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Sub-Sahara is new growth region

Swinging fortunes between Africa and Asia

Meghnad Desai, Chairman, Advisory Board

Africa has a bright future but there is nothing inevitable about it. Its prosperity will have to be earned and this requires good governance and sound economics.

We must get one thing straight: the difference with Asia. Africa has benefited from high commodity prices and its mineral resources have attracted China, India and other investors. But the logic of African development will have to be different from that of Asia. As Asia develops into a prosperous middle-income region, there are signs that labour costs are rising and Asian countries will have to stop relying on cheap labour. Africa has never been a labour surplus region; if anything the land-labour ratio in Africa is an exact contrast to that in Asia.

There is almost a universal law of development for post-colonial countries. They need about 40 years of adolescent indulgence in wrong-headed economic policies before they settle down and behave maturely. This applies to China and India. We can safely apply it to sub-Saharan Africa, which in the last 10 years has arrived as a new growth region, notching up a 5% growth rate in this period. Its demographics are good with the AIDS epidemic under control and its resources are in demand.

Over the decades, the story has swung around. In the 1950s it was different. We had the north-south split between rich and poor nations, the Cold War divided east and west. Asia was the basket case in the 1960s. Henry Kissinger said if only China and India could feed themselves, the world's problems would be eased. Africa was enjoying a prosperous decade, with many new nations on the scene and much promise from young leaders, a lot of mineral resources plus generous foreign aid.

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Angola sovereign fund, Asian currencies reserve use in spotlight

José Filomeno de Sousa dos Santos, Member of the Board of Directors, Fundo Soberano de Angola (right), describes the new Angolan sovereign fund. Hon Cheung, Advisory Board (left), explores the rise of Asian currencies in reserve management – an area where Gabriel Stein and David Marsh call for more transparency, outlining a role they hope will be played by the International Monetary Fund. **See articles on p. 4-5, 7, 10-13.**

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Dollar rules

US stays top dog

Darrell Delamaide

The dollar is still top dog in international currency competition, regardless of who is US president. But the rest of the world remains restive and looking for ways to mitigate the greenback's role. By the time the next US presidential election takes place in 2016, the world may be dealing with a fully-fledged multi-currency reserve system.

That depends less on the US president or government, more on what policy-makers in the rest of world can make happen.

There's been plenty of talk these past four years of the age of the dollar coming to an end. But that depends on what other countries do. To paraphrase the question asked during the presidential campaign: are you any closer to this goal now than you were four years ago? The answer is that they may be full of ambition, but they have a long way to go before they fulfil it.

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Order changing

Africa, Asia, Latin America step up

David Marsh, Chairman

Don't let's call this a new world order. But the order is changing across the world. OMFIF returns to Africa and Asia in November with our second core meeting in Africa at the Bank of Mauritius, and with the second Asian Central Banks' Watchers Conference, at Bank Indonesia. To mark these developments, the November Bulletin carries a number of articles that address key aspects of the African and Asian economic and monetary scene. We must not forget Latin America, which will play a big role for OMFIF activities in 2013.

Meghnad Desai expounds how countries with colonial pasts normally spend 40 years carrying out foolhardy policies and then awaken to the necessity of more sensible actions. According to this admittedly not particularly scientific rule, African countries are now due to forge ahead. It may already be happening.

José Filomeno de Sousa dos Santos, board member of Angola's new sovereign wealth fund, explains its objectives in terms of social investment as well as fulfilling the country's infrastructure needs. Albert Bressand outlines the eight Millennium Development Goals, which he says place basic human needs above ideological disputes.

Hon Cheung explains how Asian currencies are well prepared to take up the slack necessitated by the need for Asian central banks to achieve a better asset-liability mix. The drawback is that Asian bond markets are mainly still too small and shallow to handle transactions of the size and liquidity required by central banks. Gabriel Stein leads a wider investigation into the gradually-forming multi-currency reserve system, outlining how the International Monetary Fund could spearhead a drive for greater transparency.

Darrell Delamaide says the dollar may still be the world's top currency by the next presidential election in 2016 – and it's up to other countries to knock it off its perch. Paul Wilson sees parallels between present monetary turbulence and the crisis towards the end of the 16th century, when the major powers of Europe were caught up in acute political instability and economic mismanagement, with Spain at the epicentre.

Ardian Fullani, governor of the Bank of Albania, reports how south-east Europe is weathering the fall-out from sovereign debt perturbations among its European neighbours, and calls for measures to help countries like his at times of volatility. Denis MacShane argues that the UK opposition Labour party should use the period of controversy about Britain's ties with the European Union to make its voice better heard on key European issues. Michael Lafferty looks at the Liikanen report on European banking, opining that investment bank chiefs can breathe a sigh of relief that the review is unlikely to lead to much tampering with existing structures.

In his monthly BankNotes section, Darrell Delamaide describes Ben Bernanke's fight back against critics of the Federal Reserve's latest quantitative easing measures. Stefan Bielmeier analyses how a build-up of weaker countries' foreign debt lies at the heart of the euro crisis.

Peter Norman urges Europe to establish an effective recovery and resolution regime for clearing houses to prevent failure of one or more of these systemically important post-trade infrastructures. William Keegan laments the lack of leadership and concludes that former UK prime minister Gordon Brown's stewardship of the turmoil of 2008-09 looks, by comparison with what we have now, not so bad.

David Marsh

Integration benefits and costs

Assuring liquidity when the inflows stop

Ardian Fullani, Governor, Bank of Albania

Albania is a European success story. For 20 years the country has carried out substantial reforms aimed at integrating with the rest of Europe. We have done a lot to provide relief to financial markets, securing sovereign debt rollovers and maintaining macroeconomic stability. However, we are exposed to risks. South-east Europe is struggling to maintain sound economic and financial progress attained in the two decades post-communism.

Albania has made significant progress towards establishing democracy and free market principles. Economic activity has remained solid in most of this period. An important part of this process has been the presence of notable European banking groups operating in Albania and other Balkan countries. But we face challenges and difficulties, focused on the interconnection between sovereign debt and the banking system. The film 'Enemy at the Gates' springs to mind. It describes the gravity of the situation resulting from difficulties in Greece, Italy and the rest of Europe, with which we carry out about 80% of our trade and financial activity.

Coordination of monetary and fiscal policy in Albania and across the region has generally been successful in mitigating the impact of the crisis. Yet now economic activity is weak, accompanied by high unemployment, low inflation and increasing non-performing loans. All economies are performing below potential, reflecting anaemic credit growth, lower domestic confidence and weak EU economic activity.

Since the end of 2011 we have faced a significant fall in foreign banking groups' exposure towards private and public Albanian debt. This process has not been justified by Albanian fundamentals, but rather has been imposed unexpectedly from abroad. The euro area's recent measures to strengthen financial stability have taken a closed economy approach that does not sufficiently consider the cross-border implications for Europe's emerging market economies. Execution of European Banking Authority recommendations has resulted in group-level deleveraging that has caused substantial subsidiary-level problems in emerging economies. The financial burden is not shared proportionally among home and host countries.

This disproportionality is larger in transition economies such as Albania where financial intermediation is based almost exclusively on domestic resources. In principle, financial intermediation has always been funded in domestic markets, and therefore imposed no financial constraints on the parent bank's balance sheet. So the burden we are now carrying is unjust. Reduced exposure toward government debt securities has not been matched by a similar increase in exposure toward private sector credit, and therefore contributes to lower credit growth.

On the other hand, certain 'creative' measures to stimulate credit and growth through unconventional monetary policy and more relaxed supervisory requirements are potentially dangerous. They can further weaken banks' balance sheets without significantly boosting economic activity. While many European measures in the last three years have been necessary and important, they have sometimes been late, half-hearted and hesitant, and have not properly taken neighbouring countries into account. And often they have not succeeded in containing the medium-term negative impact of the financial crisis.

We are fully aware of the benefits of increasing integration of our economic and financial systems. But we see, too, the potential costs, which stem mainly from asymmetric shocks and uncoordinated policy responses. We are in the same boat. We should row in the same direction. Emerging European economies need to associate previous policies that facilitated capital inflows with measures to ensure necessary liquidity once these flows change course or stop. Given the interconnections of our financial systems, this issue deserves more attention in the future.

While many European measures in the last three years have been necessary and important, they have sometimes been late, half-hearted and hesitant, and have not properly taken neighbouring countries into account.

Asian currency opportunity

Finding route to optimum asset-liability mix

Hon Cheung, Advisory Board

In a world of super-size reserves, euro debt concerns, reserves diversification and stressed central bank balance sheets, the optimal currency allocation of foreign reserves is more than ever the central issue in reserve management. The vital question, as with any asset allocation issue, is this: what underlying liabilities are the assets intended to cover?

The vital question, as with any asset allocation issue, is this: what are the underlying liabilities that the assets are intended to cover?

This is not such an easy question to answer. Claims on the economy are interlinked with many competing policy objectives. One example is foreign exchange policy: a managed exchange rate might create liabilities necessitated by the issuance of sterilisation bonds. The answer also depends on capital account policy, for an open capital account could drive the growth in repayment liabilities related to capital inflows.

Inflation management also plays a role. For example, if the authorities follow a more tolerant attitude towards inflation, unsterilised money supply, not balanced by corresponding liabilities, might be allowed to leak into the general economy. In addition one must also take into account fiscal policy. A heavy tax burden on exports, for example, would reduce the need to sterilise excess money.

Asia's end-2009 foreign reserves total of $5.1tn comprise three basic reserve components. One element is represented by Transitory Capital Reserves of around $400bn, needed to cover liabilities arising from the repatriation of speculative capital inflows. Sterilisation Reserves of around $2.3tn are needed to cover liabilities arising from the issuance of domestic sterilisation bonds. In addition there are Surplus Reserves of around $2.4tn, totally free of liabilities.

The management of Transitory Capital and Surplus Reserves is already well established. Transitory Capital Reserves are intended to reduce the volatility of capital outflows and are therefore maintained in highly liquid short-dated bond markets, typically denominated in dollars and euros. Surplus Reserves are invested on a long-term basis in bonds, equities and other assets on a risk-return basis using strategic asset allocation techniques; there remains the question of risk tolerance and the numeraire which will have a significant impact on the optimal strategic asset allocation. For example, a natural numeraire is the domestic currency, but this gives rise to the inconvenient conclusion that the central bank needs to invest a significant amount in its own bond markets; a dollar numeraire gives rise to a more conventional asset allocation.

The optimal management of Asia's $2.3tn of Sterilisation Reserves presents a challenge. Recall that these are foreign reserves designed implicitly to cover the issuance of domestic sterilisation bonds. This gives rise to a problem in asset-liability management: finding an optimal asset portfolio of foreign reserves that best matches liabilities which are domestic bonds. This is a standard problem; in finding an answer, the starting point is to define 'best matches', in other words, the asset allocation that minimises the volatility of the asset-liability surplus.

This seems rather abstract, but remember, an additional 1% of volatility beyond the optimal minimum represents a 17% chance of an unnecessary $23bn mark-to-market loss on Asia's reserves. For Asia, the cost of sterilisation is not only the negative interest spread that ensues from holding developed market bonds; it is also the cost associated with the risk of the resultant mismatches. If private sector banks should factor in the cost of capital for balance sheet mismatches, why should not this be the rule for central banks too?

The minimum risk optimum allocation is a useful tool for minimising these sterilisation risks and analysing the dynamics of Asia's optimal foreign reserve allocation. The chart on page 5 gives an example of what the optimum currency allocation looks like using Korea as a case study.

Asia needs to develop local currency bond markets to achieve the size to exploit the predicted benefits of a reduction in asset-liability risks.

The pattern is broadly the same as for other Asian economies (with the exception of those with dollar-centric currencies such as the renmimbi and Hong Kong dollar). The theoretically optimal Sterilisation Reserve allocations have evolved as follows:

1. In the early period, the dollar bloc dominates. Asian currencies were broadly tied to the US currency, so a large allocation to the dollar (and related currencies) was optimal.
2. After the Asian financial crisis in 1997-98, we see the emerging importance of Asian currencies, principally due to lower relative volatilities relative to the domestic currency.
3. Currently, the Asian bloc dominates, since Asian currencies appear, theoretically, more optimal from a Sterilisation Reserves perspective.

These points ignore the fact that relatively low liquidity in Asian currencies make these ideal allocations possible only for the smaller reserve holders. Interestingly, for most Asian reserve holders, the renminbi, while providing sovereign risk and yield diversification, does not appear to provide any significant measure of surplus risk optimality.

One counter-intuitive feature of the optimal currency allocation is the large euro allocation in recent years. This results from the relatively low volatility between the euro and Korean won. This low-volatility phenomenon seems won-specific as the euro-bias is not observed in the optimal portfolios for other Asian currency bases.

The overall conclusion is this: Sterilisation Reserves form a large part of Asia's total foreign reserves and the optimisation analysis presented in this article provides a useful framework for understanding the future evolution of Asia's reserve management practice.

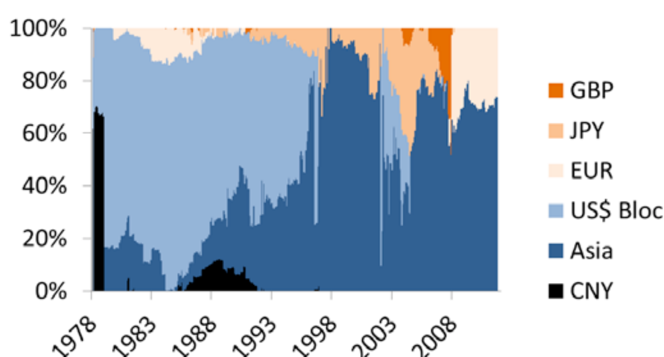
The results would suggest that the push towards greater diversification of foreign reserves is really a debate about diversification into Asian local currency bond markets.

One reason for this shift in attitude and the intense interest in diversification is that there has been a regime shift since the Asian crisis in 1997. Broadly speaking, for most Asian currency bases, the pre-1997 period was characterised by dollar dominance in the optimal portfolio.

This relationship begun to break down after 1997, when Asian currencies started to emerge as the optimal holding for fellow Asian reserve holders. The reason for this shift can be seen from the analytical framework. The optimal currency basket is driven principally by the currency volatility relative to the domestic currency. Asia's cross-currency volatilities have declined significantly compared to the major currencies.

Of course, this theoretical framework ignores market factors such as the liquidity and the size of Asia's local currency bond markets. The scale of the proposed Asian-centric optimal allocations would be impossible to implement given current market conditions, so Asia needs to develop local currency bond markets to achieve the size to exploit the perceived benefits of a reduction in asset-liability risks.

Optimal reserve currency allocation - Korea as example



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Priority for infrastructure

Angola fund sees bright future

José Filomeno de Sousa dos Santos, Fundo Soberano de Angola

Not so long ago Africa was referred to as the 'Dark Continent', a name given by western explorers as they tried to convey the mystery and romance of this immense, diverse landmass. However, over time, the name came to represent something far more negative and damaging. As part of a realignment of the world order, Africa's dark connotations are being illuminated to reveal a continent bursting with optimism and potential.

Africa's growing economies such as Nigeria and Kenya have already gained much attention. The rapid growth of Angola may come as a surprise; the country's devastating 27-year civil war ended only a decade ago. With peace and security now firmly established, Angola has quickly become an integral part of the African renaissance. Rapid development has been fuelled by immense reserves of natural resources such as oil, gas, iron ore and diamonds, allowing the government to embark on massive development initiatives. The government has invested $42bn in rebuilding aging and war-damaged infrastructure. Over 30% of the budget has been invested directly to support social programmes.

Angola, Africa's second largest oil exporter, is still over-dependent on oil as its major export. In 2008, when oil prices plunged, the government was forced to seek a $1.4nn bail-out from the International Monetary Fund. To mitigate the risk of over-reliance on oil, the Angolan government has established the Fundo Soberano de Angola (FSDEA), a new sovereign wealth fund that supports economic diversification. Launched on 17 October, with $5bn of assets under management, the FSDEA will use oil revenues to make investments in Angola and internationally to support directly the country's economic and social development and generate and safeguard wealth for future generations. The Fund will increase by the value of 100,000 barrels of oil sales per day (out of total crude output of about 1.8m).

Conscious that many sovereign funds have received widespread negative attention on account of lack of transparency and accountability, the FSDEA has been founded in accordance with established international governance benchmarks and best practices. The Fund is accountable to its sole shareholder, the government of Angola, through a legally-mandated performance review regime, which includes annual public reporting of the audited accounts through the local press and appointment of internationally-recognised independent auditors.

The FSDEA is governed by a three-member Board of Directors and an independent Advisory Council, which includes the Minister of Finance, the Minister of Economy, the Minister of Planning and the governor of the National Bank of Angola. The Fiscal Council will assess the Fund's performance relative to government-approved investment policies and benchmarks.

The FSDEA Social Charter demonstrates the Fund's accountability to the people of Angola. The Charter will address a number of key social challenges, such as access to clean water, availability of healthcare services, and the shortage of skills required to participate in the dynamic economic environment. The FSDEA's investment strategy is to create attractive long term risk-adjusted returns by investing in a wide range of asset classes, both in Angola and internationally. This diversified approach will comprise investments in financial securities as well as infrastructure investments and investments in specific industries likely to exhibit strong growth in sub-Saharan Africa.

The infrastructure and hospitality sectors are two of the first sectors targeted for investment. The Fund's infrastructure investments will focus on sectors with immediate development potential such as agriculture, water, power generation and transport. The Fund will seek attractive investments that support the development of Angola's business infrastructure and help promote Angola as a destination for foreign direct investment.

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Sub-Sahara is world's new growth region *(... continued from page 1)*

The oil shock reversed the fortunes. Sub-Saharan Africa became a byword for anarchy and under-development. Ghana, Nigeria, Angola, Congo, Mozambique, Ethiopia were all in one way or another victims of their history. South Africa prospered but under apartheid. Many African countries drove premature industrialisation, ending up with excess capacity. Asia thrived in the 1970s with the Asian Tigers joined soon after by China and in the 1990s by India, then Indonesia.

For Africa, the key is good governance. The countries that succeed show the value of preserving not destroying colonial institutions, of a stable political culture allowing smooth power transitions, of decent, easily implementable taxation policies and of honest administration. Botswana was the first country to attract attention by its clean record. Ghana overcame initial blunders by Kwame Nkrumah and his immediate successors.

Mauritius is another example of stable politics, much investment in human capital and a vibrant multi-racial culture. Mozambique was able to overcome the aftermath of a bloody civil war by adopting sensible macroeconomic policies. Ethiopia, Kenya, Uganda and Tanzania all went through a radical restructuring, following a sensible path of development. There are still problems in Sudan, Somalia and Angola, but Nigeria looks like it is on the mend if it can deal with the Islamist insurgence in the north.

Africa has mineral resources but their exploitation generates wealth but not employment. A land-rich/ labour-scarce region 'suffers' from high real wages. This may sound paradoxical as we only notice the poverty in Africa. But Africa cannot take over from Asia as the hub for labour-intensive manufacturing. African economies have high unemployment rates, but that is because of under-investment in education and skills. A high real-wage economy needs to skill its workers so that they can perform high value-adding tasks.

This malaise is visible in South Africa with its post-apartheid gulf between the small prosperous enclaves for white and some black families and the large urban areas beset by high unemployment.

The unemployed will need education to command jobs. Africa will have service industries or mid- or high-tech manufacturing but not labour-intensive industries such as cotton textiles.

Africa will need massive investment in education and skilling to prepare its labour force for the kind of service industries which can absorb its labour force and attract capital. The resource boom will not last forever especially if Chinese growth slows down to a level of 7 % or lower.

Dollar rules *(... continued from page 1)*

It seemed at the time of the last US presidential election in 2008 that the world – in the wake of the subprime mortgage crisis, the collapse of Lehman Brothers, and the cascading losses from credit default swaps – was fed up with being at the mercy of the US. Other countries were tired of the negative carry on their reserves as the US continued to rack up massive current account deficits. They felt the 'exorbitant privilege' enjoyed by the US was a relic of the past or at least should be shared with others.

Crisis meetings at the G20 were full of talk about the dollar being done for and a new era in world finance. There were hopes that the euro, the renminbi, and the yen would play a greater role in global trade and reserves, with other emerging market currencies supplementing them on a regional basis.

In the meantime, a debt and deficit crisis has wracked the euro, at times seeming to threaten its very existence. European leaders groping toward a solution often remain at loggerheads and find it extremely challenging to solve monetary problems without sufficient fiscal or political integration. Even if the euro does prove 'irreversible', it will be some years before it can regain the credibility it needs to become a serious alternative to the US currency.

In Asia, both China and Japan, in very different ways, are facing a certain amount of political instability. China must seek to balance the aspirations of a population eager for a higher standard of living with an economy that still relies on exports. On top of everything else, Japan and China are hardly talking to each other due to a territorial dispute, so that top Chinese officials stayed away from the International Monetary Fund/World Bank annual meetings in Tokyo.

It is in this environment the US Federal Reserve has launched a third round of quantitative easing to increase further the amount of dollars in existence. The US Congress has walked to the edge of a fiscal cliff and seems ready to plunge the country into a new recession by letting automatic tax increases and spending cuts take place; and both Barack Obama and Mitt Romney during the campaign competed with each other on who could be tougher towards China.

Against this backdrop, it is difficult enough to predict how things will look in January of next year, let alone in November 2016.

The key to the post-election landscape is the issue of the budget deficit and how it is resolved. What we know for sure is that the dollar will still be the world's main reserve and trading currency. Regardless of who's in the White House, that will only change when leaders in Europe, Asia and Latin America do something about it. They will contend with an economy that, however diminished relative to global GDP, is still by far the world's largest, with the biggest and deepest financial markets.

Whatever dysfunction happens to be testing its political institutions, America still looks relatively stable compared to everyone else.

Living to fight another day

Liikanen poses no threat to investment banks

Michael Lafferty, Deputy Chairman

The European Union as a whole is unlikely to follow Britain's lead and restructure universal banks as holding companies with separate ring-fenced subsidiaries for retail banking and investment banking. Reading between the lines of the new banking report of the EU's so-called High-Level Expert Group led by Erkki Liikanen, governor of the Bank of Finland, I conclude that far-reaching action is unlikely. Investment banking lives to fight another day.

There may be some new legislation but all the signs from the group headed by Liikanen are that it will not unduly upset the investment bankers who head many of Europe's big banks. Consider this following slightly convoluted statement from the Liikanen report: 'While pursuing these key objectives related to financial stability, separation also aims to maintain banks' ability efficiently to provide a wide range of financial services to their customers. For this reason, the separation is allowed within the banking group, so that the same marketing organisation can be used to meet the various customer needs. Benefits to the customer from a diversity of business lines can therefore be maintained.'

Later in the report there is another sign that the status quo will be upheld: 'Transfer of risks or funds between the deposit bank and trading entity within the same group would be on market-based terms.'

For sure, Liikanen favours separation of deposit-taking from certain risky financial activities, including proprietary trading of securities and derivatives. But this is hedged with conditions. Separation would be mandatory only if the risky activities are 'a significant share of a bank's business or if the volume can be considered significant from the viewpoint of financial stability'. Mandatory separation would not be required for what the report calls 'the smallest banks' – which sounds like most of the 4,713 credit institutions that exist in the EU.

Indeed, Liikanen proposes that the decision to require mandatory separation should proceed only if two major conditions are fulfilled: if a bank's trading assets exceed 15-25% of its total assets or €100bn, and if supervisors so decide. There is plenty of scope here for Deutsche Bank, for example, to carry on more or less as it does now, and for France and the UK to go in their own separate directions. So much for the Liikanen group's 'objective of establishing a safe, stable and efficient banking system serving the needs of citizens, the EU economy and the internal market'.

The Liikanen group may have been subjected to intense covert lobbying by universal banks opposed to anything like ring-fencing, let alone total separation of investment banking from retail or commercial banking. This pales into insignificance compared with the lobbying that is yet to come as any legislation makes its way through the EU parliamentary system.

'Be prepared for intense, slick, self-serving lobbying as the advocates of the status quo get their MEP friends to put down amendments left, right and centre,' comments one Brussels insider. In all these shenanigans misinformation is typically considered fair game. How else should we view the claim in the Liikanen Report that the type of universal banking it is supposed to have been reviewing is long-standing in Europe?

Yes, German-style universal banking has been around in Europe for more than 100 years. Now much less evident, in view of the banks having sold many of their shareholdings in industrial companies, and reduced their presence on supervisory boards, this type of system bears little connection to the Anglo Saxon-style version of universal banking combining retail and investment banking that has grown like wildfire around the world over the past 20 years. The least that can be said is that the Liikanen group seems to have got confused between these two variants.

German-style universal banking bears little connection to the Anglo Saxon-style version combining retail and investment banking that has grown like wildfire around the world over the past 20 years.

Opaque multi-currency moves

IMF should lead transparency drive

Gabriel Stein and David Marsh

The world appears to be moving towards a monetary system where the dollar shares its supremacy with the euro, the renminbi and other 'non-standard' currencies now on the fringes of international reserve holdings. The new set of reserve currency circumstances is somewhat opaque, because the world of official foreign exchange holdings is notable for its lack of transparency. A concerted effort is needed by the International Monetary Fund and its members to overcome this shortage of information.

The world has never had a stable multi-reserve currency system. At different periods during the past 150 years, sterling and then the dollar have been dominant. However, the rise of China, the ambition of the Chinese authorities for the renminbi to attain some form of reserve currency status, and the birth of the euro – for all its current troubles – raise the possibility of such a system appearing.

Recent statements by leading Asian central bankers confirm that the Asean bloc of south-east Asian countries, together with China, Korea and Japan, are building up reciprocal holdings of each others' currencies as a means of lowering dependence on the dollar. This forms part of a broader initiative under which Asian countries increasingly gain control of their own savings and distribute them around the region – effective disintermediation of the western financial system through which Asian central banks in the past habitually recycled their reserves.

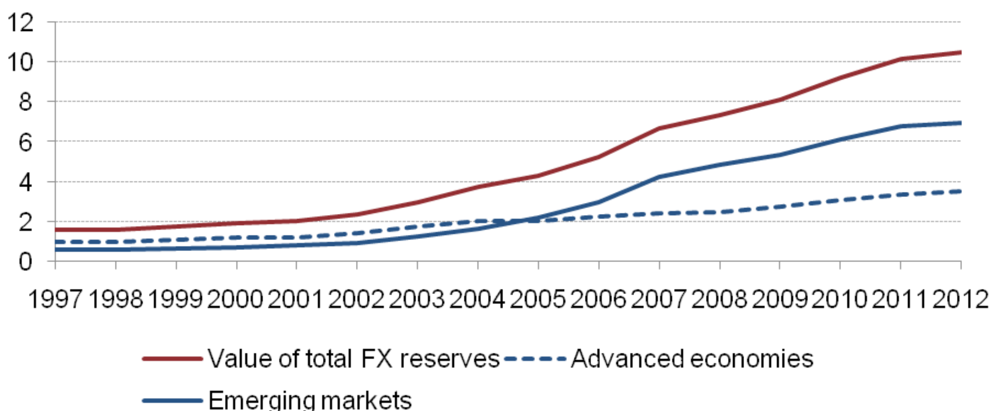
The Reserve Bank of India is exploring strategies for diversification while the Bank of Russia has confirmed the advanced state of its own move away from the dollar.

The past 15 years have seen a more than sixfold rise in foreign exchange reserves, from $1.6tn in 1997 to $10.5tn by the second quarter of 2012, according to IMF figures. This is primarily an emerging markets phenomenon. Whereas advanced economies' foreign exchange reserves have risen 3.5 times, from just over $1tn to just over $3.5tn over this period, those of emerging markets have risen 11.5 times, from $600bn to just under $7tn, as chart 1 shows. (These data do not include central banks' holdings of gold, which have also undergone substantial changes. This mainly reflects the sharp price rise over the past 15 years. Additionally, developed countries have largely stopped selling gold reserves in recent years, and emerging market economies have started to buy).

The importance of the dollar has diminished somewhat, from a peak of 71.5% of declared reserves in 2001 to just under 62% by 2012. The IMF provides a reserve breakdown for

Recent statements by leading Asian central bankers confirm that the Asean bloc of south-east Asian countries, together with China, Korea and Japan, are building up reciprocal holdings of each others' currencies as a means of lowering dependence on the dollar.

Chart 1: Value of foreign exchange holdings, $tn



Source: IMF

standard reserve currencies – the dollar, euro, sterling, yen and Swiss franc. (The inclusion of the Swiss franc is rather quixotic, since the Swiss themselves say the franc is not a reserve currency, in view of the shortage of Swiss government debt). The importance of 'other' currencies outside this definition has risen, from a low of 1.3% in 2001 to 5.3% by end-June 2012 (Chart 2), amounting to $310bn.

Another significant development is the rise in unallocated reserves. Several important countries, led by China, do not provide their reserve composition to the IMF, and many of these have made large-scale additions to reserves in recent years. In 1997, these unallocated reserves amounted to $344bn, or 21% of total reserves; by 2012, they had risen to just below $4.7tn, 44.5% of the total (Chart 3).

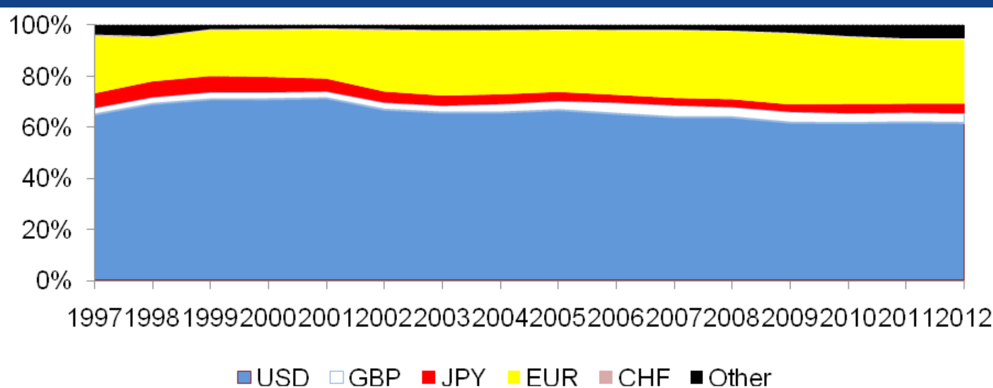
It is possible, even likely, that the composition of unallocated reserves broadly speaking mirrors that of allocated reserves, but we cannot say for certain. One piece of evidence for this is that the China Securities Journal reported in 2010 that the share of euros in Chinese foreign exchange reserves is in line with the international benchmark, at around 25%.

It is possible, even likely, that the composition of unallocated reserves broadly speaking mirrors that of allocated reserves, but we cannot say for certain.

Along with the deficiencies in publication of the composition of their foreign reserves, there are also gaps in knowledge on how they trade them. The US Treasury's monthly data on foreign net purchases of long-term US government securities are of little help in terms of establishing who buys them. The biggest gross purchases have come from the UK, which bought an average of between $4tn to $7tn per annum over the past 16 years (the net numbers are much smaller). France is the second biggest buyer, followed by the Cayman Islands. Chinese gross purchases are stated at between $150bn and $280bn. Plainly these figures do not give a very accurate depiction of the identity of the end-investor.

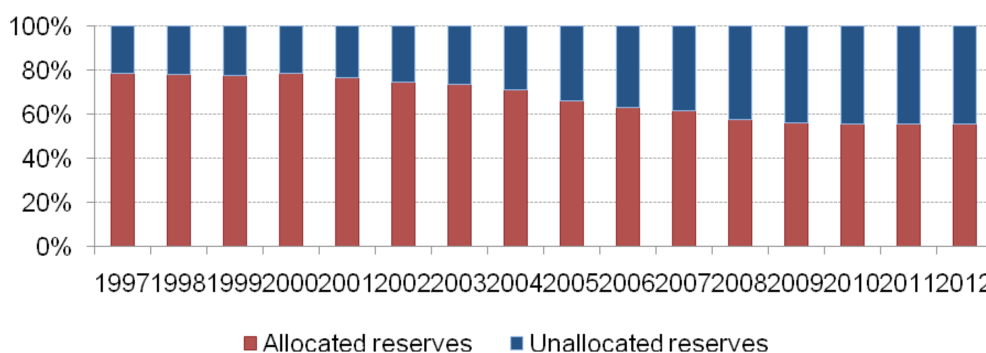
One theme behind the overall development of foreign exchange reserves is that central banks, like investors in general, are attempting to find yield and/or safety at a time when none of the major currencies seems attractive. This is the reason for the rising importance of the 'other' currencies. One clear instance is the renminbi.

Chart 2: Composition of declared reserves, %



Source: IMF

Chart 3: Allocated vs unallocated reserves, % of total reserves



Source: IMF

The Chinese authorities have made clear their desire to turn the renminbi into a reserve currency. Yi Gang, deputy governor of the People's Bank of China and head of the State Administration of Foreign Exchange (SAFE), has been seeking to place the renminbi's development as a natural side-effect of China's growing share of the world economy and international trade.

Speaking at the annual meetings of the IMF/World Bank in Toyo on 14 October he called renminbi internationalisation 'entirely a market-driven phenomenon. I don't promote it.' Stating that the renminbi was essentially in competition with the dollar, euro, sterling and yen, Yi said: 'In the past China has restricted the use of the renminbi…so what the central bank did is just remove some barriers for using the renminbi. If our trade partners or investment partners like using the renminbi, why not?' Inescapably, the renminbi is still subject to capital controls. But 10 to 15 central banks around the world now hold appreciable quantities of renminbi in their reserves – including, as the first well-known central bank in Europe to do so, the Austrian Central Bank.

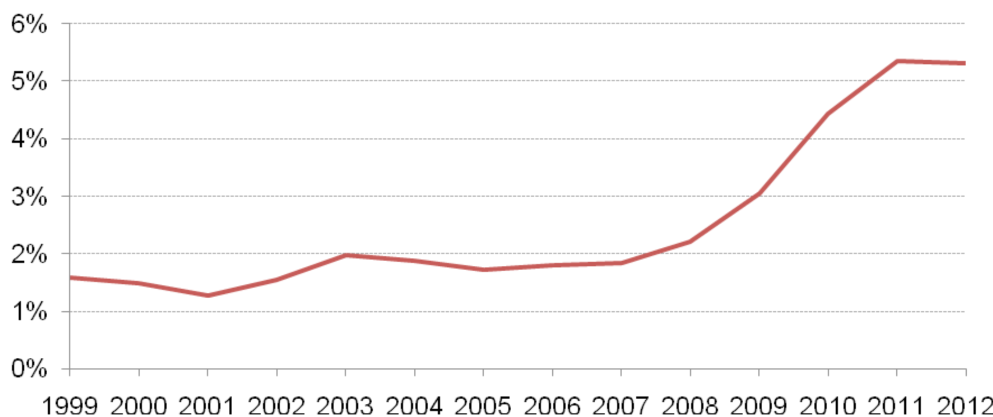
In view of the shortcomings of the IMF's data on reserve holdings, insights into the build-up of a multi-currency system are piecemeal.

In view of the shortcomings of the IMF's data on reserve holdings, insights into the build-up of a multi-currency system are piecemeal. Information is based on what holders and issuers reveal, usually on a non-systematic or anecdotal basis. It is well known, for example, that Asian countries – the 10 members of the Association of South East Asian Nations (Asean), together with China, India and South Korea - are intensifying long-held plans for mutual monetary cooperation as a result of problems with the dollar and the euro. They are gradually allowing their own currencies to be used more widely in international reserve management. And their central banks are building up their own reserve holdings of each others' currencies to reduce their vulnerability to western currency fluctuations. As well as dollars, euros, yen and sterling, SAFE's holdings include Asean currencies.

But such measures are not limited to central banks in Asia.The Swiss National Bank is a rare example of a central bank that actually publishes a regular breakdown of its reserves composition. It holds (US)$10bn of Canadian dollars and about $12bn in Australian dollars, Swedish kronor, Danish kroner, Korean won and Singapore dollars. The Bank of Finland gives a breakdown of its currency holdings, including Canadian dollars, Swedish, Norwegian and Danish crowns and Singapore dollars. Of these, the largest amount is Swedish crowns, around $200m. The National Bank of Poland held Norwegian crowns to a value of less than $6bn. The Riksbank held $8bn worth of Norwegian crowns and half that amount of Canadian dollars. The Bank of Russia provides relatively precise figures on reserve holdings. Of its $500bn reserve holdings, 40% is in euros and 9% in sterling.

Such information is often given in anecdotal form. For example, the governor of the Central Bank of Nigeria told the Wall Street Journal that the bank intends to raise its stock of renminbi to 10% of its $35bn. (The statement runs counter to the Central Bank of Nigeria's website, which describes the legal requirement for the country's reserves to be held in a convertible currency.) News reports show Norway and China buying Korean won bonds this summer; Norway now allegedly holds just under $2bn in won bonds.

Chart 4: 'Other' as % of allocated foreign exchange reserves



Source: IMF

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Data also stem from what a currency issuer thinks others hold. The Reserve Bank of Australia has attempted to provide insights in holdings of the Australian dollar, one of the most widely-traded and widely-held currencies. It has published data based on a survey of central banks which show 15 central banks definitely holding Australian dollars in their foreign exchange reserves, with another eight possibly doing so. However, the Reserve Bank gives few numbers.

Some countries – such as Finland or Brazil – provide Australian dollar holdings as a share of total reserves; some such as Poland give the figure in US dollars; others like Sweden express these holdings in local currency. Based on the Reserve Bank of Australia data, definitive official holdings of Australian dollars are slightly less than $40bn. If we include other countries that hold Australian dollars (such as Malaysia and Hong Kong), but don't give a breakdown, then a generous estimate would imply that total central bank Australian dollar holdings are around $60bn.

On an informed estimate, reserve holdings of Canadian dollars, another currency that has attracted attention because of its strong resource background, may be of a similar order of magnitude. (Finland and Switzerland report higher Canadian than Australian dollar holdings, Sweden reports roughly similar levels).

The Swedish National Debt Office reports that foreign central banks are buying large shares of Swedish bond issues. The Norwegian and Danish authorities have both been cited as voicing caution about the volumes of their own currencies building up in other central banks' reserves.

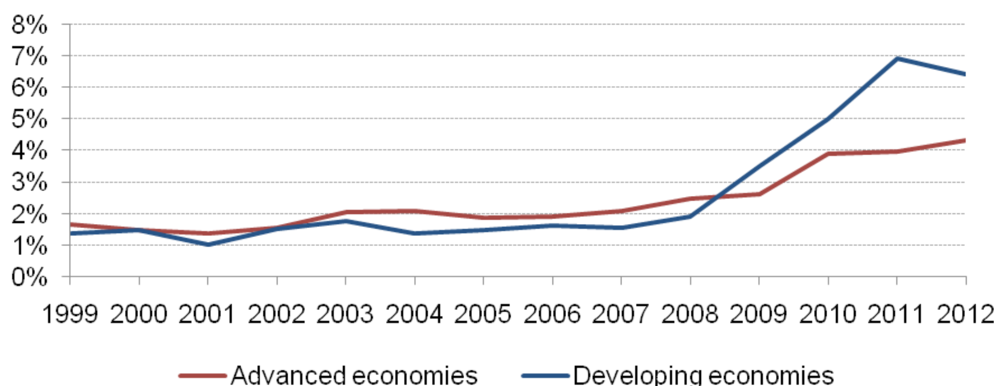
How much do these shifts represent a conscious decision to diversify foreign exchange holdings? How much can be regarded as normal in a world where there are clear uncertainties overhanging the dollar and the euro and where regional economies are becoming more important?

To clear up some of these uncertainties, it would be welcome if the IMF took determined action to fill the gaps in its data by asking countries such as China to provide data on their reserves composition, which would greatly increase the coverage represented by the IMF total for allocated reserves.

The IMF could widen significantly the template for central banks' reporting of individual currencies, which would then include the Canadian, Australian and Nordic currencies as well as Asean currencies that have become increasingly widely-held. In spite of the undoubted increases in diversification and regional currency cooperation, the dollar is still by far the world's dominant currency. But several others, not just the renminbi, are weakening the dollar's hold. To shed more light on a very important aspect of the world economy, more and better statistical information on how this is happening is badly needed. Here, as in other areas, it is up to the IMF to take a lead.

To clear up some of these uncertainties, it would be welcome if the IMF took determined action to fill the gaps in its data by asking countries such as China to provide data on their reserves composition.

Chart 5: 'Other' as % of allocated foreign exchange reserves by country grouping



Source: IMF

Social investment is key

Infrastructure, education and living standards

Jean-Claude Bastos de Morais, Chairman, Quantum Global Advisory Board

Substantial investment is required to build the infrastructure required to support Africa's development potential. However, even if billions of dollars were invested into physical infrastructure projects, this by itself would not provide the solution. The real potential lies in supporting Africa's social and economic development by creating a platform for sustainable economic growth. This means that ordinary Africans must be allowed to participate in the opportunities that infrastructure investments create.

Fulfilling infrastructure needs should be married to a broader investment approach, which can be achieved by a concerted effort to increase access to education across all age groups.

According to the World Bank, over $60bn is required for African infrastructure investments up to 2015. But there is also a significant and more immediate need to address the efficiency gap in existing infrastructure sectors such as power, transportation and water. Many sub-Saharan countries such as Angola lose considerable revenues due to massive inefficiencies, sometimes amounting to 5% of GDP annually. Africa could achieve a significantly higher annual per capita growth rate through more targeted infrastructure investments that look to boost overall production, while addressing built-in inefficiencies.

The real challenge for Africa is how to ensure such growth strategies improve living standards for ordinary Africans. According to the World Bank's Africa Action Plan, expanding primary education and linking secondary education to employment options is fundamental to this aim. Creating real social and economic opportunities through education is essential to ensure that infrastructure investments raise living standards, and do so at a much earlier stage in the development process. Africa needs a more holistic approach to investing in education infrastructure covering the primary and tertiary sectors and skills training.

According to a UNESCO statistical database covering schooling in sub-Saharan Africa, primary school population and enrolment increased by 25% and 59% respectively from 1999 to 2009. This represent significant progress for sub-Saharan Africa, but the region is still rated the lowest in the world for school standards and attendance.

Tertiary education plays a significant role in promoting economic expansion. Increasing Africa's higher education opportunities would raise growth of African output and income generation. Considering that incomes have been falling in some African countries, such growth opportunities would have a considerable impact on reducing poverty across the region. Creating skilled jobs in Africa that are then filled by expatriates as a result of skills shortages among Africans is counter-productive. Such an outcome generates less economic wealth and exacerbates social problems. African countries need not only to provide higher education for the next generation, but also to upgrade the skills of the current labour force through training courses, entrepreneurship courses or scholarships.

Building a knowledge economy and expanding related skills for competitiveness are fundamental conditions for economic development. Providing skills, increasing capacity to use global knowledge and boosting research will create additional opportunities.

Enacting these fundamental policies remains one of Africa's biggest challenges. It is incontestable that many of the region's governments have under-invested in higher education. But Africa must not shrink back from the challenge. The African diaspora can play a crucial role in the knowledge economy. Many Africans abroad undoubtedly have relevant skills and expertise. If some of these emigrant Africans return home, repatriating these skills will have a positive impact on growth and competitiveness.

To achieve the objective of higher living standards for ordinary Africans, fulfilling infrastructure needs should be married to a broader investment approach; this can be achieved by a concerted effort to increase access to education across all age groups. While infrastructure opportunities are the key to unlocking Africa's enormous development potential, long-term sustainable growth will be achieved only through social investment.

New focus on funding diversity

Enhanced accountability can broaden support

Albert Bressand, Advisory Board

The 21st century opened on a new wave of reasoned optimism regarding poorer countries. By focusing on eight compelling goals to be reached by 2015, the Millennium Development Goals (MDGs), the international community placed performance in meeting basic human needs above increasingly sterile disputes on the 'Washington consensus' or the 'New International Order'.

This targeted effort to free humanity from extreme poverty, hunger, illiteracy and disease made international and national institutions accountable for progress, leading to higher levels of support. We have seen significant advances. The number of people living with less than $1.25 per day is on its way to falling below 15% of developing countries' population in 2015 against 46% in 1990. Enrolment in primary education has increased by 18 points in sub-Saharan Africa to 76% and by 12 points to 91% in South Asia. The mortality rate for children under five has declined by a third. Other goals have proven more difficult to achieve.

The proportion of people exposed to hunger has leveled out at 16% in developing countries. The number of workers in informal 'vulnerable jobs' stopped decreasing in 2008. One in eight children in sub-Saharan Africa still dies before the age of five, twice the developing countries' average and 18 times the developed regions' average. More than ever, Official Development Assistance (ODA) must be seen as part of a broader funding and assistance package. Traditional distinctions between donor and recipient countries are challenged as emerging countries and sovereign wealth funds become key players. 'Aid for trade' paves the way for market-led solutions. Concessional funding is increasingly accompanied by private direct investment.

UN secretary general Ban Ki-moon has asked a high-level task force to propose a post-2015 development strategy. Mobilising global resources – private and public – towards a new generation of common development objectives is an essential issue. Focusing on basic human needs, the aim of the MDGs is to eschew ideological, finger-pointing debates. Yet the MDGs' strength is also a potential source of vulnerability. Focusing on a few measurable targets is bound to overlook the complexity and diversity of the development process. While the world is coming close to halving absolute poverty, the 19 'fragile and conflict-affected countries' have barely progressed. Unlike hunger, poverty is not easily defined. Reducing mortality is a step towards reducing morbidity and promoting health, an open ended concept. Similarly, the painful realisation is dawning that progress in school enrolment does not guarantee, by far, progress in 'learning'. In its contribution to the post-2015 debate, the Office of the High Commission for Human Rights (OHCHR) stresses that 'the ability to peacefully express one's views and grievances, freely and without fear, is a fundamental human right, an imperative for effective development processes.' It will be interesting to see whether this can be recognised in an international development strategy.

How to set more comprehensive objectives without losing the 'MDG momentum' will be a major challenge. In just a few years, far-reaching institutional change has laid the ground for a new development consensus. After decades of wrangling on 'conditionality versus sovereignty', the 2002 Monterrey Conference on Financing for Development led to significant progress to increase ODA including during the 2008 recession. The Global Partnership for Effective Development Co-operation in December 2011 at Busan, Korea, extends aid effectiveness to a broader group including China and sovereign funds.

The 19 fragile and conflict-affected countries have formed their own 'G7+' forum to discuss governance challenges. Acknowledging problems of conflict, corruption and ineffective management can help enhance development efforts. Mobilising financial resources across market and concessional channels alike can turn the MDG process into a lasting, sustainable strategy.

Traditional distinctions between donor and recipient countries are challenged as emerging countries and sovereign wealth funds become key players.

A storm we've seen before

Spanish 16th century defaults set tone

Paul Wilson, Advisory Board

A European currency crisis. Massive inflation in the price of foodstuffs. Capital flight and currency smuggling on a major scale. States running a current account surplus attracting the anger and envy of less successful states. Unsustainable foreign policy driving unwise economic decisions. The first of a number of Spanish sovereign debt defaults leading ultimately to the collapse of a major German bank.

Yet another grim forecast of the worst possible outcomes of our current financial crisis in Europe? No. This is precisely the situation in Europe in the period from the middle to the end of the 16th century. The major powers of Europe at that time were caught up in a period of acute political instability and economic mismanagement, with Spain at the epicentre of the crisis.

The transfer of immense amounts of bullion – initially gold and then predominantly silver – from the New World to Spain was minted into coin and moved around Europe in support of the Hapsburg Empire's political objectives of holding on to its rebellious territories in the Netherlands. In England, an unprecedented period of debasement of the coinage from 1542 to the 1550s, leading to depreciation of the otherwise impressively stable sterling, had at its root the uncontrollable spending of Henry VIII, notably on the Royal Navy.

Unable to raise taxes in the face of parliamentary opposition, the king resorted to the expedient of debasing the coinage, reducing the bullion content while maintaining the face value or fiduciary element. The resulting increase in seigniorage went into the king's grand projects. Only a complete and surprisingly successful remonetisation programme in 1560 during the reign of his daughter Elizabeth I was able to stop the rot.

A similar period of debasement in France contributed to appalling inflation – particularly in foodstuffs. The Chambre des Comptes – something like a parliamentary select committee – called for investigations into the causes of the inflation. The conventional wisdom – that the rise in prices had been caused solely by a reduction in the quality of money (debasement) – was challenged by the political writer Jean Bodin who proposed that the inflation was down to a number of causes, but that the vast increase in money entering France from Spain was probably the single biggest factor. Bodin's report is credited with being the first published exposition of a quantity theory of money.

Despite the attempts by Philip II of Spain to control transfers of gold and silver coin to other European states, he was unable to stop the extraordinary level of currency smuggling into France. Merchants of the north Italian trading states were drawn to this seemingly inexhaustible source of wealth; their highly successful drive to export luxuries to Spain, France and England attracted anger and envy in those countries.

Philip II's political project demanded unending quantities of money to pay for his army and to subsidise political allies in northern Europe. When the treasure ships from the New World were slow to deliver, he mortgaged their cargos of gold and silver to the bankers of Genoa who in turn provided bills of exchange to be cashed in the Lowlands as payment for Spain's armies there. But by 1575, the level of indebtedness to the Genoese banks was so high that the king opted to default.

The bankers of Genoa responded by blocking the flow of bills of exchange to the army in the Lowlands resulting in the sacking of Antwerp by Spanish troops in 1576. Further defaults followed, including one in 1596 which was directly responsible for the collapse of the German banking house of Fugger. Spain's defaults of the 16th century are sometimes cited as the origin of sovereign debt default. The dangerous conjuncture of high risk lending by the private sector and extravagant public sector spending, trade imbalances, unsuccessful monetary policy and capital flight is not purely a 21st century phenomenon.

The conjuncture of high-risk lending, extravagant public sector spending, trade imbalances, unsuccessful monetary policy and capital flight is not purely a 21st century phenomenon.

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Brexit door opens ever wider

Labour cannot shy away from referendum

Denis MacShane, Advisory Board

Some months ago I coined the term 'Brexit', meaning Britain exiting the European Union. Month by month the Brexit door opens ever wider. Politicians, editors, civil servants and business leaders in different European countries shrug their shoulders at the assumption that Brexit will happen.

Political Brexit began with David Cameron, before he became prime minister, leaving the main grouping of centre-right governing parties in Europe. Instead he linked with what Nick Clegg, now deputy prime minister, called 'nutters, anti-semities and homophobes' in the European parliament. Add in Tory MPs at the Council of Europe voting with Russian MPs to block investigation of human rights issues in President Vladimir Putin's autocracy and the Conservatives have never been so isolated from mainstream European politics.

The move to Brexit accelerated with the appointment of William Hague as foreign secretary. Hague has made a priority out of downgrading links with Europe in favour of supporting ties with non-democracies like China, Bahrain and Russia. Hague incessantly calls for the repatriation of EU areas of competence and has worked with home secretary Theresa May to pull out of the European Arrest Warrant, DNA data sharing and other common crime-fighting measures with EU partners.

Natural UK allies like Sweden, the Netherlands or Poland are dismayed at Hague's EU hostility. Now Cameron talks openly about a referendum. But on what? There is major EU resistance to negotiating and writing a new treaty. France does not want this at any price, let alone a subsequent referendum, as President François Hollande has made clear. Downing Street's strategy has been based on a new treaty allowing Britain to trade its veto in exchange for obtaining major opt-outs and allowing Britain a formalised semi-detached membership of a future EU. But if there's no new treaty, what happens? Cameron can hold a permissive referendum instructing him to seek to negotiate a British exception to existing EU arrangements. But there will be no obligation on the other 27 member states to accept British demands. The Pandora's Box of EU treaty revision will stay shut.

Cameron cannot now, however, row back from a referendum. And the Labour party cannot head towards the 2014 and 2015 elections as the only party opposing a referendum. It would be helpful if Labour could recover verve and vision about Britain continuing as a major European player. But if Cameron offers a referendum, Labour must follow suit and fast. Margaret Thatcher famously said that referendums are 'the devices of dictators and demagogues'. But the number of anti-referendum Thatcherites in all parties can be counted on one hand.

So Labour cannot shy away from a referendum. It needs to combine this with a new discourse that looks beyond the crisis and shapes a new partnership vision. This should be based on growth not austerity. National parliaments should form a Senate to balance the Strasbourg assembly. We need a reduced European Commission, tougher controls on banks to prevent another 2008, and a major rethink of social Europe.

Brexit does not have to happen. Europe would lose a major nation with a sense of humour, the best record on integrating non-white, non-Christian citizens, a profound love of free citizenry expressed by habeas corpus and free media, the most efficient networkers and negotiators of any state service, and English-speaking access to the world. That is what Europe loses with Brexit. What does Britain gain? Nothing. Labour has avoided speaking, hearing or seeing Europe for a decade. The Iraq war and its aftermath ended New Labour's effective EU engagement. Post-crash agonies for all EU nations have increased the toxicity of European questions. But 'One Nation' Labour cannot back a vision of Britain as an isolated nation cut off from EU partnerships. The European question is back with a vengeance. Labour must lead not follow.

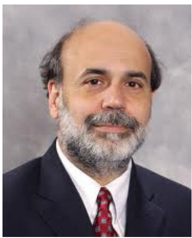
The European question is back with a vengeance. 'One Nation' Labour cannot back a vision of Britain as an isolated nation cut off from EU partnerships.

QE3 defence best form of attack

Benefits of bond-buying cited on many fronts

Darrell Delamaide, Board of Contributing Editors

After September's decision by the Federal Open Market Committee to embark on a new round of large-scale asset purchases, Federal Reserve officials in October were keen to explain and defend their action on both international and domestic fronts. Defence seems the best form of attack – or at least of promotion.



Ben Bernanke

Bernanke rejects international criticism

When he traveled to Tokyo for the meeting of the International Monetary Fund, Fed Chairman **Ben Bernanke (voter)** was not shy about rejecting criticism from emerging market countries that accommodative monetary policy in the US was making life uncomfortable for them. 'I am sympathetic to the challenges faced by many economies in a world of volatile international capital flows,' he said in a speech there. But, he added, 'it is not at all clear that accommodative policies in advanced economies impose net costs on emerging market economies.'

For one thing, capital flows into emerging markets result from various causes, including perceptions of risk and reward, and not just low interest rates in developed economies. For another, monetary policies that promote growth in the advanced economies will rebound to the benefit of emerging markets as these economies recover and increase imports.

Bernanke went on to turn the tables on his critics, and pointed out that some of the problems result from their own policies. 'In some emerging markets, policy-makers have chosen to systematically resist currency appreciation as a means of promoting exports and domestic growth,' he said, without, of course, naming names. 'However, the perceived benefits of currency management inevitably come with costs, including reduced monetary independence and the consequent susceptibility to imported inflation.' Bernanke's recommendation for them: 'Classical principles of international adjustment' – namely, refrain from intervening in currency markets and use monetary and fiscal policies to counteract effects of currency appreciation and rebalance their economies between external and domestic demand. What could be easier?

Jeremy Stein

Stein sees positive 'signaling' effect

In his maiden speech as a Fed governor, **Jeremy Stein (voter)**, a Harvard economics professor specialised in behavioral finance and capital markets who joined the Board in May, affirmed his support for the new round of asset purchases agreed last month. 'To be clear on where I stand,' Stein said at the Brookings Institution in Washington, 'I firmly believe that this decision was the right one.'

He acknowledged that the benefits of such purchases probably diminish over time. 'A number of observers have raised concerns about diminishing returns, or escalating costs,' he noted. 'I think that, at least in the limit, these concerns must be right.'

But he also observed than in addition to the 'hydraulic effects' of the asset purchases on the economy, further benefit comes from 'a signaling or confidence channel.' By backing up the Fed's 'forward guidance' of continued monetary accommodation with concrete action, the FOMC bolstered the credibility of that guidance, he said.

William Dudley

Dudley affirms Fed will stay the course

For New York Fed chief **William Dudley (voter)**, the diminishing returns of asset purchases over time were all the more reason to proceed now with a substantial programme.

'A more front-loaded programme would avoid greater attenuation compared with a policy that started out less aggressive but added stimulus gradually over time,' Dudley said at the annual meeting of the National Association for Business Economics in New York.

Any further delay in action would run the risk of the economy stalling in a deflationary mode, which would weaken the effectiveness of any programme of bond purchases at that point.

Dudley also reaffirmed the Fed's policy statement that accommodation would continue well after indications that the economy was recovering.

'If uncertainties about the US fiscal path and the future of the eurozone were resolved in a constructive manner, growth could pick up more vigorously than anticipated,' Dudley said. 'This would be a wonderful outcome.'

But, in keeping with last month's declaration, he added, 'If we were to see some good news on growth I would not expect us to respond in a hasty manner.'

Narayana Kocherlakota

Call for four more years of low rates

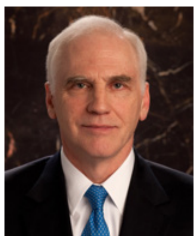
Minneapolis Fed president **Narayana Kocherlakota (non-voter)** went a step further and said monetary accommodation might actually last four or more years if his plan of targeting a sufficiently low unemployment rate is followed.

In a speech in Great Falls, Montana, Kocherlakota defended the 'lift-off' plan he introduced last month, which calls for the Fed to keep rates low until unemployment falls below 5.5% -- as long as inflation remains stable and does not rise much above 2.25%.

'Note that neither of these thresholds should be viewed as triggers,' the Fed official clarified. 'Once the relevant cut-offs are crossed, the Committee retains the option of either keeping the Fed funds rate extraordinarily low or raising the Fed funds rate.'

Kocherlakota's plan threw Fed watchers into a tizzy when he announced it last month because he had been viewed as an inflation hawk, while the plan's emphasis on an the Fed's mandate of low unemployment at the expense of its mandate to keep inflation stable seemed fairly dovish.

'The plan is neither hawkish nor dovish,' Kocherlakota clarified in his Montana speech. 'The terms 'hawkish' and 'dovish' presume that the Committee faces a tension between its two mandates. But the Committee does not see any tension between its two mandates now.'


Daniel Tarullo

Tarullo revives debate on 'too big to fail'

On another front, Fed governor **Daniel Tarullo (voter)**, who is in charge of regulatory policy on the Board, revived the debate on banks being 'too big to fail' by suggesting an 'upper bound' on a bank's growth tied to its non-deposit liabilities.

In a wide-ranging speech on implementing the goals of the Dodd-Frank financial reform act to ensure 'financial stability' and avoid 'systemic risk,' Tarullo noted an anomaly in existing legislation that gave regulators some authority to block mergers that might lead to institutions so big as to pose a systemic risk, but no power to limit a bank growing organically to such a size.

One simple, direct measure legislators might want to consider, Tarullo said, is capping a bank's non-deposit liabilities as a percentage of GDP. This would be easier and simpler to calculate than the 'somewhat awkward and potentially shifting metric' of the aggregated consolidated liabilities of all financial companies specified in some provisions of the Dodd-Frank legislation.

'In addition to the virtue of simplicity, this approach has the advantage of tying the limitation on growth of financial firms to the growth of the national economy and its capacity to absorb losses, as well as to the extent of a firm's dependence on funding from sources other than the stable base of deposits,' Tarullo said.

The Fed governor left open what percentage might be appropriate, though one bill currently before the Senate sets the cap fairly low at 2%. By contrast, current non-deposit liabilities of some $1.2trn at JP Morgan Chase represent 8% of US GDP. Even a more moderate cap of 5% or so could force the bank to shed some activities and downsize.

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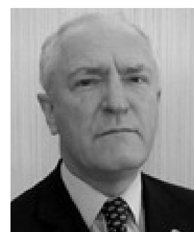
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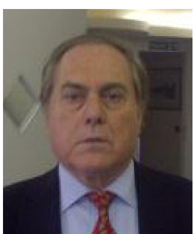
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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome Prof. Iain Begg, Professorial Research Fellow at the European Institute, London School of Economics and Political Science; Prof. Moorad Choudhry Treasurer, Corporate Banking Division at The Royal Bank of Scotland; Francesco Papadia, former Director General for Market Operations at the European Central Bank; and Prof. Maria Antonieta Del Tedesco Lins, Professor at the Institute of International Relations, University of São Paolo. This takes the total number of Advisory Board members to 111. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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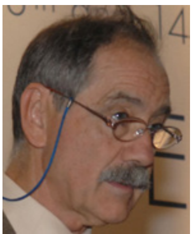
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Globalisation and euro debt

Capital flows between core and periphery

Stefan Bielmeier, Advisory Board

Ever since the euro debt crisis began, private capital has been flowing out of the periphery countries into the safe havens at the core of the currency union, led by Germany. The International Monetary Fund reports that the cumulative portfolio and other investment fund outflows from the periphery since 2010 equate to more than 10% of these countries' GDP. The other side of the coin is that the core countries, principally Germany but also France, the Netherlands and Belgium, have recorded substantial capital inflows equivalent to around 7% of GDP.

These private capital flows are financed primarily through the ECB's Target payments system. As a result, the periphery countries are building up big liabilities within the central bank system that match the core countries' corresponding assets or claims. This means that the European financial system is going through a phase of reverse integration – one might call it 'dis-integration' – as private sector cross-border assets and liabilities that accumulated rapidly during the first years of the currency union are now being reversed.

Greece, Portugal and Spain built up large debts to foreign creditors in the years preceding the crisis. Their big current account deficits, financed partly by large inflows of foreign direct investment, caused these countries' net liabilities to increase by as much as 30% between 2003 and 2007, to around 100% of GDP.

The aftermath of the financial crisis piled further large-scale debt on to these existing totals. The worst-affected countries were Ireland and Cyprus, which both had to step in to shore up their massively over-extended financial systems. Ireland's foreign debt increased from 19 to 98% of GDP between 2007 and 2011, while Cyprus's net asset position of 12% of GDP turned into a liability equivalent to 81% of GDP.

This level of foreign debt is unsustainable. Empirical studies of emerging markets show that a foreign debt burden of more than 60% of GDP damages countries' growth. The threshold is likely to be higher for industrialised countries, around 85-90%. The euro area periphery countries have now reached (or passed) this critical level.

Achieving a genuine reduction of debt, rather than merely shifting private debt into the public domain, requires a turnaround of these countries' current account balances. The periphery countries need to move into permanent surplus to pay down their foreign debt. Weak domestic demand, by slowing imports, will certainly help in the early years of this process. But progress also has to be made on improving competitiveness and gaining export market share. The lost pre-crisis ground has to be recovered.

Analyses by the EU Commission show that all the periphery countries except Greece have managed to win back some export market share since 2007. Yet Spain, Portugal and in particular Greece still have considerable work to carry out consolidation. They must continue to adapt their production structures. The relative economic weight of non-tradable goods sectors such as real estate needs to be scaled back further in favour of the tradable and competitive manufacturing sector. This change of course is having short-term negative effects on the countries concerned, lowering economic activity and employment. However, structural reforms can help not only to improve the countries' ability to compete but also to mitigate short-term problems affecting, say, their labour markets.

Ireland is the only country at present that has managed to achieve the significant current account surpluses needed to reduce the heavy burden of foreign debt. Ireland is one of Europe's most open economies and last year's trade surplus was equivalent to more than 20% of GDP. Ireland's example illustrates the potential for globalisation to help to solve the problems resulting from the euro crisis – but only if the countries concerned put their own house in order. ✉

Ireland is the only country at present that has managed to achieve the significant current account surpluses needed to reduce the heavy burden of foreign debt.

Financial markets in wait-and-see mode

Promise of 2013 China boost from new stimulus plan

DZ Bank Economic Forecast Table			
GDP growth			
	2011	2012	2013
US	1.8	2.0	2.0
Japan	-0.7	2.4	1.4
China	9.3	7.8	9.0
Euro area	1.5	-0.4	0.0
Germany	3.0	1.2	0.8
France	1.7	0.2	0.4
Italy	0.5	-2.5	-0.9
Spain	0.4	-1.6	-2.2
UK	0.9	-0.3	0.5
Addendum			
Asia excl. Japan	7.4	6.4	7.2
World	3.7	3.1	3.4
Consumer prices (% y/y)			
US	3.2	2.2	2.7
Japan	-0.3	0.2	0.2
China	5.4	2.8	3.6
Euro area	2.7	2.4	2.5
Germany	2.5	2.0	2.1
France	2.3	2.3	2.3
Italy	2.9	2.9	2.4
Spain	3.1	2.5	3.6
UK	4.5	2.7	2.4
Current account balance (% of GDP)			
US	-3.1	-3.2	-3.1
Japan	2.0	1.3	1.8
China	2.8	2.5	2.6
Euro area	0.0	0.0	-0.1
Germany	5.7	5.5	4.3
France	-2.0	-2.3	-2.2
Italy	-3.3	-2.2	-1.8
Spain	-3.5	-2.7	-2.0
UK	-1.9	-3.0	-2.0

Produced in association with DZ Bank group, a partner and supporter of OMFIF

The easing of tension in European financial markets following the German constitutional court's ruling approving the European Stability Mechanism, and the ECB's September announcement of conditional bond purchases, has been a far from steady process. Although risk premiums on the yields of crisis-hit countries' bonds narrowed significantly up to mid-September, since then there has been little progress.

This new mood of sobriety has been partly due to reports from the crisis-affected euro members to the effect that Portugal and Spain will not be able to achieve their agreed deficit targets for 2012 and 2013 and that Italy similarly will not manage to stick to its promised consolidation timetable.

As for Greece, virtually no one believes any longer that it can deliver agreed savings targets without an increase in the aid programme or a second debt restructuring.

Meanwhile the euro area business climate worsened significantly again in September. There is no sign of an economic turnaround or the beginning of a real recovery anywhere on the horizon. Although economic confidence is still higher in Germany than in most other euro member states, sentiment has deteriorated markedly even here, especially in the corporate sector. September's fifth successive monthly decline in the Ifo business climate index makes this abundantly clear.

German manufacturers are especially sceptical about their future business prospects. The outlook for exports maintained its shallow negative trend in September. On the other hand, the GfK figures show German consumers are continuing to play a stabilising role.

Economic activity remains relatively weak in countries outside the euro area. The US economy slowed markedly in the spring quarter and is unlikely to pick up speed any time soon. China's stimulus measures have still to deliver their desired effect. Beijing has already sought to counter the economy's downturn with moves such as loosening monetary policy or boosting state infrastructure investment. At best this stimulus has cushioned the downswing, and was probably too cautious in scale.

The authorities now intend to launch a new, bigger fiscal package worth Rmb1tn (equivalent to around 2% of GDP). This would certainly have the potential to inject fresh impetus into China's economy, even if the stimulus is likely to be far smaller than in the 2008-09 package. Most of the effect is likely to start to gain traction only at the beginning of next year.

We have accordingly lowered our 2012 growth forecast for China to 7.8%, but we see a slight acceleration to 9% in 2013.

Reconciling safety and competition

How to reinforce Europe's post-trade market

Peter Norman, Advisory Board

The European Union must urgently establish an effective recovery and resolution regime for clearing houses in trouble to prevent the failure of one or more of these systemically important post-trade infrastructures plunging the EU economy into another financial crisis like that of 2008-2009.

At the same time, the European Commission must ensure that efficiency and competition are not sidelined in the EU's drive to regulate all post-trade infrastructure providers and users in an all-embracing, single EU-wide market for services such as clearing and settlement. These two recommendations top my Agenda for Action for improving Europe's post-trade architecture. This is at the heart of 'Combining safety, efficiency and competition in Europe's post-trade market', a 67-page report I wrote for the London-based Centre for the Study of Financial Innovation (CSFI) in a project financed by the Depository Trust & Clearing Corporation (DTCC).

My report's recommendations seek to foster efficient and competitive post-trade infrastructures in Europe that would perform just as well in even tougher conditions should the need arise.

The world's post-trade infrastructures performed well in the acute financial crisis that followed the bankruptcy of Lehman Brothers in September 2008. The subsequent decision by the Group of 20 to give central counterparty clearing houses (CCPs) the job of risk-managing standardised 'over the counter' derivatives from the end of this year reflected the sector's success. But the absence of an effective EU resolution regime for systemically important financial market infrastructures in general, and CCPs in particular, remains a worrying gap in the EU's post-trade planning, despite news, since publication of my report, that the Commission has begun consulting on the issue.

CCPs protect against defaults by acting as the buyer to every seller and seller to every buyer in the markets they serve. In consequence, they concentrate risk, so that the failure of an important CCP could have catastrophic effects on world financial markets and the global economy. But, while financial stability and safety are essential, so too is an efficient and competitive EU single market for post-trade services: to encourage dynamism and innovation among service providers, curb the vested interests that permeate the sector, and – more broadly – help create conditions for faster economic growth in Europe.

Hence my call for an EU competition policy investigation into the pros and cons of more liberal access to CCPs, notably in the listed derivatives sector, to be balanced by a simultaneous examination into whether two-way open access can be safely applied. Other proposals in the Agenda for Action would smooth the passage of EU post-trade legislation, remove barriers to the single market for securities settlement, bring more transparency to central bank post-trade initiatives and support ethics and standards among post-trade professionals.

Reinforcing these recommendations are a small number of principles and guidelines to balance safety and competition. A 'cui bono?' test, asking 'Who stands to benefit?', should be applied to all post-trade decisions as an essential safeguard in a sector riddled with vested interests. The report also includes an Awareness Agenda, detailing issues that may require action in the future. These include the shortage of collateral in the new regulatory environment, the challenges posed by mandatory clearing of OTC derivatives for buy-side investors, the more difficult business environment faced by clearing member banks, and prospects for Target 2-Securities, the European Central Bank's securities settlement project.

Post-trade infrastructures in Europe and around the world were the unlikely heroes of the crisis. My recommendations seek to foster efficient, competitive post-trade infrastructures that would perform just as well in even tougher conditions should the need arise.

'Combining safety, efficiency and competition in Europe's post-trade market' by Peter Norman is published by the CSFI and can be purchased through www.csfi.org at £25/€35

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Mauritius starts gold bar project

Increasing range of instruments for small savers

The Bank of Mauritius is launching its Gold Bar Initiative as a 'one-of-a-kind concept' to promote a culture of savings among Mauritians, enlarging the range of available savings instruments. The Bank says small savers in Mauritius have few savings options, such as depositing money in a bank, or investing in equities or in real estate. The limited range of savings products has led investors to drive up property prices artificially. Investing in real estate is not a liquid investment.

Furthermore, the negative real rate of return on savings deposits in recent times has impacted adversely on savings behaviour in Mauritius. The savings rate has fallen from around 20-25% in the 1990s to 14-15% now. From November 2012 the Bank will be offering Minted Gold Bars of 10g, 50g and 100g in certified packaging bearing the Bank's iconic Dodo bird design. The Minted Gold Bars are meant to cater for the needs of various types of investors, mainly those who are looking for a mid- to long-term investment.

The Bank will be offering a buyback option to make the investment as liquid as possible. A person may also opt for safe storage in the vault of the Bank against a certificate of ownership. The custodial services offered by the Bank will be free of charge in the first year. The gold bar prices will be determined daily, based on the international gold price.

For the first time, the Bank will be offering a buyback option to make the investment as liquid as possible, adding to the attractiveness of the product.

Bundesbank reveals gold storage data

German central bank will repatriate 150 tonnes from US

In advance of repatriation of 150 tonnes of gold in the next three years from the Federal Reserve Bank of New York, Germany's Bundesbank has for the first time given a breakdown of gold held in Germany and abroad. Germany is the world's second largest holder of monetary gold after the US. Germany's gold is totally under the control of the central bank rather than the government.

Stocks in Frankfurt are 1,036 tonnes (31% of the total), while 1,536 tonnes (45%) are in the New York Fed, 450 tonnes (13%) at the Bank of England and 374 tonnes (11%) at the Banque de France. While the New York Fed and the Banque de France store gold free of charge, the Bank of England charges warehousing fees of roughly €500,000 per year.
The Bundesbank has faced increasing demands from German politicians to give more details on its gold holdings, including on the issue of whether it maintains rigorous controls on bullion held abroad.

At the beginning of the 2000s, the Bundesbank brought 930 tonnes of gold to Frankfurt from London and subjected the holdings to 'a painstaking inspection.' Part of the gold was melted down to create new bars which conform with the 'Good Delivery Standard'.

The Bundesbank has faced increasing demands from German politicians to give more details on its gold holdings.

Notes on contributors

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José Filomeno de Sousa dos Santos is Member of the Board of Directors, Fundo Soberano de Angola.

Paul Wilson is Director of Government Relations at De La Rue.

A regular round-up on international monetary affairs

Harsh treatment that backfires

Germans should take another look at Keynes

William Keegan, Chairman, Board of Contributing Editors

Where, oh where, is the leadership needed to resolve the present world economic crisis? Or is the very nature of the competitive political power structure around the world such that the quest for such leadership is a mere chimera?

The best example of international political statesmanship on the economic front remains the post-Second World War settlement. But even that contained a flaw which, in new guise, has turned up today. I refer, of course, to what was technically known at the 1944 Bretton Woods negotiations as 'the scarce currency clause' (or, rather, its absence) but which is more commonly seen in the refusal of countries in balance of payments surplus to boost aggregate demand when deficit countries are taking all the strain.

This kind of 'rebalancing' has been frequently urged by Bank of England governor Sir Mervyn King. To little avail. China, other east Asian nations, and the Middle East oil producers took due note of the punitive treatment meted out by western governments and official organisations during the Asian financial crisis of 1997. They concluded that the answer was to build up reserves. And a few years ago I recall a senior Chinese official saying that there would be rebalancing. But it would take a long time, at a pace dictated by Beijing, not by people like Mervyn King.

Closer to home, we have the euro area, in which it is now a commonplace that Germany recommends harsh treatment for such putatively miscreant countries as Greece and Spain, but carries on happily amassing balance of payments surpluses itself. Implied in the policy recommendations for others that pour out of Berlin and Frankfurt is the idea that all other countries should behave like Germany, and amass balance of payments surpluses – an arithmetical, indeed physical impossibility.

Now I do not want to be regarded as a Germanophobe. I have made many visits there, and follow events very closely. I am lost in admiration for the way that West Germany managed the economic shock of reunification with East Germany, despite the monetary terms, which looked so misconceived at the time that they provoked the resignation from the Bundesbank of my old friend Karl Otto Pöhl.

Nor do I have much sympathy with those British eurosceptics who complain that Germany is on some kind of conquest of Europe by less bellicose means. Nevertheless, I think German policymakers have got it profoundly wrong in urging austerity on the sick members of the euro area. Events in Greece are deeply disturbing, and who knows what catastrophes may lie in store. I do not know what the German proverb is for 'putting oneself in other people's shoes' (if they have any) but it is surely about time that Berlin, the European Commission, and those at the IMF who are still administering self-defeating austerity 'programmes', took another look at the works of John Maynard Keynes.

One of the great tragedies of our time is that former British chancellor of the exchequer and prime minister Gordon Brown lost office in 2010. There were all sorts of reasons, of course, why he lost the general election and why a coalition of the Conservatives and Liberal Democrats took over. Brown himself appeared out of touch with the electorate, which was simply fed up with 13 years of Labour rule. But as I attempt to demonstrate in my new book *Saving the World? Gordon Brown Reconsidered*, Brown was the right man, in the right place, at the right time to exercise world leadership with regard to the recapitalisation of the western banking system in 2008 and the fiscal, monetary and trade credit stimulus that arrested the 'free fall' of the world economy in April 2009.

In his excellent book *Beyond the Crash*, Brown urges a coordinated attempt to resolve the many problems that remain, in both financial and economic policy, and efforts to rebuild the banking system. He is no longer in a position of power. As one looks at the US fiscal cliff, and the state of the euro area, one wonders, with trepidation, where is it all going to end?

Looking ahead – 2012 diary dates

Second OMFIF Meeting in Africa
Africa and the Indo-Pacific: the new economic mainspring
5-7 November, Bank of Mauritius, Port Louis

Second Asian Central Banks' Watchers Conference
Asia as an engine for world growth
13 November, Bank Indonesia, Jakarta

Seminar in Washington
Government and business in the world economy
16 November, Washington D.C.

Lecture with Stefan Ingves
Governer, Sveriges Riksbank
20 November, London