The Bulletin

September 2014
Vol. 5 Ed. 8

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

OMFIF

Brics and pieces

A world apart on monetary policy

Maria Antonieta Del Tedesco Lins on Brazil and the Brics
Sahoko Kaji on the lessons of monetary union
Celeste Cecilia Moles Lo Turco on African sovereign funds
Gerard Lyons on British benefits from European reforms
Joachim Nagel and Christian Erb on Europe's future
Niels Thygesen on central banking transparency
Lamido Yuguda on managing reserves amid low yields

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Cover story

The formation of the New Development Bank by Brazil, China, India, Russia and South Africa is a reflection of the polarised state of world economics and finance, running well beyond a US-European divide in monetary policy. Within the Brics group, there are signs of fragmentation, with Russia now even less part of the structure than before following the breach with the US and Europe over Ukraine. These divisions are manifest, too, in the European Union, as monetary splits widen in the euro bloc, Scotland heads for an independent vote and doubts persist over whether Britain will remain a member.

Africa programme

After the ebola-induced postponement of the Ghana Main Meeting on 8-9 September, OMFIF is planning a full Africa programme for 2015.

AFRICA FOCUS 2014

International monetary policy

Europe and the euro

Emerging markets

Book reviews

Repeat of history for France's luckless Hollande

History seems to be repeating itself in France, where unpopular President François Hollande has promoted market-orientated ex-banker Emmanuel Macron as economy minister, in a last-ditch effort to spur growth in the stagnant French economy. Hollande's enlistment of Macron, who worked for Rothschilds between 2008 and 2012, has overtones with President Charles de Gaulle's call on Rothschilds manager Georges Pompidou as prime minister in 1962, and with François Mitterrand's elevation of former Banque de France functionary Jacques Delors in 1983. Hollande's position is much more dire than that of his predecessors. Hollande's new problems coincide with fresh monetary divisions between France and Germany following the European Central Bank's defiance of German wishes in pressing ahead with additional credit-easing measures, announced on 4 September. See articles on p.14-21.

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OMFIF

Promoting dialogue for world finance

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

Our overriding aim is to enable the private and public sector to learn from each other in different ways, promoting better understanding of the world economy and higher across-the-board standards.

OMFIF's main areas of focus are economic and monetary policy, asset management and financial supervision and regulation. OMFIF cooperates with central banks, sovereign funds, regulators, debt managers and other public and private sector institutions around the world.

Since its inception in January 2010, OMFIF has held 276 meetings in 41 host countries with the participation of 200 different official institutions.

Advisory Board

OMFIF's 157-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, weekly Commentaries, seminars and other OMFIF activities.
See p.24-25.

Bulletin

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

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

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Letters

Letters provide opinions from our readers with points of view on the subject matter in our Bulletins and Commentaries.

Diary dates

OMFIF Meetings take place within central banks and other official institutions. The frank and confidential nature of meetings provides for a deep-seated exchange of views and best practice.

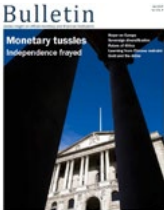
A full list of past and forthcoming meetings is available on www.omfif.org/meetings

General information

See www.omfif.org for member access to more OMFIF intelligence, including commentaries, reports, summaries of discussions and bulletin archives.

Readers with queries on the website should contact editorial@omfif.org.

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM



Systemic schisms

Differentials driving disorder in money and politics

David Marsh, Managing Director

Polarisation and schism: neither a happy nor a pretty sight, but one we will have to get used to. The divergence of interest rate policies on each side of the Atlantic, seen in the different thrusts of speeches by the US and European central bank chiefs at the Jackson Hole central banking seminar, has become a primary factor on world capital markets.

Graphs accompanying Darrell Delamaide's round-up of Federal Reserve developments on p.10 illustrate the importance of interest rate differentials in influencing the dollar's exchange rate against the D-mark and the euro. Mario Draghi, the European Central Bank president, has made clear that he favours a weaker euro to help pull Europe out of a perilous period of stagnation. His September rate cut and announcement of asset-backed securities elide with that goal.

Polarisation of views on monetary and economic policy was highlighted both in a speech at the Advisory Board summer party on 10 July by Ewald Nowotny, governor of the Austrian central bank, and in a series of conversations during OMFIF's July tour of Asia, described on these pages. The growing international roles of both the renminbi and the yen were a strong feature of these discussions. Other recurring issues are the mechanisms of exit from unconventional monetary policy, elaborated by Philip Turner and Tim Young, and Britain's view of European Union reform, the subject of a report by Gerard Lyons.

Although we point out the danger of splits among Germany, France and Italy, Gabriel Stein unveils a relatively positive perspective on growth in the euro area, resulting from the end-year completion of the first building block of banking union. Joachim Nagel and Christian Erb remind us that monetary policy cannot do everything to guide Europe to a positive path. Niels Thygesen says the ECB may be misguided in its new communications policies, Stewart Fleming ponders Europe's new leadership team, while John Nugée worries about startling flaws in Scotland's referendum process.

Maria Antonieta Del Tedesco Lins and Jonathan Fenby look at the repercussions of the decision by leading emerging market economies to form the so-called Brics development bank. Celeste Cecilia Moles Lo Turco surveys the growing attraction of African sovereign funds. Lamido Yuguda describes how central bankers are coming to terms with low yields, partly by turning to the Chinese currency.

Our book reviewers, Graham Hache, George Hoguet and Sahoko Kaji, reflect on various aspects of world disorder. Russell Silberston outlines the need for international monetary reform – something for which we will have to wait a while. ▪

Argentina: The price of default

Debt drama creates repercussions for sovereign restructuring

David Smith, Advisory Board

Earlier than many had anticipated, Argentina's government faces the consequences of its de facto default on foreign debt at the end of July. The country has suffered the first of a likely series of general strikes, called by one-time allies, now bitter critics, of President Cristina Fernández de Kirchner, who accuse her of driving the country into recession with high inflation and rising unemployment.

'The president's mismanagement of the foreign debt crisis mirrors her failure to address the crisis faced by ordinary men and women every day,' according to Hugo Moyano, leader of the CGT trade union, the country's biggest trade union.

Abroad, the Chinese government is warning that its latest infrastructure loan to Argentina could be in danger if the country does not find a way out of default and into a better relationship with the world financial establishment. The investment is earmarked for the building of two dams in the Patagonian province of Santa Cruz, homebase of the Kirchners and the source of the family's wealth. Indeed, one of the dams is to be named after the president's late husband Néstor, her predecessor. Nothing personal, just business, say the Chinese.

The government has adopted a strategy that puts domestic politics before its foreign reputation. Argentina cannot reach an agreement on how to pay off the hold-outs, representing 7% of creditors, who have won a ruling from New York Judge Thomas Griesa, for full payment of the $1.3bn they are owed on paper. At the same time, Argentina is prevented from paying its latest instalment, $539m, to the 93% of creditors holding debt-restructured bonds from 2005 and 2010, since the money is frozen by the US courts.

So the government is seeking to switch fiduciary banks handling those debt repayments as trustee, from Bank of New York Mellon to Banco de la Nación in Buenos Aires. Leaving aside the politicians, one notable Argentine economist who played a role in debt restructuring in 2005 has observed that Banco de la Nación cannot make these payments, since such a move violates the guarantees given to the US courts in the first place.

Opinion polls show the president's approval rating rising steadily as she casts herself as defender of the national interest. Yet the tell-tale signs of unrest on the home front remain. Kirchner's advisers may denounce striking workers as being part of the 'foreign conspiracy', but Argentinians are feeling the pinch, as overtime is cut, jobs are lost, and inflation spikes ever higher, with unofficial estimates now topping 30% annually. Uncertainty in domestic politics is increasingly damping foreign investment in Argentina.

A former colleague of mine, Alicia Bárcena, head of the UN's Economic Commission for Latin America, confirmed the worst. Argentina's economy will shrink this year, some private-sector estimates suggesting by as much as 3%. Bárcena wondered aloud about the big picture behind Argentina's latest default drama. 'You think there's going to be any appetite to negotiate sovereign debt after this?' she asked. 'We should be very concerned that the relationship between creditors and debtors in debt-restructuring negotiations will be very unbalanced after this.' With Argentina's high-wire act likely to last well into 2015, the fall-out extends beyond Argentina and its future. The debt drama has repercussions for many other countries too. ▪

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

ADVISORY BOARD

OMFIF has appointed Christian Gärtner and Jonathan Grant to the Advisory Board. For the full list of members see p.24-25.

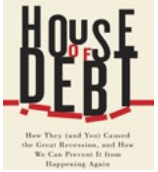
Christian Gärtner is senior executive banker at DZ Bank in Frankfurt. He has more than 20 years' experience in investment banking, asset management and risk management. Gärtner was CFO/COO of fixed income international sales at DZ Bank and before that head of quantitative product development at Union Investment. He joins the Banking panel.

Jonathan Grant joins the Public Policy panel. He is director of the Policy Institute at King's College London, where he is professor of public policy. Grant's main research interests are in R&D and innovation policy and the use of research and evidence in policy and decision making. He was formerly president of RAND Europe and head of policy at the Wellcome Trust.

BOOK REVIEWS

Reassessing Bretton Woods and the Great Recession

Using participants' diaries and undiscovered Soviet files, Ed Conway recreates the 'human drama' of the Bretton Woods meeting in 1944 that launched the World Bank and International Monetary Fund. In an epilogue, he discusses the need for a post-crisis Bretton Woods. In their 'eminently readable but scholarly work' *House of Debt*, Atif Mian and Amir Sufi assemble employment, housing and consumption data to offer a fresh analysis of the Great Recession.



BRIEFINGS

Italy's small businesses need a boost, says Rossi

Italy's economy would benefit from greater efforts to promote smaller businesses, according to Salvatore Rossi, senior deputy governor of Banca d'Italia, speaking to OMFIF members in London on 16 July. Outlining general Italian challenges, Rossi highlighted difficulties faced by smaller enterprises in exploiting opportunities offered by IT and globalisation. They have more debt and less capital than larger firms and Rossi recommended a shift to market-based lending to spur growth.

Governor of Czech National Bank on QE and euro area

Quantitative easing as practised by the US Federal Reserve, Bank of England and Bank of Japan is of only minor significance in the Czech Republic, Miroslav Singer, governor of the Czech National Bank, told OMFIF members in London on 22 July. Singer discussed the role of the traditional Czech savings culture in the present low-inflation environment in Europe, and to give his views on the monetary policy challenges faced by the euro area with which his country has significant trade and investment links

EXPERT SEMINARS

Rise of the renminbi at second Asian forum

The shift of business dynamism and financial clout from west to east since the 2008 crisis was the main subject of the second Asian forum on 14 July hosted by OMFIF and Lee Kuan Yew School of Public Policy. Questions of the role of the dollar and renminbi, financial regulation for global stability, and investment strategies for economic and social returns occupied the talks. In a keynote speech Lim Siong Guan, group president of GIC Private, gave his view on world economic developments.

Asean capital flows and currency swaps

AMRO
ASEAN +3 MACROECONOMIC RESEARCH OFFICE

The Chiang Mai initiative – the currency swap agreement between the 10 Asean nations, China, Japan and South Korea – was the subject of the AMRO-OMFIF roundtable on 15 July chaired by David Marsh and Yoichi Nemoto, director of the Asean+3 Macroeconomic Research Office. Discussions focused on AMRO's work in monitoring current account and capital account flows within Asean+3 and how to improve ways for AMRO to work with financial market participants.

Global Public Investor launch in Hong Kong

Asia-Pacific investors are in the lead in worldwide rankings of official sector asset holders, according to OMFIF's *Global Public Investor* publication. In its comprehensive survey of $29.1tn of investments held by 400 public sector institutions, OMFIF tracks the efforts of central banks to diversify their holdings. Speakers at the launch at the British Consulate in Hong Kong on 17 July included Consul General Caroline Wilson, Christian Gärtner of DZ Bank and David Marsh.

POLICY GROUP

Treasury's Sir Nick Macpherson on Britain's links with EU

Leaving the EU could have unwelcome consequences for the UK, according to a discussion over lunch at the Reform Club on 7 July with Sir Nick Macpherson, permanent secretary at the UK Treasury. The conversation touched on the political and economic considerations of the membership referendum which could take place in 2017. This could have negative repercussions for Britain's position in trans-Atlantic trade and London's role as an international finance centre. Even if it were possible to negotiate a free trade agreement with Europe, Britain might be disadvantaged by having to abide by rules and regulations over which it had no say.

Nigeria's Moghalu urges Africa to plan ahead

Globalisation has hurt Africans more than it has helped them, according to Kingsley Moghalu, deputy governor of the Central Bank of Nigeria. Over an OMFIF lunch at London's Travellers' Club on 24 July, he outlined his view that Africa has been 'passenger instead of driver' on the journey towards globalisation, and needs to 'get behind the wheel'. To do this, he urged Africans to forge a better understanding of the role they want to play in the world economy, and to improve strategic planning, risk management and governance. Areas in need of particular attention were the mortgage industry and the power sector, as energy shortages are 'limiting the growth trajectory'.

SUMMER PARTY

Speaking at the annual OMFIF Advisory Board gathering in the City of London on 10 July, Ewald Nowotny, governor of the Austrian National Bank, paid tribute to London's role as an economic, financial and intellectual hub. But uncertainties caused by a possible referendum on Britain's departure from the European Union tempered his optimism.

The gathering took place at the London headquarters of DZ Bank, overlooking St Paul's Cathedral, and later over dinner at Saddler's Hall. More widely, Nowotny highlighted unusual polarisation over monetary policy. The Bank for International Settlements was broadcasting scepticism on over-accommodative central bank action while the International Monetary Fund was calling for the European Central Bank to take further easing measures to ward off deflationary threats.

Other themes at the reception and dinner, presided over by OMFIF Chairman John Plender, were the direction of US and Japanese monetary policy, the tension over Ukraine and Russia, and unresolved problems in the euro area. This included a discussion on preparations for European banking union that are taking up an increased amount of central bankers' time.

Scenes from the summer party. Lower picture, left to right: Richard Roberts, Holger Wessling, Alan Jones, Frank Scheidig, Stefan Bielmeier, Pooma Kimis, John Plender, Dick Harrivan, Aslihan Gedik and David Marsh.

Asia-Europe decoupling: divisions ahead

Yen and renminbi internationalisation move up agenda

OMFIF carried out an 11-day tour of Asia on 14-25 July, encompassing six centres – Singapore, Kuala Lumpur, Hong Kong, Macau, Beijing and Tokyo – and including five international investment seminars. The tour benefited from 48 top-level conversations with heads of central banks and sovereign funds, other senior government and central bank officials, leading investors, pension funds, economists and academics. The public sector asset managers engaged with on these visits, including some of the world's largest investment institutions, hold investments totalling $8tn. **The following 10 points on the global economy sum up the main issues and conclusions discussed during the tour.**

1

Policy divisions between western and Asian economies seem to be growing. Increased Asian confidence and resilience are accompanied by belief that the west (and especially Europe) has lost its way. One Asian sovereign fund leader contrasted Asia's emphasis on long term returns with the short-termism and greed of western investors. 'The result of the global financial crisis was that the man in the street was devastated while bankers enjoyed their bonuses.' He highlighted the difference between western rigour on Asia over the 1997-98 financial crisis and European compromises made toward indebted countries in the EMU crisis.

2

The decoupling danger appears most acute for Europe, since the US and Asian economies were seen as more closely aligned. There was talk that the Asian economy, in terms of trade flows, was more integrated than that of the euro area – despite the lack of a common currency. One leading Asian central banker was gloomy about the European outlook, where he said 'years of restructuring' were needed, even though economic output (in contrast to Asia and the US) had not yet returned to pre-crisis levels. The most likely scenario for currencies was a firmer tone for US and Asian currencies (with the exception of the yen) and a weaker euro.

3

Belief is growing that **prolonged international monetary stimulus seems to be running into diminishing returns** and could become self-defeating. There was worry about the long-term impact of very low interest rates on pension funds and insurance companies. Monetary policy could become tighter in Asia to ward off overheating, but countries could not allow exchange rates to take the full strain, so management of capital flows were necessary. Although Asian foreign reserves can be regarded as excessive, this is no longer a major concern for most central banks, which appear wary about losing reserves as a result of foreign exchange or political upsets.

4

The Chinese economy is slowing, but the authorities seem to be in overall macroeconomic control. Growth is likely to be around 7.5% again this year. Main areas of concern are the property market and shadow banking. There were some worries that the authorities are not proceeding fast enough with interest rate liberalisation to accompany capital account liberalisation. The two reforms need to move in tandem so that allowing more capital to leave the country can be accomplished without suffering setbacks. China will be cautious on the latter while refining procedures on the former.

5

Japan seems to have turned a corner with more vigorous implementation of Prime Minister Shinzo Abe's economic reform measures this summer. Japan seems likely to tolerate a further weakening of the yen as US monetary policy gradually tightens over the next 12 months and the Bank of Japan maintains large-scale purchases of domestic government bonds well into 2015. Although core inflation fell to just 1.3% in June, officials say the rate should be rising towards the 2% target level from the fourth quarter onwards. Officials are relatively confident that Japan is not moving towards permanent current account deficits.

6

There is **considerable suspicion about the IMF** and an excessively Washington-focused view of the world. Quota reforms and governance changes at Bretton Woods institutions remain stymied by congressional refusal to ratify them. The result is frustration in leading Asian countries and a number of moves – whether through the Chiang Mai reserves-pooling initiative or the latest plan for a Brics bank – for emerging markets to lower their IMF dependence. The result may be deadlock, as the emerging economies themselves lack a consensus to move forward meaningfully on genuine alternative structures.

7

Internationalisation of the renminbi is proceeding on many fronts. The Chinese authorities now accept that the renminbi is, de facto, part of a multiple reserve currency system in which the dollar continues to play the leading role. One Chinese official said that the renminbi could succeed internationally only if it was a 'quality currency'. The number of countries holding renminbi in their official reserves has risen to around 40. The US and the IMF appear to be moving towards acceptance that the renminbi could form part of a redrawn version of the IMF's Special Drawing Rights.

8

Internationalisation of the yen seems to be taking on a new form. Tokyo Ministry of Finance officials are stepping up efforts to market Japanese government bonds to central banks and other foreign public sector investors, but purchases of JGBs will take off only after a rise in longer term interest rates from present levels below 1%. A return to more normal JGB interest rates of above 3% – which will prove loss-making for present holders such as the Bank of Japan – is not likely for at least two years. Part of the BoJ/MoF strategy of encouraging Japanese private sector portfolio shifts away from JGBs into equity-type assets is that the BoJ can bear such losses far more easily.

9

Asset managers across the region – both public and private sector – are becoming increasingly internationalised, with some of the **older-established funds serving as benchmarks** for newer, less mature funds. Large state pension funds in Japan and China are being reformed to bring their asset allocation practices more in line with international standards, with Canadian pension funds – where the proportion of foreign equity ownership is much higher than in Asia – seen as a particular benchmark. Diversification into Asian currencies is an established trend, part of moving away from the dollar as the region's main transaction currency.

10

Despite general Asian self-confidence, there were **warnings that the region could over-stretch itself**. Among the challenges are: crossing the threshold to developed country status; improving institutional governance; coping with ageing populations and rising inequality; and promoting financial development. Lack of financial markets may hinder more general economic and trade integration. Cross-border flows were said to be much greater than before the 1997-98 Asia financial crisis – emphasising the need for macroprudential controls now sanctioned by the IMF.

Labour market divides Fed policy-makers

FOMC debates timing of interest rate increases

Darrell Delamaide, US Editor

An unusual sight greeted Federal Reserve policy-makers when they went to the resort town of Jackson Hole, Wyoming, in late August for their annual symposium. Workers lobbied them to delay raising interest rates.

Thus Fed chairman Janet Yellen (**voter**) had to walk past young people wearing T-shirts saying 'What Recovery?' and carrying signs that read 'Curious about labour market dynamics? Ask a worker'. (The theme of the conference, sponsored by the Kansas City Fed, was 'Re-Inventing Labour Market Dynamics.') It was an unusual meeting, attended by economists from the labour unions and less by private-sector bankers, as is usually the case. The workers found a sympathetic ear with Yellen, who said evidence of 'slack' in the labour market – indices such as a low level of labour market participation and a high proportion of part-time workers seeking full-time work – argue against the Fed tightening monetary policy too quickly.

'I believe that our assessments of the degree of slack must be based on a wide range of variables and will require difficult judgments about the cyclical and structural influences in the labour market,' she said in her address, the highlight of the conference.

A move in inflation toward the Fed's 2% threshold might not trigger immediate action, she said. Such a rise could be due to the low rate of labour participation, and may quickly subside as discouraged workers are drawn back into the workforce.

'Tightening monetary policy as soon as inflation moves back toward 2% might, in this case, prevent labour markets from recovering fully and so would not be consistent with the dual mandate,' Yellen said.

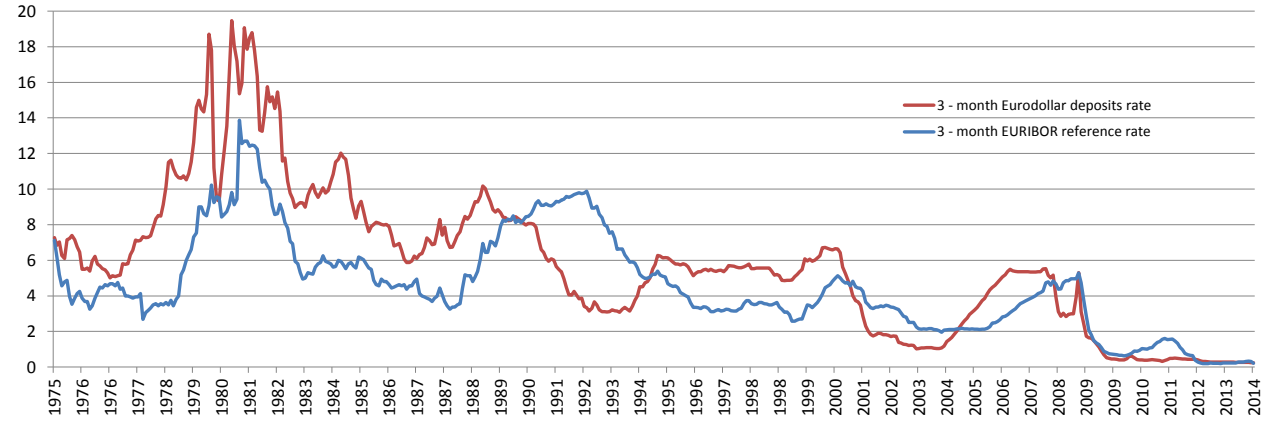
Yellen, who reportedly met with some of the labour representatives in attendance, showed her dovish tendencies in the speech.

The topic exposed divisions among members of the Federal Open Market Committee on the timing of monetary tightening.

A monthly survey of hedge funds and other big money managers by the New York Fed indicated that market participants are expecting action sooner as economic data continue to be favourable.

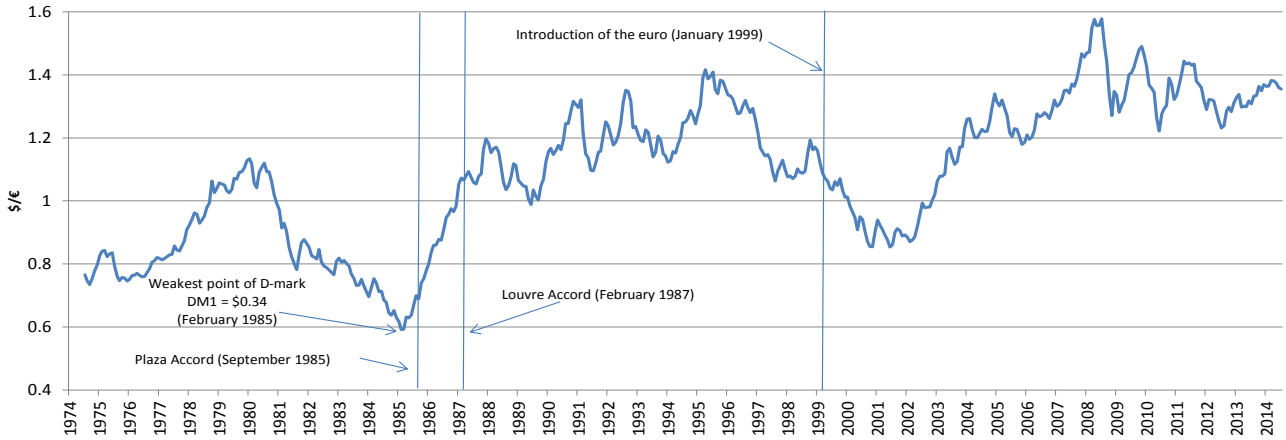
The FOMC divergences echo some of the discord among members of the ECB governing council. Given the importance (as Charts 1 and 2 show) of interest rate differentials in determining US-European exchange rates, plotting these divisions has become supremely important for capital market participants.

Chart 1: 3-month EURIBOR and 3-month Eurodollar deposit rates 1975-2014



Source: Federal Reserve, Deutsche Bundesbank, Euribor-rates.eu.
3-month EURIBOR reference rate was introduced in 1999, previous data refer to FIBOR 3-month reference rate (1985-99) and 3-month Euromark rate.

Chart 2: Value of D-mark and euro against the dollar, 1974-2014



Source: World Bank, Federal Reserve Bank of St. Louis (Pre-1999 data use D-mark converted to € at exchange rate of 1.95583.)

The July New York Fed survey showed that 41% of those surveyed now expect the Fed to raise rates before the end of June, compared to only 31% in the June survey. Equally telling, the number of those not expecting action until after 2015 fell from 30% in June to 16% in July.

Other doves backed Yellen up. San Francisco Fed chief John Williams **(non-voter)** told a television interviewer that 'significant slack' in labour markets meant the Fed could hold off until next summer with interest-rate increases. 'The economy is still benefiting from strong support from the Fed, and we don't want to remove that yet,' he said on Fox Business Network.

Degree of progress

Even Dennis Lockhart **(non-voter)**, Atlanta Fed president, not normally considered a dove, said policy-makers can probably wait until the middle of 2015 to raise rates.

'I believe the unemployment rate does overstate the degree of progress that's been accomplished,' Lockhart said in an interview with The Wall Street Journal. 'There are facets of the labour market that still remain some distance from where we want to be when we begin a tightening cycle. I'm the camp that still sees a reasonable amount of slack that can be absorbed if we are a little patient.'

But St. Louis Fed chief James Bullard **(non-voter)**, who generally occupies the middle ground, took a more hawkish tone, telling CNBC-TV that a tighter monetary policy would not necessarily harm the economy.

He said positive news about growth and unemployment 'means the committee could be more confident that the economy is going to improve in the future and handle the higher rates which will eventually come,' he said on CNBC-TV.

For the time being, he is holding to his forecast of a rate increase toward the end of the first quarter of next year, but suggested he could alter his view if warranted by the economic data. For her part, hawk Esther George **(non-voter)**, head of the Kansas City Fed and host of the Jackson Hole event, said she preferred Fed action 'sooner rather than later'.

'My objective is not to see rates rise sharply,' George told Fox Business. 'But I do think many of the policy benchmarks we look at are already signalling that we should be off of zero.' Charles Plosser **(voter)**, head of the Philadelphia Fed and a frequent critic of current Fed policy, said that monetary accommodation ran an increasing risk.

'We need to be responsive to the data, not to some calendar or point in time,' he said in an interview with CNBC-TV.

Low wage growth is not necessarily a sign that inflation will remain weak, he said, arguing that wage increases often followed rising inflation rather than causing it. Also, Plosser said, easy monetary policy may offer little further help to the labour market.

But Minneapolis Fed chief Narayana Kocherlakota **(voter)**, a late convert to the dove camp, noted in a speech prior to the Jackson Hole meeting that both the Congressional Budget Office and the Fed staff expect inflation to remain below 2% for the next few years. 'This means that the FOMC is still a long way from meeting its targeted goal of price stability,' he said before a group of community bankers in Minnesota.

On the unemployment front, the July headline rate of 6.2%, while a big improvement from 10% in October 2009, 'masks continued weakness in labour markets,' Kocherlakota said. He cited the 'disturbingly low rate' of people aged 25 to 54 who actually have a job, and, as did Yellen, the 'historically high percentage' of workers who are looking for a full-time job but can only find part-time work.'Bottom line,' he concluded, 'I see labour markets as remaining some way from meeting the FOMC's goal of full employment.'▪

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

US central bankers mull monetary tools

Even as the timing of a rise in interest rates remains subject to debate, Federal Reserve policy-makers are weighing the pros and cons of new tools to manage those rates as it transitions from years at nearly zero with a bloated balance sheet *writes Darrell Delamaide in Washington.*

The minutes for the June meeting of the Federal Open Market Committee, released in July, recapped the discussion in some detail. FOMC members refer to the rise in the federal funds target rate – the traditional benchmark for short-term rates – as 'lift-off.'

The upshot of the June discussion, however, was that the Fed intends to make the interest on excess reserves the primary method of steering short-term rates and use the rate on overnight reverse repos as a secondary tool. (In a reverse repo, the Fed lends out securities against cash.)

'Most participants agreed that adjustments in the rate of interest on excess reserves should play a central role during the normalisation process,' the minutes recounted. 'It was generally agreed that an overnight reverse repos facility with an interest rate set below the interest on excess reserves rate could play a useful supporting role by helping to firm the floor under money market interest rates.'

The minutes show policy-makers wanting to keep a role for the traditional tool – the overnight federal funds rate – but the interest on excess reserves is clearly destined to become the 'workhorse.'

They generally agreed that the spread between interest on excess reserves and the reverse repos should be about 20 basis points, as it is currently. This spread 'would support trading in the federal funds market and provide adequate control over market interest rates,' the minutes said.

Some participants went so far as to suggest that adequate control of short-term rates might be achieved even without an overnight reverse repos facility. There were also comments that other policy tools, including term deposits and term reverse repurchase agreements, might be necessary. In general, the policy-makers seemed a little nervous about reverse repos, expressing concerns that it could become disruptive in times of financial stress as counterparties sought the safe haven of the Fed facility. By the same token, they were concerned that it could be used by some institutions for 'window dressing' purposes at the end of a quarter or year – which may already be taking place.

In short, the conclusion seemed to be that reverse repos might be useful in the transition to normalcy but perhaps would not become a permanent monetary policy tool. In any case, a size limit per counterparty as currently practiced is likely to remain.

With regard to actually reducing the size of the Fed's balance sheet by ending its current policy of rolling over Treasury securities and reinvesting principal payments in mortgage-backed securities, many participants felt it would be better to wait until the FOMC was ready to raise interest rates – and preferably after it started – to avoid alarming markets that the Fed was tightening sooner than indicated.

'Some' participants held out for reducing reinvestments, sooner, because that was part of the Fed's original plan for winding down its extraordinary activity and would not have a large impact.

In any case, policy-makers agreed that the winding down should be gradual. They were also largely in agreement that the plan for transition to normalcy should be communicated clearly to the public, but there should be flexibility as the committee learns more about the new tools. ▪

Weighing options on quantitative easing

Delicate linkages on central banks' balance sheets

Philip Turner, Bank for International Settlements

On 23 July, Mojmír Hampl, vice-governor of the Czech National Bank, responded categorically to Meghnad Desai and David Marsh's provocative article on the options of exit from quantitative easing by the Bank of England (OMFIF July-August Bulletin, p.20), in which Marsh and Desai argued that the Bank could reverse its accommodative policy by transferring UK government bonds back to the Treasury and then cancelling or converting them.

Hampl warned against the 'highly addictive drug' of monetary financing of governments, arguing that standard central banks around the world might be public institutions and be part of the state (even though in many countries they also have private owners and shareholders), but they are not 'owned by the government' and are supposed to be independent. In other words, the government should not even have the theoretical ability to ask the central bank to do what Desai and Marsh are proposing.

This exchange of views is welcome in focusing attention on an issue that was once at the core of debates about monetary policy: the central bank's balance sheet. Before the crisis, the widely-accepted Ricardian equivalence theory, that debt-financed government spending leaves demand unchanged, made balance sheets seem irrelevant.

Market operations and expectations

On this view, open market operations by the central bank in government bond markets – or any other market – would merely induce offsetting changes in private demand. Market expectations of long-term interest rates would remain unchanged. Monetary policy therefore worked only through changing expectations about future short-term rates. All a central bank had to worry about was the policy rate and operate in very short-term money markets. The large post-crisis rise in central bank balance sheets, entailing the purchase of long-term government bonds and other long-term assets, has demonstrated this dogma was false. Market operations by the central bank did succeed in influencing key financial variables – the exchange rate, the long-term interest rate, market liquidity and credit spreads.

But these near-term successes in supporting financial markets and in averting a depression is only part of the story. We have yet to find out whether the exit from this balance sheet expansion will be handled well enough to avoid negative consequences in future years.

Exit strategy

An effective exit strategy will depend in part on decisions about the size and the composition of central bank balance sheets. A stylised central bank balance sheet, shown in the table below, helps to clarify thinking.

Before discussing this balance sheet, however, a word of warning is this: there is no simple and mechanical link between decisions about the central bank's balance sheet and macroeconomic or financial variables.

At several junctures, it has been the signal from the central bank that it would buy specific assets – even before actual purchases – that has eased liquidity constraints of holders of these assets, and affected market prices.

How markets read the signals from the central bank, and how they judge the likely efficacy of instruments at its disposal, will be just as important during the exit.

Central banks should avoid taking steps that could limit the balance sheet instruments at their disposal. It is true that cancelling government securities held by the central bank would have no effect on the consolidated public sector – the reduction in government bonds outstanding would be exactly offset by lower central bank capital.

Would markets be fooled into thinking public sector debt is lower? Bank reserves would remain unaltered. Such a move would be bad news for future stability because the central bank would have lost a natural tool to implement exit – the ability to sell bonds and move the yield curve up.

The central bank could still manipulate the liability side of its balance sheet (reducing reserves and increasing longer-term liabilities). But these policies have their limits.

The links between central bank and Treasury market operations have become inextricable. Before the crisis there was a simple division of labour. The central bank would issue or purchase the shortest duration official debt, usually monetary reserves for the banks, and the Treasury would determine the maturity structure of interest rate-bearing debt.

With QE, this division of labour has broken down. It is the net effect of central bank and Treasury policies in bond markets that determines the duration risk, influencing the long-term interest rate.

Normalising monetary policy

As monetary policy is normalised, central banks will have to decide what balance to strike between raising the policy rate and selling assets. If they do not sell assets, the policy rate will have to rise more. The option of avoiding active asset sales (that is, just allowing bonds to mature) would not be a neutral policy choice.

It would mean central bank balance sheets would remain large beyond 2020, and the timing of shrinking would be quite independent of future economic conditions.

There is no economic law that says central bank balance sheets should be small, and there are good reasons for thinking that the 'new normal' will be larger than before the crisis. Stronger liquidity rules for banks will increase the demand for bank reserves. Some central banks will want to use asset sales or purchases for financial stability purposes.

Nevertheless, central banks should in normal circumstances exercise restraint about the size of their balance sheet to avoid becoming so dominant in specific markets that they distort resource allocation, and to preserve their room to manoeuvre in the future. It was because central banks had very small holdings of government bonds at the beginning of the recession that they were in a position to buy bonds on such a large scale without compromising their credibility.

The balance sheet of the central bank

Assets	Liabilities
Foreign assets	Currency
Loans to banks	Bank reserves
Government securities	Government deposits
Other assets	Non-monetary liabilities
	Equity

Bringing central bank balance sheets closer to normal levels will require coordination with Treasuries without surrendering monetary policy independence.

Equally government debt management strategies will come under deeper scrutiny – should the Treasury alter its short-dated/long-dated issuance mix as normalisation gets underway? Higher long-term rates will be a necessary part of normalisation, but higher borrowing costs will be unwelcome to Treasuries that have large debts to refinance. Communicating decisions in ways that make sure that investors do not forget that the future is unknown is essential. Investors and commercial banks must be kept aware of interest rate risks.

Central banks that plan asset sales must pragmatically monitor market resilience, but not allow fears of market reactions to prevent necessary increases in interest rates.

The debate on QE exit turns on the twin traps of fiscal dominance and market dominance.

Any convincing analysis of future scenarios needs to consider the balance sheets of government and the commercial banks as well as that of the central bank. The latter will need to move in a direction that supports monetary policy tightening. ▪

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QE reorganisation through UK government bond swap 'would not produce genuine fiscal savings'

The proposal by Meghnad Desai and David Marsh for the reorganisation of UK quantitative easing to save unnecessary interest flows is intriguing, but would not produce the genuine fiscal savings they envisage, *writes Tim Young in London.*

When the Bank of England implements QE by buying UK government bonds or 'gilts', and paying for them with interest-bearing reserves that it creates, it is effectively doing no more than a maturity-transforming portfolio shift. This amounts to a purchase of fixed term, fixed interest public sector bonds, funded by the sale of public sector perpetual floating-rate notes.

Since the UK government owns the BoE, which therefore remits its profits (eventually) to the Treasury, it might seem tidy to simply cancel the gilts held by the BoE. In this way, the government would not then be effectively paying interest to itself via the BoE. Desai and Marsh's suggestion that the Bank swaps its gilt holdings for zero-coupon gilts, thus saving interest payments, has the appearance of tidiness and logic.

However, the purpose of QE is macroeconomic stimulus, and the hope is that it will be appropriate at some point for this stimulus to be curtailed and even reversed, so QE should be organised to allow this.

The obvious way to reverse QE is to re-sell into the market the gilts bought by the BoE, with the resulting payments to the BoE redeeming base money. Naturally the gilts cannot be sold if they have been cancelled and not replaced. If instead, the BoE has exchanged the interest-bearing gilts purchased for zero-coupon gilts, the BoE will, assuming unchanged interest rates from the time that QE was done, have to hold a greater nominal quantity of zero-coupon gilts to sell than the nominal quantity of gilts purchased from the market.

Government debt

The stock of government debt, however, is reported in nominal terms. So the net result of the gilts swap would be to increase government indebtedness, although the government would be able to bequeath its successors a lower interest outlay. It is doubtful that this would be attractive to incumbent politicians.

Another problem with unwinding QE by selling gilts is that interest rates may not be unchanged since QE was done, especially if the unwinding is prompted by economic recovery which would normally push up bond yields. So the prevailing market value of the gilts held may not be sufficient fully to recover the base money that QE creates.

In that case, the choice would be between either leaving QE partially in place, accepting some of the consequences that unwinding was intended to avoid (typically, inflation), or the Treasury 'gifting' the BoE some additional marketable gilts to sell. The latter would increase reported government debt, and also force the government to realise a loss on QE. A natural response to the potential awkwardness of unwinding QE is to simply leave it unwound, rolling off naturally as the gilts purchased by the BoE mature.

Unfortunately, this does not solve the potential fiscal problem. Base money is negotiable, albeit held at banks only. Economic recovery would probably generate opportunities for banks to trade their low-interest reserves for higher-returning assets, typically loan assets.

The attempts of banks, and in turn banks' borrowers, recipients of banks' borrowers' payments and so on, to trade out of base money would be inflationary. Assuming that this is unacceptable, raising the interest rate paid on reserves (or equivalently, offering a more attractive deposit or reverse repo facility) could incentivise the banks to keep holding the reserves.

However, this would reduce the margin between the BoE's income from gilts and the Bank's interest outlay, reducing its profits and hence HMT's income from the BoE, perhaps even to the point that the margin turned negative and HMT was required to reimburse the BoE.

Note that such a net interest outflow would represent a genuine loss to the public sector (which collectively would be paying out more interest on reserves than it was saving by virtue of having bought back gilts from the private sector), not some purely internal transfer between state institutions, as some commentators have suggested.

Nor would it really help to cover this loss by BoE money creation, as the extra reserves would simply add to the base money excess to be redeemed or immobilised.

Another way of avoiding unwinding QE is simply to require the banks to hold the reserves at whatever low interest rate the BoE chooses to pay them by raising reserve requirements. This would amount to a tax on banks. However, despite the banks' unpopularity, the UK authorities appear to have ruled out additional taxes on them, probably because bleeding the banks' capital would make them more risky and reduce their lending.

Finally, I should mention that it is not strictly accurate to discuss QE as if it were done by the BoE as principal and recorded on its own balance sheet.

Officially, QE is the business of the Bank of England Asset Purchase Fund Facility, which, despite nominally being a subsidiary of the BoE, remits all its profits and losses to the Treasury.

When QE was established, this arrangement for the Treasury to take any losses arising from QE was described as an indemnity given to the BoE. The return of profits and losses to the Treasury means that the BEAPFF's value to the BoE in terms of equity is effectively zero (a nominal value of £100 to be precise).

Although the reserves, with which the BoE pays for the gilts it buys on behalf of the BEAPFF, do appear as a liability bearing interest at the BoE repo ('Bank') rate on the BoE balance sheet, those reserves are exactly matched by a loan to the BEAPFF, also at Bank rate.

This arrangement should be more clearly reflected in the new European System of Accounts (ESA10), taking effect in September 2014. ▪

Berlin's softer line as deflation fears rise

ECB squeezed by Italian and French concerns

David Marsh, Managing Director

Amid fresh worries about Japan-style deflation in Europe, and the European Central Bank's September decision to cut rates and purchase asset-backed securities, the German government is likely to take the line of least resistance over latest European discord on its policies of budgetary rigour.

This will allow some extra fiscal leeway for the embattled French and Italian administrations, while maintaining a longer-term drive for reforms and orthodoxy. Yet tensions are building up that point to a deep-seated schism among these three principal members of economic and monetary union, which make up two-thirds of the GDP of the euro bloc.

Angela Merkel, the German chancellor, and Wolfgang Schäuble, the finance minister, have little choice but to acquiesce in renewed pro-growth calls. These are particularly virulent in France, where President François Hollande is looking ever more vulnerable after he was forced to sack Arnaud Montebourg following the former economy minister's assault on Hollande's budget consolidation plans.

Opposition in Berlin to quantitative easing in the form of full-scale European Central Bank purchases of government bonds appears to be softening, even though deep scepticism about the utility of such measures persists. Growing euroscepticism in German politics and the media is increasing pressure on the ECB to maintain an orthodox line.

Any eventual ECB decision on full-scale QE – which could still be months away – must be coupled with cooperation between governments on structural and fiscal reforms, a point made by ECB president Mario Draghi in his speech in the US at the end of August.

Hollande's unexpectedly speedy ousting of Montebourg over what the latter claims were German-inspired austerity policies is being greeted in Berlin as a positive clarification of France's determination to press ahead with reform efforts. Schäuble is keeping up a show of public solidarity with Michel Sapin, the pro-reform finance minister, who held the same post 22 years ago in the ill-starred government of Pierre Bérégovoy (who committed suicide in May 1993) under President François Mitterrand.

Sapin's position has been reinforced in the short term by the departure of his outspoken rival Montebourg, who blamed Merkel for launching 'absurd' policies which unleashed 'the most destructive crisis in Europe since 1929'. The French finance minister could be forgiven for being haunted by a sense of déjà vu, for the parallels with past European monetary turbulence are disturbing.

Sapin is a veteran of the upsets between France and Germany in 1992 that almost forced the devaluation of the French franc within the European exchange rate mechanism, the forerunner of EMU.

He was preparing for a breakdown of Franco-German monetary ties when antagonism between the German and French monetary authorities was overcome by a secret telephone intervention from then Chancellor Helmut Kohl, cajoling the Bundesbank to acquiesce in a statement supporting the franc's ERM parity, in the midst of talks in Paris with President Mitterrand.

At the height of the crisis, Mitterrand told Kohl, 'I am aware of the independence of the Bundesbank. But what does it want? To remain the last one standing on a field of ruins? Because it will be a field of ruins.'

Germany plays down calls for lower current account surplus

German officials are doing their best to play down increasingly pointed suggestions from the International Monetary Fund that it needs to reduce its current account surplus by stimulating domestic demand, *writes Darrell Delamaide in Washington.*

In a report in late July, the IMF quantified what many economists have criticised as the central problem in the euro area. Germany's ability to export with an undervalued currency is creating imbalances that put other member countries under considerable stress.

The IMF economists calculated that Germany's current account surplus was 7.5% of GDP in 2013, equivalent to 8.25% on a cyclically adjusted basis. 'The cyclically adjusted current account balance is 3-6 percentage points of GDP stronger than the value implied by fundamentals and desirable policies,' the IMF said in its multi-country report on external sectors.

Germany's real effective exchange rate is undervalued by between 5% to 15%, the IMF said – 6 percentage points below its historical average in the period 1979-2013. France and Italy, meanwhile, are coping with a currency that is overvalued by as much as 10%, while the overvaluation for Spain is even higher.

The IMF wants the German government to spend more money, even if it means running a deficit. IMF economists suggested that investment in transport infrastructure would benefit both Germany and the entire euro area. German officials reject these pleas. They claim that the imbalances don't create problems in the euro area because Germany's trade surplus with other countries in Europe – particularly with the rest of the euro bloc – has fallen significantly in recent years and so the major imbalances are outside the EU.

But these imbalances – however caused – are a clear source of stress in the international monetary system. Increased German demand would directly benefit the depressed peripheral economies. Furthermore, Germany cannot rely indefinitely on large surpluses with countries outside the euro area. The crisis in Ukraine and the sanctions imposed on trade with Russia have already had an impact on German exports. China's reduced demand for foreign goods is also hitting Germany.

Germany is unlikely to take much note of recommendations to increase investment. The government's draft budget for 2015 approved in July calls for no new borrowing – producing a balanced budget a year ahead of the 2016 deadline. While Finance Minister Wolfgang Schäuble optimistically allots some increases for investment spending covered by higher tax revenue, he strictly opposes any idea of taking on new debt to help France, Italy or other countries.

Both Schäuble and Chancellor Angela Merkel wish to avoid 'moral hazard', under which euro arrangements reduce incentives on member countries to structure their economies and boost underlying competitiveness. The Germans gain great benefits from currency union, but refuse to acknowledge a concomitant obligation to support other member countries. A mutual euro self-help network is as far away as ever. ▪

Glimmer of hope for the euro area

Recapitalised banks are ready to lend

Gabriel Stein, Advisory Board

It has been easy to be pessimistic about the euro area for the past five years. Recent data show that the single currency bloc is still struggling to exit recession.

Broad money and credit growth remains anaemic. Nevertheless, 2015 may bring better news. The European Central Bank's Asset Quality Review and the European Banking Authority's stress tests have combined to depress activity; but as a result, they may boost it in 2015.

One of the contributing factors to the Great Recession has been the collapse in broad money growth. This was partly because of a fall in demand for credit; but also because regulators, politicians and commentators pushed banks to shore up their balance sheets by building up their capital.

Broad money growth

Banks in several countries had to clean up their balance sheets. The insistence on doing so rapidly, usually by raising capital from the domestic non-bank private sector, intensified the slowdown in broad money growth.

Euro area broad money and credit growth remain anaemic. This is partly due to the AQR and the stress tests. The previous round of tests in 2011 was primarily designed to calm markets and to give a clean bill of health to the euro area banking system. But passing banks like Dexia, which failed the day after the results of the stress tests were announced, or Fortis, which had to be rescued shortly afterwards, gave the whole exercise a bad name. It is therefore all but certain that some euro area banks have to be failed in the current exercises and told to shore up their balance sheets further. Whatever the result of the AQR, the banks will be in a healthier position than a year earlier, having built up their capital as a precautionary measure. But this continued build-up of capital has further dampened broad money growth.

Cash in circulation

Without the growth in capital and reserves, broad money growth would have been up to 3% faster over the past six years. This is because of the composition of banks' balance sheets. 'Broad money' consists of cash in circulation and of most of the bank deposits of the non-bank private sector.

Capital and reserves are the other main liabilities of most banks. For any given total size of the banking system balance sheet, a change in capital must therefore be offset by an equal and opposite change in broad money. (This disregards other minor liabilities of the banks.) The most common way in which this occurs is if a bank issues new shares and these are bought by the non-bank private sector – increasing banks' capital but decreasing bank deposits held by the purchasers.

This effect can be avoided in three ways. One is if the new bank shares are subscribed to by the public sector. This is broadly speaking what happened in the US. Another is if they are subscribed to by foreigners.

This has occurred to some extent. The third is if investors buying the new shares borrow all the money they need for those purchases from the banks. This is highly unlikely to occur. We can expect that euro area broad money and credit growth will remain weak throughout the rest of 2014.

While there may be a boost from the ECB's new targeted long-term refinancing operations (TLTROs), which are specifically intended to accelerate credit growth, their impact is unlikely to be felt until later in the year or in 2015. Moreover, the rules surrounding the TLTROs are less clear-cut than the announcement of them in June implied. It is even possible for banks to take full advantage of the TLTROs without expanding their lending.

The full effect of the ECB's move to start asset-backed securities purchases, announced on 4 September, will also take time to work through.

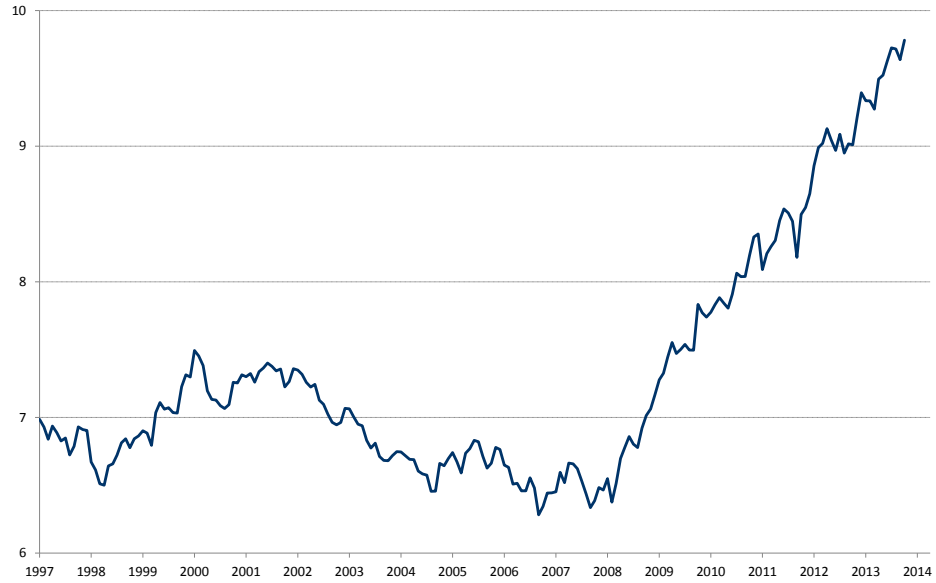
Brighter future

Further ahead, the picture brightens. The tier 1 capital ratio of euro area MFIs (capital as a percentage of the balance sheet) is higher than it has been since EMU began (see Chart).

For most of the single currency's existence, the tier 1 capital ratio (measured on the consolidated balance sheet of all euro area monetary financial institutions) has oscillated around 7%. In early 2015, it may well be up to 10%. Euro area banks will enter next year better capitalised than ever, and – no longer distracted by the AQR and the stress tests – eager to expand their balance sheets by lending. The promise of more cheap money from the ECB provides a further incentive.

This does not guarantee the euro area's recovery. There are numerous pitfalls, economic and geopolitical. Nevertheless, it is finally possible to see some light at the end of the tunnel. ▪

Euro area monetary financial institutions, tier 1 capital , % of balance sheet



Source: ECB

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Unifying money – lessons of history

The limits of monetary policy in European integration

Joachim Nagel and Christian Erb, Deutsche Bundesbank

Economic and monetary union was established as part of the great project to establish peace within Europe. It was designated as a cornerstone of Europe's integration policy since the second world war. Supranational monetary and foreign exchange policy arrangements can encourage integration, but they cannot bring it about by themselves.

Monetary and foreign exchange policy is of minor importance compared with the political and strategic issues. The crucial factor behind European integration is the political determination to achieve it.

A study of 19th-century monetary unions in Europe is instructive. The introduction of a single currency within existing states, under a unified political umbrella, was relatively unproblematic.

By contrast, monetary unions between sovereign states in the 19th century failed in the long term due to the lack of a unified political framework. History teaches us that a common currency cannot succeed in the long run unless it is accompanied by common political commitment.

Opportunity for promoting peace

During the 1950s and 1960s, European policy focused mainly on the integration of industrial and foreign trade policies. From the late 1960s, policy-makers talked seriously about establishing a monetary union aimed at strengthening and completing integration of trade and industrial policies.

The launch of European monetary union on 1 January 1999 came 30 years after the first decisions in 1969. At no stage in this process did leading politicians from across the spectrum miss an opportunity to emphasise the importance of monetary union for promoting peace within Europe.

The euro's introduction worked very well, despite much scepticism. The purchasing power of the euro was – and still is – extremely stable. Contrary to the expectations of sceptics, the interest rates of euro area countries initially converged.

The turning point came when the collapse of Lehman Brothers in September 2008 triggered a global banking crisis. In addition to the US and UK, a number of euro area sovereigns felt forced to take on the debts of distressed banks, much increasing government debt burdens.

At the same time, the banking crisis plunged the global economy into a deep recession. Debts rose, while economic output fell. Many financial market participants began to doubt whether the euro area could survive in its existing form. Interest rates for individual euro area countries started to diverge. Angela Merkel, the German chancellor, expressed fears in October 2011 that 'if the euro fails, Europe fails'.

Since then, the crisis has stabilised somewhat. In Europe, this was also the result of intervention by the Eurosystem, which pursued an expansionary monetary policy and bought government bonds from individual euro area countries. Market tensions have eased since Mario Draghi, the European Central Bank president, announced in July 2012 that the ECB would do 'whatever it takes' to save the euro.

Has the ECB now rescued European integration by rescuing monetary union? Can we breathe a sigh of relief? I fear that the answer is No, for several reasons. First, the crisis is not yet really over. Through its non-standard monetary policy measures, the ECB has merely bought time for policy-makers to act. The euro area's basic structural problems have not yet been solved. This remains the task of parliaments and governments.

Second, there are several ways in which a monetary union can be successful in the long term. But there are also ways of constructing a monetary union which, based on economic judgement and historical experience, is highly likely to lead to major problems. However, this is not the responsibility of the central bank, but of parliaments and governments.

Third, it is clear that some basic questions on the conditions for achieving a durable and successful monetary union are still open. All the problems we encounter in today's EMU also appeared in the 19th century. One fundamental issue is how to transfer a common currency in one country into a multi-country system, where in both cases a shared monetary standard is spread across regions with varying economic performance.

In modern nation states, income is redistributed regionally on a grand scale. In Germany, this takes place through the state government revenue-sharing scheme, federal taxes, statutory health and pension insurance schemes and much else. Purchasing power flows out of buoyant areas into poorer regions.

The alternative in a single-currency economy would be to offset the differences in regional economic performance by means of market adjustments. For example, wages in Berlin would have to be lowered such that they were in line with regional productivity. Money earmarked by Berlin for welfare spending, public buildings and schools would have to correspond to the local level of tax revenue. This was the model contractually agreed for EMU. Its founding members were not prepared to relinquish core elements of their political sovereignty in the form of control over the government budget, debt, their citizens' fiscal burden, transfer payments and the national stance of their economic policy.

However, the notion that Europe should develop from a confederation to a federal state was still on the agenda when EMU plans were being developed in the 1990s. A crucial question is the relationship between political and monetary union. In past discussions of this topic, we saw the collision of two conflicting theories, those developed by the 'economists' with their crowning theory versus the 'monetarists' with their locomotive theory.

François Mitterrand, president of France and Helmut Kohl, chancellor of Germany, on 22 December 1984 participated in a memorial service for fallen soldiers at Verdun, France.

The economists believed that the first step was the creation of a European federal state with corresponding transfer systems, which could then be 'crowned' with a single currency. The monetarists hoped that in a monetary union without a political union the inherent contradiction would force policy-makers to establish a political union.

The ensuing economic pressure would make monetary union pull the European Commission countries into a federal state. Many politicians, especially in Germany, favoured the locomotive theory.

Components of success

In the 1990s, policy-makers chose monetary union without political union. States remained autonomous, without a transfer union, but understood that they were obliged to aim at a similar economic level as measured by the Maastricht convergence criteria. These were set down both as entry criteria and as key elements in the Stability and Growth Pact. Now is not the time to dwell on the infringements, exceptions and amendments to the pact.

Many key states, including Germany, by no means adhered to these self-imposed obligations. The point is that monetary union is only as good or as bad as the general policy it accompanies. It cannot force integration and cooperation. For a monetary union to succeed over the long term, there remain only the two options: a transfer union – in other words, a federal state – or a market-based union with free market forces and limited political sovereignty. Monetary union can strengthen political-economic integration and hence promote peace if this aim is systematically pursued at the overall political level. In one way or another, this demands limits to political sovereignty.

Attempts to turn monetary policy into an instrument for achieving peace and political harmony are a distraction. Monetary and foreign exchange policy are separate from and subordinate to that central political objective.

Historical experiences of monetary cooperation without political union underline these points. We can look at the German Confederation of around 40 sovereign states – some of these had grown from 1834 into the Zollverein, or customs union, creating a single market for participating states under the leadership of Prussia, but excluding Austria.

This involved a large number of competing currencies until the formation of the German Empire in 1871. We can also look at the Latin Monetary Union under which, in 1865, France, Belgium, Italy and Switzerland signed an agreement with the aim of establishing a single world currency – under French leadership. When war broke out in 1914 it effectively ceased to exist, although it formally came to an end only in 1927.

The Scandinavian Monetary Union, linking Sweden, Denmark and Norway, was a result of Scandinavism, a movement supporting closer political ties and cooperation between Scandinavian countries.

In economic terms, its structure was far more stable and sustainable than its Latin counterpart. However the demise of the Scandinavian Monetary Union was likewise triggered by the first world war despite the fact that its three members remained neutral.

All the monetary unions of the latter half of the 19th century, which were contractually agreed rather than based on a political union, were fair-weather unions. They fell victim to power politics, the insistence on national sovereignty in fiscal matters, and/or the inability of contracting countries to rectify flaws in the basic design.

Events in the euro area since 2008 confirm the overriding importance of politics. The euro crisis was essentially a sovereign debt crisis. To stabilise the situation, the euro area member states were forced to relinquish some sovereign rights, either directly or indirectly, via the central bank. Has this also brought us closer to political union in Europe? Has monetary union proved its worth as a peace-promoting project?

The peak of the euro crisis was accompanied by the widespread resurgence of nationalism. In this case, the predictions of the locomotive theory have not yet come to pass.

Locomotive imagery

Building on the locomotive imagery, the embarkation point for the journey in the 1970s and 1980s was a European confederation. The train might at some distant point take us to the terminus of a united European state.

Yet the route map has changed since 1999. The concept of a 'United States of Europe' has dropped well down the agenda. Instead, support for eurosceptic political parties is gaining momentum in many countries.

Regrettably, out of necessity during the financial crisis, euro member governments did not always maintain the locomotive's steady course; the crew on board, notably the Eurosystem central banks, stepped in to keep the locomotive running. They did so because of the initially inadequate policy response of parliaments and governments.

Policy-makers have since proven that they are capable of acting when political will and market pressure are sufficiently great. In October 2012, they agreed to set up the Single Supervisory Mechanism under the aegis of the ECB, potentially the most significant decision since the introduction of the single currency. This highlights the fundamental question of where Europe, the EU and the 'United States of Europe' go from here.

Historical evidence is again useful here. At the beginning of the 19th century, several states that are now nation states were still confederations: Switzerland, Italy, Germany and, to a certain extent, the US. Before these confederations evolved into nation states, they were all involved in monetary unions, but these were clearly subordinate to the politics of war and peace. The key problem faced by these countries was the question of their place on the continuum spanning from confederation to federal state, or even to a unified state. And, in all four cases, this issue was resolved by means of violent conflict. Switzerland emerged as a federal state in its present form in 1848 following the Sonderbund war of 1847. The unification of Italy followed a series of wars between 1848 and 1870, largely fought against Austria.

It was during this period that the Kingdom of Italy was founded, in 1861. The American Civil War began in the same year, because the southern states were opposed to relinquishing what they saw as their sovereign rights.

In 1865, the Union triumphed over the Confederacy, the renegade confederation of southern states. The German Empire, too, was the successor of a confederation that waged a series of wars internally and against foreign belligerents between 1864 and 1871.

In all of these cases, there was a shared identity and a longstanding momentum towards political unity, but a unified political construction transpired only as a result of armed conflict. Following the infernos of 1914-18 and 1939-45, war is no longer a political option.

Experience teaches us that, as well as being contingent on peace, friendship and cooperation, a monetary union requires its members to achieve a high degree of political integration and to relinquish sovereignty.

It does not work the other way around. Peace, friendship and integration cannot be engineered through a monetary union. For a lasting, successful monetary union, political consensus is the conditio sine qua non. Without this, a monetary union is ultimately doomed to failure. ▪

Joachim Nagel is a member of the executive board of the Deutsche Bundesbank, and Christian Erb is an economic historian in the bank's markets department. This is an abbreviated version of the English-language version of Nagel's speech, 'Eine Frage von Krieg oder Frieden? - Historische Lehren aus Währungskooperationen und Währungsunionen in Europa' (A question of war and peace - Historical lessons from monetary cooperation and monetary unions in Europe), at Europäische Kulturtage in Karlsruhe, Germany on 23 May 2014.

In or out, Britain needs EU reform

Why outward-looking policies on Europe make sense

Gerard Lyons, Advisory Board

A recurring theme for business and investors is the potential impact on the UK economy if the country were to leave the European Union in coming years. The same question applies to the possible impact on London, which carries genuinely continental as well as British resonance.

The trouble with much of the debate on Europe is that it gives the impression that the UK will succeed either only if it is in the EU or only if it leaves. The reality is much more complex. The decision of whether to stay or leave, although important, is not the only thing that matters. The outlook depends upon the policies adopted in the UK, the rest of Europe, and the rest of the world.

My 'Europe report' on the key UK-EU issues (with emphasis on London)*, presented by London Mayor Boris Johnson in August, shows that the best outcome for London would be for Britain to remain in a reformed EU. But if the country were to leave yet retain good relations with the rest of Europe, the outlook likewise would remain positive.

Positive view

In general, business and investment professionals hold a positive view of London's prospects, and are simultaneously concerned about the weakness of the euro area economy and about the future if the UK were to leave the EU. If the Conservative party wins the UK election in May 2015, Britain will hold such an 'in-out' referendum. The Labour party and the Liberal Democrats (the Conservatives' present coalition partner) have indicated they oppose a referendum, but – if in power – they may yet decide to reverse this position.

If Britain stays in (through a referendum decision or the absence of one), the key question is whether the EU will reform. For that to happen, the UK needs to play a more engaged role. Meanwhile, if the UK leaves, the outlook will depend upon the policies adopted beyond the UK and the relationship the UK has with both Europe and the rest of the world.

The timeframe of corporate strategic planning is often only a few years, relatively short in economic terms. In that business model there is a bias towards the status quo or to avoid unnecessary uncertainty. Many in the City of London and big business were in favour of the UK joining the euro when or shortly after it was launched in 1999, on the grounds that this is what the UK's European competitors were doing. Gordon Brown, then chancellor of the exchequer, later prime minister, set down five long-term economic tests that concluded the euro was not right for the UK.

Important question

Likewise, now, the bias among business is to remain in the EU. The 'Europe report' singled out 10 studies that gave a flavour of the debate, including an excellent one by CityUK and Clifford Chance outlining the uncertainty and legal complexity associated with leaving.

Perhaps a more important question, though, is how the economies of the UK and Europe will perform over a longer period. To make a sensible comparison of the UK being in or out of the EU it is necessary to look beyond a few years. As a result, the mayor's office commissioned a private sector consultancy called Volterra, led by Paul Ormerod and Bridget Rosewell, to produce some long-term forecasts.

The formal macroeconomic models failed to predict and, more importantly, were unable to explain the 2007-08 financial crisis and what was happening as it unfolded. Such models tend not fully to capture substantial changes in the economic environment such as those discussed in the Europe report. These shifts can either be external to any particular economy, such as the rise of India and China, or can take place within an economy, such as the UK supply-side reforms of the 1980s.

A wider perspective is needed, rather than reliance on static technocratic models. The Europe report concludes the best outlook for the UK and London over the next 20 years would to be in a reformed EU. In this scenario, in real terms, the size of London's economy could increase from its current £350bn, about one-quarter of the UK, to £640bn, creating an extra 1m jobs in London.

The worst economic scenario is where the UK leaves the EU and does so on bad terms with its EU neighbours and does not produce a growth-focused policy.

This inward-looking scenario is very unlikely but if it did occur, the London economy would grow to only £430bn by 2034, a tiny increase over 20 years, and see a shedding of 1.2m jobs.

However, if the UK left the EU, maintained good relations with the EU and adopted outward-looking policies, the London economy would grow to £615bn and see an additional 900,000 jobs created over the next 20 years. This is despite the near-term uncertainty that would follow. This scenario is better than being in an unreformed EU, where Europe underperforms as it does now, and London might see an extra 200,000 jobs created in two decades.

The report presents an eight point reform plan. Three examples give a flavour. The first priority is the future relationship between the EU's euro and non-euro members, above all, safeguarding the rights of the non-euro area and their ability not to be outvoted.

This is a vital area for the City of London. There is a big worry that, in addition to UK-imposed regulation of banks, an unsympathetic regulatory burden from the EU would hamper London versus other global financial centres.

The second issue is ensuring the European single market works, addressing issues relating to services, people and regulatory intrusion.

The notion of movement of people needs to take account of the EU's eastern expansion resulting in huge variations in income levels, pay and benefits between economies such as the UK and others in eastern Europe.

Third, Europe needs to change its mindset to become more innovative, productive, outward-looking and competitive. The immediate problem is to counter the threat of deflation and the lack of domestic demand.

The further ahead one looks, the greater the need for Europe to compete, create jobs and fund its welfare system.

Europe needs to find an economic model that succeeds in the 21st century. If the continent shows that it is heading in the right direction, there is every chance that the UK will remain a solid and constructive partner. ▪

Dr Gerard Lyons is Chief Economic Adviser to Boris Johnson, the Mayor of London. His new book is The Consolations of Economics (Faber & Faber).

**'The Europe Report: A win-win situation', is available from www.london.gov.uk. For further reading on London see '2020 Vision' on London's future (June 2013); the independent cross-party 'London Finance Commission Report' (May 2013); and '2050 Infrastructure Plan' (June 2014).*

Question marks over Juncker

New Commission president must show energy and self-discipline

Stewart Fleming, Advisory Board

The appointment as European Commission president of Jean-Claude Juncker, the 59-year-old former Luxembourg leader, has been divisive. It marks the first time the EU's leaders have been forced to appoint a commission chief selected by the European parliament, a rival – and growing – source of power.

Ahead of the first meeting of the new commission in November, Juncker knows that the European Union faces wrenching internal institutional change, unresolved economic challenges and geopolitical threats (notably from Russia) to its internal stability and international influence.

Litany of obstacles

In a speech to the parliament on15 July, Juncker ran through a litany of obstacles the EU must overcome. He proposed, vaguely, some new policies to address them, including legislating to create an 'energy union' and a 'capital markets union'.

Given the dire economic performance of major countries like France and Italy, as well as smaller states like Portugal, Slovenia and Croatia, and with average EU-wide unemployment of 10%, Juncker sees reviving economic growth as critical.

Juncker's call for deeper EU cooperation through the creation of an energy union is designed to tackle the external threat from a reckless Russian government, partly by reducing dependence on Russia for fuel.

Not least through Nato, the confrontation with Russia brings the US into the heart of European economic security policy.

As Juncker made clear in his July speech, trans-Atlantic relations will, of necessity, be a focus of his commission: and not just on trade policy for which the commission has an EU-wide negotiating mandate and where Juncker says he wants the Trans-Atlantic Trade and Investment Partnership talks to produce a 'reasonable and balanced free trade agreement'. Juncker's hopes for an energy union will, for example, depend in part on cooperation with an energy-independent US.

The US is now capable of helping to diminish the EU's dependence on Russia. Washington should quickly commit to doing so. Even the capital market union Juncker mentioned would function more smoothly with better trans-Atlantic (and British) financial market cooperation. To achieve any of this, Juncker has to inspire greater trust and cooperation between the commission and the member states, particularly France, Germany and the UK, which continue to guard jealously their freedom of action on foreign policy issues.

These tendencies may be reinforced by the appointment of Frederica Mogherini as both the commission vice-president for external relations and the EU's high representative for foreign affairs and security policy. The inexperienced 41-year-old Italian foreign minister replaces Britain's Catherine Ashton in this institutionally messy dual role. Such developments will make Juncker's job harder

So can Juncker live up to the expectations he has aroused? His well-publicised tendency to drink too much, even during official dinners, is a weakness. He has a reputation for being a poor manager, a significant potential hurdle as, for the first time in his life, he takes the reins of a complex multinational government bureaucracy.

Sources of concern

There are other sources of concern. One is his record and his reputation for being 'too political'. As the first permanent president of the Eurogroup of euro area finance ministers he is criticised for feebly going along with Germany and France when, in 2005, they undermined the far from rigorous budgetary discipline of the Stability and Growth Pact. In 2005 he ill-advisedly challenged the ECB's moves to tighten monetary policy.

Then in 2007-08, while not alone, he failed to grasp the severity of the exploding financial crisis until it was too late. Since he owes his appointment to the parliament, national capitals worry that, rather than moderate its demands, he will bend too easily to the parliament's will and reinforce the commission's too-tight link with its Brussels neighbour.

There are early signs that EU member states are preparing to defend their influence in Brussels by nominating a generally high-powered selection of political figures to despatch to Brussels. So, in November Juncker will find alongside him in the commission heavyweight politicians like Pierre Moscovici, the tough and sophisticated former French finance minister, and Günther Oettinger, Germany's experienced energy commissioner.

Jean-Claude Juncker: tough time ahead

Poland's prime minister, the impressive Donald Tusk, who has just been named as the replacement for Herman Van Rompuy as president of the key inter-governmental Brussels' institution, the European Council is yet another powerful figure with whom Juncker will have to work closely.

Juncker will also have to work with European leaders such as Germany's Chancellor Angela Merkel, who made it clear that he was not her first choice for the job.

By common consent Juncker's greatest talent is as a shrewd, and often effective, late-night political fixer. He is not a man keen to grasp policy detail except when this is needed to cut deals in last minute negotiations.

Some would question whether he does have the intellectual energy and self-discipline to command the loyalty of his new colleagues and negotiating partners inside and outside the commission.

He will need both if he is to push through the ambitious agenda he has rightly identified as necessary to cope with what promises to be one of the most demanding periods in the EU's history. ▪

Stewart Fleming is a journalist and writer on international economics. His latest publications include 'Europe, China and the Group of Twenty' (in 'China, the EU and Global Governance', Edward Elgar, 2012).

ECB minutes may bring drawbacks

Scrutiny of divergence may harm bank's independence

Niels Thygesen, University of Copenhagen

Clear and detailed communication from central banks on their monetary policy strategy and how they implement it has become increasingly important.

Transparency is a relatively new phenomenon. Central banks used to be particularly secretive until developments in economic theory helped to make independence for central banks, designed to let them implement monetary policy committed to specified policy objectives, a familiar and uncontroversial notion.

How best to communicate remains a significant issue for the European Central Bank, which has been tussling for some time with the question of whether, and in what form, it should publish minutes of its governing council discussions of monetary policy. The ECB will start publishing these summary records from 1 January. (The table below underlines the similarities between the probable ECB style of publishing and the practice of the US Federal Reserve).

A plausible forecast of how the new style of communication may work is that the published summary of the debate will have to be heavily edited, so as to become relatively anodyne. Additionally, substantive and frank debate will move away from the formal council meeting to more social settings (or perhaps to more secretive closed gatherings).

Prior to the meetings decisions will probably be prepared in detail and in wording to a greater extent than in the past. This will reduce the spontaneity and relevance of the meetings. After looking at the issue from several different angles, I have come to the conclusion that it will be hard for the ECB to do better in communication than in the past – and easier to do worse.

An increasingly complex setting for monetary policy, and exceptionally strong interest by the media and the public in the minutiae of this policy, make efforts at improving communication at the same time harder to avoid and more difficult to implement. Many in the media and in policy-making circles will no doubt see this practice as enabling the ECB to catch up with the best standards of modern central banking.

Whether market participants will feel better informed is doubtful. On balance, the ECB may be ill-advised in following a fashion not designed for its structure and circumstances. The ECB would be wiser to resist this course, especially in view of substantial uncertainties and disagreements over ECB monetary policy.

The issue of ECB record-keeping and communication has been raised several times in recent years, and in concrete form since summer 2013. In a speech in Amsterdam in April, Mario Draghi, the ECB president, revealed that the ECB had decided to begin publishing – with a delay of a few weeks - a summary record of its council debates, following the practice of the US Federal Reserve, the Bank of England, the Bank of Japan, Sveriges Riksbank and several other central banks. Draghi has since explained how the ECB is working on the right format for the summaries, in the light of the special challenges facing the ECB with its diverse multi-state constituency.

Up to now the ECB has communicated its policy decisions (or absence of them) in three ways: through press conferences with its president and vice president, immediately after council meetings; in an editorial article in the ECB Monthly Bulletin about 10 days later; and by a steady flow of executive board speeches and interviews. At the same time, the

How central banks publish their deliberations

Central Bank	Voting members	Meeting regularity	Publication delay	Nature of minutes
Deutsche Bundesbank (DB) Central Bank Council	16-18	Monthly	30 years	Detailed minutes in several versions, containing named as well as anonymous citations
European Central Bank – present Governing Council	24*	Monthly+	30 years	Based on Bundesbank practice
European Central Bank – future Governing Council	24*	Every six weeks+	Three weeks	Non-attributed minutes and summary of main arguments
Federal Reserve Federal Open Market Committee	15	Every six weeks++	Three weeks	Overview of decisions made, minutes and individual votes
Bank of Japan (BoJ) Monetary Policy Board	9	At least monthly	10 years	Detailed minutes and transcripts
Bank of England (BoE) Monetary Policy Committee	9	Monthly	Two weeks	Overview of decisions made, minutes and individual votes

* When ECB constituted in 1998, governing board totalled 17.

+ Denotes regularity of ECB governing council meetings dealing with monetary policy. The council also holds separate monthly meetings dealing with non-monetary policy questions.

++ Plus unscheduled meetings. Full transcripts of FOMC meetings are published after five years.

Data sources: Deutsche Bundesbank, European Central Bank, Bank of Japan, Bank of England, Federal Reserve.

national central bank governors contribute their explanations of the monetary outlook and strategy in their respective national environments.

On the whole this seems a very creditable effort. Statements by the ECB's top officials are at least on a par with those of other central bankers. Compared with the world's currently relevant central banks, the ECB was the first major institution to hold press conferences – although here it followed in the footsteps of the German Bundesbank, which tended to hold hastily convened press conferences after it actually made monetary policy decisions (a slightly awkward form of transparency, since the press conference was normally announced before the monetary policy decision, giving those in the know a significant advance in market-sensitive information).

Two questions thus need to be raised. Could publication of a record of the policy debates add anything to what the ECB does already? And what would the new initiative be likely to change? To help answer these points, we have to re-examine two main arguments for central bank transparency.

Any central bank has two constituencies: financial market participants and the political authorities, representing the general public and represented by the media.

Transparency vis-à-vis the former is desirable to make monetary policy more effective, while the political authorities understandably see transparency as essential to justify the independence they have given to the central bank to implement monetary policy. While there is some overlap between the two basic arguments for transparency, they are sufficiently distinct to warrant separate discussion.

Market participants need to understand what the central bank is up to in order for monetary policy to be effective. The bank's ability to evaluate the economic outlook a year or two ahead, which is broadly the horizon over which policy decisions today have a major impact, is essential in policy design aiming at the one (or two) objective(s) of medium-term price stability (and output close to potential).

For central banks such as the ECB with the single objective of nominal stability, the key criterion for policy success during the Great Moderation prior to 2008 became the anchoring of price expectations over the medium term. Since the financial crisis, the apparent simplicity of a monetary strategy based on some variant of inflation targeting has been replaced by a more complex perspective, giving greater weight to the restoration of output and other real economic variables. The ECB, like other central banks, also has to try to contain the risk of renewed financial instability. This opens up new trade-offs, since market participants need to understand how the central bank is likely to react.

Indeed, the ECB now refers to improved understanding of its 'reaction function' as the main purpose of its communication, assuming implicitly that the economy it is trying to influence is stable. The other revolution in recent years is the reach beyond traditional tools into unconventional monetary policy.

Policy is no longer conducted primarily by moving a short-term interest rate close to zero; the instruments include purchases of longer-term financial assets, sometimes privately issued, and 'forward guidance' as to how the central bank is likely to act over an extended horizon, or at least until some threshold indicator of slack in the economy has been crossed.

Transparency and caution

These extensions of monetary objectives and instruments have reinforced the need for communicating with market participants. But the growing complexity (and greater controversy) surrounding the policy inevitably imposes new discipline on the way in which the central bank carries out its communication tasks. In providing messages to market participants, central banks have to find an optimal mix of transparency and caution. They must guard against excessively confident statements or commitments that appear to be unconditional. Otherwise a central bank faces the risk of appearing inconsistent as it modifies its reactions in the light of new information. And they have to try to minimise confusing discussions about differences in approach and perception among members of the policy-making body.

Given this complex background, the ECB has to ask itself whether publication of summary meeting records will help or hinder achievement of this optimal communication mix. When we consider the other targeted audience – politics, public opinion and the media – these dilemmas loom still larger.

Transparency is a prerequisite for the central bank's accountability. But the experience of publishing the debates in the Federal Open Market Committee or the monetary policy committees in the UK, Sweden and elsewhere shows that the interest generated is often more related to the differences in perspectives of individual members, rather than to the actual decision that is the outcome of the debate.

The current ECB practice of communicating mainly through press conferences focuses on

the decision taken, though possible differences of view will be raised in questions. With a written record of the debate, the interest in media reporting is bound to swing towards the divergences of views.

Even though no attribution of individual views will be made, the search is likely to intensify for who said what (or why no one made a particular point), and whether the president's press conference statements fully reflect contrarian views.

This may not matter much in institutional settings less complex than that of the ECB. Individual members of the Bank of England's Monetary Policy Committee are supposed to span different approaches to monetary economics, so divergences of view are to be expected and even welcomed.

Regional Fed presidents represent different traditions and experiences. The New York and Chicago Feds are held to be closer to markets, the St. Louis Fed places more emphasis on monetary aggregates, and so on. Even so, in both the US and the UK, excessive attention seems to be diverted to different perceptions of individual members of the policy-making bodies – to 'reading the Fed tealeaves' rather than focusing on the economic outlook and on current decisions.

For the ECB, where the national central bank governors come from different countries and political environments, a repetition of Anglo-Saxon experience could put undesirable strain on governing council collegiality and even endanger the ECB's independence.

The political authorities may become keener to set down by legislation not only the objectives for monetary policy, but also the rules by which they are to be attained – as can be observed in the US Congress. The ECB is aware of such dangers, as Draghi's recent remarks show, but they may be inherently unavoidable. ▪

Niels Thygesen is Emeritus Professor of Economics at the University of Copenhagen and a member of the Advisory Board. He was a member of the Delors Committee on monetary union in 1988-89.

Lessons from Scotland's referendum

The battle of heart and head

John Nugée, OMFIF Director

For the UK, which limits its formal election campaigns to just three weeks, the two years or so of the campaign leading to the Scottish independence referendum on 18 September has been not just a lengthy but also a deeply revealing experience.

OMFIF has closely followed this campaign, writing extensively on the subject and holding a seminar in Edinburgh on 9 June on the monetary aspects of the referendum and the relevance of European experience.

Three themes stand out. First, for all the length of the campaign, there has been very little meeting of minds or debating between the two sides. All along, the two camps have had totally different mindsets, what has been called the William Wallace approach versus the Adam Smith one*.

Arguments for independence

If you are deciding with your heart (the William Wallace approach) the arguments for independence are strong. Much smaller and poorer states than Scotland have made a success of independence, and to say outright that Scotland could not succeed on its own is not credible, not to mention precisely the sort of patronising comment that gets nationalist blood boiling.

But if you are deciding with your head (or your wallet), which is the Adam Smith approach, then there is little question that over the longer term Scotland would be financially better off staying in the UK.

So there have been two completely separate debates – the pro-independence Yes side has argued the emotional case intensively and, for many, successfully. The pro-UK No side has relentlessly put the economic facts forward, and on this territory the No proponents have shown that they hold most of the aces.

The lack of real connection between the two sides meant that there was little movement in the polls for the first two years of the campaign (as the charts below show).

The polls only started to narrow dramatically, for reasons that are not entirely clear, after the ill-tempered second televised debate on 25 August between Alex Salmond, the Scottish first minister and leader of the Yes campaign, and Alistair Darling, the former UK chancellor of the exchequer and leader of the No grouping.

The second theme is that the absence of a written constitution in the UK, usually seen by British constitutionalists as a strength, as it enables the political class to employ imaginative flexibility, has on this occasion proved more of a drawback. With no pre-agreed way of conducting constitutional change, the process has been surprisingly ad hoc and, many would say, deeply flawed.

Both the process for establishing the referendum and the terms under which it is being held run counter to best practice in mature democracies.

Future generations of historians would be excused if they looked back on the way it was set up with incredulity.

Under the terms of the 1998 Scotland Act, which established the Scottish parliament and granted it devolved powers over certain matters, the union between Scotland and England was deliberately specified as a 'reserved matter' – that is, kept as something only the all-UK parliament at Westminster could decide on.

This did not stop the Scottish Nationalist Party, victorious in the 2011 Scottish election despite winning just 45% of the popular vote, asking for permission to hold a referendum. That was not a surprise, as the referendum demand was in the SNP manifesto.

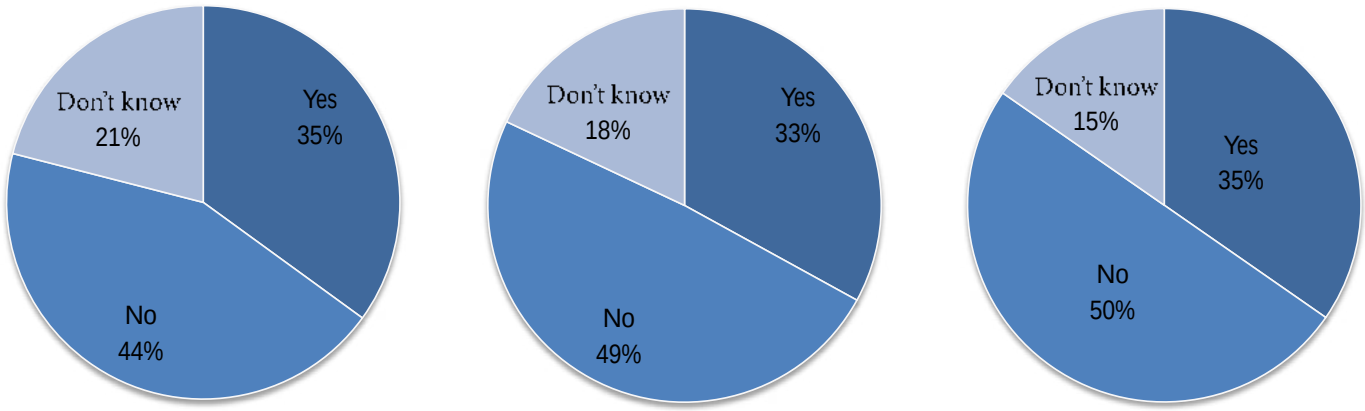
Cameron's surprise

What was a surprise though was that David Cameron, the UK prime minister, agreed to the SNP's request. Other governments facing separatist claims, for example successive Spanish administrations in Madrid which have for many years faced agitation from both Basque and Catalan nationalists, have shown more commitment to defending the integrity of the state. And they have been much more reluctant simply to agree to the demands of their separatist movements.

Moreover, Cameron decided this move without any reference to the UK parliament. The matter was concluded as an inter-governmental agreement between the British and Scottish governments (the Edinburgh Agreement of October 2012), and legislated for in an act of the Scottish, not Westminster, parliament through the Scottish Independence Referendum (Franchise) Act 2013.

In other words, a referendum with the potential to break up the UK was established without any discussion at, far less the consent of, the UK parliament. On top of this, the form of the referendum is very unusual. Most

Opinion polls 2012-14: Should Scotland be an independent country?



Source: UK Polling Report, Panelbase/Sunday Times

mature democracies that have an established process for constitutional change require proposals to pass a significant test before they accept a change to their constitution.

The most common ways of setting this test contain one or more of three elements. The first is the requirement for a super-majority; that is, not just a plurality of the vote, but, say, 60% of the vote (or 50% of the full electorate, which is in practice much the same), to show that the decision has unequivocal support.

The second requirement is for a confirmed majority, repeated over two or more votes, to show that the decision is the settled will of the people. And the third one is for a widespread majority, for example more than 50% of the votes in more than 50% of the electoral districts, to avoid one section of society imposing on another.

All three of these methods aim to prevent a narrow and potentially short-lived majority committing the country to a significant and permanent change.

But the Scottish referendum has none of these safeguards. A 50.1% vote for independence, in a one-off poll and in a country where one region (the central belt around Edinburgh and Glasgow) dominates all the other regions numerically, would be sufficient to end a union that has prospered for over 300 years.

As a final twist, the people of Scotland are being asked to vote definitively and irrevocably. For if Scotland votes Yes there is no way back, no way to ask to stay in the UK after all if the terms Westminster offers for independence are unacceptable.

Terms of independence

The Scots are being asked to opt for a status (independent or not) without knowing any of the terms under which independence would be enacted or their continued membership of the UK would be administered.

This is a classic case of being asked to buy a 'pig in a poke' and thoughtful Scots are not alone in wondering how they have been given such an impossible question to answer.

And the third theme is that, although a Yes vote for independence would indeed be final, leaving aside the small matter of negotiating the actual terms of Scotland's independence, a No vote is most unlikely to be the end of the matter.

Some people may hope that, if the pro-UK campaign wins, then the issue can be quietly forgotten about for a generation or more and we can all go back to business as usual. But this is almost certainly an illusion.

All the Westminster parties have promised Scotland further devolved powers in the event of a No vote, without specifying exactly what those extra powers would be. There is much scope for uncertainty, both in Scotland as the new powers are enacted and also, perhaps more significantly, in England, where resentment is likely to grow at the imbalances between the various constituent parts of the UK.

Famously, Scottish MPs at Westminster can vote on England-only issues, whereas English MPs have no say at all on Scotland-specific matters. This is the so-called West Lothian Question, which can only be exacerbated by the granting of further powers to those north of the border. And all the time, a pro-independence movement in Scotland which has perhaps only narrowly lost the referendum will be itching for a chance to have a second attempt.

All this means is that whatever the result on 18 September, the UK has certainly not seen the last of Anglo-Scottish tensions and political controversy. This may be a case where the campaign, and the controversies surrounding it, carry on well beyond the actual electoral vote. ▪

*John Nugée is a Director of OMFIF. He is the author of Reflections on Global Finance: Selected Essays 2002-2013. *The author owes this insight to Alastair Newton, Senior Political Analyst of Nomura International, who first phrased the debate in these terms.*

What they said : How OMFIF commentators tracked the Scottish referendum campaign

David Marsh

At times, one despairs of politicians. With the Scottish nationalists, the emotion is not despair but utter stupefaction.

Their centerpiece is a plan to maintain sterling and the role of the Bank of England even after the Scots have pulled out of the UK.

The Bourbon kings are celebrated for having learned nothing and forgotten nothing. Alex Salmond appears to have gone one step better. With respect to Europe's tortured experience with EMU, not only has he learned and forgotten nothing, but also he has drawn precisely the wrong conclusions.

Salmond has chosen to ignore the prime lesson of the euro — that you need political union to make monetary union work. With breathtaking chutzpah, Salmond believes his country can withdraw from political union with the rest of Britain — yet still carry on with monetary union with England as though nothing had happened.
(December 2013)

Andrew Large

Taxpayers in one country will not make transfers to support another without a pooling of sovereignty. The problems surrounding the euro make this all too plain.

This, however, remains the preferred option of Alex Salmond. He states, correctly, that maintaining the sterling currency union is in the best interests of the people of Scotland. But he seems unable to accept that this would require negating the very independence gained by a Yes vote. So he threatens that – unless he secures a currency union but without political union – Scotland will refuse to accept its share of UK national debt.

An independent Scotland would honour its debts only if the rest of the UK agrees to make available its own taxpayers' money as needed. Why would the rest of the UK agree to this extraordinary demand? And would self-respecting Scots be comfortable behaving in this morally indefensible way?
(August 2014)

Niels Thygesen

One of the main issues is whether Scotland could continue in a currency union with the rest of the UK after a Yes vote. Observers have argued that a successful currency union requires a political union.

This reasoning will come as a surprise to the Netherlands, Austria and Finland among others – which share their currency with Germany without contemplating political union. They retain national responsibility for most economic policies.

It is not incompatible with sovereignty to want to make use of the currency of one's main trading partner, even when the prospect of influence on the management of that currency is non-existent.

Why not see Scotland's hope to continue to use sterling and not to seek independence from the Bank of England as a recognition of the quality of an international public good supplied by the UK? So this would be a compliment, rather than solely a self-serving ambition. *(September 2014)*

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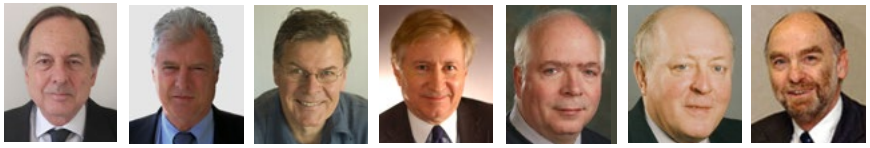

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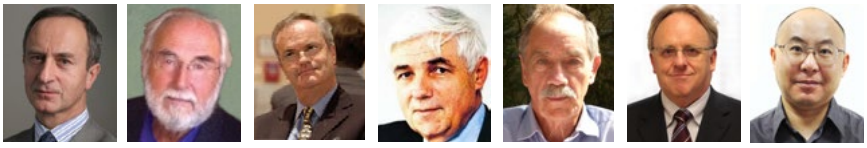

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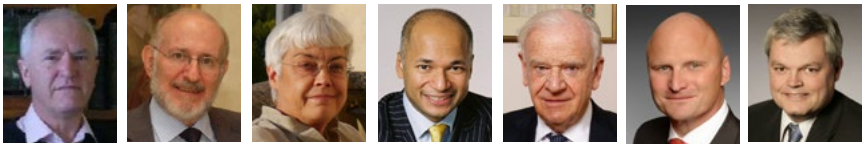

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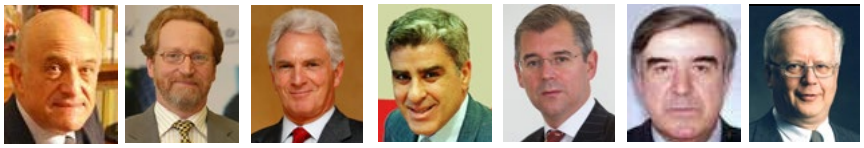

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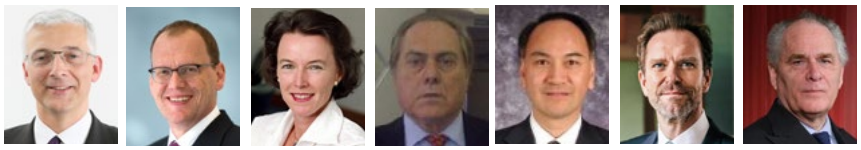

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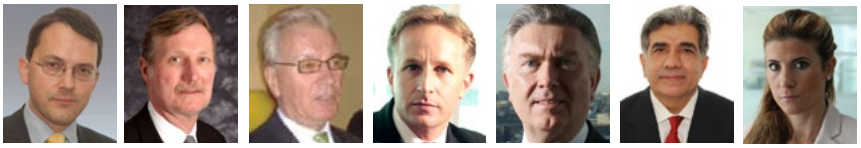

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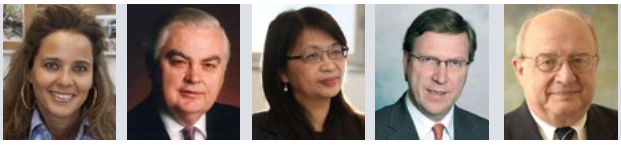

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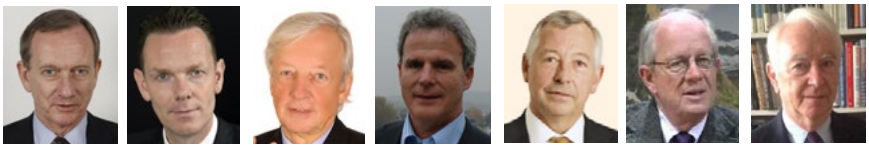

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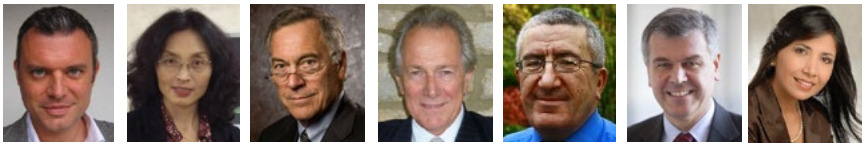

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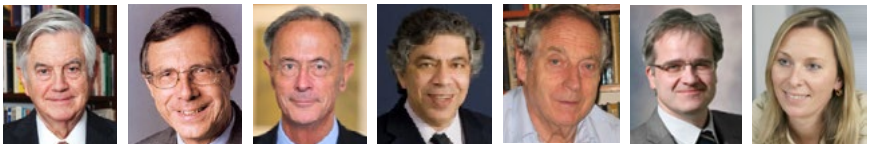

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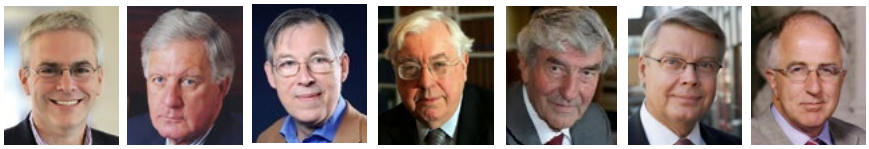

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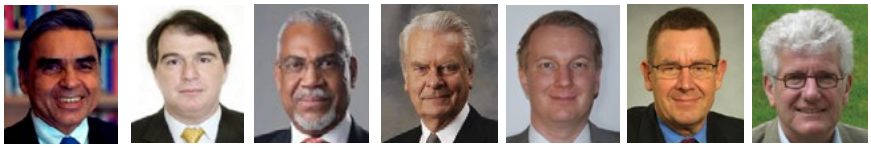

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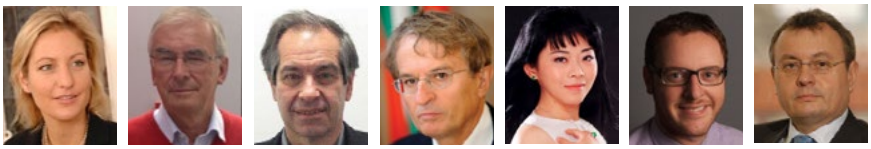

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Italy's quest for sovereign fund link-ups

Renzi's mission to promote cooperation with Africa

Celeste Cecilia Moles Lo Turco, Advisory Board

Italian Prime Minister Matteo Renzi embarked in July on an African tour aimed at bolstering trade ties, visiting Mozambique, Congo-Brazzaville and Angola.

Italy currently holds the European Union presidency and this makes the visits even more important, leading EU foreign policy towards a new focus on Africa and the Mediterranean region, addressing economic cooperation, stability, immigration and terrorism. Renzi met the presidents of Mozambique, Congo-Brazzaville and Angola, respectively Armando Guebuza, Denis Sassou Nguesso and José Eduardo dos Santos.

Sub-Saharan growth

Trade between Italy and the three sub-Saharan countries has grown significantly in recent years (see Table 1). Sub-Saharan Africa, with an expected average growth rate of nearly 5% from 2012-16, represents an important economic and political priority for Italy (See Table 2).

Sectors for possible collaboration are infrastructure, construction, agro-food, tourism, culture and education, defence and energy. Energy is the most important.

During the visit the Italian oil company Eni, a major foreign oil producer in Africa, announced investment of $50m in gas projects in Mozambique. In addition it signed a cooperation agreement with André Raphael Loemba, Congo-Brazzaville's minister of hydrocarbons, for the development of new offshore activities.

In Angola the company boosted cooperation with the state oil company Sonangol on international expansion and domestic infrastructure, with a specific focus on the Lobito oil refinery. Another sector of high interest is defence. Last year this sector saw a 40% increase in Angola's budget. Talks started when a delegation from Angola visited some Italian companies active in the military sector such as Finmeccanica, Fincantieri and Iveco. Angolan representatives expressed an interest in Selex control systems, Alenia Aircraft and the Italian carrier 'Cavour'. Italy is seeking to position itself among the traditional suppliers of Angola such as Russia, Cuba, China and Brazil.

Attracting investment

In Angola, the prime minister met the chairman of the Angolan Sovereign Wealth Fund (FSDEA) to explore possible collaboration in industry, agriculture, infrastructure and tourism.

According to the SWF Institute, 10 African funds with a total endowment of $160.5bn share the tasks of supporting domestic development and attracting foreign direct investment (see Table 3).

In its portfolio allocation, FSDEA intends to invest half of its portfolio in alternative investments that can support domestic development (see Table 4). Possible collaboration with Italian companies with significant relevant know-how could be of great importance.

While Congo-Brazzaville and Mozambique are in the process of setting up SWFs, the FSDEA is in its preliminary phase of activity but has already invested in sovereign bonds (see Table 5).

FSDEA started its activity in 2012 with an endowment of $5bn. It is the second biggest sub-Saharan fund after the Pula Fund of Botswana, with an endowment of $6.9bn.

The technical details of possible future collaborations with FSDEA will be discussed during the follow-up mission, already scheduled in November, led by Carlo Calenda, Italian deputy minister for economic development. He will be accompanied by Italian businessmen.

A possible partnership with the Italian Strategic Fund, which already has important link-ups with SWFs such as the Qatar Investment Authority, the Kuwait Investment Authority and the Russian Direct Investment Fund, has been discussed.

This is the first time that the Italian government has approached a new SWF, still in its preliminary phase of activity. This represents an important addition to the economic policy of the new Italian government.

Building relationships

According to Italy's economic policy, expected GDP growth of 1% could be achieved in three years through increased exports, the internationalisation of Italian companies and the development, among others, of the agro-food and the energy sectors. The expected results of the mission will work through into the longer term, as part of Italy's efforts to build up its overall relationships in Africa.

During the visit, Italy assured Angola of its support to become a non-permanent member of the United Nations Security Council for the 2015-16 session. This is not the first time that Italy has supported Angola; it was the first western European country to recognise its independence in 1976.

The closeness of links between Italy and Africa is becoming steadily more apparent. Renzi's visit reinforces links that will extend further in economics and politics, and build on strong historical ties. ▪

Celeste Cecilia Lo Turco is a sovereign wealth fund expert for the SWFs Strategic Committee of the Italian Ministry of Foreign Affairs and the SWFs Law Centre.

Table 1: Bilateral trade between Italy and Angola, Congo-Brazzaville and Mozambique

	Angola			Congo-Brazzaville			Mozambique		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Imports from Italy ($m)	2,072	880	733	533	312	302	462	353	470
Exports to Italy ($m)	333	363	460	295	190	255	70	47	58
Bilateral Trade ($m)	2,405	1,243	1,193	828	502	557	532	400	528

Sources: WTO International Trade Statistics 2013

Table 2: Economic overview of sub-Saharan Africa, Angola, Congo-Brazzaville and Mozambique

	Sub-Saharan Africa	Angola	Congo-Brazzaville	Mozambique
GDP 2013 ($bn)	1,317.9	121.7	13.8	15.3
GDP 2016 (exp. $bn)	1,618.2	147.7	16.6	21.5
Population (m)	876.9	20.8	4.2	25.9
Gas production (m m^3)	47,855	752	946	3,820
Oil production (m bbl/d)	5.9	1.9	0.3	-

Sources: International Monetary Fund, World Economic Outlook Database (April 2014), The World Factbook (data 2012), Doing Business, the World Bank (June 2013) and US Energy Information Administration, (2013)

Table 3: SWF Institute list of African SWFs

African sovereign wealth funds		
Sovereign wealth fund	Country	Endowment ($bn)
Libyan Investment Authority	Libya	66.0
Algeria Revenue Generation Fund	Algeria	77.2
Pula Fund	Botswana	6.9
Fundo Soberano de Angola	Angola	5.0
Nigerian Sovereign Wealth Fund	Nigeria	1.5
Gabon Sovereign Wealth Fund	Gabon	0.4
National Fund for Hydrocarbon Reserves	Mauritania	0.3
Fund for Future Generations	Equatorial Guinea	0.1
Ghana Petroleum Funds	Ghana	0.1
Mauritius Sovereign Wealth Fund*	Mauritius	3.0
*Proposed	Total	160.5

Sources: SWF Institute updated by the author in July 2014

Table 4: Expected portfolio allocation of FSDEA

Fundo Soberano de Angola - Asset Allocation		
Asset group	Cash, fixed income, G7 public equities	Alternatives
Objective	Preservation of capital	Return maximisation and infrastructure development
Asset allocation target	50%	50%
Investment universe	Cash	Emerging markets
	Sovereign agencies	High yield
	Supranational	Commodities
	Large companies (investment grade)	Agriculture and mining
	Financial institutions	Infrastructure
	Developed public equities	Property
		Brics and frontier markets equities
FSDEA will make a commitment of 7.5% to social development and socially responsible projects in the areas of education, income generation and off-the-grid access to clean water, healthcare and energy.		

Sources: FSDEA

Table 5: African SWFs

Sovereign wealth fund	Foundation	Origin	Assets ($bn)	Objectives
Fundo Soberano de Angola	2012	Commodity	5.0	Stabilisation; Future generations
Congolese Investment Fund	2014	Commodity	1.0	Saving; Fiscal buffers
Mozambique Sovereign Wealth Fund	2018-19	Commodity	n/a	Infrastructure; Independence from international finance institutions

Sources: WTO International Trade Statistics 2013

Nigeria diversifies foreign exchange holdings

Managing reserves in a low yield environment

Lamido Yuguda, Central Bank of Nigeria

Facing a low yield environment on world capital markets, many central banks have started to diversify foreign exchange reserves into less liquid but higher-yielding assets, including those on the large but still barely accessible Chinese bond market.

China ranks No. 4 in the global list of word bond markets, with outstanding bonds of Rmb25tn (over $4tn), but the market is accessible only to domestic participants and foreign investors who have secured the necessary authorisation under various entry schemes.

The Central Bank of Nigeria decided to diversify a modest portion of reserves into renminbi in 2011, first investing an initial tranche in the offshore market in Hong Kong, while the Chinese authorities were considering an application for an onshore quota.

This decision took into consideration growing Chinese-Nigerian trade, the Chinese authorities' increased efforts to internationalise the use of the renminbi, and the introduction of renminbi settlement for China's trade with the rest of the world.

Growing international acceptance

Developments in the last few years – from numerous Chinese bilateral currency swap agreements to the emergence of additional financial centres, London and Singapore, as renminbi trading hubs – underscore the renminbi's growing international acceptance as a potential reserve currency.

For central banks in general, one of the reasons for diversification and yield enhancement has been to improve profitability. Because of the need to sterilise large foreign currency reserve inflows using higher-yielding domestic securities, low interest rates on the main two reserve currencies, the dollar and the euro, have had a big impact on operational profitability.

However, for the CBN, liquidity and capital preservation take priority. The CBN pursues higher returns only with instruments that assure these two primary objectives.

The CBN is statutorily required to 'maintain external reserves at levels considered by the Bank to be appropriate for the economy and monetary system of Nigeria'.

The CBN's reserve management framework ensures the harnessing of foreign exchange receipts from all legitimate sources for the benefit of the Nigerian economy, including settlement of official external debt and meeting the needs of the private sector.

Further considerations are the proper functioning and regulation of the foreign exchange market, and the ability to accumulate excess foreign exchange that builds up the overall total, beyond coverage of short-term needs for debt and import payments.

Foreign exchange reserve growth

Nigeria's foreign exchange reserves have grown significantly over the last 10 years from around $8bn in 2004 to about $40bn in 2014, reaching a peak of $63bn in 2008 before the financial crisis. Oil and gas sales, and to a lesser extent portfolio investment flows, have driven this growth.

As a proportion of total foreign exchange reserves CBN's onshore and offshore renminbi investments now represent about 5.5%.

At the same time, the CBN has implemented an appropriate institutional structure, establishing for the investment committee broad powers over investment policy, risk limits and appointment of external managers, global custodians and other counterparties.

Day-to-day portfolio management is delegated to the reserve management staff. The functions of dealing, settlement, compliance and accounting were segregated to enhance controls and build a strong risk management culture.

Reserve management philosophy

Nigeria runs a managed float of the naira and the CBN intervenes regularly in the foreign exchange market to keep the naira exchange rate within the policy band set by the Monetary Policy Committee.

Consequently, CBN has a high liquidity requirement, helping explain its bias towards holding safe assets in the foreign exchange reserve portfolio.

These two constraints have helped CBN develop a risk aware reserve management philosophy which insists on low bid-offer spreads for eligible reserve assets and their convertibility to cash at or near previous market values, in addition to having acceptable issuer and issue credit ratings.

Sticking to this philosophy in designing asset management and securities lending guidelines has helped CBN avoid losses, especially in the aftermath of the failure of Lehman Brothers which exposed significant risks in repo markets and money market mutual funds. CBN's portfolio team manages around 75% of the reserves, with the balance managed by external managers.

Both internally and externally managed fixed income portfolios are kept by a global custodian, who also acts as a securities lending agent. The CBN carefully negotiated a securities lending programme in 2007, governed by investment guidelines that reflected CBN's stringent risk management framework.

This resulted in the exclusion from collateral guidelines of the lower quality and less liquid securities which eventually suffered impairment during the ensuing crisis one year later.

Low interest rates

The financial crisis and the response of central banks, especially in the US and Europe, have led to low interest rates and massive quantitative easing programmes.

Traditional safe assets have offered very low returns for the last six years. Spreads on riskier assets such as emerging market bonds and high-yield bonds have narrowed significantly.

Money market investments, especially US Treasury bills and commercial bank deposits, the short-term assets that central banks typically use for their liquidity portfolios, pay near zero interest rates.

In the US, interest rates are likely to be raised modestly next year if the pace of recovery continues, raising the prospects of lower or even negative returns on fixed income portfolios. So reserve managers all over the world face no significant respite from challenging conditions. ▪

Lamido Yuguda is the Director of the Reserve Management Department at the Central Bank of Nigeria.

Multipolar currency system

China-style managed capital might provide an answer

Russell Silberston, Investec Asset Management

The 70th anniversary of the foundation of the Bretton Woods System in 1944 provides an opportunity to debate a reordering of the international monetary system, in flux since the breaking of the dollar-gold link under President Richard Nixon in 1971.

In the aftermath of the most severe economic downturn since the Great Depression of the 1930s, should policy-makers consider refashioning the framework of world money? China, the world's second largest economy and one of the greater success stories in the past 30 years, furnishes some important pointers for a possible way forward.

Multipolar system

Policy-makers could aim to establish what would effectively be a multipolar currency system, held in place not by a commitment to free capital flows but by restrictions on these movements to stabilise the environment for industrialised countries and emerging market economies alike. If free capital flows were confined solely to foreign direct investment, a country could perhaps achieve internal balance and financial stability while still attracting long term capital investment. This, coupled with a shift away from a dollar-based system toward a multipolar set-up that included the dollar, euro and a free floating renminbi, might then form the basis of a more stable system.

Many politicians and financial market participants would dislike the idea, but the benefits might well outweigh the costs. China is a crucial part of these considerations. Not only because the renminbi would be an important part of a new international system that we may well see developing. In spite of the commitment to an increased cross-border use of its currency, China seems likely to maintain relatively close control of its capital account.

The International Monetary Fund has sanctioned such a set-up. It concluded in 2012, after years of deliberations, that 'in certain circumstances, capital flow management measures can be useful' to mitigate 'policy challenges' caused by 'rapid capital inflow surges or disruptive outflows'. The IMF laid down: 'There is … no presumption that full liberalisation is an appropriate goal for all countries at all times.'

As far back as 1963, economists Robert Mundell and Marcus Fleming realised that independent monetary policy, free movement of capital and fixed foreign exchange regimes were an 'impossible trinity'. In an era of free flowing capital, they postulated, only a floating exchange rate permits monetary policy independence. The alternative is to manage a capital account closely, the practice followed by China and which leading Chinese policy-makers have indicated is likely to continue.

Research published last year by Hélène Rey, professor of economics at London Business School, has gone further and highlighted a 'dilemma not trilemma' whereby 'cross border flows of leverage of global institutions transmit monetary conditions globally, even under floating exchange rate regimes'.

The constraints on national policies are still more rigorous than those outlined in the 'impossible trinity'. Even with freely flowing capital, the global financial cycle constrains national monetary policy, regardless of exchange rate regime. Those countries that adopt policies suitable for their own domestic conditions are swamped with potentially disruptive capital flows. To offset unwanted currency strength, they build up very high foreign exchange reserves – as has happened with many emerging market economies – that subsequently flow to those markets large enough to accommodate them.

This is one reason why the world lurches from one financial crisis to another. The Bank of England has estimated that, between 1973 and 2009, the world endured an annual average of 2.6 banking crises, 3.7 currency crises and 1.3 external sovereign defaults. Underlining how unbalanced, inefficient and unstable the informal international system has become.

The set-up inaugurated by the United Nations monetary and financial conference in July 1944 in Bretton Woods was based around the dollar. On the reckoning of the Bank of England, in a paper published in 2011, the system lasted in its originally intended form for just nine years. Even if we count the demise from 1968 or 1971-72, Bretton Woods was less durable than the gold standard that prevailed until the outbreak of the first world war, or the informal system with which lasted for more than 40 years.

This short history was characterised by stable economic growth, moderate inflation and virtually no financial crisis, in stark contrast to today's arrangements. There is room for debate over whether this success was because of, or despite, the Bretton Woods agreement. However, in any other system than one based on barter, it is impossible for international trade to function without a monetary mechanism. Trade growth is crucial to improving countries' economic positions. A smoothly functioning international system is a prerequisite for economic wellbeing.

After Bretton Woods

Such a system should encompass three broad objectives. The first is to achieve internal balance that allows individual countries to adopt domestic macroeconomic policies that generate non-inflationary growth. The second is to create allocative efficiency, whereby capital can move in response to relative price signals between countries. The third is to minimise the risks to financial stability.

Today, countries are free to choose their own monetary system. There is a range of foreign exchange regimes, from those still pegged to the dollar to those that fully float. Global capital movements are vast. The reform drive, therefore, should come as no surprise. Many have criticised the dominance of the dollar, the enormous amount of foreign exchange reserves created by currency intervention and the magnitude of capital flows. Some experts, including Zhou Xiaochuan, governor of the People's Bank of China, have called for a much greater role for the special drawing rights.

However, the problems are more protracted than those caused by the dollar's dominance. Richard Cooper, professor of international economics at Harvard University, concluded that, if all central bank reserves were converted to SDRs and held at the IMF, this would make very little difference to the performance of the world economy. The influence of the dollar reflects the size and nature of the US economy and its financial markets. A switch to the SDR would not eliminate capital account deficits and surpluses, would not stop speculative capital flows and would not stop financial leverage.

At present, the world is stumbling from one financial crisis to another, still bickering about how to achieve global economic balance, efficient allocation of capital and financial stability. The answer may be elusive, but policy-makers need to attempt to find a solution. ▪

Russell Silberston is the Head of Reserve Management at Investec Asset Management.

China may exert undue influence

Challenge for Brics bank: escaping Beijing's pull

Jonathan Fenby, Trusted Sources

The Brics countries have evolved beyond the status of a catchy marketing acronym. Brazil, Russia, India, China and South Africa hold annual summits and, this summer, agreed to set up a development bank to fund infrastructure projects, along with a $100bn swap line.

Some saw this as heralding the advent of a rival to the World Bank, to be followed, perhaps, by a new model of the International Monetary Fund for the developing world. It is a riposte to what the Brics see as an unfair weighting in major global financial institutions in favour of developed economies, a complaint given added edge by memories of the austerity programme enforced on developing nations by the IMF after the 1997 Asian financial crisis.

The acronym has always struck me as somewhat misleading. To put Brazil, Russia and India ahead of China seems contrarian, even more so when Brazil has slowed down and Russia risks going into reverse.

The Brics and other emerging countries have plenty of reasons to think of action, starting with the refusal of the US Congress to approve reforms that would have doubled the IMF's capital to $720bn and moved six percentage points of quotas to poorer states. Raghuram Rajan, the governor of the Reserve Bank of India, has criticised how rich countries pursue monetary policies without considering others. A closer look at the Brics bank plan induces some caution. The initial capital which will not be paid in all at once, will be $50bn with a ceiling set at twice that amount. But it must be put into perspective. China alone has pledged to funnel $20bn into Africa each year. But the swap line which gives their central banks access to foreign currency points to a potential flaw.

Left to right: Brics leaders, Dilma Rousseff, Vladimir Putin, Manmohan Singh, Hu Jintao and Jacob Zuma.

The five are to contribute very different amounts, varying between China's $41bn and South Africa's $5bn. That reflects the disparity within the grouping. The Shanghai-headquartered bank may develop into a Chinese-dominated organisation, or be subject to political divisions if other partners resist that. This would fit neatly into Beijing's drive to internationalise the renminbi and its readiness to step in to help bail-out governments in difficulties. Use of the Chinese currency has increased greatly in relative terms. But it still accounts for only 1% of foreign exchange dealing in London. Liberalisation of the capital account looks like being among the last of China's reform proposals to be enacted.

The new bank's reserves will probably be held, and its loans will be made, in dollars. So, far from offering an alternative to the rule of the greenback, it will actually create new international demand for the US currency. ▪

Jonathan Fenby is China Director of emerging markets research service Trusted Sources.

Exacting tasks for the New Development Bank: rising above international cronyism

In 2008 China's economy looked like it was coming to the world's rescue. The driving forces were largely state-owned banks funded by domestic depositors, independent of the world's frozen interbank markets and worthless subprime mortgages, *writes John Adams.*

The Industrial and Commercial Bank of China became the biggest bank in the world, in terms of deposits. Another element of buoyancy was China's own version of quantitative easing – a massive injection of funding into the economy, some 100% of GDP over four years. In the third quarter of 2014, the picture has changed. The US economy is at last recovering, and the euro area – although not looking in full health – has at least survived. The position in China is now less clear.

The massive post-2008 QE has sustained growth, but created a housing bubble, even though this is now deflating. Many challenges lie ahead. China has skilled and experienced financial policy-makers. They will be needed, in the interest of a stable, prosperous China that is essential to the world economy. For some years, China's basic structural task has been to shift the source of growth away from investment, running at nearly 50% of GDP, towards domestic consumption. While both the IMF and the Asian Development Bank affirm that transition is now taking place, their predictions in mid-2014 showed the investment remaining at this high level into 2015.

The emphasis on investment would be positive if it was channelled into productive areas, but too much has been wasted on commercial and residential property, or overcapacity in areas such a steel. On the other hand China is still investing in useful projects, such as building a high-speed rail network that puts the European Union and the US to shame.

Having linked Beijing to Lhasa and Hong Kong, Chinese railway-builders are now said to be planning a line from Beijing to Baghdad, last ruled by Beijing under the Mongols' Yuan Dynasty from 1271 to 1368. The IMF's Article IV report from July 2014 highlights both the positive factors and the constraints. GDP growth has slowed from 9-10% to a less febrile 7% annually, and is expected to continue at this rate in 2015. The current account balance has halved to around 2% of GDP. Inflation appears under control, at around 2.5%, while job creation has increased. However, on the negative side, China's total debt to GDP ratio is now 251%. *...continued on p.31*

Brazil's role in global financial governance

Questions over contingent reserve agreement

Maria Antonieta Del Tedesco Lins

The Brics meeting in Fortaleza in Brazil on 14 July to launch the New Development Bank was perfectly timed to raise questions about global financial governance and the role of large emerging economies.

It is no coincidence that the financial institutions' missions are analogous to those of the World Bank and the International Monetary Fund. However, the initial capital is fairly low, considering the size of the national economies and potential needs of the shareholders.

The $50bn available to the NDB to invest in infrastructure projects is close to the amount disbursed by the World Bank in 2013, but well below the disbursement of the Brazilian Federal Development Bank (BNDES) – R$190.4bn or $88bn last year.

In the case of the other part of the NDB, the contingent reserve agreement (CRA), this apparatus is designed as a financial protection network, made up of contributions by the five countries, proportional to the size of currency reserves and economies.

Essentially, the CRA will be a joint stock of reserves devoted to shielding the Brics economies in bad times, providing the market with signs of strength. This does not entail the transfer of foreign reserves. To be eligible for funding, a member must first agree to structural adjustments with the IMF. If this requirement is not met, the applicant may only draw up to 30% of the value. Although the capitalisation will not be sufficient to establish the Brics as an autonomous grouping, shielded from the turmoil of the world economy, this new agreement has the potential to establish a financial bond between the five countries. It could be a signal of greater future cooperation to come – despite the potential conflicts of interest that may arise.

Political overtones

Little should change in the overall global financial architecture. The move is important above all because of its political overtones.

This is particularly true in Brazil, where the political and economic situation is extremely complex. The World Cup overcame the initial pessimistic expectations. Yet, after the festival of football, the country has returned to the major preoccupations that initially animated the national debate, with tension rising during the run-up to the presidential election in October. Brazil has been suffering an economic slowdown for several quarters. The announcement of a technical recession is expected before the next polls come out.

In addition to the criticism addressed at the current government with respect to the fiscal imbalance and the continuing tolerance for the failure to hit macroeconomic targets, there is significant evidence that the Brazilian economy will be facing a reduction in its production capacity. This drop is explained by a lack of skilled labour, low labour productivity and low industry profitability, which discourages investment in fixed capital.

However, several of the positive domestic aspects that contributed to the earlier period of growth remain present: a large internal market, a sound financial system, a wide variety of investment opportunities. Macroeconomic variables can and should be disciplined.

In such a challenging scenario, an agreement for international financial cooperation with major emerging economies, including China, is undoubtedly a valuable political asset. In the Brazilian case, this asset has the capacity to serve the winning presidential candidate.

For the other Brics members, these new mechanism allow for certain political interests to be balanced with the more direct economic ones. As for global financial governance, this new development most definitely adds to the existing institutions and can serve to advance the debate.

While the NDB and CRA are too small to push aside the current order, their creation demonstrates the desire and political willingness of emerging economies to seek change, whatever that may be. ▪

Maria Antonieta Del Tedesco Lins is a Professor at the Institute of International Relations, University of São Paulo.

...continued from p.30

While this is similar to that of the US (260%) and the UK (277%), China is still an emerging economy. It acquired the debt precipitately in the short period after 2008, when the ratio was only 147%. The ADB has signalled that the acquisition of debt at such a pace is almost inevitably followed by domestic financial disruption.

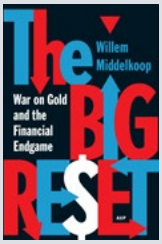
China's banks are in the main well-capitalised. But the scale of their problem is partly concealed in the shadow banking institutions funded by the mainstream banks. Any mismanagement here risks alienating large numbers of small investors and the emergent middle classes. Chinese local authorities are characterised by the ADB as high-performing in their achievements but opaque in their budgeting. If there were a crisis, they might lose access to funding and be forced to cut spending. China may have avoided a hard landing, but the runway may this time end in a sea of bad debt and recriminations.

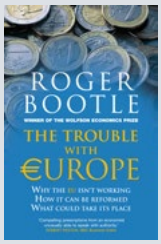
The World Bank is frank in its mid-2014 assessment: China needs a gradual and orderly deleveraging of local government debt. However, reforms in the financial sector and in fiscal policy could potentially be disruptive to growth in the short run. The big question is whether China is paying any attention to institutions like the IMF, World Bank and ADB formed in the middle of the last century, and still dominated by the US.

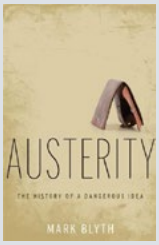
One answer is the New Development Bank. Brazil will head the board of directors, while Russia will lead the board of governors. The revolving presidency will fall to China in five years. Not enough attention has been paid to its contingent reserve arrangement, with $100bn at its disposal to counter economic volatility when the US exits its stimulus policy.

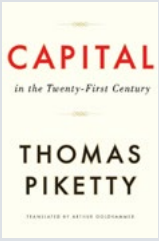
China's growth model has been hailed by some politicians (for example, in Turkey) as providing access to a new form of state capitalism based on strong central government. This avoids the need for the awkward constraints that democracy seems to place on economic growth (as perhaps in India). And it provides a sharp contrast to the world order envisaged by the west and the IMF. But, to succeed, the NDB will have to rise above being a new version of international cronyism by state-run kleptocracies. ▪

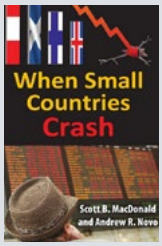
John Adams is Director of China Financial Services and HR China and Senior Adviser to the Chartered Securities & Investment Institute (CISI).

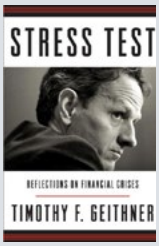












The birth of a new monetary order

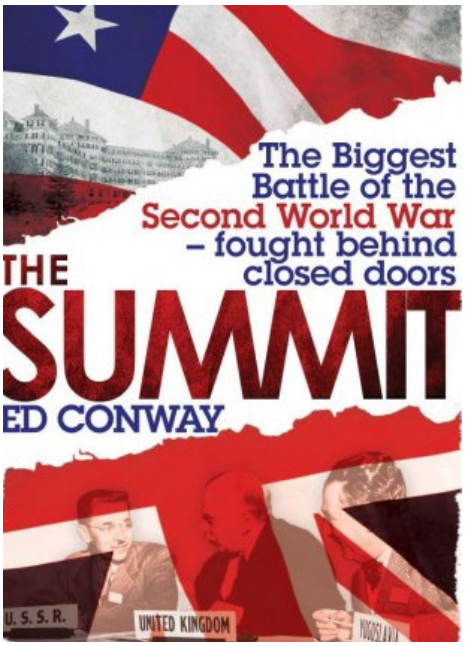
How the Bretton Woods institutions were spawned

Graham Hacche

As allied forces were advancing from Normandy in July 1944, representatives of 45 countries met at the United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire. ('United Nations' then meant the allied countries, not the international organisation yet to be formed.)

The conference agreed to establish the International Monetary Fund and World Bank, with a new international monetary system, to be policed by the IMF, including a system of pegged, but adjustable, exchange rates alongside rules aimed at the early elimination of exchange restrictions on current transactions.

This is well-trodden ground, as is the collapse of the Bretton Woods exchange rate system in 1971-73. *The Summit: The Biggest Battle of the Second World War – fought behind closed doors,* by the economics editor of Sky News Ed Conway, seeks to distinguish itself by viewing Bretton Woods as a 'gripping tale' to be told with a focus less on the economics than on the 'sheer human drama' among those involved, and by utilising previously unexplored Soviet files and participants' diaries.



Given the book's orientation, it is not surprising to find the occasional hyperbole, starting with its subtitle. Nor is it surprising that the discussion of the economics is hardly deep. But in terms of its objectives, the book is successful, providing an absorbing, often entertaining, and thoroughly researched account of the development of the Bretton Woods agreement and of the exchange rate system's subsequent demise.

Setting the scene

The book's coverage is necessarily broader than the conference itself, which occupies only a third of it. This includes the prologue and introductory chapter, which set the scene by describing the conference's closing session and its venue at the Mount Washington Hotel. They also introduce some of the personalities, including Lord Keynes and Harry Dexter White, the principal authors of the agreement reached.

Essential to an understanding of Bretton Woods is the traumatic history of preceding decades, including the collapse of the gold standard in the first world war and the monetary disasters of the interwar period, beginning with the reparations demanded of Germany in the Treaty of Versailles. This history is summarised in the first part of the book, which notes how Keynes first gained fame as a critic of Versailles.

The second part describes the work done during 1940-43 on plans for international monetary reform, most importantly the Keynes and White plans, which laid the groundwork for the conference.

One chapter revisits the question of whether White was a Soviet spy, concluding that he did provide confidential information to the Soviets, but in what he regarded as the interests of the US-Soviet alliance and without detriment to the Bretton Woods agreement.

The third part describes the three-week conference itself, with White chairing the commission on the Fund, and Keynes, in declining health. The agreement signed was much closer to the White than the Keynes plan. But some rejected elements of the Keynes plan – especially arrangements to penalize countries with persistent balance of payments surpluses – are widely regarded as gaps in the system even today.

Conway examines developments between 1944 and 1973, including the pressures on the exchange rate system that led to its collapse. An epilogue discusses developments since the advent of generalised floating, including the recent financial crisis and views on the need for 'a new Bretton Woods'. Some of the book's statements about economic policy are debatable, but its errors are few and usually minor. Not minor is the statement that the US holds the majority of voting rights on the IMF's board: this has never been remotely true, although the US has always had enough votes to veto certain important decisions.

Two omissions are notable. First, the Bretton Woods agreement stipulated that a country could propose a change in its exchange rate only 'to correct a fundamental disequilibrium' in its balance of payments. This important condition, missing from the book, might have helped to clarify its discussion of the Bretton Woods system.

Second, there is no discussion of what replaced pegged exchange rates in the IMF's rule book in the 1970s: its 'surveillance' over the international monetary system and countries' exchange rate policies. Associated with this was a new code of conduct for exchange rate and other economic policies, which the book unfortunately neglects. ▪

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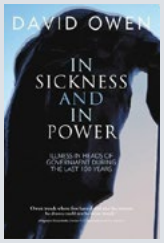
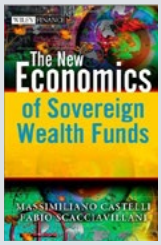
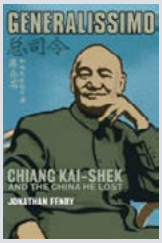
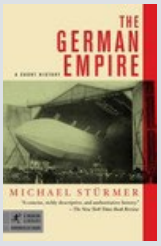








Delving into the Great Recession

The case for debt forgiveness

George Hoguet

In their eminently readable but scholarly work, *House of Debt – How They (And You) Caused the Great Recession, and How We Can Prevent It from Happening Again,* **Atif Mian, professor of economics and public policy at Princeton University, and Amir Sufi, professor of finance at the University of Chicago Booth School of Business, offer a fresh diagnosis of the causes of the Great Recession.**

The analysis is based on meticulous economic research of housing data and employment and consumption patterns before, during and after the Great Recession, particularly in the most heavily impacted US counties.

Their analysis also draws on much recent post-crisis academic research on the largest financial convulsion since the Great Depression. The authors' fundamental view is that, to cure a problem, international policy-makers should first diagnose its causes and then analyse fully the consequences. They conclude that more work needs to be done in both areas.

Ambitious questions

The authors pose ambitious questions: Why do severe recessions happen? Could we have prevented the Great Recession and its consequences? How do we prevent such crises?

In Mian and Sufi's view, the rapid growth in household debt during the 2000s and excessive household debt burdens lie at the heart of the crisis. A rapid decline in consumption by subprime borrowers was a more important cause of the Great Recession than the freeze-up of the financial system post-Lehman. Heavy reliance on debt leads to 'levered losses' once house prices start to fall.

Because the marginal propensity to consume is demonstrably higher among the poor and lower middle class than the wealthy, a policy of mortgage forgiveness and restructuring would have significantly reduced the impact of the Great Recession. (Between March 2007 and March 2009, Americans lost six million private sector jobs.)

The authors remind us that the US tax system subsidises debt and further argue that there is too much debt; debt finance poses negative externalities borne by the entire economy; and that new financial instruments, such as a shared responsibility mortgage, could attenuate future downturns.

Under a SRM, a borrower's mortgage payment schedule is linked to a local house price index. To induce lenders to offer downside protection to a borrower, a borrower would give up part of the capital gain (say 5%) to the lender when the house is sold.

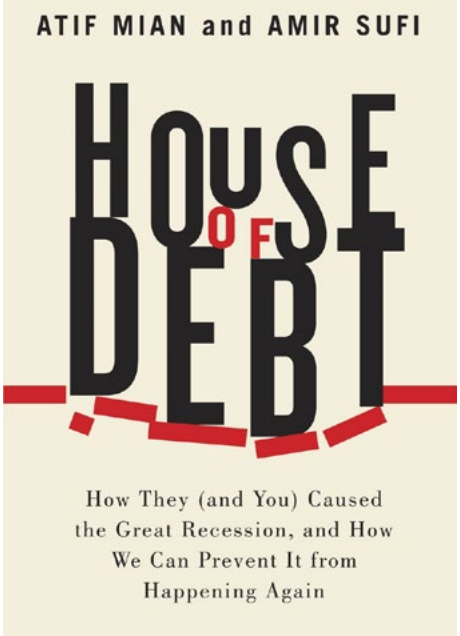
Debt forgiveness

In a distinctly Keynesian perspective, Mian and Sufi suggest that given the zero lower bound constraint and labour market rigidities, central banks cannot be counted on to 'magically fix the debt problem'.

Fiscal stimulus may be appropriate, but debt forgiveness is much more effective because it puts money in the hands of people who need it most.

This book is important because it is descriptive (with new and granular data), normative (putting forward a framework of how the financial system should work) and prescriptive (specifying new types of financial instruments to reduce the impact of both demand and supply shocks.)

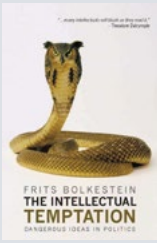
The authors also point out that in both 1818-20 and during the Great Depression, the Congress of the US passed legislation to modify household debt. And when Congress went off the gold standard in 1933, 'it was equivalent to a one-time massive debt-forgiveness program on the order of the entire GDP of the country'.

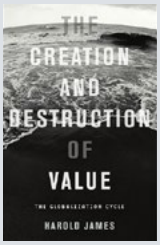


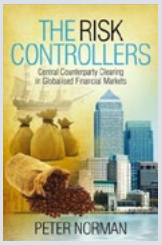
A weakness of the book is that it too breezily dismisses the massive credit contraction and financial market freeze-up that took place during and after the Lehman crisis. A supply shock – the reduced availability of credit – surely contributed to the Great Recession. And the authors fail to discuss how household mortgage debt relief would impact bank balance sheets and lending.

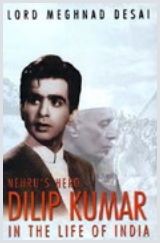
Nonetheless, this book is an important contribution to the central preoccupation of policy-makers, investors, retirees and borrowers post-crisis: 'Never again.' And, the authors' title notwithstanding, by working hard and saving, I am still not sure how I caused the Great Recession. ▪

George Hoguet is Managing Director and Global Investment Strategist in the Investment Solutions Group at State Street Global Advisors.









Challenging the thesis of Europe's tragedy

The problem of debtors and creditors

Sahoko Kaji, Keio University

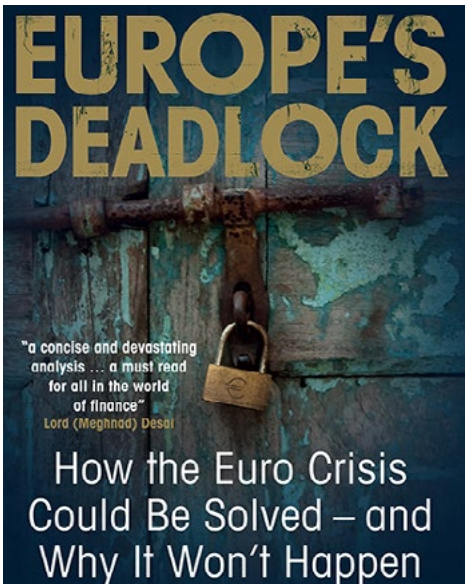
At a seminar at Keio University on 24 July, David Marsh, speaking on his latest book, *Europe's Deadlock*, which has recently been translated into Japanese, gave a concise account of why the euro crisis occurred and why things that needed to happen did not happen.

According to Marsh, the euro has been a great tragedy, its only contribution being to sketch out all that could go wrong in a monetary union without political union.

The euro area's external trade has thrived without a single currency with the rest of the world; the dollar has not been challenged by the European single currency, and German reunification would have proceeded without the quid pro quo with the D-mark.

So three of the four oft-cited motivations for introducing the euro do not stand up to scrutiny. The fourth one, the political motivation, is only as solid as the raison-d'etre of European integration itself. The euro failed to attain its objectives, and the current deadlock will continue.

I agree with his conclusion but not his interpretation. The deadlock will continue, and political unification will proceed at a snail's pace. But the euro is not the tragedy.



The asymmetry was and is always there, with or without the euro – this was and is the tragedy. In fact, the hope was that the euro's straitjacket, along with projects such as the Lisbon Strategy, would narrow the gaps in productivity and competitiveness.

But the straitjacket turned out to be visible only to those who wished to see it, and the asymmetries remained.

This led to the crisis, exactly as predicted by the theory of the 'impossible trinity', which lays down that countries can attain only two of three policies simultaneously in international economics: a fixed exchange rate, free capital movement and an independent monetary policy.

We need to ask ourselves whether a crisis could have been avoided if the euro was not there. Without the euro, the less productive and more deficit-prone countries would have continued to have the option of inflation and devaluation. Without the euro, there would have been no Stability and Growth Pact or Excessive Deficit Procedure.

Sooner or later markets would have seen the unsustainability in their finances. After a crisis, their exchange rates would have depreciated, but what good is that without export competitiveness? All it does is worsen the burden of external debt repayment.

Once the crisis occurred, Europe without the institutional framework of the euro would have taken even longer to establish the arrangements necessary for crisis resolution.

Yes, the euro did not achieve its intended goals. Revealing what happens when monetary union is not accompanied by political union. But the crisis would have taken place with or without the euro, and importantly, without the institutional framework (insufficient as it was) to handle or contain it. And yes, the deadlock will continue. The deadlock is a stable equilibrium, a stable knife-edge equilibrium.

Marsh himself describes the many aspects of this 'precarious balance' (p.68). In fact, the deadlock should continue. What is important is that neither side wins decisively. If the lenders win decisively, there will be no European transfer union or pooling of official European debt.

Any lending will come with harsh conditions completely dictated by the lenders. This will give rise to further riots and worse, kill off any sprouting effort at structural reform in the borrower nations. If on the other hand the debtors win decisively, they will safely become cradled inside a European transfer union with no more incentive for reforms.

If this happens, the lenders' exit from the single currency or even the union is not unthinkable, and the borrowers' sustainability problem will continue. Reasonable people can disagree on the virtues of post-crisis austerity.

But this is a moot point, for if voters refuse to lend to borrowers who do not accept austerity, there will be no lending.

A desirable outcome of this deadlock will be less asymmetry by way of slow but steady convergence towards fiscal sustainability and high productivity. This would be possible if the lenders can be persuaded to maintain their own economic health and also provide just enough funds to avoid both chaos and complacency in the borrower economies.

An undesirable outcome of the deadlock will be symmetry via convergence towards the bottom. Then there is the third possibility of disequilibrium, where the deadlock is broken but the asymmetry increases.

Not just Europe but also much of the rest of the world would want to avoid these latter two outcomes. If the desirable outcome materialises, then the euro will have finally achieved the goal of strengthening all member state economies. ▪

Sahoko Kaji is Professor of Economics at Keio University and member of the OMFIF Advisory Board.

ADVISORY BOARD POLL

On the 70th anniversary of the creation of the IMF and the World Bank, the Brics countries launched a bank of their own. OMFIF asked its Advisory Board whether the New Development Bank will shift the balance of power over the next five years.

The setting up of the Brics Development Bank addresses this democratic deficiency in the governance of the Bretton Woods Institutions. Indeed, I believe it may act to spur existing international institutions to reforms.

– Hemraz Jankee

The balance of power has shifted already. Whatever its success it will apply pressure. This could hasten the demise of the dollar as the key reserve currency and the advantages this has bestowed, particularly on the US. It's a pity that the Congress hasn't seen that.

– Andrew Large

For a start it will be hamstrung by bureaucracy and process, and secondly the Brics are not natural allies let alone natural trading partners. While private sector commerce including cross-border finance within Brics does have the potential to make a big impact on the global economy, expect the public sector Brics bank to be a gigantic damp squib.

– Moorad Choudhry

The funding of the NDB could be related to investment projects and therefore affect more the World Bank (e.g. China is already lending more in Africa than the WB), while other funding for contingencies seems to be closely linked to IMF involvement. The impact would be minimal and even positive.

– Celeste Cecilia Moles Lo Turco

The NDB will be loaded with non-performing assets as a consequence of poor due diligence cum political nepotism.

– Akinari Horii

This will be a significant development in the sense of demonstrating the new-found power of the Brics. However it will have limited impact because the different agendas of the individual Brics countries will make it hard for the new bank to operate effectively.

– Colin Robertson

27%

Yes - it will pose a challenge to the Bretton Woods institutions

9%

Undecided

39%

No - it will have limited impact

25%

No - it will have next to no impact

The Brics Bank sends a signal: The rising powers will not solely rely on the IMF and World Bank to exercise global monetary and development influence. They want institutions that better reflect their priorities, their economic models, and goals.

– Stuart PM Mackintosh

If the conditionality of the NDB is deemed more 'favourable' than those of the Bretton Woods institutions, some borrowers can turn to the NDB instead.

– Sahoko Kaji

I think China, through its bilateral lending, is already a challenge to Bretton Woods institutions, especially in Africa. But I don't see enough of a shared vision among the Brics for this bank to really gain a lot of traction.

– Eduardo Roberto Borensztein

It is hard to see this bank developing successful systems of internal governance. And if the Chinese dominate it, there is bound to be even more wasted money than in the Bretton Woods institutions.

– John West

The Bretton Woods institutions reflect the post-second world war order and are out of touch with the current economic reality. The fact that the IMF and the World Bank can only be presided by either a European or a US citizen is a reflection that these institutions live in the past, as well as the quota system. The new bank is a wake-up call.

– Brigitte Granville

It will take quite some time to get organised and neither the World Bank nor the Asian Development Bank are ineffective lenders. And the Brics bank can not replace the IMF which may be the real target of the new initiative of a political and symbolic, rather than substantive nature.

– Niels Thygesen