The Bulletin

October 2014
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Official monetary and financial institutions ● Asset management ● Global money and credit

Navigating the tempest

Renminbi floats into rougher seas

Claudia Buch on Europe's path to banking union
Meghnad Desai and Graham Hacche on IMF reform
Trevor Greetham on dollar and sterling strength
Julia Leung on Chinese liberalisation experiments
Ruud Lubbers & Paul van Seters on energy integration
Shumpei Takemori on next steps for Abenomics
Asset management: Norway v. Japan, Germany v.China

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African beginnings Global opportunities

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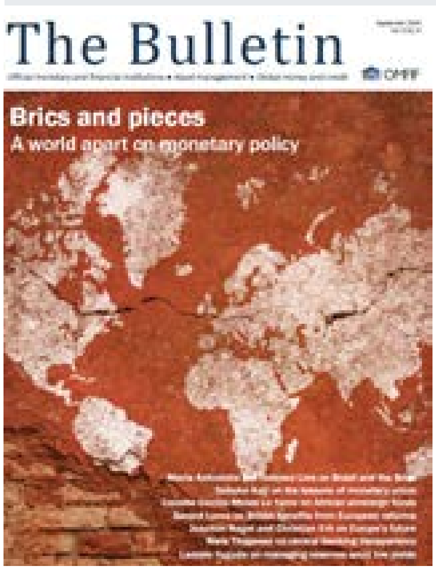
Cover story

Confrontation over restrictions on Hong Kong democracy is one of the factors clouding the renminbi landscape. As the Chinese authorities sail towards the rougher seas of financial liberalisation, Beijing may have to navigate the tempest. The October Bulletin, featuring issues likely to surface at the annual IMF/World Bank meetings in Washington, has a specifically Asian focus. As well as the course of Abenomics, we focus on fears that Hong Kong troubles could spread to the mainland, limits on the Shanghai experiment on financial reform, and China's task in managing its foreign assets. See p.20-21.



Asset allocation

In the first of a series, OMFIF looks at contrasts between Japan's and Norway's largest public sector asset managers as well as the different policies followed by China and Germany in husbanding foreign assets. See p.22-25.

International monetary policy

Europe and the euro

Emerging markets

Global asset management

Book review

Renminbi faces hurdles to enter reserves 'magic circle'

The renminbi could develop further as a world currency by entering the Special Drawing Right, the International Monetary Fund's composite currency unit used in official financial transactions and reserves. Beijing faces a challenge next year in meeting a number of criteria to move into the 'magic circle' of currencies ranked as official reserve assets. But measures already taken by the Chinese authorities to internationalise the currency, and a big increase in financial market interest in the renminbi, are pointing towards a possible broadening of the SDR's composition from January 2016, in spite of the renminbi's formal inconvertibility. The renminbi's addition to the reserve currencies in the SDR, currently comprising the dollar, euro, yen and sterling, has already been advanced by a ground-breaking decision by the British government to issue renminbi-denominated bonds, and allow the proceeds to be held in the UK reserves managed by the Bank of England, breaking two long-held taboos for the UK authorities.

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

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

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

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OMFIF's 159-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, weekly Commentaries, seminars and other OMFIF activities.
See p.18-19.

Bulletin

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

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

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

Diary dates

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

General information

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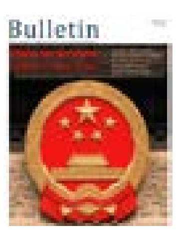

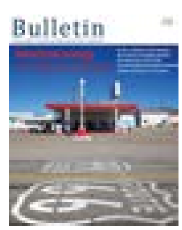

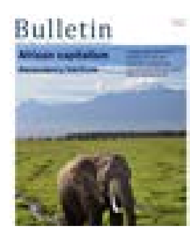

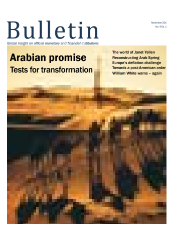

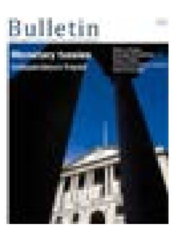

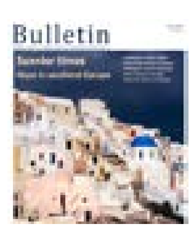

EDITORIAL

Renminbi shift adjusts Bretton Woods landscape

The contours of the word monetary order are evolving, and it is China and its allies who are moving them. The Bundesbank, which OMFIF visits again in October for our Fifth Main Meeting in Europe, once sought to prevent the D-mark from becoming an important reserve currency, for fear of losing monetary control – and ended up with the euro, a currency over which Germany has too little control for its own liking, yet too much in the eyes of some Europeans. By contrast, the Chinese authorities are now actively seeking a widespread international trade and investment role for the renminbi, including in official assets.

The UK Treasury, which tends to take a conservative line over international monetary affairs, has helped the Chinese buttress their own global currency credentials by announcing that it will borrowing in renminbi and hold the proceeds in the British official reserves. With a wide range of underlying motivations, China and other leading emerging market economies (Brazil, Russia, India, South Africa) back the notion of gradually dislodging the US from its primary position in today's unipolar world.

This shift in polarity, and the repercussions for the US, Europe, Japan and the emerging market economies, are all expounded in this month's Bulletin. The Brics are actively challenging the status quo by launching their own development bank. Graham Hacche writes that the rationale is much more complex than simply competition with the World Bank and International Monetary Fund. Meghnad Desai describes the institutional manoeuvrings as part of a much broader transition in the world economy.

All these changes can only be incremental. Julia Leung says the experiments in Shanghai's Free Trade Zone offer some key indications of China's future, but notes that the renminbi liberalisation practised there won't open the floodgates. Jonathan Fenby investigates the political strain on Beijing's relationship with its other great financial centre, Hong Kong, which continues to enjoy the legal system inherited from the UK, but is worried about never winning the democracy that the city's former rulers and its citizens believed was still more important for its future.

The British narrowly avoided losing another territory in September. Scotland chose not to separate from the UK, but the Yes-No gap was a mere 10 points. The UK is not the only EU member with a clouded outlook. Stefan Bielmeier dissects into four scenarios the future of Russo-German economic relations. The most likely outcome, he suggests, is not the most optimistic; a political and economic stalemate that restrains German growth for 2014-15. Ruud Lubbers and Paul van Seters are more optimistic, offering some praise for the European Commission's plan for a European energy union that can champion renewable energy and exert influence over gas purchases, reducing carbon emissions and tackling energy dependence on Moscow.

Shumpei Takemori compares the three-pronged plan for European economic revival championed by Mario Draghi, the European Central Bank president, with the vision of Prime Minister Shinzo Abe for achieving the same goal in Japan. One evident similarity: Abenomics, like the plan put forward by Draghi, offers more questions than answers. Abe, too, is behind the proposal for Japan's GPIF, the $1.3tn public pension behemoth, to shift assets out of debt and into equities, a move that we compare with that undertaken some years ago by another giant, but much more globally active, public investment institution, Norway's NBIM. We also focus on another instructive debt equity-comparison, between China and Germany, the world's No.2 and No.3 creditor nations. ▪

Scottish questions still unanswered

Financial markets and investors to remain wary

Colin Robertson, Advisory Board

Scotland's failure to vote for independence on 18 September led to very limited movements in UK financial markets. The lack of movement in sterling and the gilt market would appear to support the conclusion that much is still to be clarified and that we can expect a period of considerable uncertainty.

On the day of the result, trade-weighted sterling rose by less than 1% and the pound actually fell against the dollar. Gilt yields fell broadly in line with bond yields in the US and Germany while the UK equity market rose along with other equity markets. Although bookmakers' odds were heavily stacked in favour of a No vote, it is difficult to argue that the result was already priced into markets. The implication is that either the result was irrelevant – hardly likely – or the outlook has not been clarified. With any fall out in currency markets boosting UK corporate earnings, the reaction in the UK equity market was unlikely to be large. In contrast, currencies should reflect the domestic political and economic outlook and sterling has benefited over the last year from a relatively strong UK economy.

Likewise, the UK bond market should be affected by domestic factors and overseas investors' views of the UK. That neither market recovered strongly after the referendum spoke to some of the questions that have not yet been answered. Now that all the main political parties have promised further devolved powers to Scotland, it seems ironic that Prime Minister David Cameron insisted on a straight Yes/No vote for Scottish independence when nationalist leader Alex Salmond wanted a third 'Devo Max' (maximum devolution) option on the ballot paper. Due to last-ditch pledges before last month's independence referendum, Scots appear close to achieving maximum devolution anyway.

The new devolved powers will be developed in a rush, compared to more structured and thoughtful discussions which could have determined the 'Max Dev' referendum option.

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ADVISORY BOARD

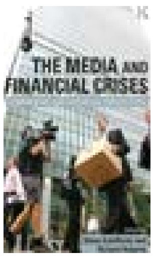
OMFIF has appointed Bronwyn Curtis and Irena Asmundson to the Advisory Board. For the full list of members see p. 18-19

Bronwyn Curtis, who becomes OMFIF's Chief Economic Adviser, is an economist and a widely published author and regular speaker on television and radio. She was head of global research at HSBC, and previously worked at Bloomberg where she was managing editor. Other roles include global head of currency and fixed income strategy at Deutsche Bank and chief economist at Nomura International. She has worked as a consultant for the World Bank and Unctad.

Irena Asmundson joined the California Department of Finance as chief economist in April 2013. She was previously a senior economist at the International Monetary Fund, where she covered policy issues such as global macroeconomic and financial imbalances and the international monetary system. She served as a staff economist on the President's Council of Economic Advisers, focusing on international trade.

BOOK REVIEWS

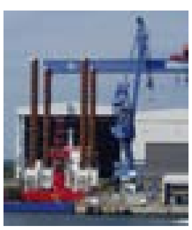
How the media deals with financial upheavals



In banking crises of yore, voluntary censorship ruled the media. To avoid fuelling panic and making matters worse, journalists kept schtum about the run on the Bank of England in 1914 and the shaky run-up to the devaluation of 1967. Today's generation of hacks do not feel as 'constrained or responsible' as their predecessors. Nevertheless, the business press has been frequently criticised, including by members of the journalistic profession, for failing to provide fair warning of the financial crisis. *The Media and Financial Crisis*, edited by Steve Schifferes and Richard Roberts, examines the role of the media in the run-up to the 2008 banking turbulence, and revisits episodes in financial history which will be instructive to everyone following economics. For review by William Keegan see p.26.

BRIEFINGS

German businesses mount pressure over Russian sanctions



Turmoil in Ukraine is having a deep impact on Germany's business with Russia and the whole of eastern Europe: 'We are falling off a cliff,' Folker Hellmeyer, chief analyst at the Bremer Landesbank, said in a telephone briefing on 3 September. It is unlikely to be a temporary shift, as Russian businesses are winding down their relations with European countries and forming new partnerships with the Eurasian region. Europe-wide stagnation and poor German growth figures show the extent of the loss of trade. Germany's lobby groups are in revolt, and pressure is building behind the scenes on Chancellor Angela Merkel to find a diplomatic solution with President Vladimir Putin.

Scotland stayed, but UK uncertainty continues

Scotland voted to remain in the UK with a 55% majority on 18 September, but the question of Scottish independence is unlikely to have definitively been dealt with, according to a telephone briefing on 19 September with Andrew Large, John Nugée, William Paterson and David Marsh. The speed with which it re-emerges depends on two factors: How and when promises of more money and power north of the border are fulfilled; and what becomes of the constitutional settlement of the UK. This includes the 'English question' and relations with Wales and Northern Ireland. 'The aura of reconciliation will continue until Scotland feels Westminster is reneging on its promises.'

EXPERT SEMINARS

Global Public Investor launches in Washington

A panel of international speakers including Clay Lowery, Vice President of Rock Creek Global Advisors; Sara Bonesteel, Managing Director and Head of Portfolio Strategy of Prudential Financial; Sonia Gibbs, Director of Institute for International Finance; and Rakesh Mohan, former Reserve Bank of India deputy governor, explored the growing importance of global public investors in capital markets at the Washington launch of OMFIF's *Global Public Investor* report on 22 September. The launch took place together with OMFIF's partners at the Atlantic Council. The study highlights how a recession-induced decline in interest rates in the major reserve currencies – the dollar and the euro – has had a seriously negative effect on the profitability of reserve holdings by central banks, adding to the drive for diversification. To this end, central banks around the world are buying increasing volumes of equities – one of the main topics of conversation at the launch.

WASHINGTON – 11 OCTOBER

Reigniting worldwide capital investment

The Fifth DZ BANK-OMFIF Washington Annual Meeting Breakfast focuses on how to increase investment in energy, infrastructure and enterprises. Panellists include Benoît Cœuré of the European Central Bank; Bertrand de Mazières of the European Investment Bank; Rakesh Mohan, former Reserve Bank of India deputy governor; Joachim Nagel of Deutsche Bundesbank; Gerassimos Thomas of the European Commission and Thierry de Longuemar of the Asian Development Bank .

LONDON – 13 OCTOBER

Fifth International Statesman Dinner with Marek Belka

Marek Belka, president of the National Bank of Poland and a former Polish prime minister with major experience at the IMF, is the guest of honour at the Fifth OMFIF International Statesman Dinner. This follows previous ceremonial dinners with Governor Zeti Akhtar Aziz of Bank Negara Malaysia, former German Chancellor Gerhard Schröder, former ECB President Jean-Claude Trichet and former Banque de France Governor Jacques de Larosière.

LONDON – 14 OCTOBER

Renminbi roadshow with International Monetary Institute

The International Monetary Institute of Renmin University and OMFIF is holding a half-day seminar on renminbi internationalisation and banking liberalisation. Featuring leading experts and industry practitioners, the seminar takes into account the increasing demand for capital market products in the Chinese currency as well as its growing use in official transactions. The seminar, at the Ballroom at the Mandarin Oriental Hyde Park, is part of a series that OMFIF is devoting to these issues in 2014-15.

FRANKFURT – 16-17 OCTOBER

Bundesbank scrutiny of international monetary system

OMFIF's Fifth Main Meeting in Europe, hosted by Jens Weidmann, president of the Deutsche Bundesbank, takes place at the Bundesbank headquarters in Frankfurt. Accommodative monetary policies have improved financial market conditions and gradually restored confidence, but as central banks across the world debate exit from unconventional policies, greater coordination is necessary to mitigate potential instability. Unfortunately, as a result of a number of imbalances and divergences, such coordination seems highly unlikely to be forthcoming. The meeting will focus on the outlook for world growth in 2015; the stabilisation of the euro area; creating equilibrium between emerging market and developed economies; the role of the dollar and other leading currencies in a multicurrency reserve system; and creating a better framework for banking regulation and supervision in Europe and beyond.

LONDON – 20 OCTOBER

Cœuré's view of managing economic and monetary union

At a lunchtime roundtable discussion, Benoît Cœuré, member of the European Central Bank's executive board, analyses the management of economic and monetary union and guidelines in the light of the ECB's latest measures to ease credit and ward off the danger of deflation. The measures, including purchasing private sector asset-backed securities, have attracted widespread criticism both for being overly aggressive and for not being muscular enough.

HONG KONG – 12 DECEMBER

Implications of China's financial liberalisation

The Fourth Annual Meeting of the Asian Central Banks Watchers Group, dedicated to an investment seminar on renminbi liberalisation, is at the Hong Kong Institute for Monetary Research (HKIMR), featuring a closed-door discussion among public and private sector participants hosted by the Hong Kong Monetary Authority (HKMA). Use of the Chinese currency on capital markets and in official transactions will be a particular focus.

How IMF's adaptability keeps it relevant

Brics bank is not a declaration of independence from the Fund

Graham Hacche, Advisory Board

The lasting relevance of the International Monetary Fund's mandate and its adaptability to changing needs, together with its accumulated know-how, still make the IMF an indispensable body in a crisis-prone world.

This is in spite of the myriad challenges to the organisation's role and authority, not least through the decision in July to establish a New Development Bank by Brazil, Russia, India, China, and South Africa.

Decision-making and quota shares

The combination of the IMF's importance and the continued question marks it faces over its governance structures underscores the need for early resolution by the US Congress of the impasse over reforming the IMF's decision-making and quota system, which has been put on hold for four years.

Unfortunately, the chances of a breakthrough on that front before the November 2015 presidential elections look virtually non-existent.

The so-called Brics countries' signing of a treaty for the establishment of both a New Development Bank and a contingent reserve arrangement (CRA) looked, on the face of it, like direct competition to the Bretton Woods institutions set up 70 years ago. The NDB is designed to boost resources for infrastructure and development projects, the CRA for the provision of liquidity through currency swaps 'in response to actual or potential short-term balance of payments pressures'.

The former is a major part of the World Bank's job, while the latter overlaps substantially with the IMF's tasks. The Brics' motive seemed clear from their communiqué: 'International governance structures designed within a different power configuration show increasingly evident signs of losing legitimacy and effectiveness.'

The Brics together account for about 27% of world GDP, but their capital-subscription shares ('quotas'), which largely determine their borrowing rights and voting shares in the IMF and World Bank, amount to only 11%. The difference is only partly explained by an understanding among the membership of the IMF that quota shares should take into account more variables than GDP and that changes in them should be smoothed over time. No one disputes the need for quota shares to be revised to better reflect the structure of today's global economy, especially the increased role of emerging market economies.

In 2010, the IMF's member countries agreed to reforms towards a more realistic distribution of quotas, with the Brics' combined voting shares rising to 14%. China's share rose from 3.8% to 6%, becoming the third largest after the US and Japan, and emerging market and developing countries gained two seats from EU countries on the IMF's 24-member executive board.

Adaptability and reform

The reform package included a doubling of quotas, and thus of the IMF's lending power, and an amendment of the IMF's Articles of Agreement to end the right of the five countries with the largest quotas to appoint their own executive directors, so that all directors would henceforth be elected.

Implementation of these reforms (as with all amendments of the articles and changes to quotas) requires an 85% majority of votes in the IMF. As of September, the package was ratified by 146 of the IMF's 188 member countries, representing 77% of total votes. But it has not been ratified by the US, which has 16.7% of the votes. So after almost four years, implementation is awaiting action by the US Congress.

Last spring, the IMF's ministerial steering committee said it was 'deeply disappointed' with the delay in implementing the reforms, which remained its 'highest priority'. Fred Bergsten and Ted Truman of the Peterson Institute have called the situation an 'existential crisis' for the IMF, because without the reforms its legitimacy is leaking away.

Yet the Brics July treaty also said, less obviously, that its five members still needed and trusted the IMF. Each country's access to credit in the CRA will equal what it puts into the pot, which will total $100bn.

But only 30% of each country's maximum access will be available without an IMF programme; the remaining 70% will be subject to compliance with an IMF financing arrangement and the associated conditionality. The Brics bank is therefore hardly a declaration of independence from the IMF.

Despite the question marks, the IMF remains an indispensable international organisation. The reason for this lies partly in the ingenuity of its founders in providing a charter with lasting applicability. It also reflects the organisation's adaptability to the changing needs of its membership and the global economy.

It is true that the IMF was established to serve a very different membership and global economy, to police changes in a system of pegged exchange rates that is long gone, and to promote the restoration of currency convertibility for current account transactions that has been largely achieved.

In addition it was designed to provide short-term financial assistance to ease the correction of current account imbalances in a world where, in stark contrast to today, capital flows were severely limited.

But in the intervening period the IMF has shown its capacity for adaptability on numerous occasions. One example is the Fund's introduction in the 1960s of Special Drawing Rights to supplement international reserves.

Importance of SDRs

From the 1980s, as floating exchange rates and burgeoning private capital flows reduced the need to supplement reserves, the importance of SDRs diminished. Yet in 2009, in the midst of the global financial crisis, the membership agreed to boost global liquidity through an SDR allocation eight times larger than the earlier allocations combined – indicating that SDRs still have a role.

In the 1970s, the collapse of the Bretton Woods system of pegged exchange rates led to the introduction of a new code of conduct for countries' exchange rate policies, together with a reformulated responsibility for the IMF to 'oversee the international monetary system' and to 'exercise firm surveillance over the exchange rate policies of members'.

IMF surveillance, which accounts for about half of the Fund's expenditures, applies to all member countries and provides the main vehicle for its policy advice to most countries, although the advice provided through surveillance clearly lacks the power of the conditionality attached to its lending.

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Functionality and need for IMF reform

The fund desperately needs modernisation

Meghnad Desai, Chairman, Advisory Board

The IMF is 70 years old. It was founded in an era when the Great Powers ruled the world. The post-war settlement at Bretton Woods was based on a realisation that war-ravaged Europe would be short of foreign exchange reserves and hence unable to service its foreign debts.

Thus a system of fixed exchange rates, with the gold-exchange standard and the dollar as its key currency, was created, monitored by the IMF. There were strict controls on capital movements across borders. The US and Europe divided the leadership of the Bretton Woods institutions between themselves with the US getting the World Bank and Europe the IMF.

In August 1971, the US reneged on its obligation to buy gold at $35 an ounce. The Bretton Woods system collapsed. The international exchange rate system has since been based on flexible rates. At this point, the IMF lost the purpose for which it was designed. It still had the ability to lend to countries faced with balance of payments crises. Those vulnerable countries were then asked to implement policies which were often irrational from their point of view.

Even so the IMF failed to foresee the debt mountain incurred by developing countries during the 1970s after the oil shock. Much of the 1980s were spent by these countries getting out of unsustainable debts. The IMF's response to the Asian crisis of 1997 reinforced its image as an organisation hostile to developing countries. When the euro area countries faced similar problems, the IMF was exceedingly accommodating and became an active supporter of soft policies which if anything postponed the required adjustment.

One example was the reluctance of all concerned, including the IMF, to allow write-downs for the unsustainable sovereign debts or to bail-in the creditors. The softness of the IMF in the Greek case, which emerged in 2010, was partly attributable to the undisguised French presidential ambitions of its then managing director Dominique Strauss-Kahn. The episode helped neither Greece nor Strauss-Kahn.

The IMF had taken upon itself to monitor financial stability as a new task in the first decade of the twenty first century. One can only say that it failed miserably in either forewarning or preventing the financial crisis when it came. The contrast with the Bank for International Settlements, which can plausibly claim to have foreseen the crash, is striking.

The IMF has also taken on the task of being a macroeconomic forecaster for its members. Here again the performance is not great, as was shown by the debacle concerning the UK's austerity policies which the IMF misread completely. In July it admitted the UK now has the fastest growth of any major economy.

A lack of democratic legitimacy explains the way Europe has a presumed monopoly on the IMF's managing directorship. There was a small relaxation of this constraint when Strauss-Kahn had to be suddenly replaced in May 2011. The job was advertised but in the end the non-European candidate, Mexico's Agustín Carstens, did not get enough support to beat France's Christine Lagarde. Two years before the end of Lagarde's tenure, it is not clear whether the IMF board will genuinely seek an open recruitment to its top job.

It is often said that an institution would have to be invented if it did not exist. This is usually said about failing institutions. But there is doubt about why the IMF should continue the way it is. Given the weight of voting rights it can be reformed only with the co-operation of the US.

It is anybody's guess when we will have a US president powerful and motivated enough and with enough support in Congress to implement the quota changes required for reform. The problem is with the faulty structure set up at the Bretton Woods conference in 1944, which consolidated the hegemony of major powers rather than creating a democratic structure. Reform is necessary if it is to regain credibility, particularly in the southern hemisphere.

The first step would be an open meritocratic process for choosing the next managing director – requiring some early decision-making that needs to start as soon as possible ▪

Lord Desai is a trustee of the Gandhi Statue Memorial Trust raising a statue of Mahatma Gandhi in London's Parliament Square, to be unveiled on 30 January 2015. To donate visit www.gandhistatue.org

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Furthermore, the IMF began to reform its lending facilities in the 1970s, first to support policy programmes of longer duration than the traditional stand-by arrangement, to encompass structural as well as macroeconomic policies, and second, to make concessional financing available for low-income countries. These reforms reflected a shift in lending away from advanced to developing economies: there was no IMF lending to advanced economies between 1978 and 2007.

The increasing importance of developing countries in the IMF's work was reflected in the growth of its technical assistance activities, which now account for almost one-third of its costs. In the early 1980s, the Latin American debt crisis, which involved several countries and a diversity of private creditors, heralded the IMF's increased role as international crisis manager.

In the late 1990s, the Asian crisis brought heightened criticism of the IMF. A major result was that the IMF became more open. It now publishes most of its documents with little delay, and is more careful to respond rapidly to criticism. Following the Asian crisis, IMF conditionality was reformed to make it less intrusive and to put more emphasis on governments' 'ownership' of their policy programmes.

After 2002 the world economy entered the Great Moderation, and by 2007 non-concessional lending by the IMF had plummeted. The decision was taken to reduce the staff by 15%.

While the process was underway in 2008-09, the financial crisis erupted and new calls arose for IMF assistance. This included large-scale financial arrangements in support of policy programmes in Europe designed by the IMF in collaboration with the ECB and European Commission – a 'troika' of organisations that involved another new modus operandi.

The troika model has elicited considerable criticism, partly because of the different motivations of the individual members of the group, and is unlikely to be continued. However, in view of the myriad shadows the financial crisis still sends over the world recovery, the IMF is unlikely to run out of roles to fulfil. ▪

Graham Hacche is Visiting Fellow at the National Institute of Economic and Social Research and former deputy director of the IMF's external relations department.

Doves rule the roost at the Fed for now

Policy-makers mull meaning of 'considerable time'

Darrell Delamaide, US Editor

Federal Reserve chairman Janet Yellen (voter) showed her dovish colours at the press conference after September's meeting of the Federal Open Market Committee meeting.

She held to the official statement that there was still considerable slack in the labour market, that it would be a 'considerable time' after the Fed ceases asset purchases before it raises interest rates, and brushed off two dissents to the statement as something 'natural'.

Charles Plosser (voter) and **Richard Fisher (voter)**, head of the regional Fed banks in Philadelphia and Dallas respectively, dissented because they felt economic conditions have improved to the point that the Fed should abandon 'considerable time' as a measure for raising interest rates to have greater flexibility.

Through the considerable discussion of 'considerable time' at the press conference, Yellen maintained it was not a ticking clock – 'no mechanical interpretation' – and not calendar-based, having been scalded for saying in March that the phrase could mean as soon as six months. In general, she won good marks for learning the art of giving long answers without saying much.

In a speech the following day, however, Yellen made it clear that her heart lies with families still struggling to catch up after the impact of the financial crisis even as the economy improves. 'The effects of the recession are still being felt by many families,' she said in a video speech to a conference on building assets, 'particularly those that had very little in savings and other assets beforehand.'

Federal Reserve Chairman Janet Yellen.

For Plosser and Fisher, their dissents were something of a swan song as both subsequently announced their retirements next spring. They have two more meetings this year as voting members, but their days of dissent are numbered.

Which doesn't mean Fisher will go quietly into the night. The weekend after the mid-September meeting he told Fox Business News he thought the Fed might be 'behind the curve' in raising rates as US growth outstrips the rest of the world. 'I am not worried about inflation now,' he said, but added, 'If we wait too long and we raise rates steeply... the Fed would drive the economy into a recession.'

That same week, he told The Wall Street Journal that he was still in favour of raising rates sooner rather than later. 'The spring may be the right time to raise rates rather than the summer,' he said.

Conditions of lift-off

Atlanta Fed chief **Dennis Lockhart (non-voter)** represented a more consensus view, however, telling an audience in Jackson, Mississippi that he did not expect the Fed to act on rates until the second half of next year.

'I supported the Committee's decision to stay the course in both substance and language,' he said of the September FOMC statement. 'For my part, I continue to expect conditions for lift-off to ripen by the middle of 2015 or a bit later.'

Chicago Fed president **Charles Evans (non-voter)** was even more dovish in remarks he made at a conference in Washington, DC.

'I am very uncomfortable with calls to raise our policy rate sooner than later,' he said. 'I favour delaying lift-off until I am more certain that we have sufficient momentum in place toward our policy goals.'

He repeated these sentiments a few days later at a meeting of economists in Chicago.

'I believe that the biggest risk we face today is prematurely engineering restrictive monetary conditions,' Evans said. 'If we were to presume prematurely that the US economy has returned to a more business-as-usual position and reduce monetary accommodation too soon, we could find ourselves in the very uncomfortable position of falling back into the [zero lower bound] environment.' In remarks to reporters afterwards, he indicated he thought trends might not be clear until the first quarter of 2016.

Maintaining monetary accommodation

The decision on 'lift-off,' as policy-makers have come to call the moment when the Fed begins raising rates, is also important because in the sequence described by Yellen in her press conference, the Fed won't stop reinvesting the repaid principal of its bonds until it begins raising rates, thus maintaining an accommodative stance.

Minneapolis Fed chief **Naryana Kocherlakota (voter)** focused on inflation in insisting on the importance of maintaining monetary accommodation. He argued that the Fed needs to emphasise 'symmetry' in its 2% target for inflation, meaning that it must be as concerned about it being below that threshold as above.

'Without symmetry, inflation might spend considerably more time below 2% than above 2%,' he said. 'Inflation persistently below the 2% target could create doubts in households and businesses about whether the FOMC is truly aiming for 2% inflation, or some lower number. This kind of unmooring of inflation expectations would reduce the effectiveness of monetary policy as a mitigant against adverse macroeconomic shocks.'

St. Louis Fed chief **James Bullard (non-voter)** said he thinks the FOMC will drop the 'considerable time' language from its statement at the next meeting in late October, when it is due to finally end the asset purchases.

At a press conference during an event at the St. Louis Fed, Bullard said he thought it was all right to leave it in the September statement because 'QE hasn't ended yet'.

He reiterated his belief that the first quarter of next year will be an appropriate time to begin raising interest rates. ▪

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

How to counter threat of rising interest rates

Decomposing and balancing factor risks in fixed income

George Hoguet, Geoff Kelley and Ric Thomas, State Street Global Advisors

Global interest rates are at or near historical lows. In the face of heightened expectations of rising rates over the coming quarters, global fixed income investors are wondering what to do.

Principal component analysis (PCA), a statistical technique that decomposes asset classes into key common factors, is a useful tool for analysing risk and constructing more resilient portfolios. Instead of thinking of portfolio construction in terms of asset classes, investors may find it useful to think in terms of factor exposures.

Prof. Andrew Ang of Columbia Business School compares asset classes to food and factors to nutrients. We eat food in order to get nutrients, not the other way around. When we invest, we expose the portfolio to risk factors (nutrients) even if our approach is based on asset classes (food). For example, an investor in Russian stocks and bonds is exposed to oil, a common factor, even if the investor chose the securities in question on the basis of other individual characteristics.

Asset classes

When applied to traditional asset classes, PCA looks for correlations. It groups asset returns together in order to identify the key common risk factors that drive returns. In the simplest of terms, PCA identifies a vector of returns, 'PCA Factor 1', that explains the most covariance across all the asset classes included in the analysis. It then identifies a 'PCA Factor 2' that is uncorrelated to the first factor and that explains the most covariance in the residuals from PCA Factor 1, and so on.

Again, each subsequent factor attempts to explain as much of the variation in the residual data as possible after removing the effects of all the factors identified before it. The important point is that PCA factors are uncorrelated with each other. The variation of each factor is independent of the variation of all other factors identified. In a typical stock portfolio, global growth is the factor that best explains the movement of the various constituent asset classes. Term structure, or global interest rates, represents the second most powerful explanatory variable. Global inflation comes third. These three factors alone can explain roughly 80% of asset class variance and covariance.

Investors can also apply PCA to their fixed income allocations, such as those benchmarked to the Barclays US Aggregate Bond Index ('The Agg' – see chart). Term structure explains roughly 89% of the index's risk, while global growth explains just 5%.

The enormous impact of lower interest rates on The Agg's value can be calculated with a formula known as modified duration. This has increased by more than a year to 5.6 years since 2003. These low interest rates have also enticed issuers to extend the average maturity of their new issuance. And heavy issuance has boosted the relative weight of US Treasuries in the index. As a result, duration risk has increased at a time when interest rates stand at a 60-year low. What to do?

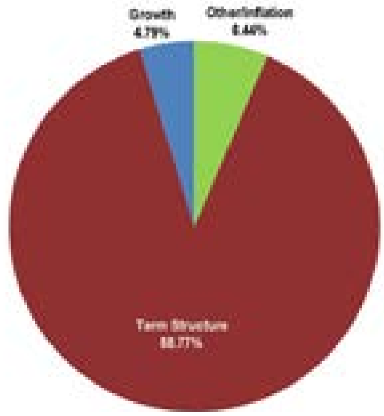
One approach is to add below-investment grade fixed income asset classes to the portfolio to reduce the portfolio's exposure to term structure and to increase its exposure to global growth. For example, emerging market debt and high yield spreads typically tighten as interest rates rise. The negative correlation between these spreads and government yields provides some degree of protection from a rising rate environment.

Of course, historical relationships do not always hold and, in a rising rate environment, some emerging markets thought to have weak macroeconomic 'fundamentals' may in fact see spreads widen. But what matters for investor returns is what happens at the overall index level, not an individual country level. And it is hard to see how an improving global economy by itself leads to deteriorating fundamentals in emerging markets.

The addition of non-index bonds alongside the Barclays Aggregate Index can create a balanced risk global bond portfolio, exposed equally to growth and term structure risks. Many of the speculative-grade asset classes are interchangeable with respect to the growth/term structure trade-off, making this type of solution easy to customise.

The addition of credit and other exposures effectively reduces the investor's exposure to term structure risk. By broadening out the fixed income portfolio, the investor accepts more of the risk premium offered by the market to accept credit, liquidity and other risks, and less of the risk premium offered by the market to hold term structure risk.

Barclays US aggregate index



Source: Barclays and SSgA

Despite the addition of speculative grade assets, this balanced risk portfolio would have generated an overall historical volatility lower than that of the investment grade-only Barclays Aggregate Index: 3.44% versus 3.68% annualised from January 1994 to March 2014.

This shows the diversification benefits of negatively correlated assets. Despite the heightened growth exposure in the added asset classes, the portfolio remains very much a fixed income portfolio, with a correlation to the Barclays Aggregate of 0.83.

From a return perspective, this balanced risk portfolio defiantly held its own in the face of a secular decline in interest rates, generating a back-tested annualised return of 6.49% against 5.76% for The Agg.

A repeat of the 1994-95 bond market sell-off seems far-fetched. But investors should consider constructing 'all weather' portfolios resilient to the state of nature. PCA is one tool to help identify risks in a portfolio and diversify common factor exposures. ■

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References: Ang, Andrew (2010) The Four Benchmarks of Sovereign Wealth Funds, NBER, Cambridge, MA.

The views expressed in this material are those of George Hoguet, Geoffrey Kelley and Ric Thomas up to 3 September 2014 and are subject to change based on market and other conditions.

Three arrows, and three questions

Why Abe should combine tax hike with stimulus measures

Shumpei Takemori, Keio University

The euro area faces three tasks: monetary stimulus, fiscal accommodation and structural reform. So said European Central Bank president Mario Draghi at the Jackson Hole central bankers' symposium in August.

Since these are precisely the same 'three arrows' targeted in Japan by Japanese Prime Minister Shinzo Abe, Europeans should realise that the fortunes of Abenomics may give them a greater number of pointers on their own economic destiny than they had earlier realised.

The easiest part of Abe's three-pronged catalogue, monetary expansion, has already run its course, and Japan is now facing three tough questions. First, what should be done with the further planned increase in consumption tax? Second, is the continuous fall of the yen against the dollar and euro still beneficial to the Japanese economy? And third, does the cut in corporation tax that Abe has decided to push forward next year truly deserve to be the third arrow in the all-important field of structural adjustment?

Consumption tax

The plan to raise the sales tax in two steps, from 5% to 8% in 2014 and then to 10% in 2015, was decided during the tenure of the previous government. Only the final decision over its implementation was entrusted to Abe.

The first step was implemented in April. As predicted, domestic consumption made a wide swing: there was a rush of consumption before the tax hike, a slump immediately afterwards, and then a gradual recovery.

The slump was more severe, and the recovery more gradual, than predicted. GDP contracted 7.1% (annualised) in the second quarter, leading the Organisation for Economic Co-operation and Development to downgrade Japan's growth forecasts to 0.9% from 1.2%. Several commentators penned premature obituaries for Abenomics.

However, it is reassuring to see that domestic consumption is recovering (see Chart). The consumption tax hike of 1997 remains a painful memory. Together with the collapse of major financial institutions, it totally destroyed the recovery phase and pushed the economy into recession.

Stimulus measure

Abe has to make a once-in-a-lifetime decision in mid-December on whether to implement the next tax hike from October 2015. If he wants to play safe and carry out the plan, he should combine it with a strong but short-term stimulus measure, such as infrastructure investment ahead of the 2020 Olympics in Tokyo.

The depreciation of the yen under Bank of Japan governor Haruhiko Kuroda has been a boon to business. Corporate profitability went up; stock prices improved; and much-awaited wage increases arrived.

Yet Kuroda has faced complaints from fuel-intensive industries over the pace of depreciation. Gas, crude and refined petroleum, Japan's top three imports, are increasingly costly. Fishermen, truckers and taxi drivers are feeling the squeeze.

That said, since the Federal Reserve indicated that an interest rate rise may come earlier than expected next year, the yen has plunged to ¥109 to the dollar, and the Japanese stock market reached a higher plateau. The critics of depreciation became rather muted.

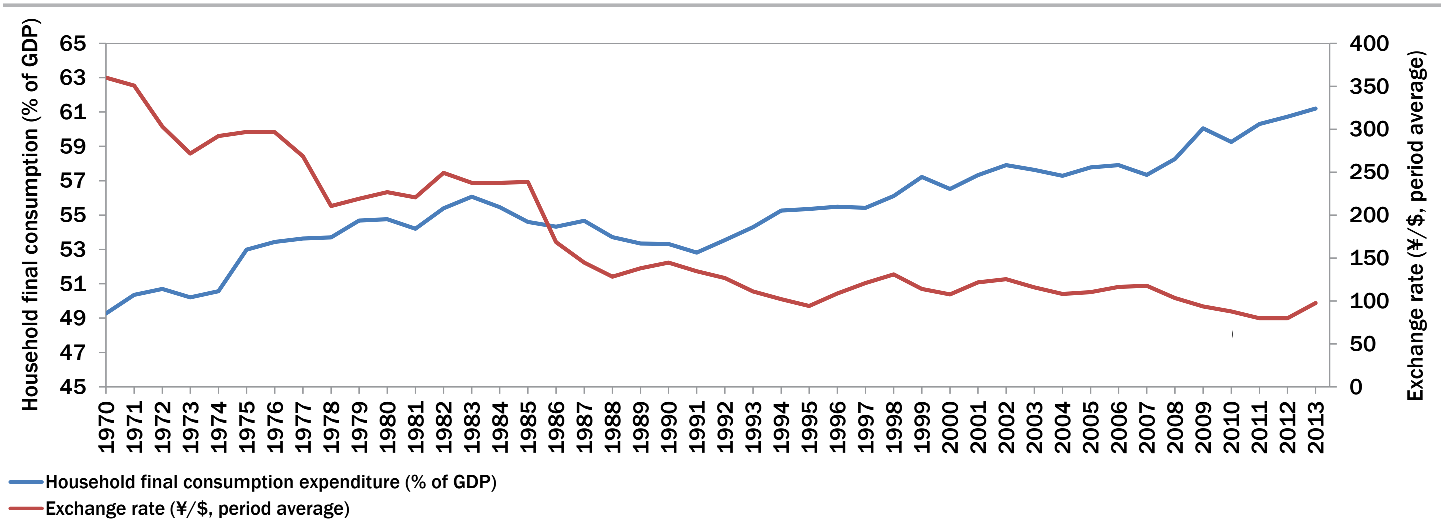
Corporation tax

As for his third 'arrow', Abe is under pressure to realise a grand growth plan including labour market reform (firms cannot sack workers unless they are going out of business), agricultural reform (such as allowing companies to buy farmland, rather than rent), reinvigorating corporate governance (by encouraging firms to take on independent board directors) and lowering corporation tax.

Abe's true ambition is to promote multiple free trade agreements, including one involving the US (the Trans-Pacific Partnership). As this is deadlocked for the time being, partly because of US politics, Abe has been obliged to settle for second best. So lowering corporation tax is his third arrow, but only by default. ▪

Shumpei Takemori, a member of the Advisory Board, is senior research fellow at the Ministry of Finance and the Policy Research Institute.

Household final consumption expenditure and dollar exchange rate, Japan 1970-2013



Source: World Bank

World economy in disinflationary recovery

Stronger dollar good for global growth and equities

Trevor Greetham, Fidelity Worldwide Investments

The US recovery is driving a period of above-trend global growth, while spare capacity and a slowdown in emerging economies are keeping commodity prices down.

Global inflation has been negative for the last two years, an outcome very reminiscent of the 1990s. This backdrop lets G7 central banks to keep policy loose, allowing the long expansion to continue.

The Investment Clock trail that helps Fidelity's asset allocation is designed to identify periods of rising or falling momentum in the global growth and inflation cycles.

The sustained nature of current trends mean the model isn't giving strong signals but it is clear that the macro backdrop is most consistent with the disinflationary recovery phase of the cycle.

Favourite asset class

Stocks remain the favourite asset class with underpinnings coming from plentiful central bank liquidity and continued improvements in corporate earnings. Stocks did very well in the disinflationary 1990s and they ended the decade at very high valuations.

As long as inflation remains mostly absent, the same could be true of the current period. Large central banks continue to print money.

Those mulling eventual rate rises are in no special hurry. The Federal Reserve is likely to normalise monetary policy ahead of the other major central banks, causing the dollar to strengthen.

This is good for global growth. A strong dollar boosts struggling exporters in Europe and Asia and it helps keep US inflation down, limiting the risk of a damaging rush to hike rates. My recommendation for currency overlays favours an overweight dollar position. At the multi-asset level, stocks tend to beat commodities when the dollar is strong and the current period is no exception.

Strengthening dollar

Good news came from the US over the past month. Despite a weaker employment report in August, the labour market continued to improve. Housing indicators were mixed, but better on balance, with the National Association of Home Builders' index – a decent leading indicator for housing activity – rising more than expected in September. Inflation surprised on the downside, partly due to dollar strength.

Within equities, the commodity-sensitive materials sector tends to underperform when the dollar is strong. This phenomenon probably has further to go and is given an underweight status. In technology stocks, a sector insensitive to the dollar and commodities and with scope for valuations to rise as they did in the bull market of the 1990s, an overweight position seems appropriate.

In terms of regional equity strategy, dollar strength and commodity price weakness are good for Japanese equities relative to the emerging markets. Japan imports commodities and turns them into consumer goods priced in dollars. Some of the large emerging markets are the opposite, importing US capital and exporting commodities. In Japan the economy continued a fragile rebound from the consumption tax hike, as negative real earnings weighed on consumption and exports remained sluggish.

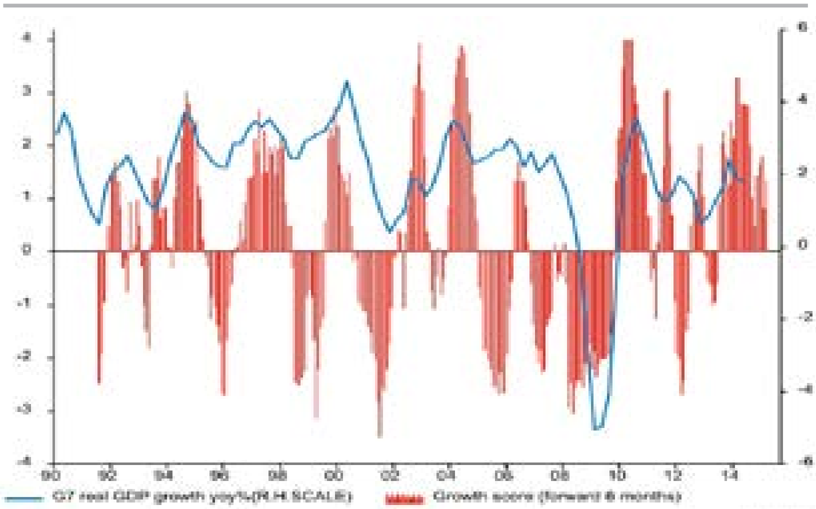
The inventory de-stocking cycle is a downside risk for growth in the second half of this year. Looking ahead, one should focus on policy moves which will ultimately set the direction for Japan's economy as well as markets. These include Prime Minister Shinzo Abe's decision on next year's consumption tax hike, the Bank of Japan's response, and fiscal measures to offset the current and – potentially – future fallout in case the next hike goes ahead.

The outlook for other emerging markets remains mixed. Signs of recovery are no longer confined to Asia. However, while a much sharper slowdown in China or a rapid tightening cycle in the US does not seem likely, at least for now, these factors could weigh on the most vulnerable markets such as Brazil, South Africa and Turkey.

Countries that have managed to build up more resilience over the past couple of years through macro policies and/or reform, such as India and Mexico, are better positioned to withstand headwinds in the months ahead. ▪

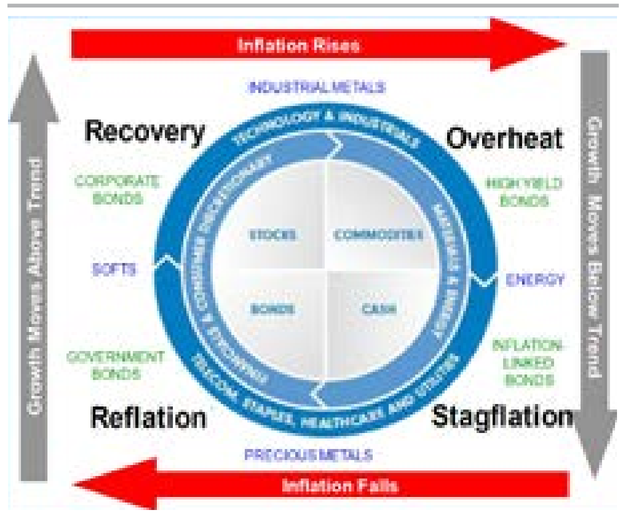
Trevor Greetham, a member of the Advisory Board, is Director of Asset Allocation of Fidelity Worldwide Investment.

Global growth scorecard positive



Source: Datastream. GDP % of 2014, scorecard pushed forwards six months.

The investment clock diagram



Fiscal backstops are needed

Delicate balance between private losses and financial stability

Claudia Buch, Deutsche Bundesbank

European banking union is a mammoth project being implemented with breathtaking speed. The question now is whether it can actually fulfil the expectations and hopes bound up in it.

In the second half of October the results of a comprehensive assessment of banks' balance sheets will be published. The European Central Bank will assume responsibility for banking supervision in November. It will directly supervise the 120 most significant banks, including 21 German institutions, and can also take on supervision of smaller banks.

The ECB provides euro area banks with liquidity in its capacity as lender of last resort. Supervision organised purely along national lines is no longer in line with the times. Liquidity assistance from national central banks can have an impact on the single monetary policy. The restructuring or resolution of financial institutions can overstretch the individual member states' financial means.

Fiscal liability

European banking union does not mean an extension of joint fiscal liability, however. Its aim is anything but that. Rather, banking union can play a role in establishing the liability principle at the European level in a better way than before. In future, private investors will have to shoulder losses.

Public funding mechanisms may only be used in very tightly restricted exceptional cases, for example if the stability of the entire financial system is at risk. And if public funds have to be used, these should be national funds in the first instance.

In this sense, the comprehensive assessment serves to ensure that apparent legacy risks do not fall within the scope of the new supervision and resolution regime. They should instead remain where they arose – at the national level and under national control.

Progress has been significant, but further steps are needed. First, we must ensure that private investors are adequately liable for bank losses. Second, banking union on its own is not the key to better separation of risks from banks and governments. We must make further progress in regulation and end the preferential treatment of government debt instruments.

Third, earlier European financial market reforms have focused on the banks.

We need further steps towards integrating capital markets to help better distribute opportunities and risks in monetary union.

The Single Supervisory Mechanism (SSM), by introducing uniform supervisory standards, will make an important contribution to better identification of risks and more complete integration of markets.

There are several areas where the institutional framework can be improved.

First, different tasks are bundled in the ECB. Alongside its actual task of monetary policy, the ECB governing council is ultimately also responsible for supervisory issues, both microprudential and macroprudential supervision, with the latter addressing the stability of the financial system as a whole.

We must guard against monetary policy decisions being influenced by supervisory considerations, which would lower the credibility of monetary policy.

Second, the non-euro area countries in the ECB general council, linking all EU members, are not entitled to vote. This hinders their inclusion in the banking union. Central and eastern European countries, in which foreign banks have large market shares, are particularly affected. Clear-cut inclusion of these countries would therefore be sensible for the creation of a single banking market.

Third, the SSM is extremely complex. A stringent organisational structure with clearly defined processes and reporting channels could alleviate ensuing frictions, but certainly not eliminate them completely. Practice will show whether these problems can be satisfactorily resolved within the existing legal framework. Otherwise we should make the necessary adjustments.

Having a uniform set of standards in banking supervision is not enough. We need procedures for dealing with banks that run into difficulties. This is the aim of the Single Resolution Mechanism. National solutions can normally be found for smaller ailing banks. However, there are hardly any tried and tested mechanisms for restructuring and resolving major banks. These are issues which pose significant risks to financial stability, requiring coordination across national borders.

These problems are not easy to resolve. All too often, in the past, stressed banks were given too much time to resolve their problems.

Finance ministers and supervisors acted too late and too indecisively. Some shied away from the consequences of banking crises for government budgets, others from the loss of reputation for supervisors. The Bank Recovery and Resolution Directive is an important step.

It harmonises the legal framework for bank resolutions in Europe. The BRRD defines the liability cascade: shareholders are liable first, followed by the creditors of subordinated and unsecured bonds. Depositors are protected up to €100,000 by the statutory deposit guarantee scheme. If the capital freed up in this way is insufficient, funds from the single European resolution fund can be used, under certain conditions. This fund is intended to hold €55bn, built up over time through bank levies.

Liability and control

To ensure a balance between liability and control, banks that are subject to European supervision also need to be resolved at the European level. Losses originating from the time before the launch of the banking union need to be remedied under national responsibility. With regard to resolution financing, national fiscal backstops and – as an ultima ratio – the European Stability Mechanism are of central importance.

Improvements to institutional structures are necessary in two areas. First, the decision-making structures of the Single Resolution Mechanism – like those of the Single Stability Mechanism – are extremely complex. A weekend deadline is unlikely to be sufficient to restructure or resolve a large bank without excessive strain on the system. The legal framework may have to be altered to produce more efficient decision-making structures. The second problematic point is the authorities' relatively broad scope for discretion.

The higher the losses assumed by private creditors, the greater the potential negative effects for stability of the financial system. The lower the private loss absorption, however, the higher the costs for government budgets – and the lower the disciplining effect for investors. ▪

Claudia Buch is Deputy President of the Deutsche Bundesbank. This is an abbreviated version of Buch's speech, 'The banking union - setting the course for better integrated and more stable financial markets in Europe?', at the 19th Handelsblatt Annual Conference on 4 September 2014.

Behind the manoeuvring, a struggle for power

Europe's banking union may end in mutual fund

Markus C. Kerber, Technical University of Berlin

The birth of economic and monetary union can be traced back to the report issued in April 1989 by a committee of experts, mainly from central banks, under the stewardship of Jacques Delors, then president of the European Commission.

When EMU was promulgated with the Maastricht treaty of 1991-92, the German political and academic communities focused their attention on the problems of its technical implementation.

They more or less ignored the political dimension under which France used monetary union as part of a quest for power in Europe. Not for nothing did Jacques Attali, the strategic adviser of President François Mitterrand, say on one occasion that Maastricht was a long document with one essential aim – to get rid of the D-mark.

We see echoes today of the developments of 25 years ago in another shift of economic power dressed up as a benevolent technical enterprise. This is the project of banking union, due to enter an important first stage in November with the passing of responsibility for 120 banks (and potentially all the banks in the euro area) to the European Central Bank.

The undertaking may eventually place burdens on German taxpayers that could eclipse the risks from repeated Greek debt restructuring.

Technical manoeuvring

In the foreground is a great deal of complex technical manoeuvring. But behind the innocent-looking intention of creating a single rule book for European supervision, we may discern a larger plan. Banks play an essential role in underwriting sovereign debt for many, largely southern member states of the euro area.

So it is not exaggerated to see in banking union the ultimate aim of creating a large mutual fund financed by the whole of Europe to hedge the risk of less solvent banks and states. The objective would be, in a banking emergency, to recapitalise banks or, in the worst case, to finance their liquidation.

The institutional infrastructure chosen to implement these plans illustrates the EU's capacity to enlarge its institutional powers beyond legal limits. Article 127 section 6 of the EU treaty (Treaty on Functioning of the European Union, TFEU) allows the ECB to take on some supervisory powers for the larger systematically important euro area banks. But now, under banking union, it is potentially being granted power over them all. This should, by rights, have sparked off a constitutional debate on the repeated actions of the EU to put itself beyond the law.

In addition, the sophisticated minds of the legal service of the European Commission have conceived a system of governance for the Single Supervisory Mechanism within the ECB which is legally contested and institutionally unsound.

These two issues provide the foundation of the lawsuit against the SSM that I and other plaintiffs have launched at the German constitutional court.

Decision-making complexities

The statutes of the ECB and the TFEU foresee only two legal bodies taking decisions within the ECB: the executive board and the governing council. In fact, the ECB supervisory decision-making process will be somewhat more complex.

The true decisions on doubtful or risk-laden banks will be taken by the SSM supervisory board, headed by the Banque de France representative Danièle Nouy, assisted by other representatives of national supervisory authorities.

But the legal position is that, after the supervisory board concludes its bargaining, the ECB board and council have to move into action, since they are the only bodies with the legal authority to do so. In practice, we will see that Nouy submits a proposal and the council approves it by not vetoing it.

The role played by the Bundesbank is worthy of study. The central bank's supervisory experts, whose duties up to now have been limited to supplying banking statistics to Bafin, the German regulatory authority, will now have a seat at the table of supervisory power.

This was hitherto neither permitted under the Bundesbank's own statutes nor desired by German legislators.

The defenders of banking union say that it does not open the way for debt mutualisation in Europe, under which taxpayers in solvent states might end up bailing out banks in worse-off euro members.

Rather, they say, banking union hinders such a development, because of the pre-eminence of the 'bail-in' principle. However, based on the experience of the subversion of the Maastricht treaty rules by France and other countries, we can be reasonably sure that this will be an evolutionary process that leads towards mutualisation.

The Bundesbank has recommended a formal revision of TFEU to put banking union onto a solid legal footing. However, the transition in the supervisory regime engineered by the EU authorities is likely to be permanent, whether or not there is treaty change.

That may turn out unfortunately to be true for the resolution fund being set up, to be funded by banking levies, to finance the resolution or simple liquidation of banks. German saving and co-operative banks have their own systems for mutually recapitalising fragile members of their banking families.

Now they are expected to contribute to a separate fund to support wider European goals. The reluctance of these two pillars of the German financial system to follow suit, and question marks about how they may react, have increased as a result of the Berlin finance ministry's failure to win them promised special treatment.

The nightmare of German saving banks paying for the rescue of distressed financial institutions anywhere in the euro area – from Cyprus to Luxembourg – is still a prospect. Politicians, functionaries and bankers alike appear to be clinging to the idea that, whatever the depths of Europe's plight, German money can set it right. ▪

Markus C. Kerber is a Berlin-based constitutional lawyer and a professor of public finance and political economy at the Technical University of Berlin.

Ukraine crisis hits German economy

The future in four scenarios

Stefan Bielmeier, DZ BANK

Despite a ceasefire agreement in early September, the situation in east Ukraine remains unclear. The ceasefire is by no means complete.

There are almost daily reports of fighting in the contested regions, and EU member states and the US have stepped up economic sanctions against Russia. Earlier this year the financial markets responded immediately and sharply to news of direct intervention by Russian troops, with European stock markets losing ground sharply and yields on German Bunds dropping. Now, Ukraine seems to have receded to the background.

Four scenarios

The Ukraine conflict and its impact on the German economy can be broken down into four scenarios. Two extreme scenarios (one positive, the other negative) are relatively improbable. In Scenario 1: a diplomatic initiative brings a breakthrough: the parties to the conflict agree on a mutual approach to de-escalation. Not only does a ceasefire emerge, but matters under dispute between Ukraine and Russia are resolved. Economic prospects brighten, with growth in Germany swiftly picking up in the second half of the year. However, this positive scenario is unlikely, with a probability of only 10%.

Scenario 4 is at the other end of the spectrum: escalation leading to a Russian invasion with large contingents of troops and severe fighting with Ukrainian units. The Russian invasion leaves the EU and US no choice but to tighten sanctions as much as possible. Russia remains out in the political cold for years and sinks into a severe recession. The west must contend with severe consequences, not least from rising energy prices. Germany and the euro area would go into recession in the second half of 2014. The probability of this scenario is a mere 5%, given the severe political and economic consequences.

Scenario 2 is the main scenario, with a probability of 55%. The situation in east Ukraine and the conflict with Russia are unlikely to be solved by diplomatic means over the next few months. The battles will go on flaring up, but there will not be an open invasion of Ukraine by Russian troops.

Diplomatic efforts will persist, and sanctions will remain in force, but will not be intensified. An open intervention by the Russian military becomes ever more improbable as time goes on and Ukrainian troops will limit themselves to preventing the separatists from seizing further territory. This leads to the financial market slowly calming, without the conflict really being solved.

Negative impact

Economic sanctions have a negative impact on the business cycle not just in Russia, but tangibly in Germany and throughout the euro area. Growth remains relatively weak, although it edges back up from its spring low in the second half of the year. Under Scenario 2, growth in Germany this year is expected to be 1.5% (EMU: 0.7%), and for 2015 1.3% (EMU: 1%). The European Central Bank will press ahead with its expansion strategy. Extensive ECB securities purchases become ever more likely, so that the yield on Bunds remains below 1% in coming months.

Under Scenario 3, the crisis neither calms down, nor escalates. This scenario, 'Unresolved conflict and continuing fighting', has quite a high plausibility of 30%. In this case, sanctions would be tightened further. If this does not succeed, the economic impact will be felt even harder in Germany.

Sanctions extended

The German mechanical engineering and automotive industries could be hit hard by sanctions being extended to cover purely civilian goods. And under such conditions we could surely expect to see further Russian counter-sanctions.

In this scenario the German recovery anticipated for this year simply does not happen. In the second half of 2014, growth might be slightly positive at best. No great improvement would be likely in 2015.

Growth in Germany in 2014 would be a mere 1.3% (instead of 1.5% in the main scenario) and would drop to 0.7% the following year (instead of 1.3%). The negative effects on the business cycle would also be felt in the euro area, with growth next year probably only 0.5%.

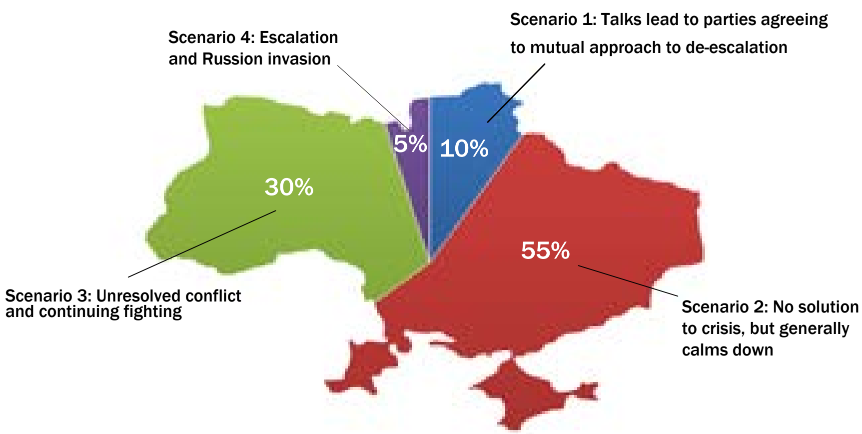
The weaker business cycle would affect inflation trends. Low demand would spell downward pressure on consumer prices, probably more than offsetting the upward effect of rising energy prices. The renewed decline in the German and EMU-wide inflation rates would inevitably add fuel to the fire of the deflation debate.

In Scenario 3 financial market volatility should rise appreciably. Uncertainty over the economic impact and the ECB's response would persist. Under such circumstances, there would be a return flight into the purportedly safe haven of Bunds, with corresponding waves of sales of higher-risk paper, such as equities.

Persistent uncertainty over possible escalation between the west and Russia and tighter sanctions would push the yield on 10-year Bunds well below 1% for a prolonged time. ▪

Stefan Bielmeier, member of the OMFIF Advisory Board, is Head of Research and Chief Economist of DZ BANK.

Four scenarios and their probabilities



At last, European energy union

Heading for world lead in renewables

Ruud Lubbers & Paul van Seters, Advisory Board

The creation of a European energy union – a single body charged with buying all Europe's gas – is in sight.

Following the appointment of Jean-Claude Juncker as the new president of the European Commission and of Donald Tusk as the new president of the European Council, concrete and detailed plans for new climate and energy policies will be discussed by the European Council on 23-24 October.

These plans are built on the triple approach of energy security, green growth and climate change. It is likely that the combined forces of Juncker and Tusk will guarantee that this triple approach becomes the cornerstone of a nascent energy union.

In Juncker's 10-point manifesto for the next Commission, climate and energy were near the top of the agenda, after boosting jobs and creating a single digital market.

The president's ambition is to create 'a resilient energy union with a forward-looking climate change policy', with an emphasis on strengthening the share of renewable energy.

This is a matter of responsible climate change policy but also an industrial policy imperative, at least if Europe wants to have affordable energy in the medium term.

Juncker wants the European energy union to become the world leader in renewables, not least to fulfil the EU's objective of limiting any global temperature increase to a maximum two degrees Celsius above pre-industrial levels. Juncker has an able partner in Donald Tusk, prime minister of Poland since 2007.

In a prescient article in the Financial Times in April, heralding a development that has now taken place, Tusk proposed an energy union to reduce Russia's dominance over European energy markets. It is no surprise that energy security is at the forefront of his mind, given Poland's dependence on Russian gas.

At the same time, Tusk wants to speed up the exploration and exploitation of shale gas in Poland, which has the largest reserves of shale gas in Europe. This would reduce the use of coal and CO_2 emissions – the American way.

More affordable energy would also improve Europe's competitiveness. For Tusk, the energy union should walk on two legs: renewable energy wherever feasible; but more shale gas and less coal. Tusk, incidentally, is not the first Polish leader to point out the need for an energy union. Jerzy Buzek, former prime minister of Poland (1997–2001) and president of the European Parliament (2009–12), called for creation of a European Energy Community in 2010 together with Jacques Delors, who was formerly president of the European Commission (1985–95).

Ensuring Europe has a stronger, deeper, common energy policy is a task which will be continued by their successors.

We think the European Council on 23-24 October should endorse the ideas of Buzek, Delors, Tusk, Juncker and others, and give the energy union a threefold mandate for energy, green growth and climate change.

After the 'Plan Van Rompuy' to overcome the euro crisis, we now need a Plan Juncker-Tusk; a new Marshall Plan for jobs in Europe through green growth and energy security. ▪

Ruud Lubbers is a former Netherlands Prime Minister and Paul van Seters is Professor at Tilburg University.

Agreement between Westminster and Edinburgh will not be easy

...continued from p.5

While former Prime Minister Gordon Brown's timetable for an agreement by St Andrew's Day (end-November) and passage by Parliament by Burns Night (25 January) seems optimistic, the Scots will demand real progress before campaigning for the May 2015 general election begins in earnest. The Scottish government will probably be allowed to vary income tax rates by at least twice the 10% variation already granted (but never used) but there is no common view when it comes to income tax bands or corporate taxation. Welfare benefits will be high up the agenda and probably contentious. With the Scottish Nationalist Party well to the left politically of the Labour party, and Scotland's new first minister almost certainly more socialist than Salmond, who resigned after his referendum defeat, coming to an agreement with Cameron's Conservative-led Westminster government will not be easy.

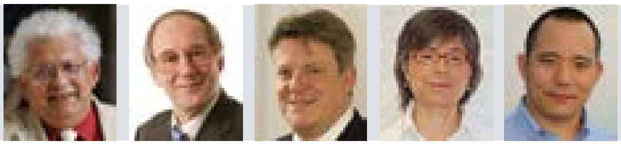
These discussions will take place against a backdrop of demands for English devolution, following English complaints about September's hasty, improvised offers of more powers to Scotland. This campaign is already causing problems for David Cameron from within his Conservative party, which worries about being outflanked on the right by the insurgent UK Independence Party.

The opposition Labour party has its own problems. English devolution means stripping Scottish legislators of a vote on English affairs, which will erode Labour's influence relative to the other two main parties. For this reason Labour can be expected to impede rapid moves to establish such an outcome. Progress towards fulfilling the Scottish referendum commitments looks likely to be chaotic, discordant and disrupted by political issues elsewhere in the UK.

This will not breed the confidence which business and investors require. Most obviously, high earners in Scotland will suffer from higher income tax rates and potentially from other taxes to pay for increased welfare benefits (the Liberal Democrats have suggested devolving capital gains and inheritance taxes). Consequently many highly paid individuals may choose to move south across the border and companies may transfer certain activities to England to retain talent. Talk of Scottish fund management companies losing assets due to the referendum seems misplaced (poor performance appears more of an issue) but fleeing fund managers could have the same effect.

Companies in Scotland also face uncertainty over taxation and possibly regulation, for example with respect to employment law. Investment, notably in property, which had been put on hold ahead of the referendum will doubtless now proceed but businesses will be cautious in making new investments until the rules of engagement are clearer. All this gives some indication of why markets did not respond with jubilation to Scotland's No vote, despite the general sense of relief across the UK.

Colin Robertson, member of the OMFIF Advisory Board, is former Global Head of Asset Allocation of Aon Hewitt.



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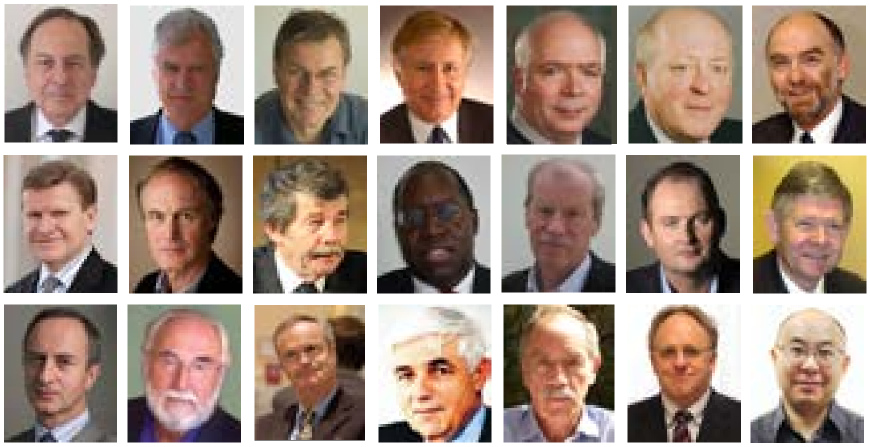

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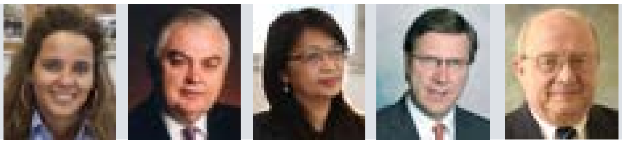

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China's baby steps towards financial reform

Shanghai's Free Trade Zone can go far

Julia Leung, Senior Adviser

A French impressionist painting, which looks good at a distance but fuzzy up close: this is how a prominent businessman described the Shanghai Free Trade Zone's rules at a recent London seminar.

If the details are fuzzy, it isn't for the lack of rules. Since the launch of the zone on 29 September last year, an array of 55 policy documents have been released covering finance, trade and governance. On finance alone, the People's Bank of China has issued five separate sets of regulations in the past year to facilitate foreign currency and renminbi denominated borrowings and transactions into, out of and within the zone.

Notwithstanding these efforts, foreign businessmen still consider the rules 'fuzzy', probably because the details do not match the rosy picture painted by Chinese authorities.

A lot of hype and fanfare surrounded the zone's launch when Premier Li Keqiang called it a 'testing ground' of national significance, and pledged to use a 'forced' mechanism (or 'daobi') to drive a new round of reform through opening up. Expectations were high that Shanghai's zone would overshadow Qianhai, another financial reform pilot in Shenzhen, and even Hong Kong as an offshore renminbi centre.

To describe the zone's role in China's capital account liberalisation, it's better to start with what it is not. It is not a special zone that pilots bold experiments on renminbi convertibility or flexibility of its external value. It is also not going to be an offshore renminbi centre established onshore to blow a big hole in the country's capital account control regime.

Shanghai Free Trade Zone

This shouldn't be surprising, because the zone's stated primary objective is to pilot administrative reforms with a 'negative list' approach to ease the straitjacket of controls and facilitate foreign trade and investment. That said, one shouldn't be dismissive of the financial reforms in the Shanghai zone. What has been achieved thus far is a series of small but rapid steps or half-steps towards streamlining the day-to-day business operations of cross-border payments.

The objective is to promote Shanghai's zone as the treasury centre for Chinese and foreign multinationals to use renminbi in overseas transactions under current restrictions.

A noteworthy relaxation is for non-financial enterprises established in the zone to be able to borrow offshore renminbi loans, subject to an overall cap tied to the paid-in capital of the borrower. The loan maturity must be more than a year and the usage is confined to the zone or overseas, in projects related to the real economy and not securities investments. There is no similar relaxation for borrowing offshore foreign currency loans.

Treasury operations

The most innovative move, welcomed by corporate treasurers, is the pilot on two-way pooling of funds – out from China and into China. This would help move funds around and unlock idle cash across a company's onshore and offshore subsidiaries. Companies can form a lead entity in the zone to manage their treasury operations. They are allowed to pool renminbi funds and foreign exchange funds from operations elsewhere into, respectively, a centralised domestic currency account and a centralised foreign currency account established in the zone.

The lead entity can process cross-border receipts and payments in both currencies under trade and other current account transactions without the need for prior approval. Through intra-company loans, funds in these accounts can be lent to overseas subsidiaries and vice versa. With renminbi convertibility, there is very little which is startlingly new. For example, foreign invested entities in the zone are able to convert at will all of their foreign equity capital into China's currency including that intended for equity investments. The prevailing rule outside the zone is that approval from the Chinese State Administration of Foreign Exchange is required each time a foreign investor wishes to convert foreign capital brought into the country into renminbi.

Approvals for convertibility related to direct investment under the capital account are already routinely given; what this pilot does in the zone is to do away with prior approvals, and move from 'prohibited unless stated' (a 'positive' list) to 'permitted unless prohibited', which is consistent with the negative list approach.

We should not underestimate these so-called 'baby steps'. All this will gradually increase the mobility of funds between bank accounts established in the zone and those offshore. However, a firewall is maintained between the zone and the rest of China, whereby the transfer of funds is subject to quotas and restrictions. It's too early to say how porous the firewall is, but the intent of the wall is to ensure that the pilots and their spillovers will be contained within the zone. The day the firewall is lifted, all capital-account restrictions would be removed.

That day is still a long way off. Reforms piloted in the zone are meant to be 'replicable' elsewhere in China. True to this design, two-way cash pooling is expected to be rolled out to other parts of the country. That would also mean any steps taken to open the capital account are bound to be small because they have to be properly sequenced, with full deregulation of interest rates to precede full capital account liberalisation and full convertibility for renminbi.

Interest rate reform is now encountering tough obstacles because of the worry that a sharp rise in interest rates may cripple the finances of those state-owned enterprises that have overextended themselves in the previous credit boom. Given the sheer size and connectivity of China's market to the rest of the world, the consequence of any wrong-footed step in reform could be punishing not only for the country, but for the rest of the world. ▪

Julia Leung is former Undersecretary for Financial Services and the Treasury in Hong Kong and a Senior Adviser to OMFIF.

Hong Kong and Beijing at odds

Narrative of 'own way' for SAR has lost its sheen

Jonathan Fenby, Trusted Sources

When Deng Xiaoping came up with the 'one country, two systems' formula in the early 1980s, he had Taiwan in mind, not Hong Kong. But Taiwan, set on an increasingly autonomous path, showed no interest.

So the Paramount Leader turned the four words to the British colony where the land leases in the New Territories would run out at the end of the century. The question of sovereignty, not mentioned since the communists gained power on the mainland in 1949, was revived.

The reassurance in Deng's formula that the territories' way of life would be preserved after they returned to the People's Republic as a special region was buttressed by the Joint Declaration signed by Deng and then-British Prime Minister Margaret Thatcher at the end of 1984. This guaranteed a 'high degree of autonomy' for Hong Kong (except in foreign and military affairs) and the preservation of its economic and social system for 50 years.

Two systems, only one country

As a result, the 1997 handover was a peaceful affair with the assumption that 'business as usual' would continue for the half-century laid down by the Declaration and the Basic Law which followed it.

The focus at the time and in the following years was on the 'two systems'. This meant Hong Kong could go on as before, and the economic rise of the People's Republic gave it a unique foothold in the world's fastest growing major economy.

Hong Kong was a bridge between the mainland and the world with its strong legal system, international corporate representation, freedom of personal and financial movement and of expression, increasing presence of PRC companies and a position as the test bed for internationalisation of the renminbi.

The chief executives who ran the Special Administrative Region had to be approved by Beijing, but the first three occupants of the post were from Hong Kong and there was the prospect of their direct election in 2017.

Controversial measures such as an anti-subversion law, which would have given China's police extensive powers in Hong Kong, were abandoned in the face of mass protests.

But now, 30 years after the Joint Declaration, the other side of the Deng formula and some of the wording in the 1984 document are taking on a different significance. What had been largely overlooked was that the 'two systems' came second – first was the 'one country'.

Now, Beijing is clear that it sees the development of Hong Kong, particularly the run-up to the 2017 election, as a national matter in which it has the last word.

The Declaration is quite explicit, saying that the SAR 'will be directly under the authority of the Central People's Government' and that 'national unity and territorial integrity shall be maintained'.

This spring, the State Council in Beijing made clear that it will determine the electoral arrangements in 2017, including vetting candidates. It also suggested that judges should have to meet a 'patriotic' criterion.

Chinese officials say this is logical since the SAR comes under the remit of the central authorities, and the Joint Declaration referred to Hong Kong as it was in 1984 when Britain did not permit democracy.

Anxious to boost trade and financial links with the People's Republic, the British government gives every impression of wanting to avoid the whole issue. Prime Minister David Cameron has been more or less turning a deaf ear to urgings from the last governor, Lord Patten, and Hong Kong's democratic leaders to intervene to check Beijing's assertion of control.

Political liberalisation

Coming on top of a groundswell of activity by pro-democracy campaigners, this has raised tensions in the SAR to a high point. Beijing's proposals for the arrangement to choose the next chief executive may well fail to gain the necessary majority in the Legislative Council, which would put back the whole process of political liberalisation.

The 'Occupy Central' movement, taking its name from the main business district, has organised protests following a mass online 'referendum' that brought a big vote in favour of an open election in 2017.

The South China Morning Post reported at the end of September that 'Distrust of Beijing hits post-handover high'.

In spite of the uncertainty caused by the protests, business does not appear to have been affected though the economy is not as robust as it was, and depends quite significantly on visitors from the mainland to keep the retail tills humming and support the property market.

But the narrative of the SAR going its own way under the cloak of the Joint Declaration and Deng's formula has lost its sheen.

Hong Kong was always a 'special place' but it faces some harsh realities as Beijing asserts its predominance. ▪

Jonathan Fenby, member of the OMFIF Advisory Board, is China Director of emerging markets research service Trusted Sources.

Seminar on Euro-RMB: Roadshow in London
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What does China want to achieve for its currency in the medium and long term? What does this mean for global business, financial services and the UK? Is this an opportunity or a threat for Europe? Will the renminbi challenge the international leadership of the dollar and euro?

For more information, please contact Adam Cotter: adam.cotter@omfif.org

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Norway shows Japan the way

NBIM and GPIF compared: asset allocation holds the key

Two of the world's largest global public investors, Japan's Government Pension Investment Fund and Norges Bank Investment Management's Government Pension Fund Global, ranked as No.3 and No.4 in the OMFIF survey of public sector investors, employ very different asset allocation strategies.

GPIF, as a state pension fund with specific liabilities to Japanese pensioners, is more normally compared with the Californian pension fund CalPERS and Ontario's Omers. But in general it seems set to move towards Norwegian-style focus on equities rather than bonds as a way of boosting the performance of the Japanese stock market and generating higher returns for Japan's senior citizens.

As of 30 June, Japan's GPIF had assets under management totalling $1,259.9bn, making it the largest pension fund in the world. It is the third largest global public investor in the world, trailing only People's Bank of China and Bank of Japan when ranked by total assets.

GPIF has been under pressure to review its allocation strategy and move more assets from bonds into public equity. With 33.2% invested in equities, split roughly evenly between domestic and foreign stocks, leading figures including Prime Minister Shinzo Abe are calling for the review process to be expedited.

Fixed income holdings may be reduced from the current 64.4% to around 40%, with capital moving into stocks. As can be seen in the Table 1, equity holdings outperformed fixed income. From 1 April to 30 June this year, equities achieved a return of 4.1% while fixed income returned only 0.7%. The portfolio achieved a total return of 1.8% .

The Norwegian way

As of 30 June, NBIM had assets under management totalling $820.1bn (see Table 2), behind GPIF in *Global Public Investor* 2014 rankings. Funded by Norway's oil and gas wealth, it is the largest sovereign wealth fund in the world, owning 1.3% of the world's stocks.

This makes it one of the most important benchmarks in the industry and a useful reference, for example, for GPIF in how to allocate its portfolio. Chart 1 depicts the countries where NBIM invests.

In contrast to GPIF, NBIM has 37.6% in fixed income, 61.3% in public equity and the remaining 1.2% in real estate.

Like GPIF, the Norwegian fund's public equity holdings outperformed fixed income from 1 April 2014 to 30 June 2014, returning 4% and 2% respectively. However, due to the contrasting allocations, the fund achieved total returns of 3.3%, outperforming GPIF's 1.8%. From 2004-13, NBIM achieved annualised returns of 6.5%, while GPIF returned only 3.2% a year on average (see Chart 2).

Yngve Slyngstad, chief executive of NBIM, recently stated that the fund will change the way it invests in equities so that 'management takes greater responsibility by defining a tailor-made reference portfolio', and doubled the size of his equity team. He argued that traditional global indices are no longer an appropriate model on which to base investments.

NBIM invests its portfolio under strategic guidelines laid down by the Norwegian finance ministry (60% equities, 35% fixed income and 5% real estate). Only 1.2% of its assets are currently allocated to real estate, which yielded 3% returns from April to June.

It will increase its holdings by 1% each year for the next three years. The fund has acknowledged the difficulty of shifting its large allocation in a short time frame.

The fund recently moved capital towards emerging markets in Asia, South America and particularly Africa to capture more of the global economy.

NBIM maintained its current allocation of fixed income and equity since 2009 and in that time has convincingly outperformed GPIF every year except 2011, when equities lost 8.8%. In 2008, NBIM had the weakest returns in the fund's history due to its equity portfolio losing 40.7% that year. With GPIF's limited equity holdings, it lost 'only' 7.6% in the same year.

Pushing allocation towards equities however proved to be a shrewd strategy for NBIM, with the equity portfolio making a return of 34.3% in 2009, contributing towards a total portfolio return of 25.6% for that year, the strongest in the fund's history. ▪

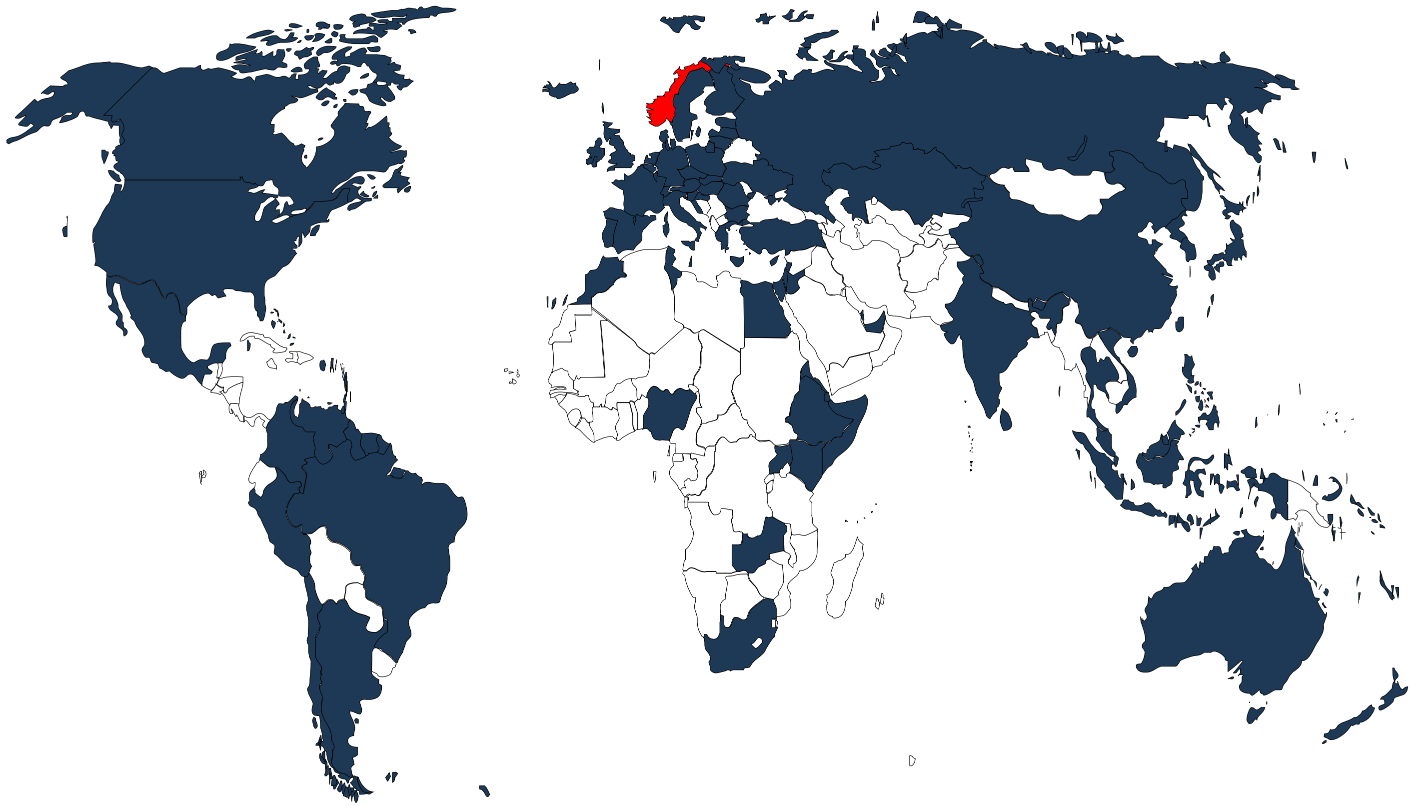
Table 1: Government Pension Investment Fund (GPIF)

Asset class	Weight (%)	Market value ($bn)	Return 1 April - 30 June 2014 (%)
Fixed income	64.4	811.6	0.7
Public equity	33.2	418.8	4.1
Short term assets	2.3	2.3	0.0
Total	100.0	1232.8	1.8
		Annual return 2013 (%)	8.6

Table 2: Norges Bank Investment Management (NBIM)

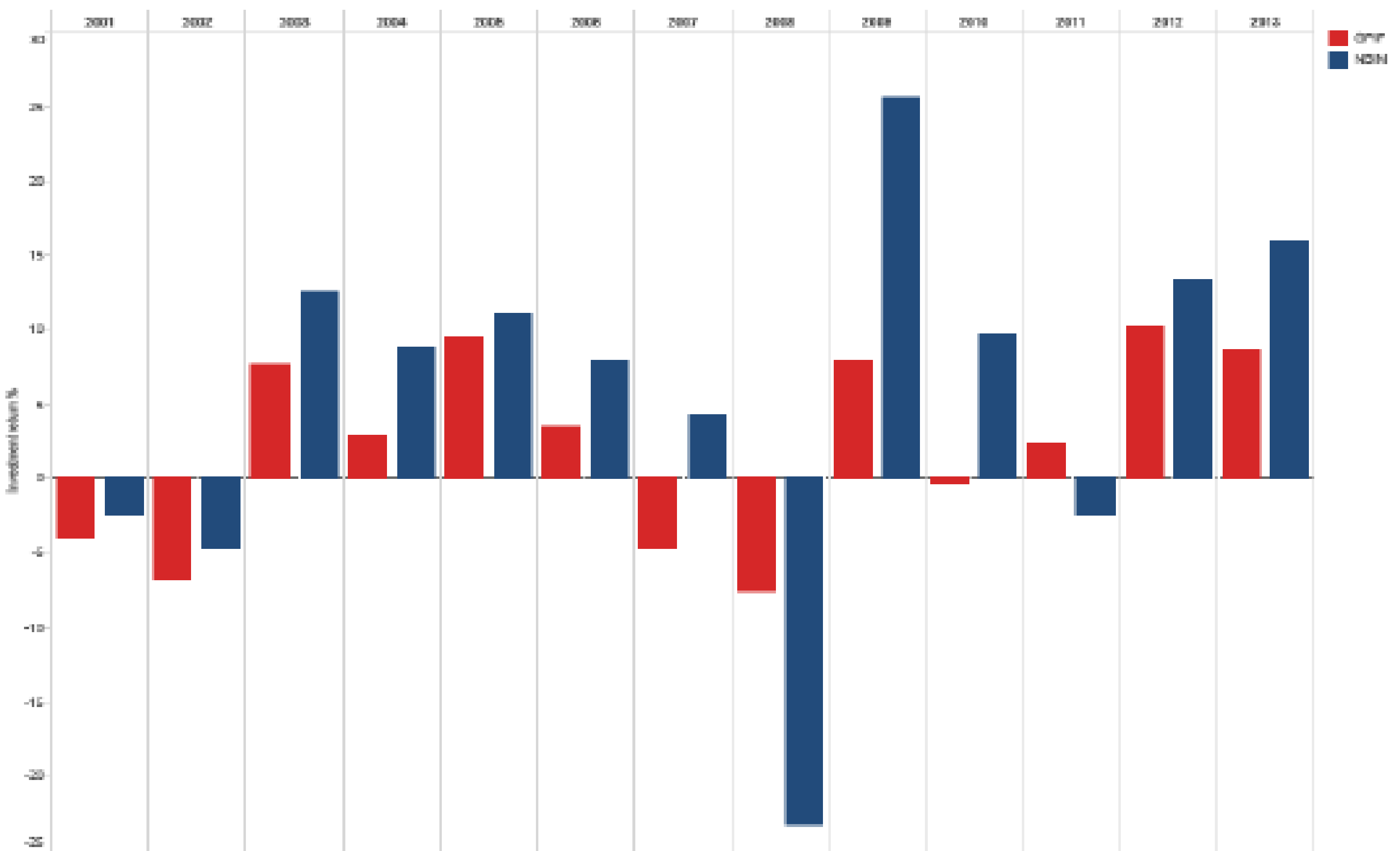
Asset class	Weight (%)	Market value ($bn)	Return 1 April - 30 June 2014 (%)
Fixed income	37.6	308.1	2.0
Public equity	61.3	502.5	4.0
Real estate	1.2	9.4	3.0
Total	100.0	820.1	3.3
		Annual return 2013 (%)	15.9

Chart 1: NBIM's investments as of 31 Dec 2013 - in 82 countries and 44 currencies.



Source: NBIM Annual report 2013
Blue shaded areas denotes countries where NBIM invests. Red area – Norway, where the fund is not allowed to invest.

Chart 2: Annual return on investment of NBIM and GPIF 2001-13



Data are from GPIF and NBIM annual reports. GPIF uses nominal investment return (after deducting interest on debts and fees). NBIM is return on the Government Pension Fund Global measured in international currency.

China-German tale of monetary parallels

Beijing aims to emulate Frankfurt in foreign assets policy

China and Germany, the world's second and fourth largest economies, share some important characteristics. They are the biggest economies and the most potent creditors in their regions.

China, as the world's No. 2 net creditor (after Japan), looks set to emulate Germany, the third biggest, in how it manages its large stock of net foreign assets.

As part of a move for the renminbi to become more freely floating, the Chinese authorities appear ready to shift a greater proportion of assets outside the ambit of the People's Bank of China. This will be accomplished particularly through the progressive lifting of restrictions on investments abroad by Chinese institutions, enterprises and individuals.

The PBoC and the Bundesbank share some intriguing historical characteristics, owing their formation to landmark events in 1948, a year before the foundation of the states (the People's Republic of China and the Federal Republic of Germany) that became their owners.

The PBoC was established in December 1948 with the consolidation of three existing banks, Huabei Bank, Beihai Bank and Xibei Farmer Bank. It was constituted in Shijiazhuang, the capital of the northern province of Hebei, and moved the following year to Beijing.

The Bank deutscher Länder, the forerunner institution of the Bundesbank (established in 1957), was set up in Frankfurt in March 1948 under the post-second world war occupation regime for the western part of Germany run by the US, Britain and France.

Post-war economic ascent

The Bundesbank's and PBoC's development reflect their states' post-war economic ascent, China's taking place 30 or 40 years after Germany's. By the beginning of the 1960s, the Bundesbank was the world's largest holder of official foreign exchange assets, accounting for 20% of currency reserves (Chart 1). It briefly regained this status in the early 1970s. Resulting from the rise of China's foreign trade, and deliberate attempts by the Bundesbank from the late 1990s onwards to lower its dollar holdings, China has now taken that place, accounting for 33% of currency reserves at end-2013.

There are parallels, too, in the convertibility and internationalisation of the D-mark and the renminbi. In seeking a greater international role for their currency, the Chinese authorities are partly following a pattern seen in Germany in the 1950s and 1960s.

This extends to a landmark decision expected in 2015 under which the renminbi, although formally not yet fully convertible, looks set to become part of the basket making up the Special Drawing Right, the International Monetary Fund's composite currency unit.

There is one big difference, though: Beijing is embarking on internationalisation as a policy goal (although in line with market developments), whereas the Germans sought to damp the progressive use of the D-mark outside their borders, fearing it could result in loss of control of the currency.

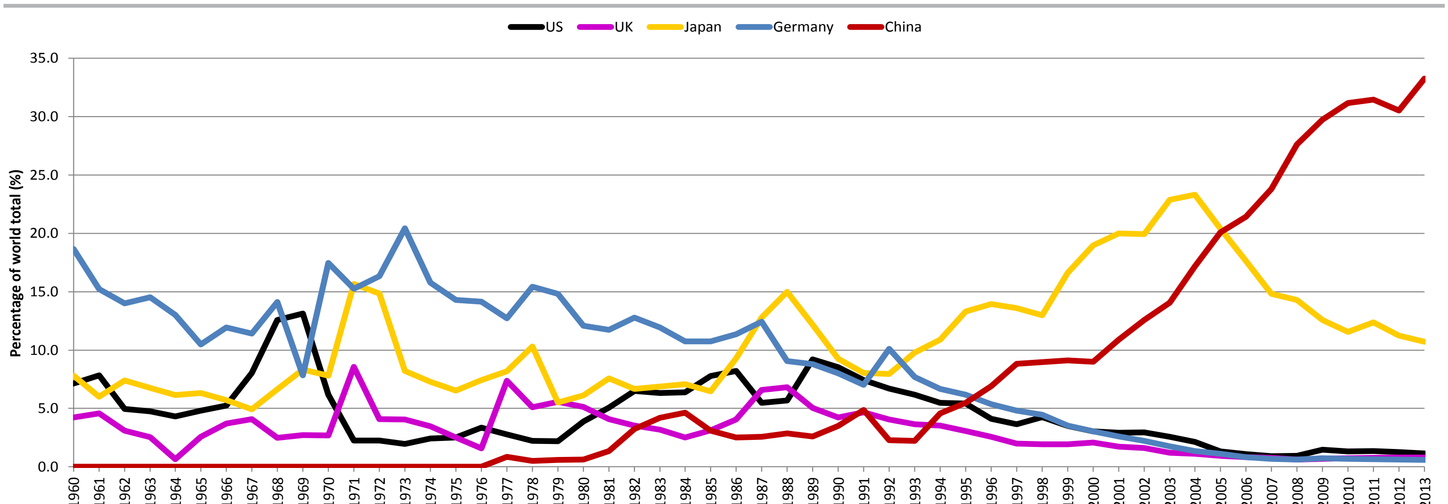
Large-scale switch

Beijing wishes to carry out a large-scale switch in its asset management procedures to enable far more international trading and investment transactions in the renminbi rather than the dollar. Liberalisation will however be gradualist and will not lead to a laissez-faire 'bonfire of controls'.

One significant incentive for the Chinese authorities to speed renminbi-isation is China's poor track record in making returns from foreign assets. A research paper from the Bank for International Settlements in September 2013* underlined why China and Germany have recorded entirely different performances in their overall foreign investments over the past 15 years.

At the end of the 1990s, both countries had rather slender net foreign assets, with China in negative territory and Germany close to zero. A string of large-scale current account surpluses in the first decade of the 2000s changed all that, with China advancing to a peak of more than 30% of GDP in net foreign assets (excess of assets over liabilities) by 2007, before retreating to around 24% more recently following the fall in the country's current account surplus.

Chart 1: Leading countries' foreign exchange reserves 1960-2013 (% of world total)



Sources: World Bank

Germany, benefiting from the enhanced competitiveness of export-orientated companies after the launch of the euro in 1999, has extended its net foreign assets to nearly 40% of GDP in recent years (Chart 2).

Although Germany's net assets have been on average lower than China's, it has made consistent annual returns since 2005 of between 5% and 6% of its net international asset position, according to the BIS paper, while China has turned in regular annual losses averaging around 3% to 4% of its asset position since 2008 (Chart 3).

Internationally held assets

The BIS experts Guonan Ma and Robert N. McCauley ascribe this to two overriding factors. First, the official sector accounts for a much greater percentage of internationally held assets in China than in Germany, a product of overwhelming state control in China.

Second, and more importantly, China's net investments have been substantially geared to other countries' (mainly the US) debt instruments, whereas Germany has been orientated far more towards portfolio investments in equities and in direct investments, often denominated in its domestic currency.

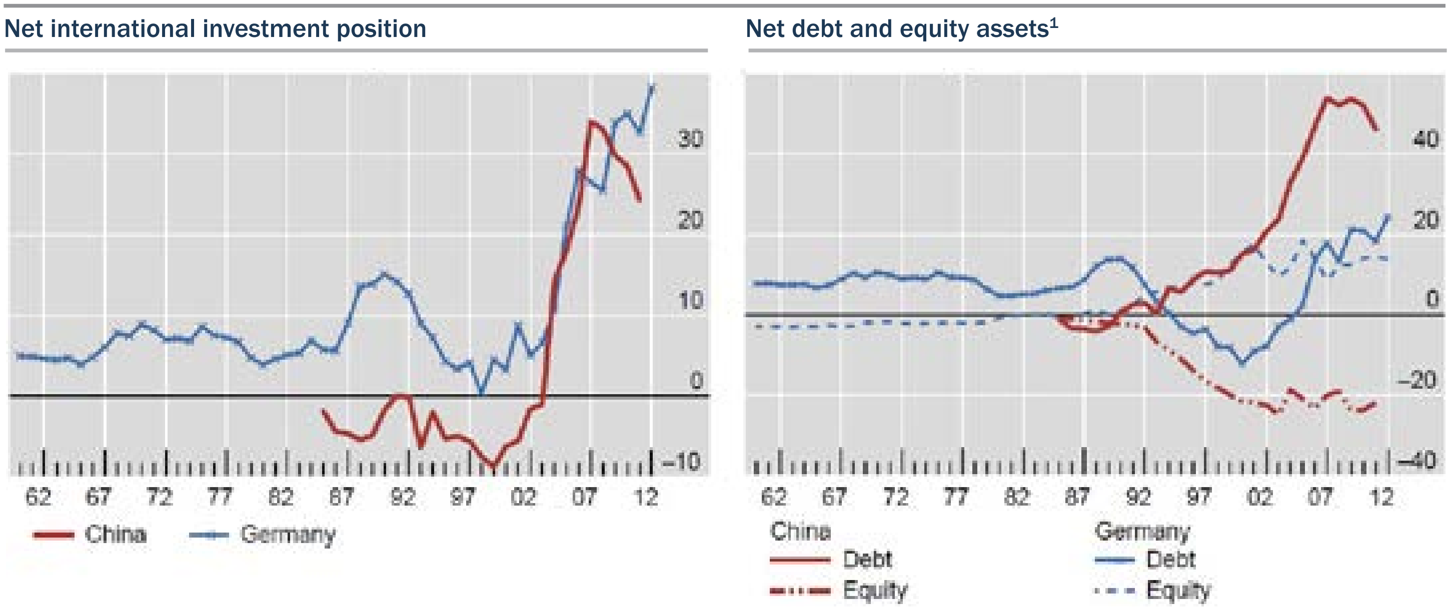
Equity investments, the BIS points out, have been higher-yielding than those in fixed income in recent years. The Chinese authorities draw two important lessons from these episodes. One is to try to economise on the state's foreign reserves.

Here, China has shown very little progress, as the continued advance of the PBoC's reserve holdings, now close to $4tn, demonstrates.

The second has been to try to increase the proportion of equities in the country's overall foreign portfolio, seen through diversification by both the State Administration of Foreign Exchange and by the PBoC itself, for example in recent announcements that the PBoC has been buying small stakes in large Italian companies – and to extend renminbi-isation. This will be one of the big international themes for banks and capital markets in coming years. ▪

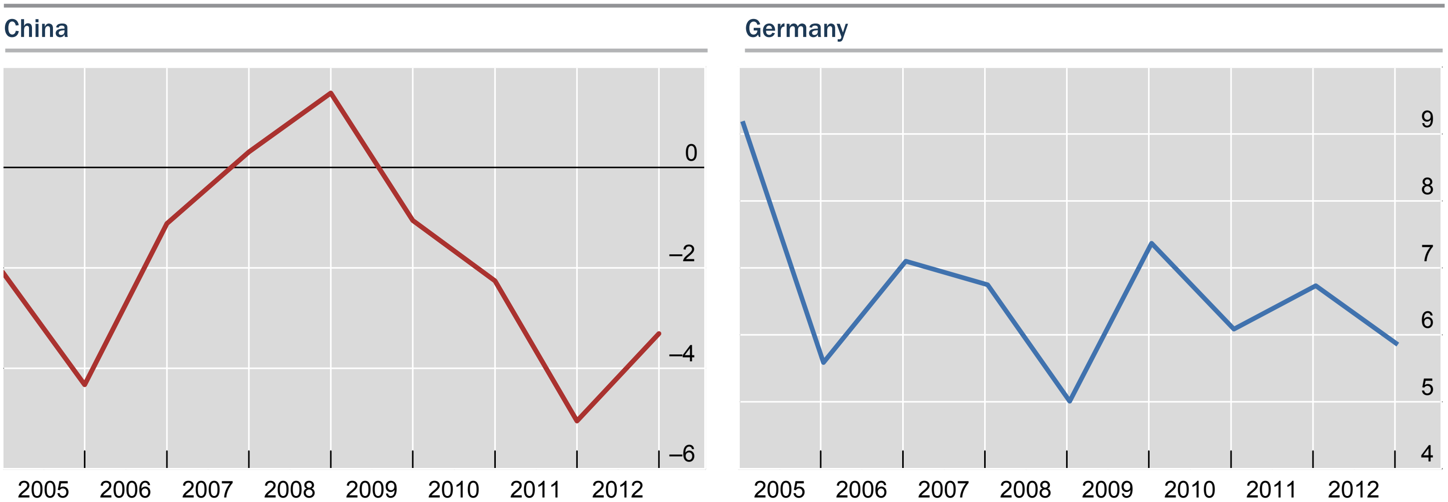
BIS Working Paper No.424, Global and euro imbalances: China and Germany, by Guonan Ma and Robert N. McCauley.

Chart 2: Net international investment position (as a % of GDP)

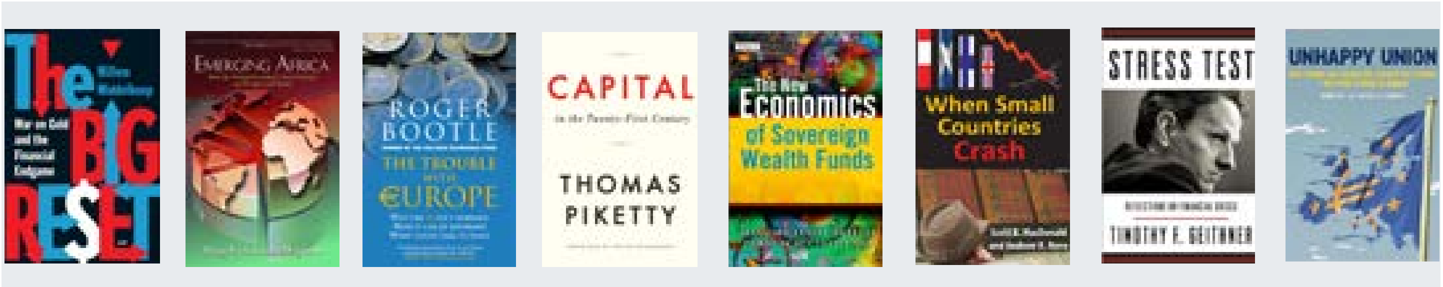


[1]Equity is calculated as FDI, portfolio investment in shares and portfolio investment in mutual fund shares. Debt is assumed as all others.
Sources: CEIC; Datastream; national data; authors' calculations. BIS Working Paper No. 424, Global and euro imbalances: China and Germany, by Guonan Ma and Robert N. McCauley.

Chart 3: Net investment income (as a % of net international investment position)



Sources: Lane and Milesi-Ferretti (2007); CEIC; Datastream; national data.



How press restraint can go too far

The role of the media in financial crises

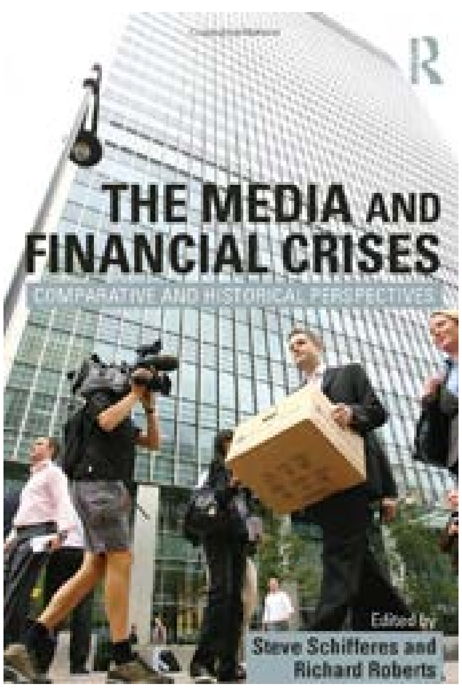
William Keegan, Advisory Board

Every schoolperson ought to know that, when officially opening a new building at the London School of Economics, the Queen asked why no one had warned her about the financial crisis.

The Media and Financial Crisis: Comparative and Historical Perspectives attempts to give an answer at least to the role of the media in the run-up to what can reasonably be called a banking and economic catastrophe.

The editors, both of whom contribute valuable chapters, are Steve Schifferes, professor of financial journalism at City University, London, and Richard Roberts, professor at the Institute of Contemporary British History, King's College, London (and a member of the OMFIF Advisory Board).

As the title indicates, this is not only an examination of the recent crisis, but also of previous episodes – episodes which a whole generation of policy-makers, economists, financial practitioners and, yes, the media managed to forget until the onset of the Great Recession.



There is now an overdue revival of interest in economic history, and this excellent tome should certainly be on the syllabuses that teachers of economics ought to be revising after leading branches of the profession into a mathematical cul de sac.

It was Prime Minister William Gladstone who declared that: 'Finance is, as it were, the stomach of the nation, from which all the other organs take their tone.' For most of us, banking and finance were taken for granted until 2007.

Although this book makes it clear that there were plenty of warnings in the press about the dangers of financial innovation, a study of the American financial press by Dean Starkman of the Columbia Journalism Review concludes that the press published 'its hardest hitting investigations of lenders and Wall Street between 2000 and 2003'. But he goes on to say on the question 'whether the business press, as it claims, provided the public with fair warning of looming dangers during the years when it could have made a difference… the answer is no'.

Significance of global imbalances

With regard to the UK, Lionel Barber, editor of the Financial Times, concedes that, although there were plenty of warnings about the risks involved in the credit boom, 'For too long, too many self-styled experts treated the financial sector and the wider economy as parallel universes.

Thus banking journalists failed to understand the significance of global imbalances, while economists failed to grant sufficient weight to credit risk.' The modern media do not feel as constrained or 'responsible' as in times past. Thus, as Richard Roberts points out in his coverage of the long-forgotten London financial crisis of 1914 – which, for historians, was overtaken by the first world war whose onset had caused the Run on the Bank (of England!) – 'voluntary censorship' ruled.

'Reporting did not accurately reflect what was known to be going on, but the motive was to avoid fuelling panic and making matters worse.'

When it came to the queues around branches of Northern Rock in the summer of 2007, British policy-makers were not inclined to accuse the BBC's Robert Peston of self-restraint in his reporting.

On the other hand, in a fascinating edited summary of evidence given to the Treasury Committee by financial journalists some time after the event, Alex Brummer, City editor of the Daily Mail, says that he exercised restraint when leant on 'at the highest level' not to publish a document that might have caused a second run on Northern Rock.

For your reviewer there was a trot down memory lane in a chapter on 'The pound and the press, 1919 to 1972' over the restraint we were told to exercise at the Financial Times in order not to rock the boat before the devaluation of 1967.

It was rumoured that Sir Gordon Newton, the editor, received his knighthood for exercising his 'patriotic duty' but subsequently had his regrets.

It was with some relief that your reviewer learned, in a chapter entitled 'Why the public doesn't trust the business press' that, when the public was asked who was most to blame for the 2007-08 financial crisis, journalists were at the bottom of the list, while bankers and politicians came top. ▪

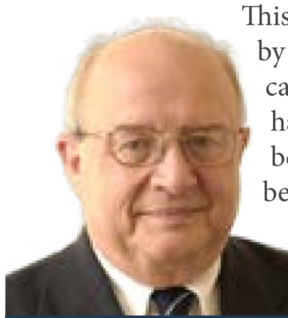
William Keegan, member of the Advisory Board, is Senior Economics Commentator at the Observer.

Modest tightening on the way

OMFIF's Advisory Board predicts the path of federal funds rates

US interest rates have been at lows since 2008, with Federal Reserve chairman Janet Yellen keen to support economic recovery and reduce unemployment. But hawks on the FOMC warn that there is an increasing need to raise rates from their current 0% to 0.25%. The Fed plans to keep rates low for a 'considerable time' after it stops buying assets in October, but anticipates a faster pace of rate rises in 2015 and 2016.

Nearly two-thirds of OMFIF's Advisory Board expect rates to be above 0.5% this time next year, with 17% expecting the rate to be between 0.75% and 1%, and 14% expecting the rate to be between 1% and 1.25%. Around a third expect rates to be between 0.25% and 0.5% this time next year. One in 10 expects rates to remain where they are.



Ted Truman

Former Assistant Secretary, US Treasury

Some time in the next year the Federal Reserve is expected to raise the federal funds rate for the first time since 2004. This will be treated as a major event by many traders and investors who cannot remember the last time this happened. But it will essentially be a non-event because it has been well advertised and will be even more well advertised by the time it happens. Anyone who is surprised, and believes in perpetually negative short term interest rates, believes in fairies.

Danny Quah

Director, Saw Swee Hock Southeast Asia Centre, LSE

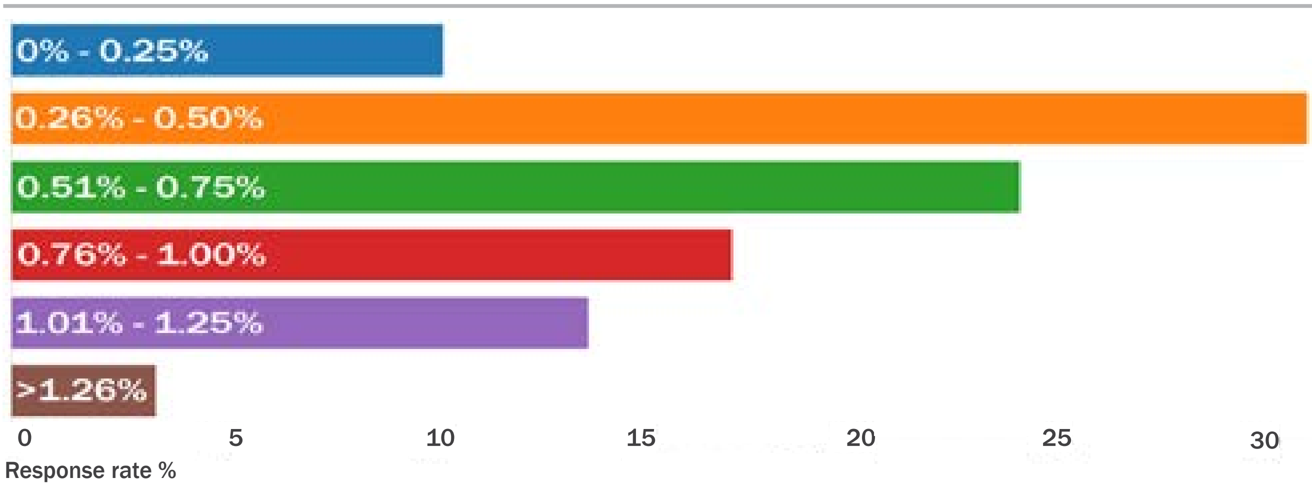
Emerging market health is better than the doom-gloom scenario that's been painted for those economies. China will continue to show robust growth but fears of China's slowdown have been so ingrained (and so often predicted) in the west over the last 30 years that, regardless of reality, any slight negative blip in China's numbers sends panic coursing through the trans-Atlantic axis. Economic growth in the US and in Europe remains truly anaemic and will continue to be so into the coming year – and it'll be on this that the Fed will focus.

There are, so to say, two yield curves in the US: one is implicit in the Fed 'dots' (the rate projections of FOMC members); the other, lower, consists of forward rates. I complicate matters by adding a third one, my own, higher still than that of the Fed. Rather than being higher because the rate increase will come earlier than the 'considerable time' mantra implies, I think it will be higher because, after the first increase in the middle of 2015, rates will be raised more quickly. The strength of the US economy will eventually overcome the resistance of the Fed to tighten.

Francesco Papadia

Former Director General, Market Operations, European Central Bank

OMFIF Advisory Board predictions of where the federal funds rate will be in September 2015




Volksbanken Raiffeisenbanken
cooperative financial network
BANK ON GERMANY
As a central bank for more than 1,000 cooperative banks (Volksbanken und Raiffeisenbanken) and their 12,000 branch offices in Germany we have long been known for our stability and reliability. We are one of the market leaders in Germany and a renowned commercial bank with comprehensive expertise in international financing solutions, maintaining representations in major financial and commercial centers. Find out more about us: www.dzbank.com.
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