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The Bulletin

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

Waiting for Buhari
Air of expectancy

Hans Genberg on China and Asean
George Hoguet on Iran investment
Hani Kablawi on global prime collateral
Anthony Robinson on Russia and Africa
Anna Stupnytska on dollar debt burdens

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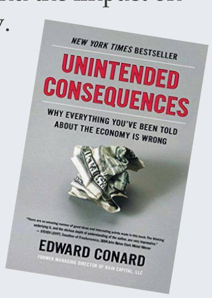
Waiting for Buhari

Muhammadu Buhari, the retired general who won Nigeria's March elections, has ushered in a democratic transition in Africa's biggest economy and most populous state – but is keeping the world waiting for news of a real shift in the country's policies. Reward-seeking entrepreneurs and investors see Nigeria as a bellwether as Africa fights to realise its well-documented but elusive economic potential. ■

Book reviews

George Hoguet weighs up the flaws and flourishes of Edward Conard's New York Times best-selling *Unintended Consequences – Why Everything You Have Been Told About the Economy is Wrong* and concludes it deserves its place in the pantheon of economic analyses for its astute post-mortem of the global financial crisis and the impact on the US economy.



While acknowledging a few minor weaknesses, Hoguet concedes it is overall a closely argued work offering much scope for reflection. ■

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Draghi prepares for Japanese-style quantitative easing in Europe

Mario Draghi, the European Central Bank president, has put the ECB on a potential collision course with Germany by suggesting the bank's €60bn-a-month quantitative easing programme could be increased and extended beyond the earlier cut-off date of September 2016.

The proposal, announced on 3 September, commands a majority of the ECB's governing council and comes at a time of receding likelihood the bank can reach its target of just below 2% inflation over the medium term.

The latest forecasts unveiled in Frankfurt show inflation across the euro area this year is likely to be 0.1% against 0.3% in previous predictions, rising to1.1% next year (against 1.5% previously) and 17% in 2017 (against 1.8%). This year's GDP growth forecast was revised down to 1.4% this year from 1.5%.

Draghi's renewed dovishness reflects the fresh fall in the oil price, contradicting earlier indications of a modest rebound this year, as well as the Chinese stock market upheaval and fresh worries about growth. The spectre of continuing QE – raising parallels with the Bank of Japan's long-running but ineffectual bond purchase programmes – is expected to stoke fresh criticism from Bundesbank President Jens Weidmann, who had hoped it could be ended as inflation revives.

The likelihood of extended QE comes at a time when fresh progress on Greece and other heavily indebted countries will be delayed by political uncertainty in the euro area. Depending on whether the Federal Reserve moves early on raising interest rates, possibly this month, the ECB announcement seems likely to weaken the euro further. ■

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OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

EDITORIAL

From Lagos to Lisbon, hope laced with trepidation

An air of expectancy – hints of hope laced with strong traces of trepidation – hangs over global financial markets and the wider political economy. Muhammadu Buhari, the leader of Africa's largest economy, Nigeria, is keeping the population and the investor community waiting an unconscionable length of time as he laboriously assembles his cabinet. The all-important post of finance minister is still vacant, more than five months after Buhari's landmark election in March. In the US, the 'will-they-won't-they?' saga over a potential interest rate rise by the Federal Reserve enters a further round. Ahead of the 16–17 September meeting of the policy-making Federal Open Market Committee, opinion is evenly split about whether the Fed will go ahead with the first rate hike for nine years.

In similar fashion, no one can predict the outcome of the turbulence on Chinese financial markets. The political and financial stormclouds over China, foreshadowed by OMFIF's July–August edition, have now burst – with effects that could either soon subside or, alternatively, produce a long-term downturn for the world economy.

In Europe, too, political and financial activism is on hold. General elections are taking place in Greece, Portugal and Spain before the end of the year; the European Central Bank awaits concrete results from its €60bn-a-month bond purchase strategy; and the International Monetary Fund makes up its mind whether to participate in the latest €86bn Greek bail-out package.

Underlining the scale of the challenge facing his country's new leader, Kingsley Chiedu Moghalu, former deputy governor of the Central Bank of Nigeria, outlines Africa's problem of 'capitalism without capital' and sets out ways of overcoming it. Anthony Robinson investigates the background to a controversial Russian–South African nuclear deal. John West explores the wider implications of Chinese investment in Africa.

Darrell Delamaide, in his monthly dispatch, reports on an undercurrent pushing the Fed towards higher interest rates this month, despite the stock market nervousness. George Hoguet writes on the options for investors seeking to capitalise on the opening of Iran after the nuclear deal with the US, and opines that investment in multinational companies which may profit from Iranian connections could be the most propitious route. Philip Turner and Jhuvesh Sobrun from the Bank for International Settlements, and Ana Stupnytska from Fidelity, dwell on the problems for emerging market economies caused by the build-up of exposure to dollar debt as the US currency rises on world markets.

Hani Kablawi describes the global need for prime collateral – the subject of an OMFIF report published this month in conjunction with the Bank of New York Mellon. Denis MacShane laments the mutual miscomprehension between Russia and the West. Antonio Armellini outlines how uncertainty over a further Greek confrontation with its creditors could influence the debate over a possible British exit from the European Union. George Hoguet reviews a post-mortem to the financial crisis – *Unintended Consequences: Why Everything You've Been Told About the Economy is Wrong* by Edward Conard – and highlights precepts for improving the climate for investment and risk-taking in the US and elsewhere – all issues the Fed will be pondering deeply as the 16–17 September decision time approaches. ■

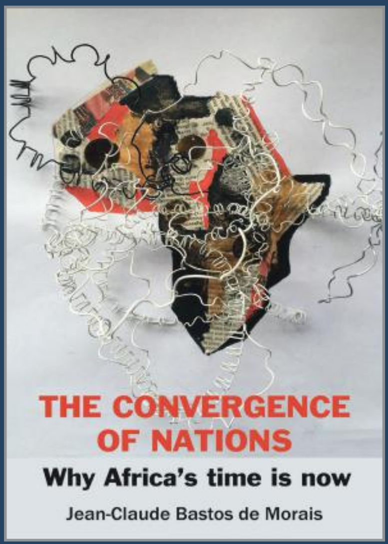
Kenyan pharmacist wins prize for original artwork used in book cover design for *The Convergence of Nations*

Underlining its commitment to deeper research on Africa, OMFIF Press will be publishing next month *The Convergence of Nations: Why Africa's Time is Now,* a compilation of international analysis and opinion on the continent's kaleidoscopic political, economic and social realities. Jean-Claude Bastos de Morais, founder of the Quantum Global Group, leads a team from across the continent illuminating Africa's opportunities and challenges.

In a search for an appropriate cover design, OMFIF ran a competition for an original work of art to be produced by African nationals living in Africa. An international panel of six judges chaired by OMFIF Chairman Meghnad Desai awarded the first prize of £1,000 to Kenyan pharmacist and amateur artist Shivani Shah for her strongly evocative depiction of Africa, which fuses different media in a way that expresses convergence and solidarity.

In the artist's own words: 'The use of red symbolises man's most primitive instincts of self-preservation; gold and silver evoke the tremendous wealth found throughout Africa; and the 3-D effect of the wires shows the increasing importance of the internet and mobile technology.'

For further news on *Convergence of Nations*, see editorial@omfif.org. ■



OMFIF ECONOMISTS NETWORK

OMFIF starts Economists Network to share international analysis

OMFIF is setting up an Economists Network – a group of economists from public sector bodies, research institutes and financial institutions – to share analysis and research among member organisations and other affiliated groups. The honorary chairman of the OEN is Prof. Ben Shenglin of Zhejiang and Renmin universities. José Manuel González-Páramo, Kevin Urama and William White are three of the vice-chairmen appointed (see below). More appointments will be announced later.

Ben Shenglin is dean at the Academy of Internet Finance, Zhejiang University, and executive director of the International Monetary Institute at Renmin University. He is a member of the 10th executive committee of the All-China Federation of Industry & Commerce. Ben holds an MA from Renmin and a PhD from Purdue University, Indiana, US. He previously held senior positions in China with ABN AMRO, HSBC and JPMorgan Chase.

José Manuel González-Páramo is executive director of Spanish bank BBVA. He was a former executive board member of the European Central Bank and was on the Bank of Spain's governing council from 1994–2004. With a PhD, an MPhil and an MA in economics from Columbia, he has been professor of economics at the Universidad Complutense in Madrid since 1988 and a lecturer at Instituto de Estudios Superiores de la Empresa (IESE) Business School since 2012.

Kevin Urama is managing director at Swiss-based Quantum Global Research Lab, focusing on econometric models of African economies. Urama, who holds a PhD in land economy from Cambridge University, is an extraordinary professor in the School of Public Leadership, Stellenbosch University, South Africa, and an adjunct professor at the Sir Walter Murdoch School of Public Policy and International Affairs, Murdoch University, Western Australia.

William White is chairman of the Organisation for Economic Co-operation and Development's Economic and Development Review Committee. He was economic adviser and head of the monetary and economic department at the Bank for International Settlements in 1995–2008. After spells at the universities of Windsor and Manchester, he began his career at the Bank of England, and was then deputy governor of the Bank of Canada from 1988–95.

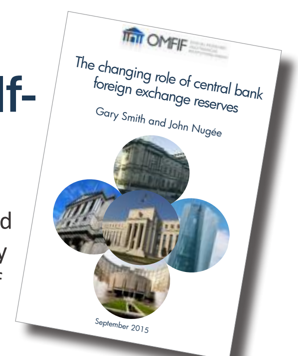
LAUNCHES

Meghnad Desai Academy launched in Mumbai

On 27 July, Reserve Bank of India Governor Raghuram Rajan (centre) and OMFIF Advisory Board Chairman Meghnad Desai (left) launched the Meghnad Desai Academy of Economics at the World Trade Centre in Mumbai.

MDAE's vision is to prepare students to take leadership in the global economy by marrying academic rigour with corporate sector know-how. As Rajan said, 'The first batches [of students] are the start of great ventures... I wish this institution goes to greater glory in the years to come.'

Central banks 'will rebuild reserves' to self-insure against shocks



Central banks around the world are expected to strengthen defences against monetary turbulence by seeking to resume growth of foreign exchange reserves after the present bout of reserve weakness, according to an OMFIF report by Gary Smith (below right) of Baring Asset Management and John Nugée, formerly of State Street Global Advisors and the Bank of England, now an OMFIF director and a noted authority on managing reserves.

The report – 'The changing role of central bank foreign exchange reserves' – discusses the diverse motivations for the build-up and maintenance of foreign exchange reserves around the world over the past 15 years, from below \$2tn in 2015 to \$11.4tn today. Because of high financial market volatility and only limited faith in official 'safety nets' from organisations like the International Monetary Fund, countries are building reserves in a desire for self-insurance against financial shocks, the report says.

To obtain a copy of the report, please email editorial@omfif.org.

African capitalism needs capital

Property rights, infrastructure crucial for growth

Kingsley Chiedu Moghalu, Advisory Board

Virtually all African countries have become capitalist economies since the end of the cold war, when capitalism as an economic philosophy won a decisive victory over communism and socialism. Yet, despite overblown talk of 'Africa rising', and the more solid reality of an Africa gradually emerging on the global economic landscape, poverty remains pervasive in most African countries. Why is capitalism yet to create the wealth of nations in Africa? And how can we alter this narrative to one in which free markets help transform the continent?

The answer lies in understanding and building the conditions in which capitalism creates widespread prosperity. The key ingredients of successful capitalism are property rights, innovation and capital itself. Capitalism without capital is the most urgent challenge. Yet the requirements are interlinked.

The problem manifests itself in a number of ways. Many African countries do not generate sufficient capital, partly as a result of a weak income and savings base and low revenue generation through taxation. Financial systems in many African countries, while improved, still lack sufficient depth and diversity, and tend to be dominated by banks, which are risk-averse and not prone to lending long-term capital.

Yet another challenge is the cost of the available capital. African countries tend to have relatively high rates of inflation because they are structurally weak, commodity- and import-dependent economies, so frequently respond to this challenge with a tight monetary policy that increases the cost of credit in the economy. This approach is often justified because the core mandate of most central banks is to ensure price stability, but expensive credit inhibits access to finance for productive activities such as manufacturing. This creates a vicious circle.

Another important reason for the high cost of capital in Africa is the continent's weak infrastructure, which multiplies the cost of practically every transaction.

Seven-step approach

Against this backdrop, a seven-step approach is needed to put capital back into capitalism in Africa. The first step is to strengthen property rights by abolishing state ownership of land, which is the prevalent system of land tenure in the continent. African citizens should be able to own land in perpetuity rather than being temporary occupiers based on occupancy rights granted by the state. If this reform is undertaken, land can be better used as collateral to obtain larger amounts of credit, and credit will be more widely available.

Second, building Africa's infrastructure will create vast amounts of capital in the continent's economies, and make capitalism more efficient and productive. Africa has a $90bn annual infrastructure financing deficit. Here, there is a happy coincidence between the real needs of African countries and the opportunity for global foreign investment deals in infrastructure.

Third, private equity and venture capital will help African economies grow. Again, a combination of domestic and foreign investment approaches can work here. African governments must prioritise the provision of venture capital to commercialise innovation and enable small businesses to facilitate growth. Kenya, which has an active industry of informal innovators, is already leading in strategic support and venture capital financing for innovation among African economies. This source of funding should be structured and institutionalised as a major fiscal spending priority. Foreign venture capital investments in Africa would be a win-win proposition, as returns in Africa are a healthy 25–30% on average. US research has established that private equity- and venture capital-backed firms create more jobs.

Fourth, financial deepening is essential for African financial markets. Financial institutions and markets need to provide a wider range of services and financial instruments to increase the efficiency, depth, breadth and access to financial services while actively managing the risks of unregulated financial innovation. Financial inclusion – bringing persons excluded from or not operating in the financial system into formal financial institutions such as banks, insurance, pension funds and effectively conceived microfinance institutions – will make capital work better for the poor.

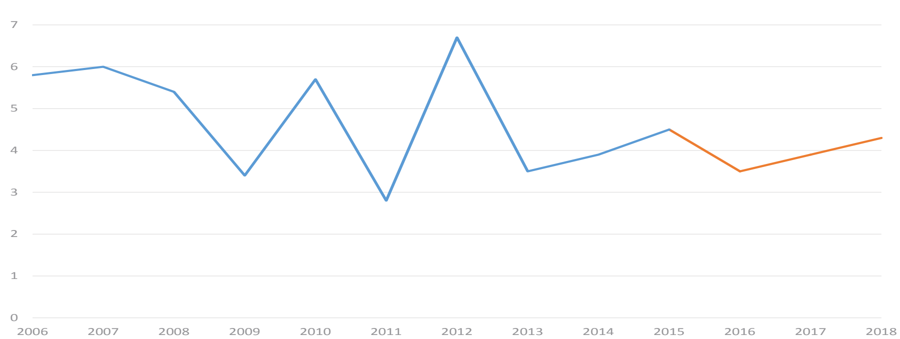
Fifth, strong regulatory institutions are essential for successful capitalism. They create a level playing field and enforce limits to acceptable behaviour. Without both, markets can become a jungle of predatory behaviour.

Sixth, well-capitalised development banks are critical for Africa's economies because they can provide long-term capital at more affordable prices than commercial banks. Nigeria has created a new wholesale development bank that will finance retail development banks.

Finally, without industrialisation, capitalism in Africa will not create real wealth. Real capitalist wealth is based on industrial manufacturing and productive economies. Otherwise, African countries face two unattractive alternatives. The first is rent-seeking based on commodities and extractive mineral industries with no value-added. The second is excessive financialisation, in which the finance that exists does not serve the real economy, but creates wealth for an elite circle of operators in the financial services industry. ■

African growth forecast to slow to 4–5% in 2016–18

Real GDP growth in Africa – projections from the OMFIF Advisory Board Poll, Aug 2015



Source: African Economic Outlook, OMFIF Advisory Board

Kingsley Moghalu is a professor at The Fletcher School of Law and Diplomacy at Tufts University and founder of Sagato Strategies LLC. He was deputy governor of the Central Bank of Nigeria from 2009–14, and is the author of Emerging Africa: How the Global Economy's 'Last Frontier' Can Prosper and Matter *(Penguin Books, 2014).*

The Russia–South Africa connection

Weighing alternatives to a controversial nuclear deal

Anthony Robinson, Advisory Board

Locked into a confrontation with Europe and the US over Crimea and the Ukraine, Moscow is seeking big business deals in countries such as Venezuela and South Africa to compensate for its deepening recession caused by the collapse in commodity prices and Western sanctions. A controversial $50bn accord to supply energy-constrained South Africa with eight nuclear power plants is the biggest, and reflects older alliances.

Soviet military and political infiltration of Africa in the 1970s filled the vacuum left by the sudden collapse of centuries-long Portuguese rule over Angola and Mozambique, and marked a new and acute phase of the cold war. But when oil prices dropped to $10 a barrel, the new Gorbachev-era politburo decided to seek a deal with Washington and Pretoria to withdraw Cuban forces from Africa, which Moscow considered the most effective way of signalling the emergence of a new Soviet foreign policy.

Moscow saved itself the costs of renting the 50,000 Cuban troops flown to Africa by President Leonid Brezhnev's regime. Relieved by the Cuban exodus, Pretoria moved to grant independence to Namibia, which was a precursor to the end of apartheid. At the time, President Ronald Reagan and Prime Minister Margaret Thatcher accepted as valid Moscow's new ambition 'to be part of the solution to global problems, not part of the problem', in the words of Gorbachev's African envoy, Anatoly Adamishin.

Old power structures

What few predicted was that opening up the economically and ideologically bankrupt Soviet system would lead to its chaotic disintegration and a decade of introversion, followed by the communist party being replaced by *siloviki* – hard men with a KGB and security background.

As a new leader, Vladimir Putin accumulated power as a result of rising oil prices. Moscow's old protégées in southern Africa were still firmly in place, and the African National Congress was triumphant in South Africa. As China's rocket-fuelled growth sucked in energy and mineral exports, the rising tide of global commodity prices led to the coining of the Brics acronym linking Brazil, Russia, India, China – and South Africa – as economic dynamos to watch. Moscow and Pretoria were among those that gained unexpected windfalls, which translated into new sources of patronage to underpin their increasingly kleptocratic and authoritarian regimes.

Viewed from the vantage point of today's commodity cycle downturn, the decade of high energy and commodity prices greatly weakened the drive for necessary structural reforms to both the inherited Soviet and the apartheid-era economic, social and political systems, and encouraged cronyism and corruption on an epic scale. Beneath the surface glitter of commodity-backed prosperity, the old political power structures were largely unchanged. Xhosa- and Zulu-dominated black nationalists in the ANC replaced white Afrikaners, while KGB-linked cadres replaced the Russian Communist party.

> **"Beneath the surface glitter of commodity-backed prosperity, the old political power structures were largely unchanged**

Meanwhile, the international competitiveness of the ageing Soviet military industrial complex- and investment-starved South African industry was further eroded by the windfall-induced 'Dutch disease'. As the Russian rouble and South African rand strengthened because of rising commodity prices, uncompetitive domestic production was replaced by imports, while non-commodity exports wilted.

Russia's oil windfall was so great it ran a trade surplus and accumulated reserves throughout this period. South Africa, which imports its oil and gas, was not so lucky. For decades, export revenues from South Africa's vast but outdated mining industry paid for the country's rising oil and gas imports. Lower energy prices helped offset the steep decline in gold and other mineral revenues after 2013, but this could not compensate for years of inadequate investment in power and other infrastructure.

'Strategic partnership': Kirienko and Joemat-Pettersson signing the controversial nuclear deal

Meanwhile, Western sanctions, imposed after Moscow annexed Crimea and invaded eastern Ukraine, have cut Russia off from needed foreign investment, threatening to cripple Russia's offshore and Arctic oil exploration.

Russia has fallen behind where it once supplied a captive Soviet and Comecon market of over 500m people with civil aircraft, railway equipment, cars, trucks and more. But it has retained military equipment and nuclear power station capabilities, albeit with a lot of imported electronics and safety devices.

Energy wheeler-dealing

Desperate to hold on to engineering sectors, Rosatom – the Russian state atomic energy corporation – is fighting French, US and Chinese competition to secure power station contracts. In September 2014, during an International Atomic Energy Conference in Vienna, South African Energy Minister Tina Joemat-Pettersson signed an intergovernmental agreement with Rosatom head Sergei Kirienko. Moscow then committed to finance and supply up to eight nuclear reactors costing around $50bn and delivering a total of 9.6GW between 2023–35.

The deal – billed as a 'strategic partnership' – immediately provoked a storm of controversy in South Africa, with suspicion centring on fears the secretive top-level deal – which bypasses scrutiny and control by state energy corporation Eskom – will widen scope for bribery, corruption and opaque deals for the principals on both sides. Such fears are inflamed by widespread corruption in both countries. Critics also point to financial and other risks implicit in such a massive dependence on nuclear power in view of rapid technological progress in solar and other renewable energy sources.

Neighbouring Mozambique has vast offshore gas fields that could fuel South Africa more cheaply, and African New Energies – a small, innovative UK–Namibian oil company – is exploring a potentially game-changing onshore oil and gas field in Namibia. Clearly, South Africa can weigh options to the Russian deal. ■

Anthony Robinson is a former East Europe and South Africa foreign correspondent for the Financial Times.

A partnership – with side-effects

China's African links spur US competition

John West, Advisory Board

Africa's economic prospects are better than they have been for half a century, in large measure as a result of a blooming partnership with China and other Asian countries.

When most African countries secured independence from their European colonial masters in the 1950s and 1960s, the continent was seen by many economists as having a bright future. Rich in natural resources and with well-established trade links to Europe, the African continent was believed to have a distinct edge over resource-poor Asia.

But Africa's promise was not realised. Poor governance sapped its potential. Further, it got caught up in the cold war competition between the West and the Soviet Union for allies. Assistance from the World Bank and others financed more corruption and waste instead of infrastructure, institutions and human capital – despite intended heavy policy conditionality.

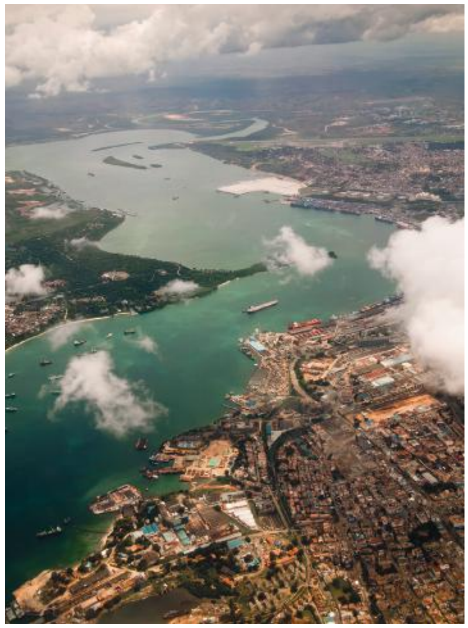
Over the past decade, Africa's development trajectory has shifted up a gear, with sub-Saharan Africa averaging a 6% economic growth rate. One important factor has been China's rich appetite for natural resources, which has boosted African exports of oil, gas, timber and minerals. China's trade with Africa has already leapt to over $200bn a year – more than twice that of the US – making it Africa's most important trading partner.

New Silk Road project

Since much of Africa's potential still lay undeveloped, China is now making large investments in the continent. According to Chinese Premier Li Keqiang, from 2014–2020, trade between China and Africa is expected to double, and the stock of Chinese outward foreign direct investment in the continent will quadruple to $100bn. African ports are critical to China's $40bn 'Maritime Silk Road' project.

China's rapidly increasing investment in African infrastructure is welcome. The continent needs improved infrastructure. According to the World Bank, just 16% of sub-Saharan African roads were paved in 2011, compared with 65% in East Asia. Only one in three Africans had access to electricity, against nine in 10 people elsewhere in the developing world.

More than 35 African countries are engaged with China on infrastructure finance deals, with Ghana, Ethiopia, Cameroon, Zambia, Nigeria, Angola and Sudan the biggest beneficiaries.



Ports of calling: African ports such as Mombasa in Kenya are critical to China's investment plans

The finance is typically channelled through the China Export-Import Bank, which often uses the 'Angola mode', whereby repayment of the loan for infrastructure development is made with supplies of natural resources.

Addressing concerns

Much debate has arisen over how much Africa benefits from Chinese investment. Common criticisms are that investment projects result in environmental damage and feed official corruption, and that too much of the employment goes to imported Chinese labour.

Some of these claims are no doubt true, but there is also a positive story. Trade and investment with China has created local jobs, lifted incomes and helped build infrastructure. This infrastructure can help unleash the economic potential of the continent through new growth opportunities in manufacturing and services sectors, including reducing intra-regional trade barriers.

Africa's partnership with China has been a means of economic diversification away from its traditional partners, the US and Europe. This is important. It is difficult to claim that Africa's close links with Western countries in previous decades led to positive results.

China has also become more sensitive to African public opinion by promoting sustainability and 'soft power', and by providing development assistance. Africa may not be a beacon of democracy, but public opinion does matter, as it also increasingly does in China. The $2bn 'Africa Growing Together Fund', which the People's Bank of China established in 2014 with the African Development Bank, is an initiative that seeks to allay concerns about China's approach to Africa.

We should not forget that, as an observer country in the Non-Aligned Movement, China is not a new partner of Africa. Its first contribution to African infrastructure began as early as the 1970s, when it financed the building of the Tanzania–Zambia Railway Authority or Tanzam railway, completed in 1975.

Natural allies

Many African countries are facing problems with the fall in oil and other commodity prices and the softening in the Chinese and other Asian economies. But sub-Saharan Africa could still achieve growth of around 5% over the coming two years, according to the International Monetary Fund.

In coming decades, China and Africa are natural partners. China's need for natural resources will grow with continued economic development. China is a manufacturer and exporter of products that are affordable for African consumers. And as costs rise further in China, and Africa's middle class emerges, some African countries will become more attractive destinations for 'offshoring' of Chinese manufacturing activities.

China's willingness to invest in African infrastructure is welcome, as the continent still lags way behind other developing regions of the world when it comes to supplying electricity and water, as well as road and railway development. And China has developed one of the world's largest and most competitive infrastructure-construction industries. As China increasingly takes on a leadership role in the international system, it is natural that China and Africa should have a blossoming partnership.

In a sign that competition is invariably healthy, China's interest in Africa has provided a new spur to US interest – which will hopefully also be welcome news for Africa. ■

John West is executive director of the Asian Century Institute.

Southeast Asia ponders China slowdown

Diverse consequences of capital market integration

Hans Genberg, Advisory Board

The Southeast Asian economic crisis of almost 20 years ago is still in the minds of policy-makers and the public, despite the economies being much more robust now.

Monetary policy frameworks no longer target the exchange rate, which allows greater scope to pursue economic growth and stability. And greater exchange rate flexibility and more sophisticated financial markets have led to the consequences of the transatlantic financial crisis being felt mostly through the impact on trade in goods and services, and less through financial contagion.

Yet challenges remain. The short-term outlook depends heavily on external factors. Medium-term growth prospects must come to grips with the 'middle-income trap', and efforts to integrate capital markets do not come without risks.

Headwinds from China

The majority of respondents in OMFIF's July–August Bulletin survey of its Advisory Board's views on the economic prospects of Association of Southeast Asian Nations were optimistic, with 62% predicting a positive outlook. Singapore and Vietnam each had an 85% positive outlook. Views of Indonesia and Thailand were less sanguine, with about 25% and 23% adverse views, respectively.

The latest forecasts of the International Monetary Fund also paint a positive picture, with GDP growth expected to increase slightly in the next three years. As Asean economies are small and highly open economies, short-term growth fluctuations are mostly determined by external factors. Currently, oil price developments and the growth outlook in China are the main factors. While the slowdown in China has a similar effect on all Asean economies, a 50% decline in the price of crude oil in the past year has different implications, depending on whether countries are net oil exporters or importers.

As net energy exporters, Malaysia and Indonesia have seen their currencies depreciate significantly against the dollar due to oil market developments. Economic growth has been sluggish. Net oil importers such as the Philippines and Thailand have experienced the opposite. If oil prices recover, as the IMF's forecasts assume, the process will reverse – economic growth will pick up in oil-exporting countries, and their currencies will rise.

The projected slowdown of Chinese growth will continue to represent a drag on Asean economies. The correlation between business cycles in China and Southeast Asia has been growing, largely owing to increased use of global value-chain production processes, whereby the value-added in a product is contributed by several countries, leading to tight inter-connections between economies.

The Chinese economy is a major node in these chains, hence its importance. However, over the longer term, growth won't be driven by external demand alone, but must rely on productivity gains, innovation and pro-entrepreneurial structures.

> **"Over the longer term, growth won't be driven by external demand alone, but must rely on productivity gains, innovation and pro-entrepreneurial structures**

Middle-income trap

Research shows economies relying on low-cost labour using imported technologies may reach middle-income status, but may become trapped and unable to reach high-income status. To avoid this, they must emphasise the quality of human resources, strengthen their research capacity, promote the rule of law and nourish a dynamic private sector. The latter can be achieved in part by developing capital markets so small- and medium-sized enterprises have ready access to funding.

Asia's financial systems have grown in the past two decades, and are now more developed than in Central and Eastern Europe and Latin America. The role of bond and stock markets has increased, both in absolute terms and relative to the role of the banking sector – the traditional source of funds in the region. But Asean capital markets remain less developed than in advanced countries, in part due to the small size of each market.

One way of increasing the size and scope of bond and equity markets is to encourage greater participation in the market by foreign investors, thus expanding the investor base and increasing competition and liquidity. This is because domestic borrowers' opportunity to seek funds in foreign markets is also a source of competition in the local market.

A double-edged sword

Yet openness to external financial markets can be a double-edged sword. A potential counterbalance to the benefits from the presence of foreign investors is exposure to the volatility of capital flows and, hence, to financial instability from abroad. Pursuing capital account openness on a regional level is potentially a way to modify the terms of the trade-off between efficiency and stability.

Foregoing full integration with global financial markets would constitute a cost, but there are compensations. Some analysts would say that having a larger regional capital market that is better able to absorb international investor sentiment swings would reduce the threat of financial instability.

A number of conceptual questions arise from this argument, however. What constitutes the optimal domain of the regional financial integration – which countries should be included, and which should not? Is it meaningful to speak of restricted regional integration if some members are integrated with global financial markets? Should regional financial integration be viewed mainly as a step towards full integration with global markets, or as a final arrangement?

Regional officials seem to have concluded that the benefits of regional financial integration outweigh any potential costs. Under the auspices of Asean, several initiatives to develop regional capital markets – in particular, debt markets – have been launched. The objectives are to create clearing and settlement systems, to create trading platforms to facilitate intra-regional trading and to strengthen regional rating agencies.

While such objectives are worthy in themselves, whether they will lead to greater cross-border trade in financial assets – and to increased access to finance for small and medium-sized businesses – remains an open question. ■

Hans Genberg is executive director at the South East Asian Central Banks (SEACEN) Centre in Kuala Lumpur.

Choosing the path to Tehran

Investment implications of Iran's opening

George Hoguet, Advisory Board

'Iran,' argues Henry Kissinger in his corruscatingly brilliant book, *World Order,* 'must decide whether it is a country or a cause.' Many factors – particularly the US –will 'determine whether it pursues the path of revolutionary Islam or of a great nation legitimately lodged in the Westphalian system of states.'

A visit to the palace of Persepolis, built in 500 BC, leads to a better understanding of the Iranian self-image. At one point, the Iranian empire extended from modern-day Libya to Kyrgyzstan and India. Unlike Iraq, Syria, Lebanon and Jordan – the current borders of which were determined by colonial powers in the 20th century – Iran, in journalist Stephen Kinzer's phrase, 'has existed, more or less within the same boundaries, with more or less the same language, for 2,500 years'.

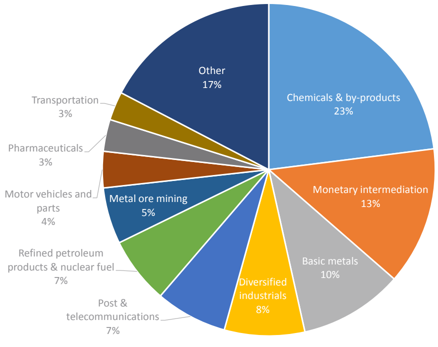
Iranian self-image: The ancient city of Persepolis

An economic snapsot of Iran

Should sanctions end, global portfolio investors may be able to invest in the Tehran stock market. But a lot has to fall into place, both from a geopolitical and an institutional perspective. A country with nearly 80m inhabitants (roughly the population of Germany) and the world's fourth-largest oil reserves presents many opportunities, as did Russia after the collapse of the Soviet Union. Its natural gas reserves are second only to Russia's. Iran is currently inaccessible to global investors; over time, it could be included in 'frontier market' indices.

The International Monetary Fund and the World Bank estimate the size of the economy in 2014 at $400bn in nominal exchange rate terms, making it larger than that of Thailand, South Africa or Singapore. Exports account for 23% of GDP. Iran produces 3.7m barrels of oil per day, and exports 1.2m bpd. Iran hopes to increase oil exports to 2.3m bpd if sanctions are lifted. Over the past three years, Iran has run a current account surplus in excess of 5% of GDP. Foreign exchange reserves stood at $110bn at the end of 2014. Iran is a net creditor in the international system.

Tehran stock exchange market cap breakdown by sector, May 2015 (%)



Source: Tehran Stock Exchange

Yet Iran experiences many of the generic problems common to other emerging markets – such as corruption, rent-seeking and public health challenges. Sanctions have significantly impeded economic development. Output contracted in both 2012 and 2013 by 0.6%. The state plays a major role in the economy, with substantial inefficiencies and incomplete projects.

Out-of-date infrastructure is not helped by international isolation. The non-oil sector is growing well below potential. Currently, the economy is experiencing high unemployment (11%) and inflation (15%). In the past two years, the rial has fallen sharply, contributing to inflationary pressures.

One route for foreign investors is through the Tehran stock exchange. Launched in 1967, it now has 440 companies listed. The Iranian state — directly or indirectly — holds large positions in many companies. The Iranian Revolutionary Guard, which is responsible for protecting the Islamic system, controls several important companies in key economic sectors.

The current stock market capitalisation is estimated at $97bn. Because of government and other holdings, the actual available capitalisation is only around $30bn; as in other markets, there are limits on foreign ownership. The largest sectors of the Iranian stock market are chemicals (23%), financials (13%) and metals (10%.) The average daily trading volume is $36bn. The largest company, Khalij Fars Petrochemical Company, is valued at $9bn as of May 2015; the second largest – the Mobile Telecommunication Company of Iran – at $3.6bn.

Evaluation

Iran's gradual integration into the world economy would be a profound event. There is ample precedent for foreign capital rushing in and markets rallying when countries liberalise stock markets, only for capital to leave – and markets crash – when policy mistakes compound. Recall that Russia defaulted on its domestic debt and the Czech Republic experienced a massive banking crisis in the 1990s. And there are many other examples of emerging market crises, such as the Mexican 'Tequila' crisis and the Asia crisis.

But Iran has potential to be one of the world's largest oil exporters – and there is demand for investment projects and consumer goods. If sanctions are repealed, investors will have to decide whether current prices correctly reflect economic, financial and political risks.

In the initial phases of Iran's integration, a prudent way to invest in Iran may be to invest in multinational corporations – including those in Turkey and other neighbouring countries, which will be active in Iran and will have well-diversified global operations. ■

George Hoguet is Global investment Strategist in the Investment Solutions Group at State Street Global Advisors.

Rousseff fights back

Brazil's Petrobas scandal adds to economic woe

David Smith, Advisory Board

Amid faltering growth and growing emerging market woes, President Dilma Rousseff is confronting a major political scandal, with thousands marching on Brazilian streets demanding her impeachment.

Even with lower numbers, the symbolism spoke volumes. Thousands in Rio's Copacabana Beach wore the country's yellow-and-green football shirts and carried signs saying: 'Dilma out.' In São Paulo, over 100,000 people took over the city centre to insist the president should go. Even in her home city, the mining capital of Belo Horizonte, the crowds gathered.

Rousseff was remarkably calm, despite her approval rating falling to 8.0% in the midst of a corruption scandal that threatens her survival.

The scandal revolves around Brazil's state oil giant Petrobras and the $3bn Petrobras executives allegedly took as kickbacks for contracts before channelling funds to politicians, including top brass in Rousseff's ruling Workers' Party. The treasurer of that party is heading for jail. The country's top construction magnate is already behind bars. The speaker of the lower house of congress is under investigation for allegedly taking a $5m bribe. Yet Rousseff, who once chaired Petrobras as energy minister, has pledged support for the judicial investigation team heading Operation *Lava Jato* (Car Wash).

Brave path: Dilma Rousseff forges ahead

What makes this political storm exceptionally turbulent is the state of the world's eighth-largest economy. The telltale signs go well beyond an inflation rate of nearly 10% and rising unemployment. Earlier, the government projected the economy would shrink by 1.8% this year; it then forecast a contraction of 2% – and this from a leadership that took power at a time of 7.5% annual growth.

Finance Minister Joaquim Levy has insisted austerity is imperative, so has planned spending cuts and tax hikes to help the government return to surplus. Yet he announced Brazil is lowering its projection of a primary budget surplus from 1.1% of GDP to a miniscule 0.15%. Shortly afterwards, the congress passed wage rises for public servants and the police, adding 2.5bn reals ($700m) to Levy's budget, a hefty chunk of what he'd saved. 'Everyone is in charge, and no-one is in charge,' said one deputy still loyal to the president. 'The clock is ticking on this presidency, as the economy collapses.'

No wonder the real is now at its lowest value against the dollar in over 12 years. Little surprise Moody's cut Brazil's investment rating to near-junk status, with Standard and Poor's suggesting Brazil could lose its investment grade by 2016.

The chief executive of one of Brazil's biggest companies offers the following arithmetic: 'Brazil needs to grow by 2%, and have a primary budget surplus of 2% of GDP to stabilise its debt ratios and bring back investors. That's unthinkable in this economic and political climate.'

Yet in an age when emerging markets are bedevilled by corruption and transparency, President Rousseff is taking the road less travelled towards the truth – whatever the consequences may yet be. ■

The battle begins: Argentina's complex mathematics add up to change

The complex mathematics of Argentina's election year defy simple conclusions. The results of August's primary elections, showing strong support for the opposition, underline how the country is starkly divided over its economy.

The chances of the ruling Kirchner dynasty carrying on have dimmed substantially. Outgoing President Cristina Fernández de Kirchner and her predecessor, her late husband Nestor, spent lavishly on creating the illusion of invincibility for themselves and their chosen successor, Buenos Aires Governor Daniel Scioli. But 12 years in power have left an economy in freefall, with inflation at 30%, rising poverty and unemployment, and a spiralling budget deficit.

The government has been borrowing at very high interest rates, its access to capital markets limited by legal disputes with 'hold-out' creditors. 'The Kirchner strategy is to mortgage the future, and leave us with a crisis of their making,' says an adviser to Mauricio Macri, Buenos Aires' mayor and now the lead opposition candidate.

Although the Kirchner ploy was to bury Macri in the first round of voting, that now seems unlikely. Macri's chances rise if the election goes to a second round. Many of the major cities – Buenos Aires, Cordoba, Mendoza, Santa Fe – voted for Macri, but there was also notable support for the third-party candidacy of former Kirchner ally Sergio Massa.

Even in Buenos Aires, Macri's candidate won the personal vote. Together with Massa's candidate, the opposition carried the province, which was unthinkable before as almost 40% of voters live there. So how these opposition leaders unite, or don't unite, could be decisive. But the fork in the road is clear: will it be more of the same – a populist, interventionist government that seizes back the oil industry and renationalises the state airline, losing millions of dollars a day in the process? That refuses to devalue the peso, even as the 'unofficial' dollar rises weekly? A new government could trigger a mini-buying stampede from investors in the energy sector whose appetite for risk is strong.

Clearly the battle has been joined. The Kirchner dynasty holds a number of important cards – not least the population's dependency on government subsidies – but the opposition has a window of opportunity, and how they use it will be critical. No wonder Mayor Macri began the final stretch by echoing Obama's campaign slogan in 2008: *Si se puede* (Yes we can)! ■

David Smith represented the UN Secretary-General in the Americas 2004–14.

Strong dollar throws up challenges

Emerging markets burdened by hard currency debt

Anna Stupnytska, Fidelity Worldwide Investment

After years of exceptional performance, emerging economies have disappointed since the start of the current decade. Growth has slowed sharply, and not just in absolute terms. The relative growth differential versus developed markets has fallen from 6.5% in 2009 to potentially just over 2.0% in 2015.

Several interconnected factors help explain emerging market struggles. These include China's slowdown, the end of the commodities super cycle and tightening in global financial conditions. The first two have already been playing out on a large scale, having delivered a double blow to the likes of Brazil, Chile, Colombia, South Africa and Indonesia – commodity exporters with close links to China.

The last factor has not yet been a substantial headwind for emerging markets, but is set to become more dominant over the next few months. As the US Federal Reserve embarks on its rate-hiking cycle, the associated rise in funding costs will weigh heavily on emerging markets, particularly in places where external imbalances are relatively stark.

Potential trouble ahead

The recent rally in the dollar – up around 20% in trade-weighted terms since mid-2014 – is a key part of the tighter financial conditions. The associated emerging market currency weakness over the past year – significantly in places such as Russia, Colombia, Brazil, Malaysia, Mexico and Turkey – has been a source of concern among investors.

Currency depreciation is not necessarily a bad thing. It supports exporters and can help reduce imbalances by reducing external deficits. It can shore up activity and boost inflation, at least temporarily – beneficial for the economies facing deflation. Yet currency weakness carries significant risks.

A pronounced fall could lead to an undesirable spike in inflation and inflation expectations, which would force central banks to hike rates and have a detrimental effect on activity, particularly if growth is already low.

Moreover, currency weakness can expose vulnerabilities arising from foreign currency mismatches as the size of unfunded liabilities in foreign currency terms increases, weakening borrowers' balance sheets. As the dollar is the main foreign currency of emerging market debt issuance, there is a chance that the recent dollar strength could catalyse further trouble for emerging markets, as in the 1980s in Latin America and the 1990s in Asia.

What happens next mainly depends on two factors: first, exposure to dollar-denominated debt; second, prospects for further dollar strength. In terms of the overall debt exposure (including local currency-denominated debt), total external debt in emerging markets has fallen from an average of over 35% of GDP in the 1990s to around 25% in 2013.

Today's levels of sovereign emerging market hard currency debt in particular are much lower relative to the 1990s crisis periods. As most emerging governments reduced foreign borrowing, abandoned currency pegs and built up foreign exchange reserves, their countries have generally become more resilient to dollar strength. But while governments have been relatively frugal, private sector borrowers in emerging markets have taken advantage of the unusually easy global financial conditions and issued significant amounts of foreign currency-denominated debt since the financial crisis.

> "The rise in foreign ownership of hard currency debt can make balance sheets more sensitive to currency fluctuations

Hard currency debt

According to the Bank for International Settlements, emerging market borrowers have issued $2.8tn of international debt securities (as of the first quarter of 2015), of which almost three-quarters was issued by the private sector and a similar share was denominated in dollars.

As emerging currencies have weakened over the past few years, the hard currency debt burden has increased further as a share of GDP, particularly in commodity exporters and/or countries with large external imbalances, such as Russia, Chile, South Africa, Brazil, Mexico and Turkey. In places where the dollar-debt stock is not matched by dollar assets, and where related servicing payments are not matched by revenues, these vulnerabilities are particularly acute.

In addition, the recent rise in foreign ownership of hard currency debt also can make balance sheets more sensitive to currency fluctuations. As foreign investors might not be willing to continue financing borrowing in light of sustained local currency weakness, countries with high foreign ownership of dollar-denominated debt might be more prone to capital flow reversals. Indonesia, Peru, Mexico, Malaysia and South Africa look vulnerable.

Fed rate hikes

Prospects for the dollar itself are important. The good news is that over the past year, the rally has been relatively well digested. It is certainly no longer a one-directional bet, as market expectations for the start of the rate-hiking cycle have largely been priced in. If the Fed rate-hiking cycle is in line with market expectations – in other words, slower and shallower than before – we might already be close to the peak of the dollar strength in this cycle, and emerging borrowers might escape relatively unscathed.

If, however, the pace of hiking is more aggressive than currently expected, the dollar might stage another rally, exposing emerging market vulnerabilities in light of much tighter financial conditions globally.

Overall, the global backdrop that fuelled the rise of emerging markets in the previous decade is no longer supportive to growth successes. Does it mean the mediocre growth of late is the new normal for emerging market economies? Are we likely to see another wave of emerging market crises as headwinds intensify?

Not necessarily. Emerging governments can still do much to improve the resilience of their economies and raise growth potential through structural reform. Enhancing education, encouraging innovation, improving the business environment and technology are key in this quest. Those emerging markets that succeed in pushing through reform over the next few years are more likely to deliver superior growth outcomes and better returns for investors. ■

Anna Stupnytska (@AnnaStupnytska) is a global economist at Fidelity Worldwide Investments.

An imbalance of comprehension

Lack of pro-Westerners in Russia

Denis MacShane, Advisory Board

Reading Russia is never easy, and it's getting harder. 'The Russian Challenge', a Chatham House report on dealing with Russia published in June, painted the country in almost entirely negative hues, lining up Poland and the Baltic States with the neo-cold warriors in Washington, who typically see Russia in terms of confrontation and containment.

Rob de Wijk, Director of The Hague Centre for Strategic Studies, considers Russia to be the greatest strategic threat to the West. He says the annexation of Crimea is 'unacceptable' behaviour, and is a flagrant violation of international law and the territorial integrity of a United Nations sovereign state. He uses the same description for Russia's dispatch of men and weapons to back armed resistance in Ukraine.

On the other side are the 'Putinversteher', as the Germans call those who seek to understand rather than condemn Putin. Yet in Moscow, there is a lack of critical understanding of the West by Russians – an intellectual imbalance that also threatens stability.

Western sympathisers include former UK Ambassador Tony Brenton, Richard Sakwa of Kent University and Mary Devjesky, a writer for the UK's Independent newspaper. While their voices are heard, Putin does little to help Westerners relax hostility to Moscow.

Alarmist essay

In an alarming – not to say alarmist – essay, 'Countdown to War: The Coming U.S.–Russia Conflict' published by The National Interest, Harvard geopolitical guru Graham Allison and publisher Dimitri Simes draw parallels with the run-up to 1914 when countries that later went to war misread each others' intentions. The authors argue that Russia's economic weakness – made worse by plunging oil prices and rouble devaluation – is offset by armed strength. This is visible in the soldiers and matériel sent to destabilise eastern Ukraine.

Russia's muscle-flexing is also seen in its provocative air patrols over European states; its turning of the Georgian region of Abkhazia into a military and missile base; and its threat to station Iskander missiles in Kaliningrad, aimed directly at Sweden and Finland.

The authors imagine a conflict involving Russian speakers in Latvia or Lithuania angered at being treated shabbily by strong nationalist politicians in both countries. As the conflict turns violent, Russia would – under the so-called Putin doctrine – carry out a limited military intervention to defend the rights of Russian speakers as it has done closer to Russia's borders. They argue that Europe's weakened armed services are unlikely to be 'killed for Kiev' or 'lay down their lives for Latvia', which leaves the West with economic sanctions that irritate but do not deter.

Intellectual imbalance: German Chancellor Angela Merkel and Russian President Vladimir Putin

> **Most members of the Russian elite have lost all faith in Western politics and seem determined to use force to educate their partners to respect — *Sergei Karaganov***

In two unambiguous essays, Sergei Karaganov, dean of the School of World Economics and International Relations at the National Research University-Higher School of Economics in Moscow and an adviser to the Kremlin, sets out how Russia sees the world and Europe. As Karaganov asserts: 'Most members of the Russian elite have lost all faith in Western politics and seem to be determined to use force to educate their partners to respect.' This statement is the most profound renunciation of the entire post-1945 settlement – the long peace – in which force was rejected as a means of educating other nations to show respect.

Karaganov dismisses the views of the 'Putinversteher', especially in Germany, that East–West bridge-building organisations like the Organisation for Security and Co-operation in Europe should be strengthened and the Helsinki process reinvented. OSCE has tried and failed to stop conflicts in Georgia, Transnistria, Georgia and now Ukraine. The Kremlin seems to want a pre-Helsinki, pre-détente world where those who do not see things through Putin's eyes are guilty of hostile acts.

One way to reduce tensions would be better diplomatic and political contacts. But it seems Russian foreign policy discussion doesn't exist outside the Kremlin. Unlike in Europe and North America, there are no mainstream Russian foreign policy analysts or media platforms who criticise their leader.

Karaganov explains this on the grounds Russia is 'inclining towards old European stand-ards – the priority of sovereignty, hitherto banned Christianity, and patriotism; the rest of Europe [is] advancing post-European values.' This may explain why there is so much Russian support for europhobe hyper-nationalists like former French National Front leader Jean-Marie Le Pen and the UK Independence Party, which argue for a return to a Europe based on pre-1939 nationalism and closed frontiers. Karaganov is cynical about his fellow countrymen, saying they achieved their desires when they dreamed of living European lives. Now they have personal freedom, well-stocked shops, clean public toilets and cars in most families. 'And they are not seriously concerned about rule of law or real democracy for the time being,' he writes.

Lack of 'Europaversteher'

While Europe has many 'Putinversteher', Russia has few or no 'Europaversteher'. Karaganov says the post-1945 era, based on US–European values of liberal democracy and open-market economies, has run its course. He believes Russia should turn east to co-operate with 'leader-type, non-liberal democracies'.

There are many in Europe who want to create better relations with Russia, ease sanctions and live with Putinism, but there are no Russians who want to understand Europe, accept Euroatlantic values and improve the economy rather than threaten military conflict.

The West has stretched out economic and political hands to Russia, but the complete absence of pro-European Russians who do not fear compromise with the West is potentially a danger – for both Russia and the West. ■

Denis MacShane is a former Minister for Europe and Member of the UK Parliament.

Brexit may be real gift of Greeks

Threat of British retreat highlights need for overhaul

Antonio Armellini, Advisory Board

The Greek crisis is far from over, and its messy convolutions could bring the UK's departure from the European Union – or 'Brexit' – closer, in a mutually reinforcing toxic link that could put the entire European construct into question.

Brexit is presently a possibility, not (yet) a probability – but to continue accommodating the UK, the EU will have to carry out a fundamental overhaul of its political *raison d'etre*.

Quite a few of the UK's propositions make sense for the EU as a whole, and could be negotiated fairly easily, as German Chancellor Angela Merkel, among others, has made clear. Others – particularly the area of the free movement of people – are not, and the red lines are there to stay. Cloaking the issues in a conveniently worded euro-Brussels muddle could be managed by the British government in time for the referendum; the rest of the 28 are sympathetic and ready to lend a hand, provided they are not stretched too far.

The real game-changer lies elsewhere, however: the request to strike the reference to an 'ever-closer Union' from the treaties might seem like another manifestation of the cultural chasm between British scepticism and European enthusiasm for high-sounding political principles, but the implications go right to the very heart of what the EU is about.

Uncertain future

The idea of a politically integrated Europe was the foundation stone of the original Six. The commitment waned as the European Community took on new members with differing agendas, but the ultimate aim of a federal Europe was never disputed; those who did not share it were content with postponing it to an uncertain distant future.

The supranational mantra was reaffirmed as the EC morphed into the EU – albeit with widely varying interpretations. The past 50 years of integration have brought an *embarras de richesses*: the advantages of Europe are taken as an irreversible given and there is a generalised resistance to further efforts. Eastern European members are instinctively suspicious of ceding parts of a sovereignty they have only recently (and laboriously) recovered. Scandinavians have similar concerns, if for different reasons. The eurosceptic movements in continental Europe welcome any opportunity to hack away at what they see as a Brussels-dominated imposition. Consensus for the British view of Europe as a broadly defined platform of shared interests and geopolitical imperatives is gaining ground, and indeed could define the EU's future in a way other members – starting with Turkey – would find their proper place. But is this what Europe should be about?

No common mantra

The Greek crisis has made abundantly clear that without a quantum leap towards political integration, the euro is doomed. The common currency is not an end in itself, but it is the essential precondition for the supranational Europe advocated by many of its members and resisted by others. The divide is clearly visible through the fog of multiple crises: without the euro, there can be no common economic, fiscal and political governance of Europe, and such political governance is unacceptable to some. No amount of institutional engineering can take away the fact that the 'ever-closer union' is no longer a commonly shared mantra.

Italy's former prime minister, Aldo Moro, was widely criticised when he devised the 'converging parallels' formula to illustrate the relationship between Communists and Christian Democrats in Italy: this semantic oxymoron effectively described how fundamentally different positions could coexist within a shared constitutional framework, pursuing aims that remained different, but were not incompatible.

The future of Europe could similarly be one of 'converging' parallel tracks, neither mutually contradictory nor mutually reinforcing. Those who wished to continue along the way of a politically integrated Europe, enjoying a common currency and insitutions, should be able to do so without being conditioned by others. Those who wanted a different pattern of co-operation should not be required to assume obligations they did not recognise. The overarching principles of democracy and the rule of law would define the outer rim of such a union – part confederation and part federation; a sort of modern version of the Holy Roman Empire which, though much maligned (as has been the EU), was nevertheless a successful form of governance in Europe for centuries.

It is far from clear the euro area would survive in its present form without a decisive supranational push. The wider European rim could easily become fractious, and the relationship between the different levels could be tricky. But unless the EU can rethink itself, the pressure of conflicting priorities and interests could bring about its demise. Ultimately, pointing out the king is without clothes may be Cameron's most unexpected and important contribution to the future of Europe. ■

Antonio Armellini was Italian Ambassador to India from 2004–08. He is a member of the International Institute for Strategic Studies and Istituto Affari Internazionali.

Messy message: The Greek crisis has made it clear the euro is doomed without political integration

Prepare for the coming collateral crunch

Changing dynamics make liquidity management critical

Hani Kablawi, BNY Mellon

New regulations, heightened risk sensitivity and rapidly evolving market dynamics are all making collateral management more critical than ever, as buy-side and sell-side firms alike find themselves confronted with new challenges and new complexities.

Collateral has always been integral to the extension of credit, but it is fast becoming the sole determinant of institutions' ability to engage in financial transactions in the cash or derivative markets.

As our clients' business models continue to evolve, they are increasingly looking for unified capabilities across collateral management and segregation in order to more effectively address regulatory changes, manage risks and improve performance.

In particular, those regulatory changes – Liquidity Coverage Ratio-friendly deposits, Money Market Reform, Dodd-Frank, European Market Infrastructure Regulation and Basel III, among others – require an extension of optimisation capabilities to the buy-side, along with the delivery of enhanced operational efficiencies.

The ability to identify, mobilise and – if necessary – transform idle assets to be used actively as part of an overall investment strategy remains key. How quickly can you access your collateral? How liquid is it? Do you have the right type of collateral and, if not, are you able to transform the securities you currently hold into acceptable collateral?

The impact of many of the new regulations – Solvency II, Basel III, Emir, central clearing – is just beginning to be felt in the market, but what is clear is that balance sheet management, liquidity and more effective financing are key challenges for an increasingly broad range of participants who must balance these drivers with a range of other priorities, such as risk mitigation, cost and operational efficiencies.

> **"With the segregation and optimisation of collateral still key areas of focus, the future of collateral management is also about efficiency**

Future financial institutions and intermediaries will need to find new and efficient ways to collateralise and fund liquidity, and identify partners who can help them repurpose common platforms that will allow them to address future collateral eligibility needs.

With collateral segregation and optimisation still key areas of focus, the future of collateral management is also about efficiency, with clients increasingly seeking out the most direct and effective approach to collateralising their assets.

While the predicted 'crunch' in respect of the volume of assets to be collateralised did not materialise, a crunch is still coming in terms of the number of collateral accounts that need to be opened. The operational resources required for processing – including account set-ups, reconciliations and legal agreements – will become a more pressing priority for clients.

Despite legislative exemptions from many of the regulatory reforms that have transformed the derivatives market, sovereign investors are feeling the indirect effects of the impact of these reforms on their counterparties.

Recognising and responding appropriately to that impact will deliver cost and risk benefits over the second half of this decade. ■

Hani Kablawi is executive vice-president and chief executive of EMEA Asset Servicing, and co-chair of MEA, BNY Mellon.

Sovereign investment institutions, or Global Public Investors (GPIs) – including central banks, sovereign funds and public pension funds – are increasingly seen as large-scale suppliers of high-quality collateral to offset liquidity shortages in international capital markets and shore up global growth.

This is the conclusion of a report by OMFIF in conjunction with BNY Mellon that explores how sovereign investment institutions have been adjusting to after the 2008–09 financial crisis to new positions as pivotal participants in the world economy.

The report, 'Crossing the Collateral Rubicon – A new territory of challenge and opportunity', says sovereign institutions have developed beyond their traditional roles in capital markets, and are now being seen additionally as providers of collateral in the form of high-quality bonds.

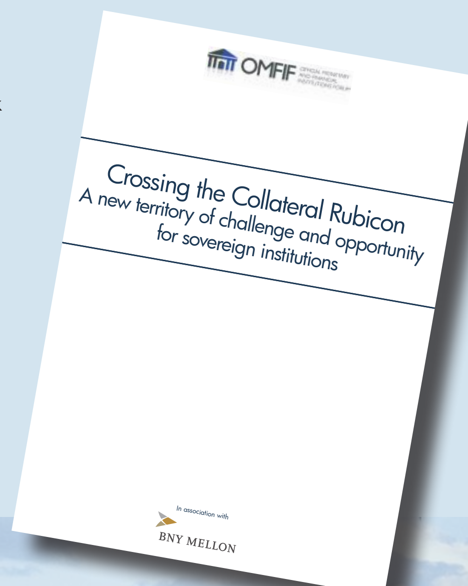
This collateral is used to facilitate basic transactions such as repurchase agreements, portfolio hedging and diversification transactions, which lie at the heart of bank and market finance in many jurisdictions.

GPIs are trying to maintain a delicate equilibrium. They are mindful of their responsibilities to provide for future generations and support infrastructure developments in their local markets, but are also trying to find the best way of generating yield and benefiting from the new environment without compromising their financial conservatism and risk aversion.

The report concludes: 'For many public bodies, this may amount to crossing the Rubicon into a new territory of challenge and opportunity.'

Some key findings of the report include:

- the need for more operational robustness for a wider range of securities and greater certainty in the timely settlement of transactions was highlighted;
- many GPIs confirm discussions on collateral management in the past 12 months, with a substantial number responding positively;
- sovereign wealth funds and public pension funds show a larger interest in securities lending than other GPIs, such as central banks;
- some large central banks are looking to undertake repo trades in highly liquid developed markets to increase income – returns are expected to be about 20 basis points on these trades; and
- sovereign funds, depending on the type and duration of trades, appear to be looking for higher returns than central banks, at between 40 and 120 basis points.



Exchange rate and dollar debt

Compressed risk premia heighten credit expansion

Philip Turner and Jhuvesh Sobrun, BIS

The exchange rates of emerging market currencies have been strongly affected by interest rate trends in major currencies, swings in commodity prices and dollar debt accumulated by emerging market companies. Appreciation pressures dominated the early post-crisis years, but many currencies have since faced strong downward pressure.

Near-zero policy rates in advanced economies may have constrained the policy rate set by an emerging market central bank more than in pre-crisis periods when global short-term rates were higher. Of greater significance, however, is that the growth of local bond markets has made the long-term interest rate in emerging markets currencies much more important as a transmission channel.

Altering short-term policy rates to counter this was often ruled out of practical consideration by the desire not to aggravate exchange rate appreciation pressures. For much of the post-crisis period, emerging market central banks accumulated foreign exchange reserves on a massive scale in an attempt to reduce currency appreciation pressures coming from low foreign interest rates (and, in some cases, their own current account surpluses).

The growth of central bank foreign exchange reserves in emerging markets has inflated local banking systems' balance sheets, usually increasing liquidity in money markets and stimulating bank credit to the private sector. Selling foreign exchange reserves – as in 2015 – tends to reverse such domestic credit expansion.

Worries about excessive currency appreciation are often rooted in concerns about financial stability. The terms-of-trade gains from currency appreciation may persuade households that their permanent income has risen so they can borrow more, and persuade banks that local borrowers have become better risks. Compressed risk premia then fuel credit expansion. Such destabilising dynamics are often particularly strong in commodity-exporting countries during a boom because the main potential counterweight (which is that currency appreciation depresses demand for the country's tradeables) is weak. And when commodity prices slump, currency depreciation does little to stimulate demand.

Destabilising dynamics are also strong when local borrowers with foreign currency debts see their balance sheets strengthen as the currency appreciates, and banks are willing to lend them more.

Currency depreciation scenarios

Most financial crises have been preceded by scenarios where currency appreciation and domestic credit expansion fed on each other. Overvalued exchange rates during cyclical booms (with large capital inflows) increase the risk of financial crises. A subsequent 'sudden stop' in capital flows forces a country to correct its trade deficit rapidly by reducing income to match the (diminished) tradeables output. The exchange rate often overshoots, making companies with currency mismatches insolvent.

Such a currency depreciation scenario can be especially damaging when the dollar is appreciating against other major currencies because foreign debts are still predominantly denominated in dollars. The effective exchange rate of the dollar has appreciated strongly, and is currently 25% above its average 2010–12 level. The 1994 Fed tightening saw no such rise in the dollar – actually, it tended to weaken.

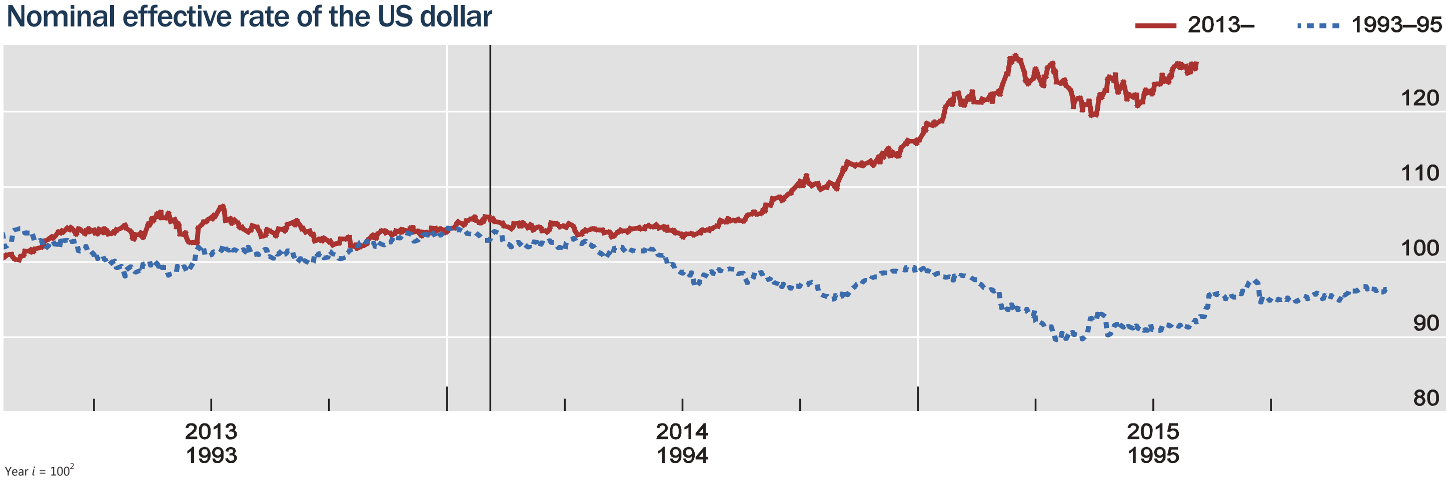
A major reason for this difference reflects current market expectations that monetary policy normalisation in the advanced economies will be asynchronous, with the Federal Reserve and the Bank of England tightening first. The balance sheets of both central banks have stopped increasing, and will begin to fall sometime after policy rates have risen. Markets expect the Federal funds rate and the UK's Bank rate to rise later this year or in early 2016. By contrast, markets expect euro and yen interest rates to remain close to zero until 2017.

Much of Europe has recently introduced negative policy or central bank deposit rates, contributing to negative yields on many medium-term government bonds. As Hervé Hannoun has pointed out, an experiment is under way in Europe to test the 'boundaries of the unthinkable' in monetary policy. The balance sheets of the Bank of Japan and the European Central Bank are expanding.

Movements in cross-rates of the major currencies created by such monetary policy divergence can affect an emerging market economy even if its own effective exchange rate is unchanged. For many companies, the most important currency for trade competitiveness (such as the yen in Asia) will not be the currency of denomination of their foreign debts (that is, the dollar). The increased foreign debts of emerging market corporations denominated in dollars bring heightened vulnerability to currency mismatches. ■

Philip Turner is deputy head, monetary and economic development, and Jhuvesh Sobrun is senior research analyst at the Bank for International Settlements. This is an excerpt from one of the authors' sections in BIS Working Paper No 508.

Nominal effective rate of the US dollar



Year i = 100[2]

The vertical line indicates 4 February 1994, when the Fed funds rate was raised for the first time for over five years.

[1] Versus a basket of major currencies. [2] i= 1993 for "1993–95" and i=2013 for "2013–".

Sources: Federal Reserve; BIS calculations.

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Strong undercurrent towards rates rise

Market turmoil disturbs plan for September lift-off

Darrell Delamaide, US editor

While the market turmoil amid concern about China's economy put a September rate hike by the Federal Reserve into doubt, there was clearly growing impatience for the US central bank to begin the process of normalising monetary policy.

The underlying data determining when the Fed would push the button on the first increase in rates in nine years – and the first change in nearly seven (namely, US employment and inflation expectations) – were little affected by the stock market plunge in August.

Fed Vice-Chairman Stanley Fischer (voter) revived belief that lift-off could come as early as this month with his forecast that inflation expectations – the somewhat-intangible measure the Fed prefers to actual inflation – are now firming. One of the few top-ranking officials to attend the annual gathering at Jackson Hole in the US state of Wyoming, Fischer referred to the July statement of the Federal Open Market Committee pledging action once there is improvement in the labour market, and the panel is 'reasonably confident' inflation is heading back to its target of 2%.

'Can the Committee be reasonably confident that inflation will move back to its 2% objective over the medium term?' Fischer asked rhetorically. His answer: 'Given the apparent stability of inflation expectations, there is good reason to believe that inflation will move higher as the forces holding down inflation dissipate further.' The dampening effect of the strong dollar and declining oil prices are 'already starting to fade,' he said.

St Louis Fed Chief James Bullard (non-voter) also saw little impact when he responded at Jackson Hole to his own rhetorical question about the market volatility. 'My basic answer is, I don't think there is that much of an impact on the outlook for the US economy,' he said in an interview with The Wall Street Journal. 'We have very good fundamentals.'

On 4 September US jobs data for August provided a mixed guide to the Fed's likely move. The headline job creation fell short of expectations in August, at 173,000. Yet previous months' figures were revised higher, bringing the summer average to a robust 221,000, and the unemployment rate dipped to 5.1%.

Bullard and Fischer's remarks at Jackson Hole came just days after New York Fed Chief William Dudley (voter), who is the vice-chairman of the FOMC, had soothed markets by saying the case for raising rates in September was 'less compelling' than it had been.

Autumn reflections: Officials at Jackson Hole, Wyoming, agreed inflation will move higher

In response to reporters' questions about the impact of market volatility on lift-off, Dudley said 'at this moment, the decision to begin the normalisation process at the September FOMC meeting seems less compelling to me than it did several weeks ago.'

He quickly added: 'But normalisation could become more compelling by the time of the meeting as we get additional information on how the US economy is performing,' as well as developments in international financial markets that could impact the economy.

Lift-off still imminent

Whether in September or not, the expectation remains that lift-off will occur this year.

Atlanta Fed president Dennis Lockhart (voter) summed up this position in noting that growth and improvement in the labour market have been steady, even if a bit sluggish, and are likely to continue. 'Consistent with this picture, I expect the normalisation of monetary policy – that is, interest rates – to begin sometime this year,' Lockhart said in late August.

He added: 'I expect normalisation to proceed gradually, the implication being an environment of rather low rates for quite some time.' The last point is a significant one for Fed policy-makers, who keep emphasising that a quarter-point hike in rates is really not a big deal.

Earlier in August, Lockhart said he thought the point of lift-off was 'close,' and emphasised that he does not see the need for completely positive data to begin the process of raising rates. 'I am not expecting the data signals to point uniformly in the same direction,' he said in a speech in Atlanta. 'I don't need this. I'm prepared to see mixed data. Data are inherently noisy month to month and quarter to quarter.'

At Jackson Hole, Lockhart told Bloomberg TV that it was reasonable to assess the chances of a move in September as 50–50.

Another attendee at the resort summit, Cleveland Fed president Loretta Mester (non-voter), echoed this assessment. 'My view so far in looking at all of the factors is that the economy can sustain an increase in interest rates,' she said in an interview Friday.

That lift-off was 'close' was the tenor of the last FOMC meeting in late July, according to the minutes released in August.

'Most judged that the conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point,' the summary said.

Fed chair Janet Yellen (voter) was conspicuously absent from Jackson Hole, sparing her the need to make any comment at all. Her challenge in September will be finding a consensus for the panel.

If the market volatility subsides, and given the mixed signals about employment, it will be difficult for her to postpone a rate increase without some dissent.

Already in July, according to the minutes, one member 'indicated a readiness to take that step at this meeting but was willing to wait for additional data'.

This is why so much importance was attached to Fischer's comments on inflation. Given the positive news on jobs and growth, concern about inflation in a quiet market environment would be the only legitimate reason to postpone lift-off any longer. ■

Darrell Delamaide is a writer and editor based in Washington, DC.

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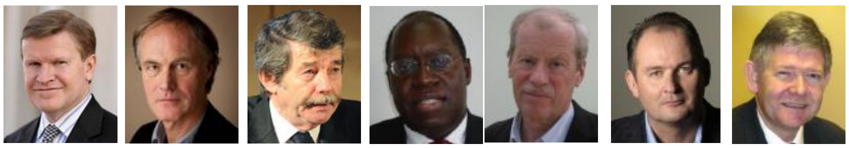

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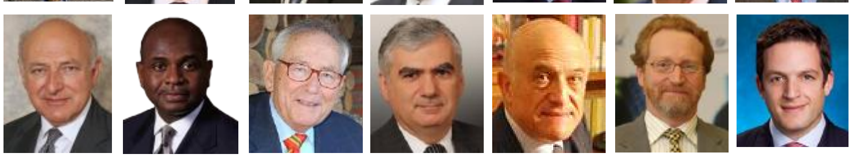

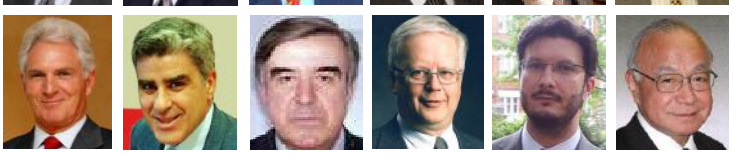

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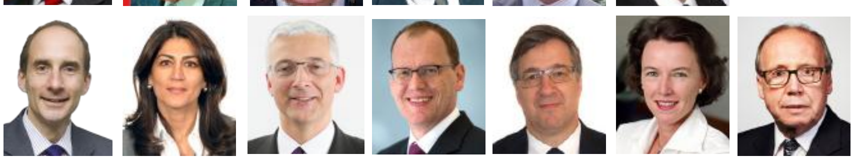

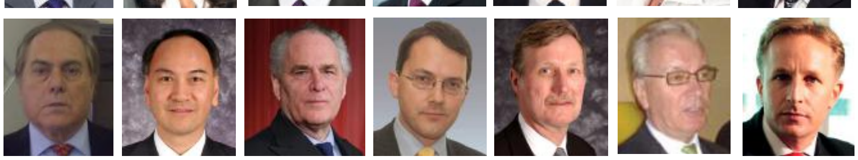

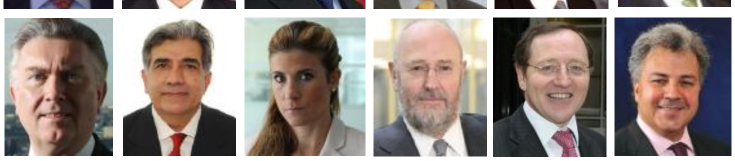

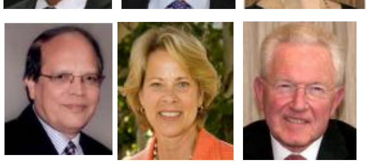

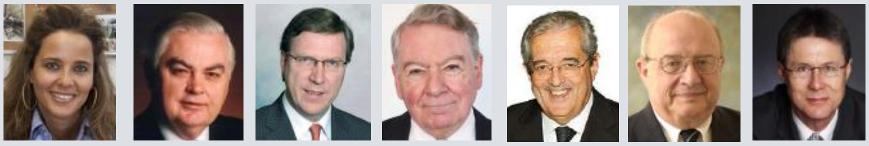

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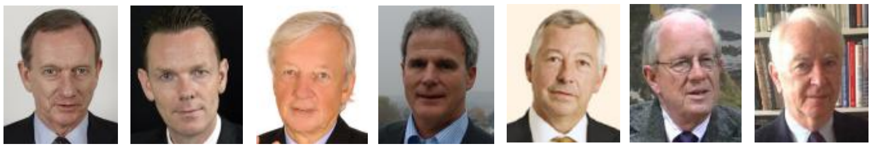

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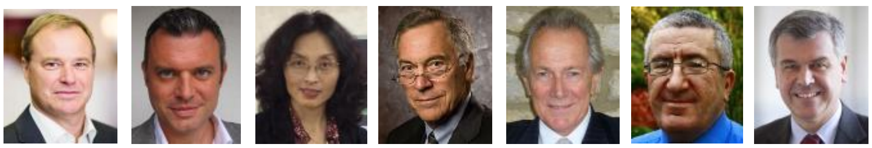

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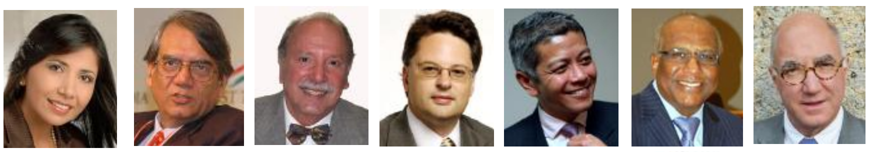

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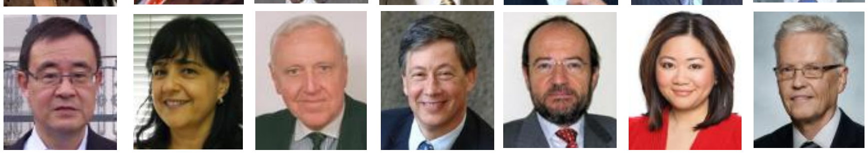

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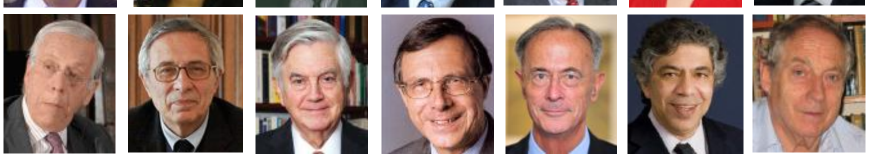

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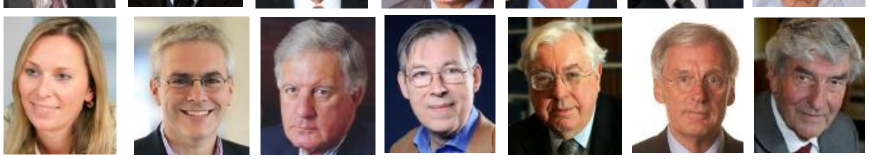

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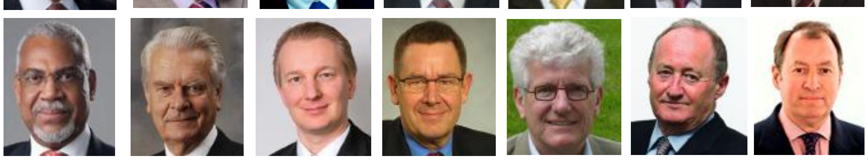

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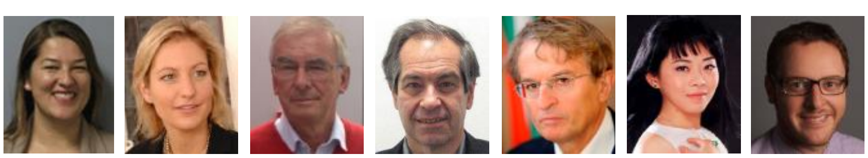

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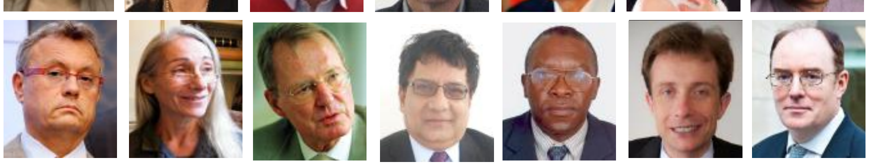

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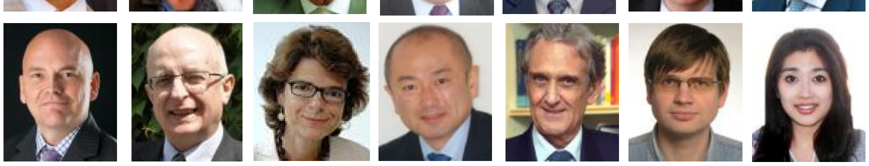

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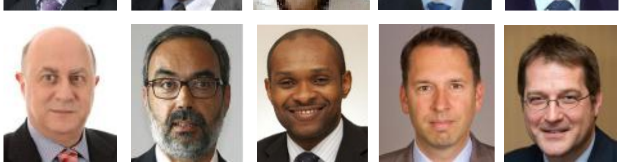

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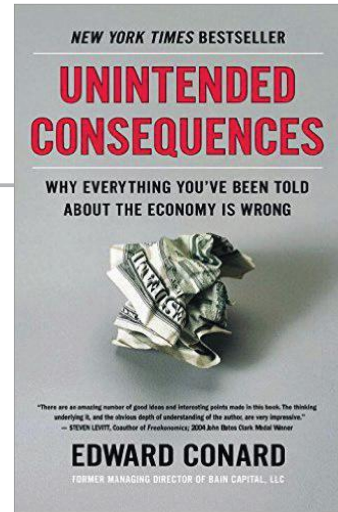
An astute post-mortem

Investment, aspiration and the deficit

George Hoguet, Advisory Board



Private equity firm Bain Capital has produced prominent alumni, such as Mitt Romney and Paul Edgerly, co-owner of the Boston Celtics professional basketball franchise. With the publication of *Unintended Consequences – Why Everything You Have Been Told About the Economy is Wrong*, Edward Conard – currently a visiting scholar at the American Enterprise Institute – solidifies his position on the list.

Conard has written an original, incisive and probing work about the global financial crisis and the US economy. He vigorously attacks some of the 'received wisdom' about the origins of the financial crisis, and sets out his version of what went wrong and how to avoid a repeat. The book is essentially a work of political economy. As he rightly observes, 'We must use empirical evidence to evaluate the beliefs that divide economics, and decide for ourselves which set of beliefs seems most plausible.'

But despite this injunction, Conard's reading of the economic evidence at times appears selective, and some of his arguments are not entirely convincing. Nonetheless, this New York Times bestseller is closely argued, and is not just another predictably hackneyed Social Darwinist manifesto. Every chapter sparkles with original insights, and the author clearly has a deep grasp of individual and corporate behaviour. Like Thomas Piketty, Conard should be celebrated for the breadth of his questions.

The quest for status

Conard begins by documenting the superior economic performance of the US economy from 1990–2008 relative to Japan and Western Europe. Why did the US capitalise on the Internet to accelerate productivity more effectively than Western Europe? Both had similarly educated workforces, access to the same technology and an abundance of capital.

Part of the answer lies in investment, which leads to innovation, which leads to buyers' surplus. Intangible investment in the US has grown more rapidly than in Europe.

Another piece of the puzzle lies in the US trade deficit, which allowed both the growth of both US investment and consumption. The trade deficit was '…essential to US growth'. Yet another lies in the continual 'aspirational treadmill' in the US. Conard views the quest for relative status as the engine that drives economic success, and believes this dynamic provides powerful economic spillovers to society as a whole.

The chapters on the US sub-prime crisis rebut many of the findings of the US Financial Crisis Inquiry Commission and point out some inconvenient facts. For example, 'If banks used securitisation to offload troubled loans onto naïve investors, why did they retain 40% of those loans on their balance sheets?"

And why did then-World Bank economist and future Nobel laureate (and vociferous financial sector critic) Joseph Stiglitz co-author a paper that concluded, 'The risk to the government from a potential default on GSE (Government-sponsored enterprises, principally Fannie Mae and Freddie Mac) is effectively zero?'

Conard believes the run on the banks, which led to asset sales at fire-sale prices, was the principal cause of bank insolvencies. A regulatory policy failure was to allow banks to fund AAA-rated sub-prime tranches with short term debt. But US lawmakers strongly encouraged sub-prime lending.

What comes next

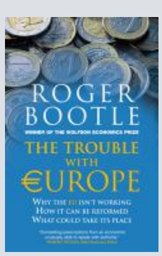
In 'What Comes Next?', the last section of the book, Conard lays out his policy prescriptions for the US economy. The crisis has led to reduced risk-taking. Additional capital for the banks does not directly address the issue of potential for panicked withdrawals. Properly priced government deposit insurance – a portion of which could be sold to the public – is part of the answer. The author's breezy dismissal of the $800bn Obama stimulus's ability to create permanent jobs resurrects one of the most contested debates in economics. The US needs to implement structural policies and 'lower the marginal tax rate permanently on successful investors' to address unemployment.

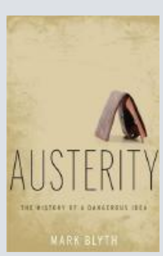
The final chapters chronicle the benefits of investment and risk-taking to society overall, and rebuts the prior beliefs of the redistributionists. Unsurprisingly, the author emphasises the importance of investment, risk-taking and incentives to long-term economic performance. Society must avoid poorly thought-out solutions that may undermine these forces and lead to unintended consequences.

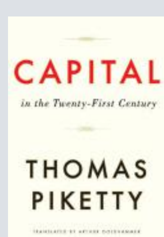
There is much to reflect on in this short book. But at times the author's arguments appear ideological. For example, he criticises talented individuals who choose to study literature and art history rather than computer programming and engineering. In his view, the former 'choose selfish solipsism over the burden of shouldering the risk and responsibility critical to increasing economic growth'.

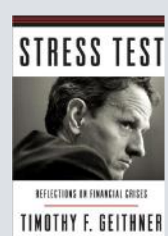
The implication that wealth accumulation should be the sole preoccupation of human existence seems ill-considered. ■

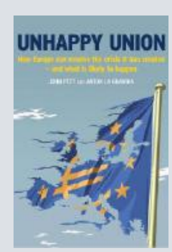
George Hoguet is Global investment Strategist in the Investment Solutions Group at State Street Global Advisors.











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