July - August 2014
Vol. 5 Ed. 7

The Bulletin

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

Bazaar economics

Central banks' influence

Weidmann's warning
Argentina and its creditors
Smart beta for institutions
When US interest rates turn
The politics of Russian gas

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GLOBAL PUBLIC INVESTOR 2014

DRIVING WORLD ECONOMIC GROWTH

DZ BANK

quantum global

Cover story

The world's central banks have left their ivory towers and entered the world of the bazaar. In view of their wider roles after the financial crisis, they are embroiled in complex bargaining processes, whether through trade-offs between monetary and fiscal policy, through potential conflicts over financial stability or through attempts to optimise returns on reserves that may add to asset price overheating. In the July-August Bulletin we focus on central banks and other public sector playing a seminal – frequently ill-understood – role in global savings and investments. See p.10.

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

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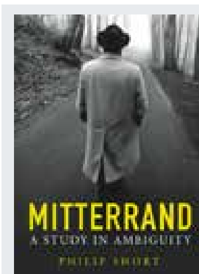

Philip Short, author of *Mitterrand – A Study in Ambiguity,* defends one of the key progenitors of the euro against charges that he was 'morally bankrupt.' See p.34.

Willem van Hasselt

Willem van Hasselt, 64, a senior Dutch foreign ministry official and an active member of the OMFIF advisory board, died in June. See tribute on p.8.

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Awkward time for ECB transparency

The European Central Bank is moving in the direction of Anglo-Saxon style policy transparency – just at the time when a dispute is simmering between supporters and opponents of quantitative easing (QE) as a means of warding off European deflation. As prefigured (OMFIF Bulletin May 2014 p.3), Mario Draghi, the ECB president, announced on 3 July that from January 2015 the ECB will move to the same cycle as the US Federal Reserve by holding monetary policy-making meetings every six weeks rather than every month. Breaking with its custom, the bank will publish minutes of its meetings in the same way as other leading central banks. See p.24-25.

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Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent, research and advisory group. A platform for confidential exchanges of views between official institutions and private sector counterparties.

Our overriding aim is to enable the private and public sector to learn from each other in different ways, promoting better understanding of the world economy and higher across-the-board standards. OMFIF's main areas of focus are economic and monetary policy, asset management and financial supervision and regulation.

OMFIF cooperates with central banks, sovereign funds, regulators, debt managers and other public and private sector institutions around the world.

Since its inception in January 2010, OMFIF has held 254 meetings in 41 host countries with the participation of 200 different official institutions.

Advisory Board

OMFIF's 151-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, weekly Commentaries, seminars and other OMFIF activities. See p.28-29.

Bulletin

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

The Bulletin reaches a wide audience of readers around the globe including public financial institutions, private asset management companies and professional services firms.

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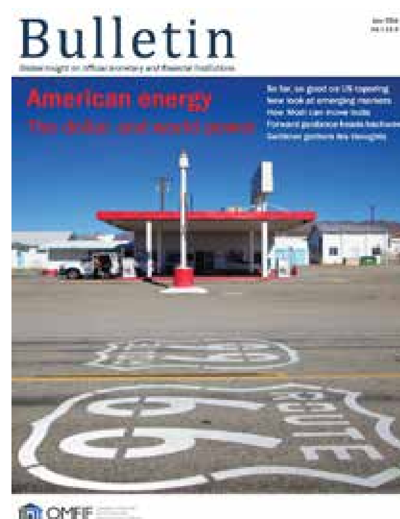
A full list is available on www.omfif.org/meetings

General information

See www.omfif.org for member access to more OMFIF intelligence, including commentaries, reports, summaries of discussions and bulletin archives. Readers with queries on the website should contact editorial@omfif.org.



Marketplace for investments and ideas

Room for conflict as central banks discharge different duties

David Marsh, Managing Director

The cover story for the fifth summer edition of The OMFIF Bulletin – as in every year, The Bulletin takes a rest in August before returning in September – centres on the increasingly convoluted marketplace for central banking policies, investments and ideas. Some might call it, at several levels, a bazaar.

As OMFIF research in Global Public Investor 2014 has demonstrated, central banks are joining in the hunt for yield by boosting equity allocations. While this is a legitimate reaction to the large-scale increase in reserves in recent years and a concomitant fall in yields on traditional investments in advanced countries' government bonds, it poses several questions, not the least of which is the issue of transparency.

As these pages of the OMFIF Bulletin emphasise, there is a deep (potential or real) conflict between different components of central banks' duties. On the one hand, they are now enjoined, post-crisis, to promote financial stability rather than to concentrate solely on their primary task of assuring stable monetary conditions. They have to juggle competing political and economic interests. And they need to generate returns on their assets to fund their operational requirements and obviate the need to seek extra capital from governments – that requests that they fear could constrain their independence.

A significant dichotomy is apparent in the calls in the June annual report of the Bank for International Settlements, the Basel-based central bankers' bank, for the main industrialised countries to rein in their loose monetary policies sooner rather than later to prevent the hazard of asset bubbles of the sort that set off the 2007-08 unrest. Commentators have pointed out that the BIS is hedging its bets.

While its shareholders implement highly accommodative monetary policies to help the recovery, their collective subsidiary, always conspicuously holier-than-thou, takes a much more conservative line and tells them that this path leads to perdition. Sooner or later, one of these views will turn out to be right.

In this edition, a broad body of opinion dwells on these themes. John Nugée and Ted Truman pose searching questions about official institutions' asset management behaviour. Gary Smith asks what will happen to the dollar in world reserves. Trevor Greetham looks at general implications for equity markets of a still-recovering world economy. Darrell Delamaide surveys the latest hawks v. doves tussles at the Federal Reserve.

Further in the international monetary section, Ric Thomas and Rob Shapiro examine smart beta strategies for institutional investors. Kevin Kliesen asks why economic forecasters so often get it wrong, while Meghnad Desai outlines a possible path for retreat from quantitative easing.

Several authors assess the still-sombre European landscape after the European Central Bank's June easing action. The man often termed as Mario Draghi's monetary counterparty, Jens Weidmann of the Bundesbank follows a BIS-style approach railing against high public debts and lax standards for reducing them. His opinions appear wholly justified on a Germanic view, less so from the standpoint of the French, whose budgetary stance Weidmann roundly criticises.

Franco Bassanini and Edoardo Reviglio take a more welcoming line on the ECB's latest moves, while Gabriel Stein bemoans lack of more forthright ECB efforts to combat the risk of deflation.

On the regulatory front, a special correspondent looks at the battle over new rules for money market funds in Europe that practitioners say could spell a death knell for important parts of the sector. Simon Tilford underlines how euro membership for the struggling southern states has been inimical to growth – a warning that countries planning to join the euro such as Poland will certainly heed. Denis MacShane says Britain, recovering from a row over appointment of the new president of the European Commission, should now concentrate on sending the right candidate to Brussels and reforming the way the Commission works.

In emerging markets, David Smith in Buenos Aires surveys the latest stage in Argentina's long-running skirmish with creditors. Aslihan Gedik takes a sobering look at political pressures on the Turkish central bank to cut interest rates. Vicky Pryce examines the issues at stake over the South Stream pipeline, while George Hoguet predicts problems for emerging markets when US monetary policies eventually normalise. Ruud Lubbers and Paul van Seters detect a positive line on green growth and better structural energy management in Europe emanating from latest EU deliberations.

In our review section, Philip Short outlines his thesis in his magisterial biography of François Mitterrand that the former French president was 'duplicitous, devious, secretive, charismatic and charming'. He did not prepare France for the strains of the euro that he helped to devise – but he was certainly not a crook. Commenting on the general wave of euroscepticism emanating from the UK, William Keegan points out that the opposition Labour party is both less carping on Europe than the Conservatives and also a great deal less anti-business than popularly supposed.

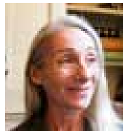
George Hoguet gives a sympathetic reception to *Austerity The History of a Dangerous Idea* by Marc Blyth, a book that Mitterrand would have found agreeably in line with his own views. Unfortunately, with consequences that are now obvious, Mitterrand never read books on economics. ▪

David Marsh

ADVISORY BOARD

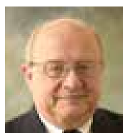
OMFIF has appointed five financial and economic experts to advisory positions: Aslihan Gedik, Brigitte Granville, Jürgen Krönig, Edwin 'Ted' Truman and Celeste Moles Lo Turco. OMFIF has 151 Advisory Board members. For the full list of members see p.28-29.

Aslihan Gedik becomes a Senior Adviser. She runs the European treasury operations of Oyak, the Turkish Armed Forces Pension Fund, and will contribute to OMFIF's efforts in Turkey and the Middle East. Gedik has extensive knowledge of fixed income trading, derivatives and money markets, having worked at InterBank, Yapi Kredi Bank Nederland and TAIB Yatirim Bank.

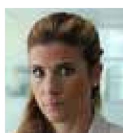


Brigitte Granville is professor of International Economics and Economic Policy at Queen Mary, University of London, and director of the Centre for Globalisation Research (CGR). She has been part of a team advising Russia's Ministry of Finance, and has been a major contributor to the analysis of the successes and problems of Russian monetary reforms.

Jürgen Krönig is an award-winning journalist, author, broadcaster and photographer. He writes for the German weekly paper Die Zeit and various publications in Germany, Switzerland and the UK. In 2005 he was awarded an OBE for his outstanding contribution to British-German relations.



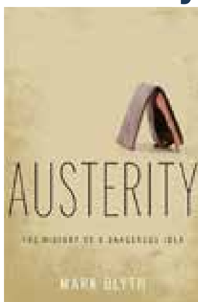
Edwin 'Ted' Truman served as assistant secretary of the US Treasury for International Affairs from 1998 to 2001, and returned as counselor to the treasury secretary from March to May 2000. He is a senior fellow at the Peterson Institute for International Economics, and will be advising OMFIF on questions of international monetary affairs, asset management and liquidity.



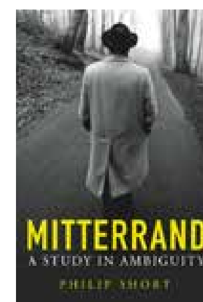
Celeste Moles Lo Turco is a sovereign wealth funds analyst for the strategic committee on sovereign wealth funds of the Italian Ministry of Foreign Affairs. She is an adviser for Ancitel, the Italian Municipalities Association, where she created the first Italian website on sovereign wealth funds and a specialised publication on SWFs.

BOOK REVIEWS

Austerity policies and French politics



Austerity does not work, argues Mark Blyth in *Austerity: The History of a Dangerous Idea*. Published while 26m people remain unemployed in the EU, the book traces the history of thought on debt and examines 'chinks in the armour of neoclassical economics', according to reviewer George R. Hoguet, global investment strategist at State Street Global Advisors. While Hoguet points out that Blyth fails to discuss the economic implications of unfunded entitlements, he sees the book as an important contribution to the debate on who should bear the burden of adjustment. Meanwhile, Philip Short reflects on the career of founding father of the euro, François Mitterrand. Morality and statesmanship are not linked, Short argues, and detractors who focus on the politician's alleged 'moral bankruptcy' understate his achievements and legacy. See p.34-35.



BRIEFINGS

Abenomics, BoJ monetary policy and Japanese growth

The outlook for revitalisation of the Japanese economy under Prime Minister Shinzo Abe was the main feature of a roundtable in London's Traveller's Club on 24 June. Other issues were perspectives for monetary easing by the Bank of Japan, the probability of a rise in inflation and prospects for a return to sustainable growth. Speakers included Michio Kitahara, deputy director general of the BoJ's monetary affairs department, and Toshio Oya from the Minister's Secretariat at the Japanese Ministry of Finance.

The Asian Development Bank's priorities for 2014 and beyond

Stephen Groff, Vice President of the Asian Development Bank, spoke to OMFIF members at the Reform Club in London on 27 June on the ADB's programme for intensified partnerships in Asia in 2014 and beyond, including its plans for link-ups with investors from within and outside the continent on infrastructure development. Possible cooperation with the new Asian Infrastructure Investment Bank was a prime topic. In addition, Groff discussed the ADB's new emphasis on building up knowledge networks with investors to enhance the quality of its interactions with world capital markets.

EXPERT SEMINARS

Scottish independence from a European viewpoint

A new Scottish nation after the referendum on 18 September would need 'a lot of patience, energy and belief in its glorious future to bear the initial costs of what would most likely turn out to be a period of some turmoil and uncertainty,' according to Prof. Wilhelm Nölling (pictured right), a former member of the Bundesbank Council. At an OMFIF seminar at the University of Edinburgh on 9 June, he drew lessons from European experience: the state must remain in control of its public budgets, and an independent central bank immune to geographical or political influence must be put in place.

Outlook for European money with growth still sluggish

In the light of still-sluggish euro area growth, setbacks for many main political parties in the May European elections and European Central Bank monetary easing measures, OMFIF convened a panel of experts at the Reform Club in London on 10 June to discuss the future of the euro. Speakers included Roger Bootle, Lord (Norman) Lamont, Prof. Wilhelm Nölling, Vicky Pryce and Prof. Niels Thygesen, three of whom were directly involved in the creation of the single currency in the 1980s and 1990s. The panel agreed that earlier assumptions that the euro would enhance competitiveness and persuade governments to follow rules of good economic behaviour had been far too optimistic. The outlook for the next two years was subdued. The chances that the 'one size fits all' policy would produce positive outcomes were seen as negligible.

Launch of *Global Public Investor* in London's City Hall

Representatives of business, finance, politics, media and academe gathered at City Hall in London on 17 June for the UK launch of OMFIF's *Global Public Investor*, the first comprehensive survey of $29.1tn worth of investments held by 400 public sector institutions. Gerard Lyons, chief economic adviser to the Mayor, Julia Leung, former Hong Kong treasury undersecretary and OMFIF senior adviser, Frank Scheidig of DZ Bank, Ulrich Otto of Quantum Global (pictured right speaking to Angela Cummine, GPI consulting editor), Crispin Simon, chief executive of UK Trade and Investment and Lord (Meghnad) Desai were among the speakers. To purchase the report please contact sales@omfif.org.

POLICY GROUP

Future UK interest rate policy: the view from Ian McCafferty

With four new members on the Bank of England's Monetary Policy Committee, uncertainty is increasing on the future development of interest rates. At a lunch on 18 June in London, external MPC member Ian McCafferty gave his view of future influences on UK monetary policy, where markets are leaning towards expecting a rate rise either at the end of 2014 or early next year. On forward guidance, McCafferty firmly believes that the policy has been successful in providing reassurance to the market and consumers. On the puzzle of falling UK productivity, McCafferty concluded that the actual decline is rather small and can be explained by a range of factors including changes in industrial and economic structures.

Charlie Bean's farewell views on managing the exit

Over a farewell lunch in Moorgate on 25 June, Prof. Charlie Bean, Deputy Governor of the Bank of England who retired at the end of the month, discussed how the Bank may move out of the current stimulatory monetary stance. He voiced his potential concerns for the economy, including the dangers of an overheated housing market which could then lead to the need for damaging rises in interest rates. Furthermore, he drew attention to the danger – shared also with policy-makers at the European Central Bank – that central banks were facing excessive pressures to heal economic imbalances.

Shift from west to east and implications for policy-making

Gerard Lyons, the Mayor of London's chief economic adviser, spoke to a roundtable on 26 June to discuss economic trends and their implications for future policy-making. In his new book *The Consolations of Economics*, Lyons foresees global growth driven by increased innovation and technical advances, with the balance of economic power shifting from west to east – a confluence of influences that he believes will be favourable for London as Europe's premier global city.

MAIN MEETING

St. Louis Federal Reserve Bank - OMFIF seminar

Prospects for economic recovery and financial renewal: discussion on Fed tightening

James Bullard, St. Louis Fed President

The outlook for the US economy and the effect of prospective Federal Reserve tightening on the rest of the world dominated OMFIF's first Main Meeting in the US, at the Federal Reserve Bank of St. Louis on 2-3 June 2014. The meeting, hosted by James Bullard, president of the St. Louis Fed (pictured left), who attended each of the six sessions, attracted 60 delegates from around the world.

Most delegates affirmed a generally positive outlook for the US economy with 4% rise in GDP expected in second quarter after poor weather-induced first quarter performance. However there was considerable doubt about the scale and timing of US interest rate normalisation after the extreme monetary accommodation and very low interest rates since the 2008-09 trans-Atlantic crisis.

Amid a general slowdown in growth in previously fast-performing parts of the world, the uncertainty over the prospective rise in US interest rates in the next two years has considerable implications for emerging market economies and their search for improved economic balance

Another major theme was the renewal of the US energy market, and the impact on the wider economy of the rapid build-up of US shale oil and gas production. The outlook for the institutional asset management sector in the light of high world savings, buoyant financial markets in 2013-14 yet lingering fears of an eventual resumption of financial turbulence were other significant issues for discussion.

OBITUARY

Diplomat-musician embodying culture, optimism and calm

Willem van Hasselt, 64, a senior European official at the Dutch Ministry of Foreign Affairs, and an active member of the OMFIF advisory board, who died in June, was an erudite, companionable and philosophical man with great talents and enormous reserves of wry good humour. His culture, his optimism and his calm, as well as his distinguished family background, placed him in a category apart. His joint Dutch-German-Danish ancestry, leavened by traces of Scotland, made him a true European. He will be sadly missed.

Upon completion of his studies and research work, including a spell at Centre National de la Recherche Scientifique in Paris, he joined the Ministry in 1982, holding a variety of positions including policy planning and serving as the Foreign Minister's speechwriter. In 2007 Willem moved to a special-tailored post liaising with think tanks. He was closely involved in almost all major EU negotiations, including the Maastricht treaty.

Fluent in many languages, he was a passionate and well-respected violin player, a member of many chamber music ensembles. He inherited from his parents a talent for drawing and painting and always travelled with a small sketchbook for aquarelles and handwritten notes. He was a member of the Kloosterkerk church in The Hague (where his memorial service took place), responsible for music for several years.

One notable forebear was Wilhelm von Hasselt (1590-1634), whose family had been members of the Cleves government for generations. Only one son survived the Thirty Years War, laying the basis for the family in the Dutch Republic. Another remarkable ancestor was Joan Derk, Baron van der Capellen tot den Poll (1741-84), rising up against corruption and nepotism surrounding the Dutch Stadhouder Prince Willem V and distributing across the country in one night a rebel pamphlet 'To the people of the Netherlands'.

Willem is survived by his wife Ernestine and three sons Kai, Winand and Diederik. He would have retired from the Ministry, but not from his thoughts and activities, in December 2014.

US policy debate takes centre stage

Among the themes developed by James Bullard and other delegates were the need to counterbalance monetary and fiscal policy in the US, with the latter on 'automatic pilot' after the large fiscal contraction caused by automatic budget correction action in recent years and with no new initiatives currently expected.

The Federal Open Market Committee would be anxious not to repeat past errors over tightening policy too late in response to eventual fears of higher inflation and asset price overheating.

There was a general consensus that, in view of relatively good prospects for US recovery combined with the lack-lustre outlook on Europe, there was likely to be US-European monetary decoupling and upwards pressure on real dollar exchange rate, which would have negative effect on US exports.

Several delegates raised questions over long-term US unemployment and whether that should be included in calculations on the real unemployment rate.

In the panel on American economic prospects, delegates stated that fiscal drag should significantly diminish after the corrective steps in the past two years to rein back the substantial deficit caused by stimulus in 2009.

Previous fiscal restraint, amounting to a 1.5% drag in GDP, will move to a neutral or positive effect this year.

In general, economists expected further improvements in corporate balance sheets, caused by a combination of lower debt and interest rates, generally soft spending and higher asset prices, in particular in house prices and equities.

With a 150% rise in equities since their trough, there was a general belief that share prices were now roughly fairly valued.

As interest rates rise, a further decline in the equity risk premium is expected.

Left to right: Cyrus Hadidi, David Marsh, Sam Killmier, James Bullard and Ian Epstein

Left to right: Haroutioun Samuelian, Mohamad Issa Soormally, David P. Bleakley and Daniyar Akishev

Left to right: Matthew Allen, James Clark, Haroutioun Samuelian, Darrell Delamaide, Cecilia Skingsley, Mohamad Issa Soormally and Paula Tkac

A farewell photo of delegates from 20 countries at the St. Louis Fed with President James Bullard and OMFIF Advisory Board Chairman Meghnad Desai in the centre

Searching for yield in global assets

Diversity and convergence among public sector managers

OMFIF publication on Global Public Investors

A build-up of equity purchases by central banks around the world appears part of a strong drive to diversification by official asset holders that is now a fact of life on international capital markets.

One of the findings of OMFIF's *Global Public Investor 2014*, the first comprehensive survey of $29.1tn worth of investments held by 400 public sector institutions in 162 countries, is the degree of commonality linking three broad institutional groups of central banks, sovereign wealth funds and public pension funds.

None of these categories is homogeneous, and – in general – diversity is increasing with globalisation. But some notable institutions from different categories, such as Swiss National Bank and Norges Bank Investment Management, share with each other more common features than with many entities within their own institutional groupings.

Drive for diversification

The study highlights how a recession-induced decline in interest rates in the major reserve currencies – the dollar and the euro – has had a seriously negative effect on the profitability of reserve holdings by central banks, adding to the drive for diversification. Some central bankers fear the need for government finance to support their budgets may strain their on independence.

Based partly on extrapolations from published central bank data, central banks around the world have foregone $200bn to $250bn in interest income as a result of the fall in bond yields in recent years. This has been partly offset by reduced payments of interest on the liabilities side of their balance sheets.

The report, focusing on investments by 157 central banks, 156 public pension funds and 87 sovereign funds, highlights how, in the aftermath of the financial crisis, different forms of 'state capitalism' have come to the fore. Whether or not this trend is a good thing may be open to question. What is incontestable is that it has happened. Global Public Investors as as a whole appear to have built up their investments in publicly-quoted equities by at least $1tn in recent years.

The assets of the overall survey of 400 Global Public Investors comprise $13.2tn (including gold) at central banks, $9.4tn at public pension funds and $6.5tn at sovereign wealth funds. The publication outlines investment by organisations as diverse as the People's Bank of China and State Administration of Foreign Exchange (SAFE), Japan's Government Pension Investment Fund (GPIF), Californian Public Employees Retirement System (CalPERS), Bank of Korea, Malaysia's Khazanah Nasional, and Australian Government Future Fund. The financial centres of Frankfurt, Hong Kong, Kuala Lumpur, London, Johannesburg, Mauritius, Qatar, São Paulo and Toronto are supporting the study.

The study recommends broad categories of public investors should adopt the Santiago Principles on transparency and accountability. It outlines suggestions on how to channel large-scale long-term funds into investment areas like infrastructure, energy and transport around the world, emphasising the need for co-investment, partnership and knowledge-sharing among diverse investment organisations from the public and private sectors. 'The size and over-arching nature of transactions make necessary an intermingling of expertise and a pooling of risk. Combining expertise in emerging market and infrastructure investments by sovereign funds and pension funds is just one area with great potential.'

Responsible equity ownership

In the field of corporate governance and responsible equity ownership, the report recommends public investors should step up engagement with private sector shareholders.

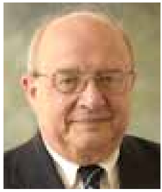
The study contains articles on Global Public Investors by 64 authors from 56 institutions in 32 countries. Among the highlights are contributions from Tarek Al-Wazir, Hessen minister of economics; Franco Bassanini, Chairman of Cassa depositi e prestiti; David Cameron, British prime minister; Heung Sik Choo, Chief Investment Officer, Korea Investment Corporation; Jingdong Hua, Vice President and Treasurer, International Finance Corporation; Boris Johnson, Mayor of London; Thomas Jordan, President and Chairman, Swiss National Bank; Jin Liqun, Honorary Chairman, International Forum of Sovereign Wealth Funds; Elias Masilela, Chief Executive, Public Investment Corporation of South Africa; Azman Mokhtar, Managing Director, Khazanah Nasional; Linah Mohohlo, Governor, Bank of Botswana; David Murray, inaugural Chairman, Australian Government Future Fund; Adrian Orr, Chief Executive Officer, New Zealand Superannuation Fund; Ipumbu Shiimi, governor, Bank of Namibia; José Filomeno de Sousa dos Santos, chairman of the board of directors, Angolan Sovereign Fund; Anselmo Teng, chairman, Autoridade Monetaria de Macau; Amando Tetangco Jr., governor, Bangko Sentral ng Pilipinas; Fiona Woolf, Lord Mayor of London.

Extra liquidity

The survey emphasises the two-edged nature of large volume of extra liquidity held by official institutions. These assets have been built up partly as a result of efforts to alleviate the financial crisis, through foreign exchange intervention by central banks in emerging market economies or quantitative easing by central banks in the main developed countries. But deployment of these funds on capital markets can drive up asset prices and is thus a source of further risks. 'Many of these challenges [faced by public entities] are self-feeding.' The report says. 'The same authorities that are responsible for maintaining financial stability are often the owners of the large funds that have the potential to cause problems.'

The report adds that official investors can be increasingly expected to have their behaviour and performance measured against wider public goals. The challenges go well beyond the pressures on western central banks caused by extension of their responsibilities into wider policy areas such as fiscal matters. 'Asset managers may face efforts to influence their investments in areas like infrastructure or social security systems. Public investors of all categories may be called upon to take part in global and regional safety nets, such as through reserve asset pooling, working alongside institutions like the International Monetary Fund.' It concludes: 'Public asset managers need better to understand and manage the political fields into which they will inevitably be drawn.' ▪

For more information about Global Public Investor 2014, including ordering details, please contact sales@omfif.org



Helping owners as well as recipients

More transparency needed in official management

Edwin 'Ted' Truman, Senior Adviser

One of any government's major responsibilities is managing the country's international assets. How well it discharges this role has profound implications. Reforms are needed to enhance transparency and accountability for this activity – in the interests of a better-functioning world economy.

Total end-2013 cross-border investments can be conservatively estimated at about $130tn. However, the share of government-owned or government-controlled cross-border investments in that total is unknown.

These investments include those of government pension funds, government-owned banks, development banks and state-owned enterprises as well as international reserves and sovereign wealth funds.

A conservative guess for the total volume of the assets of or controlled by governments is $35tn, about 25% of total cross-border assets, close to 50% of global gross domestic product at current prices and exchange rates. Most analysis is concentrated on an important but narrower category of official asset managers – central banks and SWFs.

International reserves

As of end-2013, international reserves were $13.4tn, including gold at the market price. Adding the international assets of SWFs, about $4.0tn, and adjusting for double counting, produces a total for these two broad categories of institutions of $16.2tn or 22% of global GDP. On a conservative estimate, this figure accounts for less than half of all assets held by Global Public Investors.

In the wake of the 1994-95 Mexican financial crisis, International Monetary Fund members agreed to establish the General and Special Data Dissemination Standards (GDDS and SDDS). These standards promote the quality of national economic and financial statistics. The number of SDDS subscribers has increased slightly over this period to 71. Conspicuous non-participants are two G20 members, China and Saudi Arabia. To reflect the great increase in complexity and interconnectedness of the world economy during the past 20 years, the number of SDDS subscribers should significantly increase.

People's Bank of China headquarters in Beijing

Reserve holdings

Global interest in how or where countries invest their reserves has grown over the past two decades, as reserve holdings have expanded from 6% of world GDP in 1990 to 17% today (more than 20% including SWFs.) Countries are expected to indicate the amount of their foreign exchange reserves held in assets denominated in the four currencies in the Special Drawing Right basket (the dollar, euro, sterling, and yen) and in other currencies. But that does not take us very far.

The IMF collects confidential information on the currency composition of foreign exchange reserve (COFER) holdings. However, coverage of total reported foreign exchange reserves declined from 77% in early 1999 to 53% as of December 2013. Mainland China, with $3.8tn in foreign exchange reserves at end-2013, accounts for 67% of the non-reporting by emerging market countries.

The challenges surrounding transparency and accountability in the management of governments' international assets are at several levels. Reserves in a number of countries are well in excess of their needs.

The accumulation of those reserves over a long period distorts the international adjustment process. Changes, real or rumoured, in the asset or currency composition of foreign exchange reserves have the potential to destabilise exchange rates and financial markets. Greater transparency would help to counter this tendency.

This will become an even bigger problem as the multicurrency system expands further. In the interests of the stability of the international economy and financial system, I advocate five major reforms. First, international statisticians should agree that data on international investment positions for government-owned and -controlled entities should include separate tabulations in each major institutional category, such as SWFs.

Second, participation in the SDDS and the associated Reserves Data Template should include, at a minimum, all countries with a GDP of $200bn or more, at market prices and exchange rates. This criterion would encompass 50 countries as of 2013. This means 10 additional countries would become participants: Algeria, China, Iran, Iraq, Nigeria, Pakistan, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

Third, the Reserves Data Template itself should be revised to provide more asset information. The current template was relevant to the problems and issues of the 20th century but not to those of the 21st century.

Fourth, major reserve holders should publish more detailed information on the investments. Those with combined assets of more than $50bn (26 countries on end-2013 figures) should publish regularly, with an appropriate lag of perhaps a quarter, detailed information on the types and currency of assets in their portfolios and the countries on which those claims are held.

Fifth, these major reserve holders should report confidentially their intervention and investment operations to the seven, and potentially more, countries that issue assets in international currencies under COFER.

Transparency and accountability

Transparency and accountability are important not just for recipient countries and for the financial markets, but also for the citizens of the countries that own the assets. The reserves and SWF assets of emerging market and developing countries are about 35% of their combined GDP.

A 1 percentage point increase or decrease in the rate of return on those assets of changes these countries' average annual growth rate by 0.35 points. More information about these assets is in the strong interest of the home countries, as well as for the global economy and financial system. ▪

Edwin 'Ted' Truman is Senior Fellow, Peterson Institute for International Economics. *This article appeared in abridged form in Global Public Investor 2014, p. 92-94.*

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Recalibrating dollar exposure

Time for central bank reserves to re-calibrate

Gary Smith, Barings Asset Management

Reserve managers at central banks with large reserves that have grown quickly are thinking logically when they consider reducing their dollar allocations.

The reasons lie in a combination of very low US interest rates, the shrinking US economic share of global GDP, and concerns over what exactly now characterises America's so-called 'exorbitant privilege' – a phrase first coined by the French government in the 1960s to denote the power behind the dollar's status as the world's primary reserve currency. This position is not itself under threat. However, the extent of its dominance may decline – and central banks have to be aware of the risks as well as opportunities that flow from this.

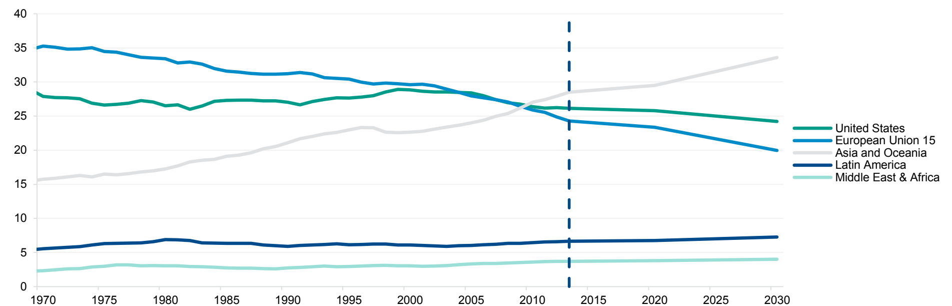
Asset allocation

The head of reserves management at a large Asian central bank confessed to me that, as his reserves grow ever larger, he struggles to identify what his 'neutral' currency composition should be. This demonstrates that asset allocation is dynamic, not static. When reserves exceed levels traditionally regarded as adequate, the pressure to rethink how best to allocate them is greatest.

Such thinking can stem from the reduced need – or justification – to hold ever-larger quantities in the primary currency of intervention. A partial shift out of the dollar will usually help to address the problem of 'negative carry', caused by interest rates in the dollar, used for investing most of a central bank's reserves, being lower than those in the domestic currency employed on the liabilities side of its balance sheet. For some very large central banks, such considerations reflect, too, an element of competition with the local sovereign wealth fund. The asset and currency selections of the very largest reserve managers often take on an appearance more usually associated with that of a SWF.

But the issue is not just about 'carry'. Some central banks I am working with are looking to develop benchmarks loosely based on the national balance sheet, including the make-up of trade and capital flows. There are hurdles to this approach. For example, a nation could have large trade and capital flows with Kuwait yet be unable to access Kuwaiti government debt. However, despite its limitations, the 'balance sheet benchmark' approach is a

Share of countries and regions in world GDP (%)



Source: SSgA, MSCI

defensible strategy, resonating favourably with domestic stakeholders. It paves the way to a more sensible alternative than holding ever-larger quantities of low-yielding dollars.

The rush into renminbi investments is a good example of currency diversification based on changing composition of individual countries' balance of payments. As many as 40 central bank reserve managers now hold the Chinese currency. In nearly all cases one of the reasons reflects trade with China. Such considerations drive, too, the increasing use of the renminbi to settle bilateral trade.

Traditionalists will point out that the dollar share of central bank reserves appears stable at above 60%, according to IMF data. This is despite a falling US share of global GDP, as the Chart shows. The use of the dollar appears out of kilter with economic reality, not least when one considers that the 60% ratio is based on incomplete data that may not capture what is happening in many of the world's very largest reserve holders. On this basis, a change is overdue.

Another factor behind the trend is some countries' concern that the US Treasury is taking the 'exorbitant privilege' to new levels. Traditionally this privilege has been viewed mainly as economic, by bringing the US the benefit of lower interest rates than might otherwise prevail. This view needs to be updated, though, because the privilege now extends still further. The US Treasury is taking advantage of the international role of the dollar to help prosecute foreign policy and achieve national security objectives.

Juan Zarate, in his book *Treasury's War**, explains how, in the aftermath of the 2001 terror attacks, the US Treasury was tasked with using the international financial architecture, including SWIFT, to close down the routes of terror financing. This was the initial objective, but the policy was extended to squeeze a wider array of America's enemies with sanctions and asset freezes.

It is against this backdrop that China has announced plans for a China International Payment Platform (CIPS). When fully rolled-out, the platform will facilitate renminbi usage by simplifying language issues, extending operating hours, and introducing SWIFT compatibility. CIPS should be viewed primarily as a continuation of the renminbi internationalisation commitment. Improving the renminbi's credentials as an alternative to other currencies is a key aspect of this policy.

International trade

The default global choice for international trade so far remains the dollar. Yet there are good reasons to consider using alternative currencies. One notable example concerns trade between large emerging market economies. It seems unlikely that the so-called $400bn gas agreement announced in May between Moscow and Beijing will be settled in the currency used to describe the size of the deal. The US tendency to use its own banking laws and regulations is designed to advance its foreign policy and national security objectives. Yet it could produce the opposite effect, by creating headwinds against the ever-wider use of the dollar. ▪

*Gary Smith is Head of Sovereign Wealth Funds and Official Institutions at Baring Asset Management. He works across the asset management companies of the MassMutual Financial group: Barings, Babson Capital, and OFI Global. *Treasury's War: The Unleashing of a New Era of Financial Warfare, Public Affairs, 2013.*

The power of state capitalism

Public sector investors must engage on governance

John Nugée, Director

The importance of Global Public Investors illustrates the seemingly inexorable rise of the corporate state, underlining how much the world has changed since the era of privatisation – the rolling back of the public sector seen initially in the US and UK in the 1980s and copied by many countries since.

The previously widely-held Anglo-American view that economic activity is best conducted and owned by the private sector is certainly not prevalent in the world as a whole any more. State corporations are powerful in many jurisdictions, not just in the developing economies.

Many developed countries still have a large role for state-owned utilities, and even in the UK, for example, where basic utilities are mostly no longer run by the British state, they are often owned by organs of other EU states.

State capitalism

Across the world, China is the most obvious example of the rise of state capitalism. This is in large measure a consequence of the rise in China's current account surpluses over the last 15 years and the deployment of these surpluses largely in the reserves of the People's Bank of China – which has arguably been a rather suboptimal repository for the country's net investment position. The current account surplus is now receding (see Chart), but the assets remain.

Some important questions arise from this. One centres on the functioning of the world economy when so much of the capital stock is in public hands. GPIs' assets represent 40% of world GDP. There must be a point at which this percentage starts to change the dynamics of shareholder capitalism. Many GPIs, for example, make a point of not exercising their votes at shareholder meetings, and most forego taking up any directorships their holdings may entitle them to. Yet a silent investor is a friend of weak or poor management. Too high a proportion of such shareholders reduce the ability of the owners to hold management to account.

There is a dividing line between 'involvement', which most people see as a positive if not essential element of ownership, and 'interference', which is frowned on in general and particularly if the actor is a state body. The dividing line is very thin and ill-defined. Indeed the same action by a shareholder could be interpreted either way. The judgement depends on whether management agrees (in which case it will probably be seen as involvement) or disagrees (in which case it is more likely to be seen as interference).

A second question is why the world appears to need so much more public sector capital than it used to. The amount of public capital needed to support a given amount of global GDP has risen sharply since the end of the last century. Whereas 14 years ago, $30tn of nominal GDP required perhaps $5tn of GPI capital – a ratio of six to one – now global GDP of about $70tn requires on the basis of these figures nearly $30tn, which is only just over two to one.

Why is the world so much less efficient at using capital, and given that capital is a scarce resource, how much does it matter? One easy answer is that, as the developing world makes up a higher proportion of total global economic activity, we should not be unduly surprised that the world overall starts to look less developed. After all, if the developing world were to reach, say, 75% of global economic activity, the dominant characteristic of the resulting world would be that it was developing.

Public capital

And just as it is well recognised that it takes more oil to produce a dollar of GDP in China than it does in the west, it would not be surprising if it also took more public capital.

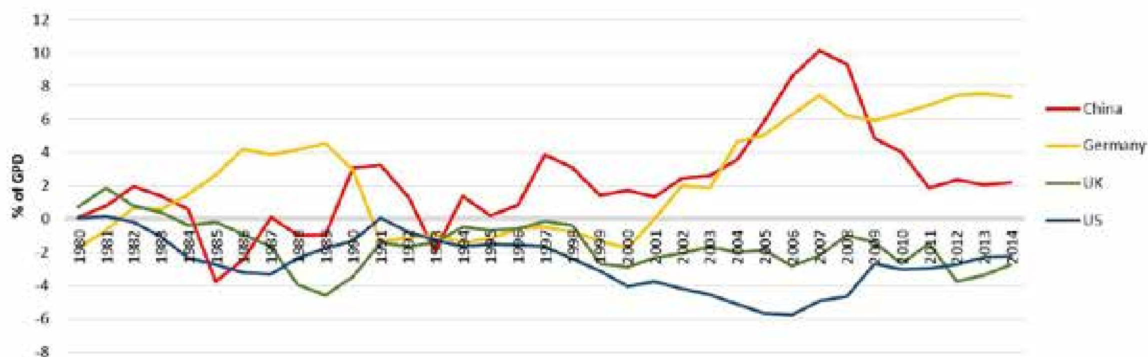
But the consequences of running a more capital-intensive global economy, and the restrictions that this might imply for economic activity and financial stability, are not clear.

At the extreme, the risk is of a world of ever larger accumulations of public sector capital, which their owners struggle to use efficiently, and which hang over markets as both a distortion and a threat to stability. We may then see these large and similar-minded investors showing herd-like behaviour, searching for the same illusive return, for example in the current 'search for yield'.

This can only create fresh volatility and complicates the task of those seeking to preserve financial order. The same authorities that are responsible for maintaining financial stability are often the owners of the large funds that have the potential to cause problems – a fascinating but not particularly attractive thought. ■

John Nugée is Director of OMFIF. He is the author of Reflections on Global Finance: Selected Essays 2002-2013.

Current account balance (% of GDP) for major countries



Source: International Monetary Fund, World Economic Outlook Database, April 2014

Towards a bout of euro weakness

Disinflationary, desynchronised global recovery

Trevor Greetham, Advisory Board

Fidelity's global growth scorecard has been positive for 18 months. The world is in a disinflationary and desynchronised global recovery, with steady expansion in the US driving above-trend global growth while the slowdown in China keeps commodity prices and inflation under control.

This backdrop allows G7 central banks to keep policy loose but, with different economies at different points in the business cycle, monetary policy divergences will create opportunities.

The big picture view is one where growth stays strong but inflation remains muted, as in the 1990s. This is good for developed market equities. However, at present growth indicators are mixed and inflation pressures have risen following higher oil price. The Investment Clock model (see Charts 1 and 2) that guides Fidelity's asset allocation is close to neutral. The growth picture may turn positive again after the summer.

A strong, housing-led UK recovery is leading the Bank of England to warn of possible base rate rise later this year. Meanwhile, the European Central Bank (ECB) has embarked on a new phase of easing to head off deflationary forces. The prospect of further liquidity injections is helping sovereign bond spreads over Germany to tighten further but the best of this trade is behind us. The best way to play divergent ECB policy is in the currency markets. A widening spread between UK and German rates suggests a new and long-lasting trend of euro weakness. An overweight sterling position appears advisable versus the euro and Swiss franc.

A dovish June press conference from Janet Yellen, the Fed chairman, saw VIX volatility close at 10.7, the lowest level since February 2007 just prior to the subprime crisis and not far off half the June average since 1990. Low volatility isn't in itself a sell signal for equities and a continued rise in prices is possible.

However, volatility usually rises from its seasonal lows between now and October and possible triggers include deeper unrest in the Middle East or slower US growth towards the third quarter. Price dips are likely to provide buying opportunities.

The world is experiencing the longest upswing in economic activity since the two year expansion of 1996-97. The benign policy backdrop allows G7 central banks to keep policy loose, easing whenever they deem it necessary to sustain growth as the ECB's latest move on 5 June illustrates. On 3 July Mario Draghi, the ECB president indicated further possible easing measures.

There has been a bounce-back in economic data in the US after bad weather in the first quarter. Elsewhere in the world the outlook is mixed. The Chinese residential construction sector remains weak but other economic data have stabilised. Japan's sales tax rise is triggering a temporary recession and a decline in aggregate real incomes could limit the strength of a bounce-back. The UK economy is strong but activity is cooling off somewhat in Germany. The world economy is increasingly desynchronised, so more evidence of improvement is needed before investors can position themselves for a sustained re-acceleration in global growth.

Fidelity has taken an overweight US equities position since early 2011 on the back of pro-growth policy and structural improvements. Earnings revisions are improving relative to other regions. The overweight position in Japan was phased out in the spring time. This reflected concerns that April's sales tax rise will hurt the recovery. However, Japan is the best play on a US-led global upturn.

Asia Pacific ex Japan and emerging markets are main underweight areas. Commodity price weakness and a return of capital to the US will weigh on these markets.

Europe has a neutral position, as a result of muted recovery and latent political risk should growth slow.

The UK takes an underweight position, since the housing-led recovery is best played through mid cap exposure and sterling.

Strong data will drive expectations for higher interest rates, even though macroprudential measures to cool housing will be tried first. ▪

Trevor Greetham is Head of Tactical Asset Allocation and Portfolio Manager at Fidelity Solutions. This article is co-authored by Eugene Philalithis, Portfolio Manager in Fidelity Solutions.

The Fidelity view of world economic and financial conditions - paying attention to the cyclical dimensions

Chart 1: Clock indicator trail spot on neutral

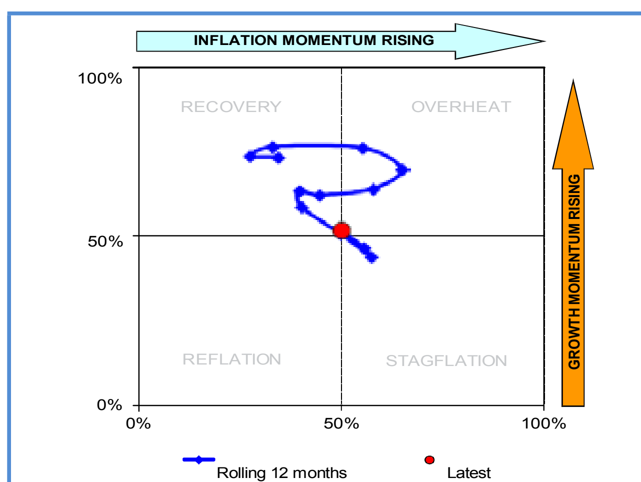
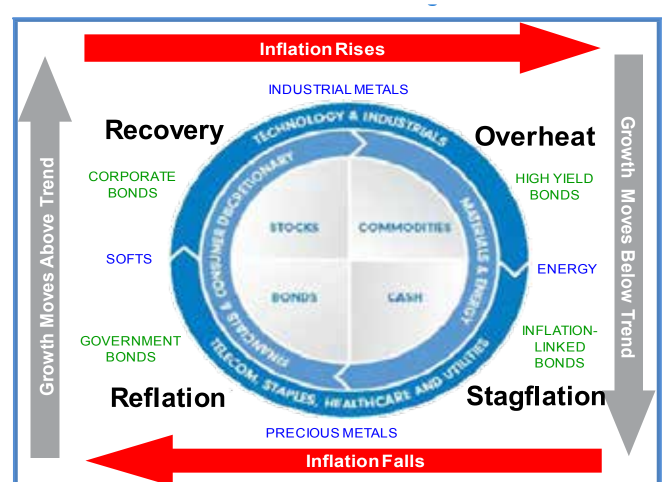


Chart 2: The investment clock diagram

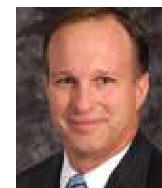


Source: Fidelity. This represents the opinion of Fidelity Solutions. For illustrative purposes only.

The importance of valuation

A multiple factor approach to advanced beta

Rob Shapiro and Ric Thomas, State Street Global Advisors



Investing in advanced beta strategies has evolved from a niche concept into an established investment belief among many institutional investors including central banks and sovereign funds.

The widespread acceptance of transparent, rules-based strategies that seek to achieve active performance by capturing specific risk premiums in the market is confirmed by various studies and surveys, as well as practical experience. Passively following an index designed to take advantage of perceived systematic biases or inefficiencies in the market costs less than active management, since there is less day-to-day decision-making, providing a plausible route for enhanced returns.

Main considerations

Initially, investors' main consideration centred on which of the advanced beta equity premiums – such as size (focused on the added premium provided by small-cap stocks), value (provided by stocks currently out of favour despite strong fundamentals), quality, or low volatility – made the most strategic sense in a diversified investment plan. But more recently, investors have started to ask whether they can dynamically rotate the timing of their exposure to these factors over the long term.

The timing question is an important one. A discussion of the valuation of these factor portfolios has been missing from the advanced beta debate so far. When investors seek to alter a strategic allocation to equities, high yield bonds, or any other asset class, they naturally look to valuation for guidance. A sharply rising P/E ratio on equities, for example, often leads some investors to reduce their equity allocation in favour of a cheaper growth asset class.

A simple method for tracking the valuation of advanced beta factor portfolios provides useful information for investors. This analysis confirms that historically advanced beta premiums are positively related to these valuations, so this method can help forecast strategy performance. This analysis can help investors make a more informed prediction of the long-term prospects for their advanced beta portfolios and provide guidance for dynamic rebalancing of portfolio weights.

Various studies show that a valuation-based approach provides reasonably accurate long-term forecasts for asset prices. Simple aggregate valuation ratios, such as price-to-earnings, dividend-to-price and book-value-to-price, can accurately predict long-term equity market returns. Studies show that P/E multiples are relatively constant in the long-run, always reverting back to a historical norm. Therefore, a high P/E ratio necessitates that either the numerator (P) must fall or the denominator (E) must rise, to bring the ratio back into equilibrium. In fact, it is often price, not earnings that adjusts to restore balance, dealing a blow to believers in market efficiency, who would have predicted that higher prices reflect a perfect sharing of information about the prospects for earnings growth. As we know, the efficient market hypothesis is not always 100% reliable.

This finding raises important questions for adherents of factor-based investing.

Chart 1: Valuation spreads of advanced beta attributes

Value—Median B/P Spread
2.0 1.6 1.2 0.8 0.4 0.0
Attractive
Expensive
Jan 1987 1993 2000 2007 May 2014
— Spread — Average Spread 1 Std Dev Above 1 Std Dev Below

Size—Median B/P Spread
1.0 0.8 0.6 0.4 0.2 0.0
Attractive
Expensive
Jan 1987 1993 2000 2007 May 2014
— Spread — Average Spread 1 Std Dev Above 1 Std Dev Below

Low Volatility—Median B/P Spread
0.4 0.2 0.0 -0.2 -0.4 -0.6 -0.8
Attractive
Expensive
Jan 1987 1993 2000 2007 May 2014
— Spread — Average Spread 1 Std Dev Above 1 Std Dev Below

Quality—Median B/P Spread
0.0 -0.2 -0.4 -0.6 -0.8 -1.0
Attractive
Expensive
Jan 1987 1993 2000 2007 May 2014
— Spread — Average Spread 1 Std Dev Above 1 Std Dev Below

Source: SSgA, MSCI

Can valuation ratios also forecast the returns on advanced beta portfolios? Are returns for low volatility equity portfolios (or for quality, small-cap or value, for that matter) poor when valuations for those kinds of stocks get expensive? Can we measure this valuation and is it possible to create a rebalancing rule that favours attractively valued advanced beta portfolios over time? The answer to all these question is Yes.

Measuring the valuation of the various attributes is straightforward. The stocks in the MSCI World index need to be divided into four different key attributes – quality, low volatility, size and value. Within each attribute, the top and bottom quintiles (the 20% highest quality and lowest quality stocks, 20% least and most volatile, etc.) can be selected. This leads to calculation of the median book-to-price ratios for each pair of quintiles.

Finally, we take the difference between these two ratios. A large spread between the ratios for the top and bottom quintiles implies that the attribute is attractively priced, and a low number suggests that the attribute is expensive. Chart 1 plots these valuation ratios for the four distinct advanced beta attributes over time.

The chart shows that the valuation ratios are relatively constant. An extreme level of cheapness (such as found in 1999) tends to correct itself and reverts back to a more normal ratio (such as found in 2004). This observation leads to the question as to whether it is prices, or book values, that adjust to restore this equilibrium.

A simple plot of the year-end valuation spreads relative to forward subsequent returns indicates that, as with equities as a whole, it is prices that adjust, and valuation spreads can help forecast advanced beta returns. In Chart 2, each point represents the book-to-price spread as of 30 May, for each of the various factors, between 1993 and 2010. The y-axis shows the subsequent three-year excess return over the cap-weighted index of a long-only advanced beta portfolio organized around that factor. The figure suggests that the return premiums to advanced beta portfolios are time-varying but predictable.

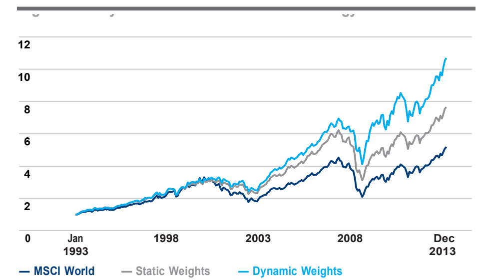
While the plots confirm a positive relationship between valuation spreads and subsequent returns, two challenges arise from fully implementing a strategy based on this finding.

Four relationships

First, the coefficient of determination, or 'R-squared', of these four relationships varies between 0.15 and 0.30. You can see this intuitively by observing the relatively wide dispersion of the points around the lines in Chart 2. Hence, while the advanced beta portfolios may be predicable, there is certainly some margin for error. Second, for each of the factors, the majority of the data points lie above 0% on the y-axis. In other words, for many investors, a simple buy-and-hold methodology with periodic static rebalancing may be enough, since in the long run many of these advanced beta portfolios tend to perform well, even if the starting point of valuation isn't optimal.

One simple rule illustrates how an investor might apply this analysis to a dynamic rebalancing method. The benchmark is a static equal-weighted portfolio of four advanced beta component portfolios – size, valuation, quality and low volatility. For a possible implementation of a timing strategy, an investor could simply divide a portfolio initially into the same four equal weights. The investor would rebalance the overall portfolio monthly, and continue to allocate to each component equally, unless the book-to-price spread declines by such an amount that it reaches a standard deviation of -1 relative to the average spread (i.e. becoming too expensive). In that case, the timing method completely sells out of the expensive portfolio and reallocates the capital equally to the remaining three. Additionally, in order to mimic a 'long-term mindset,' once a component portfolio is sold it cannot be repurchased for three years unless at some point the book-to-price ratio improves to a standard deviation of +1 relative to the average spread (i.e. becoming cheap again).

Chart 3: A dynamic advanced-beta methodology

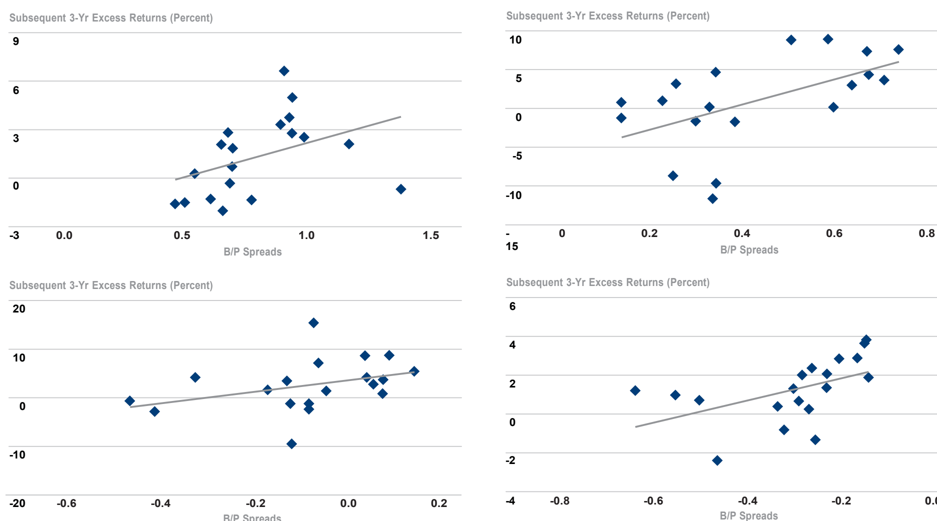


As of May 31, 2014.

Past performance is not a guarantee of future results.

Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

Chart 2: Valuation spreads versus future excess returns



Source: SSgA, MSCI

Chart 3 shows the historical performance of this methodology. The chart shows that the timing method would have added value over a purely equal-weighted method fairly consistently over long periods of time. The methodology used in this example does not have overly high turnover and transaction costs.

The added value should still be significant taking into account such costs. This finding provides hope to investors wishing to maximise the return premiums of their rules-based equity portfolios. It highlights the importance of understanding the valuation characteristics of factor portfolios before making a long-term investment.

Valuation estimates can be applied to factor portfolios as well as to traditional asset classes. For those who, because of turnover or other considerations, do not wish to implement a dynamic rebalancing process, the valuation methodology we present can be used to time their portfolio allocations. Given the long-term better risk-adjusted performance of advanced beta factors generally, it is important to be invested in them.

Valuation does matter in the performance of advanced beta portfolios over time. Implementing a simple rules-based dynamic rebalancing method based on valuation offers the potential for enhanced returns. ■

Ric Thomas is a Senior Managing Director at State Street Global Advisors and is Global Head of Strategy and Research for SSgA's Investment Solutions Group (ISG). Rob Shapiro is a Portfolio Manager at State Street Global Advisors.

How the forecasters got it wrong

Watch out for the shocks that models can't predict

Kevin L. Kliesen, St. Louis Federal Reserve Bank

The late John Kenneth Galbraith reportedly once remarked that there are two types of forecasters: those who don't know and those who don't know they don't know. Thus, it was not surprising that the onset of the 2008-09 recession was not foreseen by the majority of the professional forecasting community.

Analysing and forecasting the performance of the US and global economies is a daunting challenge, even for trained professional economists. This means the challenge facing the non-practitioner is much more difficult.

Economic relationships

The process involves assembling a great deal of data, understanding key economic relationships, and assessing which events or factors might cause monetary or fiscal policy-makers to change policy. There are two key principles that stand out. First, the economy is regularly hit by unexpected economic disturbances (shocks) that policy-makers and forecasting models cannot predict. Second, most key data used to measure the economy and track its performance are often revised – and by substantial amounts.

According to the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the US economic expansion that began in November 2001 ended sometime in December 2007. However, by the end of 2007, very few professional forecasters were predicting a recession in 2008. In fact, in the December 2007 Blue Chip Economic Indicators, the consensus of the Blue Chip forecasters was that real GDP would increase by 2.2% in 2008. The average of the 10 most pessimistic forecasters was 1.6%, while the average of the 10 most optimistic forecasters was 2.7%.

The NBER Business Cycle Dating Committee, like many non-practitioners, tends to look at real GDP as a key indicator (among other indicators) of the economy's performance. For example, increases (decreases) in expenditures for real final goods and services – such as automobiles, refrigerators, or physician services – are regularly followed by increases (decreases) in employment and a lower (higher) unemployment rate. As Chart 1 shows, throughout most of 2007 the Blue Chip Consensus (BCC) of professional forecasters was that real GDP would increase by about 3% in 2008.

This figure plots a timeline of BCC forecasts for real GDP growth in 2008. The first forecast was published in January 2007. Beginning in September 2007, though, forecasters began to steadily lower their projections for real GDP growth in 2008. In particular, the forecasts for real GDP growth for 2008 turned sharply lower after the widespread financial turmoil in September 2008. By the end of November 2008, when the NBER announced that the recession began sometime in December 2007, the BCC forecast for real GDP growth in 2008 had dipped slightly below zero.

The direction of inflation is another key indicator of economic performance. First, long-term interest rates such as mortgage rates and corporate bond yields have an inflation premium. Accordingly, if inflation or the perceived risk of higher inflation in the future increases, then interest rates also usually rise. A higher inflation rate may also spur the Fed to raise its short-term interest rate target, which could also cause long-term rates to rise.

The direction of inflation was markedly different over a good portion of this period. As Chart 2 shows, from January 2007 until March 2008, the BCC forecast was that the CPI would increase by a bit less than 2.5% in 2008. The relative stability of inflation expectations was somewhat surprising given the behaviour of oil prices and actual inflation over this period. From January 2007 to March 2008, crude oil prices rose from about $55 per barrel to about $106 per barrel. Over the same period, the year-to-year percentage change in the CPI rose from 2.1% to 4%. As oil prices and actual inflation continued to rise over the first half of 2008, forecasters began to raise their forecasts for inflation in 2008, from about 2.75% in April to 4.5% in September. Interestingly, though, forecasts for CPI inflation in 2009 (not shown) rose only slightly, which suggests that most forecasters tended to believe that the upsurge in inflation in 2008 would be temporary. This forecast proved to be accurate. ▪

Kevin L. Kliesen is Business Economist and Research Officer at Federal Reserve Bank of St. Louis. This is an abridged version of an article that appeared in Federal Reserve Bank of St. Louis review, first quarter 2014.

Chart 1: Blue Chip forecasts for real GDP growth in 2008

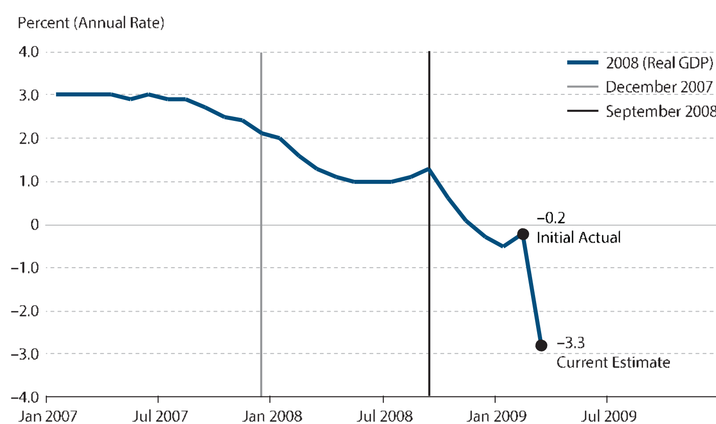
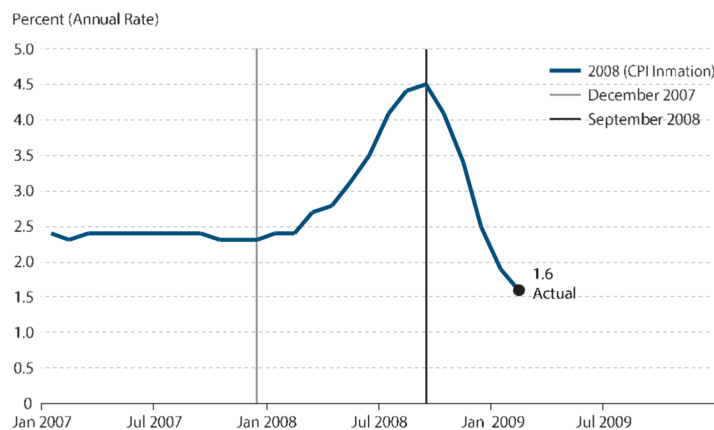


Chart 2:Blue Chip Forecasts for CPI Inflation in 2008



Source: Blue Chip Economic Indicators, various issues

Fed policy-makers fine-tune rate forecasts

Optimism on economy despite first quarter GDP decline

Darrell Delamaide, US editor

Policy-makers at the US Federal Reserve continued to fine tune their views on when monetary policy might tighten, growing more confident about the economy even after first-quarter GDP was revised sharply downwards.

St. Louis Fed President **James Bullard (non-voter)** said in effect that markets should ignore the revised figures showing a contraction of 2.9% annual rate in the first quarter, compared to the original estimate of a 1% decline. 'I think it's right to set aside the first quarter and look forward from here,' Bullard said in a television interview.

He expects the economy to grow at a 3% rate for the remainder of the year, and unemployment to sink below 6%. Inflation, meanwhile, should be heading toward the Fed's 2% target by the end of the year.

That said, members of the Federal Open Market Committee (FOMC) revised their June growth forecasts downward from those in March. They now expect growth for 2014 as a whole between 2.1% and 2.3%, down from the 2.8% to 3.0% of their previous forecast. They left the 2015 forecast unchanged at between 3.0% and 3.2%, but market participants have come to see these forecasts as optimistic and subject to downward revision.

The shifting forecasts come against the backdrop of a major transition in the Fed's board of governors, with two new members sworn in ahead of the mid-June FOMC meeting, so that five of the seven seats were filled. All the governors get to vote on policy. Taking part in the meeting after Senate confirmation were the new vice chairman, Stanley Fischer, and Lael Brainard, a former treasury undersecretary for international affairs. A current board member, Jerome Powell, was also confirmed for a new term. The White House has promised to nominate candidates 'soon' for the two remaining empty seats.

Also taking part in the meeting for the first time as a voting member was Loretta Mester, the former director of research at the Philadelphia Fed, who succeeded Sandra Pianalto as head of the Cleveland Fed.

For Bullard, his optimistic view means he would expect the Fed to raise short-term interest rates by the end of the first quarter next year, though he acknowledges that puts him ahead of other policy-makers. The targets published by the Fed in connection with the June meeting shows three of the 16 FOMC members not expecting a rate increase until 2016.

San Francisco Fed chief **John Williams (non-voter)** is also optimistic about the economy, but is in no hurry to raise rates. In a speech in Sun Valley, Idaho, Williams recalled that in 2010 and in 2012 there were those urging the Fed to tighten policy or at least stop providing stimulus. That would have been a mistake, he said.

'When you break a leg, you don't just snap the pieces back into place,' Williams told a bankers group, 'you leave the cast on until the bone heals. Otherwise, you risk doing even greater damage.'

Now, too, premature action could be damaging, he said. 'We won't raise interest rates for some time, which is the real marker of tightening policy,' he said.

Tapering off its asset purchases is a step toward normalisation, he said. 'As the economy continues to improve, we'll take off the cast,' he said, reprising his broken leg metaphor. 'When it's able to move on its own, we'll take away the walking stick.'

Philadelphia Fed President **Charles Plosser (voter)** is in more of a hurry. He explained to the Economic Club of New York that he looks at five monetary policy rules for guidance as to when interest rates should be increased, including the Taylor rule and variations of it. 'All the rules suggest that liftoff of the funds rate from the zero bound should occur next quarter,' Plosser said. 'This is considerably sooner than many seem to be expecting.'

William Dudley (voter), head of the New York Fed, came down in the middle. In response to an audience question after a speech in San Juan, Puerto Rico, Dudley termed as 'reasonable' market expectations that the Federal Reserve will start to raise short-term interest rates around the middle of 2015.

The head of the Richmond Fed, **Jeffrey Lacker (non-voter)**, does not disagree with the 2015 timing, but he adds that rates are likely to rise even if the economy remains sluggish.

At the International Monetary Fund at beginning of July, Fed chairman **Janet Yellen (voter)** made it clear that the focus remains squarely on its dual mandate of maintaining price stability and fostering maximum employment. She rebutted the notion of the Bank for International Settlements that accommodative monetary policy was creating asset bubbles. Yellen listed several positive results from the Fed policy, from improvement in the labour market to repair of balance sheets as evidence of its success.

Janet Yellen, chair of the US Federal Reserve

'Taking all of these factors into consideration,' the Fed chairman said, 'I do not presently see a need for monetary policy to deviate from a primary focus on attaining price stability and maximum employment, in order to address financial stability concerns.'

Yellen, in fact, doesn't think monetary policy is very effective in heading off financial risk. 'Monetary policy faces significant limitations as a tool to promote financial stability,' she said. 'Its effects on financial vulnerabilities, such as excessive leverage and maturity transformation, are not well understood and are less direct than a regulatory or supervisory approach; in addition, efforts to promote financial stability through adjustments in interest rates would increase the volatility of inflation and employment. As a result, I believe a macroprudential approach to supervision and regulation needs to play the primary role.'

These include general measures, such as a high level of loss-absorbing capital, to strengthen overall resilience as well as countercyclical macroprudential tools, such as additional capital buffers in times of rapid credit growth or higher margin requirements in times of stress, to 'lean against' excesses. ▪

Darrell Delamaide, member of the OMFIF Board of Editors, is a writer and editor based in Washington.

Exchange route for government debt

Options for normalising UK interest rates

Meghnad Desai and David Marsh

Except for the European Central Bank (ECB), everyone agrees that quantitative easing (QE) has more or less run its course. Both the US Federal Reserve and the Bank of England are thinking up various ways of signalling a reversal in interest rates.

The Bank of England would be well advised to consider a novel way of engineering such an outcome – through the transfer back to the UK Treasury, and subsequent cancellation and conversion, of the £375bn worth of government paper the Bank has acquired under QE.

In putting forward this new variation on a theme that has already occupied some attention, we recognise that, with the reversal of QE (just as in the advance into it), central banks are in uncharted territory. No one knows what the long-term effects on the transmission of money and on the economy will be either of the large increase in central banks' balance sheets ensuing from crisis-fighting measures since 2008, or of the likely reduction in the next few years.

The optimal size and shape of central banks' balance sheets, their appropriate asset-liability mix and the nature of their capital backing are all subjects where there are many questions and few answers. The proposal that we put forward is one of a range of options that could be considered. This is part of a series of reflections that OMFIF will be putting forward in the next few weeks regarding the present and future structure of central banks' balance sheets. The variations are considerable among the main central banks, as the Chart shows, one method already under consideration for reshaping central banking balance sheets would be for the Fed and the Bank to sell government bonds they have acquired back to the market in an orderly fashion and watch the impact on bond yields feed through to other interest rates. That would produce a monetary contraction.

Adjusting reserve requirements

There are other ways for the Bank of England to reverse direction, for example through adjusting reserve requirements and adjusting or reversing the repurchase mechanism under which central banks make loans to banks against collateral.

Our plan represents a different way of thinking about exit. The Bank is owned by the UK government. Now that QE in the UK has come to an end, the £375bn of government debt in the Bank's hands amounts to slightly more than a quarter of the total debt of around £1.3tn. Thus one part of UK plc owns the debt of another part and receives interest payments which are a burden on the national budget.

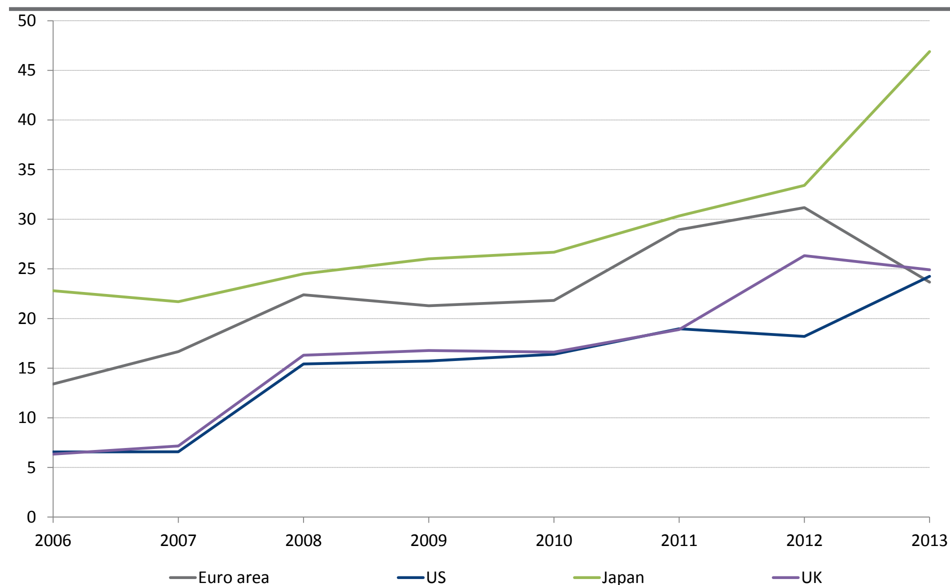
The Treasury should be able to ask the Bank to surrender the £375bn of bonds and then cancel them. As the Treasury paid £48bn in interest payments last year, we can estimate a saving of around 25% or £12bn - the exact number will depend on the details of the bonds bought back. The net saving would actually be less than this, at around £4bn since two-thirds of the Bank's profit each year is paid to the Treasury in lieu of taxation and dividend. But even £4bn would bring some relief to George Osborne, the chancellor of the exchequer. It might even be used for a tax cut.

There is a complication, since the Bank has liabilities corresponding to the assets purchased. The Bank has printed money (or issued e-money) and this resides on the liabilities side of the balance sheet as the counterweight to the bonds purchased. The bonds cannot simply be cancelled to put an end to the matter, since this would result in a straightforward loss to the Bank, like any defaulted loan on a commercial bank's balance sheet.

The Treasury could in principle offer an equivalent amount in zero coupon bonds to the Bank to balance the books. These bonds need never be marketed but just stay on the books to balance them.

It may even be that the amount of zero coupon bonds the Treasury may need to issue may exceed the £375bn. The total debt will either be reduced by £375bn if the bonds are cancelled or stay the same, or perhaps rise a little.

Central bank balance sheets as % of GDP



Public spending

A big question is how the markets would react. The monetarists used to say that the deficit must not be monetised, printing presses must not be run to finance public spending. But Ben Bernanke at the Federal Reserve reversed the wisdom of that adage and decided that buying government bonds by printing money was the correct solution to the recession.

Thus the money is already out there. It needs to be transmitted into economic activity. The risk of this approach is that interest rates could rise uncontrollably if investors lost confidence in government bonds, so the strategy would have to be handled with great care.

But a view that interest rates are about to rise could prompt companies to begin unloading their cash, which would be helpful in boosting economic activity. ▪

Lest we relax... watch for danger ahead

Why Europe must strengthen, not weaken, the fiscal rules

Jens Weidmann, Deutsche Bundesbank

The deceptive calm on the financial markets harbours the danger that we may already be forgetting what the crisis only recently taught us about public finances. That would have fatal consequences.

Doubts over the sustainability of public finances can unleash massive shocks across the euro area, as became painfully clear during the financial crisis. Faced with this predicament, the euro area saw no option but to extend billions of euros in loans to prop up a number of member states. Monetary policy-makers came under pressure to clean up the mess, and sometimes operated at the very limits of their mandate. And there is another matter we would be wise not to forget: mountainous household or public debt provides a wholly unsuitable basis for sustainable economic growth.

Solemn assurances

When the crisis was at its most acute, all those responsible gave solemn assurances that the mutual liability arrangement they had entered into purely out of necessity would be counterbalanced by tougher joint control mechanisms. This, it was claimed, would improve the balance between liability and control – a crucially important factor in the functioning of monetary union – and rectify the imbalances which had emerged. And it would represent a reliable backstop preventing the re-emergence of unhealthy developments at the national level. Monetary union, it was said, should not be allowed to evolve into a debt union.

The European undertakings were extremely clear. Fiscal rules needed to be strengthened and be endowed with greater binding force. Rulebooks needed to be shielded more effectively from political influence and safeguarded by tougher national budgetary rules.

Beyond this, in the overall surveillance process, unsound macroeconomic developments were to be given specific attention. The idea behind the new mechanisms and the commitments made by a number of countries was to regain lost confidence and lay out a reliable road map for the future. Given that monetary policy has 'bought time', so to speak, with low interest rates and a raft of non-standard measures, many voices, notably the governing council of the European Central Bank (ECB), have repeatedly pointed out that ultimately only the crisis-hit countries themselves can tackle the root causes of the crisis by pressing ahead with consolidation and reform. It is sobering how quickly the marked decline in market pressure has been followed by a chorus of political demands that the rules be relaxed.

Some politicians are demanding changes such as the exclusion of certain expenditure categories from deficits as a cunning way of concealing the additional debts that will burden future generations. Others, meanwhile, content themselves with stretching the discretionary scope offered by the rules, claiming that it was already possible to 'make the sums add up'.

In fact, the fiscal rules have not proven to be particularly tough, even after the most recent round of reforms. Take France, where calls for a softening of the rules have been particularly loud. There, the deficit to GDP ratio has exceeded 3% in nine out of the 15 years since monetary union was established. Since 2001, public debt as a proportion of GDP has risen continuously every year, with only one exception.

The story will be no different this year, with a deficit of roughly 4%. This is anything but an 'austerity diktat'.

There has never been a shortage of countries announcing that deficits and debts would be cut, but few have actually followed this up with concrete action. Even under the reformed set of rules, deficit correction targets were repeatedly relaxed, and the rules themselves were interpreted arbitrarily. Compounding this, the specifics of the procedures have become increasingly complex and opaque. Assessing adherence to the rules is increasingly difficult.

First experiences with the macroeconomic surveillance procedures, too, have produced mixed results. That was the conclusion of an analysis commissioned by the European Parliament, which reports that, in many instances, European recommendations were implemented into national policies either inadequately or not at all. The German government's decisions on pension policy, to name but one example, certainly do not serve as a model. Against this background, the fiscal rules need to be strengthened, not weakened. It would be disastrous if we ultimately failed to tackle the fundamental causes of different countries' problems and if those responsible simply relied on rescues in the form of monetary policy measures or fiscal assistance mechanisms. It is all very well to put forward a tougher fiscal regime as a core component of a monetary union which continues to be built, in principle, on the idea of national fiscal responsibility. But jettisoning these tough rules as soon as pressure diminishes would undermine confidence both in the regulatory framework of monetary union and in policy-makers' ability to take the right action.

Economic activity

Consolidation and reform measures are politically difficult to implement. Some temporary damping of economic activity may ensue. That is why governments tend to drag their feet when it comes to consolidation efforts. But sound public finances are not incompatible with growth-oriented policy-making and high employment. In fact they are a crucial basis for such outcomes. Deficit financing is not a precondition for successful structural reforms. Any attempt to trade off reforms against higher deficits paves the way for budgetary arbitrariness.

The historically low funding costs for governments, not unrelated to a very loose monetary policy stance worldwide, should not sap countries' willingness to adopt the right measures. Otherwise, countries saddled with excessively high debt ratios will find it very difficult to cope with an interest rate hike at some point in the future. That would increase the risk that monetary policy-makers would once again come under massive pressure from political quarters.

Under no circumstances should concerns over the sustainability of public finances lead the ECB governing council to delay a future policy rate hike that is otherwise warranted on monetary grounds. History has taught us that relaxing fiscal rules, or implementing them in a lax manner, is the wrong way to secure sound public finances that are essential for a stable monetary union. ▪

This is an abridged translation of a commentary by Jens Weidmann, President of Deutsche Bundesbank, Süddeutsche Zeitung, 24 June 2014.

Why Michel Barnier's proposals go too far

Finding balance in European money market funds reform

By a special correspondent

The stakes are rising in a gathering battle over the regulation of money market funds in Europe. In the opinion of market practitioners, the European Commission is playing a dangerous game in its desire to impose a 3% capital buffer on €500bn held in constant-net asset value (C-NAV) money market funds across Europe.

If the Commission's reform plans go through, the big question is what will happen to this volume of funds held by investors such as local governments, charities and businesses. This may substantially reduce a market that is widely used as a source of short-term financing – an outcome that could put a further dampener on economic recovery prospects.

Financial regulation

The proposals engineered by Michel Barnier, the EU commissioner responsible for financial regulation in the outgoing Commission, represent one of the most controversial issues in attempts to tame shadow banking activities in Europe, which worry regulators over their perceived unpredictability at a time of market panics.

Barnier wants the funds to stockpile liquid assets and – when offering a guaranteed share price – build capital buffers to avert runs, proposals that practitioners say could spell the death knell for at least part of the sector in Europe. European curbs are much tougher than expected US reforms.

The alternative to a capital buffer is that the funds might choose to convert variable-net asset value (V-NAV) funds. The overall €1tn European money market fund sector is made up of roughly equal portions of current and variable value funds, the former held predominantly by corporate treasurers, local government authorities, charitable institutions and universities, the latter mainly by French retail investors. If the capital buffer is introduced, the Commission assumes, without any supporting data (and flying in the face of various investor surveys), that investors will move to variable value funds.

In fact, this is unlikely. Imposing a capital buffer on C-NAV funds is tantamount to a prohibition. This is acknowledged in the Commission's own impact assessment which concedes that only two or three of the largest global bank-sponsored funds may survive. And, notwithstanding Commission speculation on investor behaviour, surveys indicate that, should the proposal be adopted, investors will significantly reduce holdings of C-NAV funds or stop using them altogether.

Investments held in money market funds would be displaced to short-term bank deposits, non-EU funds, and other less regulated and less transparent vehicles, such as separately managed accounts and offshore accounts. The result of such a proposal could thus be less competition, higher cost, lower availability of short-term financing for government and corporate borrowers, and greater systemic risk. This would be the opposite to what Europe needs to promote growth.

Money market industry

The truth is that money market funds, both current and variable value, are among the most highly-regulated financial products in Europe. They are subject to regulations under UCITS (Undertakings for the collective investment of transferable securities), AIFMD (Alternative investment fund managers directive) , and Rating Agency Criteria, as well as self-regulation through applicable industry associations and additional measures dictated by country of domicile. Notwithstanding this broad regulatory system, the money market industry has been proactive in seeking to work with regulators to codify industry best practices and adopt additional measures to increase fund safety and stability.

The money market funds industry in fact supports a great deal of what Barnier and his Commission colleagues propose, including stricter standards for liquidity, credit quality, duration and disclosure. *continued on p. 23*

Constant and variable value funds compared

A C-NAV fund seeks to maintain a stable net asset value, and thus a stable share price, such as €1.00, £1.00, or $1.00 per share.

It invests in very short-term, high-quality debt securities and keeps a large portion of its portfolio assets in cash or near-cash investments. These types of assets do not move much in value because they mature at par in the near term and have low credit risk.

C-NAV funds are financed entirely by shareholder equity. They do not use gearing. To maintain stable values, they follow strict maturity, asset quality, liquidity and diversification rules established and overseen by European and US regulators.

C-NAV funds invest their shareholders' cash in short-term debt issued by corporations, governments and financial institutions, which rely on these funds as a major source of short-term financing. As a result of their diversification, credit risk management, competitive returns and ease of use, constant value funds are a popular choice for short-term cash management and investment needs

A constant value fund rounds its share prices up or down to the nearest cent. It uses amortised cost accounting to value portfolio assets to speed up the valuation process and permit same-day settlement of share purchases and redemptions. The income earned by a C-NAV fund on its portfolio is distributed to shareholders each day by means of a dividend of additional shares, to maintain the stable share price. All C-NAV funds are short-term as a result of the very short maturity of their portfolio assets.

A variable value fund also invests in money market debt instruments but does not round share prices to the nearest cent. It generally follows less stringent standards for the maturity, liquidity, credit quality, and diversification of portfolio assets and its portfolio may be more exposed to risk. Many V-NAV funds credit portfolio income and gains to the share price (accumulation shares).

As a result of these differences, a V-NAV share price does not stay at a targeted price of €1.00, £1.00, or $1.00 but instead varies day to day (almost always gradually increasing in share value). A variable value fund uses mark-to-market accounting to value its portfolio assets.

Critics of constant value funds have argued that a stable share price makes them more vulnerable to shareholder runs in stressed markets, but empirical evidence shows they are no more vulnerable than V-NAV funds. ▪

Upholding Britain's trading interests

Why Cameron should send foreign secretary to Brussels

Denis MacShane, Advisory Board

The dust is settling over the surreal row about Jean-Claude Juncker, the designated president of the European Commission. David Cameron, Britain's prime minister, should now concentrate on helping to reform the European Commission – including finding the right choice of UK Commissioner.

Cameron has wasted a massive amount of political capital railing against Juncker. Yet he can emerge as the advocate of a reformed, leaner, more focused Commission ensuring that the European Union becomes more competitive, forms a stronger trading and investment community and creates jobs.

A dramatic choice for Britain's representative on the Commission would be William Hague, the foreign secretary. He was leader of the Conservative Party in 1997 when it embraced fully eurosceptic ideology.

Hague now understands from working with the US and grappling with the rise of China and the aggression of Russia that a UK outside the EU would be a global irrelevance.

Juncker insists that he wants to do all to keep Britain in the EU despite the passions of many in British politics and the press for Brexit – Britain exiting the EU. This message is repeated by Herman Van Rompuy, the European Council president, who reveals the obvious: the existence of euro area Europe, with its own rules and structures, means that the EU will have to accommodate those European nations outside the euro.

Matteo Renzi, prime minister of Italy, told the European parliament: 'Europe would not be Europe without the UK.' In Berlin, Wolfgang Schäuble, the German finance minister, says Britain leaving the EU is 'unthinkable'.

Cameron can respond to these overtures with one constructive act to win back lost prestige and lost support.

The temptation will be for Cameron to use the Commission – as many heads of government do – to reward a party loyalist who has no ministerial future back home. For a body often denounced in the populist media as 'unelected bureaucrats', the Commission is actually stuffed full of very experienced politicians who have won or lost many elections over a lifetime in national politics.

Political experience and sensitivity are essential as commissioners decide on the proposals put up by the technocratic staff. Finding the right person in Britain is not easy. Britain's best commissioner was the businessman Lord Cockfield, sent by Margaret Thatcher in the 1980s to push forward the Single European Act.

But Lord Cockfield was sailing with the wind as Jacques Delors, Helmut Kohl, François Mitterrand and the Iron Lady herself all shared a common vision of European integration in the mid-1980s. That is very different now that conditions in Europe are far more mixed.

More important than the individual name is the need to reshape the Commission. The 28 commissioners are four times the size of the Swiss Federal Council, half as a big again as the US cabinet and sprawl like an octopus with 28 legs over Brussels decision-making.

An influential group of former senior Commission officials and lawyers, called the Friends of the European Commission, is arguing for the Commission to be shaped into just five clusters headed by five vice presidents under Juncker to meet every week and take the core decisions. They suggest two commissioners should work exclusively reporting to national parliaments.

In pure theory, under the Lisbon Treaty, the Commission should be reduced to two-thirds of the 28-strong Commission by 2019. This is not politically realistic as no nation will give up its right to a commissioner. So bringing together commissioners into teams may be the best way forward. ▪

Denis MacShane is a former UK Minister for Europe.

Why Michel Barnier's proposals go too far

continued from p. 22

These changes would increase the resilience of money market funds in a crisis. However, the funds sector regards the Commission's further-reaching proposals as a step too far, as regulatory change for the sake of it. There is a strong view opposing the Commission's regulatory preference for variable over constant value funds.

Regulators have argued that C-NAV funds are subject to heavier redemption demands, or runs, that, at a time of market disruption, might disrupt short-term debt markets (particularly for bank debt). Yet the proposed solutions would not prevent runs. During the crisis, constant and variable funds met virtually the same levels of redemption.

Investors opt for redemption when they believe a fund they hold is invested in vulnerable securities, regardless of accounting treatment. Ample liquidity and high credit quality deter such runs, and gating would stop them immediately. If the regulatory goal is to prevent such runs on funds, the authorities should consider putting in place regulatory controls centring on gates and liquidity fees. This would be far more sensible than sweeping changes that would eliminate C-NAV funds as a beneficial choice for investors and an efficient source of short-term financing for businesses and governments.

Regulators have sought to justify their proposal with a call for all funds to use 'market prices.' But the notion that variable value funds use 'market' pricing is false. V-NAV funds use 'model-pricing,' which is no more accurate than amortised cost pricing used by C-NAV vehicles.

The reason why investors in Europe have placed €500bn in European C-NAV funds lies in the product's history of stability. For decades, constant value funds have provided European businesses, governments, charities, universities and other investors with an efficient tool for managing short-term cash holdings. The Barings Bank collapse in 1995 powerfully contributed to the growth of European money market funds, underlining the risk of losses from bank deposits hitherto regarded as safe.

It is worth considering the differences between the US and European approaches on money market fund regulation. The US Securities and Exchange Commission rejected a proposal for a capital buffer, but instead is considering two proposals. The first would grant authority to funds' boards to gate redemptions for a pre-defined period of time or to impose discretionary redemption fees in a crisis. The second would introduce a V-NAV structure limited to money market funds with institutional investors that invest in non-governmental issuers of short-term debt. Notably, the SEC variable value proposal would allow roughly half of all US money market fund balances to remain as C-NAV funds, even under the most drastic of its proposals. By contrast, the Commission's proposal might end up eliminating virtually all European C-NAV funds. ▪

Meet Mr Micawber at the ECB

Frankfurt steps prolong euro area agony

Gabriel Stein, Chief Economic Adviser

For far too long, the European Central Bank (ECB) has taken a similar view on the deflation threat to that of Charles Dickens' famous character Mr Micawber: 'Something will turn up'. In Dickens' David Copperfield, something did in fact turn up – but that was a work of fiction. In real life, the outcome may be less benign.

The ECB governing council on 5 June decided a raft of measures to avert threatened deflation. On 3 July Mario Draghi, the ECB president, reaffirmed that 'the risks surrounding the economic outlook for the euro area remain on the downside.' Some of the ECB's measures, such as negative interest rates on banks' deposits with the ECB, were heavily trailed in advance. Others, such as the so-called targeted long-term refinancing operations (TLTROs), were not. Quantitative easing has been proposed, but this is politically and technically controversial, and any question of implementation is mired in doubt.

Risk of deflation

The risk of deflation – or even ultra-low inflation, defined here as a sustained period of annual change in consumer prices of less than 1% – has been an issue since last year. Yet, for much of this period, the ECB has seemed strangely sanguine. This is in spite of the Japanese example of what entrenched deflation does to an economy. Additionally, it is well known that falling prices (debt deflation) can have serious harmful effects on heavily indebted economies such as the euro area. Deflation or very low inflation produces little or no growth in nominal income, so the debt burden remains at best unchanged and at worst rises. This in turn pushes indebted sectors to accelerate debt repayment, spending even less, and slowing GDP growth still further. Only in spring 2014, when annual euro area inflation fell to 0.5%, did the ECB seemed ready to take any action to avert this danger. Hence the June actions. The big question is whether they will work. There is room for doubt.

Mario Draghi, ECB President

Negative interest rates

It is first necessary to establish what negative interest rates would not do. Occasionally, proponents of negative interest rates on banks' deposits with the central bank seem to believe that these reserves make up a sum of money which, if not parked with the central bank, could be used to lend to the non-bank private sector. This is not the case. Banks' reserves with the ECB were created by the ECB when it lent money to those banks or bought assets from them. They are, as it were, an investment by the banks. If they were not parked with the ECB, they would be used to invest in something else. But, apart from their impact on balance sheet size, they have no bearing whatsoever on a bank's decision to extend credit to the non-bank private sector or not. Than can be done regardless of the size of a bank's reserves at the central bank.

The actual effect of negative interest rates could be twofold. They could affect the euro exchange rate; and they could cause banks to allocate their assets differently. But neither of these is certain. Moreover, the amount of excess reserves with the ECB is now quite low as banks have repaid their previous LTRO borrowings. In the week to 13 June, these reserves amounted to €125bn, down from a peak of just over €1tn in March 2012. As for the impact on exchange rates, the Danish experience of negative interest rates shows that there is an impact, but it is limited (about 0.5%). In the case of the euro area, it may be even less. Tellingly, the euro was unchanged over the day after the announcement.

With regard to the TLTRO, the continued repayment by banks of their previous long-term borrowing implies that their demand for further funds from the ECB may be more limited than the central bank assumes. The idea behind the TLTROs is to encourage banks to on-lend the sums they borrow. Hence, although the TLTROs will run until 2018, banks will be judged by their lending record in September 2016.

If they have not increased their credit to the non-bank private sector sufficiently (according to as yet unspecified criteria; but we know already that mortgage lending is excluded), they will be forced to repay their entire borrowing.

On the plus side, it means that banks can borrow cheaply for two years, regardless of what they do with the money, which is obviously attractive. It doesn't guarantee any increase in lending, as the UK experience with the Bank of England's Funding for Lending scheme shows. But even with the uneven euro area recovery, next year may see some further increase in the demand for credit. The ECB action will ensure that banks can continue to borrow, so overall system liquidity will remain ample over the next four years.

Question marks

In spite of these more positive angles, there are still question marks over the ECB's actions. The main near-term impact on inflation is the output gap, the slack in the economy. This will remain large for the foreseeable future. Medium term, a more important factor is the growth of broad money, which remain anaemic. Quantitative easing, specifically aimed at accelerating M3 growth, does not appear likely (if it comes at all) at least until the first quarter of 2015, in view of the political controversy of the subject and the ECB's legitimate need first to gauge the impact of the new measures.

Inflation is likely to remain at harmfully low levels not just this year, but next year as well. This will prolong euro member states' agonies. Ominously, recent Europe-wide business surveys hint that the best of the continent's economic recovery may already lie behind us. ▪

Gabriel Stein is OMFIF's Chief Economic Adviser.

Following in Draghi's footsteps

Institutions should take a lead from ECB easing measures

Franco Bassanini and Edoardo Reviglio, Cassa Depositi e Prestiti

The European Central Bank's 5 June measures were well received by the markets, which saw the action as a useful contribution to renewing growth and reducing the cost of money. The differentials between government bonds of the euro area core countries and those of the peripheral countries narrowed following the announcement.

There has been a broad consensus for some time on the need to boost medium- to long-term investment as a key route to renewing growth and competitiveness in Italy and Europe as a whole. This approach requires new financing tools, as well as a more favourable regulatory framework. Until now, Europe has witnessed mainly words rather than actions. Now the ECB has made the first step. Mario Draghi, the ECB president, once again is doing everything he can to promote growth. Other European institutions need to follow in his footsteps.

The most significant innovation centres on the targeted long-term refinancing operations (TLTROs), a line of liquidity earmarked for medium-term bank financing to the real economy This provides funds of up to €400bn at low cost (currently 0.25%).

The money will be supplied in two operations, in September and December. Banks that can prove they have increased lending to the real economy will be able to draw down additional sums between March 2015 and June 2016.

All the TLTROs will mature in September 2018. According to estimates by Morgan Stanley, Italian banks could draw down €75bn, leading to a potential reduction of 20 to 40 basis points on the average cost of loans to small and medium-sized enterprises.

An unconventional measure

The idea behind the TLTROs is fundamentally correct. Two years ago, in May 2012 writing in Il Sole 24 Ore, we proposed a rather similar unconventional measure, referred to as very long-term refinancing operation (VLTRO), to counter the credit crunch and stimulate investment. We repeated this proposal in autumn 2012 at a European Investment Bank (EIB) conference in Luxembourg. Although the proposal found ready support from Werner Hoyer, the EIB president and his predecessor Philippe Maystadt, as well as from an influential group of MEPs, it was generally received with scepticism. This reflected general belief that Bundesbank resistance would have been difficult to overcome. It is significant that, two years later, the ECB governing council, including the Bundesbank president, gave the TLRTOs unanimous approval.

ECB measures

However we should point out some differences between our 2012 proposal and the ECB measures, which could have a negative impact on their effectiveness. The first concerns the scope of the financing. The ECB decision excludes infrastructure investments (project finance, public private partnerships and so on). It is not clear why this is so. On average, 'investment grade' infrastructure projects have lower risk profiles than many corporate risks, and Europe is in great need of infrastructure finance.

Second, the duration is limited to four years, which is quite short for the medium-term financing of business investments, and a very short time indeed for the financing of infrastructure projects.

An extension to seven years (or alternatively a system under which a three-year loan could be automatically renewed for a further three under certain conditions), as we proposed, could be decisive in unblocking large numbers of investment projects now on hold.

Third, the timing is hardly propitious. When we made our proposal, Europe had endured two years of scarce liquidity and tight credit rationing.

Today, there is plentiful liquidity on the market. The problem is, if anything, risk and capital absorption. Other potential problems will perhaps require technical solutions. There is a risk that the resources unleashed by the ECB resources will end up financing not smaller businesses, which have the greatest need for them, but mostly large and medium-sized companies.

This in turn could interfere with the smooth working of a European corporate bond market that is undergoing healthy growth, and is making its own contribution to reducing credit spreads.

European Central Bank in Frankfurt

Further risks flow from the possibility that the banks will use the measures to indulge further in 'carry trades' (funding purchases of relatively high-yielding government bonds). Against a background of low banking profitability, banks face the temptation of improving their returns on equity using such trades rather than by restarting profitable loans to enterprises.

It is difficult to say what the effects of these measures will be. Much depends on the response from the credit system and from companies. The Italian government could however play an important accompanying role in mitigating risks and reducing the banks' capital absorption, thus encouraging them to participate in the operation.

Government guarantees

The TLRTO loans (particularly those made to smaller enterprises) could, for example, be backed by government guarantees provided by the Central Guarantee Fund (which could subsequently be recapitalised further, if necessary, with resources from the structural funds). An alternative, for operations not falling within the scope of the Central Fund, would be to use Caissa Depositi e Prestiti, which would in turn backed by a government guarantee. Plainly, a guarantee covering 60-65% of the risk (no more, to avoid moral hazard) would have a significant impact on the burden of the capital ratios imposed under the latest Basel III rules. This would promote credit supply to the real economy and bring about a more orderly process for the overall deleveraging that Europe still needs. ▪

Franco Bassanini is Chairman and Edoardo Reviglio is Chief Economist at Cassa Depositi e Prestiti.

Divergence not convergence is the result

Peripheral states lag behind 2004 new EU adherents

Simon Tilford, Centre for European Reform

The economic rationale for poorer countries joining the euro area was that it would hasten economic convergence between themselves and the richer members of economic and monetary union (EMU).

They would benefit from a stable macroeconomic environment and more trade and inward investment. And, Portugal aside, there was some convergence in the early years of the single currency. But this went into reverse in 2008 and by 2013 the poorer members of the currency union were no better off relative to the EU-15 average (members of the European Union before its large-scale expansion to central and eastern Europe in 2004) than they had been in 1999.

Worse still, they have been overtaken by a number of the EU's 2004 joiners, especially Poland and the Czech Republic, which in 1999 had been much poorer.

Euro area prospects

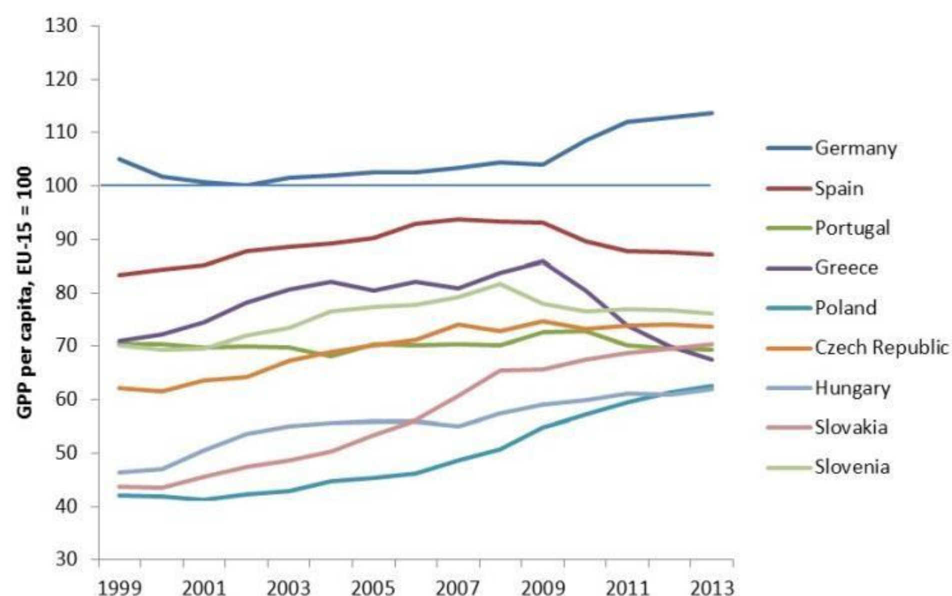
The fate of poorer EU-15 members of the euro area should give prospective eastern and south-eastern EU member-states pause for thought before joining. These countries should closely monitor the experience of Slovenia and Slovakia, which joined the single currency in 2007 and 2009 respectively. Slovenia is considerably poorer relative to the EU-15 average than when it joined. Slovakia has performed respectably within the single currency, but its real effective exchange rate has risen steeply relative to its peers (Czech Republic and Poland) and it has slipped into deflation.

For some central European countries – in particular, the Baltic states – joining the euro is about guarding their independence against a revanchist Russia. Others face a trade-off. Either they join the euro and get a seat at the top table, reflecting the reality that more and more decisions are taken by euro area countries rather than the EU. But in return they lose policy autonomy and face much-increased economic risk. Or they reiterate their commitment to join, but postpone doing so in the hope that the euro area is reformed in such a way that it becomes a mechanism for convergence rather than divergence.

The latter option is the strategy pursued by Poland and the Czech Republic. Others would be wise to follow suit, for the facts do not support the idea that EMU membership is a passport to higher living standards. In 1999, Greek and Portuguese per capita GDP were around 70% of the EU-15 average, and Spanish a little over 80%.

By 2013, Greek and Portuguese GDP was under 70% of the average. Spain has not done quite as badly, but has been diverging since 2008 (see Chart 1).

Chart 1: GDP per capita (EU15=100)



Source: European Commission

Indeed, far from converging with the richer members of the EU, the poorer states have converged with the central and eastern 2004 joiners. In 1999, GDP levels in Poland and Slovakia (a euro member since 2009) were 42% and 43% of the EU-15 average respectively. The Czech Republic's was just over 60% of the average. By 2013, these figures were 65%, 72% and 75%.

For some economists who place emphasis on supply-side policies, the lack of convergence between members of the euro area reflects the poorer members' failure to push through economic reforms, rather than anything to do with EMU's structure. This has cost them competitiveness, the argument goes, leading to economic stagnation.

Others maintain that divergence since 2008 is cyclical and will be quickly reversed. According to this view, the south is simply enduring what Germany went through in the early 2000s. Interest rates are too high for the periphery in the same way as for Germany between 1999 and 2006; conversely, they are now too low for Germany. Germany will grow more rapidly than the south for the next few years, but that will then reverse as Germany loses competitiveness and finds itself in similar position to that of the periphery now – with an overvalued real exchange rate and excessively tight monetary policy.

At that point there will be renewed convergence between rich and poor, according to this argument. At worst, on this reading, the euro area has amplified business cycles, but it has not become an obstacle to convergence between rich and poor.

There are problems with both these arguments. First, it is hard to ascertain a correlation between the kinds of structural reforms the Commission is demanding of the south (principally labour market deregulation) and economic growth. Some of the best-performing European economies over the last 20 years – notably Sweden and Austria – have relatively highly regulated labour markets. Germany – the benchmark for much of the Commission's thinking – also has a tightly regulated labour market (notwithstanding 2004's reforms), at least in regard to permanent workers (see Chart 2).

There is a case for labour market reforms to address insider/outsider problems and to help

young people and those with poor skills into work. But it is important not to exaggerate the economic effects of such reforms.

Nor can differences in product market regulation explain the lack of convergence in living standards within the euro area. First, according to the OECD, there has been steady convergence of such regulation among EU members. Second, there is no discernible correlation between levels of product market liberalisation and economic growth. For example, Sweden has among the more tightly regulated product markets in the EU, while Germany and Italy score about the same. Greece does rank badly, but only as badly as Sweden did five year earlier (see Chart 3).

Competitive product markets may indeed boost economic performance, but they can be more than offset by other things such as the wrong macroeconomic policies or misalignments of real exchange rates. The latter can have a big impact on levels of capital stock per employee and labour skills, which are more important in determining economic performance than levels of labour and product regulation. Cuts in education spending, large-scale emigration of young skilled workers and huge falls in business investment have damaged the productive capacity of the euro area's poorer economies.

The cyclical argument for the lack of convergence is also weak. There are several differences between Germany's position in the early years of the euro and the south now. By 2006 Germany had essentially completed its period of retrenchment within the euro area. By then, Germany's real effective exchange rate was no longer seriously overvalued, since inflation had risen to relatively high levels elsewhere in the euro area.

The situation today in the European south is in no way comparable. The retrenchment in the poorer members has already lasted longer than in Germany in the early 2000s, and there is no end in sight. Their loss of trade competitiveness relative to the core is far bigger than it had been for Germany in the early 2000s. They are trying to regain competitiveness by holding inflation rates below the euro area average at a time when inflation is chronically low elsewhere. They have very high debt. Their drive to improve competitiveness is pushing them into deflation, increasing the real value of debts and making it harder to deleverage. Overall levels of indebtedness in Greece, Portugal and Spain are still close to their all-time highs.

Their levels of private sector debt have fallen, but there has been an offsetting increase in public debt. According to Standard and Poor's, the so-called leverage ratio (public and private debt as a share of GDP) in Greece, Spain, and Portugal is around twice the level of the beginning of 1999. Italy's is 35% higher.

Reducing these leverage ratios will be hard. Firms and households will continue to pay down debt for a long time, depressing consumption and investment. Governments risk contributing to demand weakness by continuing their drive to consolidate public finances. The result is weak economic growth and inflation and hence slow deleveraging. This is a semi-permanent state of affairs.

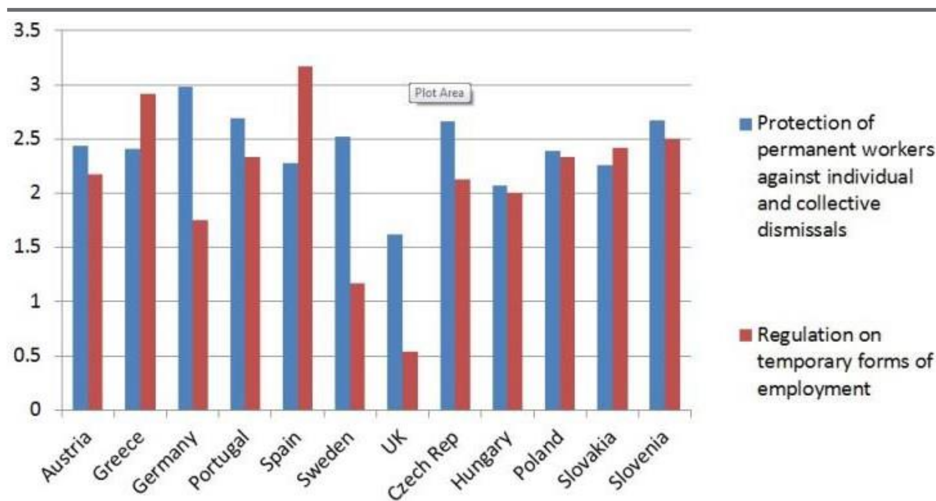
Growth in the poorer states will at some point in the future exceed that of the wealthier north. But any convergence is likely to be slow because of the permanent damage done to their growth potential. A combination of debt write-offs, co-ordinated euro area fiscal stimulus and a concerted drive by the European Central Bank (ECB) to drive up euro area inflation could head off this unfavourable outcome. However, these things look unlikely. Low borrowing costs have reduced pressure for institutional reforms, even if low bond yields should be ringing alarm bells (reflecting as they do mounting deflationary pressures).

The euro area might agree an investment programme, but a big fiscal stimulus is impossible without rewriting the rules. There is little chance the ECB will become a European version of the Federal Reserve and launch a full-blooded battle against deflation.

The southern European states will be mired in low growth for years to come. Measured against other European countries, they are likely to get not richer but poorer. ▪

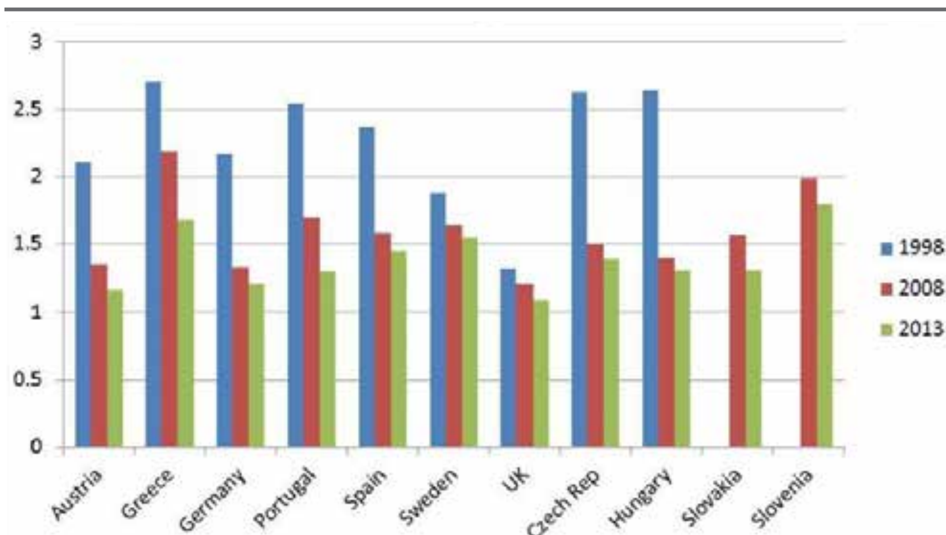
Simon Tilford is Deputy Director at Centre for European Reform.

Chart 2: OECD indicators of employment protection legislation, 2013 (0 = least restrictions, 6 = most restrictions)



Source: OECD

Chart 3: OECD indicators of product market regulation (0 = least restrictions, 6 = most restrictions)



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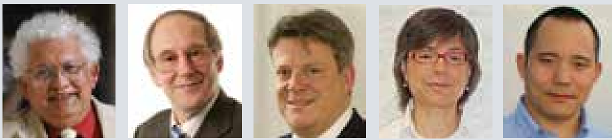

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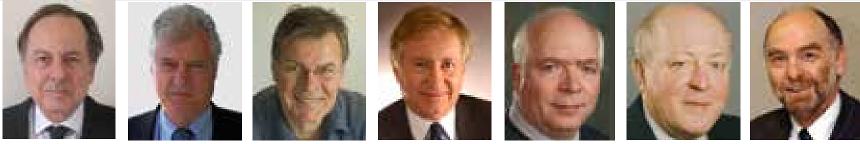

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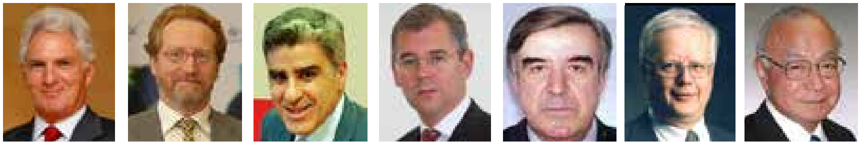

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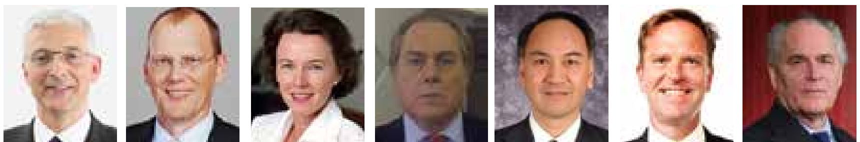

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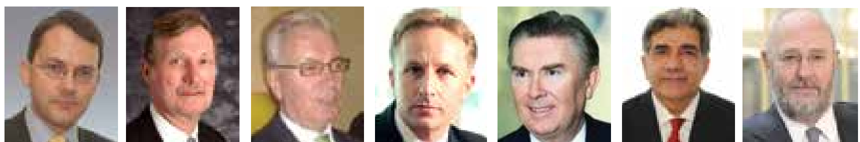

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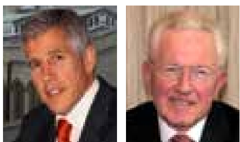

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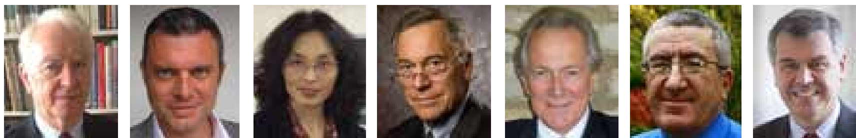

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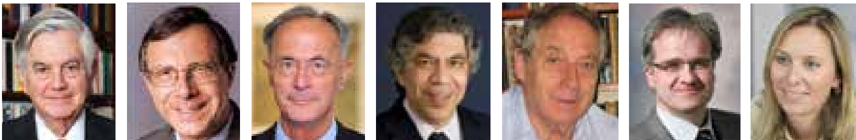

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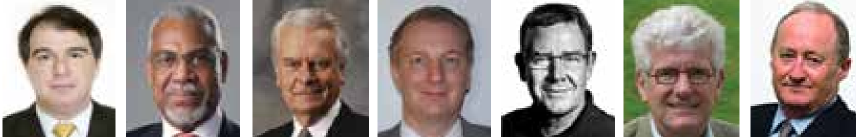

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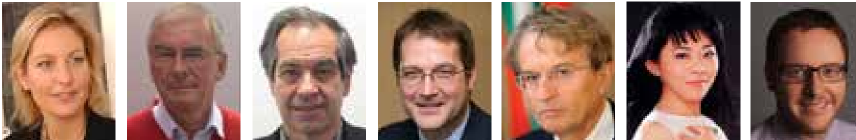

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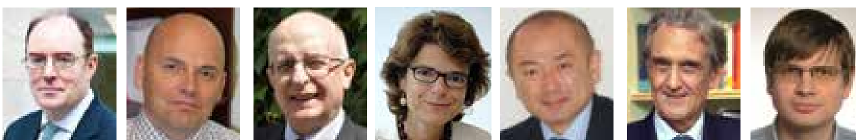

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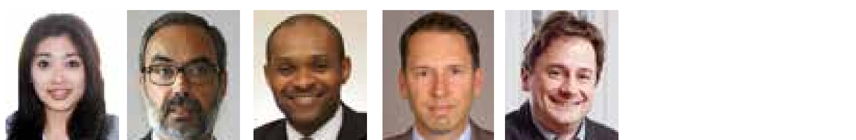

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Argentina talking to the hold-outs

Buenos Aires gambles that vulnerability gives it strength

David Smith, Advisory Board

Argentina is once again in technical default on its large debts, for the second time in 15 years. But this time around it is at least talking to its creditors – a sign, perhaps, that the country is turning a corner.

The government is gambling that its biggest weakness, the vulnerability and stigma that go with national default, equals its greatest strength in the quiet negotiations, with a mediator appointed by the judge, that are now under way. Realpolitik in Buenos Aires is that Argentina's default serves no one's purpose, least of all the 'hold-out' funds.

Difficult space

So the message is: 'We default, and you lose. Find a middle ground, and a number that can be sold to all parties, and we all win.' That is the difficult space in which all parties must try to find a compromise. Reaching it will not be made easier by an atmosphere of heightened political febrility.

Argentina has a tight deadline to cut a deal with its 'hold-out' creditors, courtesy of the New York judge hearing its case against the hedge funds which own almost 8% of the debt outstanding from the country's financial collapse and $95bn default in 2001.

Argentina's ability to take a moral line on the issue has been severely impaired by another judicial setback – this time, from within the country – under which vice president Amado Boudou has been formally charged with corruption. Boudou, a key ally of President Cristina Fernández de Kirchner, is implicated in an investigation into Ciccone, a printing company rescued from bankruptcy and awarded a government contract to produce pesos. The vice president, along with five other defendants, is accused of using intermediaries to gain a 70% per cent stake in return for favours.

President Cristina Fernández de Kirchner

Hold-out investors have said they are prepared to give Buenos Aires extra time to settle, but only if the country negotiates in good faith. Argentine officials met a mediator in New York on 7 July. As far as the economics of the debt negotiations are concerned the equation is reasonably clear. The hold-out funds are seeking full compensation, amounting to $1.13bn with interest. Argentina is paying other creditors roughly 35 cents on the dollar, comprising those which accepted the debt restructurings of 2005 and 2015.

Full value

And there's the rub. If Buenos Aires pays the hold-outs full value, as the court orders, why would others accept little more than a third of what they are owed?

The psychological climate between the Buenos Aires government and its creditors is prone to frequent oscillations. Shortly before the government announced it was ready to talk, Jorge Capitanich, the president's chief of staff, insisted publicly that there was no intent to send negotiators to meet the so-called 'vulture' fund that bought up distressed bonds from Argentina's 2001 default. The president herself had persistently denounced the case as 'extortion.'

But a ruling from the US Supreme Court, refusing to hear Argentina's case and referring it back to a lower court that had already found in the hold-outs' favour, triggered an about-turn – not least because the court ruled that the creditors could seek to impound government assets in various locations to meet their claim.

Axel Kicillof, the influential economics minister, floated the idea of Argentina paying its exchange bondholders from the debt restructuring of 2005 and 2010, without paying the hold-outs, by somehow transferring the restructured bonds out of US jurisdiction and placing them under Argentine law. A rejection from the judge in New York killed that notion instantly.

Separately, Euroclear, the European financial services company which clears securities transactions, has been sued by a group of hedge funds that hold restructured Argentine bonds, denominated in euros and governed by UK law, which they argue fall outside the US court's jurisdiction and should therefore be paid. Euroclear has written to the Second District Court in Manhattan asking for legal clarification.

Chorus of support

Argentina would like to believe it is benefiting from a Greek chorus of support from around the world. Buenos Aires has taken out adverts in international newspapers protesting that having bonds issued under US jurisdiction 'does not mean accepting court decisions that are impossible to comply with. All the more so if any such decision violates the sovereign immunity principle effective in the US.'

Much as Buenos Aires has frequently lambasted the International Monetary Fund (IMF), and fought recently to keep the IMF out of the Club of Paris talks, the IMF has warned of 'broader systemic implications' of the Argentine case for other countries seeking to restructure debt. An IMF statement, issued after the US Supreme Court's ruling, concluded: 'Argentina has limited capacity to pay the plaintiff creditors while servicing its current debt.'

That has reinforced the belief inside the government that Argentina can, even in this very tight corner, re-establish credit lines and credibility abroad, avoid another default (which would be a damning legacy) and start anew the sale of the country's perennial salvation, its vast natural resources, this time beginning with Neuquen's Vaca Muerte (in Spanish literally, the Dead Cow), deemed the world's second-largest deposit of shale oil and gas. In the negotiations to secure a compromise, time is limited in the extreme – a fact that both sides will seek to turn to their advantage. ▪

David Smith is a writer, professor and adviser to NGOs based in Buenos Aires.

Investors worry about Turkey

In line of fire over US monetary tapering

Aslihan Gedik, Senior Adviser

Tightening of Federal Reserve policy poses particular challenges for emerging market economies. These countries are generally better equipped to handle those dangers. This reflects fundamental improvements and stronger policy frameworks that many emerging market economies have put in place over the past 15 years.

However, there are some exceptions. Investors are worried that loose monetary conditions are starting to gain ground in Turkey, following renewed cuts in benchmark interest rates to well below inflation and a move to rein in central banking independence by the government of Recep Tayyip Erdoğan.

A 75 basis point cut in Turkey's weekly repo rate to 8.75%, announced on 24 June, exceeded expectations, despite inflation well above the central bank's 5% target. The central bank said the reduction, which followed negative remarks by Erdoğan on the bank's anti-inflation drive, was 'measured'. It came shortly after Numan Kurtulmuş, deputy chairman of Erdoğan's ruling AK party, proposed amending Turkey's laws to reduce central bank influence, and a fortnight after leading bank officials, including the governor's chief of staff, were moved from their jobs.

Global economy

Not long ago, emerging markets were seen as the saviours of the global economy. Capital poured in from portfolio investors, multinational corporations and many other types of asset owners. The yields on traditionally safe assets such as advanced economies' government bonds were pushed to record lows, forcing investors to look elsewhere for return. Capital cascaded down the risk spectrum to emerging economies assets. In these markets, capital rushes in when the economy is hot and departs again when it cools. We saw that phenomenon play out earlier this year, when the Argentine peso fell 15% in a single day in January, and contagion quickly spread to other emerging markets, including Turkey, South Africa and Russia, in one of recent years' single biggest sell-offs in emerging market currencies.

Emerging market currencies have been deemed vulnerable to selling pressure since the testimony to Congress of Ben Bernanke, the then Fed chairman, in May 2013 on potential unwinding of the supportive monetary policy framework, which sparked off widespread nervousness.

The Turkish lira fell significantly until 28 January, when the Turkish central bank took action, raising its benchmark one-week lending rate for banks from 4.5% to 10%. This interest rate hike is now being reversed. Much of the capital that the Fed infused into the market through its quantitative easing (QE) bond buying flowed to emerging markets. Now that the Fed is tapering QE, that liquidity is drying up.

Although this shift in US monetary policy was inevitable at some point, it seems to have triggered a broad-based sentiment shift in global markets. The role of the dollar as the global reserve currency gives the Fed a special responsibility to manage policy to promote global financial stability. However, there is little sign that the US central bank thus far is giving priority to that responsibility.

Turkey is one of the countries where interest rate pressures are greatest. Erdogan, favourite to win August's presidential election, has energetically campaigned for lower interest rates and criticised international financiers who make up what he calls the 'interest rate lobby' allegedly determined to tighten credit and reduce Turkish growth.

Erdoğan set the scene for the 24 June rate cut by complaining openly about the bank's previous 50 basis point cut, in May, and urging the bank to unwind its January rate increase. 'You raised the interest rate by 5 points all at once, but now you reduce by only half point. Are you kidding?' Erdoğan told a group of reporters in his plane while returning from a rally in the German city of Cologne.

Justifying the June rate decision, the bank said it was responding to greater global liquidity and predicted that inflation would decline markedly in future. That may be a smokescreen. Erdoğan earlier lashed out at criticism that he is thwarting the central bank's independence and reliability. 'Why this intervention? If I am the prime minister of this country, I will express my opinion. At this point, it should clean up its act. The central bank's independence doesn't affect my view on interest rate. They are separate issues,' he said. The prime minister slammed the bank's

Prime Minister Recep Tayyip Erdoğan

pledge to keep monetary policy tight until inflation is reduced to the desired levels, going against conventional wisdom by suggesting that 'inflation is the outcome of high interest rates and they are directly proportional.' Recalling that inflation is hovering at around 9%, Erdoğan said this proved the bank's policies were not working. He added that he did not accept Governor Erdem Başçi's approach on rates and hoped the bank would act immediately to resolve the issue.

In the first quarter, economic activity remained fairly strong despite a slowdown in domestic demand following tighter financial conditions. In the second quarter financial conditions recovered, but the lagged effects on recovery of past tightening seem to have gained ground.

Standard & Poor's has affirmed its BB+rating on Turkey, but kept it within junk territory, citing poor political management. 'In our view, the authorities have not used fiscal and monetary policy settings consistently enough to build up buffers against potential external risks,' the agency said.

In the political arena, news developments remain relatively negative, including Turkey's refusal to pay a fine imposed by the European Court of Human Rights over the Turkish 1974 invasion of Cyprus and the Soma mine disaster that cost 301 lives. The crisis in Iraq creates further challenges, with security risks mounting for Turks doing business in Iraq and the danger looming that the militant group Isis could extends its activity into Turkey itself. ▪

Aslihan Gedik is Deputy General Manager at Oyak Anker Bank in Frankfurt.

Intricacies of Russian gas

South Stream pipeline and Europe's energy security

Vicky Pryce, Advisory Board

Gas politics is not easy – for suppliers or consumers. In the case of the latest major European project to import gas from Russia via the still to be constructed South Stream pipeline, economics and politics have become seriously intermingled.

In theory the new 2,500km South Stream pipeline will add much-needed gas supplies direct to the rest of Europe, bypassing the Ukraine and thus increasing gas security for Europe. The latest price stand-off between Russia and the Ukraine has halted Russian gas supplies to the country and heightened concerns about the reliability of the Ukraine as a gas transit route.

In principle, anything that avoids the troubled region and adds extra capacity to southern and central Europe to add to the North Stream pipeline to Germany should be good news. But the Gazprom-financed project is dogged by controversy.

Following the annexation of Crimea and hostilities between Ukrainian forces and Russian separatists, the concern is that, rather than reducing dependence on Russia, the new pipeline would if anything increase Gazprom's hold over the market as Europe's main gas supplier. This position is likely to remain until US gas supplies enter Europe in large quantities. This scenario depends on building sufficient rather expensive liquefied natural gas terminals to allow export and receipt of US shale gas in the quantities required.

After the first 925km section under the Black Sea, the South Stream pipeline is planned to go through Bulgaria, Serbia, Hungary and Slovenia before diverting along a number of lines delivering gas to places like Italy, Greece, Serbia, Croatia and Austria. The pipeline is expected to transport some 64bn cubic metres (bcm) of gas annually and cost $45bn to build.

All nations involved have expressed enthusiasm and in many cases agreements have been signed between local construction companies or consortia and Gazprom with the blessing of their governments. Single market infraction proceedings by the EU against Gazprom were shelved during the Ukraine crisis but this is changing.

In December 2013 Brussel's challenged Moscow's agreements with the countries through which South Stream will pass. This reflected concerns that these contracts infringed anti-trust laws and EU energy liberalisation principles and allowed the parties involved a monopoly on the construction and use of the pipelines as well as exclusive rights in setting tariffs.

Russia has challenged this by referring this dispute to the World Trade Organisation. However that didn't stop the EC intervening and asking Bulgaria in early June to stop working on its part of the pipeline while the Commission investigates whether contracts for the building of the pipeline have followed proper EU procurement and competition rules. And yet, just before the European Council meeting in Brussels on 26-27 June to discuss energy security among other things, Austria itself moved to join the project formally. Günther Oettinger, the European Commissioner for energy, has been quoted as saying that the construction process should be suspended until 'it completely corresponds to the requirements of the European Union'.

The EU June summit conclusions reinforce this by stressing the need for infrastructure projects undertaken with third countries to respect fully the EU's internal market and competition rules. Yet the fundamentals in favour of the project are clear. Gas production in the continent is forecast to decline around 100bcm by 2030. In the short to medium term, Europe will have to rely on Russia, and to a lesser extent north Africa and Azerbaijan, to plug that gap.

US shale gas will take time to make a difference. US shale gas will have to compete against cheap coal whose use in Europe has been increasing. So, despite some likely perturbations along the way, the South Stream project, even if delayed, still appears a realisable proposition. ▪

Vicky Pryce is a former Joint Head of the UK Government Economic Service.

European Council moves forward on energy union

The European Union (EU) has taken important steps to promote energy security and 'green growth' by moving towards an energy union as a means of optimising energy supplies and lowering dependence on imported Russian gas, *write Ruud Lubbers and Paul van Seters in the Netherlands.*

European leaders at their summit on 26 and 27 June, as well as deciding the well-publicised appointment of Jean-Claude Juncker as President of the European Commission, spent much time on energy and climate. The formal framework for an energy union – involving mechanisms for jointly negotiating energy contracts with Russia as well as assuring member states share energy should supplies be cut off – will be decided by October 2014. The framework foresees methods for promoting better energy infrastructure including via co-financing from Brussels. In addition, the EU will improve use of fossil fuels, including coal and shale gas, and increase cooperation with partners outside Europe such as the US and Australia.

The idea is to harmonise these aspirations with principles aimed at alleviating climate change. One issue that should attract more attention is the need to make the EU Emissions Trading System (ETS) more effective by raising the price of carbon dioxide to €40 per tonne. ETS was launched in 2005 to combat climate change, and remains the largest greenhouse gas emissions trading system in the world.

But at the current price of €5 per tonne, ETS is not working and is doomed to become irrelevant. Over the past decade, ETS emission rights were granted on too generously a basis, reflecting underestimation of carbon-saving technologies.

European leaders in their June meeting failed to refer to ETS and carbon pricing, in sharp contrast to the recommendations of the Green Growth Group – an informal network of 13 European climate and energy ministers which has emphasised that ETS, based on an effective carbon price, should remain the EU's most important climate change policy instrument.

This is a lacuna that needs to be rectified in coming months. ▪

Rudd Lubbers is a former Dutch Prime Minister. Paul van Seters is Professor of Globalisation and Sustainable Development at TiasNimbas Business School, Tilburg University.

Lesson for emerging markets: Be prepared

A 10 point plan for US interest rate normalisation

George Hoguet, State Street Global Advisors

Emerging market policy-makers should use the current period of tranquility in global capital markets to enact structural reforms that will make their economies more resilient to the gradual normalisation of US interest rates. Investors are understandably anxious that higher US interest rates will lead to capital outflows from emerging markets, additional emerging market currency weakness, an increase in local currency bond yields, and possibly a liquidity crisis in one or more markets.

The resiliency to shocks varies dramatically by country, with some countries net creditors and others net debtors in the international system. But even the so-called 'Fragile Five' (Brazil, India, Indonesia, South Africa and Turkey), some of which have negative net international positions, can enhance their resilience to a possible US bond market sell-off and dollar strengthening by adopting measures that increase potential growth.

Those countries that embark upon the most durable and credible programmes are likely to be the most favoured by global investors. In this regard, the experiments currently underway in China and India are of keen interest to market participants. The success or failure of these experiments will in part determine the pace of growth in emerging Asia over the next decade and, by extension, the global economy.

The need for supply side reforms is by no means limited to emerging markets. The US faces a pressing need to reform its tax, energy, education and fiscal policies, among others. And the rigidities in the euro area and Japan are well known. But emerging markets are likely to face in the next decade a less favourable external environment than from 2000 to 2007, and their productivity growth has slowed and unlikely to increase.

Some emerging market policy-makers bemoan the lack of 'policy coordination' between developed and emerging markets monetary authorities. In fact, several countries faced headwinds even prior to the 'taper tantrum' including but not limited to missed inflation targets, high corporate indebtedness and slowing credit growth, visible political protests, and below equilibrium interest rates.

And the euro area and Japan continue to be in a loosening phase, while the US will be gradually tightening. Like it or not, emerging markets cannot change what the Soviets used to call the 'objective conditions' of the global polity and economy.

George Hoguet at the St. Louis Federal Reserve - OMFIF Seminar on 3 June with Amando Tetangco Jr, Governor Bangko Sentral ng Philipinas

Both investors and policy-makers may wish to reflect on the following 10 points.

First, normalisation of US policy, say a neutral Fed funds rate of 4%, is inevitable and, as the output gap narrows, desirable. This normalisation period is likely to be protracted, providing plenty of time for structural adjustment.

Second, the Fed does not control the term premium. The bond market will not move gradually if it feels the Fed is on the cusp of a policy mistake. We must acknowledge that financial crises in the past have taken place during periods of rising rates.

Negative spillovers will be felt most intensely in countries with the greatest imbalances and vulnerabilities and in some segments of developed market credit markets.

Third, a policy mistake by the Federal Reserve would be very costly for emerging markets. The Latin American debt crisis arose when the US tried to arrest the excesses of the 1970s.

Fourth, as Kristin Forbes of MIT points out, global liquidity and financial stability are more important for flows to emerging markets than the level of US rates.

Fifth, it is hard to argue that an improving US economy is bad for emerging markets. The positive trade, investment, and commodity channels is likely to dominate the negative interest rate channel. Sixth, the primary focus of US monetary policy will continue to be domestic concerns.

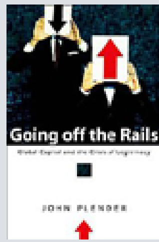
Seventh, 'convergence' is a more appropriate term than policy 'coordination.' In an ideal world, each country is growing at potential, in an environment of stable, non-inflationary growth. In addition, each country puts into place adequate macro- and microprudential safeguards.

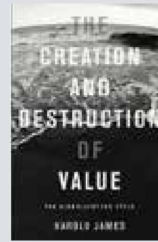
Eighth, deteriorating credit conditions in some segments of the US credit market such as high yield are troubling. Both developed and emerging market policy-makers need to carefully monitor developments in asset markets, and overall leverage in their domestic markets.

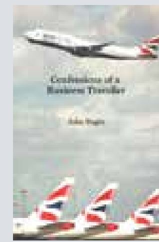
Ninth, structural reforms may depress growth in the short term, but they also inspire confidence and belief in sustainability in the medium term. Tenth, the best exit strategy by the Federal Reserve should be measured, data-dependent and well communicated.

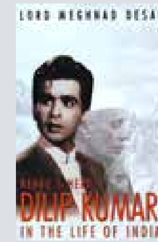
Many factors other than the stance of US monetary policy influence global investor flows to emerging markets. And the long-term trend reflects a reduction in the 'home bias.' Those emerging countries that demonstrate a credible commitment to structural reforms are best positioned to a period of gradual US interest rate normalisation. ▪

George R. Hoguet is Global Investment Strategist at State Street Global Advisors.









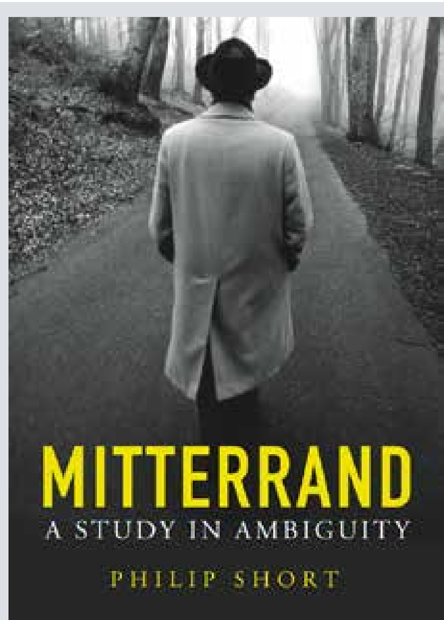
French legacy of unfinished work

Morality, duplicity, Mitterrand and the euro

Philip Short, Biographer

At an OMFIF dinner-debate in London last month, a colleague excoriated François Mitterrand, the former French president, as 'morally bankrupt'. It is a view which has a certain currency.

In France, where his alleged misdeeds have been immortalised in a best-selling pamphlet, Mitterrand and the Forty Thieves, his detractors, while acknowledging (a little enviously) his cleverness, maintain that he was a crook.



Mitterrand career highlights

Born 1916, died 1996

1943 joins Resistance, while a Vichy civil servant

1946 joins Cabinet as War Veterans minister

1965 contests Charles de Gaulle in presidential election and loses

1974 contests Valéry Giscard d'Estaing in presidential election and loses

1981-95 President of France

The issue merits reflection. Why do we try so often to reduce complicated questions to simple banalities? Mitterrand was tougher and more egotistic but hardly more immoral than most of the rest of us. Furthermore, he was an exceptionally good political operator with a steely determination to win power and leave his mark on French history.

So why the Manichean shorthand? Is it part of a general dumbing down in which we are all to some extent guilty? Or is the culprit technological advance, which requires intellectual shooting from the hip, instant reactions subbed into sound-bites to make an immediate hit? And why persist in pretending, against all the evidence, that morality and statesmanship are linked?

We do not live in theocracies. George W. Bush brimmed with morality and had a direct line to God, with consequences that the Middle East is living with today. Perhaps the line was hacked?

Mitterrand was duplicitous, devious, secretive, charismatic and charming, inspiring devotion in his followers and intimidating his opponents. That did not make him likeable. Great statesmen rarely are. Together with Charles de Gaulle, he was one of the two pre-eminent leaders of 20th century France and, even more than his august predecessor, changed France in ways which continue to fashion the world we live in today.

The European Union – and the euro – were bequeathed to us by Mitterrand and Helmut Kohl. They both heaved a joint sigh of relief that Margaret Thatcher was no longer around to put a spanner in the works at Maastricht, and bullied John Major into what some would say was tepid acquiescence. (Major, who said Maastricht was 'game set and match' for Britain, would see this differently.) Either way, for the French and German leaders, the euro was a political decision. Kohl knew a fact Mitterrand chose to ignore: that the fiscal conditions for a single currency were not in place. So they did what was possible at the time, committing Europe to the euro and leaving it to the next generation of leaders to sort out the resulting mess, which is what we have been doing over the last five years.

At home Mitterrand's major achievements, too, were political. He embraced the French Communist party to hasten its demise; he began to reconcile the Socialists with the profit motive and the market economy; and, above all, he showed that the Left was as capable of governing France as the Right, enshrining for the first time in French political practice the principle of government alternance which lies at the heart of modern democracy.

Lifetime in politics

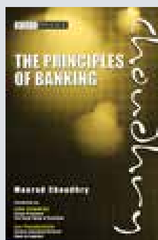
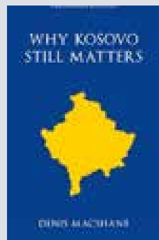
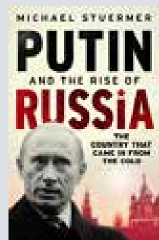
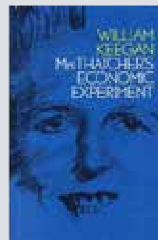
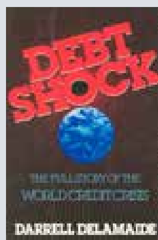
There were errors and shortcomings, too. In the 1950s, Mitterrand was way behind the learning curve on French colonialism and Algeria. In the last years of his life, his policies towards Rwanda and in the Balkans were cruelly misguided.

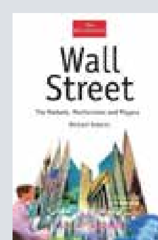
He failed to transform the Socialist party into what it needs to be – a modern, social democratic movement capable of pushing through the reforms that much of the rest of Europe is adopting and neither the Right nor the Left has been able to impose in France.

He was not a crook. When he died, it was found that, after a lifetime in politics, he had a fine library and a nice collection of walking sticks but no money. His record is not black and white, but written in infinite shades of grey. That would please him.

That was the life he lived and that is how he wished it to be. ▪

Philip Short is the author of Mitterrand: A Study in Ambiguity, Random House, 2013.



World austerity

Wrong direction

George Hoguet, State Street Global

In the Republic of the Mind, the Hegelian dialectic defines the process by which analysts advance their thinking about society and the problems it confronts. *Austerity The History of a Dangerous Idea,* **by Marc Blyth, Professor of International Political Economy at Brown University in Providence, Rhode Island, raises some inconvenient facts about both the theory and practice of what has come to be called 'expansionary fiscal consolidation.'**

Whether one believes the Austrians or the Keynesians build better models of how the economy actually works, there is much to be learned from this short and felicitous book.

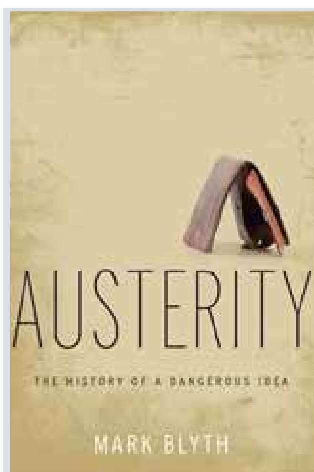
The author's thesis is simple: 'Austerity does not work.' It 'has been tried and will keep being tried, at least in the euro area, until it's either abandoned or voted out.' With 26m unemployed in the EU, 50% youth unemployment in Spain, Greece emerging only gingerly from its sixth year of recession, and nationalist parties increasing representation in the European parliament, the author's arguments merit at least a hearing, if not full endorsement.

Blyth traces the intellectual history of thinking about debt – from Locke and Hume and the classical economists right through to the present day. The discussion is particularly robust in examining the power of economic ideas and chinks in the armour of neoclassical economics.

Blyth reminds us that 'states make markets as much as markets determine the fate of states.' Andrew Mellon's famous dictum during the Great Depression, 'Liquidate labour, liquidate stocks, liquidate, the farmers, liquidate real estate', is surely discredited.

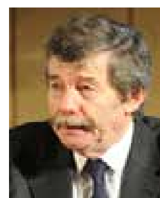
But is the reluctance of contemporary Germany to engage in fiscal stimulus in the interests of Europe or, ultimately, Germany itself?

Blyth contests the IMF's arguments that recent experience in central and eastern Europe confirms the wisdom of austerity and provides a roadmap for southern Europe.



Blyth disentangles facts from ideology, but fails to discuss the economic implications of unfunded entitlements and the tendency of markets to create multiple equilibria.

Nonetheless, following the financial crisis in which governments around the world provided at least $30tn in official assistance, it is an important contribution to the debate: 'Who bears – and who should bear – the burden of adjustment?' ▪



UK capitalism

Left-wing fortunes

William Keegan, Advisory Board

One of the curiosities of our time is that, with the exception of the European elections in Italy, the financial crisis and its consequences do not seem to have done much for the fortunes of left-wing political parties.

I dwell on this and other issues in my latest book *Mr Osborne's Economic Experiment*, due to be published in the autumn by Searching Finance, which published *Saving the World? Gordon Brown Reconsidered* two years ago. In the new book I take issue with Osborne over the deficit strategy, arguing that it was absurd to compare Britain's economic situation with that of Greece. In fact the Osborne fiscal strategy seriously delayed the recovery, and the UK recovery underway does not justify, or result from, the 'austerity' strategy.

Someone who must reflect on all this is Gordon Brown. The former Labour prime minister is one of many who, in their spirited youth, fantasised about the collapse of capitalism. Ironically, when the collapse of what used to be known as 'finance capitalism' seemed imminent in 2008-09, it was Brown who played a leading role in 'saving the world', as he once put it in a Freudian slip. Acclaimed abroad but unpopular at home, Brown spent several years out of the political limelight, until he recently emerged to make some passionate interventions on the subject of the Scottish referendum. He most certainly opposes the break-up of the union with England, but is concerned that London-based politicians and civil servants have been too 'patronising' in their lectures to the Scots, and that this could have a perverse effect.

When I gave a talk in Berlin not so long ago, people mainly wanted to know whether Scotland would leave the UK and whether the UK would leave the EU. My inclination is to focus on the natural conservatism of the British. They were hesitant about joining in the first place, but, once in, they did not want to depart when the Labour government of Harold Wilson held a referendum on that issue in 1975. The political hysteria about 'Europe' – eurosceptics often speak as though we were not even part of Europe – is truly amazing. The truth is that Brussels has become a scapegoat.

There has been much criticism of the Labour party recently, for allegedly being anti-business. Yet if there is one thing that really concerns businesses – big and small – it is the thought of the UK leaving the EU. However, Labour is much, much more pro-EU than the Conservative party. The fears about Labour and its approach to business are misplaced. The Labour party long ago embraced capitalism. But the party rightly objects to the abuses of capitalism. Miliband's criticisms, with regard to banks and energy companies, have been about the kind of abuses that should worry any citizen. ▪

BANK ON GERMANY

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