, Bernanke insisted that this was a threshold, or a marker, and not a hard target or trigger. This led to an extended discussion of thresholds and triggers.

'Our target is not 7, it's not 6-1/2,' Bernanke said in response to a question. 'Our target is maximum employment, which, according to our projections, most people on the committee think is somewhere between 5 and 6 percent unemployment, and that's where we're trying to get to.'

John Williams

The other numbers, Bernanke said, are 'guideposts that tell you how we're going to be shifting the mix of our tools' to achieve a smooth landing.

All this prompted **Narayana Kocherlakota (non-voter)**, head of the Minneapolis Fed, to urge a further evolution of Fed communication to spell out targets and thresholds more clearly, especially with regard to the federal funds rate.

Narayana Kocherlakota

'The committee has not described how it will set its fed funds rate target when the unemployment rate has fallen below 6.5% but remains above 5.5%—a period of time that I currently expect to last about two years,' Kocherlakota said in a statement.

He recommends clarifying this stance, effectively setting a lower target for the Fed to take action at the actual 5.5% unemployment the Fed wants – always presuming that inflation and inflation expectations remain below 2.5%.

'This additional clarity about future policy actions will tend to push downward on a variety of market interest rates and provide needed current stimulus to the economy,' Kocherlakota said.

'This additional clarity about future policy actions will tend to push downward on a variety of market interest rates and provide needed current stimulus to the economy,' Kocherlakota said.

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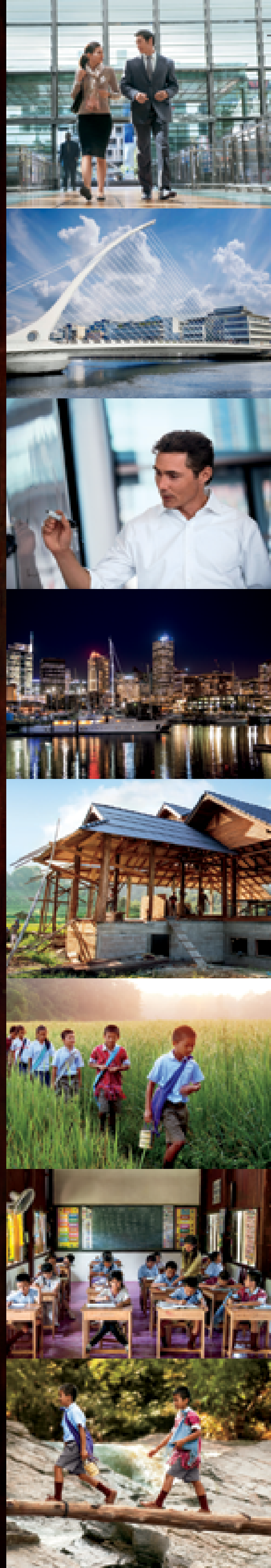
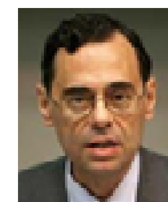




Navigating uncharted waters

Monetary policy in the crisis and beyond

Report on Golden Series Lecture with Jaime Caruana, General Manager, BIS

Jaime Caruana, General Manager of the Bank for International Settlements, gave a Golden Series Lecture on 16 May in London. He focused on the limits of monetary policy in the near term while slow recovery has structural causes, and on the need, in the longer term, for better integration of financial stability considerations into monetary policy frameworks.

Proceeding with humility

In view of great challenges ahead, Caruana emphasised the need for due modesty among monetary policy-makers, acknowledging limited understanding of the financial system and the use of historical lessons to navigate the aftermath of the crisis. This approach requires integrating a modern understanding of the financial system in models of monetary policy.

It is questionable how much more monetary policy can contribute to a generally lacklustre and uneven economy, and whether central banks can compensate for insufficient action elsewhere – namely, in balance sheet repair and structural reforms.

The financial crisis management readiness of central banks has been tested, with central banks providing ample liquidity as lender of last resort, putting targeted lending schemes in place, implementing large-scale balance sheet expansion and purchasing assets which may be of a higher risk component than those in the past.

While this unprecedented action has significantly mitigated the crisis and boosted confidence, the results have been somewhat lacklustre, with persistently high unemployment and lagging performance relative to previous recoveries. Amid mounting frustrations, questions are being asked about the need to make still deeper reforms.

Call for rapid structural adjustments

Caruana emphasised that results in the real economy will depend on repairs and reforms. Monetary policy can only have limited effects in view of weak financial institutions, misallocation of capital and labour, high levels of debt and deteriorating sovereign creditworthiness.

While monetary policy can effectively buy more time, the incentives to delay much-needed repairs and reforms – particularly in deleveraging, correcting labour rigidities and making structural reforms – run the risk of accruing costs in the future. Though progress has been made, repairs and reforms are still lagging in some areas. For instance, total debt of the G20 non-financial sector, both private and public, is still increasing at a rapid rate.

The slow pace of reforms, as well as persistently low interest rates, brings inevitable side effects. These may include masking balance sheet weaknesses, and weakening business models of life insurance companies and the solvency of pension funds.

In global monetary spillovers, upward pressure on emerging market economy exchange rates can potentially threaten the stabilisation goals of their central banks. Postponing reforms may further increase risks for central banks, as credibility may suffer with prolonged economic weakness despite repeated rounds of monetary stimulus.

Building a post-crisis monetary framework

In the medium- to long-term, central banks must reflect on how they can forge a new consensus on the way forward, particularly in developing a fully-integrated macrofinancial perspective and fostering a greater appreciation of global spillover and feedback effects. Monetary policy may complement macroprudential and international regulatory measures, such as in Basel III, in mitigating financial cycles.

As advocated by the BIS in the past, and notably before the crisis, price stability is not enough. Central banks should adopt a more symmetric approach to the financial cycle: tightening more in booms and easing less aggressively in busts. In terms of fiscal policy, this translates to accumulating budget surpluses or 'fiscal space' in good times, thereby allowing governments some flexibility to draw from in bad times.

Waiting for growth to come to the rescue is not an option, with balance sheet problems impeding growth and accruing costs of inaction. Governments and central banks are therefore under urgent pressure to formulate the correct measures.

Jaime Caruana

On the web

See full speech by Dr. Caruana on the BIS website at www.bis.org for further information and to to cite direct quotations by Dr. Caruana.

EMU future in German court

ECB may be caught in imbroglio

Holger Fahrinkrug, Meriten Investment Management, BNY Mellon

On 26 July, European central bankers and market participants will celebrate the first anniversary of the issuance of the so-called 'Draghi put'. On that day in 2012, the European Central Bank (ECB) president made his famous 'whatever it takes' statement that turned market sentiment around to start believing that the economic and monetary union (EMU) had a decent chance to survive, and that the risk-reward ratio of bets against it had turned unfavourable.

Since then, the spreads of 10-year periphery sovereign bonds over German bunds have tightened substantially, in spite of a lack of improvement in the crisis countries' fundamental debt situation.

In the week when Draghi made his remarks, Spanish 10-year government bonds yielded more than 7% and threatened to hit 8%. The market was concerned whether the European bail-out funds EFSF and ESM were large and flexible enough to cover the needs of the euro area's fourth-largest economy. And before Draghi's speech, there was no clarity what part the ECB would take in the event of financial calamity affecting a larger EMU member.

The spread contraction since suggests that the market increasingly considers this issue to have been resolved. However, the prospect of unlimited ECB bond purchases in the OMT programme is facing an increasingly sceptical public, especially in Germany. There is an increasing awareness that ECB bond purchases are not risk-free.

Their possible impact goes beyond an inflation boost and could become a national wealth issue if the ECB incurred losses that national taxpayers would have to meet. German Angst is on the rise.

The possible impact of bond purchases goes beyond an inflation boost and could become a national wealth issue if the ECB incurred losses that national taxpayers would have to meet. German Angst is on the rise.

One result of this process is that a new anti-euro party, the AfD (Alternative for Germany), has been founded to compete in the general election on 22 September. It stands at only 3% in the opinion polls at the moment, but has the potential to clear 5%, the threshold for parliamentary representation. If so, it would complicate any kind of coalition formation.

In addition, the OMT is subject to a constitutional court case in Germany which has caught great public attention. The court has no say over the ECB as such, or its concrete policy decisions, since these are matters of European legislation. But it will have to determine whether the OMT, and the risk transfer towards national taxpayers associated with it, is within the ECB's mandate and thus implicitly legitimate, or stands in conflict with the German constitution.

If ruled unconstitutional, the Bundesbank's participation in the OMT could be placed under conditions (e.g. parliamentary ratification of every bail-out) to align it with German constitutional principles. Any restriction of the OMT enforced by the court would reduce the ECB's crisis-combating powers.

Not only the lawsuits, but also the ECB's defence is relevant for financial markets. The ECB points out that the OMT has never been used, and that its announcement had been sufficient to calm markets. If this means that, to comply with the German constitution, the ECB's programme is not meant to go live, or the ECB is not planning ever to use it, then the market's assessment of fiscal sustainability would have to be reviewed, and to be based on a fundamental debt analysis, rather than just the idea that the ECB will provide a safety net.

Such fundamental analysis concludes that both Greece and Cyprus would need to run primary surpluses (budget surpluses before interest payments) in excess of 8% of GDP to stabilise their debt level this year and next.

Greece's debt is expected to hit 175% of GDP this year, and Cyprus' will jump by about 40 percentage points to 124% once the bail-out funds granted by the EU and IMF are included. Both economies will continue to shrink for some more time which will increase the debt-to-GDP ratio. Therefore, Greece's and Cyprus' debt situation is not sustainable, meaning that they are highly likely to require another writedown at some point in the not so distant future.

Coincidentally, these conclusions match the recently published self-criticism of the IMF which also stated that Greece's debt position has never been sustainable since the outbreak of the crisis, so that the IMF breached its own rules by providing bail-out funds.

Other countries' fiscal positions appear significantly healthier, but require a smart policy mix comprising both austerity and growth-supportive structural reforms in order to stabilise their debt ratios.

Of the EMU countries currently under scrutiny, Ireland and Spain have the best chances to ultimately succeed as they would, according to our calculations, require primary surpluses of only 1.5% and 2.4% respectively this year and next to stabilise their debt ratio. This should be achievable.

Portugal and Italy have slightly steeper uphill battles to fight, with required primary surpluses of 3.6% and 3.8% respectively. Primary surpluses of this size are not unusual in Italy, which is therefore considered relatively safe. However, Portugal has yet to prove that it can achieve the required fiscal discipline on a sustainable basis.

Fortunately, the EU Commission has recently adopted a slightly more relaxed stance relative to the time horizon within which the aforementioned countries need to bring their deficits down.

This buys time to establish a more balanced policy mix that avoids unreasonable economic contraction in the periphery and could open the door for some support centrally via EU vehicles, or indeed bilaterally, initiated for example by Germany, in order to avoid further deterioration of economic and social conditions in the crisis countries.

How relaxed the attitude towards the indebted countries will be going forward will not least depend on the outcome of the German general election on 22 September.

A more left-leaning government would be seen as a door-opener to more relaxed fiscal supervision and potentially intensifying considerations regarding transfer mechanisms in EMU, perhaps of a similar kind as the German Financial Equalisation Scheme which transfers funds from strong federal states to weaker ones.

A Social Democrat-led government would also be less hostile than the current one towards more joint financing in EMU, including eurobonds. And surely, it would find it easier to co-operate with the current French administration as its positions would be more compatible with those of president François Hollande than those of Merkel.

By contrast, any role of the anti-euro AfD party in the formation of Germany's next government would make compromises with France and the crisis countries very difficult to achieve. To this end, the German election will have importance far beyond the country's borders, namely for the future shape of the EMU itself.

A shift towards the left, as seen recently in France and Italy, could be seen as the removal of the last hurdle on the way towards greater fiscal union, also known as transfer union, in the euro area.

A shift towards the left, as seen recently in France and Italy, could be seen as the removal of the last hurdle on the way towards greater fiscal union.

Holger Fahrinkrug is Chief Economist of Meriten Investment Management GmbH, a wholly-owned subsidiary of The Bank of New York Mellon Corporation ('BNY Mellon'). The views and opinions expressed herein are those of the author only and not those of BNY Mellon or any of its subsidiaries or affiliates.

Redrawing the euro's contours

Thorough overhaul needed for Eurosystem

Michael Burda, Advisory Board

Economic and monetary union was always a grand gamble. It established the European Central Bank (ECB) for a region that was not a state. The ECB is a trans-European institution with governmental duties that does not represent any government in particular.

The euro's founding fathers did not anticipate all the ramifications. In particular, every expansion of the euro area has led to an automatic enlargement of the central bank council, without taking account of increased complexity of governance and monetary policy-making, including funding conditions for governments and refinancing of commercial banks.

To overcome these deep-seated governance problems, a thoroughgoing overhaul of the Eurosystem is required, including a redrawing of the boundaries of the central banks that make up the ECB's constituency. A possible plan is shown on the map on this page.

Adjustment in a monetary union is painful – as developments in the European periphery make clear – so it is paramount to prevent such misalignments from arising in the first place. Despite these warnings, European politicians insisted on setting up a system with fundamental flaws. A common monetary policy must be formulated above and beyond individual national concerns. Yet because the national euro central banks have much to say about ECB monetary policy – in fact, they own the ECB – they pose source of significant risk. One example is their well-recognised reluctance to impose 'haircuts' on the value of collateral used by member country private banks for funding their lending activities.

This is one of the few natural brakes on government borrowing, especially when it is driven by reckless fiscal policy. In this sense, the ECB should have applied that brake much earlier. By any normal reckoning, Greek banks should have faced this constraint already in 2003-04, as their government and private sectors were already overextended. Restricting credit flows to Greek banks and other lenders would have slowed aggregate demand and the deterioration of competitiveness already emerging.

The one-interest rate policy praised by Jean-Claude Trichet, then ECB president, sent exactly the wrong signal to the markets. Once markets got wise to what was going on, governments that had previously been able to borrow on the same conditions as Germany saw a drastic deterioration in their creditworthiness. By then, it was too late: after the adjustment, the ECB became so preoccupied with shoring up the financial health of the system that it was unable to apply haircuts to any single country.

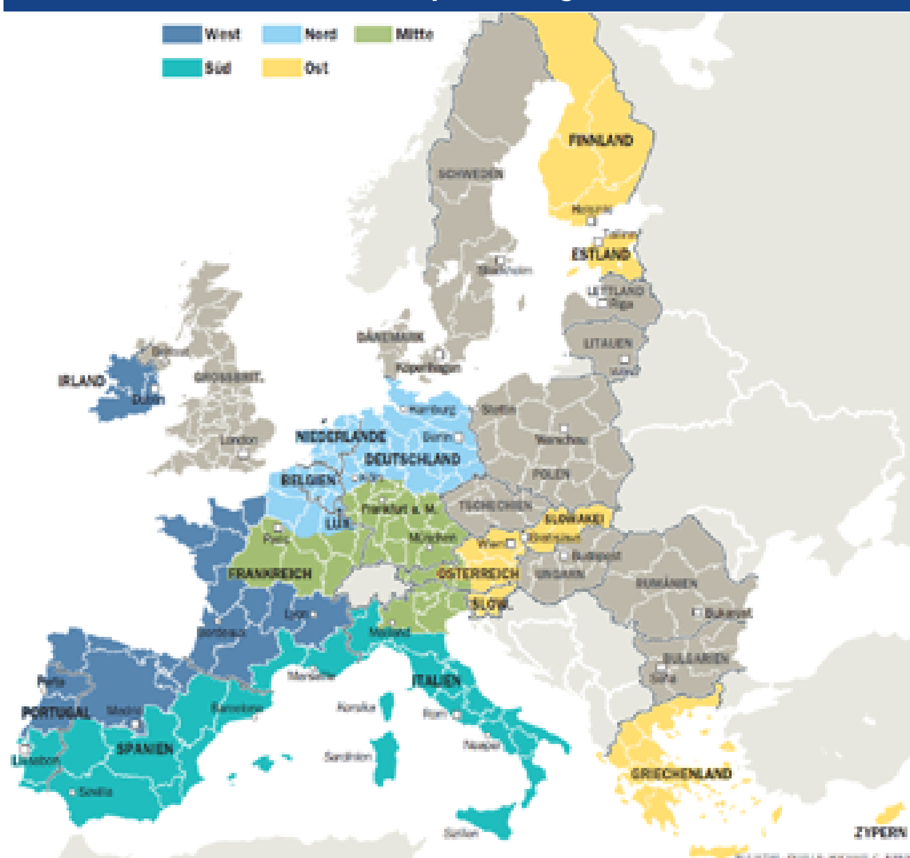
The repoliticisation of monetary policy poses a significant risk for economic integration as well as for a neutral (country-blind) money and credit policy across the euro area. The logical remedy is a redesign of the ECB in a fashion similar to the US Federal Reserve system. The regional Federal Reserve Banks represent large stretches of territory that reach beyond the borders of US states and sometimes even divide them.

Balance of payments problems and competitiveness misalignments between Federal Reserve districts do occur, but they are apolitical and immune from the pressures of state legislatures.

The map shows one possible model for repartitioning the euro area monetary authority along the lines of the EU NUTS-2 regions used for statistical analysis. Such an ECB redrawing, cutting across national frontiers, would help reestablish a neutral and politically independent allocation of money and credit.

(continued on page 20..)

The Burda Plan for repartitioning the euro area



'Good-bye, Mister Churchill'

British second thoughts on European integration

Willem van Hasselt, Advisory Board

When on 20 September 1940, Pieter Gerbrandy, prime minister in the Dutch war cabinet, met Winston Churchill at 10 Downing Street, he greeted his British counterpart with these words: 'Good-bye, Mister Churchill'. 'What, already?', responded the British prime minister. I recalled this innocent linguistic confusion when reading European Council president Herman van Rompuy's speech in London in late February. On a possible UK exit from the EU, it says: 'Leaving is an act of free will, and perfectly legitimate, but it doesn't come for free. Generally speaking, the existential question leaves a mark. How do you convince a room full of people, when you keep your hand on the door handle?'

It is said that in the 1940s and 50s, Britain rarely missed an opportunity to miss an opportunity to engage with the European project. When the UK finally did, a French veto prevented British EEC membership during the 1960s. De Gaulle's 'Non' in 1963 contrasted with the letter and spirit of the response given by Robert Schuman to Ernest Bevin at a White House meeting in 1949.

After the Americans expressed worries on British hesitation regarding European cooperation, Bevin responded: 'Frankly, we do not consider ourselves a continental nation; we have a worldwide commonwealth to look after and our attitude is somewhat like that of the US.' Schuman's reply sounded like it came from a film-script: 'Perhaps Mr Bevin would prefer to wait until the Communists had "stabilised" the continent?'

Between 1949 and 1963, the outcome of the Suez Crisis clearly defined different British and French foreign policies. British involvement in European affairs has been of serious concern for post-war Belgian, Dutch and Luxemburg governments, on the path to the Treaty of Rome and beyond. Philippe de Schoutheete has reminded us of the intensive diplomatic efforts by these member states to favour British accession to the European Community.

Of the Benelux members, the Dutch tend to consider themselves closest to the British, though aware of the blind spots. Walter Russell Mead gives a clue in his 'God and Gold', where he defines 400 years of capitalism in one sentence: 'United Provinces, United Kingdom, United States.' While completely aware of being among the founding fathers of the European integration project, the Dutch tend to view Franco-German cooperation as a necessary but insufficient condition for a sustainable EU future.

Eight years after the attempt to provide the EU with a truly constitutional dimension was vetoed in two founding EU members, the Netherlands and France, we have learned some lessons. Understanding the economies of scale argument for sharing certain sovereignties in the EU, does not (yet) go hand-in-hand with citizens' owing their (constitutional) loyalties to this 'unidentified political object' EU. Nor has 'Euroland' become the name for the euro area. The euro is a currency without a state.

The euro bank notes show a sterile Europe of imaginary buildings. Not the Parthenon in Athens, but a fantasy building paying tribute to Greco-Roman culture. Not the cathedral in Chartres, but the stained-glass windows of an unidentifiable church. Not Mies van der Rohe's National Gallery in Berlin, but a modernist building of indeterminate origin. The absence of living people, animals and real buildings resembles a metaphor of our citizens' hesitation wholeheartedly to join the union.

Such developments take decades, if not generations. But geopolitical developments require sophisticated and courageous European answers. British hesitations about Europe go hand in hand with excellent British analysis. Our European future is open. The 10 year-old daughter of a British diplomat in Brussels sensed this when she told her parents what this process called 'Europe' was about: 'Nobody knows who is in, nobody knows who is not, but everyone is part of the plot'.

The euro bank notes show a sterile Europe of imaginary buildings. Not the Parthenon in Athens, but a fantasy building paying tribute to Greco-Roman culture.

A time of tests and experiments (... continued from page 1)

The measure probably isn't as significant and as binding as some observers think. If it had been, the Bundesbank would have voted against it. But by breaking with the long-held mantra against 'precommitting' on interest rates, the ECB may be storing up more confrontations with the Bundesbank and German public opinion in the future.

The ECB's entreaties for the politicians to take responsibility for putting Europe's house in order are blocked by perhaps the most pernicious paradox. The sole escape route for the euro must run via deeper political unification and economic integration. Yet, because of mistrust between creditors and debtors caused by past miscalculations, building a genuinely federal Europe for the countries that wish it meets enormous resistance from all sides.

Lack of growth and of effective crisis management has made the ECB and other official institutions by far the largest creditor of Greece. International Monetary Fund figures show that of Greek government debt of around €300bn at end 2012, more than €200bn are held by official creditors, with less than €50bn each held by residents and private sector non-residents.

In 2009, Greece had roughly the same debt total but roughly €220bn were owed to private sector non-residents and none to official creditors.

The IMF and others who believe that Greece's debt is unsustainable are calling for a debt restructuring, almost certainly after the German elections.

The ECB is quite properly rejecting any such idea, but if it is forced to write off credits to Greece then this could be seen as a formal breach of the prohibition of monetary financing of governments.

Any slackening of liquidity flows from quantitative easing in the US and Japan is almost certain to have a negative impact on European confidence – as will do a repeat performance of subsequently-quelled June jitters about a Chinese financial market squeeze. ☒

Beijing slowdown (... continued from page 1)

Compounding the problems caused by the poor international growth environment, accelerating labour costs in China and the recent weakening of many emerging market currencies against the dollar have led to a significant recent real (inflation-adjusted) revaluation of the renminbi.

If the growth outlook darkens further, the renminbi may become vulnerable to a decline on currency markets, which could cause additional trade tensions with both the US and Europe at a time when many western observers (wrongly) regard the renminbi as under-valued and when Europe in particular needs a lower value of its own currency to kick-start what is still extraordinarily sluggish growth.

Immediate worries about a Chinese credit crunch, which added to international financial market uneasiness at the end of June, have receded.

Money market rates have declined to normal levels after the People's Bank of China damped fears of a sharp lending cutback and promised to pump in fresh liquidity to assist the financial system.

Private and public sector economists in Beijing have grown progressively more gloomy about the medium-term economic outlook. The PBoC began tightening monetary policy some three years ago, and greater financial market volatility similar to that seen in recent weeks, appears near-inevitable.

Governor Zhou Xiaochuan has done his best to play down further fears of a credit squeeze. But in view of the bank's own efforts to persuade banks to rein in rapid lending and to improve their liquidity management, further measures to curb excessive loans cannot be ruled out. Consequently, similar developments to the mid-June market turbulence may recur.

All this is being played out at the same time as China is endeavouring to drive forward interlinked agendas for capital account and interest rate liberalisation, measures with the long-term aim of modernising the Chinese economy but with plenty of potential to disrupt it if the authorities get the balance or the timing wrong. ☒

Redrawing the euro's contours (... continued from page 18)

The number of board members representing the districts could be based on population or GDP per capita. Rather than being penalised, smaller countries would benefit from a reduction in the natural hegemony of the larger member states.

The legacy of the defective status quo – the Target 2 accounts – could be reapportioned to the new ECB districts on a pro rata basis according to populations or GDP, and would instantly lose political relevance. The elimination of national influences from monetary policy would improve EMU's efficiency and functionality. A neutral, market-based framework for allocating central bank credit to member banks is essential for a functioning banking union. Rigorous haircut rules for ECB bank refinancing on the basis of creditworthiness would force member countries to apply more discipline to national finances, enabling a credible return to the no-bail-out principle.

The explosion of the Target 2 imbalances over the last five years would have been prevented by an even-handed application of collateral and leverage restrictions. Nationally-orientated bail-outs like the LTRO and OMT programmes would be a thing of the past. So would be national central bank public lobbying against supposedly independent ECB monetary policy measures.

This next difficult step along the path of European integration will be a veritable crossing of the Rubicon. Without credible de-politicisation of monetary policy, EMU is unlikely to withstand expected macroeconomic shocks. ☒

A question of trust

Credibility depends on political independence

Stefan Bielmeier, Advisory Board

In mid-June, the European Central Bank (ECB) had to go on the record before the German constitutional court to testify whether its OMT bond-buying programme fell within the ambit of its mandate. The ECB announced last summer that it would under certain conditions buy bonds issued by government in the countries in crisis. The court is not expected to pass judgment until after the German general elections on 22 September and the ruling is hardly likely to worry the financial markets. Yet the litigation shows how far central banks have in recent years departed from traditional central bank policy-making.

Expansionary central bank policy should do not more than provide time for governments to make necessary reforms: that, and nothing more.

As part of traditional central bank policy, almost all the major central banks have lowered interest rates to just about zero. The aggregated central bank interest rate for a large swathe of industrialised nations and emerging markets stands at only 1.8%. In the industrialised nations hit by the sovereign debt and banking crisis, this policy of low interest rates has not been enough by itself. The central banks had to take additional steps to steady economic performance, and, in the euro area, steps designed to secure the union's cohesion. The measures differed depending on the central banks' respective mandate and statutory regulations. The ECB concentrated on furnishing liquidity, thereby easing the quality standards for securities eligible as collateral. By the same token, the ECB has to date been cautious in acquiring government bonds, with a blurred line dividing bond purchases from government financing.

By contrast, in the US, Britain and Japan, the focus has been on purchasing securities. In both cases, central bank activities have led to larger balance sheets. Since the beginning of measures to combat the crisis, the Fed's balance sheet has grown 270% while that of the ECB has increased 70%. Of the major central banks, only the ECB has a notably contracting balance sheet. Cuts in interest rates and higher liquidity decided by the major central banks have not been reflected in rising consumer prices, probably owing to weak economic conditions. To date, there are no noteworthy expectations of inflation among private households. This would suggest great confidence in central banks. People trust that the highly aggressive monetary policy will be discontinued in good time.

This trust is the result of central banks now communicating the reasons for their decisions much more openly. These open and – up to now – reliable communications have made monetary policy easier to predict. There was admittedly a rise in volatility in almost all asset classes when the Fed openly considered the exit from its expansive policy. This was a necessary correction to what were in part very high valuations. The exit is likely to be a gradual process, buttressed by forward-looking communications – presumably avoiding a crash in bond or equity markets.

These communications are only credible with central bank political independence. A loss of independence would lead to a loss of confidence, thereby causing inflation expectations to rise appreciably and a sell-out on bond and equity markets. The incentive for politicians to clip that independence is unfortunately high. Most central bank measures aim at ensuring government refinancing functions smoothly and bond yields remain at a low level. Governments' interest loads have thus fallen in recent years, though debt levels have risen. If central banks resolve to discontinue their highly expansionary policies, yields may gradually rise to a normal level.

There is no way of avoiding the need for tightening interest rate and liquidity policy, as well as for budget consolidation and social and economic reforms. To protect the global economy from greater damage and manage inflation risks, central banking independence is a crucial asset. Governments which succumb to the temptation to intervene in central bank policy and extend relatively soft current financing conditions would face severe consequences. Expansionary central bank policy should do not more than provide time for governments to make necessary reforms: that, and nothing more. ☒

Dilemma for central banks

US accelerating to 3% growth next year

Michael Holstein, DZ Bank

DZ Bank Economic Forecast Table

GDP growth	2011	2012	2013	2014
USA	1.8	2.2	2.0	3.0
Japan	-0.5	1.9	2.0	1.8
China	9.3	7.8	8.0	8.5
Euro area	1.5	-0.5	-0.5	1.1
Germany	3.0	0.7	0.4	2.2
France	2.0	0.0	-0.2	0.8
Italy	0.5	-2.4	-1.2	0.4
Spain	0.4	-1.4	-1.9	0.9
UK	1.0	0.3	0.6	1.4
Addendum				
Asia excl. Japan	7.6	5.9	6.3	7.1
World	3.8	2.9	2.9	3.8
Consumer prices (% y/y)				
US	3.2	2.1	1.6	2.2
Japan	-0.3	0.0	-0.2	1.5
China	5.4	2.7	2.7	3.7
Euro area	2.7	2.5	1.7	1.9
Germany	2.5	2.1	1.7	2.1
France	2.3	2.2	1.3	1.6
Italy	2.9	3.3	1.7	2.0
Spain	3.1	2.4	1.9	1.5
UK	4.5	2.8	2.6	2.7
Current account balance (% of GDP)				
US	-3.0	-2.8	-2.8	-2.9
Japan	2.0	1.0	1.1	1.5
China	2.8	2.6	2.4	2.1
Euro area	0.1	1.2	1.9	2.0
Germany	6.2	7.0	6.3	5.5
France	-1.9	-2.3	-1.7	-1.8
Italy	-3.1	-0.7	0.9	1.1
Spain	-3.7	-1.1	1.0	2.0
UK	-1.3	-3.7	-3.4	-2.6

Produced in association with DZ Bank Group, a partner and supporter of OMFIF

The immediate financial market response to the recent comments by the chairman of the US Federal Reserve Ben Bernanke on the possibility that the Fed will begin to pull back from its expansive monetary stance before the end of this year was a fall in asset prices.

This reaction to the mere hint of a potential change in monetary policy illustrates the dilemma into which the central banks have maneuvered themselves. However tricky the exit process, the end of quantitative easing in the form of permanent central bank balance sheet growth and zero interest rates is inevitable.

Central banks cannot make the necessary adjustments on behalf of governments, businesses and private households. They must do this themselves. Some countries have made good progress, while others have barely started. Although US public deficits remain high, the country's private households and companies are some way along the road to consolidation. The housing market has stabilised and unemployment is falling steadily. Not only in the Fed's opinion is a 'beginning of the end' now conceivable. We expect GDP growth to speed up next year, to around 3%, with inflation subdued.

The euro area's economic problems loom larger, with the economy stuck in recession and GDP likely to fall in the second quarter at least. Unemployment is sky high in the crisis countries, and deficient credit supply to the business sector is a major problem that monetary policy cannot address. It seems reasonably likely that the economy will bottom out in the second half and that the euro area will return to growth in 2014. But the situation is bound to remain critical in the southern periphery. Significantly rising bond yields could make an already difficult recovery even trickier to navigate.

There is disappointing news flow from the Chinese economy: in addition to weak economic data, new doubts about the stability of China's banking sector have arisen. Chinese money market interbank rates jumped to alarmingly high levels — a development that reminded us of the turmoil following the Lehman bankruptcy.

The liquidity crisis appears to have been prompted by a deliberately low liquidity allocation by the central bank. The Chinese government sees the volume of credit to commercial banks, particularly financing outside of bank balance sheets, as a threat to market stability. The authorities appear willing to accept lower economic growth in the restructuring process. Some economic damage is undoubtedly being done. Nervousness is likely to persist and the stability of China's financial sector will remain the focus of attention.

Lessons of the Five British Tests

Where the UK got euro assessment right – and wrong

OMFIF Report

The Labour Government's decision not to join the euro when the decision was made in 2003, and Gordon Brown's leadership of the issue, as the then Chancellor of the Exchequer, is said by many observers to have been vindicated by subsequent events. This was the wholly convincing message portrayed by Dave Ramsden, Chief Economic Adviser to the British Treasury, and the man in charge of the technical preparations for the 2003 process, at a talk on the 10th anniversary of the 'Five Tests' procedure at the Mile End Group at Queen Mary College, London, on 25 June.

A strong insight was that if inflation is higher, real interest rates are lower and credit growth and related economic activity – such as house purchases – are stronger, at least in the short term.

Ramsden said the UK Treasury contributed to this success because of its increasing control of the decision. 'But there were issues we missed and the Treasury is continuing to learn the lessons of the post-2003 period.' The Government's 2003 decision was built around an assessment of the 'Five Tests' for UK membership of economic and monetary union (EMU) which made a first appearance in February 1997 when Gordon Brown set out the Labour party's position (then in Opposition) while on a trip to the US. The folklore became that the Five Tests were invented in the back of a New York taxi, an early example of the 'window dressing' charge that dogged the policy.

The Five Tests were actually based on the long-established economic literature relating to optimal currency areas, applied to the UK's situation in a pamphlet Ed Balls (then an adviser to Brown, later Chief Economic Adviser to the Treasury, now the UK's Shadow Chancellor) wrote in December 1992. The Five Tests covered potential benefits – captured by the Investment, City and Job tests – and potential negative consequences – covered by Convergence and Flexibility. In detail, the tests were:

Convergence – Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis? **Flexibility** – If problems emerge is there sufficient flexibility to deal with them? **Investment** – Would joining EMU create better conditions for firms making long-term decisions to invest in Britain? **The City** – What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets? **Jobs** – In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

A crucial advantage of the Five Tests was that while the Maastricht criteria dealt with exclusively nominal variables, the Tests dealt with the real economy and the macroeconomic implication of the required adjustments in markets at the microeconomic level.

Ramsden outlined 'with the benefit of 10 years of hindsight' what went well and what went less well. 'Subsequent developments do bear out much of the analysis and the UK's decision not to join. Another obvious point worth stressing is that many of these developments have been unwelcome.' The key convergence and flexibility tests illustrated where the UK analysis was strongest. 'We built up a clear and rounded picture of the different elements of economic life for a country in EMU, based on a range of analytical approaches and models.'

The UK's 2003 assessment noted that a decision to join EMU in the wrong way at the wrong time could have long-lasting adverse effects on the economy. It stressed the risk that insufficient convergence in economic conditions across countries might mean that the common interest rate set by the European Central Bank could prove problematic.

In particular, it highlighted that differences in housing markets and the degree of economic development could be exacerbated by a common interest rate. A strong insight was that if inflation is higher, real interest rates are lower and credit growth and related economic activity – such as house purchases – are stronger, at least in the short term.

Another finding was that adjustment in EMU is different. More specifically: 'Inside EMU inflation and competitiveness have to take the strain of adjustment previously undertaken outside EMU by an independent monetary policy and the nominal sterling-euro exchange rate.' Related to this, the assessment highlighted that flexibility is crucial in allowing resources to be reallocated more rapidly to mitigate the effects of a shock.

The Treasury applied these insights to modelling the adjustment paths to different shocks including the shock of entry. The Treasury went further and modelled the 'What If': What would have happened had the UK joined EMU when it started in 1999?

Joining EMU in 1999 would have meant lower UK interest rates and a lower exchange rate than actually occurred. (See Chart 1 for a review of the actual outcome.) This would have given an initial boost to GDP, which increases inflation, depresses the real interest rate, and gives further temporary growth boost until the depressing effects of higher inflation on real incomes and higher real exchange rate kick in, dampening competitiveness and earnings from trade.

'This cycle in the real economy is avoidable only with a very high degree of flexibility, enabling markets to adjust and resources to be reallocated very quickly. It played out in a number of economies.' Ramsden noted that a 2013 policy brief published by the European Commission echoed the 2003 analysis. Chart 2 shows that, through lack of convergence of structures, lack of flexibility of markets or both, the competitiveness of euro members as measured by real unit labour costs diverged, with nearly all economies losing ground relative to Germany, which scored well on both.

Ramsden said the Treasury didn't go on to develop this to look at the risks to the balance of payments. The analytical consensus was that, within the euro area, current accounts no longer mattered. But even within a single currency area, if a country had competitiveness problems, this would show as a current account deficit, and reliance on external financing, with capital inflows needed from other countries, including elsewhere in the euro.

The Treasury's assessment focused on EMU's fiscal arrangements and the implications for Treasury control of UK fiscal policy. The assessment saw the need for greater fiscal flexibility in EMU, looking at various fiscal stabilisation options, from strengthening the automatic stabilisers through to new instruments such as a consumer credit tax. The UK analysis was focused on fiscal stabilisation within countries, rather than stabilisation between countries.

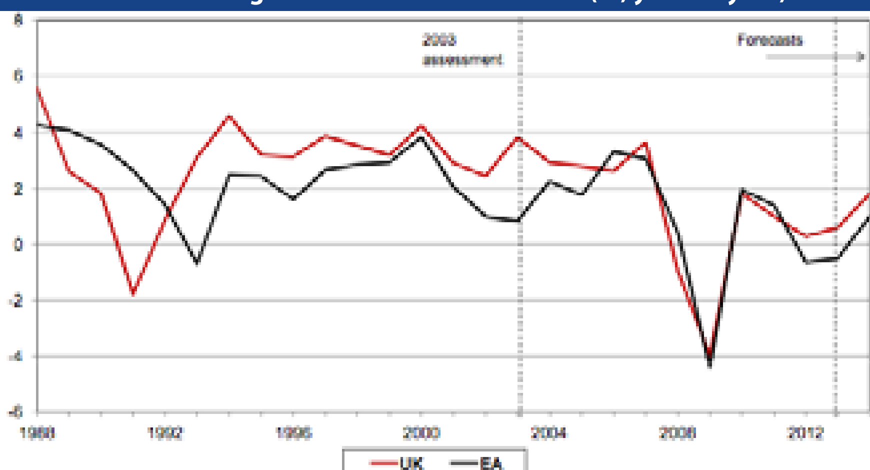
Ramsden affirmed that, since 2003, the UK economy has become more cyclically convergent with the euro area average growth rate, with slightly slower growth. But this largely reflected the degree of global convergence in the upswing, and the synchronised subsequent crash. And the euro area average masked some divergences between members, reflecting the forces the Treasury identified, such as credit.

'In terms of the growth and investment tests, the Treasury assessment was appropriately balanced in emphasising the potential macroeconomic benefits from enhanced microeconomic integration between highly convergent and flexible economies.' The evidence suggests that the UK has seen its trade share with the euro area decline, although it remains high. 'If trade has been diverted to other faster-growing economies this need not be at the expense of output.'

On the investment test, the Treasury in 2003 didn't explore what could happen if the credit channel for monetary policy became and remained impaired. Ramsden pointed out this was something that is being addressed in the UK by the Funding for Lending Scheme, but which remains apparent in the fragmentation of euro credit markets.

One of the biggest issues to which Ramsden said the UK didn't do justice was whether EMU membership was permanent or was an arrangement that a country could leave. 'This wasn't a failure of imagination, rather it was a conditioning assumption of the whole analytical and policy approach to EMU. And it was informed by the UK's more general stance on the euro from its inception. We wanted it to be a success. So like everyone else we assumed it was permanent.'

Chart 1: GDP growth for UK and euro area (%, year on year)



Ramsden added that a related limitation was the role of fiscal policy and whether EMU implied a fiscal union. 'The fiscal policy framework in the euro area was and, to a large extent, still is materially different from that of the US which we had studied. In the euro area fiscal policy is largely set at the national level with minimal fiscal transfers between countries. By contrast in the US the federal government can coordinate fiscal transfers between regions.'

Ramsden noted that the European Treaty included specific provisions – the so-called 'no bail-out' conditions – that underlined that national governments were fully responsible for ensuring that their own fiscal positions were sustainable, backed up by the provisions of the Stability and Growth Pact. 'There were a range of views about whether this would be sustainable. Some academics submitted evidence to us that inter-regional fiscal transfers were essential for the long term viability of a monetary union.'

The European Treaty included specific provisions – the so-called 'no bail-out' conditions – that underlined that national governments were fully responsible for ensuring that their own fiscal positions were sustainable.

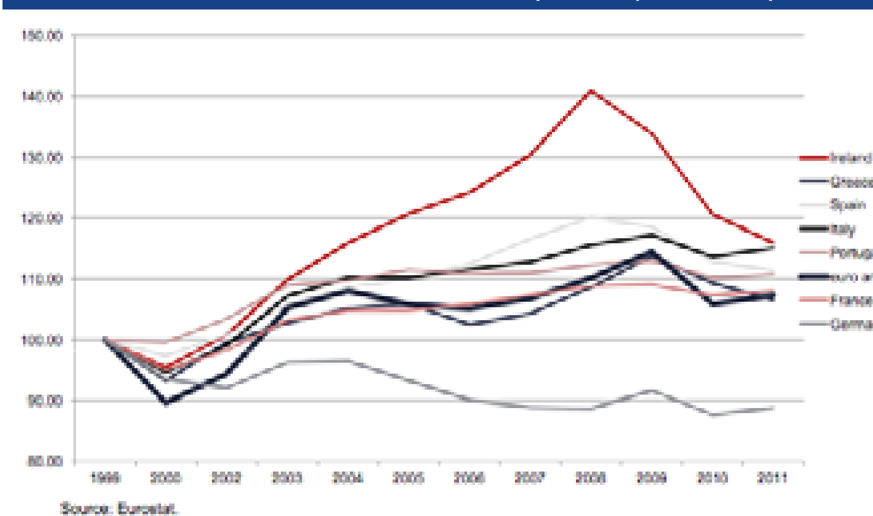
Ramsden said that, by contrast, the Treasury assessment reached the strong conclusion that a federal fiscal policy was neither necessary nor desirable in EMU. Ramsden added: 'This conclusion was much too sanguine. It underestimated the speed with which Governments could lose access to the bond markets and hence underestimated the need for last resort financing.' He said the Treasury has recognised this in its approach to the policy needs for EMU to be a success and also in its analysis of the issues facing Scotland if it were to leave the UK.

With reference to the City Test and the role of the financial sector, the Treasury presented an original application of clustering analysis and drew on the historical work of David Kynaston to understand the roots of the UK's strengths. But the assessment didn't foresee the build-up in risks in the financial sector – proxied by its increase in size as a share of GDP after 2003.

More importantly Ramsden said the Treasury didn't see the risks represented by the increasing size of the financial sector, its balance sheet and the limitations of the UK's financial stability policy framework. 'We didn't completely ignore the issues but we certainly didn't give them anything like the consideration they deserved, as evidenced by the fact that the assessment only had one short factual paragraph on financial stability.'

Ramsden added, 'The experience of several countries in the euro periphery – and indeed the UK – has shown the close relationship and risk of an adverse feedback loop between a large financial sector and sovereign balance sheet and finances.'

Chart 2: Relative unit labour costs (indexed, 1999=100)



This text is based on an abridged version of the talk 'The Euro: 10th Anniversary of the Assessment of the Five Economic Tests' given by Mr Ramsden at the Mile End Group/Treasury talk on 25 June 2013 at Queen Mary College.

On the web

A full text and related graphs are available by the Mile End Group on www.mileendgroup.com.

Right tools in toolbox

More solid perspectives for EU bank resolution

Lars Rohde, Governor, Danmarks Nationalbank

One of the lasting legacies of the global financial crisis is likely to be much better-developed regimes for dealing with failing banks, both nationally and internationally. It is hard to underestimate the importance of this point. We need to ask ourselves: Have we come far enough? And where do we go from here?

In Denmark, a toxic brew of home-grown vulnerabilities and the global financial turmoil put our financial sector under severe strain half a decade ago. Like most other countries, we entered the crisis with a mind-set focused on handling distressed banks on a case-by-case basis. We did not have a particular legal framework for dismantling failing banks that avoided drawn-out and value-damaging bankruptcy procedures. An alternative for the orderly winding-up was needed, and a full-fledged bank resolution scheme was put in place in 2010.

The government-owned Financial Stability Company was put in charge of the resolution of distressed banks. The new rules laid down that those who could lose their money if a bank fails included not only shareholders and subordinated creditors, but also unsecured creditors, including unsecured depositors. This use of creditor bail-in was in accordance with international recommendations, but nevertheless caused a stir. Indeed, its adoption and subsequent use led to a general downgrading of Danish banks because of a perceived lower uplift from systemic support.

Nevertheless we in Denmark now have a credible and effective mechanism for handling distressed banks. It is a regime that improves incentives for owners and creditors to be more cautious, diligent and prudent. And it ensures that taxpayers will not ultimately pay for losses at a distressed bank.

At the international level, a framework for handling failing banks across the EU should be coming into place before too long. Pending its finalisation, it seems clear that the new EU resolution regime will be based on the institutionalisation of creditor bail-ins as the central tenet to bank resolution. With this comes a realignment of incentives and limitation of risks to the government accounts. These are the same key principles that guide the Danish regime. The EU directive, once approved and implemented, will thus be a major component in the reshaping of EU banking, providing for a more level playing field for banks and contributing to a weakening of the so called 'doom loop' of weak banking sectors and fiscally weak governments.

When implemented, this new regime will improve the conditions for financial stability in the EU. However, it is of the highest importance to have clear and transparent common rules for creditor bail-ins. The flipside of any increase in flexibility in the final rules is increased uncertainty. And uncertainty always comes with a price.

I believe very strongly that it is of the highest importance to have clear and transparent common rules for creditor bail-in. The flipside of any increase in flexibility is increased uncertainty. And uncertainty always comes with a price.

Should we be satisfied with progress on implementation and standardisation of special resolution regimes? The converging national and international frameworks are indeed great progress. These rules and frameworks need to be duly implemented. But a challenge still remains in making sure that those regimes can be effectively used in case of the demise of a large, systemically important and quite likely internationally diversified financial institution, a so called 'systemically important financial institution' (SIFI).

As recent history has shown, the failure of or deep-seated problems at a SIFI is far from being merely a hypothetical concern. And the EU is home to many of the world's largest banks. Out of the 28 financial institutions deemed 'globally systemic' by the Financial Stability Board, half of them (that is 14 institutions) are headquartered in the EU (and two in Switzerland). As for Denmark, the biggest banking group incorporated here is in the very top size range in the EU, as measured by total assets to home country GDP. Clearly, if you have many big banks, you need to make sure that your resolution regime is robust enough to handle them, should they fail. Indeed, a credible resolution regime may well be a de facto prerequisite for effective supervision of SIFIs.

The failure or deep-seated problems at a SIFI is far from a hypothetical concern and the EU is home to many of the world's largest banks.

We know that when an institution of systemic importance, a SIFI, ends up in trouble, exceptionally serious ramifications can arise for financial stability and for the economy at large. Therefore, we, as a society, have to go to great lengths to prevent SIFIs from becoming distressed. The vision should be that public funds will never again have to be used for shoring up an ailing SIFI or banking system.

We need various defensive walls to avoid distressed SIFIs. In relation to smaller and medium-sized credit institutions, capital requirements for SIFIs need to be more stringent. There will be demanding liquidity rules. Supervision will be tighter. There will have to be well worked-out, credible and updated recovery and resolution plans. The latter subject is clearly extremely challenging for the internationally active, largest and most complex financial conglomerates. This is why work on the resolvability of globally systemic banks, taking place under the aegis of the Financial Stability Board, is so important.

Questions over SIFI resolution

We also need to make sure that we are well prepared for a scenario where the defensive walls are overwhelmed, or circumscribed. It would be possible fully to resolve a SIFI in Denmark under our current resolution scheme, but the question is whether it would be advisable, in the sense that such an approach would secure a socially optimal solution. It is in the general interest to have interventions ensuring that systemically important functions performed by the institution in distress are continued, nationally and across borders.

The emphasis is on safeguarding functions or certain activities of systemic importance, not on saving specific institutions. And it is definitely not on shielding SIFI shareholders and creditors from losses. Distressed SIFIs would need to be resolved within the coming EU resolution regime. This means that creditor bail-in represents an option that will be used. Indeed, it is of paramount importance that this option is on the table for all banks. We cannot allow the institutionalisation of excessive risk-taking that springs out of a system where profits are kept in private hands whereas big losses are socialised and bear on the national budget.

If we would allow that, we would undermine the solidity of the necessary defensive walls. What's more, we would allow a permanently tilted playing field, always favouring the larger and the more complex. Ending too-big-to-fail is required to make markets work. And the full adherence to joint EU rules for resolution (and state aid), with highly limited flexibility, will secure a level playing field between countries. That should lead to realignment of market perceptions on the likelihood of bail-in.

The final resolution design for a SIFI will depend on the specific situation. Drawing up resolution plans ahead of time and assessing the resolvability of individual institutions – requiring them to make changes if they are not resolvable – should enable us better to handle a SIFI in distress without unacceptable repercussions on the economy at large. International cooperation is key. But there should be no doubt about our readiness to inflict losses on SIFI shareholders, as well as on its creditors, when that is necessary to either bring the institution back to solvency or to dismantle it, while securing the continuity of systemic activities.

The financial crisis has taught us many lessons. The importance of having regimes for resolving failing financial institutions in an efficient and effective way is one of the lessons that we cannot afford not to learn. For supervisors, for regulators and for legislators, making sure that such regimes work for all banks, big and small, is likely to be a challenging task for quite some time, if not a permanent one. But the good news is that, increasingly, we have the right tools in the toolbox.

This is an edited extract from a speech by Governor Rohde to OMFIF in Copenhagen on 24 June.

Fostering inclusive growth

Pathway to development through inclusive finance

Atiur Rahman, Governor, Bangladesh Bank

Bangladesh, despite its low-income economy classification, has achieved steady growth on the platform of a social consensus for inclusive socio-economic development. Bangladesh Bank's inclusive financing initiatives are serving the economy well, evidenced by decade-long, above 6% annual average real GDP growth, amid the global financial crisis and lingering global growth slowdown.

Annual national budgets consistently allocate substantial expenditure outlays to the social sector (about a third of the total budget) for pro-poor human development (healthcare, education & training) and social safety nets, to unleash the creative potential of the population. Alongside investment in infrastructure and other areas, this has promoted an enabling environment for private sector-driven rapid growth.

We have supported the government's inclusive growth efforts by promoting the financing of productive initiatives, including those of the traditionally underserved farm & non-farm small and medium enterprises (SME) and innovative niche area entrepreneurs.

'We make even Standard Chartered Bank give 2% of their credit to the farmers. I make it a point — it's compulsory.'

This is supported by monetary programmes designed to maintain price and macro-financial stability. Ensuring adequate credit flows to SMEs supports macro stability, with incremental output on the supply side and employment and income generation on the demand side.

Engagement with the financial sector has advocated corporate social responsibility. We have steered the facilitation and adoption of cost saving options and the management of numerous loans to SMEs in dispersed locations. Clientele includes mobile phone/smart card-based banking using microfinance institutions and other local agents.

We have steered major upgrading of the financial sector's IT infrastructure, introducing online interbank clearing and settlement of transactions through diverse platforms interconnected by a national payments switch, and online access to credit information on borrowers.

Liquidity support, namely funded by development partners, is provided to lenders granting loans in inclusive financing target sectors, including agriculture, SME and 'green' initiatives. A partial risk guarantee scheme is expected to launch soon for lenders to SMEs with development partner support, thereby reducing high SME borrowing costs.

A government-funded Equity and Entrepreneurship Fund, supervised by Bangladesh Bank, extends equity support to agro-based and IT sector enterprises, including SMEs. Further equity is increasingly provided via venture capital. To facilitate the delivery of financial and other services, as well as networking, SMEs are being drawn to suitable local or regional clusters.

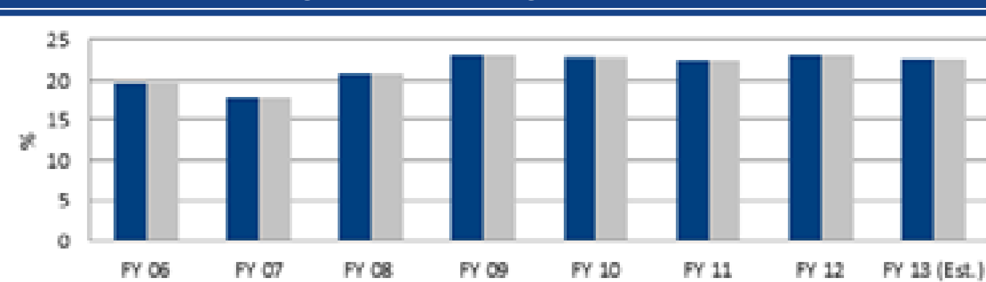
Unlike elsewhere, including advanced economies, credit flows for output activities of SMEs have remained steady amid the global financial crisis, upholding internal demand.

Our inclusive financing initiatives aim at smoothing out impediments to SME growth and other target sector financing, and not at creating a credit surge. The chart below depicts the pre and post global financial crisis trends in agricultural and SME lending trends.

Healthy macroeconomic trends upholding BB- and Ba3 sovereign credit ratings for four successive years now by S&P and Moody's respectively is well supported by robust improvement in all other key macroeconomic indicators.

The estimated size of GDP in FY2013 stood higher at about $128.8bn from only $47.1bn in FY2000, while gross national income per-capita increased by about 245% to $923 in FY2013 from only $377 in FY2000. At the end of June 2013, international reserves are expected to stand at around $15.0bn, representing over four months' imports.

Credits to SMEs and agriculture in Bangladesh as a % of domestic credit



At the end of June 2013, government debt, budget deficit and investment as a percentage of GDP are expected reach at 37.2%, 4.8% and 26.8% respectively from 46.4%, 6.1% and 23.0% respectively at the end of June 2000.

'Our monetary base has grown about 750 times in the last 40 years'

The following include the major socio-economic trends and prospects in Bangladesh:

Robust economic growth with stable inflation: Despite episodes of internal (e.g. natural disasters) and external shocks (e.g. spiraling commodity prices, global financial crisis), the economy has remained on its long-run growth path, with 6% real GDP growth in FY2013. Bangladesh Bank's monetary policy succeeded in maintaining stable inflation, and prudent fiscal policy helped accumulate higher revenues with moderate deficits, leading to a declining public debt ratio.

Strong export growth: Exports more than quadrupled over the past decade. Apparels, comprising three fourths of exports, have maintained steady market share in the US and are growing in the EU. Non-apparels exports have remained robust in sectors such as horticulture/fishery, jute goods, ceramics, pharmaceuticals, leather goods, light engineering, ship building and IT services.

Rising remittance inflows from migrant workers: Remittance inflows from migrants continue to grow at double digit rates, bolstering foreign exchange reserves and external sector viability. The government continues to facilitate the migration of workers to job markets abroad.

Substantial poverty decline: Between 2000 and 2010, the population living in poverty fell from 61.6m to 44.8m, and the consumption Gini-coefficient remained at 0.33, evidencing inclusive growth.

Substantial improvements have been made along major social indicators over the past two decades, including the fertility rate, infant mortality rate, malnutrition prevalence and literacy rate. This progress is partly attributed to 'Made in Bangladesh innovations' (e.g. micro-credit, non-formal education, oral rehydration therapy).

Challenges on medium and long term progress path: With Bangladesh positioned to cross the lower-middle income country group gross national income threshold in the next couple of years, medium and long term goals aim to reach the upper-middle income group by 2030, and attain developed advanced economy status by 2050.

Bangladesh has two important prerequisites: the demographic dividend of a large youthful workforce and a social consensus on inclusive development and social responsibility.

Demographic window of opportunity: While population growth has reached 1.5% per year, the working age population is growing at 2.5-2.8%, widening the opportunity for rapid development but also presenting a great challenge in skill development and job creation.

Looking forward, priorities include promoting social cohesion, good governance and accountability. A focus on education, training and skill development are needed, as well as innovation-fostering programmes on a massive scale for the young and the working age population, to meet the job market needs of a rapidly modernising, rapidly advancing economy.

Rapid modernisation and integration of the country's financial sector with global financial markets are required to attract and cope with the mass investment flows that typically accompany a fast-advancing economy. Bangladesh Bank will itself need to modernise and evolve quickly in steering this integration, without jeopardising stability.

This is an edited extract from a Golden Series Lecture by Governor Rahman to OMFIF in London on 21 June.

Abdul Hamid, Amirul Chowdhury, Basir Ahmed, Iqbal Ahmed, Anis Rahman and Hugh Harris

Atiur Rahman

On the web

See Governor Rahman's full presentation slides at www.omfif.org.

Small country, big ambitions

Mauritian quest to be the region's IFC

Rundheersing Bheenick, Governor, Bank of Mauritius

From simple beginnings and limited prospects, to a rising star of the African continent, Mauritius is on a quest to become a regional International Financial Centre (IFC) of high repute. This is a markedly different narrative compared with 50 years ago, when few people in the banking and business community had even heard about Mauritius, much less thought of it as a financial crossroad.

Small jurisdictions appear to have a comparative advantage as IFCs, with small states exploiting emerging niches and embracing global trends more rapidly.

As a small island-state, tucked away in a remote corner of the Indian Ocean, Mauritius was typically written-off as being without prospects, sinking under the weight of runaway population growth which its sugar economy could not conceivably bear. I have it on good authority that the first-ever World Bank mission to Mauritius in 1962, had delivered a devastating verdict: 'This country exudes an air of hopelessness.' The economy had been reduced to a race between population and productivity.

Today, Mauritius is on the path to becoming a financial crossroad. Various initiatives and policies have been implemented, beginning in the late 1970s with stabilisation and structural adjustment programs to stabilise the economy, including consolidating public finances with austerity and wage restraint, and strengthening tourism, the sugar sector and manufactured goods for the export market.

The benefits of small country IFCs

I do not view tax havens as IFCs; traditional, secretive, opaque tax-havens do not have much of a business case these days. These 'sunny places with shady finances', as they have been called, will have to change rapidly if they are to survive in some form or other. We, in Mauritius, have always rejected the tax-haven label as a jurisdiction of substance, which comes with a real, diversified and thriving economy attached.

Small jurisdictions appear to have a comparative advantage as IFCs, with small states exploiting emerging niches and embracing global trends more rapidly. Faced with limited options for development, many sought to become Offshore Financial Centres (OFC). OFCs are small, low-tax jurisdictions, specialised in providing corporate and commercial services to non-resident offshore companies and for the investment of offshore funds.

Abuse in some jurisdictions has too easily and mistakenly fed the perception that OFCs are tax havens. Small country IFCs play an important role as conduits of cross-border capital flows and investments, with over 1% of the world's population, 26% of the world's wealth, and 31% of net profits of American multinationals transiting through them.

The reputation of small country IFCs has taken a severe blow in the wake of the Cyprus crisis. The lesson is not that IFCs as a class are bound to disappear or, at best, condemned to a slow death. Rather, small country IFCs need to exercise care in the conduct of their business, appropriately assess potential sources of risk and better manage their asset and liability mix. The Cyprus episode has lessons for other jurisdictions but has no immediate relevance for most, as they do not run their banking and finance the way Cyprus did. It certainly does not mark the end of the road for solid, transparent, well-regulated IFCs.

Mauritius and its home-grown IFC model

With strong growth comes increased global investor attention. Last year, two of the best performing stock markets in the world were African – Nigeria and Kenya. Last September, Zambia's debut $750m Eurobond auction was oversubscribed 15 times, pushing its yield down to 5.6%. Africa will issue a record $7bn in Eurobonds this year, more than the cumulative sum of the last five years.

Our banking sector assets are less than three times our GDP and evenly divided between domestic and offshore assets. Our financial soundness indicators show a sound banking sector, well-capitalised and nearing Luxemburg on most measures, with non-performing loans below 4% and regulatory capital to risk-weighted assets at 17%, close behind Luxemburg's 19%.

The next growth frontier is sub-Saharan Africa. Global powers, old and new, are making a bee-line for the continent, attracted by policy reforms, institutional strengthening and resource discoveries.

Our home-grown model has proved to be more resilient than some of the models that inspired us – not least because our financial sector benefited from an increasingly-diversified and growing real sector and from a multilingual pool of professionals. Financial intermediation today provides over 2% of total employment in the country and the trend is on the rise.

Our strategic location in the Indian Ocean has proved to be an added advantage which enabled us to carve a niche in the region. When India started major economic reforms in the wake of the 1991 balance of payments crisis, Mauritius emerged as the largest conduit of foreign inflows to India averaging 43% of total inflows into the Asian giant over the past decade. Consequently, Mauritius has enjoyed a prominent place in tax treaty planning of private equity players, multinationals, and global fund houses investing in India.

We adopted high standards of rigorously-enforced regulation proposed by the Financial Action Task Force, OECD and IMF, and are committed partners in compliance legislation. These efforts have paid off, with OECD placing us on their 'white list', meaning that our jurisdiction has substantially implemented the internationally-agreed tax standards.

Our banking sector

Little did we know how radically we would transform the financial landscape when we adopted banking legislation to enable offshore banking in 1988. We then had 13 banks, all involved in domestic banking. By 1998, the numbers had changed to 10 domestic banks and 9 offshore banks. By 2002, after some consolidation, there were 10 domestic banks and 12 offshore banks when there were also 221 offshore funds and around 19,350 Global Business Licence (GBL) Companies.

Today, we have 21 banks operating in our jurisdiction, all involved to varying degrees in cross-border banking activities. Our banking sector assets represent around three times our GDP. There were nearly 25,000 GBL companies and their deposit base at the end of 2012 represented around 39% of total banking deposits. There is a long way to go before we reach the size of other small IFCs.

Our banks have contributed in no small measure to the resilience of the Mauritian economy. The Global Competitiveness Report 2012-13 ranks the Mauritian banking sector 15th out of 144 countries in terms of the soundness of banks, and 35th in terms of financial market development. In the ranking of the African Banker magazine, seven Mauritian banks figured among the top 100 banks in Africa in 2012. This is a great achievement considering that our GDP adds up to only 0.2% of African GDP.

Mauritius — an IFC with a difference

The challenge confronting Mauritius now is perhaps its toughest since it embarked on the offshore business a quarter century ago. It is one thing to be a competitive back-office hub and an efficient conduit for capital flows to India and Africa, but it is quite another to become a significant value-added platform, effectively enhancing south-south trade and investment. The name of the game now is greater substance and more value addition.

Depressed conditions in the crisis-hit west, coupled with slowdown in India, have forced Mauritius to target other markets to increase its exports. Fortunately, the next growth frontier that is sub-Saharan Africa is just next door. Global powers, old and new, are making a bee-line for the continent, attracted by policy reforms, institutional strengthening and resource discoveries. Falling trade barriers, stable interest rates, and greater currency stability are encouraging inter-regional trade.

With banking penetration rates in Africa close to 20%, large African banks are raising deposits cheaply from villages, in increasingly innovative ways, and lending it at huge spreads to the corporate sector and upper middle class.

Further, with 40% of the African workforce between the ages of 15-24, and with the continent becoming increasingly urban, Africa's challenge is to use its demographic dividend wisely.

With Western nations curtailing donor aid, fast-growing African nations, with manageable debt to GDP ratios, are not finding problems in attracting money in a world where the search for yield is increasingly important. The African growth story is just only beginning, and Mauritius, as a well-connected IFC, can expect much business to come its way.

However, as a small country with limited resources, it needs to do things differently. Mauritius cannot afford to be an undistinguishable IFC.

To add value, this requires foreign investors as well as Mauritian investors. And for this to happen, we need to show substance by bringing both knowledge and seed capital to the table.Mauritius can become the private equity vehicle of choice for small- and medium-scale projects in the Eastern and Southern parts of Africa within sectors where it has a comparative advantage.

There is a strong case to pool together available know-how and seed capital to build the critical mass required for larger projects, diversify risks, and leverage external funding. Mauritius has been considering setting up a sovereign wealth fund which could become a source of equity funding for a more aggressive move into Africa.

There is scope for increased public-private partnerships, which are still a rare phenomenon on the continent. The African Development Bank has floated the idea of an African Infrastructure Fund, financed partly from central bank reserves. It will be setting up an office in Mauritius this year. There is truly a ferment of investment and finance activity in, and around, Mauritius.

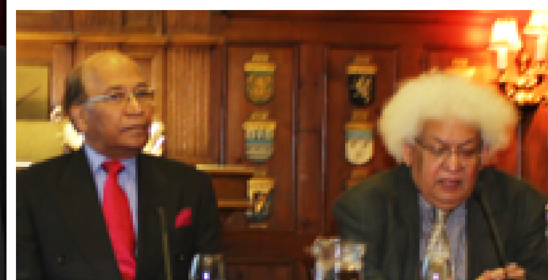
Compared to other small IFCs, we still have a long road to travel to become what Singapore is to Asia or Luxemburg to Europe. There is no dearth of growth opportunities for the Mauritian IFC from 'Aspiring Africa' next door, and the prodigious developments expected in Asia.

Mauritius has quite possibly become a financial crossroad, meeting a real need of investors, savers and corporates from all over the world – not a bad prospect for a country that was exuding such an air of hopelessness only half a century ago.

Compared to other small IFCs, Mauritius has a long road to travel to become what Singapore is to Asia or Luxemburg to Europe.

This is an edited extract from a speech by Governor Bheenick to OMFIF in London on 30 May.

Meghnad Desai, Rundheersing Bheenick and Kevin Boyfield



Rundheersing Bheenick and Meghnad Desai

On the web
See Governor Bheenick's full speech at www.omfif.org.

Still lagging in power shift

Asia rise held back by three global contradictions

Kishore Mahbubani, Advisory Board

The 21st century will be the Asian century. Economic power will continue to shift rapidly to Asia. Indeed, in purchasing power parity terms, China will become the number one economy as soon as 2017. However, the shift of political and institutional power will continue to lag behind, creating at least three major global contradictions.

The first contradiction will be between the rising Asian share of the global economy and the stagnant Asian voting share of the IMF. In theory, voting shares in the IMF are supposed to reflect a country's economic weight in the world. In practice, both Europe and America have violated this principle. Europe has fiercely resisted a reduction of its voting shares and the US congress has held back the legislation permitting a redistribution of IMF shares. This huge and growing gap will lead to progressive delegitimisation of the IMF and World Bank. Developing countries will seek closer financial cooperation with rising new powers, such as China and India. Proposals like a BRICS bank will take some time to be realised, but political support will grow if the IMF and World Bank remain mired in the past.

The second contradiction will be between Asia's dominant share of global trade and global foreign exchange reserves and the continuing reliance of Asia on the dollar as the only functioning global reserve currency. Indian prime minister Manmohan Singh has said, for example, that the bulk of savings are in Asia and the bulk of infrastructure spending will also be in Asia. However, the borrowing and lending between the demand and supply of loans are done in a foreign currency, primarily through banks based in the US and Europe. Asians have not yet learned how to lend money to themselves, and both protectionism and backwardness continue to plague Asian financial markets.

The US has undoubtedly managed its global reserve currency role responsibly, reflected in global trust and confidence in the dollar, and capital flows back into the dollar at times of global panic. Yet, the US political system has become more polarised. The US may well become incapable of making responsible long-term fiscal and monetary policies. This may damage the standing of the dollar and leave the Asians wondering whether it is safe to bet their long-term trade and financial future on the dollar.

The third contradiction will be between the rising market integration of the Asian economies and the slow institutional integration of Asian countries. In some ways, it was wise for Asians to take the opposite approach from the Europeans, where institutional integration facilitated trade integration. In Asia, trade integration is leading to pressures for institutional integration, but the traditional Asian caution is hindering steady institutional integration. Most of the institutional integration in east Asia has been centered on or led by ASEAN. The Regional Comprehensive Economic Partnership, currently being negotiated, will unite ASEAN and its FTA partners under a single free trade area.

The Chiang Mai Initiative Multilateralisation creates a $240bn regional fund to provide short-term finance to ASEAN+3 countries in financial crisis. Discussions continue to create an ASEAN+3 Multi-Currency Bond Issuance Framework. This will allow, as Hon Cheung has described, 'a system of mutual recognition by market regulators to allow local currency bonds issued in a home jurisdiction to be offered in another host jurisdiction.' However, these ASEAN-led processes are moving at a snail's pace, when trade and economic integration are moving forward almost at lightning speed. In 1990, trade between ASEAN and China stood at $8bn. By 2012, this grew to over $400bn. Despite this rapid regional economic integration, the institutional frameworks across Asia are changing very slowly.

The rapid economic growth of Asia is undoubtedly generating a lot of good but it is also generating significant challenges for global and regional policy-makers. The big question remains whether Asian policy-makers will be able to rise to these growing challenges.

ASEAN-led processes are moving at a snail's pace, when trade and economic integration are moving forward almost at lightning speed.

China party not yet over

Central bank ready to pump in liquidity

John Adams, Advisory Board

The OMFIF Monetary Policy Mission to China is trying to find seats in the packed splendour of the China World Hotel, and pondering the recent liquidity squeeze, where overnight interbank rates touched 30%, and a minor panic broke out on the Shanghai Stock Exchange with a 15% fall in the Composite Index. All this while the People's Bank was tightening monetary policy. Somewhere a pianist is playing an old Abba medley. I hear the strains of 'Money, money, money'.

What can this signify? Not much to the elegant Beijing folk sipping Pu Er Tea at $50 per pot ('clears alcohol from the body' according to the menu, but perhaps gives a monetary hangover….). The party in China is by no means ended, though purveyors of Schadenfreude in the western press might like to think so. What really happened to the financial system in that week in mid-June? Let us be clear: in our dozen or so meetings in Beijing, we encountered the complete range of opinion, from meltdown to business as usual. And the time scale for full catastrophe varied from six months to 'four years max.'

Chinese commercial bank economists we interviewed were cautious but worried. They live almost in the real world, where their gnomic utterances are acted upon, and have real-time consequences. They had been wrong-footed by the sudden squeeze, and understandably took the view that this was an error of judgement on the part of the People's Bank. Also, what can you do if your MD thinks the end of the world is nigh, except ask OMFIF politely for its views on the reasons for the crash in the gold price.

The academic economists at the major universities in Beijing were even glummer. Their Angst was centred on the systemic contradictions: this was not merely a liquidity squeeze, but a symptom of the fiscal and interest rate imbalances in the economy. The local authorities and state-owned enterprises were probably all bankrupt, and looking to the central government for the usual bailout. This would take the form of debt forgiveness, and major Chinese banks would find themselves by some malicious time warp back in 1999, before they sloughed off their toxic debt into the Asset Management Corporations and made vast and unrepeatable IPOs.

The PBoC says it started tightening monetary policy some three years ago, when it published its estimates of 'Total Social Financing' – the amount of real credit in the economy. There was no liquidity shortage, just mis-allocation of funds, particularly into off-balance sheet Wealth Management Products. (These seem to include such items as job-lots of mahogany furniture, offering 9% returns in three months to the wealthy but financially unsophisticated.)

The PBoC said it would review the situation in July, when there might be some more bumpiness for technical reasons, and again in August. The PBoC has since reaffirmed that it is prepared to make available appropriate amounts of liquidity for the financial markets, and calm seems to have returned. What of the real economy? M2 is at a record high, as is social financing, which must alarm and perplex any monetarist. Inflation, that touchstone of all Chinese governments, is subdued for the moment at around 2%.

There is plenty of housing available – at a price. A new property tax might cool the markets and improve fiscal revenues. But export growth is slowing and imports are falling. China is worried that GDP will grow not at the expected 7-8%, but perhaps nearer to 3-4%, particularly if Europe and US continue to underperform.

And there is a feeling, probably incorrect but powerful, that it was the west which snatched away the punchbowl from China's lips. Indeed China is now on its own. Western compasses do not work in this sea, and western representatives have used up most of our moral capital as economic and financial teachers.

China is now on its own. Western compasses do not work in this sea, and western representatives have used up most of our moral capital as economic and financial teachers.

Inaugural meeting in Brasilia

Cautious optimism from world economic transformation

Carlos Hamilton Araújo, Deputy Governor, Banco Central do Brasil

The growing complexity of the world economy poses significant challenges to every country, especially to emerging market economies. Five years after the outbreak of the financial crisis, we are still searching for a solution that improves world activity and provides economic and financial long-run stability.

Despite the economic growth that has been seen in emerging markets, these economies have been challenged to deal with several threats. Many emerging market economies are facing growth deceleration, inflation risks, as well as risks stemming from volatile capital flows.

The 'systemically important' emerging markets have slowed with important impacts on international prices and growth. This suggests that the Latin American economies will not benefit much from the tailwinds, in terms of the trade that prevailed in the past decade. The OMFIF meeting gave us a chance to discuss important global issues, including the economic crises, economic integration, investment funding, monetary and macroprudential measures, and new international currencies.

Most importantly, these topics were discussed from the perspective of Latin America, and how it stands before the challenges, risks and opportunities related to the transformations of the world economy.

Brazil has an important role to play for the region, not only in terms of trade, integration and financial facilities, but also in terms of cooperation and coordination of efforts for the region to develop a path of prosperity and stability.

The OMFIF Main Meeting focused on challenges, risks and opportunities for Latin America.

OMFIF summary of discussions at Brasilia Main Meeting

OMFIF, in association with Banco Central do Brasil (BCB) held its inaugural Main Meeting in Latin America at the BCB headquarters in Brasilia, on 17-18 June, featuring a confidential discussion among selected public and private sector officials. The Meeting included 68 participants from 23 countries.

At a time of renewed challenge on the world economic and monetary scene, emerging market economies demonstrate an overall combination of relative economic buoyancy, stability and confidence. This has important implications for Latin America, including Brazil, an economic colossus with 190m people and a GDP set to rival Germany's in coming years.

The meeting focused on six main themes: Latin America in the new world economic landscape; macroeconomic responses to challenges facing the global economy; regional integration, institutions, trade and financial flows; harnessing domestic and global savings for the world's investment needs; the ascent of new currencies in a multipolar world; and the future architecture of world economics. This was the eighth in a series of Main Meetings that started with the Deutsche Bundesbank in March 2010 and continued with Bank Negara Malaysia in May 2010, Central Bank of the U.A.E. in November 2010, Nederlandsche Bank in March 2011, South African Reserve Bank in August 2011, Deutsche Bundesbank in March 2012 and Bank of Mauritius in November 2012.

The Meeting voiced a mood of cautious optimism about developments in emerging market economies, despite the slowdown in major regions, with the better perspectives for the US as a force for growing confidence. Developments in Europe remained once again a cause for concern. A major theme was the ability for countries to drive forward economic integration with partners that are widely separated on a geographical scale, underlining that, because of revolutionary changes in technology and transport, opportunities for deep-seated economic cooperation transcend pure regionalism. This reinforces the message behind OMFIF's commitment to the Lusophone nations, underlined in the marking of 2013 as the Year of the Luso-Economy. Five of the ten nations in this grouping were represented at the Brasilia Meeting.

OMFIF will send to participants and other interested parties a report on the proceedings in Brasilia, under the Chatham House rule (excluding direct quotations of conversations and speeches). For reports on selected issues by some of the participants, **see articles on p. 36-41****.**

Reforms generate rapid growth

Central Africa benefits from diversification and oil

Lucas Abaga Nchama, Governor, Bank of Central African States

Central Africa, as a sub-region, is experiencing rapid growth. In fact, due to important economic and financial reforms initiated a decade ago, most of our countries experience sustainable growth despite the difficult of international environment. We are strongly involved in the diversification process of our production base, in order to reduce the vulnerability of our economies and direct us to a sustainable growth path.

The Central African Economic and Monetary Community (CAEMC) comprises six countries: Cameroon, Central African Republic, Republic of the Congo, Gabonese Republic, Republic of Equatorial Guinea and Republic of Chad. Institutionally, the CAEMC is based on two pillars, the Central African Economic Union (CAEU) and the Central African Monetary Union (CAMU).

The CAEMC includes five oil-producing countries, with oil revenues representing about 60% of fiscal revenues. In 2013, the economic outlook of CAEMC countries is characterized by a reduction in inflation from 3.7% in 2012 to 2.7% in 2013; a decrease in the budget deficit, on a commitment basis, excluding grants, from 2.7% of GDP in 2012 to 0.2% of GDP in 2013.

The six states have improved their overall current account deficits from 6% of GDP in 2012 to 5% of GDP in 2013, and have seen an increase in the money supply in the order of 8.9%. Foreign exchange reserves (8.4 months of imports) and the rate of foreign currency hedging (close to 100%) are strong.

Monetary integration of CAEMC is well advanced. The six states have a common central bank, the Bank of Central African States (BCAS), responsible for ensuring monetary stability and financial stability. The convention governing the CAMU and the statutes of the common central bank give the bank the powers of formulation and implementation of monetary policy based on four basic principles. These are a fixed parity between the CFA franc and the euro; convertibility of the CFA franc guaranteed by France; total freedom of transfers between countries of the Franc Zone; and pooling of foreign exchange reserves.

Monetary integration of CAEMC is well advanced. The six states have a common central bank, the Bank of Central African States, responsible for monetary and financial stability.

Given the uniqueness of our monetary policy, the sub-region has established a coordination of national fiscal policies through multilateral surveillance of macroeconomic policies, provided by the President of the CAEMC Commission. This exercise has identified four criteria and macroeconomic convergence indicators: the primary fiscal balance to GDP must be greater than or equal to zero; public debt to GDP must not exceed 70%; new arrears, internal and external, should not be accumulated; and the inflation rate, annual average, shall not exceed 3%.

Unification of the financial infrastructure

To accompany the monetary union, CAEMC has undertaken significant efforts to strengthen its financial infrastructure over the past decade. In this regard, it has a unique payment system that revolves around a real time gross settlement system at the regional level, in use since 2007, as well as an effective clearing system for retail payments in each country. The CAEMC is redesigning the interbank electronic payment system.

Moreover, studies have been undertaken to provide the sub-region a Payment Incidents Centre dedicated to the prevention, treatment and suppression of late payments on cheques, credit cards, bills of exchange and direct debits. In moving in this direction, we are currently working with the Central Bank of West African States, aiming towards the interconnection of payment systems of both areas.

The architecture of financial supervision and regulation is characterised by the existence of several sector regulators with regional and international expertise. We have conducted a banking union since 1990, effective since 1992. States have decided to move towards bank union, creating in October 1990 a joint body of banking supervision named the Central African Banking Commission (COBAC). They subsequently signed in January 1992 the convention on the harmonisation of banking regulation in the states of Central Africa.

COBAC is an autonomous institution that carries out a number of rules regarding credit and microfinance institutions. It has a regulatory authority, power control, administrative power and judicial power: it imposes sanctions ranging from a warning to suspension of licences. Therefore, it has the power to approve credit institutions and their leaders, and to enact regulations and decisions directly applicable to the six member states without the need for transcription into national laws. COBAC is not disconnected from the central bank, with the governor of the bank as president and staff coming from the central bank.

The CAEMC financial plan has a highly developed institutional infrastructure. Financial integration is a reality.

The banking union has largely advanced and we can be proud of being among the most globally integrated zones. We have a regional regulatory governance of credit institutions; a deposit insurance fund which works at the regional level; and a community legislation on the organisation of the accounts of credit institutions.

The insurance sector is under the supervision of the Inter-African Conference on Insurance Markets (CIMA), which includes six CAEMC states, and those of the Economic and Monetary Union of West Africa. Its responsibilities include regulating the business of insurance and the financial and accounting practices. The field of social insurance is regulated by the Inter-African Conference on Social Security, which is an institution of control and technical support of the African Social Security Funds, which includes the CAEMC countries, those of the Economic and Monetary Union of West Africa and the Comoros.

We have seen the harmonisation of financial markets supervision. Founded in 2001, the supervisory board of the financial market in Central Africa is responsible for regulating and controlling the financial regional market. In the sub-region, there is a national securities exchange, the Douala Stock Exchange, supervised by the Financial Markets Commission of Cameroon. Both regulators work with the support of international financial institutions, including the African Development Bank.

Our framework for regional macroprudential supervision combines all the bank regulators and non-banking financial sectors and is chaired by the central bank. Our market for regional public debt is regional. Subscriptions for public debt issuance are regional due to the establishment by of a cell of Regulation and Conservation Titles at the regional level, the main depository, regulating settlement/delivery and accounts of program operations.

The CAEMC financial plan has a highly developed institutional infrastructure. Financial integration is a reality. Alongside these major advances in financial integration, the community in recent years has established an important tool to strengthen its economic integration and boost the diversification of its productive base. Led by the committee of CAEMC, this tool is the Regional Economic Programme.

Lucas Abaga Nchama, João Carlos Parkinson de Castro, Carlos Cozendey, Maria Antonieta Del Tedesco Lins and Daniel Titelman

Switch in monetary fortunes

Changing QE tide brings developing country problems

Christopher Probyn, State Street Global Advisors

Shortly after the Federal Reserve initiated quantitative easing (QE), I visited Asia to be regaled by charges of US 'currency manipulation'. Shortly after the Bank of Japan announced its intent to adopt a formal inflation target and double the size of the monetary base within two years, I visited Asia, and was regaled by charges of a Japanese-led 'currency war.'

Both charges seemed inappropriate as the moves reflected legitimate reactions to domestic economic conditions, and neither included direct intervention in the foreign exchange market to weaken the domestic currency.

Given the increasing integration of the global financial system, there is no doubt that these aggressive moves pose challenges for policy-makers in developing economies. Quantitative easing typically leads to capital outflows, as domestic investors seek better returns elsewhere, often in developing economies where nominal interest rates tend to be relatively high.

The inflows into developing economies boost their exchange rates, which amounts to a monetary tightening, although the effect is partially mitigated by rising asset prices. The classic response is to accept the higher exchange rate but to offset the demand dampening effects by loosening fiscal policy.

However, developing economies tend to be export-oriented, making a higher exchange rate and the resulting loss of competitiveness more difficult to accept. If a country has a relatively small consumer sector, fiscal policy may prove relatively ineffective, especially in the short-term (although this is less true of Latin America than emerging Asia). Not surprisingly, some developing economies sought to prevent or reduce the extent of exchange rate appreciation through a combination of overly easy monetary policies, 'macroprudential polices' to deter capital inflows and, in some cases, outright capital controls.

There are trade-offs to this eclectic approach. An overly easy monetary policy risks asset bubbles and higher inflation, particularly if the economy is operating near full capacity. And, capital controls generally reduce economic welfare by preventing the stock of savings from finding its most productive use. Now that QE appears poised to end, at least in the US, such a 'potpourri' of measures further complicates policy-making.

Prospects of 'tapering', the termination of QE, and ultimately, rate normalisation, will lead to capital outflows from developing economies and a depreciation of the exchange rate. This amounts to a monetary loosening which should be offset by a fiscal tightening. But with monetary policy having been kept too easy, any depreciation of the exchange rate adds to the risk of inflation, and will be difficult for policy-makers to accept.

While capital controls can be used to limit inflows, global investors will not take kindly to any limit on outflows. Hence, policy-makers likely need to reverse the classic response by tightening monetary policy in order to limit the size of capital outflows and exchange rate depreciation, while loosening fiscal policy to offset the demand-reducing effects.

Despite the complications and potential welfare losses, the eclectic approach is likely to persist. Economists who once considered capital controls an anathema are now more amenable to them, as their use has been associated with greater financial stability. Indeed, in their 2010 study, 'This Time is Different: Eight Centuries of Financial Folly', Carmen Reinhart and Kenneth Rogoff suggest that capital controls were largely responsible for the infrequency of financial crises during the Bretton Woods era.

Prospects of 'tapering', the termination of QE, and ultimately, rate normalisation, will lead to capital outflows from developing economies and a depreciation of the exchange rate.

The ascent of new currencies

Internationalisation of the renminbi

Anselmo Lin Seng Teng, Chairman, Monetary Authority of Macao

Recent financial crises in advanced economies have wreaked havoc in financial markets of emerging market economies (EMEs), while the unconventional monetary policies pursued by advanced economies thereafter have brought in new challenges. Participants in the OMFIF Main Meeting largely believe that Asian EMEs, which have been the engine of world growth in the aftermath of the global financial crisis, would see a slowdown in growth. Nevertheless, economic growth of the Latin American region is expected to accelerate with measures targeted at boosting private investment, partly compensating for the loss.

The ascent of 'new' currencies was a top discussion topic at the meeting. The extensive use of traditional reserve currencies in merchandise trade invoicing and settlement created uncertainty in bilateral trade between EMEs, underscoring the need to promote the use of regional currencies in intra-regional trade and facilitate the increased use of non-traditional reserve currencies in international trade and finance.

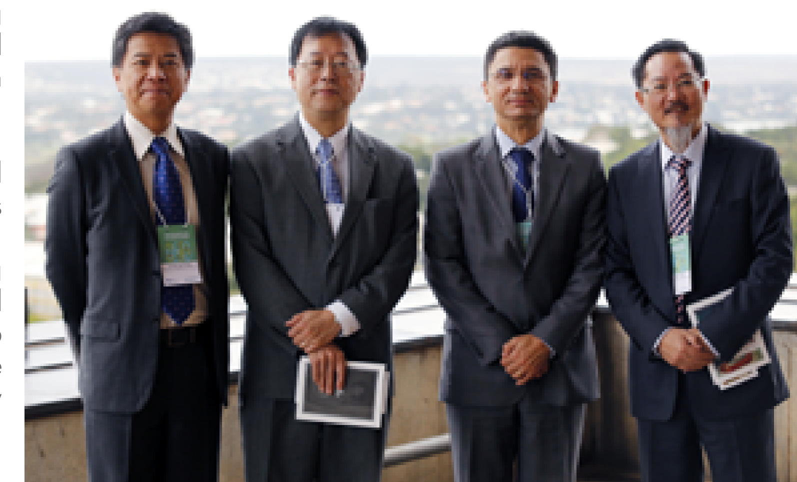
In a world of economic rebalancing, currencies of major EMEs, in particular the renminbi, the currency of the second largest economy in the world by GDP and international trade, have exhibited their potential to broaden their use in international transactions. Such a lasting phenomenon not only allows the international circulation of regional currencies to reflect better their countries' increasing proportion to international trade and economic gravity, but also to lessen monetary shocks from advanced economies to emerging markets.

Meeting participants were optimistic about the rise of the renminbi in international transactions. Since 2009, Chinese authorities have gradually promoted the internationalisation of the renminbi in cross-border trade settlement. Nowadays, virtually all Mainland enterprises, qualified to import and export, can have a free hand in using the renminbi to settle all transactions with their trade partners globally. Financial markets in Mainland China would undergo further reform to make themselves large, liquid and accessible to non-residents in sufficient capacity. Since 2011, relevant authorities have allowed foreign investment in Mainland interbank bond, equity and fixed-income markets through Renminbi Qualified Foreign Institutional Investors.

Macao, a special administrative region of China, has increased its effort in developing the renminbi business with the support of the Chinese central government, playing the particular role of a service platform for Mainland China and Portuguese-speaking countries. Macao banks now provide domestic and overseas corporations a variety of renminbi services and products. There is a marked progress in renminbi cross-border trade settlement. Against a backdrop of a consistent rise in economic transactions between Mainland China and Portuguese-speaking countries, including Brazil, there is great demand for related financial services. Macao can fully embody its platform function by providing solid financial support services.

It was underlined that Hong Kong, Shanghai and Guangdong are centres for renminbi business development. Macao's strong relationship with them, coupled with its unique ties with Portuguese-speaking countries, would greatly strengthen the special administrative region's engagement in the next step of the internationalisation of the renminbi and the apparent ascent of the renminbi in a multi-currency world.

Macao has increased its effort in developing the renminbi business, playing the particular role of a service platform for Mainland China and Portuguese-speaking countries.



Vong Lap Fong, Anselmo Lin Seng Teng, Emanuel di Stefano Bezerra Freire and Lao Kam Chio

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Need to stay on course

Success still depends on sound, stable policies

Roland Holst, Banco Central del Paraguay

A booming region is facing new challenges. Latin America, the region that for the best part of the last decade maintained relatively high levels of economic growth, financial resilience in the wake of a global financial crisis, and an increasing influx of both tourists and foreign investments, may be confronted with a scenario that isn´t as rosy as it was.

It is very important for countries with sound policies to stay the course and avoid temptation for short term responses to counter US monetary policy changes.

So far, most Latin American policy-makers and private sector players complained about US monetary policy, arguing that interest rates kept artificially at near-zero levels for years as well as stagnant economies in the developed world contributed to unstoppable capital flows into the region, driving up demand for local currencies and affecting competiveness of exports.

Countries responded differently to the same phenomenon; some fighting currency appreciation, others keeping their own interest rates low and fighting inflation by managing reserve requirements — thus, the widespread wish for quantitative easing to end. 'Be careful what you wish for,' a panelist said in Brasilia.

Timing couldn´t have been better for an OMFIF Main Meeting in Brazil. Concerns about the unwinding of quantitative easing were evident during the meeting. Tapering off QE will happen sooner or later, but it won't be a walk in the park for emerging economies. Financial markets have shown this. Asset prices closely related to emerging markets sold off during the days preceding the meeting as a result of these concerns. Emerging markets currencies did so too, raising concerns that the unwinding of loose monetary policy in the US may not be so manageable after all.

This was probably not what was wished for, especially in Brazil, where controlling inflation has been tougher than expected while growth slowed almost to a halt. The change in US monetary policy is the culprit of a watershed event. Some countries' creativity to manage capital inflows may now have to match its creativity with the opposite scenario.

Even though questions remained about the specifics of each country´s challenges, a common theme of discussion was how to cope with drastic changes in capital flows and interest rates, and the impact on exchange rates and, ultimately, growth.

A reversal in flows may present as big a challenge and this should not be underestimated. But countries in Latin America should note that their success so far has depended more on their own policy choices than on US monetary policy and euro area economic outcomes. The so-called 'Bolivarian' countries following large-scale state intervention and attacks on private property, have been struggling, with and without QE.

Notably, countries with sound macroeconomic policies, especially those comprising the newly-formed 'Pacific Alliance' (Peru, Chile, Mexico, Colombia) as well as Brazil and small economies with similar policies (Panama, Paraguay, etc.) have performed quite well before and after the financial crisis and zero-interest rates environments.

Latin America´s progress in alleviating poverty and building a larger middle class through sound economic policies may come to a transitory halt if the impact of QE unwinding accelerates. But it's still a fertile ground for new businesses and social innovation models for sustainable development.

Its economic success in medium- and long-term horizons will largely depend on domestic policy decisions. It is very important for countries with sound policies to stay the course and avoid temptation for short term responses to counter US monetary policy changes.

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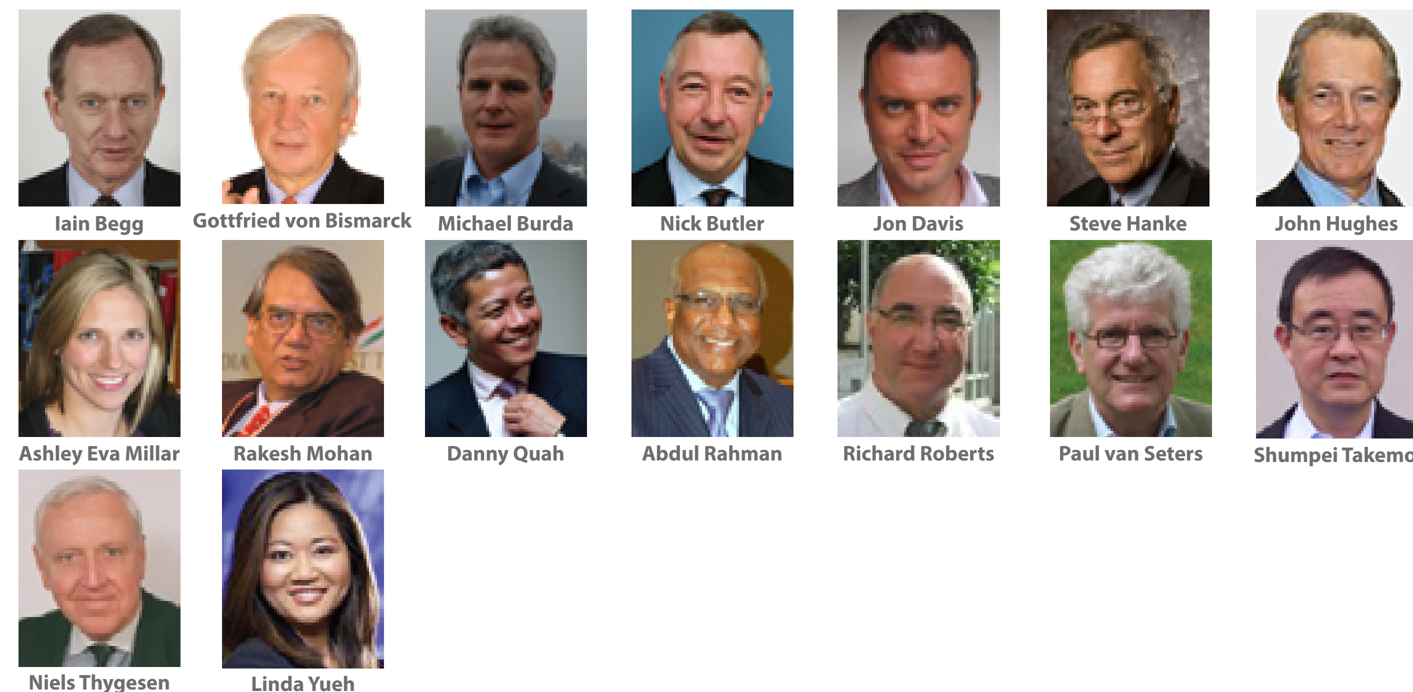

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Looking ahead – 2013-2014 diary dates

Expert Seminar
T. Shanmugaratnam, Finance Minister, Singapore,
12 July, Singapore

Golden Series Lecture
Woosik Moon, Member of the MPC, Bank of Korea
16 July, London

Expert Seminar
Panicos Demetriades, Governor, Central Bank of Cyprus
12 July, London

Expert Seminar
Lord Norman Lamont,
former UK Chancellor of the Exchequer
24 July, London

Expert Seminar
Ruud Lubbers, former Dutch Prime Minister
15 July, Utrecht

Main Meeting
Erdem Başçı, Governor, Central Bank of Turkey,
5-6 September, Ankara

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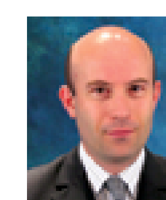
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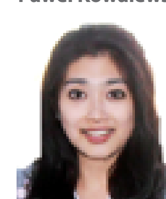
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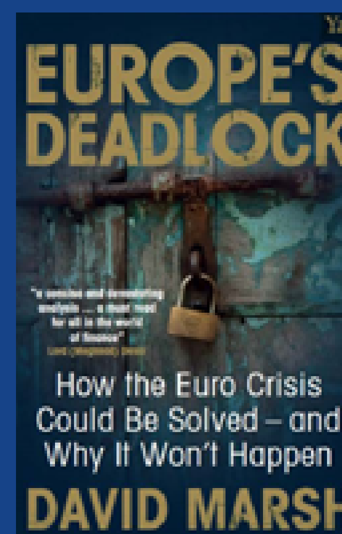

'An excellent read – I enjoyed every one of its 120-plus pages.'
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David Marsh
EUROPE'S DEADLOCK
How the Euro Crisis Could be Solved – and Why it Won't Happen

Publication in August 2013
http://yalebooks.co.uk/

In this short, fiercely argued book, David Marsh explains how five years of continuous crisis management have not only failed to resolve the Eurozone's problems but actually made things worse. While austerity-wracked southern states descend into misery and resentment, creditor countries – led by Germany – fear that they will be forced to subsidise their weaker brethren indefinitely. Constructive dialogue has collapsed as European decision-making descends into terrified paralysis, and the potential paths out of the impasse are blocked by indecision and incompetence at the top.

Mixed signals in new system

Puzzling statements point to conflict in policy

Forrest Capie, Cass Business School

One of the more important questions of the time is in danger of being ignored or misunderstood. On the one hand banks are being told to be better capitalised. We might all like to see that. On the other they are being told to lend more. We want to see that too. But these two objectives cannot be achieved at the same time. This is a bit like energy policy that advocates a greater use of renewables and a lowering of prices at the same time.

The Financial Policy Committee (FPC) has recommended that British banks should have sufficient capital to cope with future risks. Some banks will need to raise their capital asset ratios. But the head of the regulatory authority believes that concerns that this will harm lending are misguided.

According to Andrew Bailey, 'Capital supports lending and does not substitute for it.' He adds that capital 'is not money that has to be stashed away for a rainy day.' But it is. It is held precisely for the purpose of covering unanticipated losses.

The FPC concluded in March that banks should have an equity capital ratio of at least 7% of risk-weighted assets by the end of this year. Basel III argues similarly if for a lesser amount. The chief economic commentator of the Financial Times, Martin Wolf, says, 'Policy-makers need to ensure that banks are robustly capitalised. If they do not do so, it is highly unlikely that banks will expand their lending.'

Even a highly acclaimed recent book on banking, by Anat Admati and Martin Hellwig (see facing page), makes puzzling statements: 'For society, there are in fact significant benefits and essentially no cost from much higher equity capital requirements.' And further, 'Banks whose shares are traded on a stock exchange can raise money by issuing additional shares and selling them to investors. If the additional funds are used to make loans, the higher capital requirements will actually allow the banks to lend more rather than less.'

These positions seem to me at best incomplete or at minimum misleading – or else faulty. Banks make loans. All these loans have some element of risk. Some are more risky than others. They may give rise to losses. Historical experience will give an indication of the likely size of the losses and pricing can be made in such a way as to cover these kinds of losses. But what happens with unanticipated losses? They need capital for them.

There is a conflict over what can be done on the micro- and macroprudential fronts and it should be made clear. We may all agree that banks are undercapitalised and should be better capitalised. But we can't move from position A to position B costlessly.

If banks are asked to raise their capital asset ratio from say 5% to 7%, there are two ways of doing that. One is to let some assets 'mature' – non-renewal of overdrafts for example. Total assets could fall until the new ratio was achieved. The other possibility is for the bank to go out and raise new capital.

But where does that capital come from? It comes from bank deposits. There is no mysterious source of capital. Bank deposits must then fall and in effect there is a re-arrangement of the balance sheet. But in both cases lending is reduced.

It is clear that a large problem in the recent financial crisis, and indeed in all of them, was a fall in broad money growth. Across many countries the problem is the same. The desire is to restore broad money growth to its trend path. No amount of quantitative easing has managed to achieve this because the banks are not lending. They can't lend if they are having to raise their capital asset ratios at the same time. Yet the authorities and commentators continue to assert the contrary.

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The bankers' new clothes

The solution must be higher capital

Michael Lafferty, Deputy Chairman

Why are banks allowed to operate with equity capital ratios as low as 3% of their total assets when non-bank businesses rarely have less than 30% equity ratios? The explanation, according to Anat Admati and Martin Hellwig in their new book 'The Bankers' New Clothes' is that the bankers have managed to dupe everyone – from politicians and regulators to the public at large – into thinking that financial crises are inevitable and fragile banks are an essential and acceptable part of the financial system. As a result, we have been landed with a financial system that is fragile and dangerous, distorts the economy and exposes the public to vast and unnecessary risks.

Admati and Hellwig are very persuasive in arguing that the obvious solution to this is to require banks to operate with capital ratios in the 20-30% range. With capital regulation already well understood, this would shift the all-too-obvious risk in the present banking system from taxpayers to investors at a stroke.

Addressing claims by former Deutsche Bank chief executive Joe Ackermann and others that this would reduce lending, they say: 'This concern is misplaced. Making loans, like other investments in the economy, should be guided by the quality of the potential loans and by the appropriate economic cost of funding them. Having banks funded with more equity would not interfere with this process; rather, it would make credit markets work better.'

These authors do not pull their punches. They point out time and time again that today's banks are dangerous and that the system has not improved over the past five years. It is hard to argue with their core recommendations: insolvent banks (and there are lots of them out there, particularly in Europe) should be wound up and bank equity capital should be built rapidly to a level of 30% of assets, with dividends and payouts being banned until this is achieved. It would be the ultimate stress test.

One consequence of higher equity would be reduced distortive effects of state guarantees and subsidies. 'With fewer subsidies, large banks might break up without being forced to do so by law and regulation, under pressure from investors concerned about their inefficient size or complexity. High equity requirements would make it more likely that banks would become smaller naturally,' argue Admati and Hellwig.

They also demolish the claims of some bankers that banks will not be able to deliver the returns that investors require if they have more equity, pointing out that this reasoning goes against the basic principles of the financial markets in which banks operate – one of which is that investors require compensation for risk. 'For example, investors are currently willing to receive almost no returns at all when investing in safe government bonds. Any discussion that does not recognise this principle is fundamentally flawed. In targeting high returns, bankers may take risks for which their shareholders are not adequately compensated and that definitely harm their creditors or the public.'

What about the Basel approach to capital regulation? Admati and Hellwig are not fans, describing the risk weighting system as 'highly problematic' – not least because 'it trusts models that cannot be trusted and are manipulable.' ROE, another favourite yardstick of investment bankers and securities analysts, also gets a thrashing. Unadjusted for risk and leverage, it does not measure shareholder value. In fact, as the authors point out, any bank can increase average ROE by increasing leverage or risk and this only endangers the bank and the economy.

Bank equity capital ratios of 25% were typical in the early 20th century. With the world's banking system in such serious trouble today, they may well be part of the solution to the current financial crisis. This book is excellent and should be read by every central banker, regulator, supervisor, auditor and banker.

Bank equity capital ratios of 25% were typical in the early 20th century. With the world's banking system in such serious trouble today, they may well be part of the solution to the current financial crisis.

A regular round-up on international monetary affairs

Monnet question haunts us still

Britain's place in Europe and the Five Tests

William Keegan, Chairman, Board of Contributing Editors

The Financial Times is celebrating its 125th anniversary. At the recent FT anniversary party I found myself recalling the celebration of, I think, the 25,000th issue at a Park Lane hotel in the early 1970s. The guest of honour was no less a figure than Jean Monnet, generally considered to have been the founding father of what is now known as the European Union.

When it was my turn in the receiving line, the great man looked me straight in the eye and asked: 'Do you think Britain is serious about Europe?' To which I have to confess I answered: 'I don't know'.

Thanks to a lot of hard diplomatic work, and the cordial relationship between President Pompidou and Prime Minister Edward Heath, we joined. And, when Heath's successor Harold Wilson managed to appease a voluble group of eurosceptics in the Labour Party by calling a referendum in 1975, the nation voted resoundingly, by a two to one majority, to remain. Some optimists thought that this had settled the matter forever. Wiser heads were not so sure.

So here we are, experiencing the biggest financial crisis of most our lifetimes, and the prospect of yet another referendum on the in/out issue has been raised by Heath's successor David Cameron, in response to pressure from an obsessive band of eurosceptics. This is in spite of the persistent opinion poll finding that 'Europe' figures way down the list of the general public's concerns.

I believe that the naturally conservative British would once again vote to stay in; but what an awful lot of time and energy is likely to be spent on the way, at a time when there are far more important economic and social issues, arising partly from the financial crisis itself, and partly from the pre-Keynesian way in which policy-makers have responded, thereby compounding the problems. Which brings us to the euro, and Britain's decision to stay out. This was a decision, under the Chancellorship of Gordon Brown, which went against the grain of establishment opinion in the UK, but seems to have stood the test of time.

The UK may have serious unemployment problems, but they are nowhere nearly as serious as those afflicting the peripheral members of the euro area, whose economies became trapped by the twin snares of a 'one size fits all' monetary policy and by the inability to adjust their exchange rates in the traditional way against a super-competitive Germany. We have just commemorated the 10th anniversary of the publication of the British Treasury's Five Tests, the results of which were crucial in the Blair government's decision to remain outside the euro – notwithstanding Blair's personal ambition to go down in history as taking us in. The Treasury's present chief economic adviser, Dave Ramsden, delivered a powerful lecture to the Mile End Group, in which he reviewed the history (see p.23-25).

There was a widespread cynical view that the exercise was just 'window dressing' and a charade. That was not the way Ramsden saw it, and he was the economist who masterminded the exercise. He says, 'I never felt under pressure, and Gordon Brown was very careful to keep at one remove throughout.'

There was a widespread cynical view that the exercise was just 'window dressing' and a charade. That was not the way Ramsden saw it. He says, 'I never felt under pressure, and Gordon Brown was very careful to keep at one remove throughout.'

Although Brown and his ally Ed Balls did not want to join the euro, the Treasury's process, like the Swedish government's own tests, came to the firm conclusion that the disadvantages outweighed the advantages. As one surveys the carnage, one cannot but wonder why more European treasury departments did not conduct similar exercises.