The Bulletin
September 2016
Vol. 7 Ed. 8
Official monetary and financial institutions ▪ Asset management ▪ Global money and credit
Modi and the market
India passes a milestone
FOCUS on Luxembourg's role in Europe
Darrell Delamaide on Obama's legacy
Mar Guðmundsson on financial integration
John Mourmouras on debt sustainability
Wang Yao on Chinese green bonds
HISTORICAL REVIEW: SEVEN AGES OF GOLD
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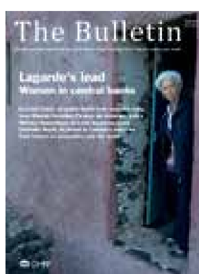
The OMFIF 167-strong Advisory Board, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors, including banking, capital markets, public policy and economics and research. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership can change owing to rotation.



EDITORIAL

India passes milestone as new governor takes over

India tops the bill of the first OMFIF Bulletin after the summer break. Narendra Modi, the prime minister, has passed a milestone with agreement on the Goods and Services Tax amendment – a major achievement on its route towards a more market-orientated economy.

After an unusually calm August for the European political economy, we are not taking our eye off the shifting financial patterns cross the Old Continent after the UK vote to leave the European Union. The September Bulletin marks the launch of a series of Focus reports on the changes among financial centres from the UK decision, starting with how Luxembourg is attempting to capitalise on new expansion opportunities. Nicolas Mackel, in charge of Luxembourg financial promotion, says the Grand Duchy can realise this aim by working with and not against the UK. John Mourmouras of the Bank of Greece and John Kornblum, a former US ambassador, weigh in with post-referendum commentaries, while Andrew Hunt unravels the symbiosis between expansion of European credit and European central banks' Target-2 balances.

In another centrepiece report, we investigate the historical background to the last few years' shift in central banks' thinking on gold. The trend since 2008 for developed countries to conserve gold stocks, and emerging market economies to build up holdings, marks the latest phase of 'The Seven Ages of Gold' delineating specific periods of fluctuating central bank gold policies over the past two centuries.

India, of course, is one of the great hubs for world gold investment. But there are three more general reasons for putting the subcontinent under the microscope – illustrated in different ways in articles by Meghnad Desai, Moorad Choudhry and Balamurali Radhakrishnan.

First, the country is now out in front as the fastest growing of the five so-called Brics economies – along with Brazil, Russia, China and South Africa – a group that has hogged the headlines perhaps too many times in the past few years. Second, the Reserve Bank of India has a new governor, Urjit Patel, a low-key yet well regarded central banker who now has to show his spurs in taking over from the mercurial Raghuram Rajan. Patel has the task of building on Rajan's promotion of monetary stability during an all-too-short three year term.

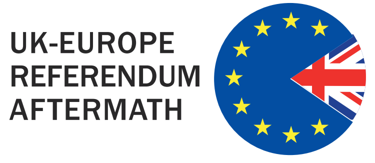
Third, in helping guide its way along the path to a more market-orientated economy, India can benefit from a substantial boost in foreign exchange holdings, now at around $338bn. The country provides an enduring illustration of developing world central banks building up reserves as a form of self-insurance against financial crisis. This is a trend that is likely to continue, once the present phase of emerging market weakness is overcome. But, for reasons Ben Robinson explains, the pace may be slower than in the past.

In other emerging market coverage, David Tonge in Istanbul examines the aftermath of the failed military coup against Turkey's President Recep Tayyip Erdoğan. Marsha Vande Berg in San Francisco believes Paul Romer, the new chief economist at the World Bank, can galvanise thinking on growth-generating cities in the developing world through the charter cities concept.

Turning to the US elections, Darrell Delamaide investigates President Barack Obama's economic legacy, and delves into Janet Yellen's latest utterings on the next hike in US interest rates. Jan Mischke of McKinsey Global Institute sets down his precepts for correcting shortfalls in public investment through adjusting public accounting standards – a theme which McKinsey and OMFIF will be developing over the next few months. Mar Guðmundsson, governor of the Central Bank of Iceland, writes on the impact of global financial integration on monetary policy transmission in small open economies. David Marsh and Bhavin Patel describe the swirling debate on using nominal GDP or nominal income as a guideline for central banks seeking a new monetary lodestar.

In our section on sustainable investment, Wang Yao of Beijing's Central University of Finance and Economics outlines development of 'responsible investment' in China. We bring two book reviews: John Nugée dwells on Joseph Stiglitz's gloomy thoughts on economic and monetary union in Europe, while William Keegan finds much to praise in Stuart Mackintosh's study of global finance.

As Merkel falters, 'new model' looms for Britain and Europe



The OMFIF advisory board is cautiously optimistic about UK economic prospects after the vote to leave the EU. A small majority of members responding to our summer survey (52% against 48%) believes Britain's growth will be above the average of the other 27 EU countries in 2017. A higher share – 70% – predicts the UK will choose a totally new model for trade and investment links with the EU-27. And the board is, on balance, relatively pessimistic about the euro area outlook: a total of 44% of respondents said UK departure would lead to a weaker euro and less cohesive euro area or even a euro breakup, against 26% forecasting a more cohesive single currency bloc and a stronger euro.

The survey appears to back up the prevalent view, after the first month in power of Theresa May's government, that a complete British divorce from Europe in the years ahead is highly unlikely, and that a new deal will be unique to Britain, not 'off the shelf'. Most probable is a 'halfway house' relationship, far from the absolutist or apocalyptic predictions of Leave or Remain campaigners. The UK and its EU partners will still carry out substantial trade and investment. Britain will make reduced payments into the European budget. And restrictions, but no swingeing clampdown, will be in place on free movement of people between the UK and the EU.

The circumstances since 23 June have embodied a touch of fantasy that has still not been totally dispelled, despite May's no-nonsense 'Brexit means Brexit' approach.

David Cameron, May's predecessor, lost a referendum he probably never believed would take place and that his opponents never expected to win. However German Chancellor Angela Merkel's ebbing power, confirmed in an election setback on 4 September, strengthens Britain's negotiating stance in the battle over the UK's withdrawal. The anti-immigration, anti-euro Alternative for Germany forced Merkel's Christian Democratic Union into third place in elections in the idyllic yet relatively impoverished eastern state of Mecklenburg Vorpommern.

Merkel's humiliation in her electoral home region, especially the rejection of her liberalism on refugees, gave victory to the Social Democrats, the chancellor's Berlin coalition partner, gearing up to oppose her in next autumn's general election. Her rebuff provides May with a chance to warn European leaders they will be dislodged by voter unrest unless they bring in EU reforms including immigration curbs. As long as the UK economy remains on a reasonably even keel, May's leverage is likely to grow in coming months.

Advisory Board

OMFIF has appointed Marek Belka, Elliot Hentov, Olivier Rousseau and Miroslav Singer to the Advisory Board. Otaviano Canuto has returned to the World Bank, Celestin Monga has become chief economist at the African Development Bank and Mario Blejer has joined the Institute of Global Affairs at the London School of Economics and Political Science. For the full list of members, **see p.26-27.**

Marek Belka is a Polish professor of economics who stepped down in July after six years as the president of the National Bank of Poland. He has served as prime minister, and deputy prime minister, of Poland, as well as holding the post of minister of finance in 1997 and 2001-02. In 2008 he became director of the European department at the International Monetary Fund. He was chairman of the Council for International Coordination for Iraq in 2003, director of economic policy in the Coalition Provisional Authority, and executive secretary of the Economics Commission for Europe.

Elliot Hentov is the head of policy and research in the Official Institutions Group at State Street Global Advisors. He joined from Standard & Poor's sovereign ratings group where he was a director and lead analyst for sovereigns and government-related entities in central, eastern and Mediterranean Europe. Before that Hentov served as a political affairs officer at the United Nations headquarters in New York. He holds a Ph.D. from Princeton University and a Master's degree in international affairs from Georgetown University.

Olivier Rousseau is a member of the executive board of the Fonds de réserve pour les retraites, the French pension state body, and chairs the asset manager select committee. In 1986 Rousseau joined the French treasury in Paris where he held various positions; he also worked for BNP Paribas for 11 years in international banking and finance. He served on the board of directors of the European Bank for Reconstruction and Development in London, and as regional economic counsellor at the French embassy in Stockholm.

Miroslav Singer is a Czech economist who served as the third governor of the Czech National Bank from 2010 to 2016. Prior to this, Singer was a member of the bank's board and vice-governor. He has been a member of the statutory bodies of financial and industrial corporations including Česká pojišťovna and Expandia Holding. From 1993, Singer worked as a researcher and lecturer, and later as deputy director for research, at the Economics Institute of the Academy of Sciences of the Czech Republic and the Centre for Economic Research and Graduate Education at Charles University.

Canuto back to World Bank

Otaviano Canuto has been appointed a World Bank executive director, returning to the institution after a gap of nine years. His previous role was executive director for Brazil and other Latin American countries, at the International Monetary Fund.

Monga joins African Bank

Celestin Monga has been appointed chief economist and vice president, economic governance and knowledge management, at the African Development Bank. He was previously managing director at the UN Industrial Development Organisation.

Blejer LSE professorship

Mario Blejer, former president of the Central Bank of Argentina, has been appointed a professor in the Institute of Global Affairs at the London School of Economics and Political Science. Previously Blejer spent 21 years at the International Monetary Fund.

Official institutions 'can act on liquidity'

Regulatory developments, government and central bank policies, and changing market structures and participants since the financial crisis have reduced the resilience of global liquidity to future shocks, according to a new OMFIF-BNY Mellon capital markets report published in September.

The study focuses on how official investment institutions can help overcome liquidity shortages and contribute to stronger financial market infrastructure, meeting the challenges of bank disintermediation and more intensive regulation. Among the other issues covered are the new role of non-bank 'shadow' financial institutions and a fall in activity by traditional banks and dealers. *For more details contact editorial@omfif.org.*

Panelists disagree on Trump economic policies

Donald Trump, the Republican party nominee for the 8 November US election, could introduce welcome boldness to US and international economic policies, according to Meghnad Desai, OMFIF advisory board chairman (right), in a 16 August telephone briefing on the OMFIF report 'The political economy of Donald Trump' focusing on infrastructure funding.

Marsha Vande Berg of Stanford University and Desmond Lachman of the American Enterprise Institute disagreed, saying Trump would be a threat to stability. Eugene Zhuchenko of the Long Term Infrastructure Investors Association said Trump would need to build investor trust. *For more details contact editorial@omfif.org.*

Kaplan outlines 'new phase' in policy

Robert Kaplan, president and chief executive officer of the Federal Reserve Bank of Dallas, outlined a 'new phase' for policy-makers in OMFIF City Lectures in Beijing and Shanghai on 2 and 4 August.

On his inaugural Asia visit in his new Fed post Kaplan stated that, to address key challenges facing the global economy, policy-makers must enter a new juncture in their thinking and actions, highlighting the need for economic policy action beyond monetary policy.

Foreign exchange reserves 'rundown'

In a telephone briefing on 12 July Gary Smith, head of sovereigns at Barings Asset Management, and John Nugée, formerly chief manager of reserves at the Bank of England, discussed their latest report on reserves management, 'Foreign Exchange Reserves in a Volatile World'. The discussion concentrated on the accumulation and rundown of foreign exchange reserves, with a focus on emerging market economies. *For a copy of the transcript contact editorial@omfif.org.*

Bitter-sweet economic picture at St. Louis

A bitter-sweet picture of the world economy, beset by low growth and polarised decision-making, was presented at the OMFIF Main Meeting in St. Louis on 14-15 July. Participants incorporated public and private sector delegates from around the world, including three US Federal Reserve Bank presidents.

Robert Kaplan, President and Chief Executive Officer, Federal Reserve Bank of Dallas; Jim Bullard, President, Federal Reserve Bank of St. Louis; Neel Kashkari, President, Federal Reserve Bank of Minneapolis

On the one hand, continued unconventional monetary policies and ultra-low interest rates, including negative rates in Europe and Japan, were staving off the risk of recession. Inflation still posed no threat to recovery, and improved financial regulation and supervision had mitigated the danger of a financial crisis. On the other hand, these unusually accommodative monetary policies, often undertaken because governmental policies, especially in the fiscal field, had been inadequate, themselves created risks for financial stability. By depressing banking profitability in key areas these monetary measures, according to many delegates, could constrain leeway for growth.

Participants underlined how the vituperative nature of the US election campaign and the rifts opening in the UK over the 23 June vote to leave the European Union epitomised the general trends towards greater divisiveness overshadowing the world economy. *For the summary of discussions visit www.omfif.org/analysis/reports.*

'Collateral damage' of BoE cuts

The 0.25 percentage point cut in Bank of England interest rates will accentuate the already dire state of UK pension funds, as it will help sustain gilt yields at extreme artificially low levels.

This was the message from participants in an OMFIF telephone briefing immediately after the move on 4 August.

The debate featured Tim Drayson, head of economics, Legal & General Investment Management; Gerald Epstein, professor of economics at the University of Massachusetts Amherst; Charles Goodhart, professor emeritus at the London School of Economics and Political Science and former member of the Bank of England Monetary Policy Committee; and Malcolm Harbour, former member of the European Parliament and member of the Committee on Internal Market and Consumer Protection.

The telephone briefing was moderated by Gary Smith, head of sovereigns at Barings Asset Management.

UPDATE ON OMFIF'S YEAR OF THE MULTICURRENCY SYSTEM

OMFIF has replaced George Osborne by Philip Hammond, the new UK chancellor of the exchequer, in the Year of the Multicurrency System logo. The depiction of the UK chancellor, along with four central bank governors, symbolises the UK Treasury's importance in currency and reserve matters.

IMF-World Bank dates

The multicurrency reserve environment
OMFIF and World Bank Treasury's RAMP discuss the risks and challenges intrinsic to multicurrency reserve asset management.
6 October, Washington

Mastering flows, strengthening markets
A reception to mark the launch of the second OMFIF-BNY Mellon global capital markets report, focused on how sovereign institutions can enhance global liquidity.
6 October, Washington

The future of emerging market growth
The Babson-OMFIF breakfast discussion centres on the role of emerging markets in the broader context of global growth.
7 October, Washington

The role of Europe in a world in transition
The DZ BANK-OMFIF breakfast looks at the economic and political future of European integration in the context of global economics.
8 October, Washington

For details visit www.omfif.org/meetings.

Redesigning India's policy framework

Continuing transition towards a market-oriented economy

Moorad Choudhry and Balamurali Radhakrishnan

India provides a case study of the classical central banker's dilemma: how to address the growth versus inflation conflict. The prevailing orthodoxy of the Reserve Bank of India remains an independent monetary policy using base interest rates as the primary management tool.

Often this involves balancing demand from the private sector for lower policy rates as the best tool to assist economic growth, against what the 'correct' rate should be to maintain inflation levels to a specified target.

Experience in India during the last 10 years is by no means unique. Businesses have called continually for a substantial reduction in the policy rate while the RBI – mindful of the damaging effects of previous episodes of high inflation – has maintained a gradualist interest rate easing stance. Indeed, the view of some outspoken Indian politicians that Raghuram Rajan, the previous RBI governor, should cut rates more quickly was one of the main reasons why Rajan left the bank after a spell of only three years. Urjit Patel, his successor, now has to carry on the work bequeathed by Rajan.

Inflation targeting

The RBI's inflation target of 4% plus or minus 2% suggests on the surface that India's monetary policy is developed. It appears identical to western central bank practice while simultaneously helping transparency, since market participants should be able to gain better insight into RBI policy actions. For inflation-targeting to work, the macroeconomic variable being targeted must be reliable and accurately reflect underlying inflationary conditions, not transitory factors. Relying on an inappropriate barometer of price pressures runs the risk of flawed decision-making.

As Chart 1 shows, the target metric is closely correlated to food price inflation, which suggests the need for a review of the consumer price index basket and its constituents. The CPI basket appropriate to a developing economy would be expected to change regularly as the economy develops.

Monetary policy committee

Another major step in India's monetary policy development has been statutory backing for the monetary policy committee. This should end the practice of the RBI governor having the final say on monetary policy decisions. The committee includes three members from the RBI and three government-nominated experts; the governor will have a casting vote only in the event of a tie.

The committee approach may add transparency, but its primary objective should be to demonstrate the RBI's autonomy. In this respect this demonstarates that Indian monetary policy is moving on to the next level of development.

The adoption of inflation-targeting and an independent policy-setting committee have been long-standing features of western central banking frameworks. However, there are questions about the effectiveness of policy transmission. With banks dominating the financial system, the private market lending rate has been the key transmission channel, but the impact of rate cuts has lagged behind expectations.

In general, the RBI wants banks to pass on lower interest rates to borrowers. However, this process has been slow, with banks citing still high funding costs.

Concerns about losing customers to small saving schemes (which offer relatively higher interest rates) have prevented banks from reducing deposit rates (see Chart 2). So the government's decision in March to lower interest rates on small saving schemes is sensible.

The RBI's introduction of a lending rate calculation methodology based on marginal cost of funds is equally commendable. But the process of reforming the transmission mechanism does not end there. For example, even under the marginal cost of funds-based lending rate regime, there has not been a visible improvement in transmission. Banks still find ways to make the rate more or less equivalent to rates calculated under the old methodology.

External interest rate benchmark

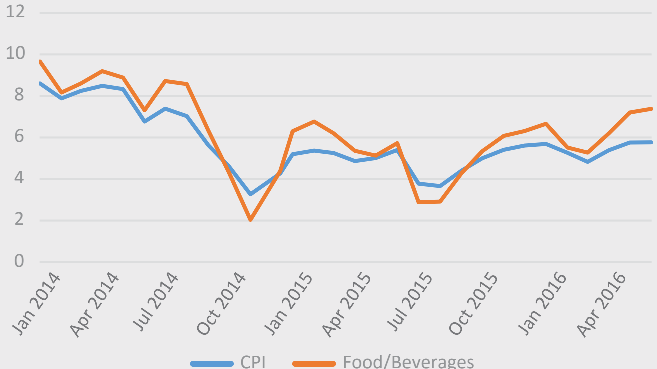
Ideally the market should seek to establish an external interest rate reference benchmark. This would form the basis for pricing financial products and make the cost of financial institutions' liabilities move in line with changes in policy rates. A genuine market indicator reference rate would improve transparency while helping monetary policy transmission, an aim the RBI can faciltate.

India is moving gradually towards a market-orientated economy. Steps to bolster the RBI's autonomy and the emphasis on an orthodox monetary framework are healthy indicators of progress. But next steps will be critical. Much depends on how Patel, the new governor, faces up to the task. ■

Prof. Moorad Choudhry is CEO of City of London Capital and a member of the OMFIF Advisory Board. Balamurali Radhakrishnan is an independent economist.

Chart 1: CPI closely linked to food price inflation

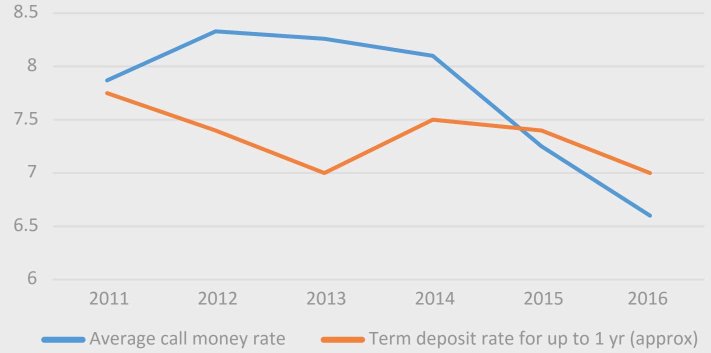
CPI and food price inflation, %, 2014-16



Source: Reserve Bank of India

Chart 2: Deposit rate unresponsive to policy changes

Average call money rate, deposit rate, %, 2011-16



Source: Reserve Bank of India. Deposit rate calculated based on figures provided by State Bank of India. Data for 2016 are to July.

Patel's tasks on reform and inflation

After tax law change, positive outlook for new governor

Meghnad Desai, Advisory Board

Urjit Patel, the new governor of the Reserve Bank of India, who has taken over from Raghuram Rajan, symbolises welcome continuity at the helm of the central bank. The government deserves praise for sticking to transparency procedures for the succession, countering earlier worries that the nomination would be prone to political manipulation.

Patel moves into the top job from his previous position as a deputy governor at a generally propitious time for the Indian economy. The Indian parliament's July to September monsoon session has turned out to be one of the most productive of recent years. With a generally low-key role up to now, Patel becomes a key player contributing to Prime Minister Narendra Modi's ambitious plans for state reform and market strengthening.

For the time being the outlook is positive. In a notable success, the government has managed to pass the Goods and Services Tax constitutional amendment after several attempts. The tax, which simplifies and rationalises the multiple taxes on goods in transit at state level, will save time on transactions, reduce corruption and establish a national market for goods and services across India for the first time.

The government has established a monetary policy framework under which the RBI's monetary policy committee will attempt to maintain inflation in the 4% range (with a tolerance band of 2%). During Rajan's three-year tenure India managed to reduce consumer price inflation from 10.5% to 5.7% (see Chart 1), but the stubborn part of inflation concerns items of daily purchase – fruit, vegetables and pulses – which show unwelcome volatility due to seasonal factors. This is a supply side issue which the government needs to tackle.

Patel's hawkish bias makes large interest rate cuts unlikely, and most economists expect any monetary policy accommodation – regularly called for by Indian politicians distrusting the RBI's monetary orthodoxy – to occur via increased liquidity easing rather than a significant lowering of interest rates.

Fiscal deficit target

A pay hike for government employees this year will add purchasing power to the economy, though it will make the task of maintaining the fiscal deficit target harder. However, Arun Jaitley, the finance minister, has said he is confident he will manage it.

With a doctorate in economics from Yale, earlier degrees at the London School of Economics and Oxford, and several years at the International Monetary Fund, Patel was the author of the inflation-targeting report now being implemented. His experience of the RBI's internal functioning should stand him in good stead.

His first challenge will be to manage liquidity during a fourth quarter of non-resident investor outflows expected to total $20bn – a figure that the RBI is trying to balance without significant calls on its $367bn of foreign exchange reserves. Further clues to RBI policies will emerge in the next few weeks with the appointment of a new deputy governor taking up Patel's previous position, as well as the three government-nominated members of the MPC.

The GST passage was a major milestone. As the tax alters the powers of states and the centre in respect of taxation, it required a constitutional amendment, now agreed after 15 years of attempts by governments of rival parties, in a rare display of unanimity. State legislatures will have to ratify the amendment. Legislation will be introduced in the winter session to implement the act, and it will then become part of the tax structure, hopefully by April 2017.

The GST has been a flagship priority for the Indian People's party/New Democratic Alliance government since it took power two years ago, and the ruling party has had to learn much in respect of cross-party co-operation during this time. It has a majority in the lower house but not the upper house, where the Congress party blocked the bill. This was the reason for the delay. But a deal has been struck and the act has been passed.

Private investment is buoyant in the e-commerce sector but sluggish in the core industrial area. Nationalised banks are reducing the burden of non-performing loans on instruction from the RBI. There is consolidation in the nationalised bank sector. The State Bank of India is absorbing five smaller banks and will become the first Indian institution to enter the league table of the world's largest 75 banks.

The longer-run task is to make the state a more efficient economic actor. India has a statist bias both in entrusting the government with many activities as provider and purchaser, and as a regulator. Governments like to create new entitlements while keeping old ones, which lowers efficiency and leads to recurring fiscal problems. ■

Lord (Meghnad) Desai is Emeritus Professor of Economics at the London School of Economics and Political Science and Chairman of the OMFIF Advisory Board.

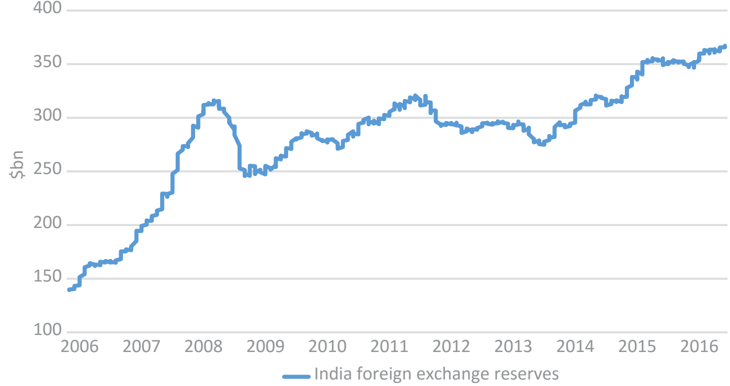
Chart 1: RBI attempts to maintain 4% inflation

India inflation rate, year on year % change, 2009-16

Source: Indian Ministry of Statistics & Programme Implementation

Chart 2: Foreign exchange reserves continue to rise

India foreign exchange reserves, $bn, 2006-16



Source: Reserve Bank of India.

Erdoğan gains from 'gift from God'

Putin thaw offsets post-coup economic setbacks

David Tonge, Advisory Board

Turkey's failed mid-July military coup has taken the country into uncharted political territory.

Of the external factors setting limits on Turkey's policies, its ties with the US and the European Union appear weakened, relations with the International Monetary Fund are unlikely to be changed substantially, and those with Russia have improved.

It has also shifted its policy on Syria, making concessions to Iran and Russia and softening its stance towards the regime of Bashar al-Assad, the Syrian president.

At home, President Recep Tayyip Erdoğan has long been pressing to change the constitution to reinforce his already considerable powers. The coup, which he has called 'a gift from God', has given him the chance of carrying out that aim.

Had the revolt succeeded, a religious-led military clique would have been in conflict with a large tranche of the population. Months of unrest and repression, arrests and show trials are likely to have followed. Hardly surprisingly, the armed forces split when confronted with the choice of whether to join the rebels or not.

In the medium term, the negative effects on the economy may be less than the positive repercussions of the progressive thaw of relations between Erdoğan and President Vladimir Putin.

At the end of June, Erdoğan said he regretted the Turkish air force shooting down a Russian warplane in November 2015, and the two presidents met on 9 August. After more than three hours of talks, the two leaders agreed to alleviate Russian trade restrictions against Turkey and to revive at least one of the four strings of the Turk Stream gas pipeline. Ankara also agreed to reclassify Russia's nuclear project in Turkey as of strategic importance.

The visit was also Erdoğan's first trip abroad since the failed coup attempt in Turkey in July, and he thanked Putin for his support. 'Your call straight after the coup was very pleasing for me and our leadership and our people,' said the Turkish president, who called Putin 'my dear friend'.

The prospect of internal confrontation and further civil war – there is already a near civil war in the south east with Kurdish rebels – has been avoided. But in the uprising aftermath the authorities showed little mercy towards those deemed to have been involved.

The government introduced a state of emergency for 90 days. It discharged 149 of the 325 generals and admirals in the armed forces, as well as 1,100 officers of lower rank. It dismissed two of the 11 judges of the Supreme Court, detained 979 judges and prosecutors, jailed about 632 and suspended another 2,745 judges. It closed 15 universities, published a 58-page list of banned schools and associations, shut down 29 publishing houses and seized corporations with a turnover of over $3bn.

Some 70,000 other state employees have been suspended in a nationwide purge aimed at eliminating supporters of the plotters.

Recep Tayyip Erdoğan, president of Turkey

> ***"In the aftermath of the uprising the authorities showed little mercy towards those deemed to have been involved.***

On 25 July Amnesty International said it had received 'credible evidence' that the Turkish state was committing mass torture – including rape – in the clampdown.

A number of the organisations targeted had no connection with the coup but were reporting on treatment of the Kurds. Meanwhile, Erdoğan has fanned the idea of reintroducing the death penalty.

All parties in the national assembly were quick to condemn the rebel officers. The coup led to around 300 deaths and the mood is sombre.

Few people have much sympathy for Fethullah Gulen, the neo-Islamic leader self-exiled in Philadelphia, accused of helping foment the coup. Gulen was allied with Erdoğan in the 1990s and early 2000s, though their ways gradually split. Gulen has established more than 300 schools in Turkey and 1,000 worldwide. For three decades he has been infiltrating his followers into the judiciary, the police and the armed forces.

In 2012, Erdoğan began to move against Gulen's schools. In December 2013 Istanbul prosecutors reportedly close to Gulen presented alleged evidence of corruption by Erdoğan, his family members and some ministers.

The coup attempt may cause foreign investors, already hesitant about the quality of Turkish justice, to delay investment decisions, but domestic investor confidence has been less affected.

Shaken by the fall in the lira and the Istanbul Stock Exchange, some Turkish savers initially switched from lira to foreign currency accounts. But, as the lira has regained much of its strength, this effect has been reversed.

Nevertheless, the upheavals have dealt a further blow to the tourism industry, already buffeted by Putin's ban on Russian tourists travelling to Turkey.

The coup's failure lays the ground for relative economic stability but at a different level and of a different societal quality from before.

The new balance will strain relations with the West over human rights in general, particularly with the US over Gulen's role and Erdoğan's demands for his extradition.

To Erdoğan's followers, measures taken in response to the uprising represent a justified response to an overt and malevolent attack. To his opponents, they resemble a witch hunt that threatens what little is left of the checks and balances normal in a democratic society. ■

David Tonge is Founder and Managing Director of IBS Research & Consultancy.

New dynamics of reserves accumulation

Financial flow patterns affecting emerging economies

Ben Robinson

After falling by more than $1tn between mid-2014 and the end of 2015, global foreign exchange reserves have started to rise again this year. However, any future build-up is likely to be slower than the two decades prior to 2014, when global reserves grew much faster than GDP (see Chart 1).

Beneath the surface of central bank policy action to bolster liquidity after the financial crisis, structural changes are taking place in the world economy, impeding the financial flows that contributed to earlier reserves accumulation. When monetary conditions tighten in the US and elsewhere, reserves may struggle to keep pace with GDP growth.

The reserves to GDP ratio is important. As Gary Smith and John Nugée pointed out in their June OMFIF report 'The changing role of central bank foreign exchange reserves', demand for reserves has risen, as a buffer against a rapidly expanding financial system. Slower reserve growth could leave central banks vulnerable to volatile capital flows.

The pre-crisis accumulation of foreign reserves came during a period of rapid expansion in global trade, which grew by an average of 7.1% annually from the 1990s up to 2007, against GDP growth of around 3%. The more than two-to-one expansion in trade relative to GDP allowed emerging market economies to accumulate reserves faster than GDP, partly through foreign exchange intervention to hold down currencies and maintain trade surpluses.

The trade to GDP ratio has fallen since 2007 to less than half its previous figure. This suggests that trade surplus-accumulated foreign reserves growth will also be slower relative to GDP.

One of the most important causes of this structural shift is the changing composition of GDP growth towards less trade-intensive services. These are predominantly supplied via foreign direct investment into the destination country rather than traded across borders. According to United Nations Conference on Trade and Development, around 63% of the stock of all FDI is in services, more than double the share for manufacturing and around six times higher than primary sector FDI.

Consequences for monetary policy

The increase in FDI has been the largest component of net emerging market financial account inflows since the 1990s, providing a mirror image of reserve accumulation (see Chart 2). The growing stock of global services-related FDI has important implications for monetary policy. Manufacturing's increasing dependence on global supply chains can make competitive devaluation self-defeating as depreciation increases import costs.

Emerging economies have sensibly used their reserves to prevent sharp movements in either direction, accumulating foreign reserves in times of capital inflows and currency appreciation, and selling them during periods of outflows and depreciation.

With FDI substituting for cross-border trade in the majority of services activity – which makes up around 70% of global GDP, against 16% for manufacturing – this logic could now be weakening.

Trade's lower contribution to inward capital flows relative to GDP, and the growing contribution of FDI, means current account balances are becoming increasingly dependent on valuation effects on net foreign investments. Competitive devaluation may therefore re-emerge as an effective tool for boosting current account balances and accumulating capital (in the way devaluation to boost exports once did). Returns on foreign investments will increase for a country with a weakening currency, while the value of outflows related to returns on inward investment will fall.

Devaluation to boost net foreign earnings is neither desirable nor sustainable in the long term. But in a world of lower capital inflows, some developing countries may implement compensation measures to maintain the rate of reserves growth against GDP.

Possible capital controls

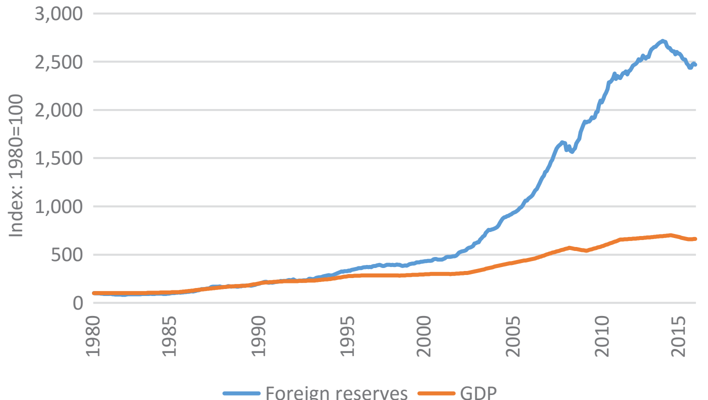
Among the possibilities are capital controls, higher bank liquidity requirements, or reallocating capital to maintain growth in total reserves. Each would result in a corresponding reduction in capital availability elsewhere, with negative effects on the cost and accessibility of credit, lowering growth prospects for the whole economy.

We see already the disadvantages of reserve accumulation in countries that are investing large amounts of capital in low- and negative-yielding foreign assets rather than productivity-enhancing domestic investments. If developing economies are intent on further building up reserves to counter the danger of financial volatility, this could detract from the resilience of the real economy. This is a highly difficult trade-off requiring tough choices for policy-makers. ■

Ben Robinson is Economist at OMFIF.

Chart 1: Reserves growth faster than GDP

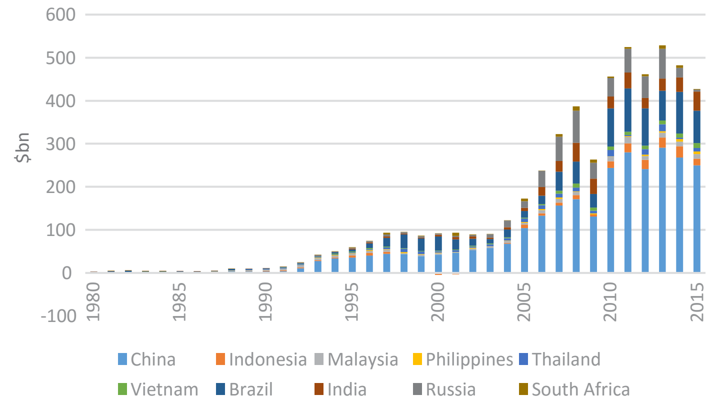
World foreign exchange reserves and world GDP, 1980-2016



Source: International Monetary Fund

Chart 2: FDI flows mirror reserves growth

Net flows, $bn, 1980-2015



Source: World Bank

Tackling megaproblems in megacities

World Bank economist's ideas on urban growth

Marsha Vande Berg, Advisory Board

Paul Romer, a respected economics professor known for his unorthodox ideas about urbanisation and growth-generating 'charter cities', takes over in September as the World Bank's chief economist, the first American in this role in more than 15 years. His appointment represents a departure from the Bank's recent practice of selecting chief economists from developing countries.

Assuming the Bank embraces his ideas and can translate them into workable policies, Romer's construct offers one possible solution to the problems of many fast-expanding megacities in developing economies, including the fate of millions of migrants facing poverty in new urban environments.

Romer is a professor at the New York University Stern School of Business and an entrepreneur. His appointment follows Kaushik Basu, previously a Cornell University economist and adviser to the Indian government, and Justin Yifu Lin, a prominent Chinese economist who has championed China as a role model for developing countries.

Nobel Laureate Joseph Stiglitz, a vocal critic of the Washington consensus and western industrialised nations' influence on international aid agencies, is the most recent US economist in the post, having served between 1997 and 2000.

Charter cities

Like Stiglitz, Larry Summers, the Bank's chief economist between 1991 and 1993, Stanley Fischer (1988-90) and Anne Krueger (1982-86), Romer embodies academic rigour and creative thinking. The task now, as the economics figurehead in a bank widely criticised for alleged bureaucracy and poor coordination, will be to turn his developmental ideas into practice in a way that can make a positive difference.

Romer is a trademark advocate of the charter cities concept embodying better rules for creating, running and living in modern societies. In the developing world context, this involves establishing autonomous cities with better rules and institutions, and brighter development prospects, than their country of location.

The real challenge, he has said, is securing the space to change the rules and give people more choices. He sees a charter city as 'a city-sized piece of uninhabited territory and a charter or constitution specifying the rules that will apply there… A well-run city lets millions of people come together and enjoy the benefit they can get from working together and trading with each other.'

The charter cities concept is not new – Hong Kong is one of the best-known models. Romer promotes his construct as an opportunity to build institutional structures in virtually autonomous metropolises favourable to expanding employment, raising families and building infrastructure, with governance and performance that are attractive to ordinary citizens and leaders, as well as investors. Key features are specific provision for free entry and exit, and equal protection under the law.

> ***"The task now, as the economics figurehead in a bank widely criticised for alleged bureaucracy and poor coordination, will be to turn Romer's developmental ideas into practice in a way that can make a positive difference.***

The World Bank could be well placed to promote such concepts. Circumstances have changed greatly since 1944, when the Bank – along with the International Monetary Fund – was created to assist post-second world war reconstruction. In the 1950s the Bank repositioned itself as an international aid organisation, with its present mission of eradicating world poverty.

China's growing influence

The Bank was heavily criticised for promoting western-dominated, top-down and, by some measures, draconian reform packages in response to economic crises in the 1980s.

The institution has now come under further scrutiny in a world witnessing China's growing influence and support for institutional alternatives to the post-Bretton Woods order.

Jim Yong Kim, World Bank president, has declared the Bank's enthusiasm for Romer's 'deep commitment to tackling poverty and inequality, and finding innovative solutions that we can take to scale'.

Kim's emphasis suggests a departure from the Bank's former single-minded espousal of the Washington consensus and standard reform packages for macroeconomic stabilisation built around opening the developing world to trade, investment and market forces.

Romer cites China as a dramatic demonstration of both the potential and the challenges of experimenting with such new sets of rules. Under the Qing Dynasty (1644-1911), China was the world leader in technology, but the country turned inward rather than embrace economic dynamism which new technologies helped foster.

Under Deng Xiaoping, the leader in the 1970s when China opened up its economy, the country began its rise to become the world's second-largest economy.

China's move to a market economy occurred incrementally. First, the country's leadership created special zones. These effectively allowed a localised economy to prosper in much the same way that the British allowed a successful market economy to take hold in Hong Kong.

Market rules

The Chinese then created the opportunity to work under market rules, realise economic incentives and deploy technologies, albeit in a controlled setting. Four economic zones were created, including Shenzhen adjacent to Hong Kong; 14 cities were designated as special areas for economic experimentation, paving the way for a consensus on moving to a more market–orientated economy.

Romer's ideas reflect academic research into how new thinking can turn around outdated norms that slow technological implementation. But he has had little success in advancing beyond mere theory. Interest in a charter city in Madagascar floundered following a change of president in 2009. A charter city project in Honduras began a year later, but it floundered too (on issues related to accountability).

Nevertheless, Romer's thoughts represent a response to a megatrend facing the World Bank and other institutions – major economic shifts in the need for jobs and in the economy as people leave behind farm jobs for manufacturing and services-related employment in urban settings. A parallel development is the refugee crisis, now encompassing more than 20m people.

All these issues are of deep significance to the World Bank and its mission to alleviate poverty. This is now an affliction that affects fewer countries as a whole but is still a blight on many millions of individuals, with increasing numbers in middle-income countries. ■

Marsha Vande Berg is a Distinguished Career Fellow at Stanford University.

Swirling debate on nominal income

Topic will remain on the drawing board

David Marsh and Bhavin Patel

One of the eternal truths of international central banking is that intellectual fashions for targeting and measuring their performance circulate in seemingly endless cycles of political and economic fashion and acceptability.

The latest fad now back in vogue is the idea that central banks, facing up to the constraints of a 30-year regime of inflation-targeting, should shift to focusing on nominal GDP as their main navigational device. Samuel Brittan, the veteran Financial Times columnist who has led a 30-year campaign to popularise the idea, emphasises that the concept is not a policy tool but an objective – but it is still enveloped by a great deal of haziness.

The NGDP (also known as 'money GDP' or 'nominal income') theme will remain a hot topic in central banking parlours for years to come. Yet there are good reasons for thinking that the nominal GDP framework – which has been sporadically aired in academic and policy circles for at least 40 years – will remain where it has habitually been: on the drawing board.

Establishing a concept linking both the inflation rate and the real level of economic activity (which together add up to nominal GDP) would, according to enthusiasts, demonstrate that central banks pay attention to both prices and employment.

These dual aims are already present in the Federal Reserve's dual mandate. But they are not specifically recorded in the policy setting of most other central banks, including the European Central Bank and the Bank of England.

Escaping negative interest rate hazards

Adopting nominal GDP for the policy framework would allow central banks both to tolerate a higher inflation rate during periods of recession, and run higher interest rates than has been the case in the past 10 years.

This would afford more leeway to cut rates during a time of economic slowdown (such as the present) and thus escape the obstacle of the 'zero bound' in rate-setting, and especially the hazards of negative interest rates confronting Europe and Japan.

Partly because of the sheer numbers of American economists and experts who like to discuss such options, as well as the very real US political debate about the powers and limitations of the Fed in tackling the last financial crisis and trying to avoid the next one, the US has been in the vanguard of 'alternative' monetary thinking.

John Williams, president of the San Francisco Fed, has suggested raising the Fed's 2% inflation goal, or replacing inflation-targeting with a nominal GDP approach, to give the Fed more scope to lower interest rates in downturns. But he emphasised that both steps could have costs.

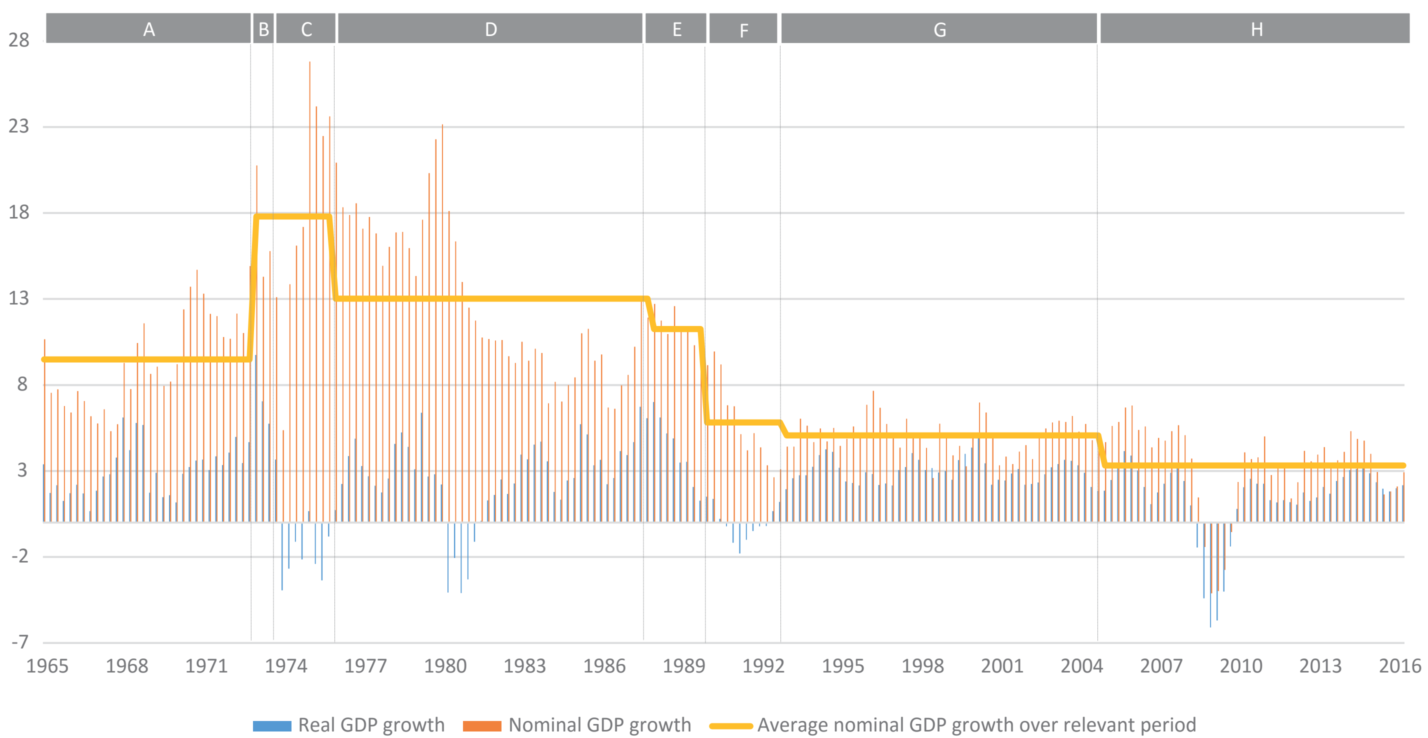
In February 2010, when the drawbacks of zero interest rates were already putting frowns on central bankers' faces, Olivier Blanchard, then chief economist at the International Monetary Fund, proposed increasing the inflation target to 4%.

Higher average inflation and thus higher average nominal interest rates before the crisis would have given more room for monetary policy to be eased during the crisis, limiting the subsequent deterioration of fiscal positions, Blanchard pointed out.

Logical enough. But the recommendation, launched just at the time when the European monetary crisis was getting under way, was widely seen as a distraction, and never advanced up the policy-making agenda.

Chart 1: Nominal and real GDP growth – a fluctuating narrative on a potential monetary policy objective

Annual UK GDP growth: nominal v real, 1965-2016



Source: ONS, OMFIF calculations

Important subjects for research

In her speech at the Jackson Hole monetary conference on 26 August, Janet Yellen, the Federal Reserve Board chair, gave a nod in the direction of methods such as an NGDP approach, which she called 'important subjects for research'.

Yellen was quick to underline that the Fed was not actively considering such ideas for an operating framework, but she did point out how lower interest rates might impair the Fed's recession-fighting capacity.

Yellen pointed to the past decade's marked decline in the long-run neutral real rate of interest – the inflation-adjusted short-term interest rate consistent with maintaining average output. She cited slower population growth and productivity gains, decreased post-crisis spending, and a lack of attractive capital projects as factors behind the decline.

A future average federal funds rate of about 3% placed an arithmetical constraint on Fed firepower, since it cut rates by an average of 5.5 percentage points in the past nine recessions – implying a shortfall of about 2.5 percentage points for dealing with an average-sized recession.

Britain offers a case study in the swirling nature of policy debate. Since the abandonment of the Bretton Woods fixed exchange rate system in 1971-73, the UK has experimented with a wide sweep of policy regimes. They range from focusing on Keynesian overall demand parameters and formulae for the money supply, to overt and covert exchange rate objectives, including the 23-month spell inside the exchange rate mechanism in 1990-92 and, since then, different forms of inflation-targeting.

One of the principal objections to using nominal GDP as a policy aim surrounds the frequent revisions of data, often for definitional reasons. The US GDP numbers from 2002, for example, have been changed nine times since the release of the initial estimates, most recently in 2014.

Deliberations will remain

Deliberations on NGDP will not go away quickly. Charlie Bean, then deputy governor of the Bank of England, pointed out in 2013 how economist James Meade advanced the nominal income theme in his 1977 Nobel Prize lecture.

> ***"Adopting nominal GDP for the policy framework would afford more leeway to cut rates during a time of economic slowdown.***

Bean himself dealt with the topic in his Ph.D. thesis in 1983, the same time as Brittan embarked on his own nominal income Odyssey.

As Bean pointed out, UK nominal income growth has been fairly stable at around 5% a year since 1999, with the notable exceptions of the 2008-09 recession and the present low-inflation period, when nominal GDP growth was nearer 2-3%.

These deviations from the long-run average graphically underline the difficulty of using the nominal income method as a target for policy-making, rather than simply as a backward-looking check on the success or otherwise of these policies. It is hard to imagine how the Bank of England, or any other central bank, would have reacted differently to the 2008 financial crisis had it been using a nominal income benchmark rather than its present set of policy tools.

Central banks in the advanced economies have faced grave problems in sticking to a 2% inflation target. The difficulties of meeting a higher inflation goal as part of a reaction to lower growth would have been still greater – as would have been the public criticism of their failure to meet objectives. ■

David Marsh is Managing Director and Bhavin Patel is Research Assistant at OMFIF.

WHAT THEY SAID ABOUT NOMINAL GDP

Charlie Bean, 2013: 'Nominal income as an idea for directing macroeconomic policy towards targeting nominal income is by no means new – new wine in old bottles.' The chain of thought goes back to James Meade, the 1977 Nobel Prize-winning economist.

Other economists to advance the concept were **Martin Weale**, formerly on the UK Monetary Policy Committee, **James Tobin**, Nobel Prize winner for Economics in 1981, and **Sir Samuel Brittan**, columnist for the Financial Times.

Meade proposed the idea in his Nobel Prize lecture, 'The Meaning of Internal Balance', while Weale spent much of the early part of his career working with Meade to develop the concept.

Tobin advocated adopting a target for nominal income around the same time as Meade.

Chart 2: How nominal GDP growth has fluctuated between policy regime periods

Nominal GDP mean growth and standard deviation*, 1946-2016

Key	Policy Regime	Period	Mean growth	Standard deviation* of growth
A	Bretton Woods	1946-72	9.5	2.8
B	'Snake' currency band	6 weeks	-	-
C	Sterling free float	1972-76	17.8	6
D	Monetary targets	1976-87	13	4.5
E	Forms of exchange rate targeting	1987-90	11.2	1.2
F	ERM	1990-92	5.8	2.5
G	Inflation targeting: 1-4% band of RPIX	1992-2004	5.1	1
H	Inflation target adjustment: 2% CPI rate	2004-present	3.3	2.5

Source: ONS, OMFIF calculations

***The standard deviation is a measure of the dispersion of a set of data from its mean – implying volatility. A higher standard deviation infers data points are further from the mean, thus a greater deviation within the data set. In our case, we estimate this dispersion within each separate regime period shown in the table.**

September 2016

The Bulletin FOCUS

Luxembourg's role in post-Brexit Europe

OMFIF

LUXEMBOURG FOCUS

At the centre of regulatory change and European realignment

Europe's financial services sector – of which Luxembourg is a major hub – directly contributes 6% to European Union GDP and employs 6.4m people across the continent, making it one of the most important sectors of the European economy.

Following the British referendum vote to leave the EU, the Grand Duchy is in the forefront of initiatives to capitalise on a reshaping of European finance and banking. No one knows for certain how the City of London's future links with the EU will look, but in the realignment of continent-wide financial services, Luxembourg will surely play a major role.

The EU has a trade surplus in financial services with non-EU countries of over €70bn, a big factor behind the EU current account surplus. Financial services have a significant impact on the real economy, with efficient funding and investment channels allowing companies, businesses and households to save, invest, borrow and expand, contributing to effective intermediation between savers and borrowers, higher growth and greater efficiency.

The sector is undergoing a period of change as global financial regulations since the 2008-09 crisis continue to affect operations and costs. Worldwide competition with the US and in particular Asia has increased. European banking union has strengthened banks' underlying business framework in some ways, while exposing weaknesses in other spheres – reflected in a smaller share of international services such as project finance and export credits, and also generating desire for consolidation in many countries. The European Commission's initiatives on capital markets union and the European Investment Plan are being implemented.

All these factors are coming under renewed scrutiny in the light of Britain's EU decision. Risks and opportunities abound. In a series of Focus reports, OMFIF is assessing the prospects for the main financial centres. Global and European financial trends overlap, producing a kaleidoscope of influences on financial centres wishing to maintain a leading role.

The growing economic power of east and south Asia and the Middle East – including important changes in the Chinese economy and the opening up of Iran – provides significant opportunities for customer expansion, new product development and service delivery, catering to the needs of emerging economies.

The growth of multicurrency and thematic investment products, including renminbi activities, green bonds and infrastructure finance, requires sophisticated and adaptable market structures, and a spirit of innovation by participants.

New technologies in many spheres, including blockchain – a form of distributed database comprising a constantly growing list of data records – are creating new possibilities as well as threat of disruption for financial services firms, supervisors and regulators alike.

Luxembourg provides a crucible for and a reflection of these manifold influences on Europe's economic and financial framework.

> *"The growing economic power of east and south Asia and the Middle East provides significant opportunities for customer expansion, new product development and service delivery.*

GFCI financial centre ranking table

Top 10 EU performers

EU ranking	Financial centre	GFCI 19 ranking
1	London	1
2	Luxembourg	14
3	Frankfurt	18
4	Munich	27
5	Paris	32
6	Amsterdam	34
7	Stockholm	37
8	Dublin	39
9	Vienna	40
10	Warsaw	48

Source: Global Financial Centres Index 19 (March 2016), examining financial centres' global competitiveness, based on profiles, ratings and rankings for 86 centres.

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Gateway for non-European investors

Ben Robinson

Among European financial centres, Luxembourg has emerged as the main gateway for non-European investors to access the European market. Foreign investors, banks and financial firms seeking access to European-based customers have established bases in Luxembourg due to its expertise in 'multi-jurisdictional' financial services.

The Grand Duchy has specialised in helping international clients operate in the heterogeneous European financial sector, where different national tax, legal and financial systems continue to exist despite the single market.

Luxembourg has led innovation in financial product development and services since the 1960s, when the Luxembourg Stock Exchange issued the first dollar-denominated 'eurobond'. In 1978 the Grand Duchy hosted the first western-based Islamic finance institution, while the Bank of China established its first foreign branch in Luxembourg in 1979.

In 1984 Luxembourg was the first country to adopt the EU Undertakings for the Collective Investment in Transferrable Securities regulation into national law, turning it into the leading centre for UCITS mutual fund issuance.

Today, Luxembourg is the largest investment fund centre in Europe and the second largest in the world behind the US. It is the base for more than 140 international banks or branches of major banking institutions from 28 different countries, hosts around 4,000 funds with total assets under management of around €3.5tn, and is responsible for over 45% of all European regulated fund sales. The Luxembourg Stock Exchange lists more than 37,000 securities in 55 currencies, from around 2,700 issuers in more than 100 countries. Luxembourg has a 20% global market share of all internationally listed securities.

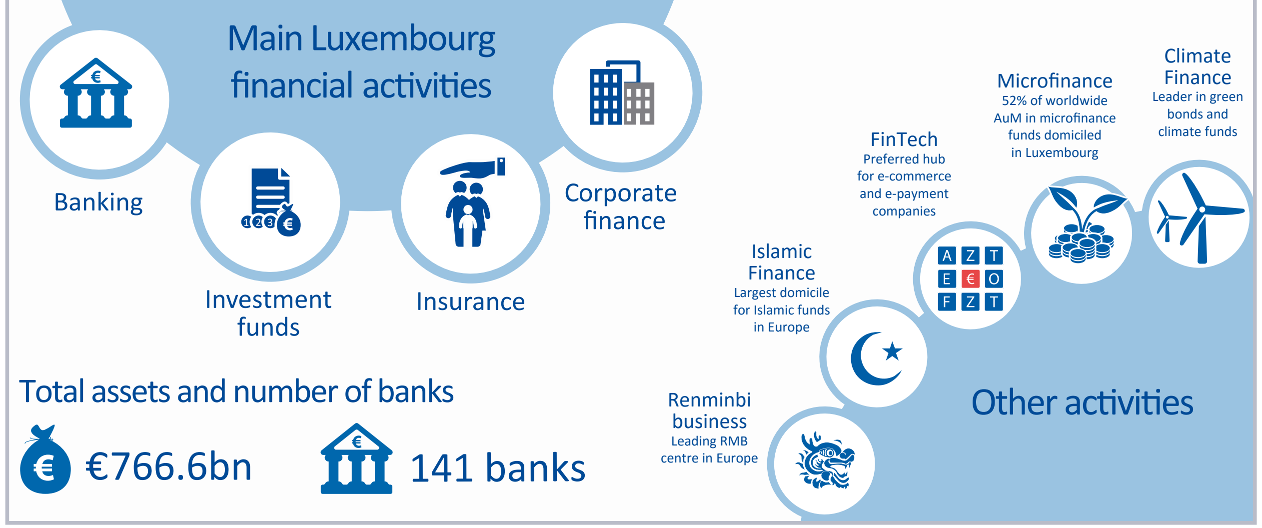
"Important issues for Luxembourg's future business are whether the UK will retain its access to the single market; whether international banks based in London will retain their passporting rights; and whether UK financial institutions will have access to ECB liquidity swap lines.

Fundamental to Luxembourg's success is the EU 'passporting' right that allows banks and financial institutions based in the Grand Duchy to access the rest of the EU. While other European financial centres such as Paris and Frankfurt also offer an EU passport to international financial institutions, the range of services, expertise and infrastructure offered in Luxembourg has made it the largest financial centre within the euro area.

Important questions on whether UK will retain its access to the single market

According to the GFCI financial ranking table, Luxembourg is in second place behind London as the EU's most important financial centre. Although Frankfurt and Paris would no doubt disagree with this proposition, once the UK's decision to leave the EU is enacted, Luxembourg stands ready to take over this title. The most important issues for Luxembourg's future business are whether the UK will retain its access to the single market from outside of the EU, as Norway and Switzerland do; whether international banks based in London will retain their passporting rights to the rest of the EU; and whether UK financial institutions will have guaranteed access to ECB liquidity swap lines. If not, international financial firms may have to relocate within the EU to preserve their access to the European market.

The growth potential for Luxembourg's financial services industry is large. Having built the relevant infrastructure and expertise over the last few decades, the Grand Duchy has become a leading centre for Islamic finance, renminbi-denominated activities, private banking and investment fund management in Europe. These instruments have been among the fastest-growing business lines, opening up new opportunities for product development and a broader customer base.



Sources: Luxembourg for Finance, Commission de Surveillance du Secteur Financier, June 2016

Targeting of Islamic finance and green bonds

Luxembourg's future growth depends on its ability to maintain its adaptability and innovation. It has targeted Islamic finance and renminbi-denominated activities, as well as private equity, green bonds and fintech, as areas for expansion.

However it faces competition from other European financial centres for this activity. London will try and maintain as large a share as possible of its existing business, including renminbi-denominated bonds and renminbi clearing, Islamic finance and fintech.

Frankfurt, Paris, Dublin and others are seeking to attract those activities that do move to other EU centres. The uncertainty over what kind of deal the UK will eventually make with the EU means decisions over relocating activities could be delayed.

There are reasons for optimism over Luxembourg's future growth. Luxembourg was the first European exchange to list an Islamic bond, in 2002, and offered the first euro-denominated sovereign Islamic bond in 2014. It has become the third-largest centre for Islamic finance after Saudi Arabia and Malaysia, and with around 20m Muslims in the EU, Islamic finance product development has significant growth potential.

In 2007 Luxembourg was the first stock exchange in the world to list a green bond. Over 50% of all green bonds listed globally are on the Luxembourg Stock Exchange, securing the country's role as a leading green bond centre. In July 2016 Luxembourg was host to the first green bond issuance by a Chinese financial institution in continental Europe, showing its strength in developing new business opportunities.

> ***"Luxembourg's future growth depends on its ability to maintain its adaptability and innovation. It has targeted Islamic finance and renminbi-denominated activities, as well as private equity, green bonds and fintech, as areas for expansion.***

Frankfurt, Paris competing heavily for renminbi clearing

China's six largest banks have their European headquarters in Luxembourg, and renminbi settlement in Luxembourg has more than tripled since 2010, albeit from a low base. However Frankfurt and Paris are competing heavily to become the leading EU centre for renminbi clearing and other activities. In the face of such competition Luxembourg may find it difficult to grow its market share in all of the areas it has targeted for growth.

Luxembourg may have a competitive advantage in appraising pan-European investment projects, facilitating infrastructure investment and mobilising capital, given its location as the home of the European Investment Bank. As the main bank for infrastructure development in the EU, the EIB will play a key role in the European Investment Plan to raise €315bn to invest in growth-enhancing and sustainable infrastructure projects in Europe.

The European Fund for Strategic Investment, which oversees the plan, is also based in Luxembourg, enhancing Luxembourg's position as the European hub for private and institutional investors from around the world seeking to access investment opportunities in a range of projects.

This should also enhance Luxembourg's position as the prime European centre for raising funds. The finance ministry has set the goal of becoming the 'prime onshore centre for private equity' by 2020, which the expansion of investment vehicles and international partnerships under the European Investment Plan are likely to spur.

Among the targeted areas for private equity expansion are start-up companies and fintech. The Luxembourg-based European Investment Fund, which operates as a venture capital fund, is one of the largest investors in these areas via its support for European SMEs. It helped to mobilise an estimated €25bn based on its commitments last year.

Luxembourg's position as a European institutional capital gives it a competitive advantage that enhances its position as a leading financial centre, contributing to product development, innovation and know-how, and ensuring access to a large pool of global liquidity and an international customer base.

Over the last few decades Luxembourg has shown it is flexible, innovative and quick to adapt to changes through expanded products, services and geographical reach. With large shifts under way in the European financial industry, the development of Luxembourg's relationship with the UK outside of the EU, and its growing engagement with countries seeking access to Europe, will be important factors to watch for its future success. ■

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A series of specialist monthly reports examining the post-Brexit opportunities for European financial centres

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UK and Luxembourg post-Brexit

Nicolas Mackel, Luxembourg for Finance

The UK's decision to leave the European Union has ushered in a prolonged period of uncertainty. At present, it is impossible to know what kind of relationship the UK will have with the EU in future. The UK, and its financial services industry in particular, has strongly benefited from access to the European single market. The EU is the most important destination for UK exports of financial services, generating a trade surplus of more than £18bn.

> *Brexit may be a new reality that the financial industry, in the UK and on the continent, needs to deal with. But it will not fundamentally change the existing partnership between the UK and Luxembourg in financial services.*

Regardless of all the speculation and noise around which European financial centre stands to gain, the UK's decision to leave the EU is regrettable. The EU will lose a member which brought a healthy dose of pragmatism to the table and which has been a key advocate for the single market.

The UK has always shared a common goal with Luxembourg of ensuring that Europe remains attractive to the rest of the world. Luxembourg is keen to further maintain and develop this close relationship.

When it comes to the export and import of financial services, the UK is Luxembourg's largest trade partner by far. Thanks to its largely complementary service and product offer, Luxembourg is an important competence centre for UK-based financial institutions and service providers. This is especially the case in the fund servicing industry. Luxembourg is today the largest fund centre in Europe and the leading global platform for the cross-border distribution of investment funds.

With almost €580bn of assets under management, UK fund promoters represent the second largest group, after US fund promoters, in the Luxembourg fund industry, with a 16.6% market share of total net assets under management. From Luxembourg, these asset managers are able to distribute their funds in over 70 markets across the globe.

For many UK-based asset managers, Luxembourg is already their main fund administration and distribution hub. UK banks represent the sixth largest group of banks in Luxembourg and the UK is the fifth largest export market of Luxembourg insurance products.

Home to the Luxembourg Stock Exchange, the Grand Duchy is an important listing centre for British issuers of bonds and other securities. Luxembourg is the home to Clearstream and four central securities depositories (including the London Stock Exchange's own globeSettle). The country also has a prominent role in depository and custodian banking. As a result, Luxembourg is a privileged access point for UK banks in terms of the management of euro-denominated collateral.

Luxembourg: a key point of access to the EU

In view of its specialism in cross-border financial services and products, Luxembourg provides a key point of access into the EU for international investors and financial institutions. Numerous financial institutions and financial service providers, from within the EU and outside, have established their pan-European centres in Luxembourg.

The six largest Chinese banks have established their continental European headquarters or hubs in Luxembourg, one of Europe's leading renminbi clearing centres. The country acts as the principal EU hub for a large number of Swiss banks. Building on our existing relationship with the City of London, Luxembourg is a natural choice for any UK-based actor seeking to expand its footprint in the EU. But this is very far from being a zero sum game. As Pierre Gramegna, Luxembourg's finance minister, recently put it, 'We do not want to take away business from London, we want to continue to do business with London.'

Brexit is the new reality – and the financial industry, in the UK and on the continent, will deal with it. But it will not fundamentally change the existing partnership between the UK and Luxembourg in financial services.

Maintaining the competitiveness of Europe and ensuring sustainable economic growth must remain our joint European objectives, whatever the outcome of Brexit. This includes facilitating and broadening access to capital, the key objective of the capital markets union.

As international, cross-border financial centres, the UK and Luxembourg are facilitating access to capital and encouraging investment into Europe. This also calls for innovation and the capacity to adapt to the needs of international investors. Investors are increasingly looking to invest according to well defined sustainability criteria – and are obliged to do so to meet the demands of shareholders.

Nowhere is this more pressing than in the vital field of combating and mitigating climate change. Financial centres have a crucial role to play in offering a broad range of products that allow private and institutional investors to invest sustainably. Luxembourg is committed to play a commensurate role. More than 50% of global green bonds are listed on the Luxembourg Stock Exchange and 67% of European assets in impact investment funds are domiciled in the Grand Duchy. Luxembourg's finance labeling agency LuxFLAG will soon launch a climate finance label for funds, as well as a green bond label.

Providing access to capital, facilitating international investments, encouraging sustainable finance: these are priorities that the entire European financial services industry shares. The Grand Duchy will continue to work closely with its European partners, including the UK, to ensure that international financial institutions and global investors find the right services and products in Europe. Luxembourg has a long-term vision enhancing growth and stability in Europe. Together with our partners, including Britain, we will achieve it. ■

Nicolas Mackel is Chief Executive Officer of Luxembourg for Finance.

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Obama's mixed economic legacy

Rising wealth, income inequality provide boon for Trump

Darrell Delamaide, US editor

President Barack Obama has been talking up his economic legacy, but it's ringing hollow for much of his audience.

Most experts give Obama credit for the 2009 stimulus package that pulled the US back from the brink of a full-fledged depression. But they also fault it for being inadequate to fuel a robust recovery, while his too-quick pivot to deficit reduction further dampened economic growth.

Worst of all for a candidate swept into office on promises of hope and change, both income and wealth inequality dramatically worsened during his tenure as he adopted a stubbornly centrist approach – instead of using the substantial political capital he had in his first two years to effect real change.

So Hillary Clinton is having a tough sell as she seeks to build on that legacy by promising even more of the same.

Labour participation

If Donald Trump still has any standing in the polls, it is because he has spoken to the wide swaths of the US population who feel the country is still in the grip of a recession. Trump has excoriated what he calls the Obama-Clinton economic policies for the sluggish US recovery over the past eight years.

In an economic policy speech in Detroit in August, he noted that the number of Americans outside the labour force had increased by 14m since Obama took office, to 94m (though some of this increase is due to demographics as an aging population retires), and that labour participation was at its lowest level in four decades.

Some 7m more people have fallen below the poverty line, Trump added, pushing the poverty rate up by 1.6 percentage points to 14.8%. Nearly 12m people have been added to the food stamp rolls since Obama took office, drawing subsidies so they can afford the most basic groceries.

Some economists talk about a 'dual economy' in the US, with employees in core sectors of finance, technology, and electronics getting higher salaries and accumulating wealth, while everybody else languishes in poorly paid jobs (or long-term unemployment) with only intermittent access to relatively expensive credit.

> ***"Trump has excoriated what he calls the Obama-Clinton economic policies for the sluggish US recovery.***

Peter Temin, a professor emeritus at the Massachusetts Institute of Technology, has noted that US workers as a group have hardly had a raise in a generation. Many are leveraged to the hilt, often for homes that are still underwater from 2008 or in hock for college degrees they could not complete.

These are the people Trump is speaking to, and they are listening. By the same token, these are the people Obama is ignoring when he boasts about his economic legacy. This is what makes Clinton's task that much more challenging.

When Clinton gave her economic policy speech three days after Trump, also in Detroit, she pointedly avoided any discussion of macroeconomic statistics. In fact, the hour-long speech did not mention Obama or his policies at all.

Clinton's detailed policy prescriptions – spending $10bn here, $25bn there – seem unlikely to have a transformative effect on an $18tn economy. The $25bn, for instance, is supposed to be government 'seed money' which will unlock $250bn in private capital to finance her plans for $275bn in infrastructure investment. Trump, by contrast, is proposing to spend $500bn on infrastructure.

Clinton lamented that the factory she had just visited imported most of its precision machinery from Germany, Italy, and Japan, and said she wanted to bring precision manufacturing back to the US. She also gave a nod to creating more non-college training opportunities and encouraging paid corporate apprenticeships for skilled blue-collar labour. In general, her prescriptions were modest, the type of incremental measures Obama has characterised as 'small ball'.

Economy remains a problem

Part of Clinton's strategy appears to be to keep a low profile in the media – based on the theory that Trump will defeat himself as he continues to provoke outrage among various categories of voters.

But the economy – which in a normal election year would be decisive – remains a problem. Not only did Trump get 14m votes in the Republican primaries; Bernie Sanders, who challenged Clinton for the Democratic nomination, got 13m votes with much the same message about inequality and lack of economic opportunity in America.

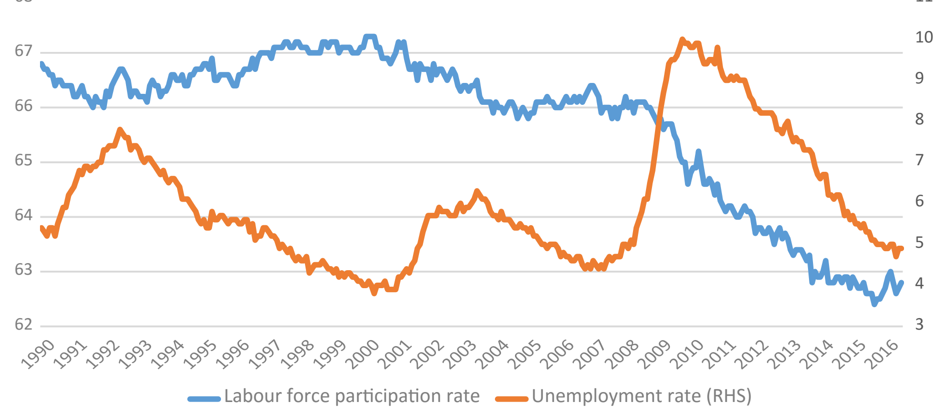
These 27m voters who are unhappy with the state of the economy compares with 16m votes won by Clinton. And Clinton has her own popularity problems, with the abiding email controversy pushing her favourability rating into negative territory.

The gap between the two major party candidates has widened to nearly double digits in Clinton's favour. But much of that margin can be attributed to aversion to Trump, including among many Republican officials who have repudiated him.

Clinton may well win the White House. But it will not be because of the strength of Obama's economic legacy – rather, almost in spite of it. ■

Chart: Labour market participants fall to 35-year low

US labour force participation and unemployment rates, %, 1990-2016



Source: US Bureau of Labor Statistics

Darrell Delamaide is a writer and editor based in Washington. This is an edited version of an OMFIF report 'Obama's mixed economic legacy'. For more details contact editorial@omfif.org.

How to raise infrastructure investment

Why we need reform of public accounting standards

Jan Mischke, McKinsey Global Institute

Multi-decade declines in net investment have depressed demand, interest rates, and growth, and fuelled a series of debt and asset price bubbles. A fundamental rethink of structural, fiscal, and monetary policies is required to reverse the trend. This could include measures to reform public accounting standards to capitalise infrastructure investments on state balance sheets.

Advanced economies appear to be caught in a vicious cycle. Weak growth and low aggregate demand are discouraging businesses from investing and limiting household income for residential investment and consumption – further dampening economic activity.

Long-term decline in investment

A long-term decline in investment has grown more pronounced in recent years. In Europe, business, residential, and public investment declined by €260bn per year in real terms between 2008 and 2015. In the US, net fixed capital formation fell from 12% of GDP in 1950 to 8% in 2007 and 4% in 2014 (see Chart 1).

Factors behind the decline include shorter asset lifecycles, falling prices for capital goods, shifts in industry mix, short-termism, housing markets constraints, public policy shifts, increasing risk spreads, and globalisation.

Prolonged lack of investment causes real damage to an economy, dampening demand in the short run and hollowing out productive capacity in the long run. It has also been at the heart of a 30-year fall in real interest rates creating challenging conditions for pension funds and other savers.

Declines in public investment have occured despite ultra-low interest rates. Increasing infrastructure investment is one obvious opportunity to address the problem. McKinsey Global Institute's estimates suggest an investment gap of 0.7% of GDP for the US and 0.4% of GDP for the UK and Germany, for example (see Chart 2).

> ***"Prolonged lack of investment causes real damage to an economy, dampening demand in the short run and hollowing out productive capacity in the long run.***

While bringing in private finance has been much discussed, higher levels of public investment could be encouraged, even in the face of tight budgets.

One option would be to adjust public accounting standards to capitalise such investments on a balance sheet and depreciate them over the lifecycle of the assets.

Such an approach could help end the debate between counterproductive austerity and non-sustainable (consumption-based) public stimulus. It would also allow for new government debt to focus on building up critical public assets.

Residential investment has followed a boom-bust cycle. Particularly in major cities, there is a structural shortage of housing, mostly due to land restrictions. This is driving up prices so that home ownership is slipping out of the reach of many households, depressing overall residential investment.

Critical reforms to land markets

Structural reform to unleash economies has been much discussed – usually cutting red tape in labour and product markets. But in today's environment the most critical reforms may have to target land markets.

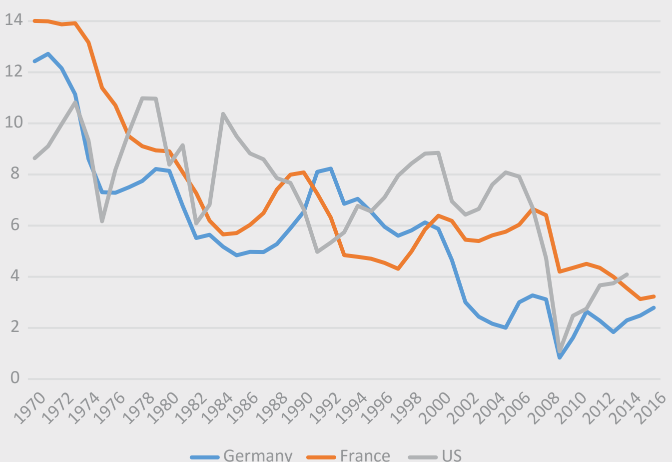
Business investment typically follows overall demand rather than leading the recovery. Since the financial crisis, businesses in the US have evolved from users of funds to net savers. But surveys show that corporate decision-makers rarely change their hurdle rates (the minimum rate a company expects to earn when investing in a project), and their investment behaviour is largely insensitive to interest rate changes.

Policies that increase consumer demand – such as 'helicopter money' – would be likely to do more to stimulate investment than ultra-low interest rates or quantitative easing. ■

Jan Mischke is Senior Fellow at the McKinsey Global Institute. This article is based on 'Bridging global infrastructure gaps' published in June 2016. MGI's research is available for free at www.mckinsey.com/mgi

Chart 1: Long-term decline in net investment

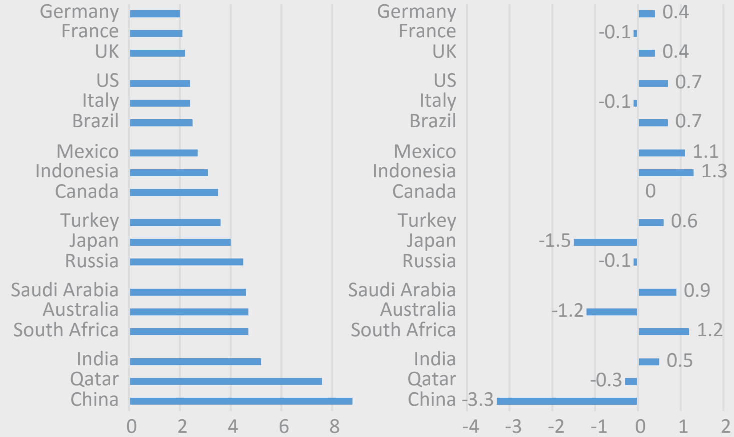
Net fixed capital formation, % of GDP, 1990-2016



Source: AMECO, BEA, McKinsey Global Institute Analysis

Chart 2: Public infrastructure investment gaps

a) Actual spending, % of GDP, 2008-13 b) Gap between spending and estimated infrastructure needs, % of GDP, 2016-30



Source: IHS Global Insight, ITF, GWI, National Statistics, McKinsey Global Institute Analysis

Fed remains ambivalent on rate hikes

Labour market improves but economy still sluggish

Darrell Delamaide, US editor

Federal Reserve Chair Janet Yellen more or less pledged that policy-makers would raise interest rates at least once more this year. At least, that was the conclusion some took from her late August speech at the Fed's annual summer conference at the Jackson Hole resort in Wyoming.

Others listening to Yellen's speech heard that the Fed chair seemed confident that the US central bank can manage monetary policy without necessarily raising or lowering interest rates.

The former group can point to what appears to be a forthright statement at the beginning in the speech: 'In light of the continued solid performance of the labour market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months.' Yellen immediately added the caveat that incoming data will determine what the Federal Open Market Committee ultimately decides.

The weaker-than-expected jobs report for August, with both new hires and wage growth tapering off sharply from June and July, is probably the kind of data that will prompt the Fed to wait a while longer, postponing a rate hike to later in the year rather than as early as this month.

In any case, the thrust of her speech was how the expanded 'toolkit' of policy options enables the Fed to manage interest rates even under conditions that make the traditional focus on targeting the federal funds rate less effective.

In particular, she cited the new tool of paying interest on excess bank reserves. 'Paying interest on reserve balances enables the Fed to break the strong link between the quantity of reserves and the level of the federal funds rate, and in turn allows the Fed to control short-term interest rates when reserves are plentiful.'

Sufficient options

Along with reverse repos, forward guidance and asset purchases – all new tools developed in response to the financial crisis – the Fed has sufficient options to cope with a recession even if the federal funds rate levels off at just 3%, limiting its ability to cut rates when economic activity slows.

'New policy tools, which helped the Federal Reserve respond to the financial crisis and Great Recession, are likely to remain useful in dealing with future downturns,' Yellen said. 'Even if average interest rates remain lower than in the past, I believe that monetary policy will, under most conditions, be able to respond effectively.'

In the run-up to Jackson Hole, some Fed policy-makers said a September rate hike was a possibility. New York Fed chief William Dudley, who is vice-chairman of the FOMC and a permanent voting member, said in mid-August that a rate increase in September 'is possible'.

'We're edging closer towards the point in time where it will be appropriate, I think, to raise interest rates further,' he said on Fox Business News, citing the improving labour market and gains in wages.

John Williams, the head of the San Francisco Fed and a non-voter this year, continued to be hawkish as he pushed for an early rate hike. 'In the context of a strong domestic economy with good momentum, it makes sense to get back to a pace of gradual rate increases, preferably sooner rather than later,' Williams said in a speech to an economic development group in Anchorage, Alaska.

> ***"Along with reverse repos, forward guidance and asset purchases, the Fed has sufficient options to cope with a recession, even if the federal funds rate levels off at just 3%.***

Another rate hike in store

Atlanta Fed president Dennis Lockhart was somewhat less specific, suggesting another rate hike is in store before the end of the year despite disappointing second quarter GDP growth.

'I caution against overreacting to the second-quarter headline growth number,' Lockhart told a business group in Knoxville, Tennessee. 'Early indications of third-quarter GDP growth suggest a rebound. I don't believe momentum has stalled.'

Philadelphia Fed chief Loretta Mester, who is a voting member this year, echoed this sentiment. 'I really believe that the economy is still on track for a pickup in growth in the second half of the year, inflation moving gradually back to 2% over time and the unemployment rate going down from where it is now,' she told CNBC on the sidelines of the Jackson Hole conference. 'So, given that forecast, I see a gradual upward pace in interest rates as being appropriate.'

William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York

Fed vice-chair Stanley Fischer went a little further. He said on CNBC that Yellen's speech was 'consistent with answering yes' to questions whether both a rate hike in September and even a second one before year end were possible.

Realistic assessment

However, St. Louis Fed president James Bullard renewed his disagreement with this projection of gradual rate increases over the next two or three years. 'We want to line that up better with a more realistic assessment of what is going to happen over the forecast horizon,' he said.

Bullard has called for just one more rate increase and then leaving the federal funds rate unchanged through 2018, in acknowledgment of the new paradigm of a slow-growth economy. Talk of getting back to 3% over this period 'is hurting our credibility', he said in a television interview.

While he has suggested that the single rate hike should come before the end of this year, Bullard was hesitant about proceeding with it in September, given the low GDP growth. The time to raise rates, he suggested, would be after 'good news for the economy'.

The minutes of the July meeting, released in mid-August, reflected this continuing ambivalence among policy-makers.

'Members judged it appropriate to continue to leave their policy options open and maintain the flexibility to adjust the stance of policy based on incoming information,' the minutes said – with some members thinking that the improved job market warranted a rate hike soon, and others wanting to see more proof that inflation is indeed nearing the Fed's 2% target. ■

Darrell Delamaide is a writer and editor based in Washington.

The Seven Ages of Gold

Central bank buying back to historical norm

David Marsh and Ben Robinson

Long-run changes in central banks' policies on buying and selling gold fall into seven distinct periods or ages over the past two centuries – the Seven Ages of Gold – each lasting an average of around 30 years.

The latest 'Rebuilding' Period VII has been underway since the financial crisis in 2008. In these eight years, central banks in both developed and developing countries have shown a new fondness for the yellow metal, rebuilding gold's importance as a bedrock of most countries' foreign reserves.

Following four decades after 1970 when central banks generally ran down their gold stocks, they have now returned to the historical norm of the previous 100 years of preferring accretions to disposals.

Annual net purchases of 350 tonnes a year over the past eight years have been in line with the 100-year average up to 1970 – reflecting the metal's renewed attractiveness as a safe haven asset in an environment of uncertainty and low or negative interest rates.

Developments since 2008 mark a powerful change from the 'Sales' Period VI in 1998-2008, when central banks, particularly in developed countries, were unloading bullion holdings. This is also in sharp contrast to the 'Demonetisation' Period V in 1973-98, when gold's role was in limbo after it was officially phased out of the monetary system in 1971-73.

> ***"Annual net purchases of 350 tonnes a year over the past eight years have been in line with the 100-year average up to 1970.***

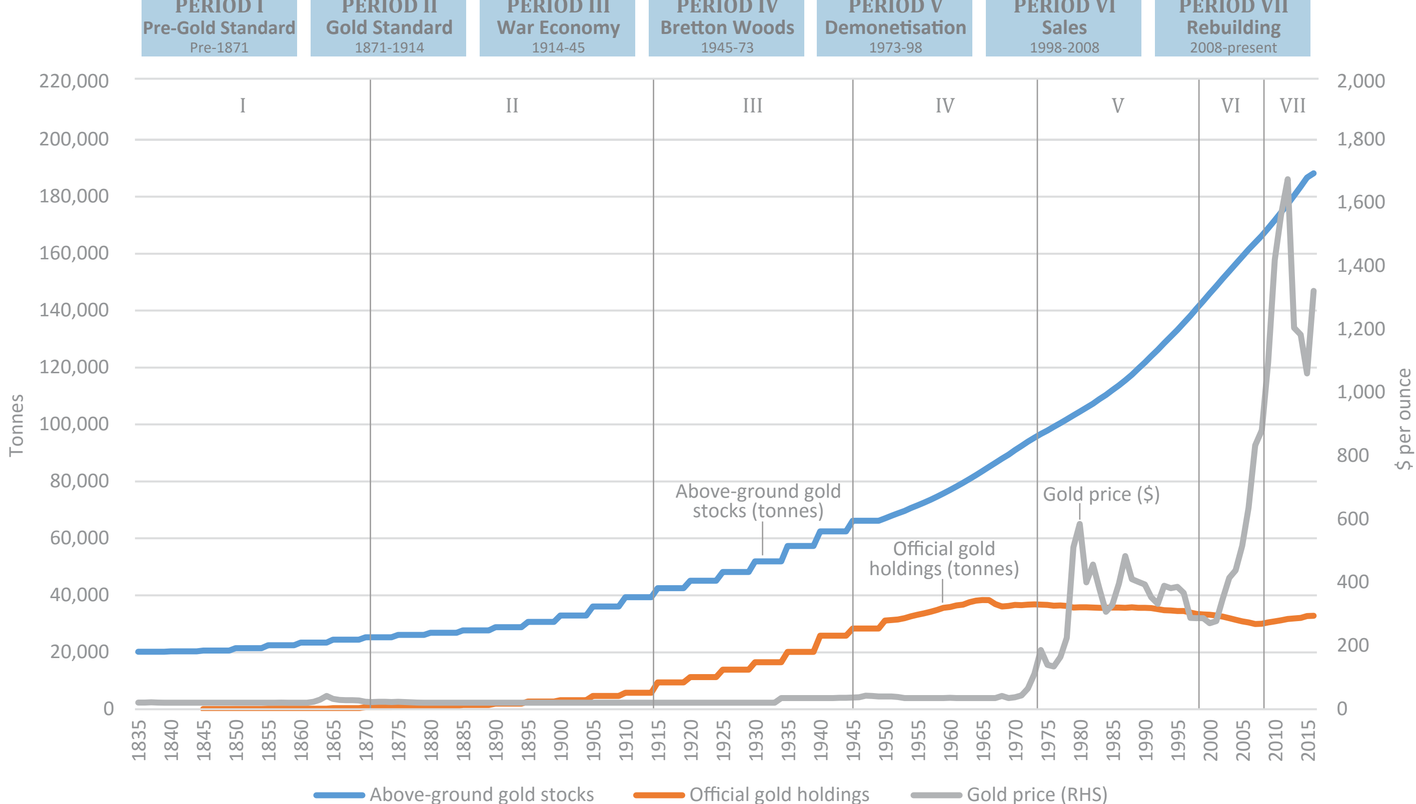
Central bank gold transactions have often been somewhat disassociated from the gold price. Central banks were net sellers over Periods V and VI, four decades of fluctuating but generally rising bullion prices.

In Period VII, central banks have been net buyers of gold every year since 2008, adding more than 2,800 tonnes or 9.4% to reserves. Developed countries (accounting for the lion's share of total official holdings) have been conserving stocks, and developing countries led by China and Russia have been building them up. This is the longest protracted spell of gold accruals since 1950-65, when central banks and treasuries acquired a net total of more than 7,000 tonnes during the economic recovery after the second world war.

The latest period since 2008 has been a time of sharp price swings in the $1,000 to $1,600 per ounce range. Central bank purchases appear to have been a factor behind the post-2015 price recovery. After the rises and falls of the post-war period, total gold holdings are back to the levels of the early 1950s. But there has been a shift over the past 70 years in gold distribution away from the US treasury towards European countries and, latterly, developing nations – symbolising the multipolar world economy.

The Seven Ages of Gold – how central banks' gold policies have fluctuated over two centuries

Above-ground gold stocks, tonnes, official gold holdings, tonnes, and gold price, $ per ounce, 1835-2015



Source: World Gold Council, GFMS, OMFIF estimates

KEY BULLION POLICY LANDMARKS FOR CENTRAL BANKS IN THE SEVEN AGES OF GOLD

The Seven Ages of Gold start with the 'Pre-Gold Standard' Period I before German unification in 1871. This triggered the widespread introduction of the system in which central banks' gold sales and purchases at a fixed price effectively regulated the world economy.

Broad international adoption of the gold standard ushered in Period II, from 1871. Central banks became the guardians of a fixed-price system, encompassing the build-up of Australian, South African and US mining output.

The 'Gold Standard' age ended in 1914, when the outbreak of the first world war caused suspension of the international gold system.

The 'War Economy' Period III runs from 1914 to 1945, spanning the reintroduction of the gold standard, the interwar depression, the gold standard's ultimate 1930s demise, and second world war dislocation that confirmed the monetary ascent of the US.

Period IV covers 1945-73, the Bretton Woods era of rising gold reserves, with European countries and Japan amassing sizeable new post-war holdings as central banks exchanged surplus dollars for gold from the US treasury.

Period V in 1973-98, after the severing of the dollar's official link to gold and the breakdown of the fixed exchange rate Bretton Woods system, was a time of falling official holdings and sharp gold price swings in response to world geopolitical tensions. Period VI in 1998-2008 was a time of gold sales by industrialised country central banks. As a result, even after the 2,800 tonnes of purchases over the past eight years of Period VII, total official holdings – at around 32,800 tonnes as of mid-2016 – are still more than 5,500 tonnes below the 1965 peak of around 38,300 tonnes.

An important milestone was leading European central banks' 2014 action in renewing an agreement, first signed in 1999, pledging a restrictive policy on gold sales for the five years to 2019.

One important reason why European central banks have preferred to maintain their gold stocks since 2008, switching away from the sales of the previous two decades, is because many banks inside the euro area regard their gold reserves as a hedge against potential monetary losses from imbalances and tensions affecting the single currency.

Based on long-term figures for gold holdings and world production, gold stocks in the hands of official institutions (central banks, treasuries and bodies such as the International Monetary Fund) appear to have steadied at around 17.4% of total above-ground stocks. This is down from 23% in 2000 and 40% in 1970, but marks stabilisation over the past decade following an earlier period in which central banks were net sellers.

The long-run figures, putting mid-2016 above-ground gold stocks at 188,214 tonnes, are based on data from the World Gold Council and the GFMS research group. Statistics on above-ground holdings need to make allowance for an unknown quantity of gold that is lost in industrial processes or otherwise unaccounted for in jewellery and investment usage. Reflecting the spread of modern mining technology and the entry of new countries into production, more than half of all the gold ever mined has been produced since 1970.

Gold's renaissance

One reason for gold's renaissance as a monetary asset has been developing countries' hesitancy about relying unduly on reserve holdings in dollars. China in particular seems to be following a strategy of using gold to counter the weight of the dollar.

Last year China lifted part of the veil over its gold reserves, breaking a six-year silence to reveal holdings of 1,658 tonnes as of June 2015 against the previously reported figure of 1,054 tonnes.

As of August 2016 it had 1,823 tonnes. Beijing moved to a market valuation of gold, which, according to latest figures, is worth $70.5bn, although this makes up only 2.3% of total Chinese international reserves.

China's total official gold holdings are judged to be sizeably larger. Metal from local mine production is believed to be held in a domestic account separate from the international gold holdings. The world's biggest official gold holder is the US, with 8,134 tonnes – more than four times that of China and more than five times Russia's 1,499 tonnes – followed by Germany with 3,378 tonnes, the IMF with 2,814 tonnes, Italy with 2,452 tonnes and France with 2,436 tonnes.

Showing the shift to a more diversified world monetary system, the US now accounts for just 25% of total official holdings, compared with 19% in 1900, 33% in 1920, 76% in 1940, 44% in 1960 and 23% in 1980. In future years, as economic clout moves away from advanced economies, developing nations are likely to build up further gold reserves as a proportion of total official holdings stocks. In the further development of the Ages of Gold, the metal's monetary renaissance that started in 2008 may have some way further to run. ■

David Marsh is Managing Director and Ben Robinson is Economist at OMFIF.

Fluctuations in US dominance: how major countries' gold holdings have shifted since the 19th century

Leading gold-owning nations: gold reserves as percentage of total world official holdings, 1880-2016

	National gold reserves as percentage of total official holdings										
	US	UK	Germany	Italy	France	Switzerland	Russia	China	Belgium	Netherlands	Austria
1880	18.2	14.8	7	1.9	21.1	1.2**	17.0	-	1.8	3	4
1900	19	6.2	6.6	3.6	17.1	0.9	20.8	-	1	0.9	10.1
1920	32.6	7.6	3.5	2.7	14.4	1.3	-	-	0.6	3.4	0
1940	75.7	5.7*	0.2*	0.5	6.9	1.7	-	-	2.5	2.1	0.2*
1960	44.1	6.9	7.4	5.5	4.1	5.4	-	-	2.9	3.9	0.7
1980	22.9	1.6	8.3	5.8	7.1	7.2	-	1.1	3	3.8	1.8
2000	24.5	1.6	10.4	7.4	9.1	7.5	1.2	1.2	0.8	2.7	1.2
2016	24.8	0.9	10.3	7.5	7.4	3.2	4.5	5.5	0.7	1.9	0.9

*Source: World Gold Council, GFMS, OMFIF estimates. *1940 uses 1935 national figures / 1940 totals. ** Uses 1885 data / 1880 totals*

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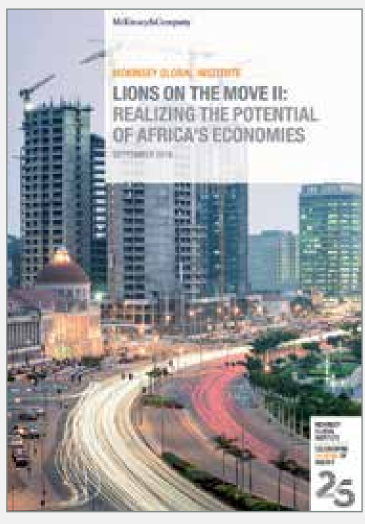

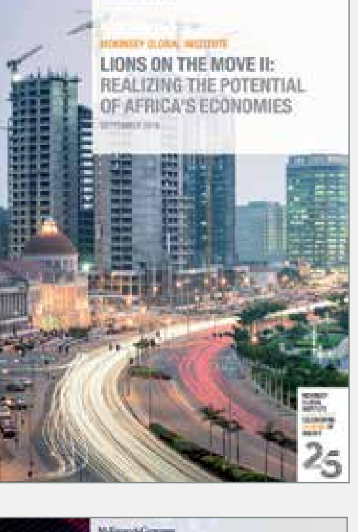

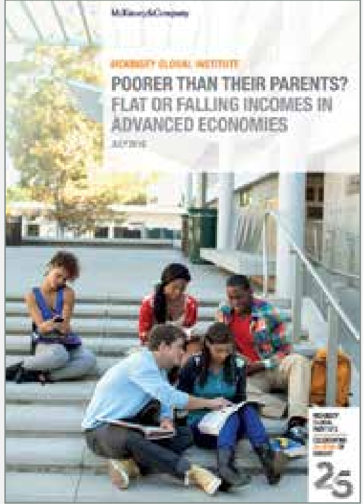

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Financial integration's limiting effect

Monetary policy transmission in small, open economies

Már Guðmundsson, Central Bank of Iceland

Global financial integration has weakened the transmission of monetary policy through the interest rate channel in small open economies that have lifted restrictions on capital movements.

In the long term these countries can still achieve their inflation targets through the exchange rate channel, but the road may be full of financial stability risks. The outcome could be improved by using additional instruments such as foreign exchange intervention, enhanced prudential rules on foreign exchange risks, macroprudential tools, better alignment of fiscal and monetary policy, and even selective capital flow management tools.

It is well known that the transmission mechanism of domestic monetary policy evolves as domestic financial markets develop, and that this in turn will affect the relative effectiveness of different monetary instruments.

Short-term bank lending

When domestic bond markets are underdeveloped, banks lend mostly short-term in domestic currency and intermediate foreign currency funds. Monetary policy tends to be conducted through direct exchange rate management and quantitative measures intended to affect the domestic money supply.

In other words, the effect of monetary policy on demand and inflation through financial markets — particularly the yield curve in the bond market — tends to be weak.

The importance of that monetary transmission channel grows as domestic financial markets develop, and both firms and households finance their expenditure and investment less in foreign currency and more in domestic currency and at longer maturities. This can take place either in bond markets or through bank credit.

This in turn will enhance the role of market-based indirect instruments, primarily interest rates on short-term lending by central banks to commercial banks, and create the conditions for market-determined exchange rates.

External liberalisation of domestic financial systems and the resulting cross-border financial integration initially further boost this process, but will eventually weaken monetary transmission through the domestic bond market.

Monetary policy in mature economic systems can affect domestic demand through several channels, including interest rates and exchange rates.

In the case of the interest rate channel, rates on medium and long maturities are partly driven by current and expected future changes in short-term rates, which in turn are tightly aligned to policy rates, at least in normal times.

This effect on longer-term rates is important: investment and consumption demand is generally much more responsive to medium- and long-term rates than to short-term rates. In the case of the exchange rate channel, changes in policy rates alter the interest rate differential vis-à-vis abroad, which in turn affects the exchange rate.

For a small open economy unable to influence global interest rates, economic theory predicts that global financial integration will gradually weaken the interest rate channel and ultimately block it completely.

> ***"Monetary policy in mature economic systems can affect domestic demand through several channels, including interest rates and exchange rates.***

The exchange rate channel would still be available to achieve any inflation target in the long run, provided the authorities allow the exchange rate to be sufficiently flexible. But the road might be bumpy.

Floating currencies

To understand better why this would be the case, let us assume a world full of global financial integration and a number of floating currencies.

In this case, investors will be able to transfer significant amounts of funds between countries at negligible transaction costs. They will do so based on comparisons of expected real risk-adjusted returns across assets denominated in different currencies.

Investors will have to form expectations about exchange rate movements over the relevant maturities.

They will calculate real returns in terms of their own consumption baskets. This would be equivalent to comparing nominal risk-adjusted returns in terms of the home currency of investors.

Reykjavik, Iceland

The implication is that, for the average investor, expected real risk-adjusted rates of return will tend to equalise. If risk premia are constant, this would imply a high co-movement of nominal interest rates. That co-movement should be stronger at longer maturities, based on the assumption that central banks are able to set short-term rates.

Long-term rates

For a small open economy that is unable to affect global financial conditions, monetary policy will be increasingly unable to affect domestic long-term interest rates as global financial integration progresses. Its ability to affect domestic demand through the interest rate channel would become progressively weaker and ultimately disappear.

However, the country could still adopt its own inflation target and achieve it by variations in short-term interest rates that would in turn affect the exchange rate.

This does not contradict the theory that long-term rates are determined by expected short-term interest rates (with the addition of risk premia).

In this case, however, and insofar as the expectations theory holds, it is global short-term rates that increasingly drive domestic long-term rates in small open economies as global financial integration comes closer to the limiting case. ■

Már Guðmundsson is Governor of the Central Bank of Iceland. This article is an edited extract of a paper published in the Singapore Economic Review in March 2016 entitled 'Global financial integration and central bank policies in small, open economies'.

Importance of ECB's expanding Target-2

Why euro area QE has failed to lift corporate lending

Andrew Hunt, Andrew Hunt Economics

Financial markets have paid vast attention to the European Central Bank's efforts to inject additional liquidity into the financial system through quantitative easing. Much less scrutiny has been applied to the relatively meagre outcome in terms of 'broad money' expansion.

Purchases of government and other bonds by the Eurosystem (the ECB and its member national central banks) began in March 2015 and will continue at least until March next year, with the chances increasing of a further extension until autumn 2017. Over the 12 months to June, the ECB's aggregated balance sheet (including lending and borrowing to national central banks) has expanded by €1.2tn, taking it back near the level of 2012 (see Chart 1). Yet the quantity of monetary instruments owned by the resident private sector has expanded by only €520bn (as measured by M3), or only €350bn if one uses an even wider measure of 'broad liquidity'.

Weakening Italian and French growth

Despite modest improvement in household sector credit trends in Germany and Spain, credit growth is weakening in the Italian banking system and also potentially in France. ECB data from June show an overall decline in bank lending to the non-financial corporate sector – though net issuance within the corporate bond markets has increased. In July, credit growth slowed and monetary growth remained anaemic.

One positive development was that a reduction in bank asset growth allowed the banking system to become a little less dependent on the intra-central bank Target-2 system, under which NCBs manage their assets and liabilities vis-a-vis the ECB. The assets of the European banking system seem to be able to expand only when the Target-2 system is expanding. The ECB appears to have to provide both the assets (bond purchases) and the liabilities (Target-2 funding) for any expansion of the aggregated balance sheet of the European banking system.

European bank lending to the non-bank financial sector remains very weak and the banks are continuing to divest, albeit slowly, from both the domestic sovereign bond markets and their overseas assets. Overall asset growth has slowed, despite the substantial expansion of QE.

Some of the leakage stems from the fact that European banks have been counterparty sellers to some of the ECB's purchases: such transactions do not increase the money supply. Similarly, many ECB counterparties have been foreign investors which have then repatriated the funds.

Increased requirements under Target-2

The primary reason has been the 'peripheral' banking system's increased requirement to draw on funding under the Target-2 system.

Italy provides a useful illustration. Over the last 12 months, the Banca d'Italia has purchased over €100bn of Italian government bonds on behalf of the ECB, five times the current rate of Italian bond issuance. Existing holders must have sold bonds to the central bank: Italian households did indeed sell more than €20bn of domestic public sector bonds.

In effect, this has created the market liquidity to allow domestic investors in the periphery, and some foreign ones, to exit their positions in favour of asset acquisitions within the core countries of Germany and Luxembourg. Italian households save only €23bn per annum at present, but they are acquiring over €30bn of foreign assets.

The banking systems of the peripheral countries (particularly Italy) are gaining assets when the central bank buys bonds. But the money that theoretically has been created is leaving their domestic systems and simply piling up as expensive excess reserves within the banks of the core countries.

The core countries' banking systems are obliged to deposit the excess reserves into the Target-2 system, which lends the funds back to the peripheral banking systems to make good the 'gap' between their now-expanded level of assets and their 'lost' liabilities. Outstanding balances in the Target-2 system have been expanding, despite the slight improvement in July (see Chart 2). And so the ECB's asset growth has not created as much 'real economy' new money as expected.

This is sustainable while banking systems within the core are prepared to acquire claims on the periphery via Target-2. These balances are implicitly underwritten by national governments. An important reason why 'surplus' banks should not continue acquiring claims on the system would be the spread of the ECB's negative rates, which have already led some German financial entities to acquire physical cash rather than interbank claims.

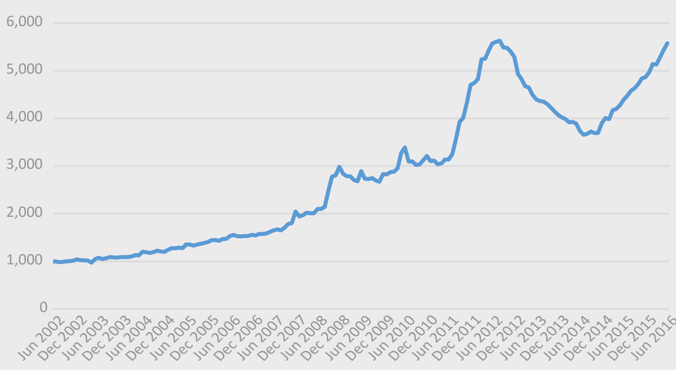
A bigger risk could emerge if one of the debtors threatened to default on its Target-2 liabilities. The off-balance sheet Target-2 system would then come on-balance sheet.

The ECB's bond purchase programmes have increased pressure on the Target-2 system, giving more bargaining power to the deficit countries. If politics were to threaten the implied guarantee on banks' claims on the Target-2 system, then the euro project would be close to collapse. ■

Andrew Hunt is the Proprietor of Andrew Hunt Economics.

Chart 1: ECB balance sheet nears 2012 peak

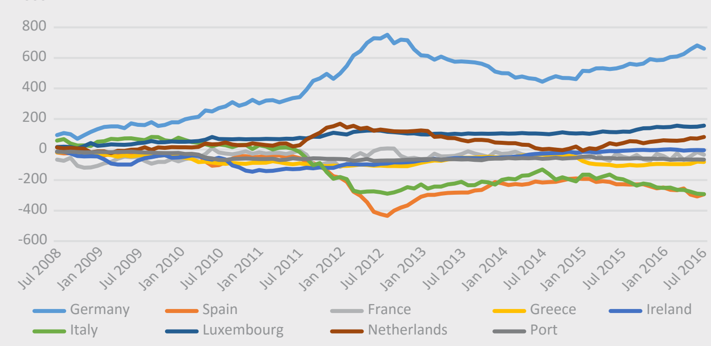
Total assets, €tn, 2012-16



Source: ECB

Chart 2: Outstanding Target-2 balances expand

Target 2 balances, €bn, 2008-16

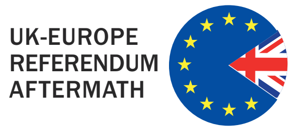


Source: ECB

Threat to debt sustainability

Euro area faces political contagion

John (Iannis) Mourmouras, Bank of Greece



Political risks have increased across the euro area, posing a challenge to the implementation of fiscal and structural reforms. Rising political uncertainty and increasing support for populist political parties with eurosceptic credentials contribute to risks for debt sustainability.

The biggest political risk is the UK decision to leave the European Union. Brexit is different from the euro break-up fears of 2012, the global financial crisis of 2008, or the bursting of the high-tech bubble of 2001. This time there is the threat of political rather than financial contagion.

No matter whether we have a full-blown or a 'light' UK separation from the EU, the political risk for the rest of Europe is that referendums will mushroom across the continent in a tug-of-war between populist forces and the political establishment.

A prime factor behind the poor state of affairs is the rise in the euro area government gross debt to GDP ratio to 93% in 2015, which has risen 28 percentage points from its pre-crisis level in 2007.

Low sovereign funding costs in nearly all rating categories currently mitigate financing concerns. However, a low interest rate environment – the new global norm due to persistently low inflation – embodies some drawbacks. It makes governments increasingly hesitant to carry out fiscal consolidation and structural reforms. Brexit could amplify this risk.

Low nominal demand

In addition to the flight to safety, major central banks have shown a rather dovish reaction. The Bank of England cut its base rate by 0.25 points in August, while the ECB may ease further too. In Japan there is even talk of central bank financing of the private sector directly with base money.

The market-implied probability of a Federal Reserve rate hike in 2016 has declined in recent months. As a result, the four major central banks' monetary policy divergence, the dominant theme in the financial markets since the start of the year, seems to be off the table for now.

The problem in the euro area is the persistent low level not only of inflation, but also of nominal demand, showing a 1% annual increase over the last seven years, compared with 3.7% before the 2008 crisis. Anaemic growth coupled with very low inflation is far from helpful for debt sustainability.

According to the latest ECB forecasts (June 2016), annual inflation is projected at only 0.2% in 2016. The UK vote will probably reduce the euro area GDP growth projection below 1.6%, with further deterioration expected in ensuing years.

Unfortunately, post-Brexit Europe has the potential to become an emergency in the not too distant future. In the past European leaders have had the ingenuity to work through such upsets. We may soon test again this form of crisis management. ■

Prof. John (Iannis) Mourmouras is Deputy Governor of the Bank of Greece and a former Deputy Finance Minister. This is an abridged version of a speech at the OMFIF Third Main Meeting in North America, at Washington University in St. Louis, on 14 July.

New global Atlantic in the making

A good shake-up for Europe and America

John Kornblum, Advisory Board

British exit from the European Union provides Europe with what it needs most: a good shaking-up. The same goes for America. The EU will continue to exist. There is even a chance that Brexit could turn out to everyone's advantage – Europe, Britain and America.

The shock of Brexit creates a new narrative, helping Americans and Europeans perceive a new global Atlantic in the making.

'Europe' as a community of nations has been stagnating badly for some time. Its goals are backward-looking, its mentality frozen and its institutions archaic. This somehow worked in a cold war world – but it cannot begin to cope with the ruthless pressure of digitalisation and global supply chains.

We are unlikely to suffer the catastrophe that pessimists in the UK and Europe are predicting. Britain will remain one of Europe's most important nations, Europe's second economic power, the financial centre of most of the world, the home of the world's global language – in short, a major global player.

The lesson of the past 75 years is that American leadership remains the glue which holds the Atlantic together. Europe cannot manage this revolution without America, and America should not wish to manage it without Europe.

Transatlantic hibernation

America, meanwhile, is awakening from its transatlantic hibernation. We Americans regularly doze off after winning a big victory. 'Clean it up and go home' is our motto.

It happened again around the year 2000 as the US rapidly turned to other concerns. Brexit seems finally to have shaken America awake.

Americans apparently did not understand that globalisation had made the Atlantic community more rather than less relevant.

We are not a collection of cultures tied together by a cold war alliance. We are a rapidly integrating cultural and economic entity, with citizens sharing the same hopes and suffering from the same dislocations.

Successive near-disasters have left Europe's leaders reeling, its economy rudderless, its voters angry and alienated. Europe as a civilisation is in no danger of disappearing. But as an entity it is shrinking ever further below the sum of its parts.

As Alvin Toffler suggested in his 1970 classic *Future Shock*, too much change overloads us psychologically and weakens our ability to act and make decisions rationally.

Europe – leaders and electorates – has been suffering from a sort of collective post-traumatic shock disorder. America is not much different.

A Britain free of endless grumbling about Europe will lose an important excuse for not facing its many internal problems. No more can the UK blame bureaucrats in Brussels or farmers in France for its own shortcomings.

Britain may be in Europe, but it is mentally not of Europe. Freed from EU frustrations, it will be psychologically a healthier place.

The shock of Brexit might help speed the replacement of 'Europe', as defined by the EU, by something very different from the current model: hopefully still unified, but more attuned to the times. ■

John Kornblum is a former US Ambassador to Germany and Senior Counsellor at Noerr LLP.

China's sustainability path

Scope for growth in social and responsible investing

Wang Yao, Central University of Finance and Economics, Beijing

International investment institutions have begun to adopt social and responsible investment strategies, and SRI has become a significant driving force in major international capital markets.

China has done much to encourage companies to increase levels of SRI and enhance corporate social responsibility practices, including initiatives aimed at assessing and taking responsibility for a company's effects on environmental and social wellbeing. But there is still significant scope for future growth.

Increased SRI assets under management

Global players have paid increasing attention to corporate sustainability and CSR at the global level over the past decade. The size of corporate SRI assets under management has grown significantly over the past five years.

SRI investments were 20% higher at the end of 2014 compared with the start of 2012, according to a study by the Global Sustainable Investment Alliance. Total global SRI assets under management over the same period rose to $21tn from $13.3tn, an average growth rate of 61% (see Table 1).

SRI assets under management in China, by contrast, grew by just 6% between the start of 2012 and the end of 2014, compared with average growth for Asia as a whole of 32%.

The total amount of SRI investment in the country in 2013 was only $1.7bn, according to the GSIA study, up 6% compared with 2011 but significantly lower than $15bn in Malaysia (see Table 2).

Despite lower levels of SRI growth in China, the trend masks considerable improvements in environmental protection and corporate reporting on environmental issues.

Legislation governing the environmental impact of companies' activities has been strengthened. Corporate sustainable information disclosure is increasing and now makes reference to international trends and standards.

There were 2,032 CSR reports in circulation at the end of 2014, a 17% rise compared with the previous year. Of these, 785 reports were issued by listed companies.

China's 2014 environmental protection law, which came into effect in January 2015, calls on major polluting companies to provide details of their emissions and disclose information on their environmental management and pollution.

The law expands the range of parties that are able to launch environmental public interest litigation. It increases the cost of non-compliance with environmental legislation, compared with the previous position whereby some companies voluntarily accepted the costs of non-compliance.

All levels of government are required to disclose publicly environmental information and improve public participation procedures.

CSR reporting

To encourage listed companies to actively fulfill their CSR obligations, provide investors with new investment in the underlying index and promote SRI investment in China, the Shanghai Stock Exchange launched its Social Responsibility Index in 2009.

The index consists of 100 stocks assessed as performing well in respect of environmental, social and governance factors, based on the Shanghai Stock Exchange's rating system. Turnover of constituent companies in 2015 amounted to Rmb26.4tn ($3.95bn).

As a near-term measure to further encourage companies to fulfil their CSR obligations, China should encourage more companies to publish reports. Furthermore, companies should be required to comply with specific reporting requirements and follow international CSR criteria.

Finally, China should develop a more rigorous and comprehensive sustainability index through capital markets financial products – to encourage good CSR practices by companies and increase SRI investment. ■

Wang Yao is Director of the Research Centre for Climate and Energy Finance at the Central University of Finance and Economics, Beijing.

Table 2: SI asset growth, market
$m, 2011-13

$m	2011	2013	Average growth rate
Bangladesh	na	$14	nm
China	$1,535	$1,729	6%
Hong Kong	$7,328	$11,329	24%
India	$153	$115	-13%
Indonesia	$595	$1,142	39%
South Korea	$6,288	$8,426	16%
Malaysia	$9,956	$15,087	23%
Pakistan	$427	$505	9%
Singapore	$2,967	$5,660	38%
Taiwan	$724	$714	-1%
Thailand	$14	$20	19%
Vietnam	na	$195	nm
Asia	**$29,988**	**$44,937**	**22%**

Source: Global Sustainable Investment Alliance

Table 1: SRI asset growth, region
$m, 2012-14

$m	2012	2014	Growth
Europe	$8,758	$13,608	55%
US	$3,740	$6,572	76%
Canada	$589	$945	60%
Australia/NZ	$134	$180	34%
Asia	$40	$53	32%
Total	**$13,261**	**$21,358**	**61%**

Source: Global Sustainable Investment Alliance

Global Public Investor 2016 **is the third annual report by OMFIF on public sector asset management and ownership. The increased detail and coverage build on analysis in the 2015 and 2014 editions.**

The 2016 publication is focused on two fundamental developments on the world investment scene: the use of a rising number of currencies in world asset management; and the growth of low-carbon investment, part of a general upgrading of the importance of sustainable investment.

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Faults and failures of the single currency

Stiglitz: euro 'makes strong stronger and weak weaker'

John Nugée, Director

Joseph Stiglitz is one of the grand old men of economics. Now in his 70s, he has been an adviser to governments (he was chairman of Bill Clinton's Council of Economic Advisers and has advised the Greek and Scottish governments); been chief economist at the World Bank; and held numerous senior positions in academia. As well as being awarded over 40 honorary degrees from universities far and wide, he received the Nobel prize for economics in 2001.

Throughout his career he has been a voice on the left, a fierce critic of globalisation and laissez-faire economics, and a believer that economics should serve the common good. For Stiglitz, if the economics profession does not improve the lot of everyman, it has failed, however erudite the theories or well-constructed the policies they inspire.

Relentless high-octane attack

And now he has written a book, *The Euro and its Threat to The Future of Europe*. The first section is classic Stiglitz, full of passion and anger, a relentless high-octane attack on what he sees as a failed structure – failed, that is, not because it does not work economically but because it does not work politically.

For Stiglitz, this means that it has not improved the life of the average European, in particular citizens of the weaker countries.

How is it, he asks, that a currency which was designed to bring Europeans together and make them more prosperous, has instead divided them and made a substantial part of the European Union worse off? How is it that Europe's political leadership, when surveying policy failures, has merely doubled down and demanded even greater austerity in the programme countries?

In the first book section Stiglitz does not delve too much into the history of the euro and why it was constructed as it is. Nor does he dwell too long on what the creators of the single currency were trying to achieve, or the political constraints they were under.

This is not a major omission – the history of the construction of the euro is well documented by others. But it leads to the slightly unexpected accusation, made repeatedly throughout this section of the book, that the euro is a neoliberal construct.

Stiglitz perhaps is using 'neoliberal' as an all-purpose term of disapproval here. But it would certainly have surprised Jacques Delors and his fellow founding fathers, most of them firmly to the left of the political spectrum, to learn that they had built a neoliberal order.

Stiglitz closes the first section with coruscating attacks on the imposition of austerity on the programme countries. This he likens to the old debtor's prison: as he puts it, the programmes almost seemed to be designed to make it impossible for the weaker countries to recover.

Here his economic analytical skills briefly surface above the political polemic. He details in convincing manner how the euro has built-in destabilisers and how it tends to make the strong stronger and the weak weaker.

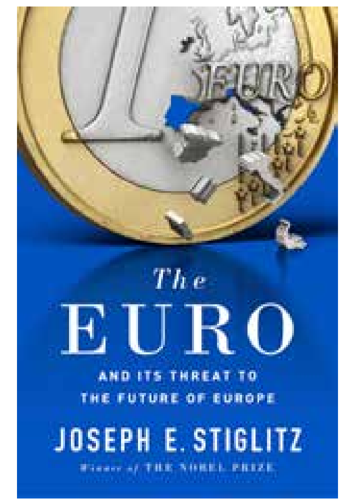
Applying the rules

He reserves particular venom for those who continue to 'apply the rules', despite all evidence that they are not producing the desired effects; those who hold to the mantra 'the euro is not a transfer union' to save their own taxpayers' pockets; and those who declaim that if five years of austerity have not solved Greece's problems, then what is clearly needed is a sixth.

So far, so good. There is not very much in this first section that the experienced student of the euro and its travails will not already know. But Stiglitz delineates the issues with a freshness and a passion which both informs and entertains.

It is the second part of the book, though, where this broad brush approach starts to be less effective, as Stiglitz moves from describing what is wrong to suggesting how to address the mess.

Solutions do require somewhat more thought and detail. None of the three proposals Stiglitz sketches out is entirely satisfactory. All three – fundamental



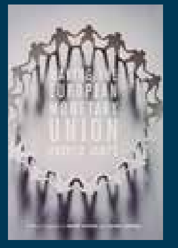
reforms in the structure of the single currency and the policies imposed on the member countries; a well-managed end to the euro experiment (through the oft-suggested device of north-south split); or a bold, new system dubbed the flexible euro – are in varying degrees unpalatable or unworkable.

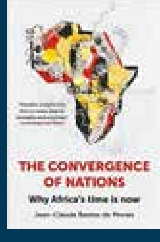
But maybe this is Stiglitz's intention. Given his political views, he defines 'success' for the euro as improving the lot of the average citizen. Given his economic views, he struggles to see a way of achieving this without some or all of devaluation, reflation and deficit spending.

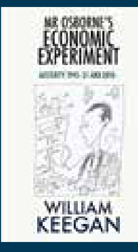
The resulting contortions as he tries to design a way in which any of those, let alone all three of them, is consistent with the single currency seem more designed to prove to the reader that it cannot, in fact, be done. It is as if Stiglitz is parodying the man who was asked, 'How do I get to X?' and answers, 'Well, I wouldn't start from here.'

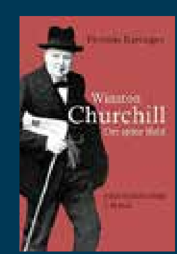
Ultimately, readers should be aware that this is more a political than an economic book. And – maybe no bad thing in itself – it tells us more about Stiglitz than about the single currency. ■

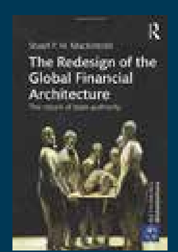
John Nugée is a Director of OMFIF and a former Chief Manager of Reserves at the Bank of England.

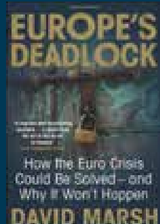












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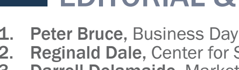

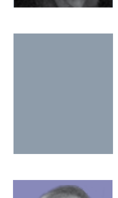
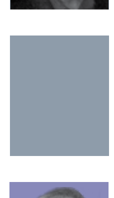

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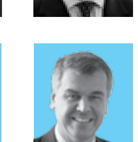
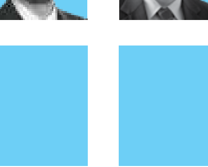
12. **George Hoguet**, CFA Research Foundation
13. **Frederick Hopson**, formerly Hessische Landesbank
14. **Matthew Hurn**, Mubadala Development Company
15. **Paul Judge**, Schroder Income Growth Fund
16. **Mumtaz Khan**, Middle East & Asia Capital Partners
17. **Celeste Cecilia Lo Turco**, Italian Ministry of Foreign Affairs
18. **George Milling-Stanley**, formerly World Gold Council
19. **Paul Newton**, London & Oxford Capital Markets
20. **Saker Nusseibeh**, Hermes Fund Managers
21. **Robin Poynder**, formerly Thomson Reuters
22. **Colin Robertson**, formerly Aon Hewitt
23. **Olivier Rousseau**, Fonds de réserve pour les retraites
24. **Marina Shargorodska**, formerly Quantum Global Group
25. **Gary Smith**, Baring Asset Management
26. **Soh Kian Tiong**, DBS Bank
27. **Marsha Vande Berg**, formerly Pacific Pension Institute
28. **Jack Wigglesworth**, formerly LIFFE

PUBLIC POLICY

1. **Antonio Armellini**, former Ambassador, OSCE
2. **Franco Bassanini**, formerly Cassa Depositi e Prestiti
3. **Frits Bolkestein**, formerly European Commission
4. **Laurens Jan Brinkhorst**, University of Leiden
5. **Colin Budd**, formerly UK Diplomatic Service
6. **Otaviano Canuto**, World Bank Group
7. **Desmond Cecil**, Areva UK
8. **Natalie Dempster**, World Gold Council
9. **Hans Eichel**, former German Minister of Finance
10. **Jonathan Grant**, Policy Institute at King's
11. **François Heisbourg**, Fondation pour la Recherche Stratégique
12. **Karl Kaiser**, Harvard Kennedy School
13. **John Kornblum**, former US Ambassador to Germany
14. **Ben Knapen**, Dutch Senate
15. **Ruud Lubbers**, former Dutch Prime Minister
16. **Bo Lundgren**, formerly Swedish National Debt Office
17. **Denis MacShane**, former British Minister for Europe
18. **Kishore Mahbubani**, Lee Kuan Yew School of Public Policy
19. **Boyd McCleary**, former HM Diplomatic Service
20. **Luiz Eduardo Melin**, formerly Brazilian Development Bank
21. **Célestin Monga**, African Development Bank
22. **Murade Miguigy Murargy**, CPLP
23. **David Owen**, House of Lords
24. **Jukka Pihlman**, Standard Chartered Bank
25. **Poul Nyrup Rasmussen**, former Danish Prime Minister
26. **Paul van Seters**, Tilburg University
27. **Christopher Tugendhat**, House of Lords
28. **John West**, Asian Century Institute
29. **Paul Wilson**, formerly De La Rue

EDUCATION & RESEARCH

1. **Iain Begg**, London School of Economics
2. **Harald Benink**, Tilburg University
3. **Gottfried von Bismarck**, Körber Stiftung
4. **Michael Burda**, Humboldt University, Berlin
5. **Nick Butler**, King's College, London
6. **David Cameron**, Yale University
7. **Forrest Capie**, CASS Business School
8. **Mark Crosby**, Melbourne Business School
9. **Jeffry Frieden**, Harvard University
10. **Haihong Gao**, Institute of World Economics and Politics
11. **Hans Genberg**, SEACEN
12. **Steve Hanke**, Johns Hopkins University
13. **Elliot Hentov**, State Street Global Advisors
14. **Ludger Kühnhardt**, Center for European Integration Studies
15. **Mariela Mendez**, Escuela Superior Politecnica del Litoral
16. **Rakesh Mohan**, International Monetary Fund
17. **José Roberto Novaes de Almeida**, University of Brasilia
18. **Michael Oliver**, ESC Rennes School of Business
19. **Danny Quah**, London School of Economics
20. **Richard Roberts**, King's College, London
21. **Paola Subacchi**, Royal Institute for International Affairs
22. **Shumpei Takemori**, Keio University
23. **Maria Antonieta Del Tedesco Lins**, University of São Paulo
24. **Daniel Titelman**, ECLAC
25. **Linda Yueh**, BBC

ECONOMICS & INDUSTRY

1. **Irena Asmundson**, California Department of Finance
2. **Robert Bischof**, German-British Chamber of Industry & Commerce
3. **Eduardo Borensztein**, Inter-American Development Bank
4. **Albert Bressand**, European Commission
5. **Shiyin Cai**, Business Adviser
6. **Efraim Chalamish**, New York University
7. **Vladimir Dlouhy**, former Czech Industry Minister
8. **Brigitte Granville**, Queen Mary, University of London
9. **Graham Hacche**, National Institute of Economic and Social Research
10. **Hans-Olaf Henkel**, University of Mannheim
11. **Hemraz Jankee**, formerly Central Bank of Mauritius
12. **David Kihangire**, formerly Bank of Uganda
13. **Pawel Kowalewski**, National Bank of Poland
14. **Gerard Lyons**, Greater London Authority
15. **Stuart Mackintosh**, Group of Thirty
16. **Winston Moore**, Moore Asociados
17. **Vicky Pryce**, formerly UK Department for Business
18. **Edoardo Reviglio**, Cassa Depositi e Prestiti
19. **Pedro Schwartz**, CEU San Pablo University
20. **Vilem Semerak**, Charles University, Prague
21. **Song Shanshan**, SDIC CGOG Futures
22. **Gabriel Stein**, Oxford Economics
23. **Takuji Tanaka**, Innovation Network Corporation of Japan
24. **Jorge Vasconcelos**, New Energy Solutions
25. **Obindah Gershon nee Wagbara**, Georgetown University
26. **Volker Wieland**, German Council of Economic Experts

Legacy of rampant deregulation

Danger of a loss of historical memory

William Keegan, Advisory Board

In *The Redesign of the Global Financial Architecture*, a commendably concise examination of events before, during and after the financial crash of 2007-08, Stuart Mackintosh has produced something very close to a masterpiece.

Let us face it: financial regulation is hugely important. But books and articles about it seldom make for exciting reading, not least when they are written by economists whose mastery of mathematics tends somehow to interfere with their prose style.

True, as a central part of his thesis, Mackintosh has to make frequent use of that terrible word 'paradigm'. But he does not get bogged down in too much jargon, and has written a book that ought to be essential reading for politicians, historians and the intelligent lay person, not just the financially and economically initiated.

'Shamelessly irresponsible deregulation'

His main point is that, after the era of shamelessly irresponsible deregulation that began with Margaret Thatcher and both presidents Reagan and, alas, Clinton, there has been a 'paradigm shift' under which, as the book's subtitle proclaims, we have witnessed 'the return of state authority' in banking and the financial sector generally.

Mackintosh, a member of the OMFIF Advisory Board, is executive director of the Group of Thirty, which is indubitably one of the most prestigious international think tanks.

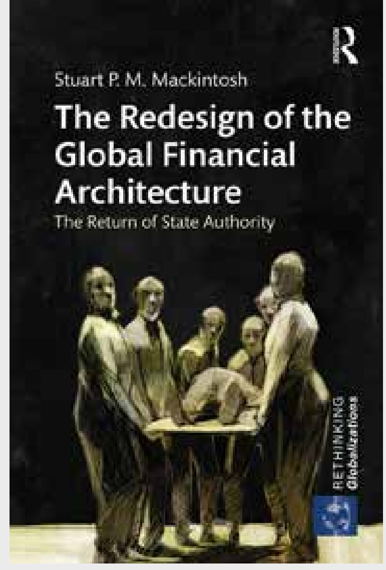
In this position, he has had close contact with leading central bankers and financial leaders, both public and private sector, and studied the evolution of their thinking and practice.

He covers the way that the financial sector grew too big for its boots, with official connivance, indeed encouragement, until the onset of the crisis.

Mackintosh laments how 'neoclassical economic beliefs – in market equilibrium, in rational actors, and in the efficiency of liberalised markets – were championed and behavioural economics languished, notwithstanding the latter's greater explanatory power regarding the business cycle and the nature of booms and busts.'

Historical memories had been forgotten. Almost none of the existing policy-making community had experienced severe crises: 'Instead, they viewed events discretely, individually, not systemically as a whole and across entire markets.'

"Mackintosh makes clear that the return of state authority has most certainly not been exercised to the full on the macroeconomic front.



In the era of rampant deregulation, too much trust was placed in the supposed wonders of the financial sector, and the spurious claim that it was spreading risk rather than intensifying it. In one of his most biting pieces of sarcasm, JK Galbraith headed one of his chapters in *The Great Crash*, 'In Goldman Sachs We Trust'.

Financial supervision

The bulk of Mackintosh's book explains how governments and central banks came to the rescue from 2008 onwards, with the restoration and improvement of banking and financial supervision playing a vital role, most notably via the work of the Financial Stability Board.

Such moves constituted what the author hopes is a 'paradigm shift'. But he notes that some critics maintain the reforms were either too slow to qualify as a paradigm shift or did not go far enough.

However, while Mackintosh is reasonably happy in his belief that much has been achieved on the 'macroprudential' front, he forensically analyses the way that, after the great macroeconomic rescue operation in 2008-09, culminating in the G20 London summit on 2 April 2009, things began to fall apart at the G20 summit in Toronto in 2010. This was not least because of the baleful influence of pre-Keynesian German policy-makers, aided and abetted by George Osborne, the new UK chancellor of the exchequer.

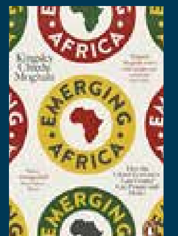
Growing wealth inequalities

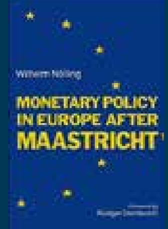
Mackintosh makes clear that the return of state authority has most certainly not been exercised to the full on the macroeconomic front.

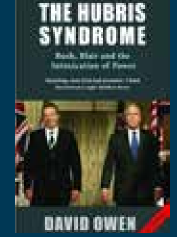
In his final chapter, he expresses the wish that 'the visibly destructive macroeconomic results (such as secular stagnation) of growing inequalities in wealth, may lead to action instead of wringing of hands'.

Perhaps, he concludes, 'the next crisis may more fully expose... the grossly unacceptable societal costs and outcomes borne by the state and the voters of private decisions by the wealthy few.' ■

William Keegan is Senior Economics Commentator for The Observer.







UK economy expected to grow faster than EU-27

OMFIF Advisory Board says UK will adopt totally new trade model

The UK's vote to leave the European Union provided the backdrop for this month's Advisory Board poll. We put three questions to Advisory Board members. 'Which economy will grow faster in 2017 – the UK or the EU-27?'; 'Which model will the UK choose for trade and investment links with the EU-27 – the single market/Norwegian model, single market/Swiss model, World Trade Organisation rules similar to the US, or a totally new model?'; and 'What will the UK's departure lead to – a more cohesive euro area with a stronger euro, a less cohesive euro area with a stronger euro, a more cohesive euro with a weaker euro, a less cohesive euro area with a weaker euro, euro break-up, or no change/too hard to call?'

A narrow majority of respondents to question 1 – 52% – said that the UK economy would grow faster than the EU-27 in 2017, while 70% of respondents to question 2 said that the UK would choose a totally new model for trade and investment links with the EU-27. A further 19% said that the UK would choose WTO rules. Just 7% thought the UK would opt for the single market/Norwegian model.

Opinion was more divided on what the UK's EU departure would lead to in respect of the euro area and the euro: 37% believed it would lead to a less cohesive euro area with a weaker euro; 26% that it would lead to a more cohesive euro area with a stronger euro; 19% that it was too hard to call or that there would be no change; and 7% that it would lead to the euro's break-up.

'Control of population movement will trump other UK considerations. The UK will end up with WTO rules plus some ad hoc UK-EU measures to avoid disrupting existing value chains.'
François Heisbourg, Fondation pour la recherche stratégique

'Following the IMF's post-23 June estimate, I expect the UK and the EU will both experience very modest growth in the range of 1.3-1.4%, with the UK at the low end, especially in 2017.'
David Cameron, Yale University

'Regulations over financial activity in euros could become less market-friendly after Brexit as EU policy, to a greater extent, will be influenced by semantic discussions rather than pragmatic consideration in the Anglo-Saxon style.'
Akinari Horii, Canon Institute for Global Studies, Tokyo

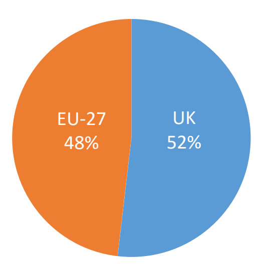
'The UK will grow more rapidly, not necessarily because UK growth will increase substantially, but because the EU-27 will continue to struggle.'
Hans Genberg, the SEACEN Centre, Kuala Lumpur

'In the longer run a more cohesive euro area is likely, but this needs more time, in view of the upcoming elections across Europe. It will not be in 2017.'
Hans Eichel, former German finance minister

These additional statements were received as part of the July-August poll. The poll was conducted between 21 July and 3 August, with responses from 27 Advisory Board members.

Majority thinks UK will grow faster in 2017

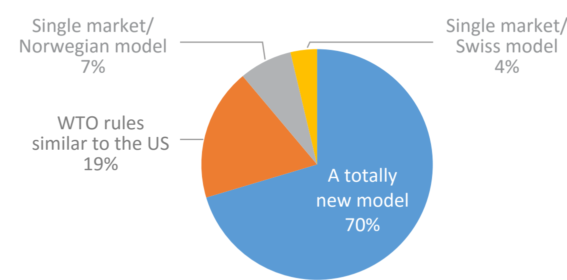
Percentage of respondents



Which economy will grow faster in 2017?

UK's new model for trade, investment links with EU

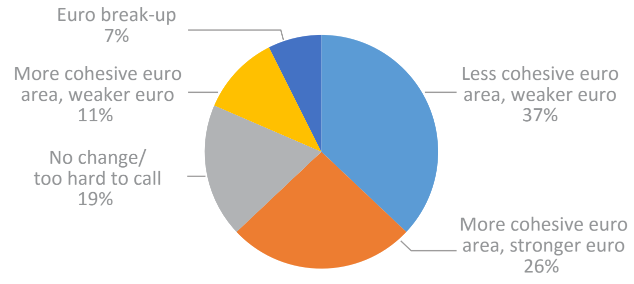
Percentage of respondents



Which model will the UK choose for trade and investment links with the EU-27

Predictions of less cohesive euro area, weaker euro

Percentage of respondents



What will the UK's EU departure lead to?

October's question

What changes, if any, do you expect the European Central Bank to make to its Quantitative Easing programme before it expires in March 2017?

What is your prediction for the euro area inflation rate, on the ECB's measurement, in 2017 and 2018?

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