Bulletin

September 2013
Vol. 4 Ed. 8

Global insight on official monetary and financial institutions

The need for Asian integration
Turkey: the way forward
The renminbi and the rupee
Citizen rights to sovereign wealth
Germany's elections

Asia's uneasy maturity

The strains of growing up

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Cover story

Asia's uneasy maturity

As emerging markets around the world grapple with the task of adjusting to a gradual withdrawal of the Federal Reserve's monetary stimulus, Asia in particular faces tough challenges. Despite considerable efforts over the last decade, Asia needs to redouble initiatives to promote regional integration. We highlight the significant task facing the Chinese monetary authorities over China's economic rebalancing, as well as problems facing other Asian states caught up in US-prompted monetary volatility.

International monetary policy

Europe & the euro

Emerging markets

Global financial regulation

Tasks for Asian leadership: OMFIF-National University of Singapore Forum

The Lee Kuan Yew School of Public Policy at the National University of Singapore staged a seminar with OMFIF on 12 July, 'The role of Asia in the global economy', focused on the tasks for Asian leadership in monetary and financial policy at a time of continued strain in the world economy. Left to right below are Changyong Rhee, Asian Development Bank, Tharman Shanmugaratnam, Deputy Prime Minister and Finance Minister, Singapore, Prof. Kishore Mahbubani, National University of Singapore, and Prof. Niels Thygesen, University of Copenhagen. See p.30-35 for articles on the seminar.

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OMFIF

Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent globally-operating financial think-tank and 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 130 meetings in 25 host countries with the participation of 150 different official institutions.

Advisory Board

OMFIF's 134-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars, and other OMFIF activities. See p.22-23 for full details.

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 banking structures and regulatory issues.

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

Submissions

Contact the editorial team for details on article submissions at editorial@omfif.org.

Letters

Letters provide commentary on articles in the previous month's edition of the Bulletin. Contact the editorial team for details on letter submissions at editorial@omfif.org.

On the web

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Global Insight on Official Monetary and Financial Institutions
A time of tests and experiments
Central bank shake-ups bring pressures for markets
Latin America emerges as net positive force for world economy at OMFIF meeting
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OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Asia's uneasy maturity

High-flying countries brought down to earth

David Marsh, Chairman

The OMFIF Monthly Bulletin moves into a new phase this month with a layout revamp that seeks to encapsulate the organisation's growing international reach. For the 41st issue since our establishment in January 2010, we are launching the first publication with a full-scale cover photograph, part of efforts to upgrade the publication's visual appeal. And we are devoting more space to the challenges facing emerging markets. These countries are being brought down to earth by domestic imbalances and nervousness about Federal Reserve policy.

The tasks facing Asia form the centrepiece of this month's issue. Asia has forged ahead in the growth stakes and set down a marker for economic and political stability. Yet institutional infrastructure lags behind. Europe is enduring a long period of uncertainty engendered by the most advanced and ambitious form of integration – forming a single currency. Asian integration, as a series of articles in the September issue underline, has been more honoured in acronyms than in applications.

For the world as a whole, Meghnad Desai looks glumly ahead at what he imagines may be the downturn phase of a Kondratieff cycle. Jukka Pihlman extols progress in currency internationalisation, while Alan Bollard explores Asia's gaps in integration. Woosik Moon unveils Korea's interest in further globalisation. G. Padmanabhan of the Reserve Bank of India explains the contrasting fortunes of the renminbi and the rupee. We have reports on our Brasilia and Singapore meetings in June and July. David Tonge and Aslihan Gedik set the scene for OMFIF's Main Meeting with the Central Bank of Turkey on 5-6 September. Winston Moore looks at landmark oil industry moves in Mexico.

Niels Thygesen analyses signs of European growth. Michael Kaimakliotis and Stefan Bielmeier describe the political and economic stakes riding on Germany's election on 22 September. Gabriel Stein and Colin Robertson examine latest changes in international central banking behaviour. Darrell Delamaide describes the on-off debate on how and when the US Federal Reserve will cut back quantitative easing. Angela Cummine shows how some sovereign funds are trying to become responsible investors. William Keegan provides a sceptical postscript on whether central bankers care about unemployment. ■

David Marsh

Warning on possible backlash against China economic liberalisation

China's new government under prime minister Li Keqiang, pictured left, faces a potential backlash against economic liberalisation efforts from powerful Chinese vested interests, according to an OMFIF report on China's monetary and economic transformation published on 3 September.

On full opening of the capital account, China faces a risk that large capital outflows may cause the renminbi to fall substantially, with the danger of a currency crisis, according to the report 'Understanding China's monetary policy.' In such an eventuality, the Beijing authorities should accommodate outflows, while using the country's large foreign exchange reserves to stabilise the renminbi. The report underlines that Chinese policy-makers have a better chance of rising to forthcoming challenges than many other developing countries in a similar position, in view of China's current account surplus and high foreign exchange reserves together with the Beijing authorities' policy credibility on world markets. ■

GOLDEN SERIES LECTURE

'To prevent slowdown and sustain growth, Korea needs continued globalisation and liberalisation, in particular through expanding exports and promoting foreign direct investment.'

Woosik Moon, Member of the Monetary Policy Committee, Bank of Korea, 16 July, see p.10-11.

ADVISORY BOARD

OMFIF welcomes four new members, José Roberto Novaes de Almeida, Otaviano Canuto, Murade Isaac Miguigy Muargy and Daniel Titelman. Their appointments take the number of Advisory Board members to 134. For full list of members see p.22-23.

Otaviano Canuto is Senior Adviser on BRICS Economies in the Development Economics Department of the World Bank. He has completed a four-year term assignment as the Bank's Vice President and Head of the Poverty Reduction Network. He served at the Inter-American Development Bank and the Brazilian Ministry of Finance. Canuto has an extensive academic background, serving as Professor of Economics at the University of São Paulo and University of Campinas in Brazil.

Murade Isaac Miguigy Murargy is Secretary General of the Community of Portuguese Speaking Countries, based in Lisbon. A career diplomat, he has been Mozambican Ambassador to Brazil, France, Germany, Switzerland and the United Nations. From 1995 to 2004 he was Chief of Staff to the President of Mozambique.

Prof. José Roberto Novaes de Almeida is a tenured professor at the Department of Economics of the University of Brasilia. He began his career as an Economist at the Banco Central do Brasil, after which he served as Technical Advisor to the Executive Director for Brazil at the International Monetary Fund (IMF). He is a leading author on Brazilian legislation on pension funds.

Daniel Titelman is Chief of the Financing for Development Division at the United Nations Economic Commission for Latin America and the Caribbean (ECLAC). He has held various other positions at ECLAC including Chief of the Development Studies Section, Coordinator of the Special Studies Unit of the Executive Secretary and Expert on Monetary and Financial Policies. He has worked on issues related to financing and social security, particularly in health and pension reforms.

MAIN MEETING

Towards a new balance in emerging markets

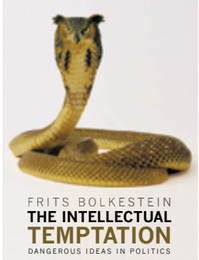
The OMFIF Main Meeting in Brazil, on 17-18 June, held at Banco Central do Brasil's headquarters in Brasilia, pictured left, developed new ideas for a constructive balance between emerging markets and the industrialised countries, at a trying time for world capital markets.

The most discussed issue was the prospect of a US recovery and gradual withdrawal of unconventional monetary policies, especially quantitative easing (QE). The effects of tighter US monetary policy on liquidity and capital flows would have both positive and negative implications for emerging market economies. There was some concern that the prospective ending of QE in the US, coupled with its prolongation in Japan, could lead to sharp movements in currencies with detrimental effects on emerging market economies — foreshadowing volatility that actually took place in July and August.

Emerging market economies were also seen as coping with uncertainty in Europe and the difficult transition in China's economic model from an investment-led to a consumption-led economy, which may slow Chinese growth and its demand for resources. For a summary of the meeting, see p.28.

INTELLIGENCE

Bolkestein sees economic peril in parlour theorising



In 'The Intellectual Temptation' former European Commissioner Frits Bolkestein demonstrates that intellectuals' parlour theorising, however glamorous the results might be, has been downright dangerous for politics and culture. Bolkestein complains that such political players frequently suffer from lack of experience, and are unused to the hard tests of vetting and verifying ideas.

Bolkestein bears the insignia of years of political tussles, having been European Commissioner for the Internal Market, Taxation, and the Customs Union, and Dutch Minister for Foreign Trade and of Defence.

The focus of Bolkestein's book appears in the Books & the Advisory Board section (p.38), a monthly feature on books written by members of the OMFIF Advisory Board. For further details see www.clarionreview.org.

The new global frontier

A new OMFIF report, 'The new global frontier: Understanding China's monetary policy', by Advisory Board members John Plender and Gabriel Stein, has been distributed to members. This is the third in a series of 2013 reports on China, part of OMFIF's Year of Renminbi Focus.

The report deals with the monetary policy implications for China and the rest of the world of the planned switch of the Chinese economy towards a more market-oriented system, including through the liberalisation of the capital account and interest rates. This fundamental Chinese transition is a great opportunity, but also poses deflationary risks for the world economy that have not been fully understood. The authors discuss the current and future policy framework, lessons from Japan, and put forth several policy recommendations including more active and efficient communication by the People's Bank of China.

For further details about OMFIF reports, contact editorial@omfif.org.

EXPERT SEMINAR

Tasks for Asian leadership

There was a positive undertone to the NUS-OMFIF forum in Singapore on 12 July, despite the turbulence from international monetary developments. Asian economies remain resilient in various areas: liquidity remains ample, with sufficient international reserves cushions and strong regional demand. The banking system reforms following the Asian financial crisis have kept Asian economies strong during the global financial crisis. However, considerable tasks for Asian leadership remain. See p.30-35 for articles on the seminar.

'Upgrade European Central Bank,' Lubbers says

The European Central Bank (ECB) should be given 'a full mandate' to operate on financial markets in a similar fashion to the US Federal Reserve and the Bank of Japan, as part of a move to establish a more cohesive basis for economic and monetary union (EMU). That was the message from Ruud Lubbers, former prime minister of the Netherlands and a member of the OMFIF Advisory Board, in Utrecht at the Second OMFIF Symposium in the Netherlands on 15 July. The speech, 'The future of Europe and the world economy', was given at a dinner concluding an afternoon of discussions on Dutch and international policy issues, attended by experts from the Netherlands and further afield.

On the web
See Ruud Lubbers' full speech at www.omfif.org

We all fall down together

Developed world spreads its problems

Meghnad Desai, Chairman, Advisory Board

Welcome to the fully integrated global economy. There is no decoupling, no hiding from the general chaos. Slow growth will be the result. No more bumpy rides; it's a hard slog through mud and slush.

We bear witness to the persistent asymmetry of financial power: between the US, the G7 group of industrial countries and the rest – whether the G20 or just the emerging market economies. China and other Asian countries can export goods and credit but they don't control any levers of the global economy.

Weak capacity

The financial market upsets hitting a range of emerging economies show their weak capacity for macroeconomic stability policies. China, India and Brazil have in various ways failed to see the macro imbalances coming or to do anything effective to correct them.

There were dreams based on naïve compound interest calculations that China and India would catch up and surpass the US by 2020 or some such date.

These projections are based on two major and one minor fallacies. First, that the future would be like the past; rates of growth would be high and constant forever.

Second, that total GDP inflated by population would give China and India clout.

A third minor fallacy is to put the sums in terms of purchasing power parity dollars, thereby rewarding countries for distorted trade structures.

Productivity matters

Size, especially population size, does not matter. Productivity per person matters. The emerging economies are still poor cousins.

The indebtedness that was at the root of developed countries' problems is now being visited upon the emerging economies as well. High-value assets floating in bubbles justified the first bout of borrowing.

These asset values have collapsed, and developed economies will find it hard to pay back the debt they owe. In the meantime, the cheap paper they fobbed off to the emerging markets propelled these latter countries into a bubble, and now a post-bubble crisis.

BRIC tonic

What a change from the start of the century. Investors recovering from the dotcom collapse were thrilled to receive a tonic with the invention of the BRIC group (subsequently BRICS with the addition of South Africa to Brazil, Russia, India and China). Young men at their trading desks could now buy and sell exotic equities with a new acronym. A sure-fire thing. A boom decade as the 21st century opened.

The emerging markets seemed to be decoupling from the developed world.

Another idea put forward by Ben Bernanke was that the emerging economies should be grateful that the developed nations, especially the US, became spenders of last resort, absorbing excess savings in the rest of the world.

So, one way or another, the emerging markets and BRICS were pivotal to the global economy. They served the richer countries with cheap exports, easy credit and markets for high tech manufacturing. A marriage made in heaven.

Today, the whole concept of emerging markets and BRICS is in a shambles.

Lenders of first resort

The symbiotic relationship between the spenders of last resort and the lenders of first resort proved near-fatal for both. The spenders collapsed in 2008 in a crisis that was not just financial but real.

And the emerging market buyers of their debt discovered they were not immune to the disease. Decoupling wasn't going to happen. And the debt they had been buying could not be repaid.

The emerging market economies had a sound fiscal base, so they could afford the Keynesian cure of a large fiscal push. China, India and Brazil all found protection.

They maintained their growth rates by shifting out of exports and going into infrastructure investment (China) or spending on consumption (India).

Self-inflicted doldrums

Alas, the good story did not last long. The developed economies, in self-inflicted doldrums, could no longer afford sustained Keynesianism.

They have sought to counter their problems by dumping immense amounts of paper money on the world at large.

Bernanke devised the solution of quantitative easing (QE) from his thesis on the Great Depression.

There was no QE then; hence the depth of the crisis. So this time QE had to be the answer. Or not, as the case may be.

Developed world's misery

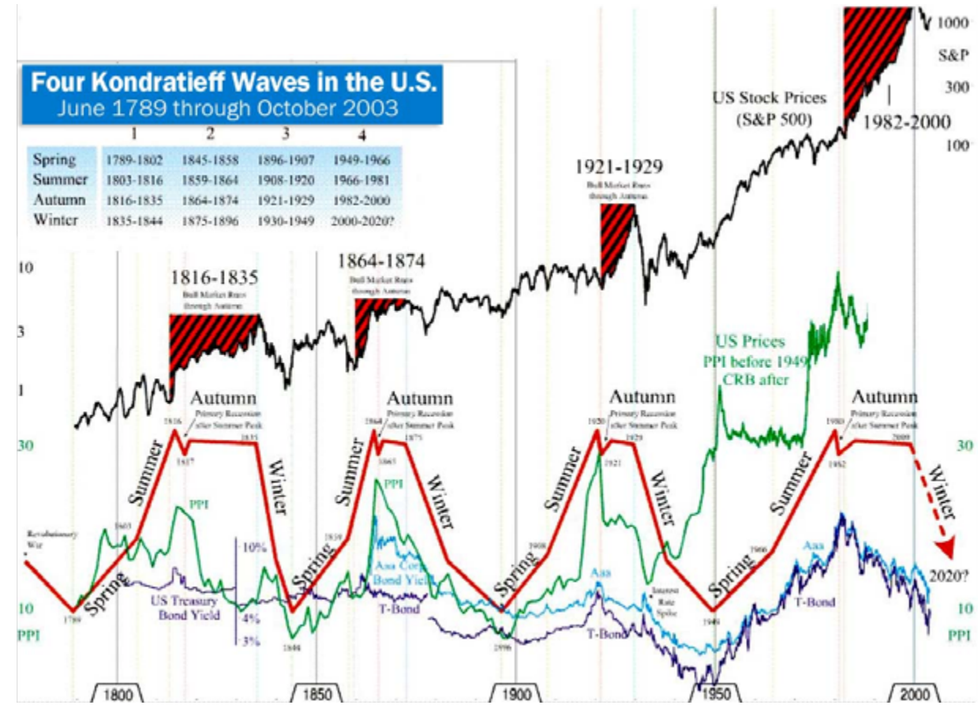
Quantitative easing was a way of exporting the developed world's misery to the emerging markets. So between 2010 and 2013 the emerging markets experienced a mirror image of the developed world's 2002-07 bubble.

Many like India and Brazil ran up trade and budget deficits and piled up dollar debts.

China had a financial boom and a housing bubble. That boom has now collapsed. The US is recovering and the hot money is flowing back. Emerging market economies' currencies are falling sharply.

The wheel is turning. We know why it's turning, but not how to stop it. ■

Lord (Meghnad) Desai is Emeritus Professor of Economics at the London School of Economics.



Source: Longwave Analytics

Riding the cycle: Maybe we are facing a Kondratieff plunge ahead

Perhaps we are in a Kondratieff Cycle, ***writes Meghnad Desai in New Delhi.***

Perhaps the world is witnessing the confirmation that we are subject to the notorious fluctuations of the Kondratieff Cycle (see Figure above).

These cycles – named after the Soviet economist Nikolai Kondratieff – are never precisely calibrated in terms of length or phases. Kondratieffs are long cycles of around 50 years on average.

If you think of the Keynesian quarter century as the boom phase of the Kondratieff – 1945-71/73 (some start the cycle in 1940) – and the downward phase as 1971-73 to 1989-91, that makes a 45-50 year cycle.

In an eerie parallel, the 19th century downturn began in 1871 as well.

Continuing in this vein, we can time the boom phase of the latest cycle as 1992-2008, a rather shorter boom than the earlier Keynesian quarter century.

You could extend it by adding four years since the emerging market economies did not slump until this year.

The 19th century boom phase lasted from 1896 until 1913. That would bring us up to 1992-2013, marking a 20 year cycle.

Can we then expect a downward phase of 2008-13 until 2030-33?

I don't like to be a doomsayer. But I tell you this: you have been warned. ■

Korea at the crossroads

Planned development as north east Asia's economic hub

OMFIF Report on Golden Series with Woosik Moon, Bank of Korea, 16 July 2013

Dr. Woosik Moon, Member of the Monetary Policy Committee of Bank of Korea, outlined the transformation of Korea's growth model as part of the OMFIF Golden Series in London on 16 July, to an audience of 80 financial services practitioners and other experts at the Innholders Hall.

Moon's lecture, 'The role of Korea in the Asian and world economy', focused on past Korean crises, processes of transformation, current and future challenges, and policy implications for Asia and the rest of the world.

Korea is a notable case of successful export-led growth and international trade integration, as well as technological catch-up – home to world-class leading global firms in semiconductors, cell-phones, LCDs, automobiles, ships and steel.

Despite two major economic setbacks – the 1997-98 Asian financial crisis and the 2007-08 global crisis – Korea managed a rapid recovery. Contrasting macroeconomic policies were adopted during the two episodes, showing how Korea had learned valuable lessons from the experiences, with the crucial difference that it was able to adopt a more expansionary monetary and fiscal policy in reaction to the latest upheavals.

Structural reforms were imposed in 1997 by the International Monetary Fund (IMF), which had significant repercussions for Korea, with unemployment rising fourfold from 1996-98.

The 1997 crisis marked a turning point for Korea, accelerating diverse liberalisation schemes and programmes to open up and globalise the economy, shaping a very different growth model. Labour reform – namely the revision of labour law in allowing company lay-offs – played an important role in this transformation.

Moon made a general point about recipes for future growth: 'Everyone seems to be talking about regulation, but the recovery will come from less regulation and more liberalisation.' While traditionally relying on domestic investment for growth, in a manner similar to Japan and China, Korea has moved towards export-led growth. Indeed, the share of Korea's exports has increased significantly following the 2008 crisis (see Chart below). Moon attributes successful economies' swift recoveries to these strong exports.

Moon pointed out that China has reached a crossroads in shaping its growth model. For China, very low capital efficiency is a key weakness in what appears to be an unsustainable investment-led strategy.

Since 2008, the Korean economy has strengthened further as a global competitive force, with technological catch-up at the firm level and increasing labour productivity – particularly in the manufacturing sector. Despite this progress, Korea is facing a growth slowdown, largely attributed to decreasing fixed investment.

'To sustain growth, Korea needs continued globalisation and liberalisation, through expanding exports and promoting foreign direct investment.'

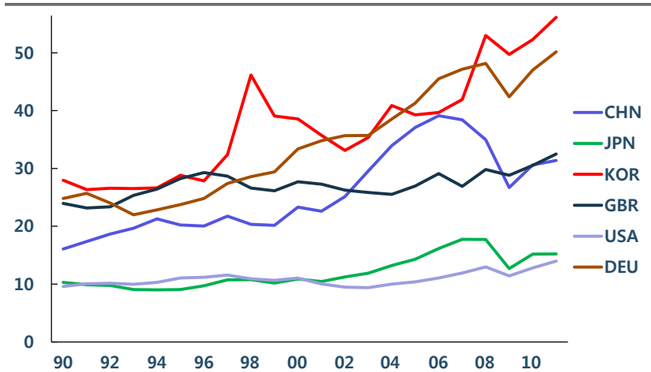
While growth and gross fixed investment have consistently fallen since the 1960s, the current profit rate for manufacturing is on an upward trend. This is due to increased labour productivity and greater globalisation among Korean firms, as seen in the cases of Samsung and Hyundai.

Moon called for continued globalisation and liberalisation of the Korean economy, namely through the expansion of export markets and promotion of foreign direct investment in Korea.

Moon further advocated greater regionalisation to mitigate the slowdown. Since 2003, Korea has forged free trade agreements with 47 countries, including the US, the EU, India and ASEAN countries. One aim is for Korea to leverage its manufacturing base to become the economic hub for north east Asia, as Singapore is for south east Asia.

Korea may benefit from its potential mediator role between China and Japan, by providing a gateway to penetrate their markets. ■

Exports as a proportion of GDP



Source: World Bank

Learning lessons from the past

Export growth, monetary expansion improve performance

Stewart Fleming, Advisory Board

Korea learned several harsh lessons in 1997 and 1998. Caught up in the Asian debt crisis which shook the world economy in those two years, it had to turn to the IMF for $30bn of financial support and undertake a wrenching economic adjustment programme.

Dr. Woosik Moon, a member of the Monetary Policy Committee of the Bank of Korea, the Asian nation's central bank, underlined that Korea did not, however, permit this crisis to go to waste. Korea, he said, drew from this harsh experience the lesson that increased and continuing economic liberalisation was vital to achieve and retain competitiveness in a globalising world economy.

The reforms it implemented 15 years ago included ending the era of 'jobs for life' for its (mainly male) working population, making 2m people unemployed. These reforms have, however, helped Korea cope with the global economic crisis which began in 2007, a crisis which, the US apart, is still shaking much of the world economy.

He suggested that China, Japan and the euro area, each of which is facing severe economic challenges in order to compete, need to learn the lesson which Korea drew from the 1997-98 upheavals and, today, themselves embrace structural economic reforms designed to liberalise their economies.

As for the prospects for the adoption and implementation of such reforms, Moon, guardedly and reticently, nevertheless left his audience in no doubt that he was not overly optimistic, at least in the short term. This was a remarkably frank assessment given Korea's delicate geopolitical situation, poised, between east Asia's economic giants, Japan and China. These are two countries whose tense relationship is soured by both past history and an increasingly bitter contemporary rivalry.

They are also countries which have the ability to exercise considerable influence over Korea, economically as well as politically. Both countries are, of course, vital trade partners with which Seoul is seeking bilateral free trade agreements.

Critically, along with Russia and the US, China and Japan are also key players in the smouldering crisis in the north of the Korean peninsula at a time when Seoul is also quietly preparing for reunification with its troubled and poverty-stricken northern neighbour.

It fears the Pyongyang regime so lacks political legitimacy that it could suddenly implode.

Focusing on economics, however, Moon highlighted the different economic background to the 1997-98 and 2008 crises. In the first crisis Korea adopted tight monetary and fiscal policies to complement the structural reforms.

In 2008, its increased international competitiveness, current account surplus and more stable private and public finances, allowed it to adopt expansionary fiscal and monetary policies. So, for more than a decade, and still today, its international competitiveness has allowed it to enjoy export-led growth with steady levels of consumption.

China, in contrast, has forced fixed investment up to more than 40% of gross domestic product (GDP) and squeezed consumption. This has left it with an unsustainable investment-based economic growth model with excess capacity and very low levels of efficiency. Beijing is now hoping to reverse this trend and quickly – having tried and failed earlier to shift policy in this direction.

In Japan, fixed investment has been declining as a share of GDP from the 1980s and consumption has been rising only slowly.

It too has to reshape its growth model, in Moon's view, and so far it does not seem ready to undertake the sort of wrenching structural reforms which Korea embraced.

For its part, Moon argued that Korea must further increase its competitiveness and so its exports, partly by attracting more foreign direct investment, for example, through more structural reforms, such as raising the still low female labour participation rate. ■

Stewart Fleming is Senior Member at St. Antony's College at Oxford University.

Woosik Moon on 13 June in London

On the web

See Dr. Woosik Moon's full presentation slides at www.omfif.org

Limitations of a new policy fashion

Don't become dependent on forward guidance

Gabriel Stein, Chief Economic Adviser

The Bank of England (BoE) and the European Central Bank (ECB) have followed the US Federal Reserve by providing 'forward guidance', in the form of more detailed information about the future course of monetary policy.

For the BoE, this was expected once Mark Carney took over as governor. For the ECB, the step marked a significant break from past statements (notably from previous president Jean-Claude Trichet) against 'pre-committing' on interest rates.

Taking markets by surprise

Central banking has come a long way from the days when changes in Federal Reserve policy had to be inferred from its actions rather than its communications; or when the Bundesbank felt that an unanticipated policy change, because it took the markets by surprise, was automatically a success.

Forward guidance is not completely new. Many central banks have given some indication of the near-term and in some cases medium-term course of monetary policy, from using code words (a speciality of the ECB) to more explicit statements about the suitability or otherwise of current monetary policy (the Reserve Bank of Australia) and outlining an interest rate path (the Riksbank).

But recent developments are more detailed. The Fed initially spoke only about keeping monetary policy unchanged for an extended period.

This was then qualified to include dates; and finally (at the end of 2012) to involve thresholds that would be reached before monetary policy would change.

Fairly vague

The ECB's forward guidance is still fairly vague beyond a commitment to keep interest rates low for a few years.

By contrast, the BoE has set more details, promising to keep interest rates unchanged until unemployment drops to 7% (which it believes will occur in 2016), subject to three 'knock-out' conditions. These are:

1. If the Monetary Policy Committee (MPC) forecasts that inflation will be 0.5 percentage points or more above the 2% target over an 18-24 month time horizon;
2. If medium-term inflation expectations are no longer sufficiently well-anchored; and
3. If the Financial Policy Committee – the MPC's sister committee, which monitors potential systemic risks – judges that the monetary policy poses a significant threat to financial stability.

Mark Carney, Bank of England governor, giving a speech in Nottingham, UK, on 28 August

The timing of the ECB and BoE announcements was to some extent guided by the calendar: the July meeting of the BoE monetary policy committee coupled with the change of governor; and the July meeting of the ECB governing council.

Both central banks were keen to distance themselves from the Fed in the wake of chairman Ben Bernanke's June statements about the possibility of an imminent tapering of the Fed's quantitative easing.

They each wished to make clear that neither was in the process of changing monetary policy.

From this perspective, the policy was successful. Euro and sterling markets calmed down. Commentators generally saw developments as positive.

Questions remain

However, questions remain whether more forward guidance really is an unalloyed good. It increases the transparency of monetary policy, but there may be occasions when surprise adds potency to a policy move.

Forward guidance is – and must always be – conditional. Although central banks do not necessarily spell it out, forward guidance is valid only as long as nothing happens beyond what they expect. If circumstances change, so will policy.

That is presumably part of the rationale behind the BoE's third condition, which gives it an excuse for changing policy at any time, if it finds it necessary.

The other two conditions are less relevant. The MPC has never forecast inflation above 2.5% over an 18-24 month horizon, regardless of the fact that inflation has been above that level for most of the time since late 2009.

Long-term inflation expectations tend to be guided by the central bank's official target and the belief that it will achieve this over the policy-relevant horizon (see Chart on p.13).

So forward guidance is in some ways just a safety device to calm markets, through the pretence that nothing will change. Since that doesn't hold true, it can be misleading and even potentially harmful.

Forward guidance promising to keep monetary policy ultra-loose for the foreseeable future risks giving the impression that things are much worse than they are, thus underpinning pessimism and fears of deflation.

There are other risks, too. Once central banks start guiding the market in this way, this changes the pressure point at which they have to tell the market that they are changing direction. Previously, when central banks changed policy, markets had to make a definite move to adjust.

Now, when central banks announce under what circumstances, and potentially when, policy will change, markets are given the opportunity to adjust in advance, but also the time to marshal their arguments against the indicated policy change.

This has probably contributed to the latest Fed fluctuations, where a fairly hawkish statement from the June Federal Open Market Committee meeting was followed by an astonishingly dovish Bernanke statement in July.

The more central banks practise forward guidance, the more markets will come to depend on their soothing statements. The more aggrieved they will become if circumstances and thus policy change.

Markets will probably become more volatile, too. Textual exegesis will reach new heights of absurdity, when every single nuance change in a central bank statement will potentially be taken as a signal to act upon.

The danger is that, instead of complementing economic analysis as a key input in investment strategy, central bank guidance will replace it. That would be regrettable.

Lagging indicator

Another problem with forward guidance is the way the Fed and the BoE have chosen to tie monetary policy developments to an indicator – unemployment – which is beyond their direct ability to control or influence, and which is a lagging indicator.

Monetary policy always operates with lags. But tying a supposedly forward-looking policy (dealing with inflation or deflation in advance, rather than when such developments actually occur) to a lagging indicator is at the very least a gamble.

In some ways, forward guidance shows the increasing impotence of central banks. This is because forward guidance, like other policies, is subject to the law of diminishing returns.

In their attempts to maintain its force, central banks are driven to clarify and expand the forward guidance; but that means further eroding its efficacy, as new targets are introduced and new caveats are added that are potentially mutually incompatible.

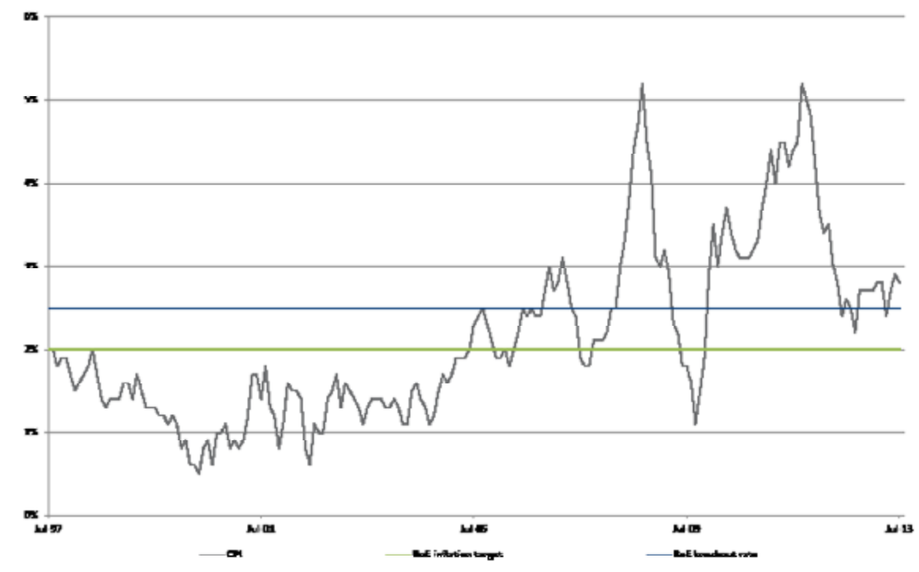
With monetary policy in uncharted waters, forward guidance can play a constructive role, particularly the Fed/BoE style, with economic development thresholds for action.

Yet the risk is that central banks are impeded from exiting from ultra-loose monetary policies, and that markets become overly dependent on central bank guidance. As a result, forward guidance should be used relatively sparingly. Yet there can be compensations.

When most investors rely heavily on central bank statements, those who actually analyse economic developments will be able to spot and profit from changes in trends much more quickly. ■

Prof. Gabriel Stein is OMFIF's Chief Economic Adviser and Managing Director of Stein Brothers.

UK consumer price index, 12-month change per annum, %



Source: Office for National Statistics

Towards declining central bank influence

Struggle to guide the direction of financial markets

Colin Robertson, Advisory Board

The apparently perverse reaction of sterling and the gilt market to Bank of England (BoE) governor Mark Carney's forward guidance could mark the start of a new era in the influence of central bankers over financial markets. More detailed guidance will lead to more debate and less ready acceptance. The outcome may be that investors become less in awe of central banks. So, for central bankers, influencing the direction of financial markets will be more challenging - precisely the opposite of what was intended.

Recent BoE Monetary Policy Committee guidance that interest rates will not rise before unemployment falls to 7%, combined with its own assumption that this is unlikely to take place before 2016, could have been expected to weaken sterling and restrain any rise in gilt yields.

However this did not take place as even the initial reaction of investors was to be more questioning than has been the norm, with market participants apparently believing that either the unemployment target will be hit sooner or that the inflation conditions will not be met.

Admittedly, the inflation conditions are quite subjective, being based on the bank's expectations for inflation 18 to 24 months down the line and on medium-term consensus inflation expectations, but this subjectivity can only act to weaken the impact of guidance.

Improvement unlikely

Nor is confidence in the course of UK monetary policy likely to improve over time.

What happens if employment continues to be better than one might envisage against the more general economic backdrop, so that the employment target is met when the economy has clearly not reached escape velocity?

True, there is no commitment to raise rates at the 7% threshold but it is not difficult to imagine unflattering commentary over clarity of policy at that time.

The point is that investors will be led much less easily by the BoE, regardless of whether monetary policy is right or wrong. Greater clarity on intentions is not the same as greater clarity on outcomes.

Global issue

This is not a parochial British issue. The Bank of Japan's repression of bond yields while at the same time trying to raise inflation to 2% would become a less credible combination of policies if bond investors actually believed 2% was achievable.

In Europe, peripheral bond yields may have been guided down by the prospect of outright monetary transactions (OMT) but there are increased doubts as to whether the European Central Bank (ECB) can make this work in practice.

The German elections on 22 September have been widely projected to open room for new European initiatives and lower pressure on the ECB to use monetary policy to break through Europe's growth impasse. Whether, however, we will see such a breakthrough and pressure on the ECB ease remains open to doubt.

Not least in US

In the US, the Fed will have to work hard to retain the high level of confidence which investors have placed in it. The transition from Greenspan to Bernanke was uncontroversial and continuity of policy was thought assured.

Today we face shorter-term uncertainty until the new Fed leadership is confirmed. However, we also face a period of waiting to see how the new Fed chief, especially if it is Lawrence Summers, can influence markets positively in the way that predecessors have done in the past.

Valuing central bankers

The last three decades have seen central bankers become ever more revered, and credited with ever greater abilities, not least to influence financial markets.

The great bull market in bonds started when Paul Volcker exercised his authority in the early 1980s and in recent years quantitative easing, in particular the potential for more of it, has reassured bond investors.

In equity markets the 'Greenspan put' where the Fed comes to the rescue has been added to the old adage of 'don't fight the Fed'.

If one rated central bankers like stocks, one might surmise that the price/earnings ratio rose from single figures in the 1970s to the 20s or 30s at the peak, while remaining well above historical norms today.

Questions around political independence and more growth orientated policies are two potential risks to current lofty 'valuations.'

Directing markets

As central banks strive to provide investors with more detailed guidance on policy, it is inevitable that certain aspects of the guidance will be debated and taken less at face value than in the past.

This in itself is in no way a negative development. However, there are clear implications for the way that central bankers are perceived by participants in financial markets.

In particular, it will become increasingly difficult for central bankers to influence the direction of financial markets in the way they have done in the past.

It will also be harder because investors will become less in thrall to central banks.

Therefore the likelihood is that central bankers will have less influence on the direction of financial markets than has become accepted.■

Colin Robertson is the former Global Head of Asset Allocation at Aon Hewitt.

Markets look for tapering in September

Fed officials remain cautious, emphasise flexibility

Darrell Delamaide, US Editor

By the time central bankers and hangers-on gathered at Jackson Hole in late August, market opinion had reached a consensus that the Federal Reserve would begin 'tapering' its asset purchases with at least a token reduction of $10bn from the $85bn a month in place since September 2012.

However, when news of a sharp drop in durable goods orders in July came in the last week of August, some investors grew hopeful that the Fed would delay tapering until later in the year.

Jackson Hole, the Wyoming resort where the Kansas City Fed sponsors a symposium on monetary policy every August, was noteworthy because for the first time in 25 years the chairman of the Fed did not attend. **Ben Bernanke (voter)**, who is expected to quit the post when his term expires in January, announced some time ago he would miss the meeting because of a 'scheduling conflict.'

Early expectations that Vice Chairman **Janet Yellen (voter)** would speak instead as part of her transition to the top spot were dashed as a vigorous, eleventh-hour campaign by former White House aide Larry Summers to get the Fed job made Yellen's accession far less sure.

The tussle over the Fed job combined with 'taper tantrums' by stock market investors subdued not only Jackson Hole but Fed commentary in general during the latter part of the summer.

While the minutes from the July meeting of the Federal Open Market Committee (FOMC), released in August, supplied no sure timing for the start of tapering, most Fed speakers fuelled the notion that it would be sooner rather than later.

Concern about economy despite gains

The July minutes showed that staff economists had become somewhat more pessimistic about near-term prospects after first half growth came in weaker than anticipated.

FOMC members, too, were less confident about the economy than they had been in June, the minutes recorded.

Likewise, despite solid gains in payrolls, some members were concerned about the continued high unemployment rate and low readings on the participation rate and the employment-to-population ratio.

Nonetheless, the dovish head of the Chicago Fed, **Charles Evans (voter)**, told reporters at a breakfast meeting in early August that he wouldn't rule out the FOMC reducing its bond-buying programme at its meeting September 17-18. This response to a question came after he said the Fed was likely to reduce the purchase rate later this year.

The somewhat less dovish head of the Atlanta Fed, **Dennis Lockhart (non-voter)**, sought to preserve the same flexibility in an interview with Market News International.

He said a move could come in September, but it might wait until later in the year, depending on how robust growth in the economy and employment is.

A week later, in a speech in Atlanta, Lockhart indicated the Fed would wind down the bond purchases in baby steps.

'As I see it, a decision to proceed—whether it is in September, October, or December— ought to be thought of as a cautious first step,' he told members of the local Kiwanis Club.

Tapering is not tightening

Speaking at another Jackson Hole meeting in mid-July, Philadelphia Fed chief **Charles Plosser (non-voter)**, a hawk who has opposed the asset purchases, said 'the time has come for us to exit our current asset purchase programme and commit to a way forward that seeks to normalise monetary policy.'

He called for winding down the asset purchases by the end of the year. He also felt the Fed should clarify its forward guidance by declaring a 6.5% unemployment rate (compared with 7.4% in July) a 'trigger' for tightening monetary policy rather than a 'threshold' for considering a change.

But he reiterated the message from other FOMC members that it was a mistake to consider the tapering itself as a tightening of policy.

'It is also important to note that even the end of purchases is not the start of policy tightening,' Plosser said at the Fifth Annual Rocky Mountain Economic Summit.

Federal Reserve chairman Ben Bernanke

'It simply means the effort to push rates even lower will cease, but policy will remain very accommodative.'

Cleveland Fed chief **Sandra Pianalto (non-voter)** told a local group in early August that unemployment had improved faster than she expected when the Fed embarked on the new round of asset purchases.

'In light of this progress, and if the labour market remains on the stronger path that it has followed since last fall,' she said, 'then I would be prepared to scale back the monthly pace of asset purchases.'

Pianalto, who has announced she will step down early next year after more than 10 years at her post, didn't comment on the timing of the tapering.

James Bullard (voter), head of the St. Louis Fed, was cautious about the timing for tapering. 'The Committee still needs to see more data on macroeconomic performance for the second half of 2013 before making a judgement on this matter,' he said in the outline of remarks for a mid-August event in Paducah, Kentucky.

Bullard, who considers himself an inflation hawk but has turned dovish on monetary accommodation, also warned against thinking that the Fed would make its move in September or December, when press conferences are scheduled, so it could explain the action. He said the FOMC should be able to move anytime, including the October meeting, when economic data warrant a change.

At a breakfast event the next day in Louisville, Bullard said he sees no evidence that the Fed's bond purchases were creating an asset bubble like that in technology stocks in the 1990s or in real estate prior to the financial crisis. 'I don't see a bubble of that magnitude right now for the US economy,' Bullard said in answer to a question.

Bursting bubbles

In the past, Fed policy-makers have claimed that monetary policy is, in any case, a blunt tool to deal with asset bubbles.

Fed governor **Sarah Bloom Raskin (voter)**, however, outlined a way that the Fed could use its regulatory tools to deflate incipient bubbles. After sketching a hypothetical scenario as to how an asset bubble could arise from investors and banks chasing higher yields in a low-interest-rate environment like the current one, she said that regulatory policy, joined with effective prudential supervision, can work against that trend.

'Regulatory policies can lean against emerging asset bubbles and the vulnerabilities that attend them by restraining financial institutions from excessively extending credit,' she said at a July event in Washington.

These tools could include credit underwriting restrictions like higher down payments to counteract a bubble, or increased margin requirements in short-term funding markets.

Raskin, a former state bank regulator in Maryland, has been rumoured as a candidate to succeed Neal Wolin at the No.2 spot in the Treasury Department.

Federal Reserve vice chairman Janet Yellen

Some commentators have suggested that the White House would nominate a woman to this job to blunt criticism about passing over Yellen to give Summers the Fed chairmanship.

Of course, adding her departure to that of Bernanke, Yellen (virtually certain if she is passed over), and Elizabeth Duke's exit at the end of August would leave the seven-member Board of Governors severely depleted if Summers were nominated to join and the Senate confirmed him. ■

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

'Confirmability' may hold key to Fed race

In the fluctuating tussle between Lawrence Summers and Janet Yellen over who becomes chairman of the US Federal Reserve next year, Summers' perceived lead in the approval stakes may be less clear than he would have us believe, *writes John Kornblum in Washington*.

The President appoints, but the Senate approves. 'Confirmability' could end up being the most important criterion.

Summers could be a stalking horse to help a less mercurial candidate gain easier approval. If I had to bet on it, I would wager euros (not dollars) that, in this intriguing, seemingly two-horse race, Yellen may finish a nose ahead.

In some superficial ways, the race shouldn't raise more than a yawn. The title is uninspiring, the salary at $199,500 is miniscule by banking standards.

But Fed chairmen have always been among the world's most powerful figures. They stay in office a long time. Eras of economic growth or decline are often defined by their names.

This is one reason why the debate over Ben Bernanke's successor is unusually heated. Bernanke's programme of quantitative easing is credited by many as keeping the US economy on a recovery path, but discussion of next steps has already begun. The second reason is power. Today's Washington is even more polarised than usual.

The new chairman's mandate will extend into the next administration, with corresponding influence through personal and political channels. Summers may be a stalking horse for a less mercurial candidate. ■

John Kornblum is former US ambassador to Germany.

Retaining national responsibility

Focus on shorter-term requirements for success

Niels Thygesen, Advisory Board

Modest improvements in the performance of most members of economic and monetary union (EMU) – signs of growth in Germany and France and slowing contraction in peripheral economies – have modified financial markets' pessimism.

External deficits in the periphery have shrunk or disappeared, and not only because of import compression.

Political uncertainties in Italy and Portugal and inertia in the French policy debate have not led to the disasters some had predicted. And there is some optimism that the German elections on 22 September could open up room for new initiatives.

How long will this more relaxed mood last? One hurdle could be that the German consensus favouring a step-by-step pragmatic approach to EMU rather than spectacular decision-making will prove durable after the elections.

We may see problems in weaker countries where new painful economic decisions need to be taken. We can expect further public comments on still-unsustainable public debt levels in Greece and Cyprus.

The more favourable environment could, nevertheless, survive and even strengthen, once recognition gains ground of the scale of improvements in EMU's long-run robustness agreed since 2010.

Proposals that EMU must move towards a political union with substantial fiscal elements are both politically ambitious and economically superfluous.

A narrower focus is needed. As so often, the 'best' – in terms of longer-term political aims and democratic legitimacy – may block the 'good' that can be achieved over the next few years.

We need to separate what may be ultimately desirable for EMU's longer-term performance from what is needed over a shorter period to end the crisis.

European Central Bank president Mario Draghi

Restoring national responsibility

One big question is how to make future EMU crises much less likely. When the EMU treaty was agreed in Maastricht more than 20 years ago, only monetary policy was centralised, leaving fiscal and structural policies largely as national responsibilities, though subject to relatively mild constraints on public deficits and debt.

EMU members were no longer able to use the safety valves of devaluation and inflation.

Policy-makers were excessively optimistic that market forces and peer pressure would prevent countries from building up uncompetitive external imbalances that they would be unable to adjust and finance.

But the fear of deficits turned out to be too remote to influence national government behaviour. The rules were increasingly disregarded and not monitored seriously by partners or by the European Commission.

The intensive reform efforts of the past three years have largely repaired these weaknesses.

These reforms include, in particular, a focus on external, as well as public finance, imbalances; greater clarity of rules, making them easier to observe and monitor; and improvements of national budgetary procedures, in part through national fiscal councils.

One can always discuss whether these repairs will prove sufficient to prevent a repetition of laxity and divergence.

However there is a form of deterrence in the negative experience of countries suffering partial or entire exclusion from financial markets, leading to negotiations with the European institutions and the International Monetary Fund (IMF) on a conditional lending programme. These are episodes that no EMU member would wish to repeat.

Countries that carry out overly expansionary policies, whether related to public expenditure or to credit expansion to private domestic borrowers, become dependent on international financial markets.

When capital inflows dry up, they have to seek assistance and they lose national sovereignty. That is the case in the global system, and that would be the case in Europe without EMU.

This continues to provide the clearest argument why EMU countries should retain national responsibility for national economic policies outside the monetary field.

This is the sole framework covered by democratic legitimacy in Europe today. So that must also be the framework for the longer term – not fundamentally different from the original vision for EMU – that the euro area should be trying to restore.

Crisis management

This long-run task has become obscured by the more urgent tasks of crisis management. Steps have been taken that seem to require a centralisation of authority, measures for which there is little popular support, and which would require (should they become permanent) changes in the Lisbon Treaty and/or national constitutions.

Some politicians and academics support the strategy of using the crisis to move dramatically towards political union with substantial fiscal elements. However, they might consider whether an ad hoc approach is not more likely to succeed.

Several constructive steps of crisis management have been taken more or less within the existing Treaty framework. The most significant was setting up the European Stability Mechanism.

Another has been the initial stage of Europeanising banking supervision, first in the area of systemic risks (on an advisory basis), and more recently for individual banks, a step made possible by a historical accident at Maastricht that left the possibility of vesting such authority in the ECB.

Accepting that some national debt was unsustainable, and that Greece had to restructure its debt to private creditors, is a third example of pragmatic action by EMU authorities.

Euro area leaders have shown a constructive attitude in adapting the conditions for national adjustment programmes, including extending time horizons. These steps have taken EMU a long way forward in crisis management.

But more could be done on an ad hoc basis, including at some point either additional lending for some hard-hit countries, or restructuring part of their debt to public authorities (above all, for Greece).

These decisions have been essentially discretionary. The main problem in going beyond them is that the next logical steps in crisis management are of a different nature, involving mutual obligations, which could bring uncapped liability for creditors.

This applies to the next stage of banking union: the Single Resolution Mechanism and the authority to run it. And, above all, it applies to most of the schemes for joint bond issues, in particular those with joint and several guarantees.

Some proposals aim to make steps in this direction temporary or limited in scope – for example, limiting joint debt issues to Eurobills of short maturities of at most two to three years, or finding other ways of ensuring they made up only a small part of national debt, or have a European Debt Agency mandated to charge different rates of different sovereign borrowers.

Some of these possibilities are now presumably under study in the review of different models, in an expert group set up by the European Commission.

There are however important obstacles to the overall notion of joint liability, both from creditors who find unpredictable commitments unacceptable, and from debtors who resist the unprecedented oversight of their policies entailed by sharing debt.

Retaining national responsibility in key fields is a prime question in the debate on European banking union.

This issue illustrates further the dangers of mixing up what is desirable in the long run (where national responsibilities creep back in through the bailing-in of creditors when a bank fails and other disincentives to excessive lending again become important) with short-term crisis management, where more improvisation will often be required.

Banking union was initially seen as a crisis management tool, but it is too elaborate to construct to serve that purpose now; the Cyprus crisis was 'solved' prematurely with longer-term tools.

Crisis management is urgent. It should not be delayed on the pretext that only the most solid (and difficult to construct) long-term framework is good enough.

It is not easy to find additional ad hoc measures that are adequate to the task. But this is less difficult than finding acceptance for longer-term ambitions within a short time frame and against an unpropitious political background.

Necessary short-term tasks require more audacity and generosity than the longer-run design which may ultimately be needed.

The goal of reinforcing EMU will be better served if necessary strengthening measures are carried out in the right sequence. ■

Prof. Niels Thygesen is Emeritus Professor of Economics at the University of Copenhagen.

ECB headquarters in Frankfurt

The European question for Merkel

Aid, not punishment, is the answer to peripheral countries' woes

Michael Kaimakliotis, Quantum Global Investment Management

There's been lots of relatively good economic news from the euro area lately, but the difficulties are far from over. The leaders of Europe, above all from Germany, must develop an economic and political model that will avoid a decade or more of extremely high unemployment in the peripheral countries and a probable rise of anti-European political factions.

A great weight of responsibility rests on Angela Merkel, the German chancellor. She is likely to remain in power – at the helm of a coalition that is still not certain – after the country's elections on 22 September. Post-poll decisions (or non-decision) by her and other leaders will shape Europe not just for years but for decades ahead.

Emerged from recession

The euro area emerged from recession in the second quarter. Confidence has grown. The euro has been strengthening. Credit spreads remain well below last year's levels.

I have been bullish on European risky assets generally since the speech of Mario Draghi, the European Central Bank president, in July 2012 in London, where he unveiled the 'Draghi put'.

But we must not take a modest near-term improvement as an 'all-clear' sign. The divergence between core and periphery euro members is a festering sore.

Spanish unemployment

There seems little likelihood of improved economic conditions in the periphery any time soon. The International Monetary Fund expects Spanish unemployment to remain above 25% for at least five more years. Other peripheral countries are in similar condition. I do not see how their people will remain committed to austerity and the euro after another five years of suffering.

Sentiment is already deteriorating dangerously. A recent Pew Research poll showed that across the main European countries the median proportion of people favouring the European Union declined 15 percentage points between 2012 and 2013 to only 45%. Europeans generally identified Germany as the 'least compassionate' country. The exceptions were France and Germany which awarded the UK that attribute.

Deeply divided

Europe is deeply divided. The trend is accelerating. We can learn something from the key decisions of the 20th century. After the First World War, the European victors imposed heavy reparations on Germany. The message was clear: don't do the crime if you can't do the time.

The decision led indirectly to the Second World War. After this second, even more disastrous, conflict, initial pro-reparations proposals gave way to US reconstruction aid, amounting to $26bn (before and after the Marshall Plan was enacted).

This was geared towards the defeated Axis powers Germany and Italy as well as countries that had fought with the Americans. The aid represented about 10% of US GDP – corresponding to $1.4tn today.

The Marshall Plan was not simply charity. Rebuilding Europe, fostering integration, and strengthening western Europe against the Soviet Union were in the US interest. These steps, unlike the ones after 1918, worked out positively; they were probably the most important economic policy decisions of the 20th century.

Closer to reparations

Unfortunately Europe today seems closer to reparations rather than to the Marshall Plan. The countries of the periphery are being taught a tough lesson. Past sins have painful consequences. This is understandable and is worth teaching. But the degree of imposed hardship will have negative repercussions in coming decades as attitudes towards Europe shift – especially among young people who have never had the chance to enter the workforce. This is a ticking time bomb.

Europe's leaders seem to have recognised the risks. But the response is too little and too late. The European Investment Bank (EIB) is evaluating three proposals which may boost lending to small and medium-sized enterprises by up to €100bn between 2014 and 2020.

These are loans rather than grants and the EIB actually 'creates' value based upon the spread between its own financing costs and those of the commercial banks to which it lends. That spread to EIB funding relative to the average of five year BBVA and Intesa São Paolo rates is about 2%. So if €100bn of EIB loans are extended over five years that would amount to a transfer of roughly €10bn: a sizeable transfer but not enough to turn around the periphery.

When the bailouts are viewed from this perspective little real money has flowed into the peripheral countries. When countries borrow at close to zero interest rates and lend to others at 5%, that's not aid. This is a game stacked in the lenders' favour.

Debt forgiveness

To emerge from the impasse, Europe's leaders should combine their demands for economic restructuring with significant debt forgiveness and pledges of large-scale aid and investment. This would cost real money but would allow the countries of the periphery to regain their footing with a sustainable debt backdrop. Private investment would flow to the region. That could avert many dire consequences.

Unfortunately, I am sceptical whether this will happen. In conversations with policy-makers from northern Europe, I hear that their country is 'at the limit of its generosity' and that the periphery 'must be made to suffer'. We can only hope that Merkel, probably continuing in power, can convince the Germans to do the right thing. We don't know whether she has the will and the ability to do this. The next century may depend on the outcome. ■

Michael Kaimakliotis is Head of Investments at Quantum Global Investment Management.

Taxation makes the difference

Merkel will stay – but it's still a watershed for Germany

Stefan Bielmeier, Advisory Board

Germany faces a political watershed – even though the chancellor since 2005, Angela Merkel, is widely predicted to remain in power. The weight of expectations on Germany is such that the elections on 22 September are being followed with bated breath well beyond the country's borders.

Whether we see a continuation of the centre-right coalition or a new Grand Coalition between the Christian and Social Democrats depends on the perennial question of whether Merkel's junior partner, the liberal Free Democrats, manages to scrape beyond the 5% of votes needed to re-enter parliament.

European issues, although much followed abroad, are not the main questions in the campaign.

Financial market regulation, the shape of the reform process and distribution of the burden across the individual countries are important subjects, but they do not decide elections.

Clear differences

On the euro and the sovereign debt crisis, there are clear differences between the main parties. The opposition Social Democrats (SDP) and Greens call for a European Debt Redemption Pact that envisages a common administration for at least part of crisis countries' debt burden.

Merkel's Christian Democrats call for debt rescheduling for countries with excessive debt, while the Free Democrats (FDP), favour a European sovereign insolvency decree.

The far Left Linke party adopts an extreme position and wants the European Central Bank to shoulder all the debt.

On domestic economic policy, the debate revolves around tax policy and redistribution. Germany is in a very comfortable revenue position, yet the campaign has hinged so far on the issue of tax increases.

In 2012 tax receipts by federal and state governments and local authorities totalled €600bn, a new record. The figure was up almost 5% on 2011, while the nominal increase in economic output was only 2%. The overall tax rate rose to 22.7%, the highest since the 2008 crisis.

Angela Merkel, German chancellor, in campaigning mode

The opposition parties emphasise a possible rise in the top rate for income tax rate for redistributional reasons. The Social Democrats, Greens and Linke parties advocate reintroduction of a wealth tax and an increase in inheritance tax.

Controversial issues

Other controversial issues are withholding tax on capital gains and the retention of the policy of splitting differences in spousal incomes. All parties with the exception of the liberal FDP favour a financial transaction tax.

According to calculations by the economic research group Institut der deutschen Wirtschaft, aligned with German industry, the parties' proposals for fiscal policy would result in widely different outcomes.

The Christian Democrats' and their allies' plans would result in taxpayers paying up to €100m less.

The SPD and Greens would bring a €18-20bn higher bill, while the Linke manifesto would raise taxes by €100bn. There are also redistribution plans in social security insurance and pensions.

Almost all parties propose different forms of stronger financial market regulation. Only the FDP opposes separating investment banking from commercial banking.

Stock market outcomes

The stock market is not likely to be greatly affected by the outcome of the elections. However, a change of government could potentially have a negative impact on property companies, utilities and financial service providers.

A minority SPD-Green coalition government supported by the Linke would lead to substantial stock market losses – and this could easily reverberate around the continent. But on balance such an outcome appears highly unlikely. ■

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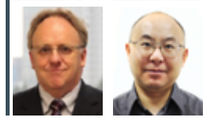

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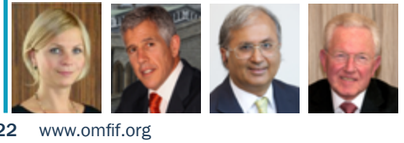

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Daniel Titelman, Economic Commission for Latin America and the Caribbean
Linda Yueh, BBC
Peter Walton, ESSEC Business School

PUBLIC POLICY

Frits Bolkestein, formerly European Commission
Laurens Jan Brinkhorst, University of Leiden
Octavio Canuto, World Bank
John Chown, Institute for Fiscal Studies
Neil Courtis, Sensible Media
Natalie Dempster, World Gold Council

Willem van Hasselt, Netherlands Ministry of Foreign Affairs
Peter Heap, formerly British Embassy
Akinari Horii, formerly Bank of Japan
Paul Judge, Schroder Income Growth Fund
Sahoko Kaji, Keio University
John Kornblum, former US Ambassador to Germany

Norman Lamont, House of Lords
Ruud Lubbers, former Dutch Prime Minister
Bo Lundgren, formerly Swedish National Debt Office
Denis MacShane, former British Minister for Europe
Luiz Eduardo Melin, Brazilian Development Bank
Philip Middleton, Ernst and Young

Murade Miguigy Murargy, Community of Portuguese Speaking Countries
Winston Moore, Moore Asociados
Athanasios Orphanides, formerly Central Bank of Cyprus
David Owen, House of Lords
Jukka Pihlman, Standard Chartered Bank
Poul Nyrup Rasmussen, former Danish Prime Minister

Nasser Saidi, formerly Bank of Lebanon
Paul van Seters, Tilburg University
Christopher Tugendhat, House of Lords
Paul Wilson, De La Rue

ECONOMICS & INDUSTRY

Katinka Barysch, Allianz
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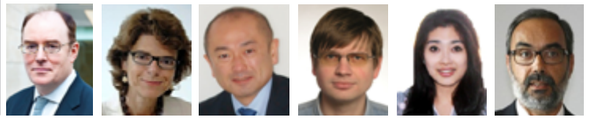
Paul Boyle, formerly Financial Reporting Council
Albert Bressand, European Commission
Efraim Chalamish, New York University
Shiyin Cai, Dialogue in the Dark

Vladimir Dlouhy, former Czech Industry Minister
Hans-Olaf Henkel, University of Mannheim
Hemraz Jankee, formerly Central Bank of Mauritius
David Kihangire, formerly Bank of Uganda
Robert Koehler, SGL Carbon
Pawel Kowalewski, Deutsche Bundesbank



Gerard Lyons, Greater London Authority
Vicky Pryce, formerly UK Department for Business
Takuji Tanaka, Network Corporation of Japan
Vilem Semerak, Charles University, Prague
Song Shanshan, SDIC CGOG Futures
Jorge Vasconcelos, New Energy Solutions

German consumers leading Europe

Export worries, Syrian unrest damp improved mood

Michael Holstein, DZ BANK

DZ Bank Economic Forecast Table				
GDP change (%)				
	2011	2012	2013	2014
US	1.8	2.8	1.7	3.0
Japan	-0.6	2.0	1.9	1.9
China	9.3	7.8	7.5	7.9
Euro area	1.5	-0.5	-0.4	1.2
Germany	3.3	0.7	0.6	2.0
France	2.0	0.0	0.2	1.0
Italy	0.5	-2.4	-1.5	0.5
Spain	0.4	-1.4	-1.6	1.0
UK	1.1	0.2	1.0	1.6
Addendum				
Asia excl. Japan	7.6	5.8	5.9	6.6
World	3.8	3.0	2.7	3.7
Consumer prices (% y/y)				
US	3.2	2.1	1.6	2.2
Japan	-0.3	0.0	-0.2	1.5
China	5.4	2.7	2.7	3.7
Euro area	2.7	2.5	1.7	1.9
Germany	2.5	2.1	1.7	2.1
France	2.3	2.2	1.3	1.6
Italy	2.9	3.3	1.7	2.1
Spain	3.1	2.4	1.9	1.5
UK	4.5	2.8	2.6	2.5
Current account balance (% of GDP)				
US	-2.9	-2.7	-2.7	-2.8
Japan	2.0	1.0	1.1	1.5
China	1.9	2.3	2.3	2.3
Euro area	0.2	1.2	1.9	2.0
Germany	6.2	7.0	6.5	5.5
France	-1.7	-2.2	-1.7	-1.8
Italy	-3.1	-0.5	0.9	1.1
Spain	-3.7	-1.1	1.0	2.0
UK	-1.5	-3.8	-2.8	-3.0

Fears of a military strike against Syria by the US and its allies have greatly increased capital market volatility. The yields on German Bunds have fallen back somewhat after their post-May surge. At the same time, crude oil prices have leapt higher and gold has been trading at its highest level in four months.

With luck, the Syrian crisis may not depress the markets for long. However, economic prospects for the industrialised countries were already looking only lukewarm for the rest of the year, while the new turbulence in emerging markets has added a new cause for concern. The new factor of Syrian unrest provides a further dampening influence.

Upward pressure on the oil price should prove only temporary, since Syria is not an oil producer and the Gulf states have plenty of spare capacity.

In the meantime, the outlook for the euro area has brightened. The DZ Bank 'Euro-Indicator' has been signalling the end of the bloc's recession for several months. The data for the second quarter have confirmed the trend. The economy has improved in the core economies of Germany and France during the spring, and the recovery is on the horizon in the crisis countries as well.

The German economy moved out of its slowdown and developed encouraging momentum in the spring. Gross domestic product expanded by 0.7% in the second quarter after stagnating at the beginning of 2013.

Germany's domestic demand is recovering. The signs are that the economy will continue to rally in the second half of the year. Corporate sentiment indicators such as the Ifo index have been positive in recent months, and firms are more confident again about business prospects. Surveys show more optimism among private households.

Germany's relatively good employment situation and rising incomes create a supportive environment for consumption. The foreign trade outlook remains cloudy in view of uncertainties in Europe and the emerging markets. But the strong domestic economy has led us to adjust our economic forecast for Germany slightly. GDP growth this year is expected at 0.6% (instead of 0.4%), but the forecast for 2014 was cut slightly from 2.2% to 2.0%. ■

Michael Holstein is Head of Macroeconomics at DZ BANK. Produced in association with DZ Bank Group, a partner and supporter of OMFIF.

Weidmann hits at sovereign bond purchases

Shortly before the German elections, and with a credible anti-euro party competing for the first time, the utterances of the Bundesbank president take on more than usual weight. In a well-received address to Germany's foreign ambassadors in Berlin on 26 August, Jens Weidmann appeared to be arming himself and the Bundesbank for post-electoral tussles over the European Central Bank's deterrent policy of sovereign bond purchases. Weidmann's polite but firm message was that he didn't think that was a very good idea. His remarks may prove apposite if the German Constitutional Court, in a ruling that will probably come in October, decides that potential ECB bond purchases infringe German law.

Bundesbank president Jens Weidmann

Weidmann criticised with unusual firmness the Basel Committee on Banking Supervision for its ruling before the euro was introduced that government bonds be valued as risk-free assets, which meant that banks did not have to back them with capital. 'Sovereign insolvency became less credible for reasons of financial stability,' he complained. ■

Turkey retreating from model status

Gezi Park protests, Fed changes worry investors

Aslihan Gedik, Advisory Board

Turkey's Gezi Park demonstrations in June, which have since evolved into wider anti-government unrest, come after a decade of widespread macroeconomic transformation.

The country has lowered inflation, strengthened the banking sector, and improved the profile of public debt. Turkey's currency and local bond markets are among the largest and most liquid among emerging market economies.

This has had a favourable impact on foreign investors. But now, amid general signs of turbulence in emerging markets, and uncertainty over a slackening of the Federal Reserve's bond purchasing programme, Turkey seems to be retreating from its model status. International investors have borne losses on their Turkish assets – and are pondering what will happen next.

Investment grade rating

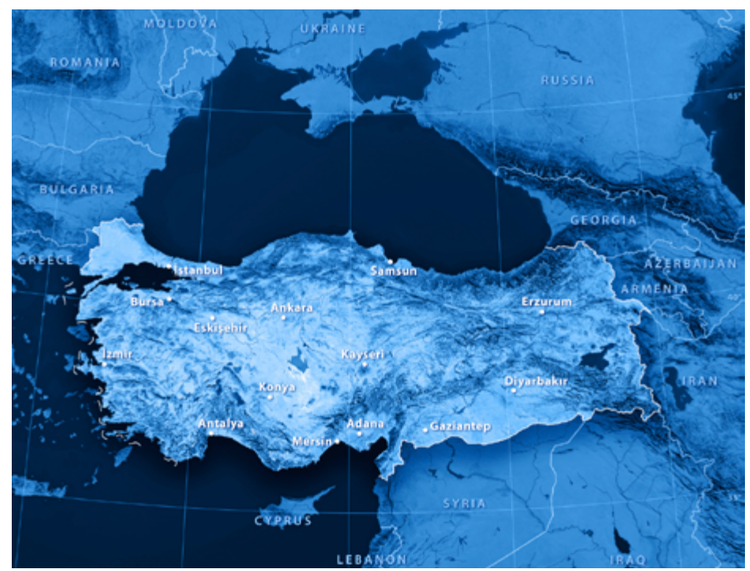
Rating agencies have been part of the more positive picture. Moody's raised Turkey to investment grade with a stable outlook in May. This followed Fitch's decision to give the country its first investment grade rating last November. Turkey has become more attractive to a wider field of investors and Istanbul has boosted its credentials as an international financial centre.

Recent escalation has increased Turkey's economic and political risks. Moody's has warned about a ratings deterioration if protests continue. The intensification of the demonstrations and the harsh rhetoric of Recep Tayyip Erdoğan, the prime minister, caused tensions on credit and foreign exchange markets.

The Central Bank of the Republic of Turkey (CBRT) intervened to support the lira and sold more than $6.5bn since 11 June to defend the currency, which tumbled to a record low against the dollar of 1.9740 on 8 July. It has since recovered only marginally to $1.95.

Central bank governor Erdem Başçı revised his year-end inflation forecast to 6.2% from an unrealistic 5.3%, citing lira fluctuations and rising energy import costs, with higher prices of food and oil a particular problem.

The CBRT's monetary policy committee raised its overnight lending rate by 75 basis points, from 6.5% to 7.25%, representing a step towards addressing market concerns. It followed this up on 20 August with another 50 basis points increase. However, the central bank left the one-week repurchase (repo) lending rate unchanged at 4.5% and the overnight borrowing rate at 3.5%.



The CBRT's key message is that inflation and financial stability risks – as well as recent reserve losses – necessitate some monetary tightening, but that underlying pressures do not justify a more aggressive move.

The CBRT is shifting towards greater reliance on interest rates rather than direct foreign exchange intervention to protect the lira, announcing that on days of market stress it will not intervene on the foreign exchange markets but will stop providing funds to banks via repo, raising the cost of bank funding.

The most obvious risk is that Turkey becomes caught up in further generalised emerging market outflows. According to latest figures, the capital outflow from Turkish markets reached $16bn between 24 May and 14 June. Inflation climbed to 8.9% in July, with expectations for greater volatility in the future.

Asset price recovery

For a recovery in Turkish asset prices, the country will have to improve its current account deficit, and introduce positive real interest rates at the short end of the yield curve. The best hope is that the CBRT's measures, a slowdown in the pace of outflows from emerging markets and stabilisation of US Treasury yields will bring some respite.

New negotiations on European Union accession are set to be opened in October, which may bring some relief.

But, for market participants, greater volatility may become a fact of life. If this continues, Turkey will see the recent upsurge in its geopolitical and financial importance starting to peter out. ■

Aslihan Gedik is Division Head of Treasury and Financial Institutions at Oyak Anker Bank.

Ankara dreaming of higher growth

On crest of wave, the task is now to show sustainability

David Tonge, Advisory Board

Turkey has been riding the crest of a wave. Since the governing AK Party came to power a decade ago, GDP has grown by an average 4.9% per year.

Now, the government, keen to lift Turkey from its current position of the 17th or 18th largest economy in the world, is setting a 5.5% growth target for 2014-2018.

To most observers, such growth targets are hubris. The world and Turkey are rougher places than they were. To Turkey's south, Syria is falling apart, becoming a breeding ground for violence which both Al Qaida and Kurdish elements seek to exploit.

Prime Minister Recep Tayyip Erdoğan's support for the opposition there and in Iraq means the country now has bad relations with Baghdad and Tehran, just as its support for the Muslim Brotherhood has ruptured its relations with post-coup Cairo. It has long been in confrontation with Tel Aviv.

These regional anxieties cast their shadow at a time when the Federal Reserve is beginning to 'taper' its quantitative easing, scaling back its asset purchases and reducing this stimulus to world growth.

Another negative factor is that the euro area, so important for Turkey's foreign trade and investment relationships, shows little sign of ending its stagnation.

Further, at home, the Gezi Park events have shown the increasing polarisation of domestic politics – with the authorities' subsequent policies accentuating the divide. Television stations and newspapers damped down their coverage of opposition, with a number of journalists losing their jobs.

Freedom of expression

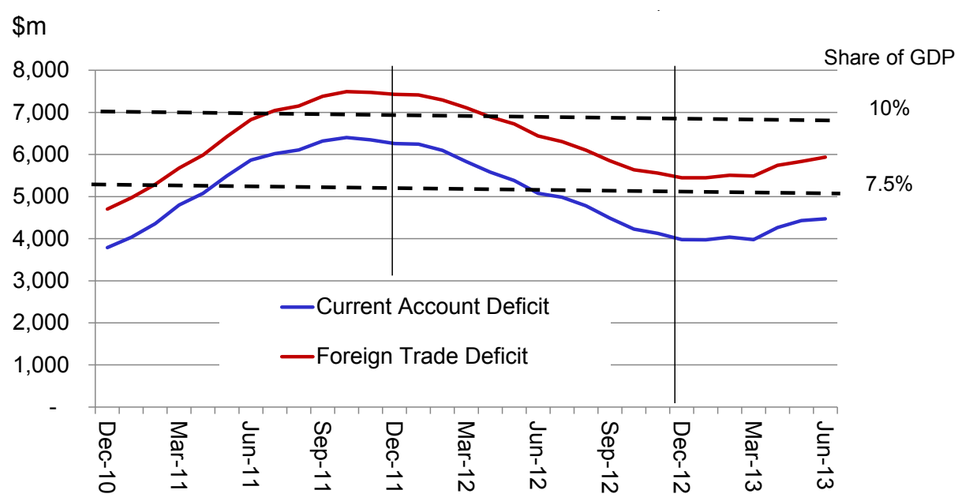
Freedom of expression is withering on the vine. Students who participated in the events are finding their scholarships terminated, and a popular soap opera, Leyla ile Mecnun, has been pulled, apparently because its stars supported the demonstrators.

Erdoğan has emphasised how his party won 46.7% of the votes in the June 2011 general elections and looks forward to a strong showing in the March 2014 local elections and general elections due by 2015. He also appears set to be elected by the General Assembly as President of the Republic in August 2014.

Less certain is whether this will be on the basis of the present Constitution or, as Erdoğan as sought, after pushing through amendments which would reinforce the powers of the President. To most observers, the Gezi Park events make these amendments less likely.

But all his plans depend on continuing to deliver economic growth – and here the challenge is to show that recent policies are sustainable.

Current account and foreign trade deficits, 2010-13
Monthly average of 12-months to date



Source: Turkish Treasury

For these policies involve living with inflation - in July 2013 consumer prices were 8.9% above a year earlier, almost double the 5% annual target – and running a current account deficit equivalent to 6-10% of GDP.

Dangers of deficits

Countries like Greece have shown the dangers of deficits of this order and the deficit is the key item worrying foreign analysts. In the twelve months to June 2013, the trade deficit averaged 8.9% of GDP and the current account deficit 6.7% — and both were on the rise.

The Turkish authorities believe the trade deficit is under control. But studies by the International Monetary Fund (IMF) last autumn concluded that the trade deficit reflected the Turkish lira being overvalued by 10-20%.

The IMF concluded that last year's falls in the current account deficit had been the result of cyclical changes, not of any structural improvement in the situation. (See IMF Staff Report for the Article IV Consultation, 31 October 2012 and Chart on left-hand side).

Turkish exports

Turkish exports have been affected by the slowdown in Europe and turmoil to its south, while the bill for energy imports remains high: these accounted for 25% of imports in 2012 and 21% in the first six months of 2013. Tourism revenues earned the country $11.7bn in the first six months of 2013, but there remained a current account deficit of $36bn in this period.

Such a deficit reflects a dramatic fall in the national savings rate. In the late 1990s, these savings had been equivalent to 25% of GDP. By 2012, the ratio had fallen to 14%.

Financing the current account deficit has long depended on foreign capital inflows. These are mainly short-term and represent a source of vulnerability.

Add in Turkey's short-term debt of around $160bn, and Turkey's annual external financing needs run at around $200bn.

Non-residents' investments

Also to be considered are the $200bn invested in stocks and bonds by non-residents.

Little wonder that in May 2013 when Moody's followed Fitch by raising Turkey's debt to investment grade, it also warned:

> 'Turkey has some of the highest external vulnerabilities — as measured by the current account deficit and the external vulnerability indicator (which measures short-term foreign debt obligations in the economy as a proportion of foreign exchange reserves) — within the investment-grade sovereign rating universe.' (See Moody's May 2013 Global Credit Research article below).

In this situation, the success of the economy – and Erdoğan's hopes for a sweeping re-election – depend largely on the country's monetary policy continuing to win the support of the international financial community. This appears to be a challenging task.

Since 2010, this monetary policy has been implemented in a way which commentators and analysts have referred to as unorthodox or experimental.

Inflation targeting

The IMF pointed to the dilemma in December 2012. It said:

> 'Instead of relying on one interest rate as inflation-targeting central banks usually do...the Central Bank of the Republic of Turkey (CBRT), in face of strong capital inflows attracted by high nominal interest rates, resorted to using a wide variety of instruments.' (Turkey: Selected Issues, December 2012, IMF Country Report 12/339).

These instruments included:

- The interest rate corridor, delineated by overnight borrowing and lending rates, within which the CBRT varies the price of liquidity it provides
- A set of repo facilities through which liquidity is injected
- Reserve requirement ratios that are differentiated by currency and maturity
- Regular and irregular FX auctions

From October 2010, with strong capital inflows, it lowered the overnight borrowing rate, tightened reserve requirements and introduced uncertainty in short-term market rates, aiming to deter speculative inflows.

However, in the IMF's view, these turned to be counter-productive in containing the current account deficit or combating inflationary pressure. In August 2011, the CBRT changed its policies lowered reserve requirements and stopped its regular FX auctions.

Since 5 January 2012, the framework has focused on varying daily the amount of liquidity provided via different facilities and thus the effective cost of funding.

The CBRT sees its monetary policy as an imaginative attempt to deal with the problem of volatile capital flows that besets many emerging markets.

The IMF considers that in 2011 this approach did not succeed in that the current account deficit widened and inflation accelerated.

Its view on 2012 is also questioning but as it writes: 'Ultimately, the success of a monetary policy framework is tied to its ability to achieve the inflation target.'

Which is why the CBRT, like the government, is now watching with particular concern the recent upward trend in inflation. ■

David Tonge is Managing Director of IBS Research & Consultancy, which assists direct investors in Turkey.

On the web:
See Moody's full May 2013 Global Credit Research article at www.moodys.com

Turkish prime minister Recep Tayyip Erdoğan

Opportunities for Brazil and its neighbours

'No longer a problem for the world, but world is problem for Latin America'

Banco Central do Brasil-OMFIF Report on the Main Meeting in Brasilia, 17-18 June 2013

At a time of renewed challenge facing the world economic and monetary scene, emerging market economies demonstrate an overall combination of relative economic buoyancy, stability and confidence. The Inaugural OMFIF Main Meeting in Latin America took place at Banco Central do Brasil in Brasilia on 17-18 June, on 'Latin America's place in the new international financial and monetary architecture.'

The main priority for Latin American countries must be to maintain healthy macroeconomic policies while taking steps as far as possible to resist external shocks that may stem from gradual removal of international monetary policy stimulus, particularly from the US.

The region has shown a relatively good performance after the transatlantic financial crisis of 2007-09, but continues to confront testing external circumstances. One participant summed up: 'Latin America is no longer a problem for the world, but the world is a problem for Latin America.'

Latin American economic policy cannot be separated from a problematic and uncertain international environment. Sub-optimal growth in advanced economies and the deleveraging and balance sheet repair processes in banks and households are taking their toll on Latin American growth, particularly through shocks from commodities.

Participants discussed gradual changes in the monetary system, in particular the rise of the renminbi and other emerging market currencies as important components of a new move towards multipolar international transactions and reserve holdings.

Latin America and the US recovery

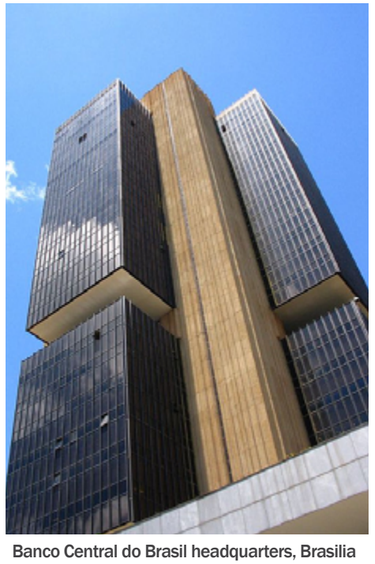
The most discussed issue was the prospect of a US recovery and gradual withdrawal of unconventional monetary policies, especially quantitative easing. The effects of tighter US monetary policy on liquidity and capital flows would have both positive and negative implications for emerging market economies.

These countries must cope with uncertainty in Europe and the difficult transition in China's economic model from an investment-led to a consumption-led economy, which may slow Chinese growth and its demand for resources.

There was some concern among participants over possible world-wide competitive currency depreciation — 'currency wars.'

This would be a still greater cause for concern if the prospective ending of US quantitative easing, coupled with its prolongation in Japan, led to sharp competitive movements in currencies with detrimental effects on emerging market economies. ■

Other forthcoming Main Meetings include: Central Bank of the Republic of Turkey in Ankara on 5-6 September 2013; Central Bank of Qatar in Doha on 27-28 November 2013; Deutsche Bundesbank in Frankfurt on 12-13 March 2014; and Federal Reserve Bank of St. Louis in St. Louis on 2-3 June 2014.



Banco Central do Brasil headquarters, Brasilia

On the web

See full details on the Brazil Main Meeting at www.omfif.org

Deeper, broader markets & infrastructure financing

Deeper and broader financial markets are a vital condition for financing necessary infrastructure and promoting higher-value economic development.

Better-functioning financial markets would buttress other large-scale objectives in a way that would lower the relative importance of commodities exports to distant countries. An example is a shift towards technologically advanced exports to neighbours.

Improvements in infrastructure were cited as essential for driving greater productivity, output and exports. However, average investment in this area in the last two decades was less than 2% of GDP. Governments alone cannot finance all infrastructure needs.

Regional and international insurance and pension funds, where assets are growing at double digit rates, are important potential sources of capital.

Favourable developments in some countries in the region were seen as helping stimulate longer-term investments.

Examples are the 'Novo Mercado' listing segment of the stock market and incentives to private equity in Brazil and the new financial instruments for infrastructure and capital investments (Fibras and Cecades) in Mexico.

Allied to this, central banks in the Southern Common Market (Mercosul) are making significant headway in spurring financial services integration and promoting regional payments systems.

Improvements in regional financial markets are an essential adjunct to other positive moves in Latin America, such as, the transition to higher growth rates since the 1990s, and other gains in integration. ■

Mexico eases oil sector constraints

Bold state oil company reform plan

Winston Moore, Advisory Board

Mexican President Enrique Peña Nieto has unveiled an ambitious plan to reform Petroleos Mexicanos (Pemex) the state oil company that exercised control without permitting national and international oil companies to operate in the sector following nationalisation of the oil industry and the creation of Pemex in 1938.

Included in the reform is the state-run power company Commission Federal de Electricidad (CFE). Pemex reform is considered the most significant economic reform since Mexico joined the North American Free Trade Agreement (NAFTA) in January 1994.

Pemex is no small fry. It is the 10th largest oil producer in the world, holding an estimated 115bn proven barrels of oil, generates $126bn in revenues a year and the profits handed over account for 30% of state income. Pemex employs 160,000 people, but is riddled with inefficiency and corruption.

In announcing the reform, Peña Nieto made it clear Pemex and CFE would not be sold or privatised and would remain wholly-owned Mexican public companies.

He declared the objective of the reform is to attract investment, create jobs, boost productivity, create greater market share, improve efficiency and profitability, promote scientific and technological development, and also lower electricity and natural gas prices for industry and consumers. Once implemented, the reform will prove a shot in the arm for the Mexican economy by boosting economic growth by at least 1% of GDP.

To implement the reform programme Peña Nieto submitted a bill to Congress to amend articles 27 and 28 of the Mexican Constitution. This will inject dynamism and modernise both companies by allowing private investors including international oil majors to participate in exploration and development projects under a proposed profit sharing scheme. Investors will be able to bank expected cash flow as balance sheet assets despite not being allowed to book any reserves that will remain property of the Mexican state.

President Peña Nieto is confident he will secure safe passage of the constitutional reforms, together with associated legalisation and regulations backed by his own centre-left Institutional Revolutionary Party (PRI) and the opposition centre-right National Action Party (PAN), which prepared its own proposal to further open up the oil industry to private investment and know-how.

The PAN has suggested the creation of a 'Fondo Petrolero' sovereign fund to administer hydrocarbons income and ensure it is not used by the state for current expenditure. Clarity on how the proposed reform moves forward will only emerge once the enabling legalisation is completed following approval of the constitutional amendments.

This is a bold initiative for the PRI to undertake as it is an institution in its own right. The PRI is not only the direct heir of the 1917 Mexican revolution, President Lázaro Cardenas also nationalised the oil industry, taking over 17 foreign-owned companies in 1938. Pemex is considered a national treasure with nationalisation of the oil industry deeply imprinted in the Mexican psyche, commemorated in schools and civic events.

In unveiling the Pemex reform programme, Peña Nieto ably took this into account, recovering the legacy of Lázaro Cardenas, but also qualifying that the reforms introduced to the oil industry in 1960 distorted the original purpose of nationalisation and damaged the sector and country by banning private companies from entering into development contracts although oil industry service providers were allowed.

Debate over the Pemex reforms is now focused on Congress and the 'Pact for Mexico' that Peña Nieto unveiled in December 2012 to establish a forum for political consensus by inviting all political parties unite for the good of the country. Having secured the support of the PAN, opposition to constitutional reform is expected to come from the centre-left Party of the Democratic Revolution (PRD) led by Cuauhtémoc Cardenas, the son of President Cardenas who nationalised the oil industry 75 years ago and keen to safeguard that legacy.

Andrés Manuel López Obrador a former left wing Presidential candidate who heads the National Council of the Movement of National Regeneration (Morena) has in turn called for mass rallies and demonstrations to oppose the Pemex reform programme.

Pemex produces 2.6m barrels of oil per day (mbpd) and exports 1.3 mbpd, but needs to ramp up production to return to the 3.5 bpd output enjoyed in 2004. Mexico risks becoming a net importer of oil by 2020 unless the Pemex reform programme is implemented.

To achieve this it needs to invest $900bn to develop deep-water crude reserves in the Gulf of Mexico estimated to hold 27bn barrels. Mexico has important shale gas prospects along the Gulf coast border with the US.

Although it is the second biggest supplier of crude to the US, sales have dropped by 13% in the last decade. Mexico is also a net importer of natural gas piped in from the US as well as liquefied natural gas shipped in from Perú, Qatar and Nigeria. ■

Dr. Winston Moore is Director of Moore Asociados.

Meeting the challenge of Mexican offshore oil

Tasks for Asian leadership

Challenges for integration on bond markets and beyond

OMFIF Report on LKY-OMFIF Expert Seminar in Singapore, 12 July 2013

Participants at the Singapore forum between the Lee Kuan Yew School of Public Policy and OMFIF discussed the shift in the balance of economic power, likely to continue over the long term.

By 2060, the combined national incomes of India and China will be larger than all 34 members of the Organisation for Economic Co-operation and Development (OECD).

Asian central banks have played a crucial role in macroeconomic stabilisation and safeguarding the health of the banking system. They have used an enhanced policy toolkit, using instruments such as macroprudential measures and policies to support trade finance and programmes for small and medium enterprises.

Asian economies remain resilient in various areas: liquidity remains ample, with sufficient international reserves cushions and strong regional demand. The banking system reforms following the Asian financial crisis have kept Asian economics strong during the global financial crisis.

International policy coordination

Policy coordination has increased since the onset of the global crisis, but national policy-making is still carried out with little regard for points of global interdependence and spillovers – a problem particularly exhibited by the European Union (EU), the US, China and Japan.

China is still in the process of rebalancing, by allowing consumption to grow faster than GDP, focusing on lowering its balance of payments surplus and other largely domestic problems. Japanese Abenomics represent frustration with past economic performance, with looming questions over the long-term sustainability of these policies.

Inward-oriented approaches

According to some participants, the excessively inward-oriented approaches of these four areas perpetuate a low level of coordination, with the underlying argument that global economic problems call for global solutions – especially in global public goods and areas with large spillover effects.

Regional bodies may act as intermediaries in this initiative. A rising level of collaboration and trust among Asian central bankers is visible through initiatives such as The Association of Southeast Asian Nations (ASEAN), ASEAN+3, and the Executives' Meeting of East Asia-Pacific Central Banks.

Further initiatives to deepen collaboration are evidenced by the Chiang Mai Initiative and the Asian Bond Fund – phases one and two.

Asia is currently facing a set of risks, such as the susceptibility of financial markets to threats of unwinding monetary policies (easy money) in advanced economies, especially the US. Forward guidance, and the way in which it will unfold, remains crucial.

The challenge is ensuring continued growth in Asia. With a stagnant labour force and falling investment, growth in Asia must come from total factor productivity growth, which may be achieved if labour is consistently upgraded.

While it is difficult to develop capital and bond markets in Asia, capital markets are needed to reduce dependence on the dollar.

There are a set of challenges for Asian bond markets: the depth and liquidity of domestic debt capital markets are still low; large markets are closed to foreign investors and issuers (China and India); other markets have not consolidated or standardised to achieve scale; emerging market Asian assets are still a small percentage of global investment portfolios; and emerging market Asian local bond markets have lagged behind local equity markets.

While bank finance is still dominant, bond markets are not yet an effective alternative and both the financial infrastructure and legal framework must be developed.

Participants discussed the need for a deeper debt capital market. Problems include the existence of a savings and investments mismatch, with loan to deposit ratios below 100% in many Asian countries.

With an ageing population, there is a further need for lower risk investment for pension funds (e.g. bond markets).

Concerns over liquidity loom larger, with lenders unwilling to lend for more than two to three years, rendering infrastructure financing unattractive.
Regulatory and political risks in emerging market economies also create the need to incentivise investment in debt capital markets. ■

Changyong Rhee, Tharman Shanmugaratnam, Kishore Mahbubani and Niels Thygesen

On the web
See full details on the LKY-OMFIF forum at www.omfif.org

Grappling with global governance

Gaps must be filled in Asia-Pacific

Alan Bollard, Executive Director, Asia-Pacific Economic Cooperation Secretariat

We have learned to worry about international governance wherever there are synergies — good things that will only happen if economies group together — or threatened spillovers — where bad things can infect other economies. The world of economic policy has always been full of such issues. The more we globalise, the more acute they become.

In the eyes of post-war diplomats, Bretton Woods was to provide the original architecture to deal with this. But the Bretton Woods institutions are showing their age. This is clear in the problems the World Trade Organisation has had in trying to conclude the Doha Round: the big developed economies and the big developing economies are now all sitting around the same table, but they have not agreed on continuing traditional trade liberalisation.

Instead we see a huge array of overlapping bilateral and regional trade agreements varying in quality and scope.

Governance structure

The current mega-negotiations of the Trans-Pacific Partnership, the Transatlantic Trade and Investment Partnership and Regional Comprehensive Partnership may change the entire governance structure, but it is still too early to draw conclusions.

At the same time, the Asia-Pacific Economic Cooperation (APEC) continues with the approach of liberalising trade and investment on more pragmatic lines.

A few years ago, the markets had been worried that the recession might have sparked off renewed trade or capital protectionism, but for the most part this has not happened. However, the global financial crisis has set off its own set of governance problems around economic and financial issues.

During the east Asia and emerging market crises a decade and a half ago, the International Monetary Fund (IMF) played a lead role in restructuring and refinancing.

This time it has proved harder, partly owing to difficulties the IMF faces in reforming its own governance. The financial crisis has sparked off serious governance reforms around the regulation of banking and finance. The Bank for International Settlements, the Basel Committee on Bank Supervision, the Financial Stability Board and the G20 have played a role. Yet problems remain with coverage, legitimacy, duplication and extra-territoriality.

The IMF and these other international bodies have found it very difficult to have serious discussions and influence on the vexed question of capital and exchange rate movements. For a variety of reasons, monetary policy continues to be applied on a unilateral basis. With four large economies engaged in quantitative easing, it has been very difficult to deal with the consequent spillovers on to capital accounts, distortions to asset prices and exchange rates in third countries.

The withdrawal from quantitative easing should mark a return to a 'new normal', but getting there will not be straightforward. We may need to confront a new generation of governance problems, as developed APEC economies rebalance and developing ones move towards middle-income status.

We are already seeing issues around cross-border tax, trade in illegal products, cross-border environmental issues, the need for food and other product certification, and people movement issues – be they businesspeople, emergency workers, tourists, migrants, or criminals. These are all technically and politically complex matters.

The APEC approach has been to establish voluntary pathfinder projects through a number of working groups focused on harmonising standards and improving the regulatory balance in these areas. Intelligent models of governance are required to ensure the improvement of Asia-Pacific prosperity. Some of those are already in place, but there are still big gaps that need to be filled. ■

Dr. Alan Bollard is the Executive Director of the APEC Secretariat.

Intelligent models of governance are required to ensure the improvement of Asia-Pacific prosperity. Some of those are already in place, but there are still big gaps that need to be filled.

The renminbi and the rupee

Internationalisation and integration of Asian capital markets

G Padmanabhan, Reserve Bank of India

The global financial crisis and its aftermath have renewed debates on the functioning of the international monetary system. Questions are being asked anew about the need for a multi-currency system, and whether there is a viable alternative to the dollar. These debates coincide with Chinese authorities taking measures to bring about greater internationalisation of the renminbi.

The financial system is still dominated by the dollar, followed by a few other advanced economy currencies at the margin. In contrast, emerging market currencies are hardly used for international transactions, though these economies are increasingly integrating in the global economy and contributing to global growth, trade and financial flows.

According to a Bank for International Settlements (BIS) paper last year, there has been significant progress in achieving greater regional financial integration in the Asian equity and bond markets.

The extent of integration, however, still appears to be limited. The process has stalled in recent years, and the two major regional blocs – mature and emerging markets – have different degrees of integration. According to another BIS study, there has been de facto integration in Asia, but it is above all Sino-centric, involving bilateral trade between China and other Asian countries.

Integration of Indian financial markets

Indian financial markets are increasingly integrating with global financial markets, reflected in the increasing volatility in Indian financial markets, resulting from fluctuations in international markets.

The rupee has come under pressure, primarily due to external factors. Equity and bond prices witnessed volatility due to global factors, such as deleveraging by foreign institutional investors, on fears of impending winding up of the Fed's quantitative easing.

In the Indian context, integration of financial markets has largely been facilitated by various measures in the form of: (i) free pricing; (ii) the widening of participation base in markets; (iii) the introduction of new instruments and; (iv) improvements in payment and settlement infrastructure.

Free pricing in the form of the market-determined exchange rate, freeing of interest rates, gradual liberalisation of the capital account, and so forth, helped in greater Indian financial market integration.

The advent of institutional investors with access to domestic and international markets has had a profound impact on domestic financial markets. The link between the domestic foreign exchange market and the overseas markets (vertical integration) was facilitated by allowing banks and authorised dealers to borrow and invest funds abroad (subject to certain limits), and to lend in foreign currency to companies in India.

This supplements allowing Indian companies to raise resources from abroad, through American/global depository receipts, foreign currency convertible bonds and external commercial borrowings.

New instruments

Several new instruments were introduced, particularly derivative products, which facilitated the deepening of markets and enabled participants to hedge currency and interest rate risks.

A number of institutional measures and improvements in technology and payment and settlement infrastructure have significantly strengthened the financial sector market infrastructure.

These include the introduction of delivery versus payment, real time gross settlement systems, the electronic trading system at the exchanges, as well as the government securities order matching platform, which christened the negotiated dealing system order matching segment (NDS-OM).

New RBI governor Raghuram Rajan

Reform chance for new Indian governor

Raghuram Rajan, the new governor of the Reserve Bank of India, can turn the crisis engendered by the rupee's fall into an opportunity to reform the objectives and the instruments of Indian monetary policy, *writes Ila Patnaik in New Delhi*.

A Government of India committee, the Financial Sector Legislative Reforms Commission, has suggested that the RBI Act of 1934 be replaced with a new law. Anchoring expectations on inflation would require narrowing policy objectives and bringing financial sector reforms that can strengthen the weak transmission mechanism of monetary policy.

The rupee has fallen sharply. Reforms that have been delayed in the past are now manifestly necessary. There are structural reasons behind the rupee's fall that go beyond weak GDP and the large current account deficit.

After the 2008 crisis the currency was largely allowed to float, but the move from a pegged exchange rate was not accompanied by a well-defined nominal anchor that could guide price expectations. All these factors increase the sense of crisis – but monetary reforms may now rise higher up the policy agenda than would otherwise be the case. Rajan has the chance to show his mettle. ■

Internationalisation of Asian currencies

China's rapid economic growth and its increasing economic integration with the world have accelerated the progress of Chinese currency's internationalisation. At present, the renminbi is neither a store of value nor an anchor.

However, within limits, China's endeavour to internationalise the renminbi has begun. Some progress is visible in transactions with its trading partners, such as Vietnam, Laos, Myanmar, the central Asian states and Russia.

For capital transactions, China has promulgated provisional rules governing the issuance of renminbi-denominated bonds by international development institutions. China has permitted renminbi invoicing for trade with mainland China.

Chinese foreign exchange reserves

With regard to its management of foreign exchange reserves, the People's Bank of China (PBoC) has entered into a series of bilateral currency swap agreements with over 20 central banks.

The Chinese authorities have taken a number of steps to develop an offshore market for the renminbi. Comparisons are inevitable between the renminbi and Indian rupee on the issue of internationalisation. The rupee is not fully convertible at this stage.

While the current account has been made fully convertible, the Reserve Bank of India has followed a calibrated approach to capital account convertibility. Unlike China, which runs large current account surpluses, India has generally been a current account deficit country. Therefore, the exchange rate of the rupee is susceptible to the debilitating influence of large capital movements, especially during crisis periods.

Our accumulated reserves are in a sense borrowed reserves and not earned reserves. The country still aspires towards an international currency, with increasing global integration through trade and investment channels.

The Reserve Bank of India has taken several measures to promote rupee invoicing for trade-related transactions. The path to the internationalisation of Asian currencies is influenced by several factors. Empirical evidence suggests that, despite some progress, the integration of Asian equity and debt markets is still incomplete, and the level of integration is divergent.

China has been making definite moves, but there is hardly any integration in the rest of Asia. However, spillovers from international markets are increasingly felt in other Asian markets, including India, indicative of growing integration of Asia with global markets.

Apart from local factors such as credit or liquidity risks in some Asian economies, the divergence and lack of progress in financial market integration can be attributed to the failure to harmonise standards in the regions' capital markets, among other factors.

Currency internationalisation, which entails market liberalisation, requires putting in place regional credit guarantee institution, hedging facilities, and regional credit rating agencies to foster cross-border investments.

This must be accompanied by the harmonisation of legal and regulatory systems, market practices, rating standards, accounting and auditing practices, and withholding taxes on bond coupon payments across countries in the region.

Greater internationalisation of Asian currencies requires well-developed and deep foreign exchange markets with diversified foreign exchange hedging instruments, thereby facilitating the issues of foreign bonds in domestic markets and local currency bonds by foreign entities. Such preconditions are not fully met in the region.

No single market

The ASEAN countries are nowhere near forming a single market as in the European Union. There have been proposals regarding establishing an Asian Monetary Union and a single regional currency, but implementation is still far off.

Full-fledged integration in the region will require the creation of a supranational institution on the lines of EU, but this is far-fetched at the moment.

The lessons from the unpleasant experience of European monetary integration will weigh on the minds of Asian policy-makers. In any case, the greater integration and internationalisation of Asian currencies would require an agreement between the participating countries to be bound by collective decisions rather than bilateral ones.

Most Asian countries are more individually linked to the global economy than to the regional economy. Financial market integration is, however, important to the region's economic development. The slow pace and varying degrees of integration in the region warrant concerted policy actions to surmount the constraints.

Asian countries have shown their political support for greater financial cooperation and integration. There is certainly scope for channelling regional savings into the region, for instance, for investments in infrastructure. However, obstacles need to be addressed in areas such as differences in economic structure and development, and maturity of individual markets.

Coordinated strategy

The question remains whether a coordinated strategy for promoting the integration of Asian financial markets can be achieved. This would be a great step facilitating the internationalisation of Asian currencies.

For this to be accomplished, we must acknowledge that internationalisation requires overcoming the problems of unfettered integration with global markets. In such cases, local fundamentals recede to the background and global factors start playing a major role in creating unwarranted volatility, as recent developments have amply demonstrated.

India has approached this issue the same way as the country approached capital account convertibility – as a process rather than as a definite step. A gradual approach is required rather than a big bang. India, like other countries, must adapt its policy in line with its individual strategic intents and interests. ■

G Padmanabhan is Executive Director at the Reserve Bank of India.

Ila Patnaik, member of the Advisory Board, is Professor at the National Institute of Public Finance and Policy.

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

Progress on Asia internationalisation

Renminbi on way to reserve status before full convertibility

Jukka Pihlman, Standard Chartered Bank

Just after the 10-year anniversary of the launch of the Executives' Meeting of East Asia Pacific Central Banks (EMEAP) Asian Bond Fund (ABF) initiative, the participants of the Lee Kuan Yew (LKY) School of Public Policy and OMFIF Forum agreed on the scale of Asian capital market developments since then. However, these markets still have some way to go to become truly internationalised.

Most of the discussions centred on the renminbi, but views on the speed of internationalisation and process towards reserve currency status ranged from European-American caution to Asian optimism. In this context, the participants discussed the importance of Asian currencies being added to central bank portfolios.

Functioning capital markets

Asian central banks and international financial institutions have long understood the importance of functioning capital markets. This is important for economic growth, through channelling domestic and international savings into productive investments and closing financing gaps for infrastructure, housing, small and large companies. It is helpful for stability, by improving risk management, managing the effects of crises and absorbing capital flows. And it assists efficiency, by determining a fair price for capital across tenors and risk profiles.

It was in that spirit that the EMEAP, in collaboration with international financial institutions, launched the first phase of the Asian Bond Fund (ABF1) in June 2003. The purpose was to promote bond market development in the region, by channelling some EMEAP central banks' foreign reserves back into the region.

Building on the success of the ABF1, EMEAP launched the second phase, ABF2, in December 2004. ABF2 expanded the investments from dollar-denominated bonds to domestic currency bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP members.

Forum participants cited these initiatives as successful examples of collaboration among central banks with significant impact on development of capital markets.

This has been confirmed in a Bank for International Settlements paper in 2011, reviewing the ABF2 initiative. This concluded that liquidity in the eight government bond markets had improved considerably in most countries.

Expansion of bond issuance (both in frequency of issuance and in size of individual issues) and consolidation in a few benchmark maturities resulted in increasingly reliable yield curves.

The size of Emerging Asia's local currency bond markets has grown more than fivefold in the past decade according to Asian Development Bank (see Chart 1).

Participants conceded that work remained to be done. Market depth and levels of liquidity could still be improved by the development of more active secondary and repo markets making exchange rates more flexible, as well as a further opening up of the markets to non-resident investors.

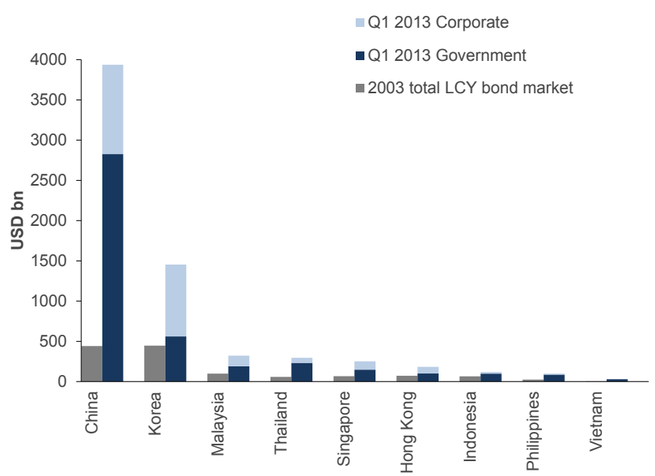
While still low compared to most advanced markets, the share of foreign ownership in the EM Asia local currency government bond markets has grown substantially, from less than 3% of the total in 2004 to more than 10% in 2012. Notably, foreign holdings made up around a third of Indonesian and 47% of Malaysian government securities by Q1 2013 (see Chart 2).

A particular focus of the discussion was on central bank investment into Asian local currency markets. In the past few years, the growth in non-resident ownership has increasingly been driven by central banks. This has reflected positive developments in emerging market countries' credit quality and on capital markets in general.

Additionally, the prolonged low yield environment and continued question marks over traditional reserve currency markets have increased the appeal of emerging markets.

Further factors have been macroeconomic questions such as trade linkages to emerging markets and the tendency of strategic investors to find assurance in the increasing numbers of other central banks investing in emerging markets.

Chart 1: The size of the EM Asia local currency markets 2003-13



Source: ADB and various central banks

This has been especially true for central banks investing in renminbi. This has been so strong that it can be called 'renminbi fever'.

About a dozen central banks, largely from Asia, have publicly announced investments in renminbi. Through Standard Chartered's work with central banks around the world, we know of over 30 central banks investing in renminbi, onshore and/or offshore, and several others are preparing to invest.

Africa and South America are the continents outside Asia where the desire for renminbi investments appears highest. Central banks in North America and Europe are much more cautious, with only Austria and Norway publicly announcing renminbi investments.

Central banks' investments in other Asian local currency markets have thus far been largely limited to Asian central banks buying each others' currencies. The exceptions are the Korean won and the Singapore dollar.

Opening ceremony

The publicly known investors in these latter markets include Banco Central de Chile, Norges Bank, and Swiss National Bank, which held an opening ceremony for its Singapore branch a day before the LKY-OMFIF forum.

Norges Bank opened its Singapore office in 2010 to supplement its Shanghai office to cover increased operations in Asia. We know of several other central banks either already investing or about to invest in these markets. Public data on central banks' investment amounts in Asian local currency markets are scarce, but participants agreed that, despite unprecedented interest, these investments are still very small, probably less than 1-2% share of global reserves.

Jitters over Fed

Forum participants agreed that central banks are likely to continue diversification. This is despite jitters caused by the Fed's potential tapering of quantitative easing and the prospect of the low interest rate environment coming to end.

The trend is structural and largely reflects the increased importance of emerging markets in the global economy. This is especially true for China, already the world's largest exporter, which is expected to overtake the US as the world's largest economy in coming years.

Renminbi's reserve currency status

The renminbi's progress to reserve currency status was seen as not a matter of 'if' but 'when'. But there is a divide in the views of participants from different parts of the world.

While not perfectly analogous, this divide can been seen in the differences in the diversification to 'other currencies' in the IMF's COFER data on foreign exchange reserve diversification. The emerging market countries' share of reserves in 'other currencies' increased by almost 400% since 2003, whereas advanced economies' share grew only by slightly over 200%.

China's current account is already practically fully convertible. The Chinese authorities' gradual liberalisation of the capital account is making the renminbi increasingly international. According to Standard Chartered's Renminbi Globalisation Index, (see OMFIF Bulletin, January 2013), the renminbi is now more than 10 times as internationalised as it was in January 2011.

The offshore renminbi market is fully convertible with no restrictions for investors. For the onshore renminbi markets, the Chinese authorities have given central banks and other sovereign investors preferential treatment in the Qualified Foreign Institutional Investor (QFII) category (e.g. on the size of the quota and the length of the lock-up period).

There has been a special investment quota giving direct access to the interbank bond market through the People's Bank of China.

Unlike for the QFII, the People's Bank of China quotas for central banks are not publicly known. But some of those announced by investing central banks are up to 10 times larger than in the QFII and, most importantly, according to some of these announcements, free of any capital controls.

In view of all these factors, the renminbi may become a de facto reserve currency before it is fully convertible. ■

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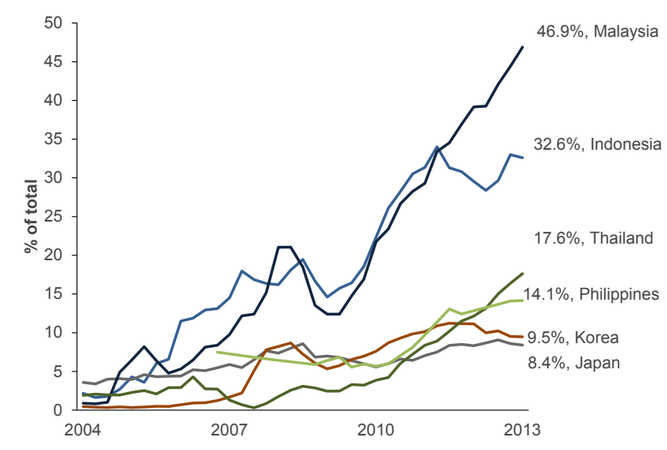
Chart 2: Foreign ownership of the EM Asia local currency markets



Source: ADB, various central banks and Standard Chartered Bank research estimates

On the web
See January 2013 edition of the Bulletin at www.omfif.org

Responsibility for public investors

The challenge of greater scrutiny

Angela Cummine, University of Oxford

Public investors, by virtue of their state-sponsored status, are increasingly encouraged to practise Responsible Investment (RI), also known as Socially Responsible Investing. However, with the exception of a handful of high profile sovereign wealth funds, most public investors do not consistently employ RI strategies and approaches.

But that is likely to change as the borrowing and investing activities of governments come under increased scrutiny and regulation, forcing public funds to improve RI capabilities.

'Ethical', 'responsible', 'socially responsible' or most recently 'extra-financial' investing is an approach to investment that directs capital towards assets deemed to have a positive impact on communities, employees and/or the environment.

It acknowledges that for investors to generate long-term sustainable returns, environmental, social and governance (ESG) factors must inform decisions on asset allocation, stock selection, portfolio construction, shareholder engagement and voting.

Public investors – whether SWFs, central banks or public pension funds – share several attributes that make them desirable candidates for adopting RI. First of all, their state ownership explicitly links these entities with the apparatus of government, making such funds potential public policy instruments.

Similarly, their investment activities implicate a sponsoring government and community in their decisions by virtue of the public status of their capital.

This in turn generates a high degree of interest from citizenries most affected by these funds, fuelling demand for greater accountability, transparency and ultimately responsibility by public investors.

Public funds are also generally long-term investors with lengthy return horizons. This long-term outlook encourages consideration of environmental and community impact where more short-term orientation makes this impossible. In addition, government backing makes public funds better candidates for riskier investment strategies, avoided by private financiers, in non-traditional asset classes.

These factors, in combination with rising asset levels across all public investors, mean that the interest in how returns are generated by these entities will only grow. Total holdings by all forms of public institutions are estimated to be worth about $20tn. The roughly $5tn in SWFs already eclipses the $2.1tn in global hedge funds and matches the holdings of private equity.

If, as forecasts suggest, SWF holdings more than double to $12tn as soon as 2015, and a further 20 sovereign funds are established in the next five years, then governments will certainly eclipse private financiers as the most influential market participants in global capital markets and their ultimate beneficiaries are likely to demand to know more about how these public financial assets are preserved and augmented.

Growing domestic scrutiny of public funds

The growing interest in the responsible investment of these public funds was evident last year when certain investments by public investors came under close scrutiny regarding their ethical implications.

New Zealand's $20bn Superannuation Fund (NZSF), a widely respected global leader in RI, came under sustained domestic pressure to divest equity holdings in mining giants Freeport and Rio Tinto following allegations of human rights breaches, corruption and environmental harm at the companies' gold and copper mining operations in West Papua.

Despite attempts by NZSF senior management to justify engagement with the companies in an effort to improve the conditions at the mine, public criticism continued.

A high profile media piece at the time questioned whether the NZSF's 'engagement' approach to investee companies was 'doing good… [or if it was] simply helping to prop up activities that would be illegal in [New Zealand] – activities that most New Zealanders would be horrified to support let alone make money from, if they were happening here?'

Following ongoing public concern about the investments, in September 2012, the NZSF divested its NZ$1.28m holding in Freeport and began to revisit the appropriateness of its engagement strategy for pursuing RI outcomes.

In defending the decision, the NZSF management concluded that further engagement would not be successful, and that such a consideration was a relevant factor in deciding which RI strategy to pursue.

At that same time, neighbouring Australia was also undergoing a heated debate over the integrity of its national sovereign fund.

Australia's $88bn Future Fund faced a radical change to its mandate with the introduction of legislation into the national parliament proposing an ethical investment obligation to 'forc[e] the Fund to divest its "unethical" holdings' in tobacco and nuclear investments.

The Bill sought to impose RI obligations on all federal government investment funds, constraining fund investments in relation to environmental concerns, labour practices, human rights, and weapons of war, while prohibiting investments in tobacco, cluster munitions components, and nuclear weapons.

The move came after public furor in 2011 over the Future Fund's holdings in nuclear weapons, tobacco and gambling entities.

In a Senate Enquiry into the proposed legislation, the Future Fund argued against the ethical curtailment of its mandate on the grounds that this posed an increased risk of diminished returns.

Responsible Investment, the Future Fund argued, can threaten returns in a number of ways: by impairing a fund's ability to diversify its portfolio in accordance with best practice investment and risk management; reducing the available opportunity set of investments; restricting access to specialist managers and strategies given the difficulty in monitoring full compliance with EI obligations through outsourcing investment, and increasing costs and resource requirements in managing the administrative burden of screening, divesting, monitoring and targeting.

The Australian Government ultimately rejected the Bill, partly concerned by its uncertain implications for the performance of the Future Fund. But the public controversy surrounding this debate was significant enough to lead Future Fund management to initiate an internal review of its tobacco holdings.

In February 2013, the Fund announced it would divest itself of all tobacco holdings. Grassroots pressure then in both New Zealand and Australia led to a strengthening of RI approaches and strategies among the country's respective flagship public funds.

Current RI practice among public investors

Despite such episodes, public funds have not rushed to formally embrace RI. Of the world's more than sixty sovereign funds, only three are subject to a RI mandate.

Two of these —Norway's Government Pension Fund Global (GPFG) and New Zealand's Superannuation Fund (NZSF) — have been investing ethically for almost a decade, and are considered world leaders in RI.

The third is Papua New Guinea's Liquefied Natural Gas fund, legislatively created in 2012 but not due to become operational until 2014 when scheduled to receive its first cash transfer. At that point, once active, the fund will be obligated to invest responsibly.

The adoption of an explicit RI mandate by one of the world's newest public funds is perhaps cause for optimism regarding a turn to RI among public investors.

Interestingly, PNG's RI mandate is identical in wording to that of the NZSF, suggesting potential for established responsible investors to influence the design and operation of emerging funds.

However, as only one of four newly created SWFs in 2012 along with, Western Australia's Future Fund, Angola's Fundo Soberano and Panama's Fondo de Ahorro de Panama, none of which incorporate explicit RI obligations in their mandate, PNG's embrace of responsible obligations is still the exception rather than the rule among public investors.

The story is similar across central banks, where overarching RI mandates are almost unheard of, most likely on account of the short-term investment horizons and liquidity constraints.

Among the more than 1000 signatories to the United Nations Principles for Responsible Investment (UNPRI), the world's leading initiative with regard to responsible investment, there are no central bank signatories.

The situation is somewhat more promising if we look beyond overarching investment mandates to ad hoc or limited RI obligations. Rigorous data are difficult to source, but current estimates suggest that between 18 and 22 public investors practise some form of RI, most commonly through exclusions of certain asset classes or products.

Ted Truman of the Peterson Institute surveyed 53 SWFs and public pension funds in 2010 on a range of accountability and transparency measures and found that only 14 of these funds had explicit ethical investment guidelines.

Another review conducted by the Australian Future Fund in 2012 for its submission to the Senate Enquiry mentioned above found that of 22 sovereign and pension funds examined, 11 funds used exclusions policies and four funds were subject to human rights obligations.

Growing scrutiny of public funds and RI

But this relatively low uptake of RI among public investors looks set to change as sovereign investors face renewed attention at the international level.

In 2011, in the wake of the financial crisis, the United Nations Conference on Trade and Development (UNCTAD) produced a set of Principles on Responsible Sovereign Lending and Borrowing, the first of its kind to specifically target sovereign financial activities.

Other aspects of sovereign financing were considered in several OECD reports in 2008 and 2009, examining the behaviour and design of state-owned enterprises and SWFs. Such initiatives reflect the heightened interest of the international and regulatory community in government investors.

As for the influential UNPRI framework developed in 2006, these principles do not distinguish between public and private investors.

But given that the majority of signatories are asset managers (759 out of 1223 signatories), official monetary and financial institutions - even if they are not UNPRI signatories - are likely to face pressure to pursue RI strategies.

This suggests that even if public funds are not directly targeted by such initiatives, the wider uptake of RI across the rest of the investment industry may force government investors to consider such strategies with greater intensity. ■

Angela Cummine is a sovereign wealth fund analyst, having completed her DPhil in Politics at University of Oxford on citizen rights to sovereign wealth.

Concepts and ciphers down the ages

The winding march of the public intellectual

Frits Bolkestein, Advisory Board

This book is about intellectuals and politics. It begins with a definition. Intellectuals are people who are interested in abstract ideas. Some may be about the arts or sciences, religion or culture, others about politics. In the case of politics, such ideas are eventually communicated to the public. Three elements — abstract ideas, politics and communication — combine to form what is known as the 'public intellectual.'

Not all ideas of public intellectuals are valuable. Far from it. For ideas to have value they must be based upon and capable of being tested by experience. Those who promoted the Russian Revolution did not have a clue as to what should happen afterwards.

According to Geroges Sorel, French philosopher, Marx once said that anyone who makes plans for after the revolution was a reactionary. Since the middle of the 19th century, the state has intervened deeply in society. The domain of politics has thereby become much more extensive. The mass media now play a very important role. It is, in fact, difficult to think of public intellectuals apart from the media.

Words are like money

These two developments have caused a great increase in their ranks. But words are like money: they often suffer from inflation. Today few individual public intellectuals are heard. But collectively, they make an incessant din, amplified by a barrage of opinion polls.

Moreover, with whom do public intellectuals associate? Other public intellectuals. They often form an in-crowd susceptible to hypes, captivated by appealing ideas (rather than sound ones), and with a predilection for trumpeting catastrophes. The book consists of four parts. The first concerns the 18th century and its three main currents: Classicism, Enlightenment and Romanticism. The second deals with the 19th century. It discusses German idealism, the influence of intellectuals in Russia and the Austro-Hungarian Empire, and the philosophy of the will — Nietzsche, Bergson and Sorel.

The third part is about the last century: First World War; the collectivist ideologies of fascism, national socialism and communism; and the rise of the counterculture. The last part considers the major political debates of the last 50 years: the European Union, development aid, the cultural revolution of 1968, intellectuals and capitalism, and multiculturalism. The book ends with an analysis of the diminishing confidence of Europe in its own civilisation.

Many revolutionaries

Some concepts or themes recur in the book. To begin, the mantra 'First we destroy and then we'll see.' This was not only the Russian anarchist Bakunin's slogan but also that of many revolutionaries who came after him.

Second, the frustrated love for the common working man. Alexander Herzen and Leo Tolstoy both admired the self-governing peasant village, the *mir* — a love that was not returned. The Russian *narodniki* wanted to educate the peasants, but the peasants turned them over to the police.

Third, the concept of 'true needs' which differ from needs that are 'manipulated' by society: what Timur Kuran speaks of as 'preference falsification.' This is foreshadowed by Rousseau, given expression by Marx, put in practice by communists and surfaces in the writings of Herbert Marcuse — prophet of the generation of 1968.

Fourth, a loathing of the bourgeoisie. This is a constant theme among intellectuals. Both Alexander Herzen and Georges Sorel were very explicit about it, as was Gustave Flaubert. It is telling that 'bourgeoisie' has remained a common term of abuse to this day. Fifth, faint-hearted sympathisers who remain on the fence and finally undermine their own position. The sad story of the Weimar republic — a democracy without democrats — showed this clearly.

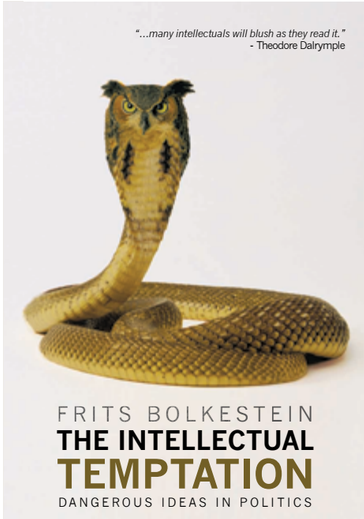
Sixth, the importance of youth for the development and reception of the ideas of intellectuals. Fascism appealed to *giovinezza*. Many young Germans, such as were to be found in the *Wandervögelbewegung*, the 'Birds of Passage' Movement, supported the National Socialists. The left-wing Nazi, Gregor Strasser, famously said 'Out of the way, old man' (*'Macht Platz, ihr Alten'*). The Revolution of 1968 inspired almost exclusively young people: 'Don't trust anyone over 30.'

Lastly, boredom, which has not often been recognised as an important political factor. Yet it underlay the enthusiasm which enveloped a large part of Europe in August 1914. As Eric Hobsbawm wrote, 'it meant an end to ... the graduation of the 19th century improvement.'

The Counterculture rose in the 1950s, although there were no events at that time which could really explain it, except the boredom of bourgeois society. A few months before the student revolt of 1968, Pierre Vianson Ponté wrote, 'The French are bored.'

Heidegger may well have been right when he said: 'Boredom is the fundamental mood [*Grundstimmung*] of our age.' There is thus a fundamental tension at the heart of modernity: as peace spreads, people become ever more fascinated by warfare. ■

Frits Bolkestein is a former European Commissioner.



Central bankers in search for employment

When policy-makers speak about 'stability', I become sceptical

William Keegan, Chairman of the Board of Consulting Editors

Unemployment is all the rage – not creating it as the banking crisis did, aided and abetted by an unholy alliance of pre-Keynesian policy-makers and right wing economists.

No, the emphasis now is on getting unemployment down, not least with various UK and European elections on the horizon.

The big election coming up of course is in Germany, an economy, shall we say, which has not fared too badly by comparison with its euro partners, and where, whatever the latest worries about a declining population, unemployment is relatively low and Chancellor Angela Merkel's re-election chances look decidedly more than reasonable.

Germany was the principal force behind the modest, but nonetheless welcome, upturn in the euro area during the second quarter.

Many commentators, not least those who work for the European Commission, are hailing a 'recovery', but that, at his stage, seems to me to be stretching the language somewhat.

Rehn's claim

What offends me even more is the claim by Olli Rehn, the Commissioner for European Affairs, that this mild upturn 'supports...the fundamentals of our crisis response: a policy mix where building a stability culture and pursuing structural reforms supportive of growth and jobs go hand in hand...'

If what the euro area has been experiencing is 'stability' then I have clearly been living on another planet.

Indeed, when policy-makers start talking about stability I am inclined (as Oscar Wilde remarked, regarding his habitual reaction to mention of 'integrity') to start counting the spoons.

Which brings us to the most celebrated star in central banking since Che Guevara was governor of the central bank of Cuba, namely one Mark Carney.

Carney has now joined his banking mentor Ben Bernanke in making a reduction in unemployment a key aim of central banking policy, and his first London press conference on 'forward guidance' and low unemployment targets made a splash in the world's capital and currency markets.

True, the initial splash was not quite what was intended – markets did not at first go along with his timetable for interest rate changes – but give him time!

Good account

A good account of the evolution of Carney's thinking is in that invaluable work, 'Banking on the Future: The Fall and Rise of Central Banking', by Howard Davies and David Green.

They note that at the Jackson Hole Conference of August 2009 Carney referred to 'an emerging consensus that price stability does not guarantee financial stability and is, in fact, often associated with excess credit growth and emerging asset bubbles.'

The authors suggest that he may have been 'somewhat anticipatory' in identifying such a consensus, but that is the way things have moved, and it is helpful to see Carney's policy of long delays before resorting to increases in interest rates in the context of his strong belief in macroprudential regulation as the 'first line of defence against bubbles and financial instability.'

House price bubbles

This is especially interesting since within days of the unveiling of Carney's New Financial Policy there were concerns about house price bubbles in London.

Now, your correspondent attended Carney's first Bank of England press conference and I am pretty sure that I heard him describe interest rates as 'a crude weapon.'

Anyway, it is unusual for members of my generation to find a central banker who is so publicly concerned about unemployment, and I wish him well. Yet we need a sense of historical perspective.

Full employment used to be defined as a level of around 2%. The lowest Carney seems to be aiming for is between 5% and 6%, with 6% as a 'staging post.' ■

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