Bulletin

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Global insight on official monetary and financial institutions

Puzzle for Merkel

Wait-and-hope in Berlin

Spain's recovery
Effects of a UK-less Europe
Growth in Arabia
Emerging market reforms
The monetary policy triangle

OMFIF
OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Cover story

The German elections on 22 September were meant to usher in a new way forward for Europe, heading off an important source of instability in the world economy. Confirmed as the pivotal leader of Germany and Europe, Chancellor Angela Merkel has won an election, but she has lost a coalition partner – throwing her country and the continent into confusion, when fresh uncertainty in Italy and Greece accentuates the need for Berlin to show resolution on Europe.

International monetary policy

Europe & the euro

Emerging markets

Warning over world's slowdown: Main Meeting in Ankara

Attempts by emerging market economies to ward off the ill-effects of tighter US monetary policy formed a centrepiece of OMFIF's Main Meeting in Ankara on 5-6 September, with the Central Bank of the Republic of Turkey. Lord (Meghnad) Desai, chairman of the OMFIF Advisory Board (pictured left, flanked by Muhammad Baasiri, Vice Governor of the Central Bank of Lebanon), praised monetary measures to counter the risks of capital outflows, but warned of the danger of a synchronised international downturn.

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(See p.20-21 for full details)

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OMFIF

Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum (OMFIF) is an independent globally-operating financial think-tank and a platform for confidential exchanges of views between official institutions and private sector counterparties.

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

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

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Advisory Board

OMFIF's 138-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars, and other OMFIF activities. See p.20-21 for full details.

Bulletin

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

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

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OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Europe needs a strong, resilient Germany

Attention swings back to Old Continent amid further US uncertainties

David Marsh, Chairman

OMFIF's attention swings back to Europe in October with Economists Meetings in Prague and Madrid, a European governors' session at the International Monetary Fund/World Bank Meetings in Washington and a visit to London by William White, formerly of the Bank for International Settlements. These coincide with fresh question marks over Europe thrown up by the ambiguous outcome of the elections in Germany and doubts over Enrico Letta's government in Rome.

As the US hesitates over its monetary policy stance and lurches towards a new compact on public debt and deficits, Europe should be providing a more confident voice on the world stage. Many had hoped for a more resilient Germany after the September poll. Chancellor Angela Merkel has bucked the trend of most other heads of government by confirming her place as Germany's (and Europe's) undisputed leader. But, as Michael Stürmer writes in our cover story, we will have to wait before any decision-making force emerges in Berlin. We may once again see central banks moving (reluctantly) towards centre-stage.

Francesco Papadia, Ruud Lubbers and Paul van Seters provide contrasting analyses of the Berlin result. Harald Benink explains how implementation of the planned European banking union has become both more urgent and more difficult. Tim Oliver says the much-mooted departure of Britain from the EU would have grave implications for the European Union itself.

On a wider front, Gabriel Stein deciphers the contortions of broad money growth in the major advanced economies. Seung Je Hong explains how the Bank of Korea has been using a range of financial indicators to chart a path to stability. Darrell Delamaide describes the back-and-forth debate at the US Federal Reserve on the issue of reining back quantitative easing. John Kornblum reflects on the inevitability of Lawrence Summers' withdrawal from the race to become next Fed chairman.

Luis M. Linde, Governor of the Bank of Spain, explains steps taken for Spanish economic revival including a roadmap for restructuring and recapitalisation of the Spanish banking sector. Eva Zamrazilová and Vilém Semerák focus on new signs of problems in the Czech economy after an initially encouraging recovery from the European recession of 2009. Rahul Shah shows how the fluctuating history of reserve currencies suggests China's renminbi will come into prominence, while Simon Derrick ponders People's Bank liberalisation plans. Philip Turner dwells on the implications for monetary policy in emerging market economies of greater integration with the advanced economies. Niels Thygesen outlines difficult challenges ahead as emerging market economies grapple with risks of lower exchange rates and higher inflation. On a more positive note, Fabio Scacciavillani describes how Arabian peninsula states offer considerable benefits for investors seeking stability amid international turbulence. ■

David Marsh

For emerging market economies, era of reforms has only just begun

The postponement of the Federal Reserve's gradual exit from quantitative easing (QE) has given financial markets a respite. But many challenges remain, *writes Stefan Bielmeier in Frankfurt.*

Economic growth in most emerging market economies is losing steam, partly due to weak growth in industrialised nations. Meanwhile, there are signs of economic recovery in the most important industrialised countries. At mid-year 2013, the economies of North America, Japan and the UK showed encouraging signs of life, and the protracted recession in the euro area is coming to an end. Although growth remains weak, the trend is moving in a positive direction. A shift is taking place in the global balance of power. Since 2011, the dynamic growth in emerging market countries has provided strong support for the global economy, preventing an even steeper decline. Excess liquidity in industrialised countries had driven yields down to historical lows and diverted investment capital to the emerging market countries, contributing to a boom. The economies of the industrialised countries are now gradually getting back into gear, boosted by expansionary monetary policy.

Money has been withdrawn from the emerging market countries again. When tapering ultimately starts, some commentators question whether we will be faced with large-scale capital flight from these countries – a re-run of the Asian crisis in 1997-98. This is unlikely. Not all the large emerging market countries are suffering from high current account deficits. And, unlike the end of the 1990s, most exchange rates are flexible today. Many large emerging market countries have built up massive currency reserves in recent years, which they can use to intervene in the foreign exchange market, if necessary.

However, the large emerging markets are undeniably facing their own domestic difficulties. In many cases, structural imbalances have accumulated. In China, growth is too reliant on exports and investment, while productivity in Brazil and India is hampered by inadequate infrastructure and a lack of investment. Debt has surged in many countries, posing an increasing problem for firms and banks. The emerging markets will not be able to avoid adopting reform and consolidation policies. The era of the global flood of liquidity is approaching an end, but the era of reform, consolidation and balance sheet adjustment has only just begun. ■

Stefan Bielmeier, member of the Advisory Board, is Divisional Head of Research & Economics at DZ BANK.

ADVISORY BOARD

OMFIF welcomes four new members, Harald Benink, Eduardo Borensztein, Forrest Capie and Philip Whyte. Their appointments take the number of Advisory Board members to 138. For full list of members see p.20-21.

Prof. Harald A. Benink was appointed Professor of Banking and Finance and Fellow of the Centre for Economic Research (CentER) at Tilburg University in 2008. He has been a Senior Research Associate to the Financial Markets Group of the London School of Economics since 2001. Before joining Tilburg University, Benink was Professor of Finance at the Rotterdam School of Management, Erasmus University and Executive Director of RSM Corporation.

Eduardo Borensztein is Regional Economic Adviser of the Southern Cone Department of the Inter-American Development Bank. He previously worked at the International Monetary Fund (IMF), as Adviser of the Research Department, member of the Editorial Committee of IMF Staff Papers, Adviser to the Editor of Finance and Development, and Chief of the Strategic Issues Division of the Research Department. Borensztein has served at the Secretary of Finance of Argentina, the Central Bank of Argentina and FIEL.

Prof. Forrest Capie is Professor Emeritus of Economic History at CASS Business School, City University, London. He has taught at the London School of Economics, the University of Warwick, and the University of Leeds. He has been a British Academy Overseas Fellow at the National Bureau, New York, Visiting Professor at the University of Aix-Marseille and at the London School of Economics, and Visiting Scholar at the IMF. Capie has served as Head of the Department of Banking and Finance at City University and Editor of the Economic History Review from 1993 to 1999.

Philip Whyte is Chief Economist at the Centre for European Reform (CER). After working at the Bank of England and the Economist Intelligence Unit, he joined the CER in September 2007. He has published commentaries in numerous newspapers, including Financial Times, International Herald Tribune, Wall Street Journal, The Times, The Guardian, El Pais, Handelsblatt and Tageszeitung.

MAIN MEETING

Emerging markets economies in transition

The OMFIF Main Meeting in Ankara, on 5-6 September, held in association with Central Bank of the Republic of Turkey, discussed the evolving role of Turkey and other emerging market economies in the international economic and financial landscape and long-term investment opportunities in the next decade.

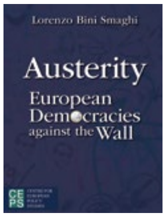
The symposium, hosted by governor Erdem Başçı (pictured left) and attended by 80 delegates from across 40 countries (see picture below), dealt with regional policy responses to the macroeconomic environment, as well as the changing face of international financial regulation and supervision.

A major issue overhanging the two-day discussions was the increasing integration of emerging market economies with credit markets and macroeconomic policy in the US and other industrialised economies. See p.23 and 32-33.

BOOKS & THE ADVISORY BOARD

From the ECB to Bollywood, OMFIF's international guide

This month's feature covers three publications. Austerity: European Democracies against the Wall, by Lorenzo Bini Smaghi, a former member of the executive board of the European Central Bank, points to the strains on democratic accountability in Europe from the sovereign debt crisis. Lord (Meghnad) Desai, chairman of the OMFIF Advisory Board, departing from his normal concentration on purely economic matters, reflects on the golden age of classic Bollywood in Pakeezah: An Ode to a Lost Era. Hans-Olaf Henkel in Die Eurolügner (The Euro Liars) takes an acerbic view on the euro. See p.36-37.



INTELLIGENCE

New China focus on links with developed economies

Yang Hua, Counsellor and Director of the Policy Analysis Section, Chinese Embassy in London (pictured right), was the guest of the OMFIF Policy Group on 25 September in London, focusing on developments in the Chinese economy and steps to improve economic and business ties with the UK, the rest of Europe and other parts of the developed world. OMFIF launched its report on 'The new global frontier: Understanding China's monetary policy', by Advisory Board members John Plender and Gabriel Stein, at a meeting of the Centre for the Study of Financial innovation in London on 11 September and in a series of telephone briefings. A further study, on Chinese monetary policy liberalisation, the fourth report in the series, is due to be launched in the next few weeks.

BIS expert sees fall-out from credit normalisation

Philip Turner, Director of Policy, Coordination and Administration and Deputy Head of Monetary and Economic Department at Bank for International Settlements, sketched out the implications for emerging market economies of increased integration with global debt markets by referring to what he called the 'monetary policy triangle.' Speaking at the OMFIF Main Meeting in Ankara, Turner pointed to the difficulty of combining independent policies for short- and long-term interest rates and the exchange rate – circumstances that expose emerging market economies to possible further attrition from interest rate normalisation in the US. See p. 32-33.

Turkey faces setback over Olympic Tokyo decision

David Tonge, OMFIF Advisory Board member (pictured right), hosted a lunch meeting in Istanbul on 7 September that focused on the political and economic complexities facing Turkey in the light of Middle East uncertainties heightened by the civil war in Syria. The gathering took place on the eve of the decision to locate the 2020 Olympic Games in Tokyo rather than Istanbul, a setback to the plans of prime minister Recep Tayyip Erdoğan to promote Turkey's credentials as a forward-looking modernising force in Europe, Asia and beyond.

Thygesen calls for flexible response in emerging markets

Prof. Niels Thygesen, Emeritus Professor of Economics at Copenhagen University and member of the OMFIF Advisory Board, spelled out a 'flexible response' policy for emerging market economies in the face of gradually rising US interest rates. 'Using interest rates to defend exchange rates is a sensitive exercise. Almost inevitably, emerging market economies facing potentially destablising outflows must carry out a delicate balancing act involving difficult choices among a range of objectives. They may have to risk short-term pain to the economy as the price for achieving longer-term gain.' Thygesen (left to right with Turkey's governor Erdem Başçı and former Bundesbank president Ernst Welteke) took part in the OMFIF Main Meeting in Ankara. The article on p.23 is an abridged and edited version of his speech on the first day of the meeting on 5 September.

Morning-after syndrome in Berlin

Happy ending may be elusive as Merkel seeks partners

Michael Stürmer, Advisory Board

Before and even shortly after the German federal elections on 22 September, Chancellor Angela Merkel looked like the Queen on the European chessboard. Now Berlin is beset by morning-after syndrome. The impression of decision-making power has ebbed away. Where we had hoped for verve, we have a vacuum. Not leadership, but a black hole.

The future of the euro, carefully kept out of the election campaign, will continue as a question of high importance, never spoken about in public. The expert advisers of the chancellor and finance minister Wolfgang Schäuble know that several countries including France are far from reaching their reform targets. The grand bargain under which genuine reforms pave the way for sufficient credits and guarantees to solve the crisis has not been sealed.

The new bout of sobriety spreads through Europe. The liberal Free Democrats, Merkel's ex-partners in government, are the most conspicuous casualties. They failed to clear the 5% threshold for Bundestag representation. Instead of continuing where she left off, as she had hoped, Merkel has to secure a new coalition.

Despite her better-than-expected score of 42% of the votes, almost securing an absolute majority of Bundestag seats, this was a poor outcome for Merkel's Christian Democratic Union/Christian Social Union (CDU/CSU) conservatives. The Opposition Social Democrats (SPD), too, are deeply disappointed at gathering only 26%.

Uncertainly spreads to the Greens, beaten into fourth place in the Bundestag by the far-left Linke party which – despite their manifest support in western and eastern Germany – are still treated as something of a pariah. In an act of cruelty ill-fitting their saintly image, the Greens fired their entire leadership.

A happy ending is not guaranteed. The SPD and the Greens, Merkel's two possible coalition partners, are not in the mood for the serious business of coalition-building. Party activists need to be appeased or enthused. The process could unleash destructive dynamism that stands in the way of reason and consensus.

For Merkel, election victory was the easy part. Now, the hard part. If Merkel's invincible charm fails to secure a Bundestag majority, then – unlikely though not impossible – we may see the main parties engineering new elections, perhaps early next year, in the hope of a more convenient outcome.

On the euro, the Germans still haven't faced the much-postponed moment of truth. The problem is not only Greece and the other smaller countries. France is the indispensable partner which refuses to play the partnership game.

The original thinking behind the Maastricht treaty was that Germany's commitment to Bundesbank-style virtue would spread to other countries, as the substructure of a level playing field for German industry. This

A good result for the euro: the Germans show they want the single currency

The German elections conclusively disprove the idea that the Germans are against the Berlin government's support of the euro and the peripheral countries, ***writes Francesco Papadia in Frankfurt.*** **Despite the many-sided nature of the outcome, the elections are basically positive for Europe and the euro.**

The coalition negotiations will be complicated and not easy to read. The parties are playing a tactical game. But, looking beyond the bargaining, it is difficult to envisage another outcome that would be more favourable to Europe. Drastic changes in German policy towards Europe are not expected. But it's important to realise that the elections were a resounding victory for pro-Europe parties. The election outcome makes this plain: the pro-Europeans are represented by roughly 90% of the Bundestag and 80% of the voters.

As a consequence, Chancellor Angela Merkel should be emboldened to pursue the policy she has followed so far, under which, in a down-to-earth yet sometimes over-hesitant manner, she has effectively protected the euro area. One cannot exclude that, in finding the optimal point on the trade-off between maintaining domestic support and driving forward more advanced solutions for Europe, she may move somewhat towards the latter. Two arguments reinforce this view. The Free Democrats, Merkel's previous coalition partners, who have been lukewarm on Europe, will be replaced in a future coalition by the Social Democrats or Greens, who are more open to European solutions. Second, Merkel will not be a captive of the right of her party and the Bavarian Christian Social Union, as would have been the case had she won an absolute majority.

A lot has been made of the relative success of the anti-euro Alternativ für Deutschland. The new party's development has to be closely followed. However, winning just under 5% of the votes in an election, or even having the sympathy of 25% of overall voters (as opinion polls suggest), against 70% who are supporters, doesn't strike me as dangerous, at least for now.

In the years following Italy's political unification in 1861, probably far more than 5% of Italians believed a southern lira should remain in being, separated from the northern lira. Nonetheless, the lira remained intact as a combined currency until it was replaced by the euro in 1999-2002. The same long life awaits the euro. ■

Francesco Papadia, former Director at the European Central Bank, is member of the OMFIF Advisory Board and Fellow at the Bruegal Institute.

plan has failed. Germany with some allies have financed the crisis and supported the euro through thick and thin. But the bargain will come to its natural end when reforms elsewhere in Europe fail to materialise, when public unrest around the southern rim becomes uncontrollable and when Germans refuse to foot the bill forever.

For more than a year before the German poll, people around the continent had been waiting for a new government and a new mandate in Berlin to make the necessary decisions to get Europe on to a new path. Hopes were high for significant steps towards banking union, for a renewed drive to more cohesive political structures and for backstop loans and write-offs to lower the debt burden of the peripheral countries.

More patience will be needed. The murky picture crystallises around a cluster of parties united by mutual disdain. After a new coalition has been formed, Merkel (or whoever is in charge) will have to confront the unenviable task of announcing unpleasant tidings.

Adding to the complexity of this game of chicken is the new anti-euro party, Alternativ für Deutschland (AfD), representing deep-seated doubts among Germany's disenchanted middle classes on the construction and credibility of the common currency and the European Central Bank. The party's poorly-financed campaign, run with beguiling amateurism, achieved an electoral blitz, just failing to make it into the Bundestag. In the future the AfD will be the uninvited, invisible guest at the cabinet table.

Under the British electoral system, in a first-past-the-post contest, the CDU/CSU would have secured a landslide victory. Four out of five constituencies produced a parliamentary deputy carrying Merkel's colours. But in Germany ultimate power is decided by proportional representation, modified by the 5% hurdle.

Coalition negotiations will take many weeks, and there is some talk that a new government may not be in place until the New Year. Any possible partner of the CDU has to convince its respective rank and file that being in government is preferable to being in opposition. The SPD, as well as the Greens, must decide which is the lesser evil: serving under Merkel, or crying in the wilderness. For the time being, and for the foreseeable future, an alliance by the established parties with the recycled communists of the far-Left can be excluded.

Common ground is in sight. Germany has two social democratic parties – one a little bit more catholic. By now, with the liberals out, there are only social democrats left in the Bundestag, though waving different flags. Not all of them swear allegiance to Merkel. But the CDU and the SPD both hanker after raising taxes – and are doing so already in background discussions.

Those negotiations will have a mostly domestic agenda. A minimum wage, higher taxes, road tolls, investment in education and research, support for parents versus support for public nurseries. Most of this is not a matter of principle but of bargaining. The SPD will have to strike a hard bargain to pacify their more radical supporters.

The Greens will not feature too much. Their dream of a left-wing majority is on the rocks. The leadership they have thrown out includes Jürgen Trittin, an ex-Maoist who rose to be a larger-than-life leader. They will have difficulty presenting an agenda and negotiating it with Merkel's wily diplomats. As the dust settles in Berlin, we will see much confusion where everything – and nothing – appears possible. ■

Prof. Dr. Michael Stürmer is a former Adviser to Chancellor Helmut Kohl.

Coalition search is chance for green growth to pave the way

We should not neglect the possibility that Chancellor Merkel could form an alliance with the ecologist Green party, *write Ruud Lubbers and Paul van Seters in Amsterdam*. This would give Merkel the opportunity to forge ahead with a plan to reinvigorate the European and world economy via environmentally-oriented green growth.

Euroscepticism is much more prevalent in Merkel's Christian Democrats and their coalition partners hitherto, the liberal Free Democrats, who have now been ejected from parliament. Both the Social Democrats and the Greens favour the introduction of mutualised Eurobonds, and they also back a fiscal union and a banking union.

Merkel's manoeuvring room since the outbreak of the euro crisis in 2010 has been limited by growing anti-European sentiment in Germany generally, and within the two coalition parties in particular. A Grand Coalition or CDU–Green government would provide Merkel with a new lease of life, allowing her to play a much more decisive role in applying stronger and more effective European governance. Merkel should throw her full support behind the plan for growth, investment and jobs put forward by Herman Van Rompuy, president of the European Council.

This is the chance for Germany to overcome what the Oxford historian Timothy Garton Ash calls Germany's particular political affliction, 'reluctance to lead'. In the latest issue of the New York Review of Books, he asks: 'Can Europe's most powerful country lead the way in building both a sustainable, internationally competitive euro area and a strong, internationally credible European Union?'

Merkel already went on the offensive after the Fukushima nuclear disaster of March 2011 by deciding the so-called 'Energiewende' to replace nuclear energy with green energy. Although the policy has been heavily criticised on cost grounds, it is the right approach. However there is more at stake than green energy. In the US shale gas is causing an energy revolution. Solar has become spectacularly cheap. Wind is going off-shore. All in all, climate change remains the overarching challenge. Merkel's commitment to greening Germany's energy sources is of historic importance. After 22 September a new coalition could further strengthen this commitment.

In the Netherlands an energy accord has recently been signed by the Dutch government, employer organisations, trade unions and a number of social organisations. There is considerable overlap – in spirit as well as in content – between the energy transition in Germany and the Dutch accord. Both can and will greatly profit from the new European budget. In coming years, the European Union and its member states should make green growth into a vibrant centrepiece of the European economy. That is an important way for Angela Merkel to show the world she is the leader Europe needs and is waiting for. ■

Ruud Lubbers, former Dutch Prime Minister, is member of the OMFIF Advisory Board and Chair of the Council of the Rotterdam Climate Initiative. Paul van Seters, member of the OMFIF Advisory Board is Professor at Tilburg University.

Preparing for European banking union

Supervision and resolution must go hand in hand

Harald Benink, Advisory Board

Five years after the Lehman Brothers bankruptcy, European banking union seems more urgent than ever. The euro area banking system remains undercapitalised, fragile and fragmented. Without instruments to allocate losses of banks to both shareholders and unsecured creditors, taxpayers in the euro area are likely to bear the burden of losses. Fiscal capacity to cover these losses is limited in the crisis countries. Taxpayers in other EU countries are unwilling to pay for a bill running into hundreds of billions of euros.

Banking union is seen as a remedy. It would create entities for supervision and resolution with authority and capacity to deal with the largest banks, with a minimum demand for taxpayer involvement. The 'too-big-to-fail' problem would be addressed by the creation of a mechanism for resolution that would allocate losses to shareholders as well as unsecured creditors of the banks in a predetermined and predictable order. This 'bail-in' mechanism would alleviate the distortion of risk-taking incentives of banks with access to excessively cheap funding from creditors expecting to be bailed out.

The progress to full banking union is slow for reasons that are easy to understand and predictable. So far, there is agreement on the Single Supervisory Mechanism (SSM) for the largest 130-150 banks – an important first step. But the objectives cannot be achieved without effective resolution mechanisms.

The agreement that the European Central Bank (ECB) will become the single banking supervisor in the middle of 2014 is an important step. The EU's Recovery and Resolution Directive sets a deadline of 2018 for national resolution mechanisms with bail-in provisions. In the meantime, bail-outs are likely to remain the rule for resolving large banks in distress. Bail-ins will be ad hoc and politically tainted as in the Cyprus case.

Three phases of implementation

The implementation of banking union can be divided into three partly overlapping phases. The European Shadow Financial Regulatory Committee (ESFRC) considers it important to separate these three stages.

The first phase involves preparing the ECB as the SSM for most of the banking system in the euro area. A critical aspect is the so-called Asset Quality Review. The ECB plans to execute this over the next 12 months.

The second phase involves creating largely similar national rules for restructuring and resolution of banks as envisioned in the Recovery and Resolution Directive. Several euro and EU countries lack appropriate bank resolution procedures and authorities. Implementing this directive, or at the least creating temporary intervention laws for banks allowing bail-in of unsecured creditors, is urgent. The Asset Quality Review may lead to problem banks being identified which must be either resolved (or bailed-out if no bail-in mechanism is in place). The ESFRC argues that this phase should begin before the Asset Quality Review is completed.

The third phase calls for a EU-wide or at least euro area-wide resolution regime, consisting of common rules and one common implementing institution. There are substantial disagreements about this phase, which may require a treaty change. Nevertheless, the implementation of the first two phases must be done with the ultimate objectives of the Banking Union in mind.

The ESFRC, founded in Brussels in 1998, is part of a global network of Shadow Financial Regulatory Committees. The committee consists of 12 members – including professors and independent experts in economics, finance, law and the regulation of financial institutions and markets – representing 12 European countries. Closely inspired by the US model, its three defined roles are to observe and comment critically on current regulatory policy and practice; to serve as a bridge between academia and industry; and to provide a European forum for the discussion of regulatory and supervisory issues. This is based on the assumption that constructive analysis by independent researchers can contribute to the quality of the ongoing discourse in Europe regarding banking and financial regulation, to the quality of regulatory and supervisory policies and practices, and ultimately to the stability and efficiency of national and supranational financial systems. ■

The ECB must have a clear view of banks' strengths and weaknesses when it takes over responsibility for supervision in 2014. It would be detrimental to the reputation of the ECB in its new supervisory role if a major bank would collapse only shortly after it has taken on its new role. The asset quality review may reveal that many banks are in a worse condition than generally believed. Steps may be needed to write off asset values and/or increase equity capital. Some banks may have to be closed down or resolved in a way that minimises contagion effects. At present, the ECB is not in a legal position to request and enforce measures to alleviate such situations.

The ESFRC recommends that the ECB should not accept supervision of banks from countries without effective procedures. It lies in banks' strong interest to be supervised by the ECB. They can be expected to put pressure on national legislatures to act.

The ESFRC has argued that the ECB should enter contractual agreements with national authorities for clarifying responsibility between the ECB as supervisor and the national resolution authorities. These contracts could include early intervention and appropriate actions on the national level to avoid failures. The contracts should include agreements that restructuring and possibly recapitalisation must not amount to bail-outs of shareholders and unsecured creditors but follow agreed upon rules for bail-ins.

Finally, we note the asset quality review should not be conceived and implemented in a narrow sense. The quality assessment should address the viability of a bank's business model and its governance structure.

An important lesson from the Lehman Brothers bankruptcy is that great value losses can occur in insolvency proceedings when there are jurisdictional conflicts and the financial institution is opaque. In the case of Lehman Brothers the bankruptcy of its US entities went relatively smoothly but the bankruptcy of its subsidiaries in several other jurisdictions was costly and time-consuming. The main reason why substantial and unnecessary losses occurred was that the legal organisation of Lehman Brothers did not resemble its operational and functional organisation. The operations of its legally separate subsidiaries were tightly integrated. Subsidiaries therefore found themselves cash-strapped when the parent went bankrupt; assets associated with activities in one subsidiary could be booked in another.

European cross-border banks are generally operating as subsidiaries in host countries in spite of close operational and functional integration. The host country banks operate as de facto branches in spite of being separate legal entities under host country jurisdiction.

The resolution of a cross-border bank in the EU will encounter exactly the same problems of Lehman Brothers if responsibility for resolution is entirely a national responsibility. The banking union in its complete form represents a remedy for this problem. But until a Single Resolution Mechanism is realised, the Lehman problem will exist.

The jurisdictional conflicts can be minimised with a requirement that host country subsidiaries must be operationally separable from a distressed home bank within 24 hours. New Zealand has such a requirement as a part of its Open Resolution Procedures. The ESFRC recommends that the EU implements a 'separability' rule for the period before the Single Resolution Mechanism is in place. This rule would require that subsidiaries conduct its important functions within 24 hours after closing as a result of distress of the home bank. Without such a rule the complexity of resolving a cross-border bank may leave authorities with no choice except a bail-out. Separability includes information and risk-management systems, participation in payment systems, customers' access to deposits and clarity with respect to the booking and origination of assets and claims. Living wills can help prepare resolution authorities but, without a clear separability requirement, jurisdictional conflicts are most likely inevitable.

European finance ministers have held many discussions focused on creating a truly European resolution authority. Unfortunately, urgent questions on the first two phases of implementation of the Banking Union are not yet answered. ▪

Prof. Harald Benink is Founding Chairman of the European Shadow Financial Regulatory Committee.

On the web

See full ESFRC statement at www. esfrc.eu.

A European Union without Britain would have big implications for Europe too

Developments in the UK and the European Union (EU) make a referendum on UK membership increasingly likely, *writes Tim Oliver in Washington*. Among heated debates about what it would mean for the UK, one question is being overlooked: how would the EU change if the British quit?

Prime Minister David Cameron's announcement that a future Conservative Government will seek a renegotiation of Britain's EU relationship, to then be put to the British people in an in-out referendum, means the EU could face losing 63m Europeans and 15% of its economic area. His announcement did not come entirely as a surprise. Britain has long struggled in its relationship with European integration. More than any other member state Britain sees the EU as a means to an end, with that end not being the EU's founding aim of 'ever closer union among the peoples of Europe.'

Numerous recent opinion polls indicate a growing willingness of the British people to vote to withdraw. While such polling results have been seen in the past, this rise has been accompanied by the growth of the UK Independence Party, staunchly committed to securing the withdrawal of the UK from the EU. Added to this is a sense that an EU beset by problems holds Britain back from dealing with the opportunities and threats of the modern world. As one Conservative MP put it, in joining Europe 'we shackled ourselves to a corpse.'

Neither the UK nor EU should savour the idea of a divorce. It could be traumatic for both. This could be especially so for the UK, as it would mean withdrawing from its most important and comprehensive international relationship. For the EU a British withdrawal would trigger three inter-related series of challenges. First, negotiations with Britain over its withdrawal could last two years or even longer. Despite the inclusion of Article 50 in the Treaty on EU setting out a withdrawal process, the procedure is something of an unopened Pandora's Box. Putting Article 50 to the test would set precedents, possibly aiding future withdrawals and developing further the idea of expelling a member state.

Second, the EU will have to negotiate interally on how to change its institutions, voting allocations, policies and budgets to reflect the departure of one of its largest member states. This could shift its balance of power. The EU could become more inward looking, isolationist and protectionist; smaller states could gain at the expense of larger states; north and west could lose out to south and east; and Germany's position could be further strengthened.

On the other hand, rid of a notoriously awkward member, the EU could more easily move forward towards 'ever closer union.' Without the threats of British vetoes, Europe's social model would be freed of UK attempts to weaken it. However, the euro area crisis has shown that even with the UK out of the room, the EU can still struggle to find the necessary solidarity and leadership to manage EU-wide problems. Meanwhile, the crisis itself is both exacerbating Britain's feeling of detachment from the EU, while distracting attention from the possibility and implications of a withdrawal.

The third problem is how the EU should manage relations with the UK following its exit. Article 50 requires any withdrawal agreement to include a framework for future relations with the withdrawing state. The EU could agree to the UK adopting a relationship similar to Norway or Switzerland, to a customs union similar to that with Turkey, or to the relationship of a WTO member with no special arrangements with the EU. Each of these has implications for the integration of the EU and wider European cooperation.

If the UK is sleepwalking towards exit, then the EU should not itself be asleep to what this could mean for the union itself. The implications for the EU are open to much speculation, in large part because of a lack of discussion of the subject. Shying away from discussion adds to uncertainty, and this benefits the backers of UK withdrawal. There is a chance a referendum could be triggered sooner than widely anticipated. The EU has to make a calculated decision about whether or not to press ahead with a renegotiation. It must assess whether or not it's worth making the effort to keep the UK inside on renegotiated terms, or whether it might be better to seek a new arrangement altogether with the UK on the outside. ▪

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On the web

See the full SWP Research Paper at www.swp-berlin.org/en/publications

The message of broad money

Contrasting developments in US, UK and euro area

Gabriel Stein, Chief Economic Adviser

Sir John Vickers, previously head of the British government's Independent Commission on Banking, was reported in September as saying he ideally would like British banks' tier one capital ratio to be 20%. This is twice the 10% his commission recommended and which is now the norm for British banks.

On the same day, Bloomberg produced a story saying that Spanish companies are running out of cash and are finding it difficult to secure bank financing.

Although the articles referred to different issues, they are both significant from a monetary perspective. Strangely, there seems to be little awareness that growth in broad money and credit is related to the development and composition of banks' balance sheets. Raising the capital asset ratio means that something else has to give – usually, as we have seen in recent years, the amount of credit banks can extend. Meanwhile, the Spanish article illustrates the relationship between broad money and credit growth on the one hand and economic activity on the other.

Broad money growth

Specifically, what matters is broad money, much more than credit. This is clear from both US and UK developments. The American economy is clearly in a recovery phase, although its strength remains disappointing. The UK economy has recently surprised on the upside and it seems that the long-awaited recovery finally has arrived – again with due note taken of the weakness of that recovery.

In both cases the leading indicator that heralded the recovery was broad money growth: in the US, a growth rate in excess of 4% since November last year and in excess of 6% since May; in the UK a growth rate of more than 4% since August last year (US broad money refers to Stein Brothers' recreation of M3; UK refers to M4x).

Credit growth

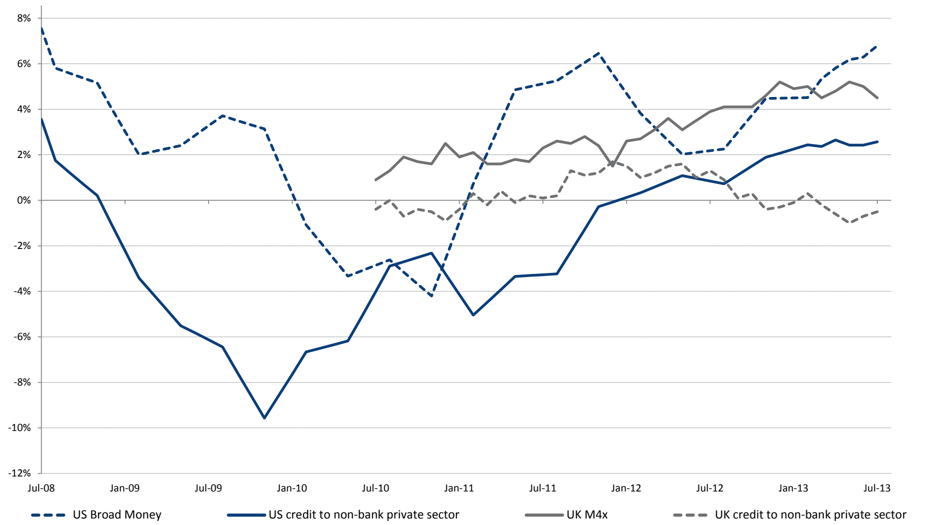
By contrast, credit growth remains subdued in both countries. Crucially, current broad money trends point to continued recovery in both (see Chart 1). For the euro area the picture is more complicated. On the one hand, there is the overall euro area picture. Broad money (M3) growth picked up to 3.9% in the year to October 2012, but has since slumped back to 2.2% in July, while credit to the non-bank private sector continues to contract (see Chart 2). However, as has been made painfully clear over the past three or four years, the euro area cannot be seen solely as one economy. National differences remain in force. Recent national broad money and credit trends for the euro area countries do indeed show some interesting divergences.

Looking first at the four largest euro area members, there are two striking developments. The first is that broad money growth is slowing again in Germany, France and Italy. The German contribution to euro area M3 grew by a 12-month average of 7.1% in 2012; so far (January-July), the 2013 growth rate averages 4.9% – but the trend is down.

In France, M3 growth averaged 2.7%, while so far in 2013 it averages 2.2%. The Italian numbers ostensibly look better – an average growth of 0.7% in 2012, rising to 4.2% in 2013 – but this is based on extremely weak broad money growth in early 2012, accelerating later in the year and now slowing again. For all that it remains faster than in Germany and France.

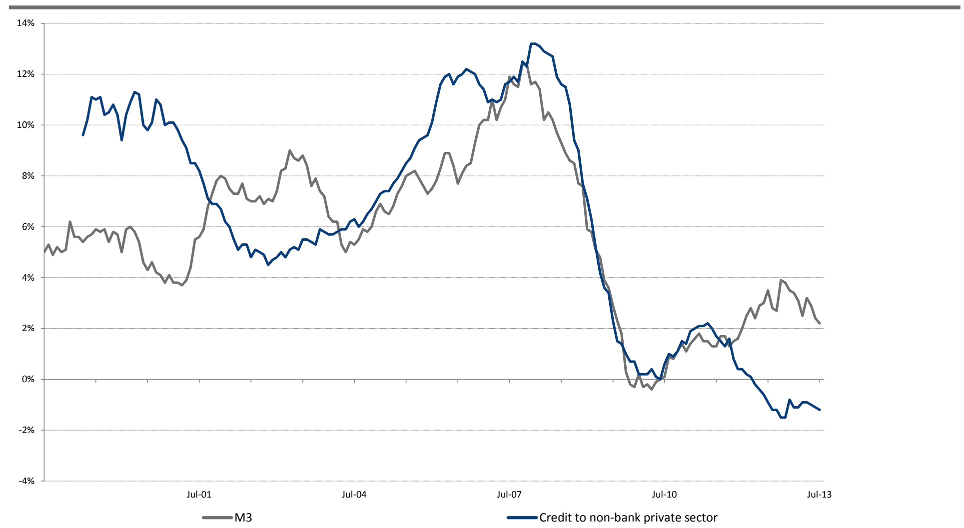
By contrast, the contraction in Spanish M3

Chart 1: US, UK broad money and credit, 12-month change, %



Source: Bank of England, Stein Brothers

Chart 2: Euro area broad money and credit, 12-month change, %



Source: European Central Bank

growth seems at long last to have come to an end last July (see Chart 3).

Credit data, while less important than broad money, show a similarly disappointing trend, with lending to non-financial companies and household contracting in Italy and in Spain and barely growing in Germany and France. These numbers point to the continued weakness of domestic demand in the main euro area countries and raise a warning signal over the strength of the recovery over the next year to 18 months.

Italian broad money growth

The one country where broad money numbers hold out some hope of growth is Italy (in spite of the slowdown in M3 growth). However, it is still not clear why Italian broad money growth remains so strong by euro area standards. It may be that Italian households are shifting from other asset classes to holding cash – perhaps perceived as safer – but that would boost money supply only if households are selling assets either to the government or to the banking system, both of which can create money and whose cash holdings are not part of broad money.

This does seem to be the case: while household assets and liabilities are available only on a quarterly basis, Italian banks have substantially increased their holdings of government bonds over the past year. Whether the growth in Italian broad money eventually will lead to higher activity depends on whether households' desire to hold money has risen (see Chart 4).

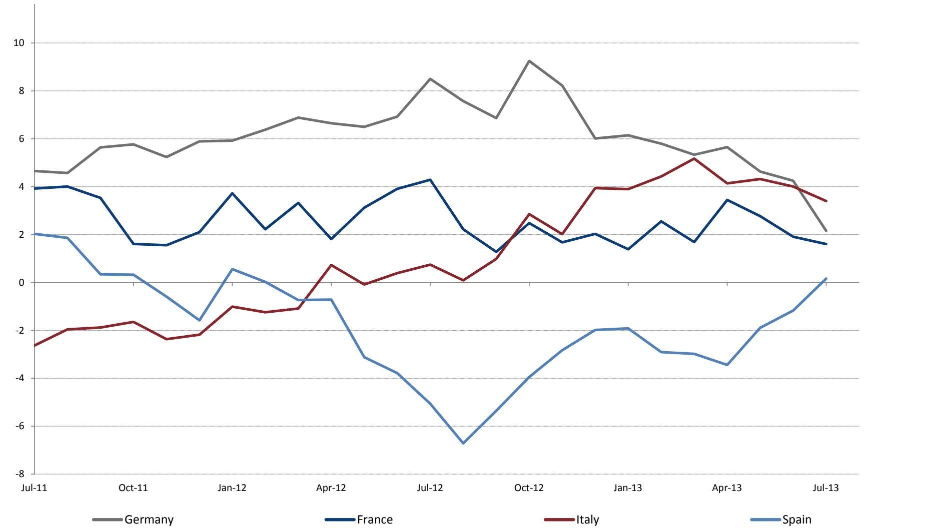
If data from the larger euro area countries are disappointing, there is some modest good news from some of the smaller crisis economies. Irish and Portuguese broad money growth continues to contract, but at a slower pace (although Portuguese data only goes up to last May), while Greek broad money growth has turned very robust, if so far only for three months. Credit to the non-bank private sector is still contracting in all three, but, again, at a slower pace than in 2012 (see Chart 5).

Therefore, the overall picture from the euro area broad money and credit data implies that the worst of the recession is over in the periphery, a view generally shared by commentators and forecasters. The data indicate, too, that growth in the core countries will continue to disappoint – a view that is not as widespread.

Sweden

While most important continental economies are part of the euro area, there are a few that are not. A key one here is Sweden.

Chart 3: National contributions to euro area M3 growth, 12-month change, %

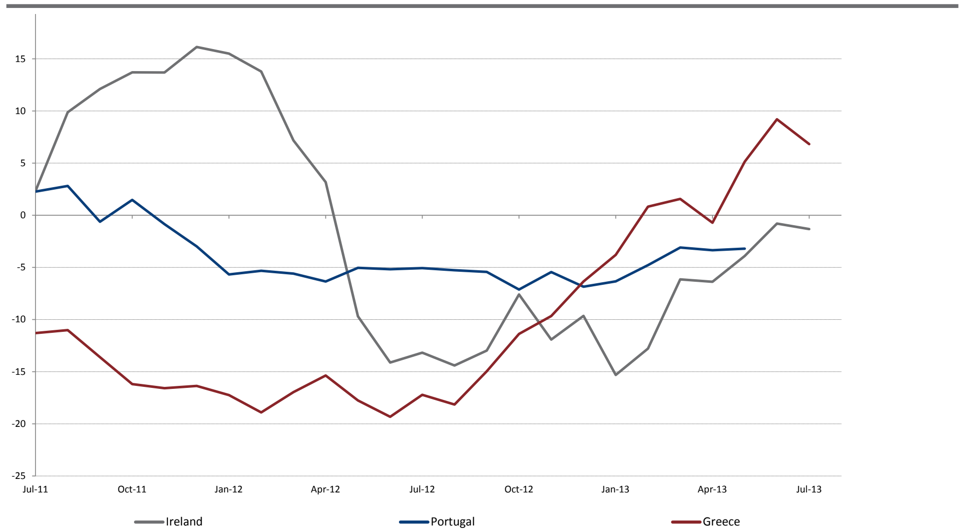


Source: Haver Analytics

Chart 4: Italian MFIs – holding of government bonds, levels, €m

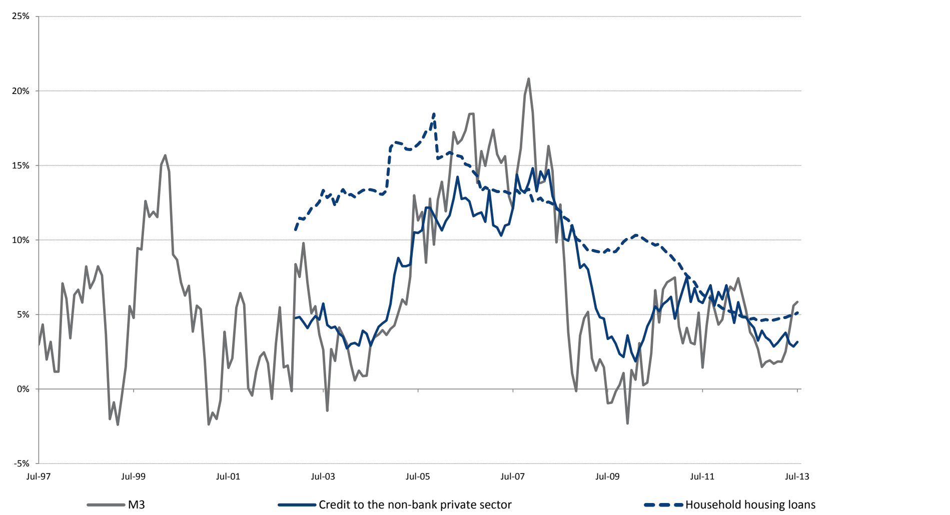
Source: Haver Analytics

Chart 5: National contributions to euro area M3 growth, 12-month change, %



Source: Haver Analytics

Chart 6: Swedish broad money and credit, 12-month change, %



Source: Sveriges Riksbank

Sweden is interesting from a monetary perspective for two reasons. First, because the last few years have seen a continued build-up of housing-related household debt and a housing boom. The Riksbank has repeatedly warned about the dangers this involves, but with little effect. With inflation below the Riksbank's 2±1% target range since July 2012 (the August 12-month rate was 0.1%), there has been little justification for raising interest rates, while other measures, such as a loan-to-value ceiling, have been circumvented by the banks.

The second reason is that in early September the responsibility for macroprudential supervision was assigned to Finansinspektionen, the Finance Inspection – Sweden's SEC or FSA.

This is in sharp contrast to the trend in other developed markets, where the perceived disadvantages of multiple regulators are giving way to regulatory consolidation.

In theory, this should leave the Riksbank free to concentrate exclusively on inflation, potentially leaving the way open for another cut in the repo rate (currently 1%). In practice, however, the Riksbank was not keen on giving up macroprudential supervision (the actual division of responsibilities was previously unclear) and, judging by comments from some of the monetary authorities, a rate hike is just as likely a next step as a cut, if not more so. There is some justification for such a move. Among other developments, broad money growth has recovered to close to 6% in the year to August and housing loan growth is edging up again (see Chart 6), which brings a range of implications.

Add to that a recovering world economy, and the idea of a higher Swedish policy rate is no longer fanciful. But it certainly is not intuitive. ■

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

Fluctuating history of reserve currencies suggests renminbi will have its day

Nothing lasts for ever. This adage applies to reserve currencies as much as to empires and dynasties, *writes Rahul Shah in London.* Going back to the Age of Discovery, around 1415 Portugal was a dominant force establishing a so-called first global empire. Its neighbour Spain then took over the world in the 16th century, known as 'the Golden Age.'

For a brief period in history, the Netherlands was the central force in the world with its excellence in trade, science and military might. The first French empire was snuffed out by the defeat of Napoleonic France in 1815. From then, Britain enjoyed a century of almost unchallenged dominance across the globe. After Bretton Woods, for the first time, a non-European country – the US – has taken over the reins. The question is, for how much longer? Many market practitioners agree that the global financial crisis and the subsequent sovereign debt uncertainties in Europe have drawn reserve managers' attention to the need for increased diversification from the dollar and the euro.

Official reserves of all central banks have grown from $2tn in 2000 to nearly $13tn this year. This increase is mainly felt in the emerging market central banks, in particular the BRIC and ASEAN nations. Central bankers must increase diversification, with excess dollars and euros in the vault, setting them on a mission to explore alternative currencies. Emerging market countries are increasingly pressing for more power within supranational bodies such as the International Monetary Fund (IMF) and the World Bank. Leaders of emerging market countries have called for more than one principal reserve currency and are increasingly transacting in non-traditional currencies in bilateral agreements.

China's renminbi is receiving plenty of attention from the world, despite limited availability and convertibility. China's rise in the global economy has forced central banks seriously to consider renminbi-denominated assets. Momentum gathered over this year alone is evidence that the renminbi is here to stay. One symbolic move this year was the three year currency swap agreement between Britain and China – the first in its kind between China and a major western country. So far, the People's Bank of China (PBoC) has signed nearly Rmb2tn worth of currency swap deals with roughly 20 countries and regions. The direct trading volume has doubled in just over a year with Japan and Australia has reached an agreement where it can directly exchange the Australian dollar with the renminbi – signifying the currency's growing importance in world trade. Singapore and London are acting quickly to set up clearing services for the renminbi and developing its off-shore markets. SWIFT shows that the value of payments using the renminbi grew 171% between January 2012 and January 2013, pushing the renminbi past the Russian rouble to the 13th spot for world current payments. From virtually zero in July 2010, the renminbi is now used to settle over 12% of world transactions.

The international landscape shows the prevalence of deteriorating credit quality. According to Standard & Poor's, only a handful of AAA and stable countries remain. With this backdrop, Australia, Canada, Switzerland and Scandinavian countries are increasingly attractive in providing alternate currencies. This is suggested by the inclusion of Australian and Canadian dollars in the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER).

Gold stands to benefit from the diversification from traditional reserve currencies, bringing its own advantages of market size and depth to complement those of the dollar. ■

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Global liquidity in an interconnected world

Financial indicators help task of macroprudential stability

Seung Je Hong, Bank of Korea

In an era of financial innovation and globalisation, financial stability has emerged as a key issue for both academia and policy-makers. Coupled with the rising uncertainties from unconventional monetary policies and their exits, there are concerns that recent developments in globally-interconnected financial markets may pose severe implications for all, especially emerging economies.

The Bank of Korea was early in foreseeing these dynamics. Since 'financial stability' was added to its statutory mandate in 2011, the Bank has begun reporting its Financial Stability Report to the National Assembly on a biannual basis. Recent analyses show that the Korean financial system remains stable and resilient (See Financial Stability Report link below). This is despite uncertainties in economic conditions domestically and abroad.

Domestic recovery

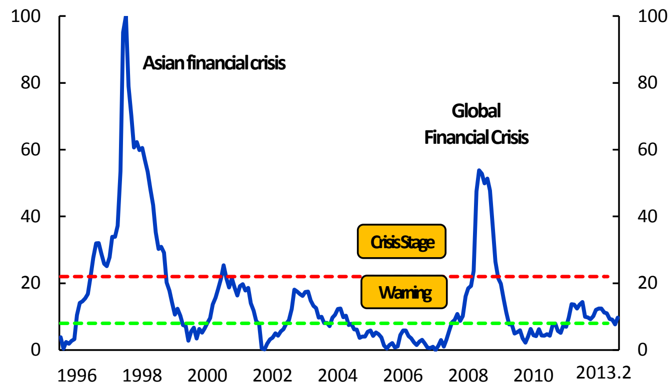
External economic conditions have improved with the easing of international financial market unrest and declines in uncertainties in the US and China since the second half of 2012. However, with the domestic recovery delayed and lack of improvement in household debt servicing capacity, there are still problems. The financial soundness of corporations has worsened, owing to declines in their profitability and increases in their loans-to-assets ratios.

In the banking sector, the profitability has worsened slightly. Credit risks related to household and corporate loans have increased. However, banks' overall financial soundness is still satisfactory, with capital adequacy improving. Financial market volatility remains, partly because of re-emergence of geopolitical risk. The basic position of the foreign exchange market remains sound, with foreign exchange supply still exceeding demand. This reflects the current account surplus, and an improvement in Korea's external debt repayment capacity given the increase in foreign reserve holdings.

Two key financial indicators

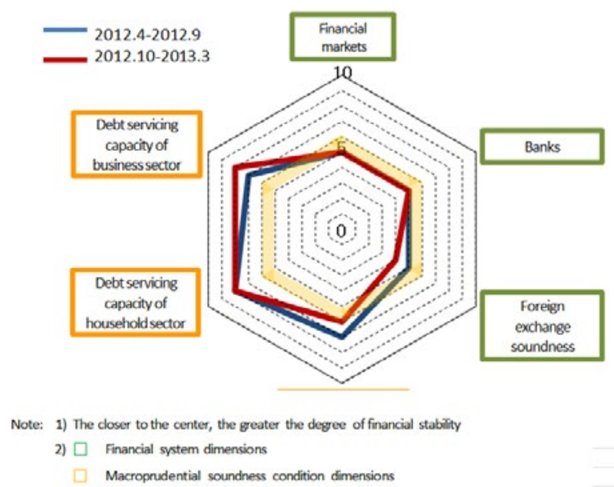
This underlying soundness is reflected in two key Bank of Korea financial indicators: the financial stability map and financial stability index (see Charts 1 and 2). The financial stability map presents a comprehensive picture of stability in six dimensions – three concerning the financial system (the financial markets, banks, and foreign exchange soundness) and three with regard to macroprudential soundness conditions (the domestic and global economies, the debt servicing capacity of the household sector, and the debt servicing capacity of the business sector).

Chart 1: Financial stability index



Note: The Financial Stability Index is measured based on values from 0 (min) to 100 (max). The closer it gets to 100, the higher the level of instability.

Chart 2: Financial stability map



The decile reading of a particular metric indicates the corresponding degree of stability compared with average levels in the past (since 1995). The financial stability index has shown an improving trend since August 2012, reflecting recent improvements in macroprudential conditions.

However, the Bank of Korea knows that financial instability could resurface even when these macroprudential indicators show a relatively benevolent conditions. So we are continually improving our early warning system and our capacity to respond to contingencies. The bank monitors risks using models such as systemic risk assessment. Risks are kept in check by measures including macroprudential stability levies. We look forward to sharing our perspectives with international partners as part of an effort to optimise the two-way process of global coordination. ■

Seung Je Hong is Director-General at the Office of International Affairs at the Bank of Korea.

On the web

See Bank of Korea's Financial Stability Report at www.bok.or.kr.

Fed failure to taper confuses markets

Fiscal uncertainty clouds economic outlook

Darrell Delamaide, US Editor

Scene at the New York Stock Exchange as Ben Bernanke announces tapering news on 18 September

Can forward guidance get too far ahead of itself? This was one of the questions after the Federal Reserve's surprise decision in September to maintain its asset purchases at $85bn a month – in other words, not to taper. The decision left many market participants scratching their heads, since most had interpreted the statements following the June meeting as indicating at least a token reduction in the pace of purchases, given the steady, if slow, improvement in economic data.

Chairman **Ben Bernanke (voter)** explained the decision of the Federal Open Market Committee at a press conference following last month's meeting. 'In evaluating whether a modest reduction in the pace of asset purchases would be appropriate at this meeting,' Bernanke said, 'the committee concluded that the economic data do not yet provide sufficient confirmation of its baseline outlook to warrant such a reduction.'

Catch-22 for policy-makers

In part, policy-makers were caught in Catch-22: As soon as they started talking about tapering, markets bid up yields, which in turn has apparently delayed the tapering. 'The committee has some concern that the rapid tightening of financial conditions in recent months could have the effect of slowing growth,' Bernanke said, 'a concern that would be exacerbated if conditions tightened further.' Last but not least, there was the whole ruckus in congress about possibly shutting down the government or not raising the debt ceiling, potentially pushing the US into default.

'The extent of the effects of restrictive fiscal policies remains unclear,' Bernanke continued in his bland Fedspeak, 'and upcoming fiscal debates may involve additional risks to financial markets and to the broader economy.'

While at least one FOMC participant held out the possibility of tapering starting at the meeting 29-30 October, most Fed watchers felt that any action would wait now until December. At that point, however, Bernanke will have one foot out the door, so a fair number of analysts have concluded that tapering will now wait until a new chairman is installed.

It was St. Louis Fed chief **James Bullard (voter)** who jumped in immediately with the suggestion that the Fed could begin reducing asset purchases as early as this month. In a television interview, he said last month's decision was 'borderline,' and suggested that 'a small taper is possible in October.' For Bullard, the fact that inflation is substantially below the Fed's 2% target was another reason not to start tapering so soon. 'While I expect inflation to rise during the coming quarters, I want to see evidence of such an increase before endorsing less accommodative policy action by the FOMC,' Bullard said at a New York meeting of business economists two days after the meeting.

Guideposts for tapering

Atlanta Fed President **Dennis Lockhart (non-voter)** said it was unlikely the Fed would start tapering in October. Citing mixed economic data and uncertainties on the fiscal front, he told a Wall Street Journal interviewer, 'In the short time between now and the October meeting, I don't think there will be an accumulation of enough evidence to dramatically change the picture.'

New York Fed chief **William Dudley (voter)** gave some of the clearest guideposts for when to expect tapering to start.

'To begin to taper, I have two tests that must be passed,' Dudley said at Fordham University the week after the meeting. One is evidence that the labour market has shown improvement, and the other, he said, is clear evidence that the economy's momentum is strong enough to ensure that the labour market will continue to improve in the future.

Unemployment rate

With regard to the first test, Dudley said that even though the unemployment rate had dropped from 8.1% to 7.3%, other parameters of the labour market – hiring, job-openings, job-finding rate, quits rate and the vacancy-to-unemployment ratio – continue to be unsatisfactory.

'In particular, it is still hard for those who are unemployed to find jobs,' Dudley said. The New York Fed chief doesn't think the second test has been passed, either. 'The economy has not picked up forward momentum and a 2% growth rate—even if sustained—might not be sufficient to generate further improvement in labour market conditions.' And he, too, spoke of 'fiscal uncertainties' that might slow down that already sluggish growth rate.

There were also dissenters to this consensus. Kansas City Fed chief **Elizabeth George (voter)**, who has routinely dissented from the FOMC statements since she became a voting member this year, once again objected to continued monetary accommodation because of the risks it entails. She also complained that defying market expectations of a taper diminished the Fed's credibility.

'Delaying action not only allows potential costs to grow, it also has the potential to threaten the credibility and the predictability of future monetary policy actions,' George said in a speech in Denver. 'Waiting for even more evidence in the face of continuing economic growth unnecessarily discounts the very real progress made over the past few years and also discounts the potential costs of a policy tool with which we have limited experience.'

Winking in the dark

Dallas Fed chief **Richard Fisher (non-voter)** also voiced concern about the Fed's credibility. In a speech in San Antonio the following week, he cited the objection he made during the FOMC meeting: 'Doing nothing at this meeting would increase uncertainty about the future conduct of policy and call the credibility of our communications into question.' With his penchant for homely expressions, Fisher responded to a question with a further remark about the effectiveness of the Fed's forward guidance: 'My father said never wink at a girl in the dark. What that means is if the message is not received you didn't communicate it.'

In the debate following the decision whether the Fed needs to speak more clearly or the market needs to listen more closely, the consensus seemed to be that a little bit of both is required.

Fed governor **Jeremy Stein (voter)** suggested one way to avoid volatility in communicating the pace of tapering would be to tie it to an economic indicator like unemployment. 'There would be a great deal of merit in trying to find a way to make the link to observable data as mechanical as possible,' Stein said at a conference in Frankfurt. 'For example, one could cut monthly purchases by a set amount for each further 10 basis point decline in the unemployment rate.'

For his part, Minneapolis Fed chief **Narayana Kocherlakota (non-voter)** said the Fed should be even more aggressive in combating stubbornly high unemployment, and act as boldly as it did in the 1980s, when it did whatever it took to tame double-digit inflation. In this case, Kocherlakota told an audience in Houghton, Michigan, 'doing whatever it takes will mean keeping a historically unusual amount of monetary stimulus in place—and possibly providing more stimulus.'

Given the range of opinions, it may not be the Fed's communications that are murky, but the situation itself. So markets may not expect any action soon. As Lockhart said in his Wall Street Journal interview, 'I don't have expectations that the fog will clear dramatically between now and October.' ■

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

Summers did what was expected of him

In the end, the issue of Senate 'confirmability' was indeed crucial to the nomination of the next Federal Reserve chairman, *writes John Kornblum in Washington*. The writing was on the wall when three Democratic members of the Senate Finance Committee announced publicly that they would not vote to send forward Larry Summers' nomination for consideration by the full Senate.

Given tight majorities, this step was a fatal blow to Summers' hopes. Rounding up three more Republican votes to replace the wayward Democrats would have been an almost impossible task. So Summers did what was expected of him. In a letter to President Barack Obama, released to coincide with his announcement, the former Treasury secretary said he had 'recently concluded that any possible confirmation process for me would be acrimonious and would not serve the interests of the Federal Reserve, the administration or, ultimately, the interests of the nation's ongoing economic recovery.'

In the OMFIF Commentary distributed on 29 August, I opined: 'the President appoints, but the Senate approves.' My prediction that Summers could be a stalking horse to help a less mercurial candidate gain easier approval turned out to be reasonably prescient. The prediction was that the other main contender, Fed deputy chairman Janet Yellen, 'may finish a nose ahead.' President Obama said he accepted the decision by his friend even as he praised him for helping to rescue the country from economic disaster early in the president's term.

Most commentators have assumed that if Summers stumbled, the job would go to Yellen. This may still be the case, although former board member Donald Kohn has been mentioned as a strong contender. It's possible that Obama will reopen the search and find someone not now on any list. If he does so, he must hurry. Ben Bernanke's term expires in January. Ushering through a new chairman in the midst of a debate on Syria, a worsening dispute over the debt ceiling and government shutdown and the Fed's fluctuating decision-making process over 'tapering' its purchases of government bonds will not be easy.

Ultimately Summers was defeated by one of the unusual coalitions which have now become characteristic of US parliamentary bargaining. Conservative Republicans were ready to oppose him on principle. Add to this Liberal Democrats who felt that Summers, as a member of the stable of economists around former Treasury secretary Robert Rubin, had been too cosy with Wall Street and had blocked banking regulation during and after his time in government.

These views were represented by one of many comments to the Washington Post after the news was released: 'Lawrence Summers is one of a tiny group of political economists (Summers, Rubin, Greenspan, Phil Graham) who sabotaged established banking regulations which led to the Second Great Depression which is yet to end. That President Obama even considered for a moment Summers' appointment as head of the Fed is a further troubling indicator to Obama's supporters of his naiveté and that he can be intimidated by power.' These are sentiments that Obama right now does not need. Larry Summers' withdrawal was the right decision. It should help the economic and political healing process that has manifestly not yet ended. ■

John Kornblum, a former US Ambassador to Germany, is Senior Counselor to Noerr and Member of the OMFIF Advisory Board.

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Haihong Gao, Institute of World Economics and Politics
Steve Hanke, Johns Hopkins University
John Hughes, former UK Ambassador to Argentina
Ray Kinsella, University College, Dublin

Mariela Mendez, Escuela Superior Politecnica del Litoral
Rakesh Mohan, International Monetary Fund
Michael Oliver, ESC Rennes School of Business
Danny Quah, London School of Economics
Abdul Rahman, International Academy of Retail Banking
Richard Roberts, King's College, London

Shympei Takemori, Keio University
Maria Antonieta Del Tedesco Lins, University of São Paulo
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Daniel Titelman, Economic Commission for Latin America and the Caribbean
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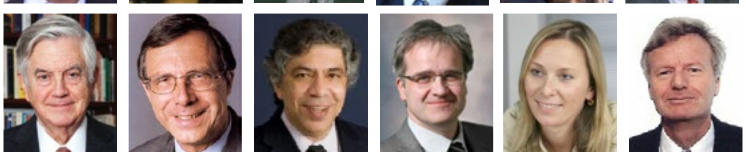
PUBLIC POLICY



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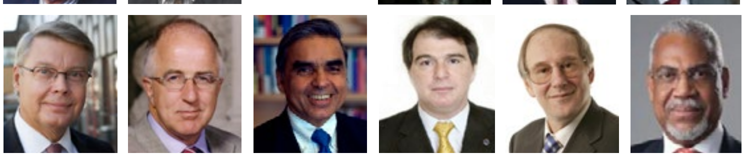

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Denis MacShane, former British Minister for Europe
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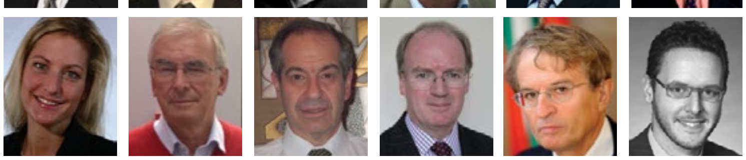
ECONOMICS & INDUSTRY



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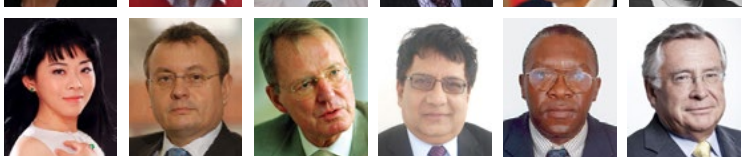

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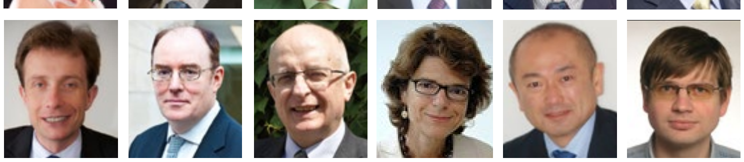

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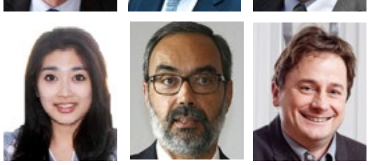

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Growth still anaemic across world

Dubious claims over austerity from UK government

William Keegan, Chairman, Editorial & Commentary Panel

DZ Bank Economic Forecast Table

GDP change (%)

	2011	2012	2013	2014
US	1.8	2.8	1.7	3.0
Japan	-0.6	2.0	2.0	1.9
China	9.3	7.7	7.5	7.9
Euro area	1.6	-0.6	-0.4	1.2
Germany	3.3	0.7	0.6	2.0
France	2.0	0.0	0.2	1.0
Italy	0.5	-2.4	-1.5	0.5
Spain	0.1	-1.6	-1.4	0.8
UK	1.1	0.2	1.0	1.6

Addendum

	2011	2012	2013	2014
Asia excl. Japan	7.6	5.8	5.8	6.6
World	3.8	3.0	2.7	3.7

Consumer prices (% y/y)

	2011	2012	2013	2014
US	3.2	2.1	1.6	2.2
Japan	-0.3	0.0	0.1	1.8
China	5.4	2.7	2.7	3.7
Euro area	2.7	2.5	1.7	1.9
Germany	2.5	2.1	1.7	2.1
France	2.3	2.2	1.3	1.6
Italy	2.9	3.3	1.7	2.1
Spain	3.1	2.4	1.9	1.5
UK	4.5	2.8	2.6	2.5

Current account balance (% of GDP)

	2011	2012	2013	2014
US	-2.9	-2.7	-2.7	-2.8
Japan	2.0	1.0	1.1	1.5
China	1.9	2.3	2.3	2.3
Euro area	0.2	1.2	1.9	2.0
Germany	6.2	7.0	6.6	5.9
France	-1.7	-2.2	-1.7	-1.8
Italy	-3.1	-0.5	0.9	1.1
Spain	-3.7	-1.1	1.0	2.0
UK	-1.5	-3.8	-2.8	-3.0

Produced in association with DZ BANK Group, a partner and supporter of OMFIF.

The annual meetings of the World Bank and International Monetary Fund take place with none of the fundamental imbalances in the world economy resolved, and many observers worried that the chances of another financial crisis looming are a lot higher than they ought to be.

The recovery from the 2009 recession started off reasonably well, following the correct macroeconomic policies made by governments around the world orchestrated in the G20 process. However, as a result of a series of developments – reflecting a combination of unforeseen events, missteps and ill-luck – world growth has turned distinctly anaemic.

Now Britain's Chancellor of the Exchequer George Osborne has thrown another spanner into the works, by proclaiming that the economic recovery recently experienced in the UK amounts to justification of his policy of austerity.

The truth about the UK's situation is that thanks to the economic stimulus applied by Gordon Brown's government in 2009-10 a promising recovery was under way when the Coalition of Conservatives and Liberal Democrats was formed. However, George Osborne, encouraged by the Bank of England, raised VAT and announced a series of public spending cuts, not least in investment in the infrastructure, which arrested the recovery in its tracks.

The recovery now apparently taking place – and confidence in its strengths seem to ebb and flow with almost every publication of an economic indicator – is not, as Osborne claims, the consequence of his austerity programme. What actually happened was that the combination of spending cuts and higher taxes was guaranteed to delay recovery; that recovery is taking place in spite of the austerity programme, not because of it.

The claim that the causal relationship lies the other way round is dangerous, as even the IMF realised when it changed its tune on the British austerity programme and joined the ranks of those advocating a 'Plan B'. The meetings in Washington will indicate how far along the path the world growth debate has travelled – and how much further we need to go. ■

William Keegan is Senior Economics Commentator at the Observer.

Fed non-move dominates markets

The US central bank's unexpected decision to postpone the start of its gradual exit from ultra-expansive monetary policy has triggered strong rises in the industrialised countries' equity and bond markets, *writes Michael Holstein in Frankfurt*. It has provided a welcome pause for emerging market economies.

But putting off is not the same as putting right, and the Federal Reserve will have to begin its quantitative easing pull-back sooner or later. Meanwhile, another source of uncertainty for the US economy is looming on the horizon, this time on the fiscal policy front. Washington has failed to meet the deadline for agreeing on the budget for the next fiscal year by the end of September. The stalemate between the Republicans and Democrats in congress is threatening once again to cripple the US administration.

In China, the economy has been sickly for several months – but the data for August show growth stabilising. Annual industrial production has increased by over 10% for the first time this year.

The outlook for the euro area economy has continued to brighten for several months (see latest forecasts, left). But the considerable risks inherent in Italy's simmering government crisis and Portugal's talks with the troika should not be overlooked. After Germany's elections, talks on forming the next federal government are under way.

Germany's economic recovery will probably turn out to have been somewhat subdued in the quarter now ending compared with the spring. This is implied by the recent flow of weaker manufacturing data. Looking forward, the current expansive policy framework among other factors lead us to predict a robust, primarily domestic demand-driven rally in the German economy. ■

Michael Holstein is Head of Macroeconomics at DZ BANK.

Risks of excessive currency depreciation

The delicate task of mounting an interest rate defence

Niels Thygesen, Chairman, Education & Research Panel

The global economic outlook reflects changing fortunes. The US and Japan are recovering, Europe is doing less badly, but several emerging market economies (EMEs) are decelerating, though so far moderately. This rebalancing raises two questions. Is international policy coordination working in the present environment? What is the best strategy for EMEs faced with a slowdown?

In particular, emerging market economies confronting a reversal of capital flows face the challenge of attempting to avoid an excessive cycle of currency depreciation and inflation. The risk is that, if they allowed that to happen, that would undermine their longer-term economic performance, impede inflows of direct longer-term investment needed to sustain their competitive positions, and ultimately force brutal policy adjustments. Meeting this challenge requires the authorities to adjust upwards their range of interest rates to defend against the risks of unwarranted depreciation.

International coordination

With regard to international coordination, the picture that emerges is not particularly encouraging. Despite the emergence of the G20 as a greater global force over the past five years, there has been no coordination of economic policies since the significant joint boost to demand in 2009, except for some agreements on financial regulation. This is hardly a surprise. The international monetary system has only very rarely risen to the challenge of policy coordination and the empirical evidence to underpin it is not overwhelming.

US policy-makers have always pursued domestic objectives. They are interested in the rest of the world only where there is feedback to the US. But the US is not alone. The recent swing in Europe's current account balance into strong surplus, while overdue on regional grounds, is another example. So is the massive easing of Japanese fiscal and monetary policy.

The policies that have been adopted in the major industrial countries may appear domestically desirable. In a longer-run international perspective, they probably contribute to stability. But these policies raise challenges for a number of EMEs. This applies both to the US policy changes in the direction of quantitative easing (QE) announced a couple of years ago, and also to the much-discussed US move to reduce slack at home, and move towards monetary normalisation.

US monetary policy is in a special category. As QE was building up, short-term rates were pushed to zero, and increasingly strong 'forward guidance' was provided signalling easy policies. Capital flowed into international financial markets, depressing interest rates and/or leading to appreciation of non-dollar currencies. Since the Federal Reserve announcement of 'tapering' of bond purchases in May – even though this has not yet been translated into higher official interest rates – capital flows have reversed and the currencies of India, Brazil, Indonesia, South Africa and Turkey (and of others) have depreciated. In most cases they have fallen to levels below where they were when US easing started, giving rise to fears of inflation.

Half a century ago Robert Mundell and Marcus Fleming showed that a country's choice of exchange rate regime offered some scope for short-run protection of the domestic economy against undesired cross-border disturbances. A flexible rate preserves some monetary autonomy in pursuing domestic objectives. Recent experience and research suggest that protection is very limited in today's world of massive capital flows. This even applies to a large regional currency bloc like the euro area, where participants have huddled together around a common currency and exchange rate policy, as part of an effort to spread the impact of global disturbances more widely.

For individual EMEs this European-style option – which anyway proved far less robust than expected during the financial crisis – is not available. Their task is to evaluate carefully the appropriate combination of changes in policy instruments – exchange rates, short term-interest rates or 'macroprudential', i.e. supervisory or regulatory measures – they can best ride out a difficult period.

This theme figured prominently on the agenda of a September OMFIF symposium at the Central Bank of Turkey, which can pride itself of having developed a highly sophisticated system of short-term monetary management. Like other EMEs recently faced with outflows and a weakening currency, Turkey has a substantial current account deficit and an above-target inflation rate. If a weaker exchange rate marks a return to a more sustainable level, then it is warranted to let the rate fall and in this way take the brunt of the outflow. This is particularly the case if outflows look likely to stop within a relatively short period.

The argument can be raised that it would have been preferable to stop the earlier unwarranted appreciation, even though this would have exposed the countries concerned to US accusations of 'currency manipulation'. At the same time, these countries could have dampened the rapid credit expansion in previous years. However, such advice is now only useful for the long term.

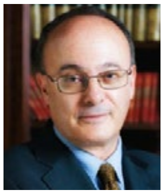
If the normalisation of interest rates in the US and other industrial countries becomes more of a trend, as argued by Philip Turner of the Bank for International Settlements (BIS) in a contribution to the symposium, it will be crucial for the Turkish authorities and other emerging market economies to evaluate whether the best strategy is to continue to let the exchange rate be the main absorber.

Costs of fluctuations

There are costs to accepting fluctuations – and also to taking measures to withstand them. A rise in policy interest rates to ward off a fall in the exchange rate would, for example, spill over into higher longer-term rates. The adjustment costs would be borne by different groups in society. Higher inflation especially hurts consumers, while higher interest rates hurt borrowers. Letting the exchange rate weaken will in the short run help the internationally-exposed trading sector, although this would be offset by the high element of imported materials in export goods. Letting interest rates rise to stabilise the exchange rate would have a broader impact on the economy. This would damage some of the sheltered sectors of the economy that may have excessively expanded in the recent past, in emerging market economies and in some developed European countries.

Using interest rates to defend exchange rates is a sensitive exercise. Almost inevitably, emerging market economies facing potentially destablising outflows must carry out a delicate balancing act involving difficult choices among a range of objectives. They may have to risk short term pain to the economy as the price for achieving longer-term gain. ■

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



Path to sustainable recovery in Spain

Gradual restoration of growth is underway

Luis M. Linde, Governor, Banco de España

The Spanish economy is emerging from a double dip recession which was at its worst in 2012, against the background of the heightening crisis in the euro area. At that moment our economy was undergoing a severe confidence crisis along with strong funding difficulties. Fortunately, we are now in the process of overcoming this difficult episode. Forceful measures taken at both the European and domestic levels have contributed to easing financial tensions and correcting the macroeconomic imbalances built up during the years in the run up to the Great Recession.

In the first half of 2013, the pace of contraction of Spanish activity eased significantly. GDP fell in the second quarter by 0.1%. Forecasts point to a stabilisation of the economy in the second half of this year and to a modest expansion in 2014. The gradual restoration of growth will be based on the continuation of the significant positive contribution from external demand and, more importantly, on a progressive rebalancing of the economy, which will stabilise domestic demand.

The aforementioned recovery in the Spanish economy has proceeded alongside the correction of some of the macroeconomic imbalances accumulated in the previous expansion, namely the external imbalance, the high level of leverage of households and firms, and the sharp deterioration of public finances. In addition, structural reforms in key areas such as the labour market and the financial sector are contributing to set in place more robust foundations for growth looking forward.

Correction of external imbalance

One of the most visible aspects of the rebalancing of the Spanish economy is the adjustment of its external deficit. The imbalances built up during the previous expansionary period gave rise to a very high current account deficit, of up to 10 % of GDP in 2007. The correction since then has been intense. Indeed, the economy was already in surplus in the second half of 2012, and by the end of this year the external surplus could climb to levels above 2% of GDP.

Part of this adjustment has been cyclical owing to the sharp contraction of domestic demand during the recession. But it has also been caused by the domestic adjustment of relative prices and costs. Measured in terms of relative unit labour costs, the Spanish economy has already recovered almost all of the competitiveness lost since the beginning of economic and monetary union (EMU). Improved competitiveness is one of the reasons behind the export share gains we have observed in all markets, especially outside the euro area.

Private sector deleveraging

Deleveraging in a recessionary environment is necessarily a slow process, due to weak income growth, and must unfortunately be based mainly on the contraction of lending to the most indebted sectors and firms. The completion of the correction of imbalances will still require further effort from households and firms: the reduction of the high level of accumulated debt that started in 2009 needs to continue. More time is still required and financial conditions will remain tight for a while. But there are encouraging signals, especially in the case of the financing of the most dynamic export and innovation-oriented sectors.

Fiscal consolidation process

After the sharp deterioration of public finances during the crisis, the fiscal consolidation effort made since 2010 has achieved remarkable results despite the adverse macroeconomic circumstances. In 2012 the public deficit was cut by four percentage points of GDP to 6.8 % of GDP (excluding the one-off impact of the financial assistance for bank restructuring).

In terms of the structural deficit, the reduction was close to seven percentage points of GDP. This sizable drive is unparalleled in the industrialised countries, although further efforts will be required to stabilise public debt and to place it on the necessary downward path.

Labour market reform

The most serious repercussions of the crisis have amassed in the labour market, with job destruction on a huge scale and unacceptable rates of unemployment. There was a cyclical component to this worrying performance but it was also motivated by severe structural distortions in the functioning of the labour market. These distortions prevented the necessary adjustment of wage costs, so that the full weight of the adjustment was borne by employment destruction.

The labour market reform implemented last year has tackled these problems at their roots, by introducing more flexible means of hiring and a collective bargaining system more aligned with firms' needs. Wage settlements now reflect the required adjustment. The effects of the reform on job creation would probably need some more time to materialise because of the medium-term nature of many of the modifications made. However, recent employment developments have also improved short-term labour prospects, meaning the labour market could begin to recover in late 2014.

At the same time, significant steps have been taken to strengthen budgetary discipline and to ensure the sustainability of the public pension system. Budget deficit limits have been enshrined in the Spanish Constitution and a new Budgetary Stability Law has been approved, with strict limits that apply to all levels of government. In addition, the creation of a new independent fiscal authority is currently under way.

Financial sector reform

In 2012 a clear roadmap for the restructuring and recapitalisation of the Spanish banking sector was established. The first stage of this process was the identification of banks' capital needs through a detailed asset quality review and a bottom-up stress test. This led to the approval of rigorous restructuring and recapitalisation plans, and the recapitalisation of banks with capital shortfalls. Finally, their problematic real estate-related exposures were transferred to an asset management company.

In addition to these measures aimed at addressing the specific problems of the most vulnerable institutions, several across-the-board actions were taken so as to strengthen the Spanish banking sector as a whole. These measures included the implementation of additional provisioning requirements for real estate exposures – introduced in the

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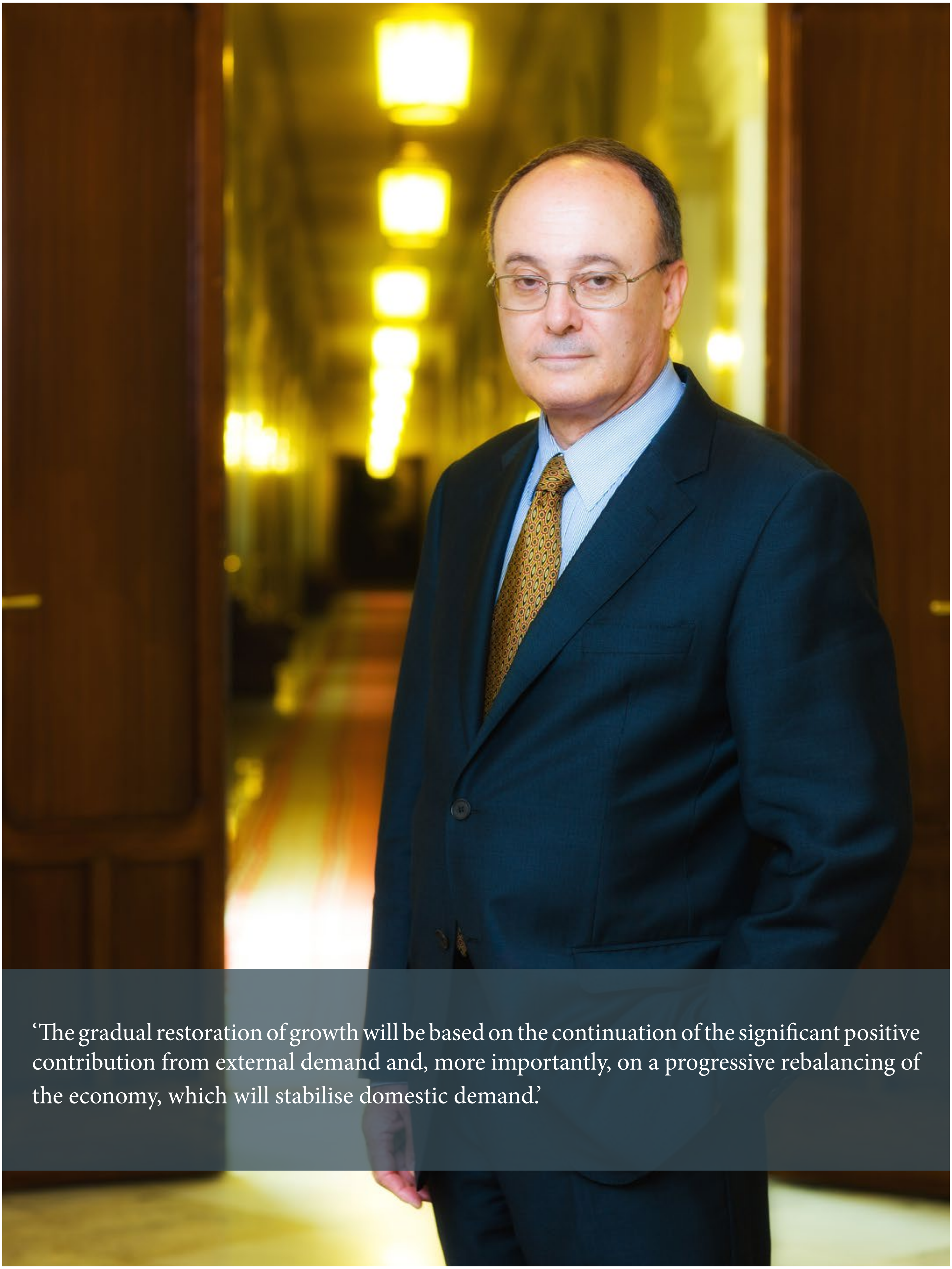


‘The gradual restoration of growth will be based on the continuation of the significant positive contribution from external demand and, more importantly, on a progressive rebalancing of the economy, which will stabilise domestic demand.’

Towards a new model for Spanish growth

Need to keep debt under control when economy rebounds

Jorge Sicilia, BBVA Research

Spain is in a better position than a year ago. We have not seen dramatic changes over the past 12 months, rather the cautious continuation of trends that were already unfolding at the time.

Across Europe, the process of reconstructing the euro's institutional framework is still under way. The authorities are using the breathing space provided by the invisible but resilient bridge built by the European Central Bank's commitment towards the euro. Spain can build further on its strengths by carrying on the work of adjustment along a path that has already provided some strong successes.

The underlying condition of the Spanish economy has shown improvement. Spain's GDP declined in 2009 and stagnated in 2010 and 2011, before falling once again in 2012 and 2013. But if we exclude the sectors that require adjustment – construction, the public sector and financial services – the rest of the economy, which accounts for nearly 70% of GDP, grew at over 2% in 2010 and 2011. These sectors declined somewhat later on, but less than the country's overall GDP. In 2013, a mild recovery is likely to have started in the second half of 2013.

These positive developments are mainly a result of exports, which are already up close to 20% on pre-crisis levels and around 25% since the cyclical trough in 2009. Together with the fall in imports, the foreign sector has increased its contribution to growth by 0.3 percentage points in 2010, 2.1 points in 2011 and 2.5 points in 2012. BBVA Research estimates that it will contribute by around 2 percentage points in 2013. This is reflected in the reversal of the previously high current account deficit.

Emerging market economies are becoming an increasingly important destination for exports. While Spain's prime export markets are in Europe, lower demand in these countries has been offset by welcome gains in market share.

Despite the 20% increase in Spanish unit labour costs compared with other industrialised countries over the last 10 years, some companies have managed to be competitive. And they have done so in spite of China's entry in the international trade arena. During that period, Spain has seen its share of world exports reduced by 9%, compared with falls of 40% in France and even 12% in Germany. In some sectors, including legal services, engineering, architecture and marketing, Spain has increased its global market share from 2.5% to 3.2%, which is no mean feat.

Such companies' ability to gain market share in such an adverse environment can be explained by their commitment to increased intensity in technology and human capital, involving a higher-than-average proportion of permanent and non-temporary workers, combined with lower-than-average labour costs.

These success stories have displayed great adaptation capacity and creativity, achieving much higher productivity than the rest of the economy. Unfortunately, this applies to just a few examples: Less than 4% of exporting companies account for nearly 90% of the value of total exports.

The common factor among these firms is that they are relatively large, underlining the disadvantage of smaller companies in

Path to sustainable recovery in Spain (...continued from page 24)

first half of 2012- and the establishment of a 9% minimum core tier 1 capital ratio for all banks. Moreover, a new resolution framework, in line with forthcoming international standards, was introduced and further transparency requirements were set on real estate exposures and restructured and refinanced loans.

These measures, along with other policy action taken at the European and domestic levels, have considerably eased the pressure on Spanish banks and have allayed concerns regarding their soundness. Funding conditions have considerably improved, as shown by the significant reduction in borrowing from the Eurosystem. Moreover, the latest figures show modest improvements in profitability, in line with the baseline scenario of the stress test conducted in 2012. Pre-provisioning profits, which reflect the income-generating capacity of banks, are growing at positive rates and doubtful assets, though increasing, are slowing down.

The outlook for Spanish banks remains challenging. In a context marked by slow economic growth, subdued credit demand and low interest rates, interest margins will remain under pressure. Moreover, doubtful loans will continue rising in the short term, although the resulting effect on provisioning requirements is expected to be below that of recent times. Against this background, banks must continue their efforts to contain costs and improve their efficiency. In particular, it is essential that institutions which required recapitalisation should comply strictly with their restructuring plans, which envisage significant capacity reductions.

All in all, the situation of Spanish banks is very different from that in 2012. Today, their exposure to the real estate sector is manageable, their loss-absorbing capacity has been considerably reinforced, their balance sheets are more transparent and their funding conditions are clearly more favourable. Of course, as in other countries, significant challenges remain ahead. But actions taken have addressed the major structural problems of Spanish banks and they are now better prepared to make a sustainable contribution to economic growth.

Lessons for confidence

Spain has already made a tremendous adjustment effort to rebalance its economy. The progress made is helping to improve internal and external confidence and is already evident in the narrowing of the sovereign spread and in the normalisation of external financing conditions. The completion of the adjustments in the real and financial sectors, and of the highly ambitious programme of reforms now under way, are the key factors for resuming growth in the near future. ■

this context. Size matters because it enables companies to cross a productivity threshold, to make the most of economies of scale, and to invest in technology. Unless export price structures continue changing, there is a limit to these improvements.

We need, however, to focus on the positive side. Since 2008, only Ireland has been able to cut unit labour costs more quickly than the 5% that has been achieved in Spain. In France and Germany unit labour costs rose more than 10% in this period. The Spanish accomplishments have been the result of a strong increase in productivity, amounting to 12%. In industry and manufacturing productivity increases have exceeded 20%.

The pattern of the recovery is similar to previous ones, where strong growth in exports leads the way, and followed by higher operating surpluses that spark a recovery in machinery and equipment investment – up 8% in the first half of the year.

What happens next? Employment should start growing soon. Adequate credit certainly needs to be available to shore up economic growth. We have achieved the most difficult part of the journey, but we need to travel further. These next steps have to be taken without the immediate help of recovery in the residential property sector. Meanwhile the deleveraging process must continue. The future is thus not free of challenges.

The rest of the economy will have to continue adjusting. This is not incompatible with growth. The public sector needs to continue moving toward a structural balance to remove the uncertainty surrounding the pace of debt reduction when the economy grows again. In the future, the public sector needs to adapt spending and tax structures to move toward a new type of growth. This will involve a lower weight of consumption, and a taxation model more conducive for job creation.

Reform of the financial system, already at an advanced stage, needs to be completed. This is vital for consolidating growth through the granting of credit to companies and in particular smaller businesses that can then become bigger. Doing this is compatible with reducing debt in over-indebted parts of the private sector such real estate. This process can also be combined with getting credit flowing to companies with good future prospects. This can be achieved by implementing the right measures for small business lending.

The labour market needs to improve faster, too. Over the last 30 years we have lived with a dysfunctional labour market, where each poor economic cycle resulted in unemployment rates of over 20%. The 2012 labour reform has alleviated some important and long-lasting problems such as lack of flexibility in wage negotiations and high redundancy costs for some privileged sections of the workforce, which makes it more difficult for new workers to enter the labour market with permanent contracts.

BBVA Research estimates that wage moderation following the labour market reform and trade union and corporate agreements has avoided the loss of 60,000 jobs in the short term. This wage moderation would have avoided the loss of 1m jobs had it started in 2008.

More must be done to accelerate job creation. This requires generating active employment policies, increasing incentives for hiring permanent employees, providing employee training, and doing whatever it takes to reduce the duality between permanent and temporary workers. For these measures to be truly effective, it is essential to increase competition in closed sectors and make it easier to set up new companies by removing barriers to business formation. Spain is perfectly capable of returning to growth rates over 2%. The task would be facilitated by additional reforms at home and more decisive European moves towards a stronger and more integrated euro area.

Spain can do its own homework and has already made impressive strides. The achievements will be all the greater if they are matched by positive action in the rest of Europe too. ▪

Jorge Sicilia is Chief Economist of the BBVA Group and Director of BBVA Research.

Reasons for Czech investment drop

Foreign investment may bring vulnerability

Eva Zamrazilová, Czech National Bank

Before the crisis the Czech economy was growing at rates well above those of its 'old-Europe' (EU-15) counterparts with no obvious macroeconomic imbalances or inflationary pressures. A sharp drop in 2009 and a modest recovery in 2010 and 2011 were followed by six quarters of recession.

The economy pulled out of recession in the second quarter of 2013 mainly due to exports, which benefited from a moderate increase in economic activity in the Czech Republic's major trading partners, notably Germany. Household consumption is starting to stabilise slowly as households gradually absorb the increase in prices caused by rising indirect taxes and respond to the better news from the global economy. Investment demand however remains very weak.

Investment slump

Gross capital formation is down almost 25% in absolute terms from the historical high attained in the first quarter of 2008, just before the crisis broke out. During the crisis, investment activity recorded a slump comparable with historical data from the Great Depression. This slump deserves closer attention.

Investment demand is treated as a component of domestic demand, but unlike household demand it does not depend solely on the economic condition of, and sentiment in, the Czech economy. The foremost factors here are export performance and external demand. However, exports of goods and services were 15% higher in the second quarter of this year than at the start of 2008, so the downturn in exports during the crisis cannot explain such a dramatic and sustained weakening of investment activity.

Why has investment activity declined so strongly? There is a general consensus that the pre-crisis success story of the Czech economy was largely due to foreign direct investment (FDI). The Czech Republic was one of the most successful countries in terms of attracting FDI. Czech FDI inward stock – amounting roughly to two thirds of GDP – is not only one of the highest in the central and east European region, but is also well above the global average.

Foreign-controlled companies

Foreign-controlled companies have helped boost Czech exports, and industry generally, with some positive spillovers to domestically-owned companies. However, those spillovers have not been strong enough to prevent the emergence of a dual economy consisting of more efficient and profitable foreign-controlled companies and purely domestic laggards. Foreign-controlled companies have been generating around 75% of direct export sales in industry – the backbone of the Czech economy.

The contributions of multinationals in the business sector to employment and gross value-added have been stable, at around one third and one half respectively, since 2006. Differences in productivity are evident. The contribution of multinationals to profits generated in the business sector is stable, amounting to two thirds. Moreover, the Czech economy is in the 'World Top Twenty' in terms of return on equity from inward FDI (UNCTAD: FDI database), which amounted to 13% in 2011.

While the contributions of foreign-controlled companies to employment, gross value-added, and profits have remained stable, their contribution to investment in the business sector has declined from 46% in 2007 to 40% in 2011. There is a clear discrepancy between the contribution of foreign-controlled companies to profits and to investment. This may partly explain weak investment demand in recent years.

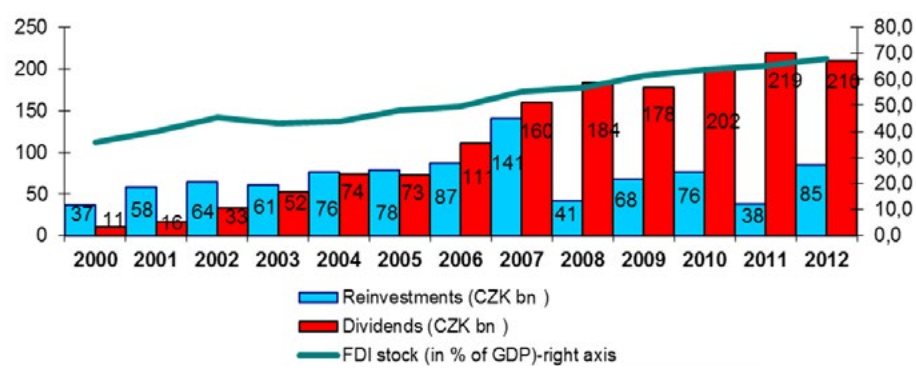
With the onset of the crisis, foreign-controlled companies fundamentally changed their strategy for splitting profits between reinvestment and dividend payments to foreign owners. In contrast to the roughly fifty-fifty split before the crisis, reinvestment in Czech companies has accounted for no more than 25% on average over the last five years.

We have to bear in mind that the timing of the crisis and the natural life cycle of FDI might have been coincidental. It is natural that after their initial investment, owners have to invest a larger share of profit until the company gets into a good and profitable shape. On the other hand, the long-term ratio between the reinvestment and repatriation of profits is only slightly below fifty-fifty according to long-term international studies by the United Nations Conference on Trade and Development (UNCTAD).

The fact is that parent companies of Czech foreign-controlled firms are almost exclusively from countries hit hard by the crisis. The profit of Czech subsidiaries can thus help solve the existential problems of their parents. Simply put, the children are feeding their parents. We can only speculate on the long-term consequences of such policy for Czech companies: living on capital, and a lack of technological innovation to name a few. The traditional argument explaining weak investment demand – insufficient capacity utilisation – may mask the fact that capacity created before the crisis will gradually become outdated. The condition of, and sentiment in, the global economy will therefore be crucial not only for Czech exports, but also for the investment and overall growth potential of the Czech economy. ■

Eva Zamrazilová is a Member of the Board at the Czech National Bank.

Profits of foreign-controlled companies in the Czech Republic



Source: Czech National Bank, 2012, author's estimates

Salutary lessons from slowdown

Home-grown shortcomings are mainly to blame

Vilém Semerák, Advisory Board

Ahead of the 2008 financial crisis, the Czech Republic was a success story. The economy was growing fast, the currency was gradually appreciating, unemployment was falling and public debt remained low. The financial sector was stable due to the consolidation and privatisation of banks during 1990s. There were only two minor flaws.

The government failed to use the opportunity significantly to reduce deficits. And the supply of new jobs generated from exports (mainly via investment projects financed from abroad) led to labour shortages. By 2008, the labour market suggested that the Czech economy was close to overheating. The fall from grace has significant implications for other countries within and beyond Europe.

Fundamental health during financial crisis

The Czech financial sector was fundamentally healthy in 2008. Not only were banks' balance sheets clean of non-performing loans, but local (foreign-owned) banks had not amassed any significant amounts of the assets which subsequently became toxic. Thanks to the conservative behaviour of borrowers and lenders, there was a much lower share of foreign currency-denominated loans in total loans to private sector (below 10% in 2008 compared to over 85% in Estonia).

The Czech financial sector did not require direct financial assistance. However the economy was hit by a significant and sudden decline for its exports. Low dependence on the supply of foreign liquidity meant that effects of the sudden freezing of flows to central and eastern Europe were small. Private consumption thus continued to grow in early 2009. While GDP dropped by 4.5% in 2009, the Czech economy was the second least-hit country, after Poland, in central and eastern Europe during 2008-10. It began to return to growth in the third quarter of 2009.

The Czech recovery stalled in mid-2011 and turned into a recession while other central and eastern Europe countries continued to grow. Even countries which suffered a much worse initial combination of shocks, such as the Baltic countries, caught up and eventually overtook the Czech Republic. This development was not simply due to the adverse external environment caused by the debt crisis in Europe; after all, other central and eastern European countries share significant dependence on EU markets. The reasons for the different behaviour seem to lie in fiscal policies and in political dynamics, which had a substantial effect on consumer and business confidence.

While the Czech Republic had very low public debt initially (29% of GDP in 2008), the dynamics of the debt and differences between planned and actual deficits were disconcerting. The Czech government opted for its own austerity programme in the form of expenditure cuts and VAT increases. The original strategy would have had positive effects on debt stabilisation if it had been designed and implemented properly and if the European Union had returned to growth.

However, the programme was undermined by numerous accusations of high-level corruption and abuse of public funds, combined with a reduction of nominal incomes in the public sector, higher inflation caused by VAT changes, increasing unemployment and the constant crisis in the euro bloc. This further dampened private sector expenditure and investment.

By early 2011 the real growth of final consumption in the Czech economy turned negative. The lacklustre performance of Czech exports was insufficient to keep GDP growth in positive numbers. The financial sector and monetary policy played a relatively passive role in this development. The financial sector remained fundamentally healthy and was swimming in liquidity, but the willingness to maintain low policy rates clashed with negative expectations of consumers and investors.

The effort to stabilise public budgets was less than convincing. The initial improvement to a deficit of just 3.3% of GDP in 2011 was followed by a widening of the gap to 4.4% in 2012. The public debt to GDP ratio increased from 37.9% in 2010 to 45.9% in 2012. This meant that the position of the Czech Republic worsened relative to that of its neighbours.

Latest GDP data show that Czech GDP grew in the second quarter of 2013, with a rise of 0.6% quarter on quarter. This suggests that the Czech economy is finally emerging from its protracted recession. The economy may return to growth in 2014. The export sector was the main influence behind this result, although private consumption and government expenditures also show signs of stabilisation. These trends are likely to continue: exports will increase thanks to a gradual calming of adverse economic conditions across Europe. If a new government comes to power in Prague in forthcoming elections, public expenditures are likely to rise – and this will have a deleterious effect on attempts to stabilise public debt.

The Czech experience shows that, however high is the temptation to blame negative experiences on factors beyond the borders, the most negative effects normally stem from a country's own actions, not from those of other people. ▪

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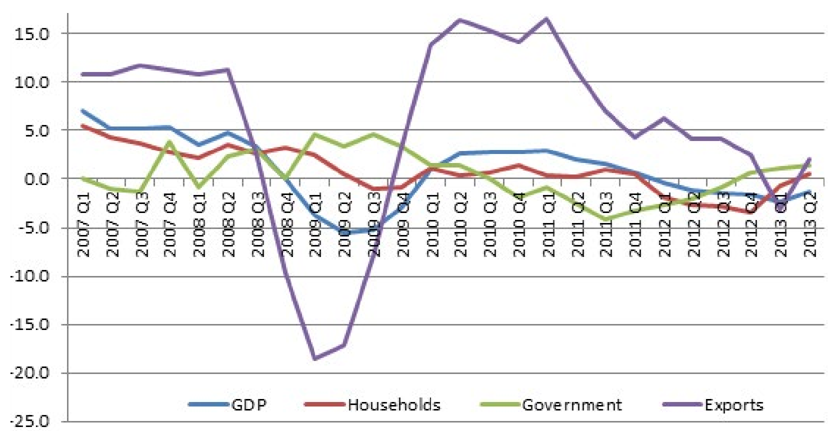
Changes in volume of main categories of demand and GDP (%)



Source: Czech Statistical Office

Signals on timing of Chinese reforms

PBoC hints on shift in liberalisation plan

Simon Derrick, BNY Mellon

If 2011 and 2012 were the years when the debate over foreign exchange, interest rate and capital account liberalisation took shape in China, then 2013 appears to be the year that meaningful plans are being put in place.

The first sign of this emerged in a Reuters report in early March. It quoted 'sources with knowledge of the latest PBoC thinking', explaining that the central bank was set to abandon a timetable approach to liberalising capital controls, moving instead to a series of reforms that would give more freedom to invest offshore currency deposits (currently around Rmb1tn) on the mainland.

By doing this the PBoC reportedly believed the economy would be shielded from the risk of a 1997-98-style Asian currency crisis that could be triggered in the wake of liberalisation. Reuters quoted a 'former top official in the PBoC's international division' as saying: 'Responding to foreign demand for renminbi products would be the best way of maintaining momentum for capital market and capital account reforms. The bank is worried about opening up the capital account because when it does, it knows that anything could happen. But if you give investors a market-based reason to hold renminbi, they will.'

A second source told Reuters: 'Improving international access to domestic capital markets is key. Without this, there is no chance for the renminbi to become a true reserve currency.'

Signals have continued to emerge that 2013 could see some significant developments on the policy front. The National People's Congress in late March brought a pledge from Premier Li Keqiang that China would introduce measures for currency reform and interest rate liberalisation, and participants at an International Monetary Fund seminar in April told the Wall Street Journal that PBoC officials had made clear they were moving ahead with liberalising the capital account.

Further detail of the timetable for currency reform came a month later in May in a paper co-written by a senior researcher at the PBoC, stating that the bank aimed to make the renminbi fully convertible by the end of 2015. The same month saw the State Council state that the government would outline a plan for full convertibility of the renminbi by the end of this year, while PBoC Governor Zhou Xiaochuan told a financial forum in Shanghai in June that China would speed up the opening up of its capital account (though he noted the process would be flexible enough to re-impose restraints in the event of big speculative capital flows).

PBoC Governor Zhou Xiaochuan

There appears to be some evidence of a degree of impatience with what is seen as the previously slow pace of reform. This is apparent from the response to the State Council's announcement in July that it was establishing a pilot zone in Shanghai to test interest rate liberalisation and full convertibility of the renminbi. One senior financial official told the Wall Street Journal on 18 July: 'It's hard to carry out financial reforms only through those pilot programmes. It has to be planned on a national scale.'

So what could the next step look like? One clue came in a front page commentary published in the China Securities Journal on 19 July. The paper argued that the government should expand the renminbi's trading band to increase flexibility, which could ease expectations of further appreciation and mitigate the risks of intensive capital flight triggered by the Fed's exit from quantitative easing. The paper also argued that the renminbi central parity should be linked more closely to closing prices on the spot market and that the government should speed up capital account convertibility. Given that the Journal is sponsored by the Xinhua News Agency which, in turn, is subordinate to the State Council, this might well have given an indication of the most recent official thinking on this key issue.

In fairness, it seems unlikely that any move to widen the band will happen this year. Governor Xiaochuan has said (in an interview with state television on 19 August) that 'I don't think there will be any big adjustment (in monetary policy) in the second half of the year.' This, presumably, would preclude the idea of a significant shift in currency policy. Nevertheless, given that the State Council's promise in May, it seems reasonable to expect at least some guidance about the timetable for liberalisation over the next few months. With this in mind it is worth noting that the third Plenary Session of the 18th Communist Party of China (CPC) Central Committee is now scheduled for November. This could provide the venue for thought-provoking news on the foreign exchange front. ▪

Simon Derrick is Chief Currency Strategist at BNY Mellon.

The monetary policy triangle

Increase in uncertainty for decision-making

Philip Turner, Bank for International Settlements

The monetary and financial stability policy choices facing emerging market economies have been changed in a major way by the development of a market-driven long-term interest rate in most emerging market economies.

The deeper integration of emerging market economies into global debt markets has made them more sensitive to changes in monetary and financial developments in advanced economies. A crucial change has been a transformation of local currency debt markets in emerging market economies over the past decade or so. Marketable local currency bonds outstanding now amount to $5-6tn – compared with only $1tn in 2000.

These markets have become much larger, more closely integrated with global bond markets; they have grown larger in maturity and importance. In many cases, non-residents now own 25% or more of all marketable government debt. It has become much easier for emerging market corporations to borrow in capital markets – local and foreign.

Decline in the term premium

Bonds issued by non-financial corporates have gone from $60m in 2000 to well over $1tn by mid-2013. Since 2005, emerging market local currency bond yields have moved closely with US yields – which was not the case earlier. Global bond markets over the past decade have been dominated by a phenomenon that is not fully understood – the decline in the term premium in 10-year US Treasuries (see Chart 1). Before 2005, most would have expected the term premium to be between 100 and 200 basis points, where it had been for much of the 1990s and early 2000s. Since 2005 – that is, even before the recent crisis – it has generally been below 50 basis points.

Whatever the causes of this extraordinary and long-standing shift, the impact on emerging market economies has been huge. The decline in the yield on Turkish government bonds – from around 15% in early 2009 to just over 5% in early 2013 – was remarkable. The nominal long-term yield in a sample of other major emerging market countries fell from an average of about 8% at the beginning of 2005 to around 5% by May 2014. Using the year-on-year change in consumer prices, this amounted to a real long-term interest rate of just 1% last year. Such low real rates must have had a pervasive impact on fixed investment and financing decisions.

But between May and August 2013, global bond yields rose and the term premium in US Treasuries has moved closer to zero (but is still negative). This substantial rise in long-term rates happened without any change in the policy rate in the US and in the face of assurances by the Fed of no near-term rise. In this sense, it was triggered not by monetary policy tightening but by some shift in expectations.

The 5-year forward 10-year yield, which should be free of changes in expectations about near-term short-term rates, rose from around 3½% in May to 4½% in late August. This is slightly below the 5% that the standard explanatory factors such as inflation expectations, trend GDP growth, expected future government debt and Federal Reserve purchases would suggest (see Chadha et al, 2013). This may indicate that much of the apparent mispricing earlier in the year has been reversed. But because the causes of the long downward movement in the term premium are not understood, no one really knows.

Monetary conditions in an open economy change not only when the short-term policy rate changes, but also when the exchange rate changes. Some central banks have developed indices of monetary conditions based on summing these two variables. Whether formalised in such a way or not, the exchange rate matters for monetary policy decisions in emerging market economies.

Over much of the pre-crisis period, very low policy rates in the advanced economies led to strong exchange rate appreciation pressures in many emerging market economies. As currency appreciation lowers aggregate demand, many felt that any domestic need to raise the local policy rate had been eased.

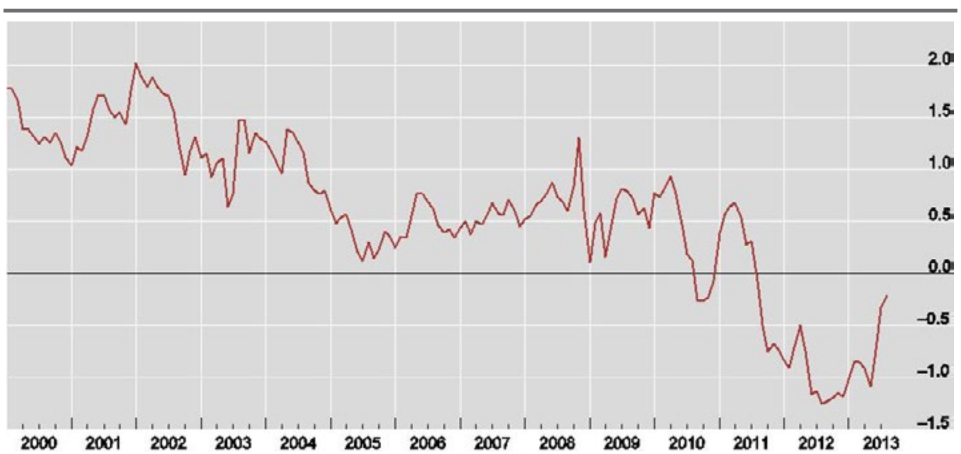
Domestic long-term interest rate

The new factor in many emerging market economies over the past decade is the greater importance of the domestic long-term interest rate. This factor has become an important intermediate target of central banks in advanced economies. The Fed, the Bank of Japan and the Bank of England have all purchased government bonds on a massive scale to lower the long-term interest rate and stimulate aggregate demand.

Therefore, monetary conditions could be characterised along at least three dimensions: the short-term policy rate, exchange rate, and long-term interest rate on government bonds. The lesson of policies over the past decade is that the central bank balance sheet can be used in attempt to influence both the short-term policy and exchange rate. So, some element of 'monetary policy target' has been added to the exchange rate and the benchmark long-term rate – though how effectively either can be controlled is an open question.

There is, in short, a monetary policy triangle (see Chart 2). If this characterisation

Chart 1: The nominal term premium on 10-year US Treasuries, %



Derived from econometric term structure models; Sources: Bloomberg; national data; BIS calculations is correct, it would carry three implications. The first is well-known: that any quantification of the stance of monetary policy must consider all three variables. Hence the impact of a higher policy rate may on occasion be outweighed by a lower long-term interest rate driven by foreign, not domestic, conditions.

This may well mean that the monetary policy stance in many emerging market economies has been much looser over the past two years (before May 2013) than a simple examination of the policy rate would suggest – because of the substantial fall in real long-term rates.

If an indicator including both the short-term rate and long-term rate indicates no change in the overall stance of policy – meaning in its impact on aggregate demand – could the central banks then relax? The answer is No. The policy rate and the long-term rate affect different components of real GDP. A higher policy rate lowers domestic consumption while a lower long-term rate may stimulate house building and other long-term investment projects. Similarly, a higher interest rate lowers domestic demand, while a higher exchange rate lowers external demand. Central banks and governments will not be indifferent to these different outcomes.

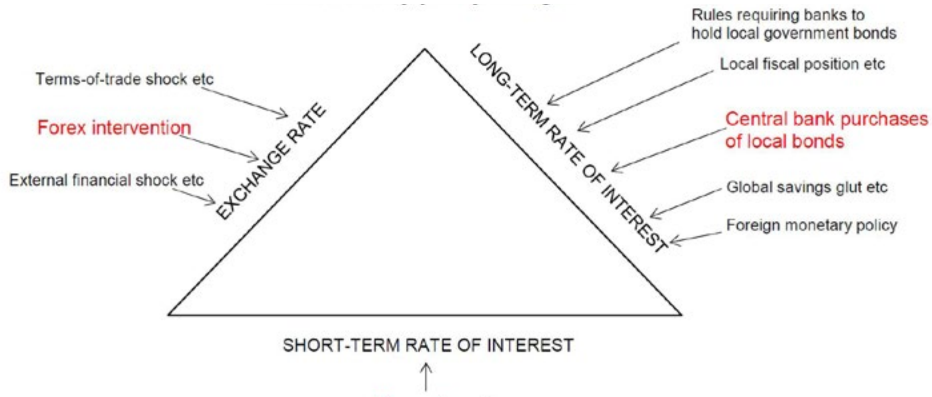
Second, the stance of monetary policy becomes more uncertain. The central bank may influence but cannot precisely determine the long-term rate or the exchange rate. Sharp market-driven movements in either may be regarded as transitory so the central bank would normally prefer to wait before reacting.

The source of market shocks matters: for instance, an exchange depreciation from a decline in export prices stabilises real income. But a sharp depreciation from a sudden stop financial shock may not be so welcome on monetary policy grounds. Current pressures in both foreign exchange and bond markets in many emerging market economies illustrate such uncertainty. Depending on how expectations change, an increase in the policy rate has an ambiguous effect on such markets. And the impact of central bank transactions on asset prices is itself uncertain.

Further, during episodes of market turbulence, the aggregate demand effects of exchange rate changes (currency depreciation providing stimulus) and of bond market changes (higher yields curbing demand) will be of opposite sign. This uncertainty complicates the decisions of central banks and their communication.

Third, monetary policy independence is weakened. Without capital controls, and assuming the country's credit standing is constant, changes in the long-term rate will be heavily influenced in global markets. This loss is independent of the country's choice of exchange rate regime. A BIS Working Group agreed in 2009 that capital controls could, 'at least in the short-run, help monetary policy by moderating the size or the volatility of inflows.' How this unravels in the face of a long-sustained anomaly in global financial markets – a zero or even negative term premium – is of course another story.

Chart 2: The monetary policy triangle



The central bank can use the policy rate and can buy or sell foreign exchange and government bonds

The long-term interest rate

The long-term interest rate is fundamental for financial stability. It is the foundation of the financial system and must be a key focus of any macroprudential policy orientation. In the absence of sovereign default risk, the long-term interest rate on government bonds defines the credit risk-free maturity transformation over time. It provides the basic discount rate, thus central to the pricing of all long-term assets. When the long-term rate is 'too low,' the prices of long-term assets can rise 'too high.' It influences the market value of assets that potential borrowers have as collateral for getting new loans.

A negative term premium can become a systemic concern if sustained for very long. Households individually (and via their unregulated collective savings vehicles) decide not commit their savings to longer-term instruments. They may calculate that they can earn more by investing in, and rolling over, short-dated papers. But prudent borrowers will want to finance fixed capital formation (in long-term physical assets) with long-term debt rather than short-term debt.

Hence the financial system will be called upon, one way or another, to bridge the wider gap between savers' preference for short-term assets and borrowers' preference for long-term debt. That is, financial intermediation will have to provide greater maturity transformation. Exactly which bits of the financial system are doing maturity transformation now, we do not know. There is no agreed, simple metric for measuring how much a particular bank or insurance company is doing. Nor is it known how much maturity transformation is done within the emerging market economies, and how much is done abroad.

Word of warning

A warning for the emerging market economies is that the severity of the recent financial crisis in the advanced economies owed much to excessive but largely hidden maturity transformation by firms that were ill-equipped for this. Some financial products masked true maturity risks. Many investors took highly leveraged positions in long-term assets with short-term finance.

Before the last crisis, unusually low volatility in bond markets and a positive term spread seemed to offer investors an almost assured profit from borrowing short to buy bonds. Central banks in emerging market economies will have to think very carefully about the size of the term premium in the yield curve for their own government bonds, about the desirable degree of volatility in these markets and about how maturity transformation in their financial system is changing.

Many emerging market economies are now grappling with a sharp simultaneous fall in their currency and in the prices of their government bonds. The difficult decisions that central banks face on their policy rate and on the best use of their balance sheet have seldom been more complex. ■

Philip Turner is Director of Policy, Coordination and Administration and Deputy Head of the Department Monetary and Economic Department at Bank for International Settlements.

Unwinding of liquidity has silver lining

Emerging markets may speed up structural reforms

Otaviano Canuto, Advisory Board

Summer was marked by a strong pressure of capital outflows and exchange rate devaluations in several systemically relevant emerging markets. A global portfolio rebalancing was put in motion on 22 May, when talk of the US Federal Reserve shrinking – and eventually reversing – its asset purchase programme, quantitative easing (QE), was made public.

The global portfolio adjustment – away from countries/markets deemed as vulnerable to QE unwinding and toward those whose prospect improvement has justified a possible future policy change – follows previous movements in the opposite direction. This has been seen as universally bad news for emerging markets. However, there are reasons to believe that apparently the dark cloud of QE reversal may contain an important silver lining.

Gloomy prospects

We have seen a massive capital reallocation and associated changes in leverage capacity moving from advanced to emerging market economies. Gloomy prospects for advanced economies and the euro area crisis, combined with diverse channels of transmission for QE, provided the impetus for portfolio shifts to emerging markets, helped by their post-2008 resilience.

The world witnessed a very significant increase in assets and exposure to emerging markets in 2009-12. This was despite capital controls and other measures adopted by countries that were the object of unwelcome inflows. Therefore it is not surprising that another large wave of portfolio rebalancing has been generated by expectations that monetary policy transmission will go into reverse. The announcement of future 'tapering' of the Federal Reserve's asset purchases, to be followed by an eventual shrinkage of the central bank's balance sheet, was enough to spark a major turnaround. News on a growth slowdown in major emerging markets contributed to this outcome.

The 22 May announcement from the Fed, signalling some confidence in the US recovery, led to an immediate rise in 10-year Treasury bond rates, triggering a massive unwinding of long positions in emerging markets. The reversal was particularly sharp in emerging markets with current account deficits that are prone to exchange rate devaluations.

The magnitude of previous capital flows pre-figured the size of the subsequent realignment of global portfolios, amid conditions that some market participants described as 'mayhem.'

The effects of the announcement of a prospective reduction of Fed monthly asset purchases were felt immediately, well before announcement of any start date. There have been forecasts that US long-term Treasury yields could skyrocket when the Fed begins to shrink its balance sheet toward more normal levels. Some commentators have predicted that future unrest could make the current turmoil look relatively insignificant. However this is not necessarily true.

Fed balance sheet expansion

The Fed's balance sheet expansion has not been much greater than the world's demand for money. The evolution of 10-year Treasury yields accompanying the quadrupling of the US monetary base does not indicate that the Fed has been systematically pushing for abnormally low 10-year yields.

There are grounds to believe that the Fed has mostly accommodated the private (bank) demand for 'excess reserves.' Therefore, one might expect that, provided that the US economic recovery settles in and private demand for long-term bonds normalises, the Fed will not have to dump huge quantities of unwanted assets on the market. This counters fears that we will see very large discounts and substantially higher interest rates. There is no reason to expect that the Fed will risk derailing the recovery by going in this direction.

Another important reason for not expecting sharply higher US interest rates is that there is no sign of a rise in US inflation. Inflation expectations also remain solidly anchored at a low level. This means that the US economy is likely to remain a low inflation environment for some time. Despite all the gloomy predictions, I believe that, as a result, emerging markets economies are not as vulnerable to credit setbacks as they were in previous periods of global interest rate hikes.

One big issue is the prevalence of exchange rate devaluations in some major emerging market economies. This reflects these economies' need for flexibility in their currency regimes, in stark contrast to the pegged exchange rates that in the past made emerging market economy currencies evident targets for large-scale speculative attacks on the currency markets.

Furthermore, reserve asset stocks are much larger than in the past, providing a sizeable cushion against unwelcome currency buffeting. In addition, both corporate and public sector indebtedness in most emerging market economies is in a much less fragile state than during previous bouts of turbulence that sparked off the various 1990s crises.

Another favourable factor is that the proportion of equity-like investment and domestic currency-denominated debt is much higher in these economies than it was 20 years ago. Finding the right policy responses will be challenging, but – although some countries do face substantial vulnerability – there is more room for policy to react in a stabilising fashion than during previous shifts in global portfolio realignment.

Procyclical consequences

Another important point needs to be taken into consideration: a mismatch between adjustment measures by countries in different states of development. In advanced countries, unconventional monetary policies have necessarily been anti-cyclical in recent years as part of measures to combat recession. However, these measures have had inappropriately pro-cyclical consequences on emerging markets – boosting credit and demand when most economies among the latter were already heating up. The result has been to magnify the scale of the eventual slowdown.

Regardless of the role played by liquidity flooding into emerging markets, these countries have in general been too complacent over the need for structural reforms. All in all, unwinding QE policies may ultimately be good news for emerging markets, especially if the withdrawal of global liquidity is followed by a sharper focus on promoting country-specific reform and restructuring. ■

Dr. Otaviano Canuto, member of the OMFIF Advisory Board, is Senior Advisor on BRICS Economies and ex-Vice President at the World Bank.

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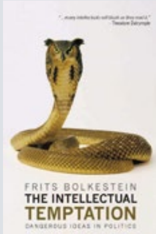
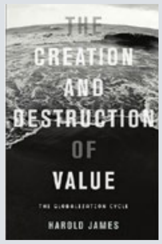
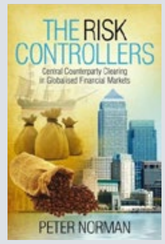
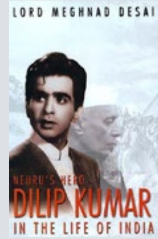








Why more market integration is needed

Over-dependence on exports is dangerous

Lorenzo Bini Smaghi, Harvard University

Imbalances within the euro area before the financial crisis were created primarily by deficit countries as a result of excessive growth of consumption and wages that were not in line with productivity. The correction of imbalances therefore had to fall mainly on deficit countries. Demands for symmetrical adjustment, in which surplus countries, too, would have faced the burden of adjustment, advanced on several occasions in particular by Christine Lagarde, who at the time was France's finance minister.

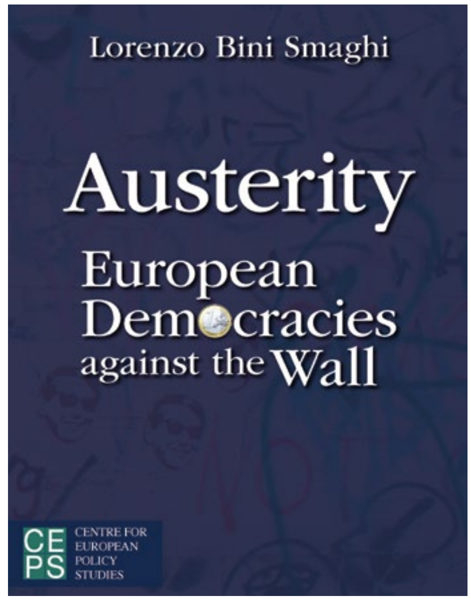
These demands have always been rejected by Germany. Wolfgang Schäuble, the finance minister, has habitually noted that competitiveness is earned with wage moderation and by investing in research and development. He says Germany's finances are too fragile to risk being jeopardised by expansive fiscal policies that would have a limited impact on demand for exports from uncompetitive countries. With world trade ever more integrated, global competitiveness cannot be measured only within the euro area, but must above all be determined in comparison with of the rest of the world, including emerging market economies.

From the German point of view, the external surplus is not the result of policy choices, but rather Germans' high propensity to save due to worries about an ageing population. According to this view, a mature economy like the European Union should have an external surplus and should export capital to faster-growing less developed countries. The Germans' strong propensity to save, moreover, reflects a system of taxation that tends to penalise consumption.

The adjustment of euro area imbalances depends in part, too, on the general context. So far demand for German products from emerging countries has partly offset the decline from European countries members carrying out fiscal adjustments. Therefore Germany has been affected only minimally by the euro area's fiscal problems. The decline in German interest rates that followed the European Central Bank's accommodative policies and the influx of capital from other countries has created favourable conditions for growth of consumption and investment. Wages began to grow faster in Germany than in other countries. Yet Germany's favourable situation could change if the world economy slows, especially in emerging markets.

All in all, it is inevitable that the recovery of competitiveness by deficit countries will change their growth model. They will shift to less dependence on the domestic market and greater exposure to international markets. This development may be desirable for the countries of southern Europe relatively closed to international trade. But for the euro area as a whole, the largest economy in the world after the US, overdependence on external demand risks tying growth too much to exogenous developments beyond European control.

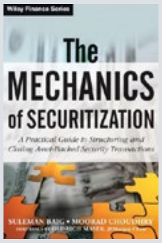
A 'German' euro area, with an economy that is more reliant on exports and not counterbalanced by a more 'European' Germany – with a more developed internal market – risks growing more slowly. It will be more susceptible to shifts in the world economy. To guard against this, it is not necessary to have more coordination of national fiscal policies, as is often urged. The margins for strengthening common procedures were expanded with measures adopted in late 2011. What is needed is more integration of national markets to create a true single market that will make it possible to develop autonomous growth on the continent.

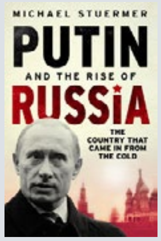


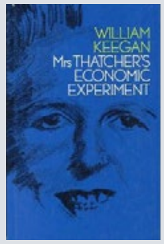
There are ample margins for greater economic integration as highlighted in the Monti report presented to the European Commission in May 2010. The unfortunate timing of this report, coinciding with the outbreak of the euro crisis, encouraged European institutions to give priority to emergency measures.

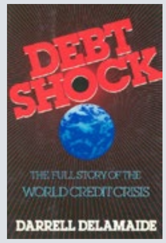
In many respects, particularly with regard to finance, the crisis led to a renationalisation of markets. It is time to get back to basics for Europe and adopt new integration measures to favour adjustment of imbalances and create the basis for more balanced growth. That is an important element of the way forward that will also help produce a more stable and prosperous world economy. ■

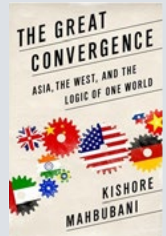
The article above is an extract from Austerity, published by Centre for European Policy Studies. Dr. Lorenzo Bini Smaghi, former Member of the Executive Board at the European Central Bank, is Visiting Scholar at the Program on Transatlantic Relations at Harvard University.

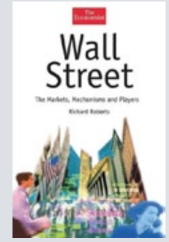












Pakeezah, a Bollywood classic

Tale of love in a train compartment

Meghnad Desai, Chairman, Advisory Board

My latest book, Pakeezah: Ode to a lost era, published by Harper Collins India, is on a Bollywood classic film which was released 41 years ago in 1972. It had been 17 years in the making. The story concerned two 'dancing girls'; one the Mother Nargis, who dies quite young, jilted by her lover to whom she bears a child, who grows up to follow her mother's profession under her aunt's supervision.

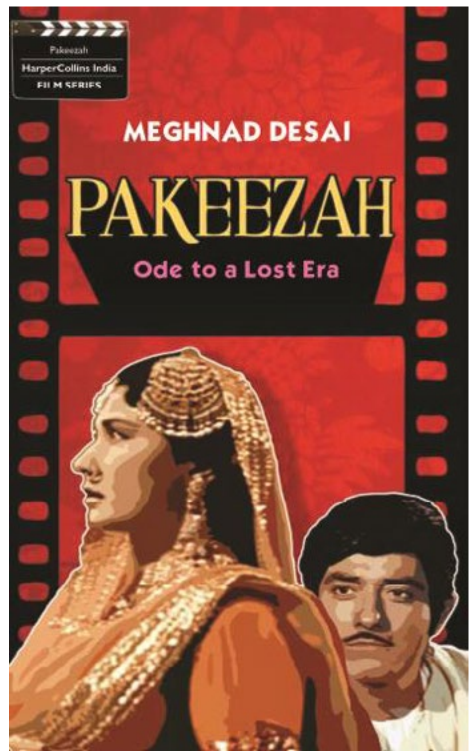
As Sahibjaan she performs dances for her clients in the Delhi quarters where many such girls perform. Her mother's lover discovers he has a daughter 17 years after the event and comes looking for her. Her aunt takes her away to Lucknow where she resumes her career in an exclusive palace. There are rich patrons who want her exclusive services. But on their way from Delhi to Lucknow, a stranger has come in her train compartment by chance.

While she is asleep, he admires her beauty and pens her a compliment which indicates he is infatuated by her. Sahibjaan treasures this memory and by chance runs into the man, Salim, who is from a respectable and rich family. He is by chance the nephew of the lover who had jilted Nargis. Salim wants to marry her but she is aware that she is not the type respectable men marry. She runs away and rejoins her house. At the climax it is all revealed and she does marry her lover.

The heroine of the film Meena Kumari was a leading tragedienne of Bollywood in the 1950s and 60s and won several awards for best acting. The producer director was her husband Kamal Amrohi but they separated half way through the shooting. She became an alcoholic but when she realised she did not have long to live, she was reconciled with her husband and finished the film. It was released to much fanfare.

Then Meena Kumari died within three weeks of the release of the film in Mumbai. It became as if this was her personal story. Though the film ends happily she made it into a great tragedy by dying just in time. The film is one of a handful where Bollywood picks up a Muslim cultural theme. Lucknow was the capital city of the last great Muslim kingdom of North India. If you saw The Chess Players film of Satyajait Ray, you will have seen the story of the last Nawab of Lucknow. The film is soaked in nostalgia of a culture where dancing girls were a welcome part of the culture and were keepers of good manners, classical music and dancing arts. The film has superb music based on songs written by some formidable Urdu poets. It has dazzling costumes and was shot in Cinemascope and Eastmancolor. ■

Meghnad Desai, Chairman of the OMFIF Advisory Board, is Emeritus Professor of Economics at the London School of Economics.



Hans-Olaf Henkel, former president of the Federation of German industry (BDI), a former euro supporter turned into a full-time sceptic on the single currency, doesn't believe in taking hostages. In his latest book Die Eurolügner (The Euro Liars) Henkel attacks monetary union with undisguised venom. Henkel supported the single currency in its early years on the grounds that it would shore up stability in countries outside Germany and help German exports and prosperity. That sounded too good to be true – and it was. Henkel is too politically astute to think that the euro will simply wither and die. Nor does he think that the euro bloc will quickly dissolve into a hard money north and a soft money south segment – even though that is the solution that Henkel tirelessly advocates. Monetary union will limp on – bowed but undefeated. The same goes for Henkel on his voyage of discovery and provocation. ■

Force for growth and stability in Arabia

Sustainable, diversified growth in the GCC countries

Fabio Scacciavillani, Advisory Board

Countries with sizeable endowments of natural resources often find transforming underground wealth into prosperity for their citizens extraordinarily difficult. Historically, such countries all too frequently provide case studies for hopeless balancing acts and highly unforgiving economic precepts. Happily, the Arabian peninsula states of the Gulf Cooperation Council (GCC) show some positive counter-examples.

In the six GCC countries, Saudi Arabia, the United Arab Emirates, Qatar, Kuwait, Bahrain and Oman, a momentous effort is underway to upgrade infrastructure and effectively to anticipate demand in many fields. The realisation of ambitious infrastructure projects encompassing highways, airports, railroads, free zones, utilities and urban mobility has set in motion a virtuous circle: higher productivity and competitiveness have spurred a flurry of private domestic and international investments.

As a result, the GCC countries – with the exception of the short-lived debt crisis in Dubai – have displayed a remarkable resilience to the 2009 recession. Furthermore, the non-oil GCC sector has taken the lead in the growth process.

In an international business environment seeking patient, long-term funding, there is a large area of manoeuvre for sovereign funds in the GCC countries, which amount to a considerable force for investment growth and stability.

Sustainable growth

In well-known international cases, the academic literature has coined colourful descriptions from 'Dutch disease' to 'resource curse' to describe problems in a number of countries ranging from Mexico and Nigeria to the Netherlands. Tales are widespread of how windfalls can be wasted, destabilising the economy and underlining the social fabric.

Governments find it hard to resist the temptation to build consensus through short-term hand-outs and benefits to vested interests, especially where institutions lack solid roots. Nevertheless, lessons have been learned. A country such as Chile has designed one of the world's most effective fiscal frameworks.

The Arabian peninsula has been largely immune from vast-scale resource mismanagement. The drive to use hydrocarbons export revenues for diversifying the economy has been a major policy objective since the rise in oil prices in the early 1970s. At times the process followed an erratic path featured by various booms and busts induced by oil price volatility. But throughout these episodes, the countries of the GCC succeeded in sectors such as petrochemicals, energy intensive manufacturing and small enterprises predominantly serving the domestic market.

With the new century, diversification gained more powerful traction, thanks to a much more prudent fiscal stance combined with a determined strategy to create a knowledge-based economy.

Sustainable growth rests on two economic pillars: infrastructure and human capital. The latter pillar combines formal education, research facilities, on the job training and economies of networking. In the GCC, public investments in academic institutions and research have been considerable and have included women. The result will be incremental over the next decade, but in the meantime, the GCC is a magnet for top international professionals in all sectors and foreign companies, especially in the free zones. This is a development of great importance, triggering skill transfer and cross-fertilisation on a massive scale.

Institutional capital

Another critical – albeit immaterial – ingredient of growth is institutional capital. Economic liberalisation fosters the optimal allocation of public and private resources and talent. It must be combined with the quality of institutions and their governance, efficiency of the judiciary, property rights, and clarity of regulation. This materially affects the return on investment, labour market rigidity, unambiguous decision-making processes, and the timely implementation of measures.

The International Monetary Fund (IMF) has listed five areas to address. These include: greater trade integration regionally and globally, a catalyst for other important reforms; business regulation and governance reforms to ensure a level playing field for companies; labour market and education

reforms to expand employment opportunities and boost workers' protection; improving access to finance to sustain entrepreneurship and new ventures; public finance reform to streamline expenditures and reduce vulnerabilities to adverse shocks.

Sovereign wealth funds as a gateway

The next phase will hinge on the expansion of higher value-added sectors and new fields. In this effort, the role of sovereign wealth funds has become central. Given the clouds hanging over the global economy, the GCC countries have become an attractive destination for international investors and multinationals. Beyond these prospects in the GCC markets, the Arabian peninsula often provides the ideal platform – in terms of location, lifestyle and facilities – for Africa and India. These are two areas with vibrant demography in the next few decades, supporting growth prospects on par with those of China and southeast Asia.

Sovereign funds are allocating considerable resources to joint ventures with multinationals in search of equity partners to fund global expansion plans or advance new technologies. In essence these funds combine the long-term stability of public institutions with private sector tools to jump start a new engine of growth among the areas most open to foreign investors, gathering the largest pool of international talent in emerging market economies and providing up to date infrastructure.

All this creates considerable confidence that the GCC states will surmount their challenges and move forward to a brighter future. ■

Fabio Scacciavillani is Chief Economist at the Oman Investment Fund.