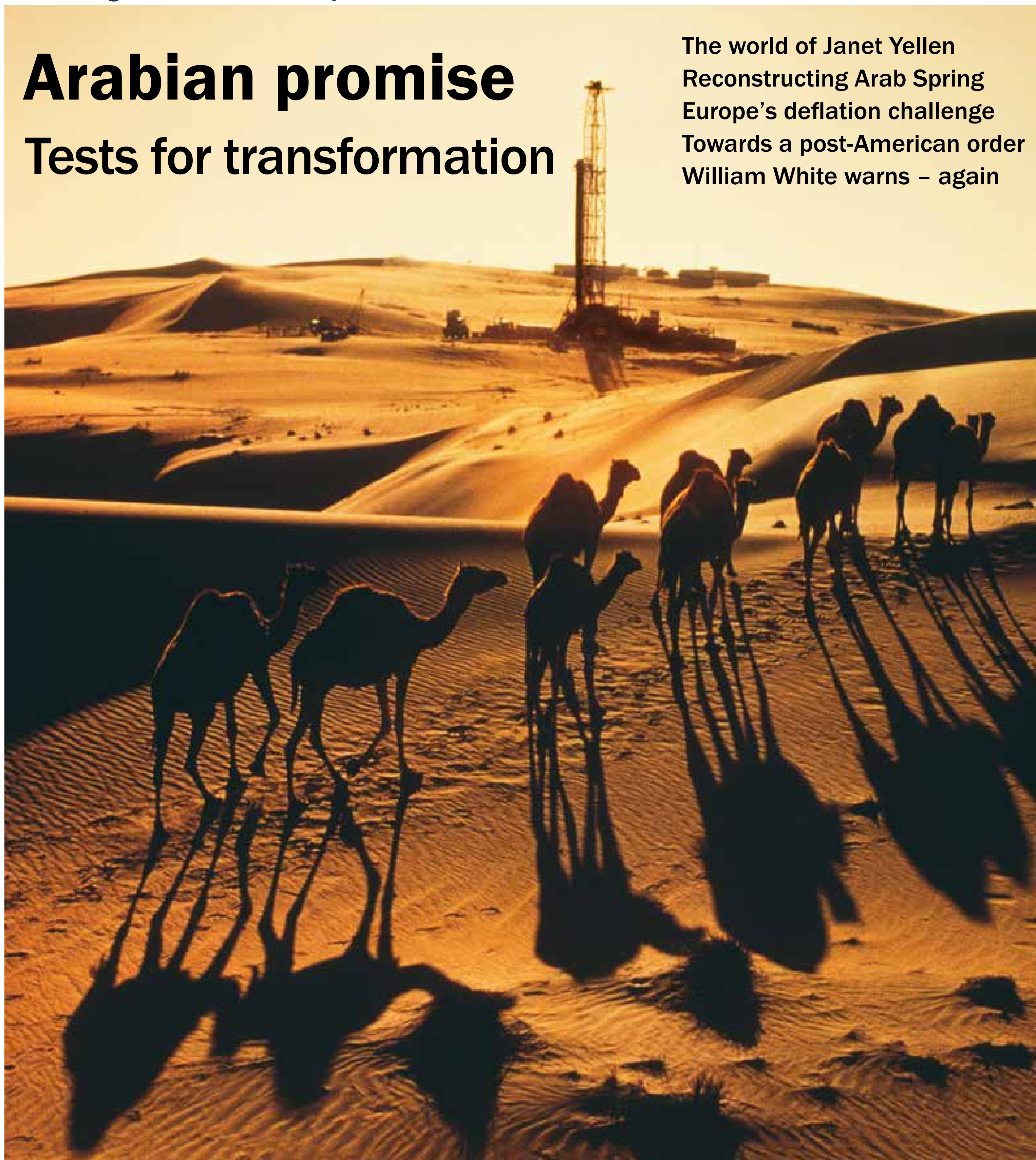
Bulletin

November 2013
Vol. 4 Ed. 10

Global insight on official monetary and financial institutions



Arabian promise

Tests for transformation

The world of Janet Yellen
Reconstructing Arab Spring
Europe's deflation challenge
Towards a post-American order
William White warns – again

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

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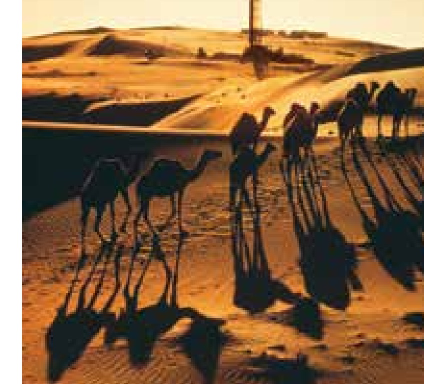
Cover story

At a time of transition and uncertainty for the main economic regions of America, Europe and Asia, the world is looking once again with hope to signals of promising developments in the Middle East. The Arab Spring has turned into the Arab Firestorm, according to Lebanese thinker Nasser Saidi. However, a period of soul-searching over the Middle East and North Africa, coinciding with cautiously positive news from Iran and Syria, could be the trigger for the region's considerable economic potential at last to be unleashed.



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Yellen move shows transition into male bastions

Janet Yellen's nomination is part of a shift of female central bank governors gradually moving into male bastions across the world. See p.8-11 for The World of Janet Yellen and the 19 female central bank governors ranging from Somalia to Samoa.

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OMFIF

Promoting dialogue for world finance

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

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

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

Since its inception in January 2010, OMFIF has held 170 meetings in 40 host countries with the participation of 160 different official institutions.

Advisory Board

OMFIF's 142-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars, and other OMFIF activities. See p.22-23 for names and p.42 for the latest Advisory Board poll.

Bulletin

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

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

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Letters provide opinions from our readers with points of view on the subject matter in our Bulletins and Commentaries. See p.42.

Diary dates – past and forthcoming

A full list is available on www.omfif.org/meetings

General information

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Middle East in transition

Precepts for success in a region rocked by Arab Spring

David Marsh, Chairman

OMFIF turns its attention this month to the sands of Arabia and the waters of the Gulf to scan for signs of a revival in international business and financial confidence. Amid considerable uncertainty in the principal areas of the world economy, we are organising a visit to Qatar for the Second Main Meeting in the Middle East on 27-28 November, hosted by the Qatar Central Bank.

We look at prospects for transformational and sustainable economic growth in a region that has been rocked by political instability in countries ranging from Syria to Libya but still provides the bedrock for world energy. This is demonstrated by a build-up of oil production among the big Gulf suppliers. In spite of the much-heralded rise in US shale production, the balance of power in the world energy market remains solidly with the countries of the Gulf Cooperation Council (GCC) that feature heavily in this edition.

Abdullah Saud Al Thani, Governor of the Qatar Central Bank, our host for the Main Meeting, sets down why the region is of pivotal importance not just for harnessing positive forces for expansion but also for well-ordered world governance. Fabio Scacciavillani outlines the main factors impinging on economic patterns across the Middle East and North Africa (MENA) and describes relevant precepts for deploying sovereign funds. Efraim Chalamish highlights changes in the investment management behaviour of these funds. Hamood Sangour Al Zadjali, Executive President of the Central Bank of Oman, discusses the move away from oil, with a focus on business and infrastructure. Nasser Saidi explains why the region needs its own resconstruction bank to spur development, similar to the institution launched in Europe after the fall of the Berlin Wall. Erik Berglöf and Hanan Morsy from the European Bank for Reconstruction and Development outline how Arab countries can benefit from European experience and global best practices. Nick Butler explains the pivotal role of gas in the global energy equation. Haizhou Huang gives us a more upbeat perspective for China, based partly on trade patterns with the rest of the world.

The main waves in the world economy continue to emanate from the US. Darrell Delamaide examines the different factors influencing Janet Yellen as she prepares for Senate confirmation proceedings that seem likely to confirm her nomination as the first woman chairman of the Federal Reserve. Steve Hanke and William Keegan weigh in with further insights on the American fiscal and monetary debate, including looming prospects for a further bout of budgetary wrangling in Washington in the New Year. Kishore Mahbubani and Meghnad Desai analyse America's steady decline from political and monetary grace and warn that we should prepare for a post-American world. William White, formerly of the Bank for International Settlements, tells us what went wrong with the world economy in the last decade – and why no one listened when he and others gave prescient warnings. Along with an analysis of the swirling Fed discussion about when to start gradual scaling back of monetary stimulus through quantitative easing, we investigate the new wave of female promotions to the top ranks of central banks around the world. There are no less than 19 lady central bank governors around the world – far more than most people would recognise – and we name them all.

Turning to Europe, Denis MacShane writes on the decline of economic liberalism in Germany. John Kornblum summarises the pernicious cocktail of official spying on the chancellor and US complaints about the Germans' persistent current account surplus that has poisoned Berlin. Gabriel Stein spotlights how trends in household savings can affect countries' ability to withstand financial crises. Desmond Lachman admonishes Europe over deflationary dangers. We sum up the result of meetings with the Spanish, Portuguese and Czech central banks – where the various governors concerned have been very careful about claiming that Europe has in any meaningful way turned a corner. The European Central Bank's decision to cut interest rates on 7 November, taken against the advice of some of the 'hard money' governors on the ECB council, underlines the concern felt at the highest echelons about deflationary risks in Europe, especially in peripheral countries. There's a long period of further attrition still to come. ▪

David Marsh

Buoyant oil prices, diversification drive GCC growth

The six countries of the Gulf Cooperation Council (GCC) offer a rare sight of sustained annual growth of around 4% in a world mired in problems in both advanced and emerging market economies, *writes Fabio Scacciavillani in Muscat.* The combined GDP of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates is likely to reach $1.65tn in 2013, equivalent to that of India or Canada, almost triple the level 10 years earlier.

The resilience of the GCC economies – in spite of the perturbations of the Arab Spring – has been underpinned by buoyant oil prices, but equally important has been diversification away from energy commodities engineered by policy-makers. Disaggregating the contribution to real growth of the oil and non-oil sectors highlights that expansion in the former declined from about 5% in 2011 to almost nil in 2013, while in the latter has remained constant at roughly 4%. In fact, oil production has not increased substantially (with the exception of massive new gas production in Qatar), while energy revenues deployed domestically have triggered a robust multiplier effect. ▪

ADVISORY BOARD

OMFIF welcomes four new members, Caroline Butler, Desmond Cecil, Reginald Dale and Stuart Mackintosh. Their appointments take the number of Advisory Board members to 142. For full list of members see p.22-23.

Caroline Butler of Walcot Partners is a UK-regulated international investment adviser. Previously, she was Director and Head of Risk at Lord North Street. Prior to 2004, Butler was Managing Director and Head of UK Private Wealth Management at Deutsche Bank in London. Butler was educated at University of Oxford and the London Business School.

Desmond Cecil has been Expert Chair at AREVA since 2006, responsible for strategic and public policy areas of AREVA's UK energy business in nuclear and renewables. He was previously BNFL's Senior International Adviser and British Diplomat for 25 years, serving in the FCO, secondment with the Board of P&O European Ferries, Embassies and the UN. Cecil studied Chemistry and Philosophy, Politics and Economics (MA) at University of Oxford.

Reginald Dale, international journalist, has worked at the Center for Strategic and International Studies (CSIS) in Washington since 2006. He is Director of the Williamsburg-CSIS Global Forum, Senior Fellow in the CSIS Europe Program and Director of the CSIS Transatlantic Media Network. He was educated at Winchester College and Oxford University and the University of Grenoble in France.

Stuart Mackintosh is Executive Director of the Group of Thirty, an international financial think-tank. Previously, Mackintosh was a Washington-based economist, Country Risk Manager for Mitsubishi International Corporation and Chief of Staff and Principal Speechwriter at the European Parliament. Mackintosh has a BA from Newcastle University, an MSc from the University of Edinburgh, and is completing his PhD.

EXPERT SEMINARS

Korea surmounts monetary obstacles

Governor Choongsoo Kim of the Bank of Korea outlined Korea's new-found abilities to withstand unfavourable flows of international funds caused by fluctuations in US quantitative easing. He opened the Third Asian Central Banks Watchers Group Meeting at the Korean Banking Institute in Seoul on 28 October. Listening, left to right: Dody Budi Waluyo, Executive Director, Bank Indonesia; Meghnad Desai, Chairman, OMFIF Advisory Board; Edgar Baltazar Barquin Duran, President, Bank of Guatemala.

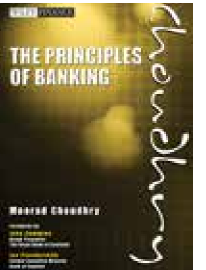
Europe making progress on arduous journey

Europe is moving forward after the upheavals of the last three years in the euro bloc, but completing the arduous task of reform and renewal, above all in the peripheral countries, will take most of the next decade. That was the cautiously optimistic, but still sobering message from the Fourth OMFIF-DZ BANK IMF Annual Meetings breakfast on 12 October in Washington. Central bankers on the panel are pictured below, with David Marsh: Governor Miroslav Singer, Czech National Bank; Governor Luis M. Linde, Banco de España; Governor Carlos da Silva Costa, Banco de Portugal; Deputy Governor Turalay Kenç, Central Bank of the Republic of Turkey; Governor Luc Coene, National Bank of Belgium.

BOOKS & THE ADVISORY BOARD

Reflections on world finance and the vicissitudes of banking

This month's feature covers two publications. Reflections on Global Finance by John Nugée, containing selected essays from SSgA's Official Institutions Group 2002-13, provides a succinct set of viewpoints about global financial and capital market affairs from a leading expert on official monetary issues. Nugée, Deputy Chairman of the OMFIF Advisory Board, who is stepping down from SSgA after playing an important role in building the company's official institutions business, is a previous reserve manager at the Bank of England. The Principles of Banking by Advisory Board Member Moorad Choudhry, reviewed by Colin Johnson, 'is a clear and comprehensive book that provides learning and revision in a single place'. See p.41.



GOLDEN SERIES

William White, former economic adviser at the Bank for International Settlements, gave the OMFIF Golden Series lecture on 23 October in London, dwelling on lessons of the trans-Atlantic financial crisis. White divided his talk into three parts: 'What has gone wrong with the world economy?', 'Why were the warnings ignored?', and 'What have we learned from the experience?' And in a nutshell, the answers he gave us were, respectively, 'Just about everything, 'Because nobody wanted to listen to bad news' and 'Almost nothing'. See p.16-17 and 35.

Carlos da Silva Costa, Governor of Banco de Portugal, described the progress on financial stability in Portugal on 30 October in London. Pictured right, with John Nugée, Deputy Chairman of the OMFIF Advisory Board, and Gabriel Stein, Chief Economic Adviser, Governor da Silva Costa outlined plans to strengthen solvency, liquidity and the regulatory framework. Visit www.omfif.org/meetings/golden-series for details on our forthcoming lectures.

ECONOMISTS MEETINGS

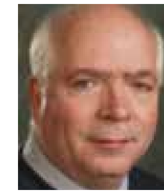
Prospects for Czech economy

An international group of economists and capital market specialists as well as leading Czech banking and financial experts joined Miroslav Singer, governor of the Czech National Bank, and his colleagues for the First Czech National Bank-OMFIF Economists Meeting at the central bank in Prague on 1 October. Participants heard a range of views on the status quo and prospects for the Czech economy and wider European conditions, influenced by the long euro area recession and the only moderate recovery in the country's most important trading partner, Germany. Pictured right, Dr. Tomáš Holub, Executive Director of the Monetary and Statistics Department at Czech National Bank, gave an overview on 'The influence of European and world developments on the Czech economy'.

Spain reports progress after end of long recession

The First Banco de España-OMFIF Economists Meeting in Madrid on 21 October heard evidence of concrete progress following the end of the long Spanish recession, driven by the need to curb economic overheating and balance external accounts after excesses in the early 2000s. The morning workshop, attended by international and Spanish officials and economists (pictured right) was followed by an address on banking union by Governor Luis M. Linde, as part of a day-long series of meetings in Madrid. Despite strong export growth and much-improved competitiveness, Spain faces several years of further tough adjustment, with unemployment and budget deficits still uncomfortably high. See p.20 and 25.

Yellen now moves truly out of the shadows. At 5 foot 3 inches with a low-pitched Brooklyn accent, Yellen was considered by some in the vetting process to lack gravitas. As if only a 6 foot 7 inch gravel-voiced cigar-chomping male like Volcker could have that quality.



The world of Janet Yellen

A spirit of eclectic pragmatism holds sway in Washington

Darrell Delamaide, US Editor

Janet Yellen, likely to be confirmed as the first female chairman of the US Federal Reserve, encapsulates a new mood of eclectic pragmatism at the helm of international central banking. In the aftermath of the financial crisis, central banks are being called upon to take up an ever-wider set of responsibilities, straining their operating maneuverability as well as their independence.

In a role with genuinely world-wide clout, Yellen seems likely to accomplish that task better than most. She can combine her first-class economics training with ability to draw in diverse sets of experience to master two great challenges: returning US monetary policy to a more normal path, and helping prepare America for a multi-polar world in which it shares economic and financial power more equitably with other countries, not least in Asia.

What is remarkable about Yellen's nomination is not that she is a woman. She was, after all, the best candidate for the job. More important, she had to overcome the favouritism of the old boy network at the White House, where President Barack Obama haplessly clung on, almost to the last moment, to his preferred choice, former Treasury secretary Lawrence Summers.

At a time when Obama's policies on debt and deficits have exposed him to continuous high-wire wrangling in Washington, the president eventually had to take the line of least resistance and accept Yellen's impressive credentials. By raising her reputation for independence and damaging that of the president for sound judgment, the episode is likely to harm Obama more than Yellen.

Wave of women in central banking

Already, for reasons unconnected to gender, she has made history for several reasons. At 67, she is the oldest person ever appointed Fed chief and the first vice chairman to ascend to the top job. She is the first Democrat called to lead the Fed since President Jimmy Carter appointed Paul Volcker in 1979.

Assuming that she makes it through Senate confirmation procedures due to start with a Senate hearing on 14 November – highly probable despite announcement of sporadic Republican blocking antics – she is part of a wave of women making it to the top of official monetary institutions.

Aside from Christine Lagarde at the head of the International Monetary Fund, her opposite numbers include Zeti Akhtar Aziz, Gill Marcus and Linah Mohohlo, respectively governors of Bank Negara Malaysia, the South African Reserve Bank and Bank of Botswana; Sabine Lautenschläger, deputy president of the Bundesbank; and Anne Le Lorier, first deputy governor of the Banque de France.

Just days after Yellen's nomination, Elvira Nabiullina took over as governor of the Central Bank of Russia, with official international reserves of $500bn, the world's third largest. At around the same time, Karnit Flug was appointed permanent governor of the Bank of Israel after several months as acting chief following Stanley Fischer's retirement. She had to wait out two misfires by the government of Benjamin Netanyahu, which first sought male candidates of allegedly stronger international standing.

Yellen herself is likely to prove resolute yet flexible and pragmatic, moving the Federal Open Market Committee (FOMC) cautiously to tighten monetary policy as economic conditions warrant. (Fed policy-makers insist that initial tapering of asset purchases, which had been expected next year, but are now thought possible in December after better-than-expected job data published on 8 November, does not represent tightening, but simply a slower pace of monetary expansion.)

One big question mark is how well she can handle the Fed's regulatory responsibilities, expanded under the Dodd-Frank financial reform. Yellen has called this the 'third mandate' for the Fed, though her own experience overseeing the San Francisco Fed's regulatory responsibilities has been somewhat limited. In remarks accepting the nomination, Yellen was careful to include safeguarding the financial system among the Fed's responsibilities, along with maintaining price stability and maximum employment.

In this way, she aligns herself with the mainstream of central bank governors who have to accept (for better or for worse) that their responsibilities have got a lot wider. Both Mario Draghi at the ECB and Mark Carney at the Bank of England, have a wider (and more difficult) remit than their predecessors – one that may expose them to considerable conflicts of interest.

Symbol of continuity and consensus

Being a Democrat may assist her passage through the Senate (she was approved for the vice chair position in 2010 by voice vote) but Democratic presidents have reappointed incumbent Republican chairmen three times since Volcker. Yellen got White House assent because she is (unlike Summers) an experienced central banker with a reputation for getting her own way without antagonising or belittling her interlocutors. As the Fed begins the delicate task of unwinding quantitative easing, she symbolises continuity and consensus.

In announcing her appointment, Obama cited Yellen's forecasting prowess in recognising early the potential harm from a housing bubble and excesses in the financial sector, as well as the risks of a major recession.

Yellen is a Keynesian economist but not dogmatic. She has been overshadowed in past

Janet Yellen's power of prediction

As head of the San Francisco Fed in the period 2004-10, Yellen was one of the first top Fed officials to talk about a housing bubble and its risks to the economy. 'Certainly, analyses do indicate that house prices are abnormally high—that there is a "bubble" element,' she said in an October 2005 speech. 'I think it's obvious that a substantial cooling off of the housing sector represents a downside risk to the outlook for growth.'

At the December 2007 meeting of the FOMC, Yellen offered what some present considered the gloomiest prognosis. 'The possibilities of a credit crunch developing and of the economy slipping into recession seem all too real,' she said, according to the transcript released five years later. She noted that the 'shadow banking sector,' those institutions involved in securitising assets, was 'all but shut for new business.'

As head of one of 12 regional banks – she was not a voting member at that December 2007 meeting – Yellen's field of action was limited. But the Wall Street Journal recently scored 14 Fed policy-makers on 700 predictions in the period 2009-12 and found Yellen, who was vice chairman from October 2010 onwards, the most accurate.

years by her husband, 73-year-old George Akerlof, who won the Nobel prize for economics in 2001.

At 5 foot 3 inches with a low-pitched Brooklyn accent, Yellen was considered by some in the vetting process to lack gravitas – as if only a 6 foot 7 inch gravel-voiced cigar-chomping male like Volcker could be said to have that quality.

Yellen now moves truly out of the shadows. She is extremely smart but has no need to appear the smartest person in the room. In Senate hearings, she will face questions (not just from Republicans) about her putative dovish tendencies and commitment to fighting inflation. In past years Yellen has drawn considerable attention to the balance sheet vulnerabilities of US banks that would face large-scale write-down on their bond holdings should the Fed abruptly stop asset purchases. If QE wind-down coincides, as planned, with a pick-up in the economy, an increase in banks' lending and a reduction in their government bond holdings, then this factor will be a great deal much less crucial.

Assuming the confirmation process runs smoothly, Yellen will inherit a depleted Board of Governors when she takes over in February. The other two women on the seven-member body will be gone. Elizabeth Duke left in August after serving several months beyond the expiration of her term and Sarah Bloom Raskin will be leaving once her nomination as deputy Treasury secretary is confirmed. And, of course, Ben Bernanke will be departing as well.

This will leave the White House with the task of appointing a new vice chairman as well as two more members. Conventional wisdom in Washington has it that at least one of these appointments will have to be a Republican in order to get the nominations through the Senate, and at least one will have to be a woman.

Among the candidates in the rumour mill who fulfil one or the other of these conditions are Lael Brainard, the Treasury undersecretary for international affairs, and Thomas Hoenig, the long-time chief of the Kansas City Fed, currently vice chairman of the Federal Deposit Insurance Corporation (FDIC).

It will be up to Yellen, along with the other remaining board members – Daniel Tarullo, Jerome Powell and Jeremy Stein – as well as New York Fed chief William Dudley, to maintain continuity. The board traditionally follows the lead of the chairman with any official dissent coming from the ranks of the regional Fed presidents who rotate through voting positions on the FOMC.

The board has largely fallen in line with Bernanke's dovish policy of monetary expansion. The extraordinary measures necessitated by effectively a zero-interest rate policy have already disrupted the normally steady hawk-dove divide at the Fed. John Williams, Yellen's successor as head of the San Francisco Fed and a certifiable dove, has drifted into hawkish territory in recent months. Narayana Kocherlakota, the head of the Minneapolis Fed, has in the meantime gone from being a mild hawk to talking like a fierce dove.

The chairman-designate will need forbearance and staying power. Coping with the variety of sometimes shifting FOMC voices, navigating as calmly as possible the eddies of US politics, and earning the trust of a swirlingly interconnected world will keep Yellen fully occupied into her 70s and beyond. ▪

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

Female central bank governors gradually move into male bastions across the world

Remarkable shift towards female participation at the helm of central banking

Janet Yellen's ascendancy to the top of the Federal Reserve, although still to be confirmed in a Senate confirmation vote, is part of a remarkable shift towards female participation at the helm of a central banking profession that over many years and in many countries has been the sole bastion of men.

Provided she passes the Senate hurdle, Yellen will join other well-known female governors Zeti Akhtar Aziz, Gill Marcus and Linah Mohohlo, respectively heads of Bank Negara Malaysia, the South African Reserve Bank and Bank of Botswana. Counting Yellen, there are now 19 female governors around the world in far-flung locations. Just days after Yellen's nomination, Elvira Nabiullina took over as governor of the Central Bank of Russia, one of the world's biggest reserve holders, while around the same time, Karnit Flug was appointed to the No. 1 job at the Bank of Israel. The full list of nations where women head central banks is: Argentina, Aruba, the Bahamas, Belarus, Botswana, El Salvador, Honduras, Israel, Kyrgyz Republic, Lesotho, Malaysia, Russia, Samoa, São Tomé and Príncipe, Serbia, Seychelles, Somalia, South Africa and the US.

In the top two economies in the euro bloc, in 2011-12 Sabine Lautenschläger was appointed deputy president of the Bundesbank, and Anne Le Lorier, first deputy governor of the Banque de France, in both cases the first women to accede to these functions. Counting Yellen as well as other representatives such as Hu Xiaolian, deputy governor of the People's Bank of China since 2009, and Agathe Côté, deputy governor of the Bank of Canada since 2010, there are female governors or deputy governors at institutions representing nearly half of world GDP – a share that would have been thought beyond reach only five years ago.

The central banking gender swing makes the all-male make-up of the 23-member European Central Bank council, grouping the ECB board and country governors from the 17-nation bloc, look especially incongruous. ▪

Elvira Nabiullina, Central Bank of Russia

The first woman to lead the central bank of a G8 economy, Nabiullina was formerly Russia's Minister of Economic Development and Trade and chief economic aide to President Vladimir Putin. Appointed in June 2013, she is a strong supporter of long-term institutional solutions for the Russian economy. She faces the task of keeping a steady hand on the tiller at a time of potential tensions over the country's growth slowdown.

Dr. Karnit Flug, Bank of Israel

Flug was chosen to replace Stanley Fischer, after serving as deputy governor and acting governor of the central bank. She formerly worked at the International Monetary Fund and the Inter-American Development Bank, though the majority of her career was with the Bank of Israel. She now has the leading role in a challenging landscape, with a large budget deficit, an appreciating shekel and mounting real-estate prices.

Dr. Zeti Akhtar Aziz, Bank Negara Malaysia

Aziz is the first woman in Asia to lead a central bank. She was appointed as acting governor, tasked with managing the ringgit at the peak of the Asian financial crisis. She has worked with Bank Negara Malaysia for over 25 years, making great strides in reforming the exchange rate, capital markets and banking industry. She has become a major force gaining widespread international support for Islamic banking and finance.

Linah Mohohlo, Bank of Botswana

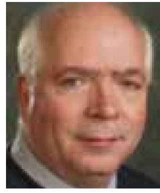
Governor since 1999, Mohohlo has served at the bank for over 30 years. She formerly worked for the International Monetary Fund. Mohohlo is a member of the Commission for Africa and promotes the use of public-private partnerships to encourage inclusive development in Botswana. She has been an inaugural member of the Botswana Economic and Advisory Council, and serves on boards of major corporations in Botswana and abroad.

Gill Marcus, South African Reserve Bank

Known as an advocate for an inclusive South Africa, Marcus is the first female governor and deputy governor for South Africa. With roots as part of the African National Congress (ANC), she was later elected to Parliament, appointed as deputy finance minister and deputy governor. She has been chair of Absa Group, chairman of the Western Areas mining company and non-executive director of Gold Fields.

Mercedes Marcó del Pont, Central Bank of Argentina

Central bank chief Marcó del Pont is known for promoting unorthodox economic policies. With a background in Development Economics at Yale University, she formerly led Development Research Foundation. She controversially supported the use of foreign currency reserves to pay government debt and is a general supporter of policies for industrial development and job creation through state intervention and reflation.



Fed doves defend decision not to taper

Possible move after better-than-expected October jobs data

Darrell Delamaide, US Editor

After the surprise decision in September to maintain asset purchases at the rate of $85bn a month, Federal Reserve policy-makers spent much of October explaining the nuances of when tapering should or will begin.

With the Board of Governors in Washington preoccupied with a leadership transition and the departure of three of its seven members, most of this explaining was done by the regional bank presidents.

The doves who dominate the current Federal Open Market Committee (FOMC) were in the forefront of defending the Fed's non-action. Boston Fed chief **Eric Rosengren (voter)** explained the reasons for the September decision in a speech at the Council on Foreign Relations in New York.

'We saw weaker economic data emerge between the June and September FOMC meetings, and a higher than anticipated jump in market interest rates, along with the risk in September of possible fiscal policy disruptions,' he summarised. 'Given those data and risks, in my view continuing the asset-purchase programme was warranted.'

He noted that markets had not paid sufficient attention to the caveats when policy-makers spoke about tapering. In general, he said, it is hard to be precise as economic performance fluctuates. 'The experience of the past several months makes it clear that a data-driven policy that also considers the risks to our forecasts can be difficult to communicate,' Rosengren said, 'because the policy will necessarily change as we update our forecasts and risk assessments in the face of new economic data.'

Lack of data means further delay in taper

If the economic risk from the government shutdown and the budget travails stayed the Fed's hand in September, the ensuing murkiness of the data provided another reason for hesitancy. On the other hand, much better-than-expected figures for job creation in October released on 8 November, showing the economy shrugged off the three week shutdown, has led to speculation that the Fed could bring its tapering move forward to its December meeting.

'Only the data can tell us how much progress we've made, and they aren't saying much right now,' Chicago Fed chief **Charles Evans (voter)** said in a mid-October speech in Madison, Wisconsin. His provisional conclusion: 'It is not yet time to remove accommodation. The data are still not definitive enough…I expect our overall stance of monetary policy to remain highly accommodative for some time to come.'

John Williams (non-voter), head of the San Francisco Fed, reiterated that reduction in the volume of asset purchases would come only when the economy seems on sure footing. 'With monetary policy continuing to provide needed stimulus, I expect economic growth to pick up somewhat next year,' Williams said to a group in Boise, Idaho. 'As the economy continues to get better, the highly accommodative stance of monetary policy will need to be gradually adjusted back to normal.'

As Fed policy-makers are wont to do, Williams emphasised that this reduction does not represent a tightening of monetary policy. 'This won't be a slamming on the brakes, it will be an easing off the gas,' Williams said. 'And it will not be a fixed date on the calendar.'

Hawks not happy

Even Dallas Fed chief **Richard Fisher (non-voter)**, an opponent of quantitative easing, acknowledged that now is not the time to start tapering. 'We don't want to upset the boat here,' Fisher said in an interview on CNBC. He faulted the standoff between Congress and the White House for forcing the Fed's hand, mixing his transportation metaphors: 'Here we are full throttle at the Fed, they've got the foot jammed on the brake and they're smashing the instrument panel at the same time, and we're in mid-flight.'

Another hawk, however, thinks the Fed should have begun tapering in October regardless of concerns about data or fiscal turbulence. 'It would be important to start now,' Kansas City Fed chief **Esther George (voter)** said in Oklahoma City, 'to start slowly to allow markets time to adjust, to recognise this is likely to be a 'long process in terms of unwinding.'

George has dissented from the consensus statement at every FOMC meeting this year, warning of what she sees as the considerable risks and limited benefits of quantitative easing.

Philadelphia Fed chief **Charles Plosser (non-voter)**, also a hawk, insisted that tapering should have started in September.

'We missed an excellent opportunity to begin this tapering process in September,' he said in Johnstown, Pennsylvania. 'In my mind, this illustrates just how difficult it is going to be to wean ourselves off the extraordinary process of increasing accommodation we have embarked upon and begin to normalise monetary policy in a timely manner that ensures a healthy and stable economy in the future.'

A somewhat less hawkish policy-maker, **Sandra Pianalto (non-voter)**, head of the Cleveland Fed, said she would have supported tapering in the September meeting. 'For me the improvement in labour markets seemed substantial enough to support a scaling back of the asset purchase program at last month's FOMC meeting,' she told an audience in Pittsburgh in early October.

Looking to a return of interest-rate policy

Speaking at a conference on central bank independence in Mexico City, New York Fed chief **William Dudley (voter)** addressed the concerns expressed by George and other FOMC hawks that the Fed's expanded balance sheet would inhibit it from stepping in to check inflation in a timely manner.

'I think that the size and composition of the Federal Reserve's balance sheet actually creates incentives that reinforce the pursuit of the Federal Reserve's objective with respect to inflation,' Dudley said.

He reasoned that the Fed would want to raise interest rates to nip any sign of inflation in the bud, even though this would lower its net interest income, because allowing inflation to take hold would lead to even greater rises in short-term interest rates. By the same token, the size of the balance sheet discourages a premature rate hike because it would unnecessarily reduce the Fed's net interest income without benefiting the goals of its dual mandate.

San Francisco's Williams betrayed what may be a widespread feeling on the FOMC among the committee members that they will be happy when they can leave unconventional measures like asset purchases behind and conduct monetary policy primarily through interest rates. 'I don't see [large-scale asset purchases] as being part of the FOMC's toolkit once we leave the zero bound behind us,' Williams told a meeting of economists in Boston. 'We're still much less certain about their effects than we are about the effects of changes in the federal funds rate…. Given this understanding and the predictability of the effects of conventional policy, the short-term interest rate remains the best primary tool for future monetary policy.'

Yellen interviews herself

Fed vice chairman **Janet Yellen (voter)**, has entered into a 'quiet period' pending her confirmation hearing in the Senate and so is not giving speeches or interviews. However, the assiduous reporters at The New York Times unearthed a 1963 interview with senior Janet Yellen when she was named class valedictorian at Fort Hamilton High School in Brooklyn, conducted by the editor in chief of the school newspaper at, The Pilot – one Janet Yellen.

In this charming self-interview, Yellen disclosed that he had been collecting rocks since she was 8 and had over 200 different specimens; that she had been studying probability, matrix algebra and finite dimensional vector spaces in an honours programme at Columbia University; that she had visited Haiti, Italy, Switzerland, France, various countries in South America and the Caribbean and seen much of northern Europe in a Baltic-North Sea cruise; that her hobbies included off-Broadway theater, eating, riding the 69 St. Ferry, exploring New York City, and reading philosophy 'so that I can write unpopular essays.' She added that she had studied piano for seven years and had just completed a course in contract bridge.

Her plans after graduation were to attend Brown University in Providence, Rhode Island, to study maths, anthropology – or maybe economics. ■

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On the web

See the full version of Yellen's interview with herself at

www.economix.blogs.nytimes.com

On money supply, Yellen's a hawk, not a dove

In past months, the press dubbed Janet Yellen the Queen of the Doves, pointing to her reluctance to roll back the Fed's quantitative easing programme. However, when it comes to money supply, Yellen seems downright hawkish, *writes Steve H. Hanke in Baltimore.*

Traditionally, the dove label refers to the Fed's mandate to pursue full employment, while hawks focus on the Fed's price stability mandate. In practice, however, the dove-hawk distinction comes down to the money supply: to increase, or not to increase?

We must define what measure of the money supply we are talking about. The Fed has turned on the money pumps in the wake of the 2008 crisis, but it directly controls only what is known as state money, also known as the monetary base, which includes currency in circulation and bank reserves with the Fed.

The vast majority of the money supply, properly measured, is what is known as bank money. This is money produced by the private banking sector via deposit creation, and it includes liquid, money-like assets such as demand deposit and savings deposits.

The Fed has indeed been quite loose when it comes to state money, with the state money proportion of the total money supply increasing from 5% of the total before the crisis to 19% today.

Given Yellen's support for continuing the Fed's interest rate and easing policies, it would appear that, when it comes to state money, Yellen is indeed a dove. But where does Yellen stand on the other 81% of the money supply? To answer this question, we must look not to her stance on monetary policy, per se, but rather on financial regulation.

For some time, I have warned that higher bank capital requirements, when imposed in the middle of an economic slump, are wrong-headed because they put a squeeze on the money supply and stifle economic growth. Thus far, the result of efforts to impose these capital requirements has been financial repression – a credit crunch. This has proven to be a deadly cocktail to ingest in the middle of a slump.

In the aftermath of the financial crisis, politicians, regulators and central bankers around the world (including Yellen) have pointed accusatory fingers at commercial bankers. They assert that tougher regulations and more aggressive supervision, centred around higher capital requirements for banks, are crucial to preventing future crises. Yet when capital hikes are imposed during a slump, they become pro-cyclical. The imposition of higher capital requirements in the wake of the financial crisis has caused banks to shrink their loan books and dramatically increased their cash and government securities positions.

For a bank, its assets (cash, loans and securities) must equal its liabilities (capital, bonds and liabilities which the bank owes to its shareholders and customers). In most countries, the bulk of a bank's liabilities (roughly 90%) are deposits. Since deposits can be used to make payments, they are 'money.'

To increase their capital-asset ratios, banks can either boost capital or shrink risk assets. If banks shrink their risk assets, their deposit liabilities will decline. In consequence, money balances will be destroyed.

The US, with Yellen's blessing, has employed a loose state money/tight bank money policy mix. For all the talk of QE3 and Fed's loose monetary policy, the inconvenient truth is that the overall money supply in the US, broadly measured, is still, on balance, quite tight – thanks in large part to ill-timed bank capital hikes. With bank money making up 81% of the total US money supply, broadly measured, it should come as no surprise that the US is actually registering a money supply 'deficiency' – 6.5% to be exact

The shrinkage in bank money has far outstripped the Fed's efforts to boost state money. So the money supply is only 2.6% above its pre-crisis peak, and still sits well below the trend-rate level. This is bad news for the real economy, particularly the labour market.

If Yellen were truly a dove, she would have been advocating laxity in bank capital requirements and supervision, not stringency.

Alas, despite the massive regulatory burden that has been heaped upon the banking system by the Basel III and Dodd-Frank regulatory regimes, and the repeated capital hikes that have been imposed on banks by domestic and international regulators, Yellen is not satisfied. Indeed, she calls this effort 'unfinished business.' These are clearly not the words of a dove. ■

Steve Hanke is a Professor at The Johns Hopkins University and Director of the Troubled Currencies Project at the Cato Institute.

How to stave off US decline

America's debt crisis and the exorbitant privilege

Kishore Mahbubani, Advisory Board

America enjoys the 'exorbitant privilege' of being able to print the world's reserve currency. This brings massive advantages to the American people. All this is possible because the rest of the world still has full confidence in the dollar as the global reserve currency.

But confidence is being steadily corroded. The brinkmanship over US debt and the possible default that was staved off in October will accelerate this process.

Just read the regular announcements made at the BRICS summits. Each summit expresses concern over the dollar. Many countries have begun to hedge their bets. More and more trades will be done in other currencies, especially the renminbi. Although the dollar will not soon lose its dominant position, London's decision to become China's first foreign offshore renminbi trading centre is a clear sign of new winds blowing.

The US has always provided the gold standard for democracy. For all its flaws, there was near universal admiration for America's political system. Its checks and balances ensured stability and continuity. Many the world over have sought to emulate America's democracy. Now that moral authority has been eroded.

There is genuine shock among policy-makers and thinkers abroad that America's political system, with all its checks and balances, could carry both the American economy and the global economy to the edge of a financial precipice. Admiration for the US has naturally been dented, especially when many are aware that another crisis may surface in a matter of months.

Another major loss is in the geopolitical arena. The world is watching carefully the changing relative weights of America and China. In 1980, in PPP terms, America's share of global GDP was 25% while China's was 2.2%. Come 2017, the American share will decline to 17.6% and China's will rise to 18%.

Most Americans seem convinced their country will remain the world's leading power. No US politician dares to speak otherwise. Yet the majority of the world sees an irreversible change. American perceptions are out of line with global perceptions.

Economic weight provides only one dimension of geopolitical power. America's strength was that it could provide global leadership. For all the headlines and speculation, China still is not in a position to pick up the slack. But things are changing. I was in Bali for the APEC summit on 7 October. President Obama was absent – because of the debt crisis. China's president, Xi Jinping, was there and made quite a splash. The excitement that greeted Xi's arrival was palpable. Some of the more powerful countries saw first-hand a new world order in which America is distracted while China, by comparison, seems much more focused.

To regain the strong grip the US had on the global imagination, Americans must first understand what they have lost. In the past eight years, I wrote three books trying to wake up Americans to new realities. None caught much American attention. I discovered that Americans read books written by fellow Americans, not non-Americans.

There is a simple change Americans can make. The Declaration of Independence said that America should show 'a decent respect to the opinions of mankind.' The first way to show respect is to listen to these opinions. Non-Americans make up 96% of the world's population – and they are losing their awe for the country. Americans need to listen more. That way they could learn a lot – and stave off a decline that otherwise may accelerate. ▪

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Towards a post-American world: Budget wrangle a proxy for falling influence

There's more going on than the temporarily-broken logjam over the US government shutdown and threatened debt default, *writes Meghnad Desai in London*. Last-minute one-upmanship in Washington is a proxy for something bigger. We're witnessing the dawn of a multipolar world in which the US is manifestly in decline.

Many would welcome this. But a world without a hegemon will be chaotic. This was the case between the two world wars with Britain receding from its prime position and America unwilling to take on the burden. This time, China is the most likely new hegemon, but is reluctant to take on the role. We now face several unsettled decades.

Empires decline in different ways. Some collapse because of wartime defeat, as with the Austro-Hungarian, Ottoman and the Czarist empires at the end of the First World War. After the Second World War, the Maritime empires – Dutch, British and French – fell apart.

America has been a great – not to say the greatest – power in history. The decline of America has been under discussion for 40 years. This time however America's ability to intervene abroad – as we have seen over Syria – is limited by a mixture of fatigue and incapacity. The problem is domestic too. We see a breakdown of consensus sufficiently serious that the fiscal soundness of the American state is at stake.

If the Republicans are diehard, the president also has no incentive to compromise. He does not face re-election. If he had conceded over the budgetary dispute, the rest of his term would have been a disaster. His hope was to make the Republicans take the blame until they relented. This would help the Democrats in the 2014 elections. That is the prize Obama is waiting for.

The anger and the vehemence of the Tea Party people can be explained. Average US wages have been under downward pressure in the 40 years since the 1973 oil shock, yet profits have forged ahead. With manufacturing shrunken and new jobs requiring college degrees, the semi-skilled manual worker has lost out.

The anger of the Tea Party against Obama is not just against Big Government; it also reflects, it has to be said, a certain amount of racist distaste towards a mixed-race president (recall the controversy over his birth certificate). Whatever the causes, it has undeniable results. The American age is on the way out. ▪

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'A damned near-run thing'

US fiscal and monetary policies running in opposite directions

William Keegan, Chairman, Editorial & Commentary Panel

The October annual meetings of the World Bank and International Monetary Fund in Washington were overshadowed by the 11th hour negotiations between the White House and Congress over the intransigence of the extreme Right of the Republican party, the Tea party, over the debt ceiling.

These meetings have become used to threats of government paralysis, but this time really was exceptional. Although the financial markets rightly bet that in the end there would be a settlement, it was, in the words of the Duke of Wellington on another historic occasion, 'a damn near-run thing'.

I knew the game was up when I read in the Washington Post that there had been a nationwide plunge in the Republicans' opinion poll ratings. That concentrated the minds of the 'reasonable' members of the Republican leadership who, until then, had been running scared of the lunatic fringe.

There were many aspects to the dispute. But the central issue was the refusal of extreme Republicans to accept that Obamacare had been passed by both Houses of Congress, approved by the Supreme Court. Obamacare is to the US what the introduction of the National Health Service was to the UK after the Second World War. The plight of over 40m Americans without proper access to healthcare has always been a blot on the reputation of the world's mightiest economy. One of the more hypocritical tactics employed by the Republican dissidents has been to complain that, in its initial stages of being put into practice, Obamacare is not viable. This is because some Republican-controlled states have been refusing to channel funds due from central government.

One, possibly the principal, reason for the dive in support for the Republicans was the way that the partial shutdown of the government was already causing widespread disruption and distress around the country. The US media were replete with hard-luck stories. Immediate reaction after the truce was divided between those who thought that the Republicans had had such a fright that commonsense would continue to prevail and those concerned that the Tea Party would regroup and carry on the fight.

I was much struck by a fine article in the Washington Post by Lawrence Summers, the man who dropped out of the running for the Fed chairmanship. Summers wrote: 'If even half the energy that has been devoted over the past five years to "budget deals" were devoted instead to "growth strategies", we could enjoy sounder government finances and a restoration of the power of the American example.' However, I was worried by an article in the Financial Times by James Baker III, another former Treasury secretary (and Secretary of State) under earlier Republican administrations. I have always seen Baker, in common with George Schultz before him, as one of the best of the moderate Republicans. It was therefore disturbing to find him, while urging his party to calm down, reassuring them that after that they could always have another onslaught on Obamacare. The US budget problem is not that bad. One of the themes to emerge from Washington was that the forecasts from the Congressional Budget Office indicate that the budget deficit is under much greater control than the public commentary would have us believe – falling to 2% GDP by 2015 on present policies.

There is much talk about when the Federal Reserve may begin to tighten monetary policy. Fed officials emphasise that, with unemployment so much higher than the historical average, and inflation well below target, such tightening may come much later than markets expect. There is a conflict between US monetary policy, aimed at expansion, and fiscal policy, which is acting in the opposite direction. This is not a phenomenon unique to the US. It's the same in the UK and the euro area. All these parts of the world, in different ways, need better balance. ▪

William Keegan is Senior Economics Commentator at the Observer.

Americanised world will stay and it's partly the Europeans' fault

The clumsy torment of American politics, and the intense psychological separation between the leading reserve currency country and the rest of the world, are obvious. Yet there's no alternative to further US world economic and monetary leadership, *writes David Marsh.*

As Winston Churchill said, the Americans generally do the right thing after they've tried everything else. World central banks generally stick with the dollar as a reserve currency after they've tried all the alternatives. Chinese pontificating about a de-Americanised world is beside the point. It will be years before the renminbi is a real world currency.

The Europeans roll their eyes condescendingly at the big, bumbling, inconsistent American cousins and claim to know better. But if we have an Americanised world, it's partly the Europeans' fault. Their inability to solve the euro crisis has undermined the world's second reserve currency and secured America's currency hegemony.

The Americans' leaning to grandiose, stagey shows of less-than-optimal behaviour shouldn't make us think they're vulnerable. More the opposite: on display is a capricious sovereignty. There's a clear link between troubled international economic conditions and the dollar's dominance.

Things haven't really changed that much since 1971 when the Europeans tut-tutted fruitlessly over President Nixon's decision to go off gold. That, at a time of worldwide monetary uncertainty, the US feels it can grandstand on the budget and toy with default testifies to a feeling of built-in superiority. A less self-confident nation would worry about the repercussions. A real hegemon doesn't bother. America believes the exorbitant privilege of the dollar is here to stay. The US has carried on for 40 years in calling the bluff of the world's monetary agencies and private institutions about holding the dollar. And this will continue. In world of pygmies, the one who's taller doesn't have to be ultra-competent or ultra-convincing.

Power games within different political systems reflect the varied nature of nations. The internal state of the US and the position of its leading corporations demonstrate recovery. Both the Chinese and the Europeans face far more difficult and contradictory situations. For China to translate economic strength into real political power, the Communist party would have to relinquish significant elements of control, threatening the economic cohesion on which its potential is built. ▪

Why the world didn't listen to the sceptics

Risks of systemic failure in an interconnected world

William White, former Economic Adviser, Bank for International Settlements

Five years or more after the beginning of the crisis, the global economy continues to be in very poor shape. After a sub-par recovery from the recession of 2009, one might have anticipated some acceleration in growth. In fact, the IMF and OECD are predicting such a development in 2014. It is worth noting, however, how bad their forecasting records have been in recent years. This is not designed to criticise, but rather to accept the economy as a complex, adaptive system, in which non-linearities are the norm and forecasting almost impossible.

Recoveries from economic downturns associated with financial stress are typically very hesitant. Across the global economy there are downside risks in virtually every region. Troubles in one spot could easily have significant implications elsewhere. In recent weeks, many warnings have been issued about the dire global effects of the US failing to raise the debt ceiling. Work has been done on the global implications of further trouble in the euro area.

US upturn

In recent performance, the US upturn is most advanced, but many points of fragility remain. Employment and household income have been weak, household debt levels remain high and saving rates low, and the underlying strength of the financial system remains questionable. And no one needs reminding of the continuing political problems in the US. In the euro area, the current calm masks the absence of real progress on the many 'unions' (fiscal, banking, economic and political) required to remove all doubts about its future survival. Shorter term measures ('believe me, it will be enough') remain untested and highly conditional.

China may or may not be on a significant reorientation of its growth model, but either way dangers lurk. Its current investment and export led strategy is not sustainable, while a transition to consumer led growth faces many challenges. In Japan, Abenomics seems to have many similarities to the growth model that the Chinese are actually trying to get away from, which is odd to say the least. There has been a remarkable slowdown in many emerging market economies. The rush of capital towards 'the exits' has revealed years of wasted opportunities for structural reforms.

Unfortunately, our room for manoeuvre is now highly limited. In many, perhaps most, countries high sovereign debt levels make further discretionary fiscal stimulus problematic. Expansionary monetary policy could be pursued still more vigorously but has its dangers. Structural reforms take time to spur growth, and can have undesirable short run consequences as well. An expansion of international trade might pay big growth dividends, but in practice we seem to be heading quietly in the opposite direction. The roots of our problems are very deep. As monetary policy and the pursuit of low inflation took centre stage in the 1980s, monetary policy was eased repeatedly whenever growth seemed remotely threatened. I think in particular of the 'Greenspan put' of 1987 and the subsequent bouts of easing in 1991, 1998 and 2001. Neither monetary policy nor fiscal policy was ever tightened as aggressively in the upturns as they had been eased in the downturns. Sovereign debt levels have ratcheted upwards and policy rates have ratcheted downwards for over three decades.

The developments leading up to the crisis of 2007 need special attention. Historically, most significant crises have had their origins in some 'good news' that has justified 'rational exuberance'. I suggest that the most important piece of global good news in recent decades was the fall of the Berlin Wall, the reintegration of previously isolated economies into the world trading system, and the strong disinflationary forces that accompanied these developments. The introduction of the euro gave new promise to Europe.

Given a monetary system based on fiat money, the rational exuberance these developments generated quickly morphed into 'irrational exuberance' in the advanced economies generally and the European periphery in particular. This development was inadequately resisted by both central banks and regulators. Credit growth rose sharply in the years preceding the crisis, adding to debt levels already swollen by earlier cycles of easing. This led to a series of imbalances. By 2007 the global economy and the euro area economy were accidents waiting to happen.

These expansionary forces in the advanced economies should have led to a depreciation of their currencies against those of the emerging market economies. The EMEs refused to accept this and resisted exchange rate appreciation through both foreign exchange intervention and conducting an easier monetary policy than they would have done otherwise. The end result was an explosion of liquidity at the global level. The 'boom' to which this gave rise eventually led to the financial 'bust' of 2007 and the deep global recession of 2009.

What has happened since the start of the crisis? In the advanced economies virtually all the executed policies have been desirable for their short-run implications for crisis management. Yet each has also come with undesirable medium-term effects that now render the achievement of 'strong, sustainable and balanced growth' much more difficult.

More reliance than ever has been put on expansionary monetary policy. Easier monetary conditions were needed to help reestablish the proper functioning of financial markets in the early years of the crisis, but many central banks are now relying on this factor to stimulate demand. There are many reasons to believe (not least the 'headwinds' of debt) that this will not be effective.

Among a host of such effects, easier money has impeded required deleveraging. This has helped create zombie companies and zombie banks, not least in Europe. It has contributed to more risk-taking and unjustified increases in asset prices, not least bonds. It has encouraged risk on-risk off behaviour in financial markets.

Inflow of capital

Such policies in the advanced economies led to a sharp inflow of capital into emerging market economies which created both inflation and imbalances in those countries to mirror those seen earlier in the advanced countries. In spite of the current calm and several positive signs, it would be unwise to think the crisis is over.

There were a few who did warn that there were serious problems building up under the smooth surface of the Great Moderation. I would like to believe that we at the BIS saw it more clearly than many others, though the timing and the precise nature of its unfolding eluded us. That these warnings (both public and private) were not heeded reflected a set of false belief systems.

All parties who contributed to the crisis (borrowers, lenders, regulators, central banks, academics and politicians) were each seduced by various influences into believing different things that were not true. Institutional relationships between these various parties were contributing factors. These false beliefs affected borrowers who were eager to believe that borrowing could substitute for earning and that higher house prices constituted an increase in wealth – where such an increase is defined as the wherewithal for enjoying a higher standard of living in the future.

Lenders followed the false beliefs that the world had become a permanently less risky place and that banking was solely about profits. Numerous bad practices have subsequently come to light, not least the misselling of 'toxic assets' and the manipulation of LIBOR. Finally, it was wrongly believed that the gaming of the bank regulatory system, through the shadow banking system, would keep risky activities permanently off banks' balance sheets.

The pre-crisis beliefs of regulators and supervisors were overturned by the crisis. These beliefs were that regulators actually had a good understanding of the health of the system as a whole; that all the efforts put into the development of Basel II would be sufficient to keep the financial system safe for the foreseeable future; and that the employees of financial firms would continue to respect the obligations of 'fiduciary trust' and act in the best longer term interests of their firm. Alan Greenspan, in almost tearful testimony to a Senate committee, said harbouring this belief was the greatest mistake he ever made.

Implicitly, Greenspan was saying he made no big mistakes with respect to the conduct of monetary policy. In contrast, I would assert that much of what central bankers believed prior to the crisis was not true. The principal belief was that stable prices (low inflation) effectively guaranteed macroeconomic stability. This belief seems to have originated in the 1980s when fighting inflation was justified on the grounds that it was 'necessary' for macroeconomic stability. This then morphed into the belief that price stability was 'sufficient' for such stability.

The relationships between these various economic agents also served to reinforce the pernicious effects of these false beliefs: the relationship between bankers and regulators; bankers and politicians; politicians and voters; central banks and politicians; and regulators and central banks. For instance, the interactions between regulators and central banks have left a lot to be desired. Prior to the crisis, systemic concerns about financial stability fell between the cracks. Regulators were concerned about the health of individual institutions while central banks felt their mandate was essentially limited to price stability.

Since the crisis, systemic stability in the financial system has clearly moved up the agenda. Nevertheless, there is no international agreement on the best institutional structure to pursue such an objective. The US, the UK, the Europeans and the Japanese are all going down very different paths. Further, the regulators might be accused of having their foot very much on the brake (with higher

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White's analysis on learning from collective failure

Audiences at OMFIF's Golden Series lectures have been privileged to hear from many leading official sector speakers on the global financial system, but few have been as erudite, or as eagerly anticipated, as our speaker on 23 October, William (Bill) White, *writes John Nugée in London.*

White is the Chair of OECD's Economic and Development Review Committee, but more famously he was the Economic Adviser and Head of the Monetary and Economic Department at the Bank for International Settlements during the period of the run-up to the global financial crisis, when his long and increasingly strong warnings of the impending crash were so comprehensively ignored by those who should have known better. The opportunity to hear him speak on the crisis drew a full house at the Innholders' Hall.

White divided his talk into three parts: 'What has gone wrong with the world economy?', 'Why were the warnings ignored?', and 'What have we learned from the experience?' And in a nutshell, the answers he gave us were, respectively, 'Just about everything, 'Because nobody wanted to listen to bad news' and 'Almost nothing'. Behind these simplistic – if somewhat sobering – soundbite answers, though, White unpacked a detailed and comprehensive analysis of collective failure which few in his audience will have enjoyed, but even fewer could have argued against.

The central theme in White's analysis of the failure was that the crash of 2007 was a long time building and had many contributory causes. Some were familiar refrains – the complexities of structured finance, the laxity of regulations and the overwhelming reliance on debt to maintain economies and consumption. Others were more insightful: one that may have surprised the professional economists in the audience was White's assertion that the academic community should share in the blame – in his view, they promoted a misguided belief that macroeconomics is a hard science, and an approach that held that economies can be modelled using quantitative data.

The result of this was that policy was repeatedly directed to smoothing out the business cycle, to ameliorating short-term adverse economic performance even at the expense of creating longer-term instabilities. The imbalances grew, until it was no longer possible to keep them in check, to keep all the plates spinning or to keep economies stable. And then the crisis struck.

Since then, White observed that the world has in effect 'doubled up'. Virtually all the policies that the authorities have followed since the crisis started have been necessary and effective. We have avoided another Great Depression. But each of them has come with undesirable medium-term effects that make a return to strong, sustainable economic growth ever more difficult. It is a telling commentary on the situation of the world economy, where the main cause of the crisis was too much debt, and the main result of five years of policy hyper-activity to restore order, using both fiscal and monetary levers to the limit, is even more debt.

White looked for a new paradigm, a realisation that we cannot return to the immediate past and an understanding that at some point 'creative destruction' does need to include some destruction to cleanse the system. He noted the number of economic studies that contained the word 'new' as evidence that this message is slowly dawning. But he also left his audience in no doubt that we have finally reached the end of the road we have been kicking the can down. Without new thinking, the world will remain in deep distress. ▪

John Nugée is Deputy Chairman of the OMFIF Advisory Board.

Household debt and the financial crisis

Higher savings can cushion but not cure effects of borrowing build-up

Gabriel Stein, Chief Economic Adviser

One trigger for the global financial crisis of 2007-08 was the sharp rise in the debt of US households. Their debt burden reached just short of 130% of personal disposable income (PDI) in 2008, when it effectively became unserviceable. Since then, US households have deleveraged and the debt/PDI ratio has fallen to just below 110%, a figure which may be within the maximum stable zone of 100-110% of PDI. In other countries, the range of tolerable household debt appears much wider – for reasons that need to be analysed.

US households seem to have to stop spending and start saving at a debt/PDI level of 110%. Households in other countries appear able to live with far higher debt/PDI ratios. In Australia the ratio reached close to 155% of PDI and is now barely below 150%. In Sweden the number has been close to 180%, although has since fallen slightly to 171%. In Denmark the debt/PDI ratio peaked at over 250% in 2010 (see Chart 1). Yet in these countries life goes on and Australia and Sweden, at least have weathered the Great Recession better than the US. What explains the difference?

First, the bulk of household debt tends to be housing debt. In Australia mortgage debt is 90% of total household debt; in the US it is 70%. That implies that the bulk of the debt is mirrored on the asset side of balance sheets by the value of the house.

One reason why British and Australian households (and others, like the Dutch, Norwegian, Danish or Finnish) can carry more debt than their American counterparts is because these countries (in the case of Australia, its habitable land) are relatively small and house prices are correspondingly higher because of land shortages. But this does not by itself explain why Swedish households carry a higher debt than American, given Sweden's relatively large size and small population.

Nor does it seem to matter whether mortgage interest is tax-deductible – as in the US and Sweden – or not, as in the UK. Variable interest rates help households carry more debt, particularly if they are rapidly falling. But the bulk of mortgage lending is at variable rates not only in the US (where, even if it is technically not variable, it is relatively easy to change the loan) but also in the UK, Sweden and Denmark.

One key factor that can explain some of the difference in debt service capacity is the household savings rate. Although the numbers have been revised in different directions as part of regular US national accounts revisions, US household savings are by international standards very low, averaging 4.6% over the past 10 years compared with 6.7% in Denmark, 10.5% in Sweden and more than 12% in the Netherlands (see Chart 2). Only in the UK was the 10-year average similar that of the US at 4.6%.

A higher savings ratio can help offset the effects of higher debt because, if the interest rate burden rises, households can lower their savings rate (and even draw down the absolute level of their savings) and continue to consume at the same rate as before. If on the other hand they save little or nothing, they have to lower consumption to service their loans.

This theory can be tested by analysing whether households lowered their savings rate or cut back consumption when the crisis struck. This does seem to be what happened in the Netherlands and in Denmark. By contrast, in Sweden and – even more so – in Australia and the UK, the savings rate rose. This is because households accelerated their deleveraging process, since debt repayment counts as savings. However, a breakdown of the savings data by quarters shows that, even in Sweden and Australia, the initial household response to the crisis was to lower the savings rate somewhat, supporting the theory that savings act as a buffer against high debt ratios.

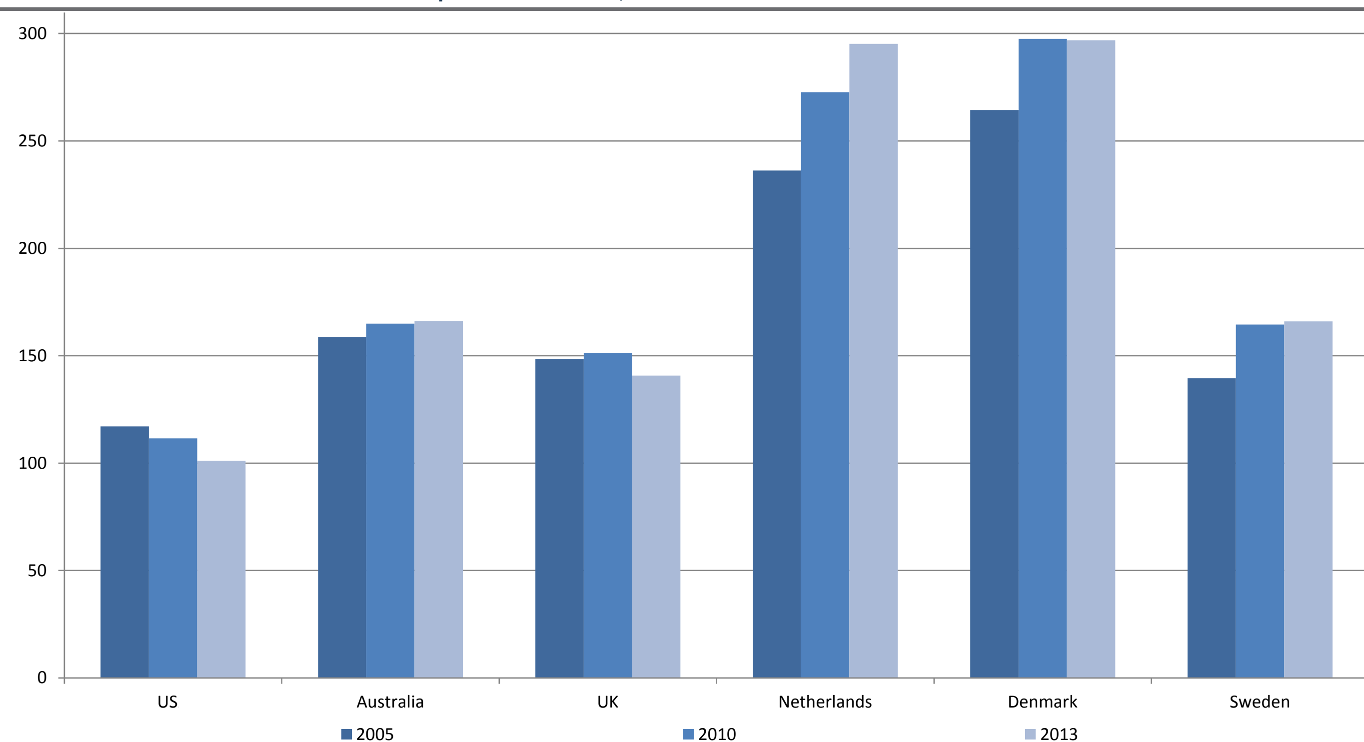
But this is not the whole story. In Spain, a country badly hit by financial upheavals, Inish households had double-digit savings ratios in the past decade, an average of 12.2% in the past 10 years, 13.5% in the past five years. This barely mitigated the effect of the crisis. So clearly there are other factors involved. One factor worth investigating is whether an extensive social welfare net along the Nordic or Dutch models makes households more prepared to hold debt than the somewhat sparser US and UK models.

One crucial factor seems to be the interaction between savings and amortisation. The Reserve Bank of Australia has noted that part of the reason for the relative weakness of the Australian economy in recent years has been that households are pre-amortising, i.e. paying down debt. By contrast, in Sweden, although there is a long debate about forcing households to amortise debt on a regular basis, much lending is still done on the basis of interest-only payments.

This is clearly a risk for the future: at some stage, interest rates will rise. At that stage, Sweden, which until 2012 was a star performer among developed nations, could face a rapid slowdown. This will to some extent be offset by stronger exports, as higher interest rates are likely to come only when the world economy has recovered, which will benefit a small open economy like Sweden. Ultimately, a high savings rate can enable households to carry a higher debt burden. Household debt is not the only indicator on which we should focus. Clearly, when debt burdens become overwhelming, a higher debt ratio is likely to make the recovery more protracted. Deleveraging produces an even higher savings rate than before and a lower rate of consumption. The higher savings rate in countries like Australia, Sweden, Denmark and the Netherlands may help matters but it does not shield them fully from the effects of any further debt build-up. ■

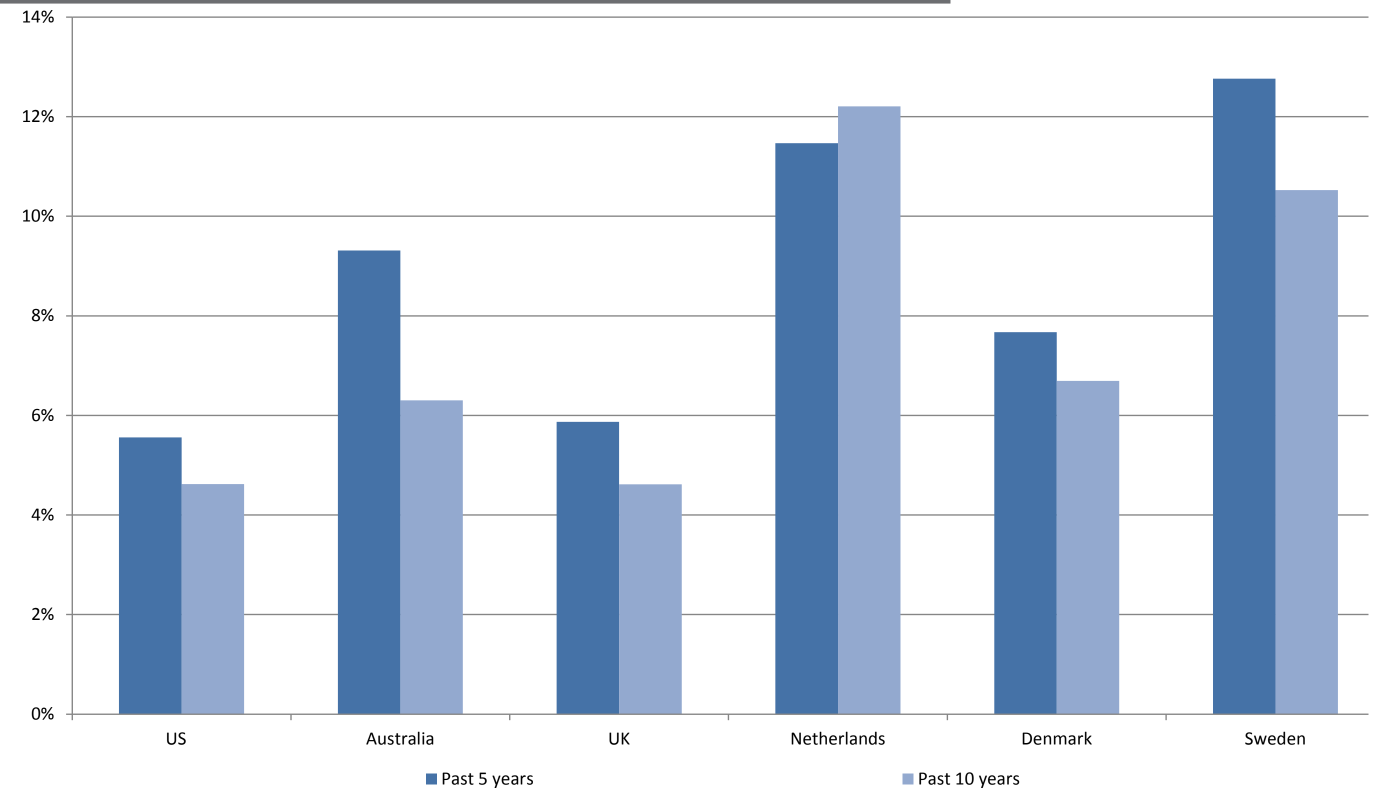
Gabriel Stein is OMFIF's Chief Economic Adviser and Managing Director of Stein Brothers.

Chart 1: Household debt as share of disposable income, %



Source: Federal Reserve, RBA, ONS, Statistics Sweden and Eurostat

Chart 2: Household savings rate as share of disposable income, averages, %

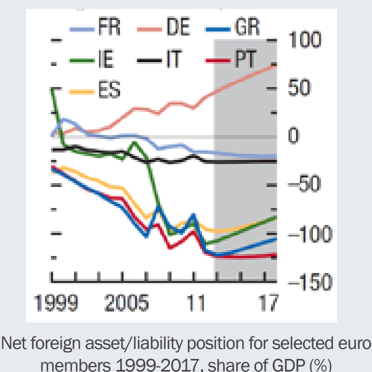


Source: Federal Reserve, RBA, ONS, Statistics Sweden and Eurostat

IMF gloomy on debt levels in euro area

The IMF's latest world economic assessment paints a gloomy picture of euro rebalancing. The sharp fall in peripheral countries' current account deficits has been largely due to cyclical factors. 'The implication is that current account deficits could widen again significantly when cyclical conditions, including unemployment, improve, unless competitiveness improves further.'

The IMF foresees that Germany will continue with current account surpluses of around 5% of GDP at least until 2018 (compared with 7% last year). The IMF's key indicator of vulnerability – the net foreign liability position – will continue up to 2018 at more than 80% of GDP in Greece, Ireland, Portugal, and Spain, as growth remains low and unemployment persists at high levels. The worst-off debtors, Portugal and Greece, will both remain with net liabilities above 100%. The German net foreign asset position is expected to rise to an astonishing 75% of GDP by 2018. (See accompanying chart.) ■



Net foreign asset/liability position for selected euro members 1999-2017, share of GDP (%)

Spain in gradual recovery from long recession

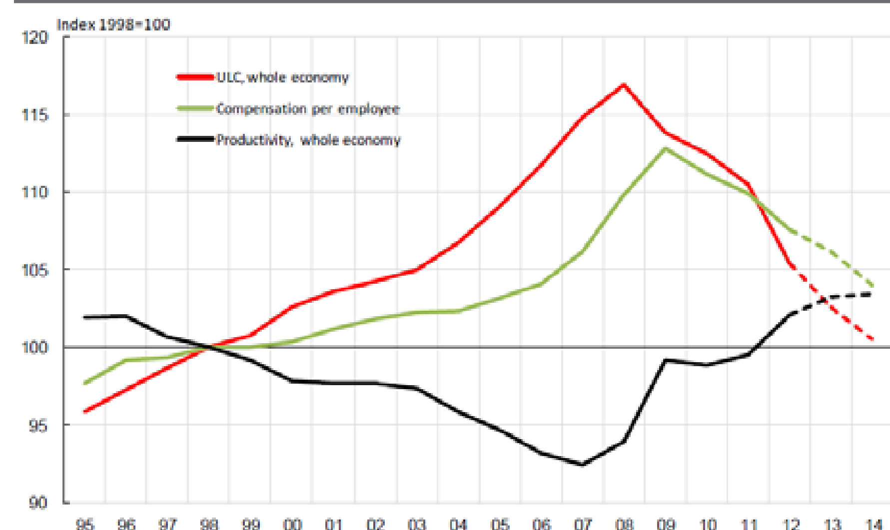
Reforms and adjustment through internal devaluation and deleveraging

OMFIF Report on Banco de España Economists Meeting in Madrid, 21 October 2013

Spain is making good progress in emerging from a nine quarter-long recession that has brought GDP back to the level of 2007 and forced unemployment to 26% in a massive adjustment to the excesses in the first decade of economic and monetary union (EMU).

The message from a day-long series of official meetings in Madrid on 21 October is that structural reforms under prime minister Mariano Rajoy in line with Spain's agreements with the European authorities are becoming gradually embedded in the economy. However uncertainties remain over the longer-term outlook, partly as a result of continued financial fragmentation in Europe.

Relative unit labout cost: Spain vs. euro area



Source: Banco de España

Quarterly growth

The Spanish economy is showing the first signals of positive quarterly growth since the beginning of 2011. According to latest International Monetary Fund (IMF) forecasts, Spain's GDP this year will decline 1.3%, slightly better than the earlier-predicted fall of 1.6%, growing 0.2% in 2014, compared with a previous forecast of zero growth. The Banco de España has published figures showing annual GDP growth of 0.1% in the third quarter. The IMF sees hardly any improvement in unemployment at 26.9% this year and 26.7% next year.

There is no sign of complacency in Madrid. Officials warn of a difficult and demanding process underway, with much work still to be done. However, there is confidence that, by comparison with other leading euro area economies such as France, Italy and even Germany, Spain is making significant advances in competitiveness, export performance and reforms in areas like pensions and the labour market.

Despite unmistakable signs of success in achieving a significant internal devaluation in an unpropitious growth environment, several more years will be needed for adjustment, with persistent high unemployment. Further public and private sector deleveraging is needed to set the economy on a firm growth path. Reflecting financial fragmentation, falling costs for public sector financing have been transferred only to a very limited extent to private borrowing.

Overall net foreign indebtedness has remained at 90% of GDP since 2009 (compared with 30% in 1999). The sharp swing in the current account to a surplus of 2% of GDP this year, against the pre-crisis peak deficit of 10%, is an important step in the right direction, but needs to go further to have any significant effect in reducing high debt levels. Showing the extent to which domestic demand is being sacrificed in the interests of debt sustainability and external rebalancing, the current account surplus is expected to reach 5% of GDP by 2017.

High overall debt, the low growth trajectory and lack of leeway in fiscal adjustment make Spain vulnerable to external shocks. In spite of the European Central Bank's commitment to maintain low interest rates for a protracted period, there is some anxiety about whether Spain and other European countries can decouple from expected US monetary normalisation in the next two years as the Federal Reserve's quantitative easing is gradually withdrawn.

Spain has been given more time by its European partners to bring down the budget deficit to the targeted 3% by 2016, after persistent overshooting in recent years. Government debt is projected to continue to rise slightly to 100% of GDP in 2016.

Behind the still relatively high budget deficit, estimated at 6.7% of GDP this year, lie structural changes in the economy resulting from the move from deficit to surplus in the current account. Because consumption is easier to tax than exports, officials say that Spain is now generating €60bn less in tax revenues than in 2007. As a result, the government is intent on bringing in tax reforms to broaden the fiscal basis of the economy.

Improvements in Spanish competitiveness look likely to survive the modest upturn now under way, with unit labour costs compared with the rest of the euro area back to levels ruling shortly after the euro was introduced in 1999. Labour market reform is an important factor supporting gains in competitiveness.

Improved state of banks

An important boost to recovery prospects has come from the improved state of the banks, with lower exposure to real estate, improved underlying profitability and solvency ratios, and stabilising non-performing loans. The European asset quality review and stress test exercise now in prospect are unlikely to reveal any significant requirement for new capital for Spanish institutions.

Progress towards banking union – despite delays to implementing the single supervisory mechanism and legal and technical doubts over establishing a full-scale European resolution regime – is seen as underpinning improved financial prospects. Officials say that Spain will continue to manage the process of boosting banks' capital without the need for direct recapitalisation through the European Stability Mechanism that was once seen as crucial to break the link between sovereign debt and the banks.

Officials are concerned by the lack of a European growth strategy, made more uncertain by the lack of a clear policy line from Germany. Spain is not banking on any significant EU growth impulse but is relying on its own efforts to inch its way further out of recession, above all in driving forward internal reforms and diversifying export markets.

There is no European policy to make creditor countries share more equitably in the burdens of adjustment. This means, as one official put it, that Spain is trying to repay its debts towards euro area creditor countries like Germany and the Netherlands by exporting to the US and China. This is seen in Madrid as a much less satisfactory state of affairs than if Europe followed a policy of boosting euro area demand.

Fiscal policies / budget deficit

There was some discussion regarding whether Spain might speed up fiscal adjustment to improve further the fall in interest rate spread between German and Spanish government bonds, by enlarging to 4.5 percentage points from 3.7 points the planned fiscal improvement in the next three years through sharper 'front end-loaded' efforts to increase taxes and cut spending. One economist claimed that this would not have an adverse effect on growth and would have a generally beneficial effect because of falls in the risk premium for Spanish bonds.

Officials rejected this suggestion as unnecessarily ambitious and possibly counterproductive, stating that the top priority is to stick to Spain's newly reset budget targets.

Unit labour costs and competitiveness

The improvement in Spain's competitiveness was achieved up to 2009 through increases in productivity from a sharp rise in unemployment. This is now attributed to falling wages in response to reforms boosting labour market flexibility.

Officials contrasted previous gains in competitiveness during Spain's membership of the exchange rate mechanism, caused by progressive peseta devaluations, with the latest competitiveness improvement brought about by declines in internal costs. In the period following 1991, Spain actually lost competitiveness slightly in spite of a series of nominal devaluations, compared with the substantial competiveness gains in the last three years at a time of nominal exchange rate stability.

Spain's GDP per capita is now back to levels of the early 2000s. Compared with a linear extrapolation of Spain's unsustainably high pre-2008 growth rates, Spain's GDP is now €307bn (32%) below levels that were earlier thought possible. This is seen as permanently lost output.

External adjustment

The 12 percentage point improvement in Spain's current account position between 2007 and 2013 has been one of the largest on record.

According to a recent WTO report, Spain is ranked as the third most successful country in the world (after China and the UK) for export growth.

Spain's 2012-13 export performance in the euro area is seen as outstripping that of France and Germany.

There has been a significant increase in the number of Spanish companies involved in exporting on a regular basis. Spain needs to give priority to increasing the size of smaller companies to make them more robust on export markets.

The share of exports in GDP has risen from 25% in 2006 to 34% now and is set to increase to 40% in 2016 – compared with German levels of around 52%. Spain is diversifying export markets, with the proportion of exports to outside the EU rising to 42% in 2013 from 25% in 2007. Annual growth in Spanish exports to areas outside Europe is put at 40% to the Middle East, 15% to Africa, 10% to China and Latin America and 6% to the US.

Spain has been upgrading its export output in areas of capital goods including sectors like high-speed trains, Airbus components and chemicals. The big motor manufacturers in Spain including GM, VW, Nissan, Ford, Citroen and Seat have all announced plans to increase Spanish investment, with output destined principally for exports.

Slow growth and high unemployment

Officials say Spanish society remains resilient in the face of the domestic demand shock and the lack of prospects of a rapid improvement in unemployment. The Spanish people have had to live before under high levels of unemployment, which were around 25% at the beginning of the 1980s and 1990s – a sign of Spain's previous difficulties in introducing reforms reducing propensity to shed labour.

In contrast to the position in France, Italy or the UK, and bucking a trend seen even in Germany, there is no significant party favouring anti-euro policies or splitting away from the EU. The separatist movement in Catalonia cannot be compared with the campaign of the Scottish Independence Party for a separate Scotland. Officials said there was no legal or constitutional possibility for Catalonia to secede from Spain.

One factor bringing down unemployment in coming years is demographics, reflecting the country's low birth rate and return to their home countries of immigrants previously attracted to Spain by the expanding jobs market.

The Rajoy government, with an intact mandate until the end of 2015, has a relatively stable position from which to carry out further reforms and ensure the economy remains on its growth path. But there is still a long way to go. ▪

Spain 'more competitive than France and Italy'

Spain is now more competitive than France and Italy, the No. 2 and 3 economies in the euro area, according to Jean-Claude Trichet, former president of the European Central Bank, *writes Nick Bray in Paris.*

Trichet singles out the Madrid government as launching one of the most successful strategies for economic adjustment to correct earlier imbalances caused by southern European governments' failure to hold down wage increases.

At a meeting with members of France's Association of Economic and Financial Journalists (AJEF), Trichet warned of rising public debt and high budget deficits and said euro members needed to remained internationally competitive.

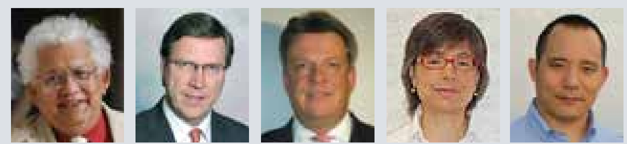
'European governments have a very heavy European and global responsibility. We are the epicentre of a very serious crisis,' he intones.

Excessive wage increases in some countries hit competitiveness. Trichet sticks to his mantra of seeing the euro's problems as emanating from individual countries and not from the system. 'The crisis is a crisis of the euro area not of the euro.' Germany has worked hard to improve its competitive position, France has been more lax. 'There will be further crises,' he predicts, and they will hit those countries and regions that fail to adjust their production and decision-making processes to new realities. 'We live in a world that is extremely cruel.' Europe faces a choice between cutting excessive costs and wages, or facing the prospect of an Argentina-like rout.

While Germany is close to overcoming unemployment, other countries continue to protect labour market insiders. In an environment characterised by rising distrust of public institutions, European governments must win the support of their citizens for the tough budgetary and labour market decisions that lie ahead.

Trichet advocates strengthening the role of the European Parliament so it can call national governments to account for their economic and fiscal policies. 'Fiscal and budgetary decisions lie at the heart of democracy. Countries whose budgetary policies are perceived as destabilising for the euro should be held to democratic account by the European Parliament, as the only body elected at a Europe-wide level by universal suffrage.' ▪

Nick Bray is former Head of the Press Department at the OECD.



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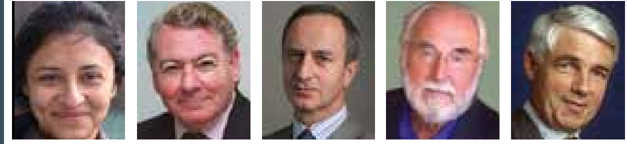

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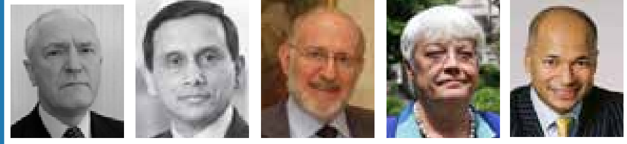

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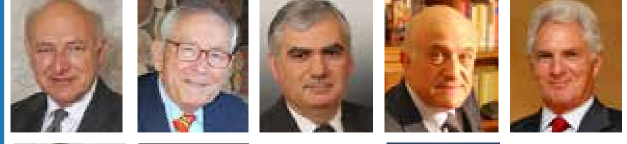

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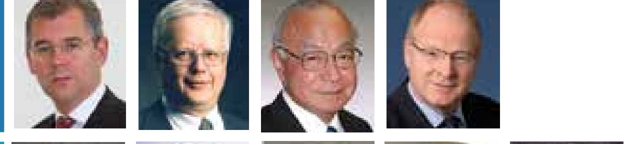

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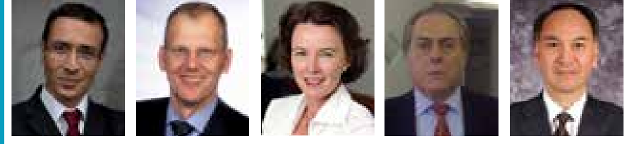

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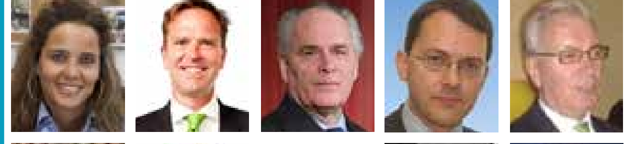

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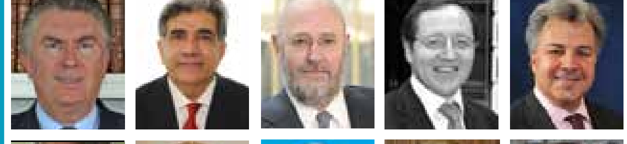

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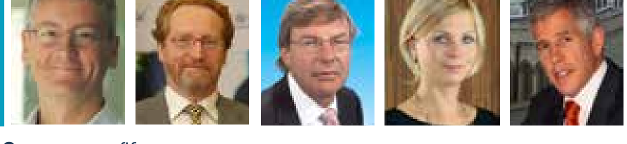

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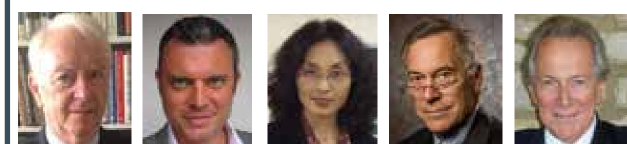

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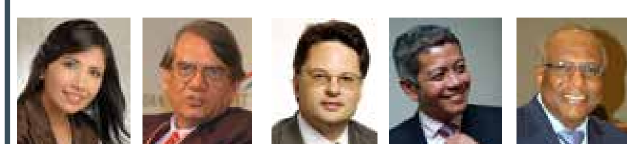

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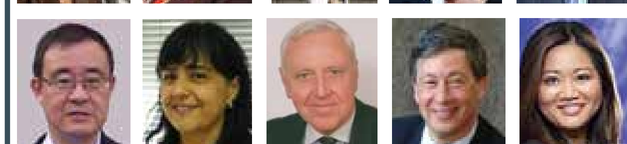

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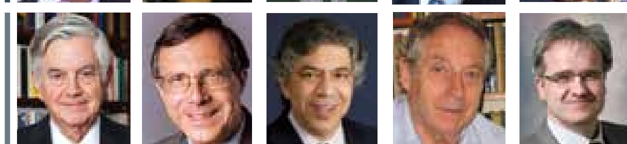

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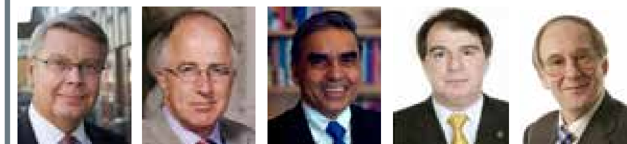

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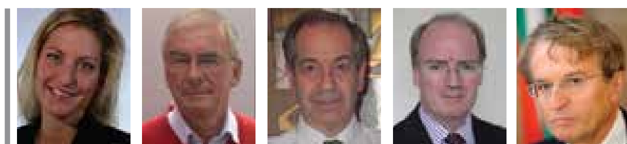

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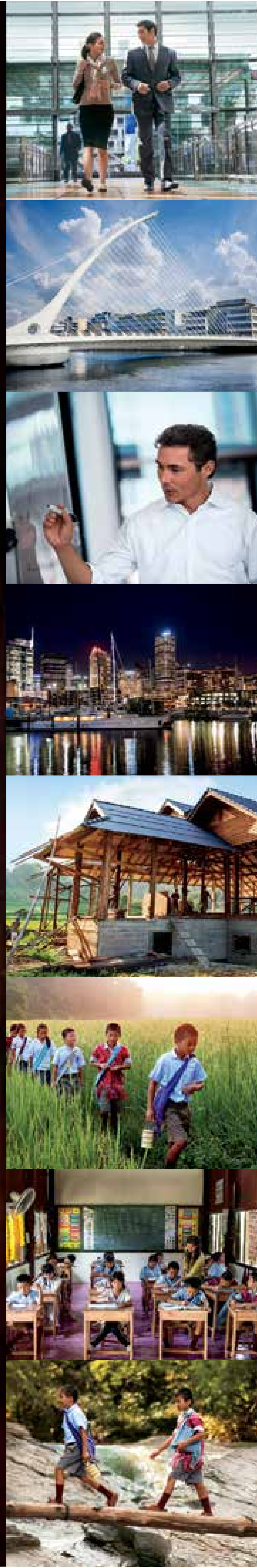

Resolute path to banking union

Rigour and transparency key to restoring confidence

Luis M. Linde, Banco de España

Within a year, the European Central Bank will, together with the national supervisory authorities, assume broad supervisory competence over the euro area banking sector and other EU countries which decide to opt in to banking union.

Those credit institutions deemed to be significant will be directly supervised by the ECB with the assistance of national supervisory authorities, while the rest of the system will be indirectly supervised by the ECB through national supervisors. Out of roughly 6,000 euro area credit institutions, the ECB will directly supervise around 130 banks, covering around 85% of total banking assets.

European policy-makers have been working since the end of 2012 on preparing the Single Supervisory Mechanism (SSM). The challenge is to make operational the new framework agreed by European governments before the ECB assumes its supervisory tasks.

A new institution has to be created, requiring considerable recruitment. A completely new framework has to be developed to underpin the supervisory decision-making process, keeping it separated from the ECB's monetary policy structures. Additionally, before the SSM is fully operational by November next year, the ECB will perform a comprehensive assessment of the European banking system.

The transfer of responsibilities from national authorities to the ECB should be a smooth process. The national authorities have the expertise in the supervision of credit institutions. These bodies, including national central banks, have the necessary information, knowledge and staff.

A rational division of work is required. The ECB will have the direct oversight of significant banks with the cooperation of national authorities. The national authorities' direct supervision of less significant institutions will be carried out in harmony with the ECB, The national authorities will have to comply with regulations, guidelines and general instructions issued by the ECB.

This will not be a two-tier system, but a single one with a distribution of tasks. We are setting up not a 'confederation' but a 'Union' of supervisors under a single European authority. Steered by a High-Level Group on Supervision, chaired by the ECB president, the work schedule provides for mapping all the EU banking institutions. Integrating 17 national supervision systems (some of them made up by two authorities), along with the ECB, into the SSM is a major challenge. Joint Supervisory Teams (JSTs), consisting of supervisors from the ECB and the national authorities, will take care of direct supervision of the significant banks, under the guidance of an ECB coordinator.

The ECB plans to devote two Directorates General to this direct supervision of significant banks, DGs I and II. Additionally, a DG III will be created to deal with the indirect supervision of the Less Significant institutions. Finally, a DG IV will carry out horizontal functions such as supervisory quality assurance, methodology and standards, enforcement and models approval. Overall, including the Secretariat, the ECB will need around 1,000 new staff, 750 of them directly involved in supervision.

The comprehensive assessment of all banks that will come under direct ECB supervision will consist of three elements: a supervisory risk assessment, a balance sheet assessment and a stress test. This will be concluded before the ECB assumes its supervisory functions in November 2014.

The supervisory risk assessment will incorporate supervisory judgments on all risk factors, summarising in comparable form all potential sources of risk. This risk assessment will be used for the portfolio selection to be undertaken as part of the balance sheet assessment.

The second element, the balance sheet assessment, will be carried out at a given point in time and on an accounting basis. This assessment will be broad and inclusive, covering credit and market exposures, on and off-balance sheet positions, domestic and significant non-domestic exposures. One key issue will be the capital threshold used for this exercise, which, in accordance with the definitions of the Capital Requirements Regulation and Capital Requirement Directive IV will take into account the transitional arrangements and the need for a demanding threshold.

The third element, the stress test, will review the major risks of banking groups under various scenarios, testing the sensitivity of bank balance sheets to hypothetical external shocks. The assessment will probably be made with a reference date of December 2013 and will be finished in November 2014, when its results will be published.

The ECB will manage and oversee the exercise in close cooperation with the national authorities and with the support of an international consultancy firm. Quality assurance processes will be in place at every stage. This exercise has to be rigorous and transparent, so as fully to restore confidence in the European banking sector. ▪

This is an edited and abridged version of the speech delivered at the Economists Meeting in Madrid on 21 October. Luis M. Linde is Governor of Banco de España.

Governor Linde discussing the Spanish economic outlook in Madrid on 21 October

Introspective Germany struggles with reality

US attacks worsen Berlin's dilemma over world role

John Kornblum, Advisory Board

Spying action by the American National Security Agency and an unusual attack by the US Treasury have added to a mood of adversity between Washington and Berlin. The NSA's bizarre if not idiotic decision to tap the phones of Angela Merkel and a dozen or more other world leaders has set off a firestorm of German anger and soul-searching – complicating Germany's process of coming to terms with its new, more important world role.

The NSA affair is only the most recent of many rude international intrusions into the carefully-constructed stability that has formed the basis of German society since the Second World War. Many are now asking how a nation dependent to an astonishing degree on US behaviour can overcome a drastic decline in trust with Washington and remain a European anchor.

Compounding the problems, the US Treasury in its semi-annual currency report blamed Germany's large current account surplus for imparting a deflationary bias to the euro area and the world economy. The Treasury elevated its comments to a 'key finding' alongside China's undervaluation of the renminbi and Japan's monetary stimulus. 'Germany has maintained a large current account surplus throughout the euro area financial crisis, and in 2012, Germany's nominal current account surplus was larger than that of China,' the Treasury said. 'Germany's anaemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment.'

The Treasury's critique recognises that tackling the euro crisis remains Berlin's priority task. The origins are complex, but they lie crucially in southern European countries' inability to manage their finances in a single currency area battered by the pressure of globalisation. Berlin's strategy on the euro has criticised, but it is essentially right. Merkel's drive for 'austerity' not only is essential for an EU grown lazy on subsidies and corruption, but also coincides with Germans' deep-seated belief in thrift as a prerequisite for stability.

As Germany began leading Europe in this direction, its reward has been to be battered incessantly by those who did not want to leave the cosy Brussels world of mutual back-scratching. Memories of the Third Reich were rapidly revived. Merkel was pictured as Hitler. Germany and the Germans attracted opprobrium throughout the continent. Many Germans would argue that Germany has moved beyond traditional definitions of national pride and individual achievement. They would argue that Europe has built a new sense of identity based on consensus, rule of law and social equality. However, as the backlash against German economic precepts demonstrates, the post-war consensus is no longer producing satisfactory results.

As recently as two years ago, most Germans would have defined the European Union as part of the German national fabric. That's no longer the case. The same holds true for ties to the US. As the desultory pace of coalition talks in Berlin demonstrates, Germany's leaders still give priority to their own internal party battles over external affairs. As it struggles with reality, Germany's reaction to demands that it show more leadership will probably be to find a new basis for internal stability. Over the longer run, Germany will find it necessary to lead, but on its terms and not as some two-thirds 'America in Europe.' Germany's partners need to be patient.

The NSA scandal is only one of several recent demonstrations of the fickleness of American support. Germany can no longer leave political initiatives to others. As Merkel has stated, Germany has become the America of Europe. With this dubious role comes growing responsibility, but also the problem of being criticised when things don't go right. It's not a position the Germans much like. And, for the time being at least, their answer seems likely to be a retreat into introspection. ▪

John Kornblum is former US Ambassador to Germany and Senior Counselor to Noerr.

Germany retreats from economic liberalism

Germany is likely to retreat firmly from liberalism in the Grand Coalition that will probably be formed after laborious government-building talks now under way in Berlin, *writes Denis MacShane in London*. The result will comfort left-leaning governments in the other two big economies in the euro area, France and Italy, but may discourage foreign investors seeking to build up business in the euro's heartlands.

Economic liberalism – sometimes but wrongly called neo-liberalism as an all-purpose insult – has had a 30-year run since the years of British prime minister Margaret Thatcher and US president Ronald Reagan. But we are now witnessing in Germany the de-liberalisation of European politics. Although one important strand of modern liberalism – the promotion of individual rights – stands upheld, another – the belief that less state, lower taxes and more rights for employers can generate economic growth – is unravelling.

In the short term, the swing to the left in the German parliament (despite a better-than-expected score in the 22 September elections for Christian Democrat (CDU) chancellor Angela Merkel) may improve cohesion in economic and monetary union (EMU). But, presuming the Christian Democrats team up with the hitherto opposition Social Democrats (SPD), it's still not clear how Berlin will pay for additional demands on public spending without increasing taxes. Whatever happens, the new Berlin government looks likely to maintain a hard line on bail-outs and transfers for struggling debtor states in EMU.

In the SPD's guidelines for forming a Grand Coalition, the big-ticket demand is for a state-imposed legal minimum wage of €8.50 per hour. Merkel and the CDU's more right-wing Bavarian partner, the CSU, have swung into line, though German employers remain opposed. The new German government will be based on hard bargaining. Not all in the SPD's 10-point wish list – ranging from more money for pensioners and healthcare through to higher spending on infrastructure – will be achieved. The SPD has made clear it expects Merkel's support for Martin Schulz, the left-wing president of the European parliament, to become EU Commission chief next summer.

Merkel's trump card is that she incorporates many social democratic and Green policies including phasing out nuclear power. She worked reasonably well with the SPD in a previous coalition in 2005-09 and has good personal links with top SPD politicians. ▪

Rt. Hon. Denis MacShane is former Minister for Europe and former Labour Member of Parliament for Rotherham.

Europe's deflation challenge

More action needed from ECB and other European policy-makers

Desmond Lachman, American Enterprise Institute

In the wake of Europe's longest post-war recession, there are some signs of growth resuming. The European Central Bank has acted to respond to the European periphery's deflationary challenge, cutting its policy interest rate by a further 0.25 percentage point on 7 November to a record low of 0.25%. The ECB's action, which came earlier than many market commentators had expected, was welcome, if overdue, and needs to be backed up by general changes in European policy-making. If deflation does take hold in the European periphery, it will make the resolution of the sovereign debt crisis all the more difficult.

The latest European consumer price data leave little room for doubt that the European economy is already in a distinctly disinflationary process. According to Eurostat, euro area inflation more than halved from 2.6% for the year ended September 2012 to 1.1% in September 2013, and fell further to 0.7% in October. The latest inflation numbers indicate that consumer prices are now falling in Greece, while countries like Ireland, Portugal, and Spain are all now on the cusp of price deflation.

The rapid deceleration in European inflation is hardly surprising given the very large output and labour market gaps. Five years after the Lehman crisis, the European economy is yet to regain its pre-2008 output level, while overall European unemployment remains stuck at a record rate of more than 12%. Meanwhile output gaps in countries like Italy and Spain are now well in excess of 10% and unemployment in the European periphery is considerably above the high European average.

The prospect for a further deceleration in European inflation is all too real given Europe's weak economic outlook and the strength of the euro. With countries in the European periphery still required to pursue budget austerity in the context of a continuing domestic credit crunch, it is difficult to see how Europe can stage a strong economic recovery.

As the Japanese experience with deflation over the past two decades would attest, deflation can constitute the strongest of headwinds to economic recovery. Not only does it incentivise consumers to delay expenditures, it also has the effect of increasing the real burden of private sector debt and raising the real cost of borrowing. This is the last thing that a struggling European economic periphery needs. A particularly troublesome aspect of this deflation is that it limits the ability of countries like Ireland, Italy, and Portugal to reduce their public debt burdens. These counties have public debt ratios of around 125% of GDP and budget deficits in excess of levels consistent with stabilising those ratios. An anaemic economic recovery at best, coupled with a move towards price deflation, raises the very real prospect of stagnating nominal GDP growth across the periphery. Such a prospect makes it difficult to see how the countries in the periphery can put their public debt on a more sustainable path.

Overall European inflation is now less than half the ECB's target rate of 'close to but below 2%'. This makes understandable the ECB's 7 November action. Low interest rates close to the zero bound will remain necessary for a long period – even though this may lead to divergences with countries like Germany that would like higher interest rates. European policy-makers need to accept the implications of the credit crunch in the periphery.

Bank credit continues to decline at a significant pace in the peripheral countries and the small- and medium-sized enterprises that have access to credit pay interest rates that substantially exceed those paid by enterprises in the core countries. Despite the ECB's recognition of the malfunctioning of its monetary transmission mechanism, the ECB has come up with no initiatives to address this problem. European policy-makers seem unable to find the political will to move more rapidly to a banking union that might offer hope of ending the credit crunch.

Over the past year, the easy global liquidity conditions associated with quantitative easing in the US have helped mask the public debt vulnerability in the European periphery. European policy-makers would be making a grave mistake to count on those liquidity conditions persisting and of not taking advantage of the window that liquidity still affords them to take the necessary policy action to get credit flowing again in the European periphery. ▪

Desmond Lachman is a resident fellow at the American Enterprise Institute.

Amid European uncertainty, Czech Republic shows resilience

A major paradox struck participants at the Economists Meeting at the Czech National Bank in Prague on 1 October. Even though the Czech Republic is one of the European economies most highly integrated with the No. 1 country, Germany, entry into the euro bloc is not remotely feasible for the foreseeable future. Though the country benefits from good relations and intensive communication with its EU partners, the earliest date for adhesion to economic and monetary union (EMU) was put at 2025.

The Czech Republic is acutely aware of the north-south creditor-debtor divide. Building efficient procedures and institutions to handle the problems are priorities before EMU accession can be considered. Some of the shine has rubbed off Czech economic performance over the past 18 months, with the country entering the double-dip European recession and only during the summer showing evidence of renewed growth. The Czech Republic none the less gains advantages from its semi-detached position in monetary arrangements. The central bank is taking an independent line on the issue (raised by the Bundesbank) of a zero capital weighting for banks' holdings of government bonds. Under consideration in Prague is the issue of unilaterally bringing in higher capita weightings as part of efforts to discourage local bank purchases of Czech government bonds. This would shift the weight of ownership towards retail holdings, placing budgetary financing on to a more stable longer-term footing. ▪

Governor Miroslav Singer, Czech National Bank

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Industrialised countries take up the strain

Fading growth in emerging markets – but relief from elsewhere

Stefan Bielmeier, Advisory Board

DZ Bank Economic Forecast Table

GDP change (%)	2011	2012	2013	2014
US	1.8	2.8	1.7	3.0
Japan	-0.6	2.0	2.0	1.9
China	9.3	7.7	7.5	7.9
Euro area	1.6	-0.6	-0.4	1.2
Germany	3.3	0.7	0.6	2.0
France	2.0	0.0	0.3	1.0
Italy	0.5	-2.4	-1.6	0.6
Spain	0.1	-1.6	-1.4	0.6
UK	1.1	0.1	1.4	2.0
Addendum				
Asia excl. Japan	7.6	5.8	5.7	6.5
World	3.8	2.9	2.7	3.6
Consumer prices (% y/y)				
US	3.2	2.1	1.6	2.2
Japan	-0.3	0.0	0.1	1.8
China	5.4	2.7	2.7	3.7
Euro area	2.7	2.5	1.7	1.9
Germany	2.5	2.1	1.7	2.1
France	2.3	2.2	1.3	1.6
Italy	2.9	3.3	1.7	2.1
Spain	3.1	2.4	1.9	1.5
UK	4.5	2.8	2.6	2.5
Current account balance (% of GDP)				
US	-2.9	-2.7	-2.7	-2.8
Japan	2.0	1.0	1.4	1.6
China	1.9	2.3	2.3	2.3
Euro area	0.2	1.3	1.9	2.0
Germany	6.2	7.0	6.6	5.9
France	-1.8	-2.2	-1.7	-1.8
Italy	-3.1	-0.6	0.9	1.1
Spain	-3.7	-1.1	1.0	2.0
UK	-1.5	-3.8	-2.8	-3.0

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Following the global financial crises, emerging market economies were the beacon of the world economy. Most of these economies enjoyed vigorous cyclical rebounds. Expansionary macroeconomic policies helped buffer the loss of demand from the advanced economies.

Today, emerging market and developing economy growth rates are down some 3 percentage points from 2010 levels, with Brazil, China and India accounting for about two-thirds of the decline. But there appears to be a strong positive trend in the industrialised economies. Manufacturing indicators and consumer confidence surveys signal a turn for the better. Expansionary monetary policy remains the dominant factor. Central banks are maintaining their policy rates at very low levels, even in countries that moved out of recession some time ago. Real interest rates are negative at the short end and frequently at the long end of the yield curve, depressing savings and promoting investment.

Reinforcing monetary policy, fiscal policy is now less restrictive. Austerity has been relaxed slightly in Europe's crisis-hit countries. The US does not have political consensus on a long-term consolidation strategy, something it should have, considering the level of debt. Instead, the country staggers from one short-term compromise to another.

An important factor is the increasingly expansionary bias of fiscal and economic policy. One result is an upturn in the housing market in many countries. The property market rally has been one of the central drivers of the improvement in consumer confidence. The pace of recovery has accelerated especially strongly in recent months in those countries that had suffered particularly severe housing market crises. In the US and the UK, house prices are rising at remarkable rates.

House prices are rising on a broad front in Germany where the property market did not suffer a slump in the crisis, albeit at a much faster pace in the cities than in rural areas.

The national average house price inflation rate is over 3%, but many big cities are seeing double-digit rates of increase.

This upturn in virtually all the important industrialised countries is preparing the ground for a self-reinforcing global economic upswing. However, we do not expect the global economy to return to pre-crisis growth rates. A rerun of the past, for good and bad reasons, is not in prospect. ▪

Stefan Bielmeier is Divisional Head of Research & Economics at DZ BANK.

Euro outlook continues to brighten

The outlook for the euro area economy has continued to brighten, with Spain finally finding its way out of recession, *writes Michael Holstein in Frankfurt*. The euro area economy will record GDP growth in both the second and the third quarter (see latest forecasts, left).

Reduced pressure from the financial markets is generally damping governments' commitment to essential consolidation. This explains EU efforts to negotiate bilateral 'consolidation agreements' with individual member states that will lift the pace of reform again. The US government shutdown kept financial markets and large numbers of federal employees on tenterhooks. The economy will catch up at least some of the lost output during the current quarter. The jobs market recovery is likely to have stalled temporarily and the whole adventure is bound to have postponed the start of 'tapering'. The US upturn is not in doubt. We see 3% US GDP growth in 2014.

In Germany, the signs suggest that there will be substantial labour market 're-regulation' and faster government spending growth. The new government will make more money available for transport infrastructure, education, pensions and long-term care, among others. Even though there are several signs that economic policy will put German companies' competitiveness to the test in the years to come, the outlook for next year remains positive. Low interest rates will continue to stimulate corporate and household investment activity, and rising incomes are boosting private consumption. ▪

Michael Holstein is Head of Macroeconomics at DZ BANK.

Wide range of Gulf influence

A region that looks beyond oil and gas

H.E. Sheikh Abdullah Saud Al-Thani, Qatar Central Bank

The Middle East and North Africa (MENA) region is of great importance to the global economy. Hydrocarbon resources have been the major driver for the regional economy since the discovery of oil. Almost two thirds of the world's oil reserves and a quarter of natural gas reserves lie within the region, with member states producing about a quarter of the world's petroleum.

The oil industry dominates the economic structure, especially in the countries surrounding the Persian Gulf. Although some countries have a significant manufacturing base, the region as a whole broadly exports crude oil and natural gas, while it is a net importer of most other goods and services.

Economic growth

The Middle East has experienced tremendous economic growth since the 1970s, facilitated by the dramatic rise in oil prices following the OPEC oil crisis. As oil prices rose to new highs, most states in the region benefited from higher revenues. Oil-producing states benefited directly in the form of higher export earnings. These states had many job opportunities available as a result of booming Gulf economies, and so economies of the Gulf were able to achieve per capita income levels rivaling, and in some cases surpassing, economies of western Europe.

The non-oil producing MENA states reaped some benefits. Many people migrated from non-oil producing states to the oil-producing states in search of greater employment opportunities as teachers, construction workers, oilfield workers and so on. Remittances gave a significant boost to non-oil-producing economies, which benefited from increased levels of foreign aid from their oil-producing neighbours. Enormous social achievements occurred as infant mortality halved, life expectancy increased and adult literacy rose significantly.

In the recent period, the Gulf Cooperation Council (GCC) countries were relatively less affected by the global financial crisis. Growth remained robust, supported by expansionary fiscal and accommodative monetary policies. Proactive government intervention in support of the financial sector coupled with lower exposure to toxic sub-prime assets enabled these countries to avoid the perils of the aftermath of the global financial crisis.

The MENA region is of fundamental importance for shaping future economic, social and governance systems. With the benefit of demographic dividends arising from a young population and vast energy endowments in some of the world's fastest-growing economies, the region as a whole has the potential to reap significant benefits. Two years after the culmination of the Arab Spring, this promise is compounded by a clear urgency for decision-makers to deliver development and ensure prosperity across generations. Business, civil society and government can jointly seize a unique opportunity to make historic gains in crucial areas, such as youth unemployment, transparency, income disparity, private sector development and infrastructure.

These efforts must be seen against the background of continued global economic slowdown, amid geopolitical tensions and uncertainties. Creating resilience anchored in macroeconomic stability, robust national consensus, and effective and timely international partnerships, including with emerging markets, is critical for realising these opportunities. Progress towards GCC monetary union is a positive step.

With regard to economic performance, growth of MENA oil exporters is expected to moderate in 2013 in the wake of weak global demand and reduced domestic production. Meanwhile, uncertainties arising from prolonged geopolitical conflicts, and a weak external environment, weigh on confidence of the oil importers. Growth is expected to pick up in 2014 with improved global conditions and a recovery in oil production. However, sustainable and equitable growth over the medium term depends on an improved geo-political environment and macroeconomic stability, increased economic diversification, and accelerated job creation. The MENA region, particularly oil exporters, can play a pivotal role in meeting global energy requirements by ensuring uninterrupted supply of oil and gas.

Risks to the near-term MENA outlook are broadly balanced. On the upside, geopolitical shocks and supply disruptions may push oil prices higher, benefiting growth in oil suppliers with spare capacity as they compensate for shortfalls in other oil exporters. On the downside, weaker global demand could put downward pressure on oil prices. Downside risks to growth in the euro area and the GCC economies present potential problems for the region's oil importers, through spillovers on tourism, trade, and remittances. Limited exposure to international capital markets should limit risks of a sudden stop in capital inflows for most MENA countries.

Increased risks

In an environment of increased risks due to regional tensions and heightened political uncertainty, policy goals need to focus on creating jobs, undertaking fiscal consolidation, and embarking on structural reforms. In this regard, high and rising unemployment calls for an urgent focus on job creation with governments playing a key role in revitalising economic activity through growth-enhancing public investment and well-targeted social assistance. With concerns about rising debt, most countries would need to structure and execute fiscal adjustments prudently. For this purpose, a credible medium-term fiscal consolidation strategy would be required.

Finally, a bold structural reform agenda is essential for propelling private sector activity and fostering a more diversified, competitive and inclusive economy.

Reforms in the MENA region must focus on improving business regulation and governance. Qatar provides a positive example. The new Qatar Central Bank Law enacted in 2012 establishes the central bank as the competent supreme authority with regard to regulation, supervision, payments and settlement systems in Qatar.

In view of the new law, all the regulatory institutions are coordinating resources to harmonise Qatar's financial sector regulatory framework and enhance its infrastructure, and more importantly the payment and settlement systems, in line with international standards and practices. The Financial Stability and Risk Control Committee, established under the new law, will minimise regulatory overlap thereby strengthening financial stability – not just for Qatar, but for the region as a whole. ▪

H.E. Sheikh Abdullah Saud Al-Thani is Governor of the Qatar Central Bank.

Gulf countries spur MENA renewal hopes

How combination of oil and diversification is driving growth

Fabio Scacciavillani, Advisory Board

The Middle East and North Africa (MENA) region offers an awkward mix: important pockets of economic buoyancy are shot through with significant political question marks. Steady growth and smooth-flowing oil revenues in the Gulf countries are juxtaposed with large-scale geopolitical uncertainties and social dislocation emanating from the civil war in Syria, doubts over the future course of Iran and post-Arab Spring turbulence in a number of leading countries.

Sustained annual growth of around 4% in the countries of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE) – provides a welcome bright spot in a heterogeneous economic picture, both regionally and worldwide. Annual expansion has tailed off from the 6%-plus reached in the heady period of 2000-08. In the year of international recession in 2009, growth fell sharply to 0.8%. However the GCC area has shown an impressive rebound with growth up to 5.5% in 2010 and 7.2% in 2011, before settling in the 4 to 5% range thereafter.

The size and experience of the region's prominent sovereign wealth funds – which I refer to as the Magnificent Ten, holding combined assets that unofficial reports estimate at around $1tn (from countries with a total population of roughly 40m, including expatriates) – amount to a considerable positive factor for the GCC. This lends weight to the region both within and outside the GCC, providing political as well as economic clout and giving rise to an extraordinary multiplicity of investment approaches in regional economies as well as on a wider scale.

Diversified growth

GCC economic resilience has been underpinned by buoyant oil prices as well as diversification away from the energy sector, with non-oil activities making up a progressively larger share of combined GCC economies. Channelling revenues into infrastructure projects, especially in transport, communications, utilities, health and education has boosted potential output and created favourable private sector conditions. These efforts should pay off over the next few years, more than offsetting the long-term gentle downward path of oil and gas export revenues.

Public spending in the past has often been geared to absorbing the unemployed in the civil service – arguably in areas where understaffing was not perceived as a main problem – thereby putting at risk long-term fiscal stability. As a consequence the oil price that is estimated to ensure a balanced fiscal budget – the break-even Brent price – surged in recent years. The Institute of International Finance estimates that between 2008 and 2013 this price went from less than $30 per barrel to about $50 in Qatar, from $30 to $52 in Kuwait and from less than $60 to well over $80 in Saudi Arabia.

For the GCC as a whole, the weighted average break-even Brent oil price in 2013 is estimated at $78 per barrel, still well below the current market price, but with a marked tendency to increase. In essence, fiscal discipline might prove hard to enforce if an unforeseen shock were to hit oil prices because expenditure on public wages will be hard to contain and cuts in fuel subsidies deeply unpopular.

Furthermore domestic consumption of hydrocarbons needs to be reined in because, as the most productive fields are depleted, hydrocarbon extraction is becoming increasingly energy-intensive. According to certain estimates, domestic energy consumption could double by 2030 in the absence of corrective measures.

Nevertheless these threats should not be over-emphasised. The GCC governments have accumulated considerable foreign assets and are still running robust budget surpluses. Hence serious risks to their stability are manageable, given that the authorities have ample room to take corrective actions if needed – as the response to the 2009 trans-Atlantic crisis demonstrated.

Another benefit is that inflation, which in previous years was rampant in places such as Qatar and the UAE, due to overheated government projects and massive immigration, flows has abated considerably, stabilising in the GCC in the 2-3% range. Barring some unpredictable external shock, price pressures are nowhere in sight.

Adding to the positive factors, the banking system has learned the lesson of 2008. Despite the turmoil in the Middle East, GCC financial institutions have displayed a remarkable performance, continuing to reinforce capital and liquidity buffers. Capital adequacy ratios exceed international standards and ample provisions for non-performing loans have been set aside. Credit growth in the two leading economies, Saudi Arabia and the UAE, is expected to pick up this year and the next, fostering credit expansion in the other countries. This bodes well for the revival of mega-projects, especially in the UAE where they had been on hold, for launching new companies and for promoting foreign direct investment.

A fundamental challenge will be employment creation for the young and growing working-age population. This problem is most acute in Saudi Arabia, while in the rest of the GCC the local population is much smaller. Policy-makers are aware that educational standards and achievements need to catch up with those prevailing in mature economies and in the most dynamic emerging markets. So they have devised plans to improve education systems, gearing studies towards private sector needs. In addition two crucial elements of the policy mix would be genuinely flexible labour markets and reforms in the business regulations especially for start-ups and service companies – which typically represent labour-intensive segments of the economy.

Regional sovereign wealth funds

A basic picture of economic stability and steady diversification forms a propitious background for operation of sovereign funds in the region. This generic term encompasses institutions quite diverse in terms of objectives, investment styles and government control. Those based in the Middle East are predominantly future wealth funds, with the primary objective of transferring oil and gas revenues to future generations.

The most prominent examples from the GCC include Abu Dhabi Investment Authority, Saudi Arabia Monetary Agency, Qatar Investment Authority (QIA), Oman Investment Fund (OIF), Abu Dhabi Investment Council, Kuwait Investment Authority, Emirates Investment Authority, State Reserve General Fund, Mubadala and Mumtalakat. (To be precise, the Saudi Arabia Monetary Agency is not a sovereign fund, but the central bank of Saudi Arabia which manages the reserves of the Kingdom. Given their size, estimated in the order of $300bn, these reserves entail active management which is in practice akin to that of a sovereign funds).

These funds, the 'Magnificent Ten' – are not under intense pressure to deliver short-term results and can focus on more distant horizons. Other sovereign wealth funds, which claim to be patient investors, in practice operate under

a discount factor that is akin to that of private investors or asset managers. Often this is the result of multiple layers of scrutiny, which inevitably drive the emphasis towards quarterly results rather than coherent strategic goals.

Government investment vehicles

In addition to institutions that are classified as sovereign wealth funds, governments in the Gulf manage surplus revenues through an array of entities like the Qatar Foundation Endowment, which recently acquired 5% of India's Bharti Airtel, or the Investment Corporation of Dubai, which owns a host of the Emirate's public corporations.

Moreover state-owned companies such as Qatar Telecom (now Ooredeo) spearhead sovereign investments in the specific sector where they have built expertise and know-how. In this regard Dubai has developed a notable multi-pronged approach, often described as the Dubai Inc. The Emirate has only limited hydrocarbon resources and therefore did not create an Investment Authority, but it deployed its resources through various state-owned companies, operating aggressively to maximise profits. Some of them have become extremely successful on the international stage, for example Emirates Airlines or Dubai Port, but they include also Emaar – the construction company that led much of the city breakneck expansion – and Jumeirah, a high-end hotel and tourist company now extending operations worldwide.

The GCC sovereign funds have been perceived as chasing trophy assets, partly due to some high-profile property investments, including London's Harrods in 2010 or the Shard real estate project, both by Qatari institutions, not to mention European top league football clubs. The reality is more low-key, and more varied. Operations that gain media attention form only a small part of overall acquisitions across a wide range of assets. The larger institutions especially those with over $100bn under management, are sophisticated, not extravagant, investors. Without the burden of defined liabilities, they enjoy degrees of freedom that give them exceptional breadth of manoeuvre.

Some GCC funds such as Mubadala, Mumtalakat and OIF have dedicated more resources to boosting domestic expansion while others have focused on investments with a social and environmental angle. Mubadala has financed Masdar, a zero emission city, while Qatar Holding (an arm of QIA) invested in boosting the supply chain of agricultural goods in east Africa and in general it seems determined to finance lower scale, high impact infrastructure in frontier markets. ■

Fabio Scacciavillani is Chief Economist at the Oman Investment Fund.

Sovereign wealth funds show new investment trends

In the last decade, along with a significant rise in the number of state-owned funds worldwide, their investment behaviour has changed and new trends are emerging, *writes Efraim Chalamish in New York.* While sovereign funds have traditionally served as quiet, passive and isolated investors, they are now becoming more collaborative and better diversified. In some cases, a trend towards more philanthropic investment behaviour has come to the fore. Transparency about their operations, which has traditionally commanded attention, is gaining still greater prominence.

Most funds have dramatically increased their investment in real assets, such as real estate. This asset class fits the nature of the sovereign wealth funds as long-term investors and helps tackle the ultimate problem of over-exposure to correlated assets. The US economic recovery has allowed many funds to open offices in the US and invest in real estate and large oil and gas projects that benefited from growth revival. The Norwegian sovereign fund announced at the end of last year that it would like to invest a third of its planned 5% real estate allocation in the US market. Others have traversed this path or will do so.

Another important trend is that sovereign funds are moving towards a 'co-investing' model, in which investments are led by a consortium of sovereign financial institutions. Each fund brings different financial capability, networks and specific knowledge. This new model is driven by several motivations: political pressure and the financial need to diversify risk, the growing size of assets or projects and foreign policy considerations that support cross-border collaboration. Further, some governments have realised that co-investment is a less complicated and expensive method of developing necessary know-how internally. For example, several sovereign funds have joined forces to co-invest in International Finance Corporation's private equity funds.

The role of sovereign funds in international forums has facilitated the process of bringing funds together and creating co-investment opportunities. The World Economic Forum put together a sovereign group to create a dialogue on long-term investing. The IMF has established a secretariat which will institutionalise the sovereign funds community around common issues of concern and interest, such as risk management, talent management, working with OECD countries, and improving co-investing operations.

Another tendency to watch is that funds around the world are simultaneously investing in the future of innovation. As countries invest in developing a culture of innovation and entrepreneurship, sovereign financial resources are perceived as a source of investment for venture capital firms and companies that create local ecosystems to foster innovation. Investing in such firms abroad would enable national governments to bring valuable intellectual property back to the home country. The Malaysian government is using its sovereign fund in this way to foster innovation at home and abroad.

Historically, sovereign funds focus on liquid and stable currencies, such as the dollar and the euro. Yet political instability and depreciation has opened the door to new currencies, such as the Canadian dollar and the Australian dollar. Moreover many sovereign funds are increasing their renminbi holdings in light of the fact that more and more assets are tied to the Chinese currency.

Sovereign funds are also looking at philanthropy as an integral and critical component of their investment operations. Several existing sovereign funds have established their own foundations as part of their mainstream investing. This allows governments to support objectives that promote national goals outside the financial targets of their particular funds. Qatar Foundation for Education is a good example. This is part of a larger trend, under which some sovereign funds are becoming more vocal on corporate boards and as shareholders.

Many sovereign wealth funds, like institutional investors in general, have developed mixed feelings about interactions with external asset managers. On one hand, they have the breadth to explore a high number of external managers.

At the same time, many of the fund managers in recent years underperformed, charged high fees, and were not transparent enough about their operations. Several sovereign funds are working extensively to develop in-house capacities, with a significant potential impact on external managers. ■

Dr. Efraim Chalamish, member of the Advisory Board, is a law and economics professor and adviser.

Emphasis on diversification

Oman promotes focus on business and infrastructure

H.E. Hamood Sangour Al Zadjali, Central Bank of Oman

Despite adverse global developments in recent years, the Omani economy continued to sustain growth momentum. The major drivers of growth have been a recovery in crude oil prices in international markets, sustained domestic demand, mainly supported by large public expenditure, and accommodative monetary policy. Taking advantage of this high growth, the government and private sector are focusing on diversification. This is part of Oman's long-term development strategy, The Vision for Oman's Economy for 2020. Part of this vision is gradually to decrease the contribution of the oil sector to GDP and to gradually increase the contribution of non-oil sectors.

The government has entered its eighth Five-Year Development Plan (2011-15), with an emphasis on a large public investment programme, particularly in infrastructure and social sector reforms. This plan looks to intensify efforts to develop small and medium enterprises (SMEs), develop the financial sector, finance the private sector, improve the investment climate and develop infrastructure.

With respect to the Banking Law 2000, the Central Bank of Oman acts as a monetary authority of the country, a regulator of all financial services (with the exception of securities and insurance), and a supervisor of banks and non-bank financial institutions.

Under a fixed exchange rate and open capital account, monetary policy hinges on the developments in the anchor country to avoid pressure on the exchange rate. Monetary policy in the recent period was formulated against the backdrop of easy liquidity conditions, lower inflation, low Omani Rial interest rates on deposits and surpluses in fiscal and balance of payment positions.

Diversifying hydrocarbon revenues

The fiscal consolidation path followed by Oman since the initiation of our Long Term Development Strategy (1996-2020) has been successful to a large extent, despite some setbacks during 2009, when the fiscal deficit in Oman resurfaced after seven years of fiscal surplus. Following the setback of 2009 in the fiscal consolidation process, the Sultanate's fiscal position improved as oil prices recovered in global markets along with improvements in oil production. With surging oil revenues, government spending, particularly current expenditure, increased sharply, in response to social pressures and subsequently larger wage bills and unemployment benefits for job seekers.

The fact remains that Oman is highly dependent on hydrocarbon revenues. In the recent period, hydrocarbon exports averaged around 70% of total exports, while hydrocarbon revenue comprised around 80% of total revenue. The large dependence on hydrocarbon export revenues make it vulnerable to sharp declines in oil prices and global energy demand. The government is therefore prioritising reforms aimed at diversifying and broadening revenues.

New chapter of Islamic banking

Oman's banking sector comprises 16 commercial banks, two specialised banks and two full-fledged Islamic banks together with six local commercial banks, operating separate Islamic windows for banking operations. The recently launched Islamic banking will provide a significant alternative banking channel. The Sultanate is striving for the harmonious growth of both conventional and Islamic banking.

It is expected that Islamic banks will diversify banking services and increase financial inclusion, and add to the competitive environment not only in terms of efficiency and innovation, but also by providing consumers with the choice between conventional and Islamic banking products.

Islamic banking will open up new segments and players from domestic and foreign banks, providing opportunities for new foreign investment. The government is looking to develop the Islamic bond market (these Sharia-compliant bonds are known as sukuk) by formulating standardised and transparent legal and other procedures, developing secondary markets, improving liquidity in this market and encouraging corporates to participate in the sukuk market. Islamic banks are optimistic that they will be in a position to significantly increase business and that this will bode well for the economy.

The banking sector in Oman has continued its overall positive growth trend. The most significant achievement has been the improvement of the financial health of banks in terms of asset quality, provision coverage, capital adequacy and profitability, along with an increased focus on risk management. The Central Bank of Oman has always strived to follow international best practices in regulation and supervision.

Promoting foreign investment

In order to promote foreign investment, the Sultanate offers an investor-friendly legislative environment, flexible tax system and transparent corporate governance. There is low tax on profits and no personal income tax. The flexible tax system allows exemption on tax on profits for five years, renewable for a further five years for certain sectors.

An array of incentives is offered to foreign investors, including nominal lease charges for plots of land in specified areas, reduced utility charges and tax exemptions. The Ministry of Commerce and Industry provides a 'one stop shop' for assisting domestic and foreign investors to quickly obtain all required clearances. Foreign investors are allowed to own real estate in Oman within specified integrated tourism complexes. There is no restriction on remittances abroad of equity, debt, capital, interest, dividends, profits and personal savings. With this liberal policy, there has been a sharp rise in foreign investment in the recent period.

Three major industries which have attracted substantial foreign investment are oil and gas exploration, manufacturing and financial intermediation. Together, these sectors have attracted almost 80% of foreign investment in the last few years. Areas which the government has been focusing on to attract foreign investment include export-oriented projects, food processing industries, tourism, information technology and infrastructure. Oman has also been focusing on industries which could use local raw materials, employ Omanis and promote traditional industries.

The government, central bank and private sector are focusing on diversifying the economy and increasing employment opportunities. The growth of Islamic banking and financing SMEs are the major challenges of the banking sector. Oman's young and growing population holds great promise for the future development of the country. ■

H.E. Hamood Sangour Al Zadjali is Executive President of the Central Bank of Oman.

How to counter a firestorm

Arab development bank needed for region in turmoil

Nasser Saidi, Advisory Board

The time has come to set up an Arab Bank for Reconstruction and Development (ABRD) to address the multiple challenges faced by countries in transition in a region where the 'Arab Spring' has turned into a firestorm.

The new bank would drive forward transformation and collective action. It would help to jettison outdated development models based on large public sectors that have failed to generate sustained growth, productivity gains, inclusiveness or poverty alleviation. The region would be propelled decisively in the direction of supporting job-creating private business and boosting infrastructure. Investments in both spheres are crucial for accelerating growth and for reducing inequality and poverty.

A development bank for the MENA region

The Arab countries across the Middle East and North Africa (MENA) represent the only region of the world without a dedicated development bank. Regional institutions are better placed to satisfy regional needs. If there is one important lesson of the upheavals following the overthrow of repressive governments three years ago, it is that the region needs to own its transformation. Countries must develop their own roadmaps rather than reply on others' efforts. But they need help from outside. As in Europe after the fall of the Berlin Wall, which led to the formation of the European Bank for Reconstruction and Development (EBRD), countries in transition need not only a vision to formulate their goals but also assistance in achieving them (see p.36).

The Arab Spring is sadly no longer the correct characteristic for a region in turmoil, heading towards an uncertain destination. Firestorm is a better word. Once ignited, it spreads everywhere, burning all in its path and leaving behind devastation. Establishing the ABRD would recognise that the countries hit by this firestorm are being affected as much by economic as by political influences. So far, much of the focus in the Arab world has been on political change and transition. But economic reform and transformation are fundamental for any successful political change. The ABRD can help nurture the spirit of entrepreneurialism and self-help that has been absent during the years of dictatorial regimes and is still painfully lacking. The Arab upheavals are as much about economic rights, lack of participation, and absence of 'trickle down' or 'pull-up' in the running of countries' economies as they are about political rights, human dignity, corruption, bribery and parasitic institutions. Recent estimates by HSBC suggest that the GDP of the seven worst-hit Arab countries – Egypt, Tunisia, Libya, Syria, Jordan, Lebanon and Bahrain – would be around 35% lower in 2014 than if the turmoil had not happened, representing about $800bn in lost output.

The ABRD that I am recommending would be a multilateral institution owned by the Arab countries and capitalised at $100bn. This would be largely subscribed by the Gulf Cooperation Council – Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Bahrain and Oman, running a joint current account surplus of around $300bn – and their aid agencies, along with the G20 countries. The ABRD could reflect the structure of other regional development banks, but would be different in terms of participation from both the public and private sector entities, including regional sovereign wealth funds. The European Investment Bank (EIB), the EBRD, the Islamic Development Bank and other international financial institutions would participate in the bank's capital and provide management expertise.

The case for ABRD is strong. Demand and supply would come into better balance through a mechanism that would be more effective in providing regional public goods, especially those requiring large initial investments and regional coordination mechanisms. The ABRD would deal with multiple tasks. It would handle reconstruction and infrastructure finance, including regional and cross-border projects and investments that promote regional economic and integration. It would generate and promote private participation in infrastructure, drive the development of financial markets in the region and finance private sector activity, with a focus on small- and medium-sized enterprises.

There would be substantial benefits outside the immediately-affected region. With the global economy languishing, the GCC and G20 countries would directly benefit from massive infrastructure spending across MENA. The Arab firestorm is a defining moment for the GCC countries that should take the leadership in setting up the ABRD and provide a new vision of hope. They have a direct geostrategic interest in the economic development, social and political stability of the Arab countries.

There is a great deal at stake. Given the risk-averse nature of MENA's banks, it is urgent to mobilise funds and channel resources to meet growing capital needs. Private participation in infrastructure can help countries undertaking reconstruction by extending access to basic necessities for economic growth and improving the quality and reliability of services. Based on World Bank data, the MENA region ranked among the lowest region in public-private partnerships in infrastructure projects both in terms of number of projects and total investment.

Reconstruction and infrastructure investment require a multi-year effort built around regional cooperation and institution-building. The demand for long-term funding will continue to grow, driven by demographic factors, increased urbanisation, growing social aspirations and the need to create jobs for a rapidly-growing labour force. However, shallow financial markets, the economies' narrow product range, limitations on longer-term finance and limited banking capacity are important constraints.

While the international financial institutions recognise the need to step up financing for the region, they continued to underinvest: less than 8% of their portfolios are in this region. Similarly, the MENA Transition Fund set up under the Deauville Partnership to support economic and political transition in the firestorm countries has delivered meetings but little funding. About $100m has been approved to date, nearly half of which goes to Morocco and Jordan.

The MENA region is a land of contrasts and contradictions. The region is among the richest in terms of energy and natural resources, resulting in high per capita incomes in the GCC countries while others are mired in under-development. Per capita annual income in 2012 varied from a miserly $984 in South Sudan to a modest $3,112 in Egypt, while Qatar towered at $104,756.

Growth in MENA has underperformed other emerging economies, with increases in output mostly accounted for by natural resource production, with little productivity growth or innovation. The oil-and government-based development model has failed. Youth unemployment rates are the highest in the world.

Growth has been volatile, punctuated by wars, violence and destruction, notably in Palestine, Iraq, Sudan, Syria, Libya, Lebanon and Yemen, depleting human capital and infrastructure. The costs of reconstruction are staggering and exceed $1.1tn: $700bn for Iraq, at least $250bn for Syria, and $150bn for the other countries. In addition to reconstruction investment and finance to remedy the ravages of war and violence, rapid population growth, the Arab 'youth bulge' and urbanisation require massive infrastructure investment. Instead there has been severe underinvestment in the region's infrastructure despite the high economic and social returns. The World Bank estimates MENA's infrastructure investment and maintenance needs through 2020 at $106bn per year or 7% of annual regional GDP. But there is a $60bn financing gap. These figures are likely to be a severe underestimate. They exclude regional development projects and reconstruction of war-torn countries. Infrastructure investment is job-creating as well as growth-lifting. Each $10bn invested can lead to 1m new jobs. Badly-needed infrastructure spending can underpin social solidarity and peace.

The ABRD by itself cannot be a panacea, but it would be an important step towards safeguarding a region that risks being thrown back into its turbulent past. Governments within and outside the region need to consider this plan now – before it's too late. ■

Dr. Nasser Saidi is on the IMF's Regional Advisory Group for MENA and is Co-Chair of the OECD MENA Corporate Governance Working Group.

How the international development banks do their business — a peer group for comparison

	European Investment Bank	European Bank for Reconstruction and Development	Asian Development Bank	African Development Bank	Islamic Development Bank
Lending capacity	In 2012, €52.2bn of new loans in over 60 countries.	In 2012, €8.7bn invested in 388 individual projects.	Assistance totalled $21.6bn including $13.3bn in direct financing.	At end-2012, loans signed amounted to UA29.7bn.	In 2012, total financing approved was $9.8bn.
Infrastructure funding	In 2012, composite and urban infrastructure loans of €458m and €2.18bn.	In municipal and environmental sector, 2012 business volume €554m.	Energy, transport and ICT and water totalled $4.9bn, $5.0bn and $1.4bn.	Energy, water supply and transport were 32.2%, 8.4% & 2.8% of loans/grants.	Approvals in infrastructure amounted to $2.6bn.
Capital	Subscribed capital of €242.4bn.	Subscribed capital of €29.6bn at end-June 2013.	Subscribed capital of $163.1bn in 2012.	Subscribed capital of UA65.2bn in 2012.	Subscribed capital of Islamic Dinar 1.8bn.

Why the world didn't listen to the sceptics (...continued from page 17)

capital and other requirements) while the central banks seem to have their foot very much on the accelerator (low policy rates, quantitative easing and forward guidance).

Closely related is the issue of the interactions between central banks and politicians (governments) and the particular issue of central bank 'independence'. Being drawn into the financial stability business implies that central banks will increasingly have to cooperate with other arms of government pursuing similar aims. During the crisis, central banks pursued policies with important distributional implications at the micro level. Who was to receive support and who not? But distributional issues are archetypically political. Further, current monetary policies are in the process of redistributing vast sums from creditors to debtors. Since governments are among the biggest debtors around, there might be a presumption that they will lobby hard to ensure this state of affairs continues.

Finally, and probably most important in a democracy, there is the question of the interaction between voters and politicians. Voters consistently vote for policies that promise easy answers and preferably a short term pay-out. Given this bias, politicians eschew the identification of difficult problems whose resolution will only pay long term dividends. To 'kick the can down the road' then becomes the chosen default strategy, with all the longer term costs that entails. In the end, the voters get the governments they deserve.

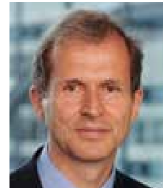
Something has gone seriously wrong with the global economy. For many economic agents, it seemed to come out of nowhere. And its effects have lingered far longer than most originally expected. These surprises might have been expected to generate a wholesale rethinking of originally-held beliefs. In fact, we remain very much in a 'muddling through' mode, with no dramatic suggestions for rethinking or reform yet having broad support.

Why is this so? All paradigm shifts are hard to achieve. Intellectual capital built up over a lifetime is not easily jettisoned. Moreover, rethinking implies the possibility or even admission of previous error. This is a particular problem for policy-makers. Big shocks to prior beliefs more typically result in a retreat into those old beliefs rather than the opposite. Their respective historical experiences help explain the current German and euro area obsession with government deficits (and avoiding possible inflation) and the American obsession with lowering unemployment (and avoiding possible deflation). Yet there are some indications that lessons have been learned. Both borrowers and lenders have become more prudent, though perhaps too prudent in some cases. Regulators have become tougher and more focused on systemic financial interactions, though their efforts to prevent future crises might also have contributed to extending the current one. Some central banks become more open to the idea that monetary policy might have contributed (and still is contributing) to dangerous financial imbalances, though the Federal Reserve is not first among them.

Initiatives are coming from economic institutions that have not been responsible for policy-making in the past. The work of the Santa Fe Institute on complexity modelling is receiving increasing attention. The Institute for New Economic Thinking has attracted attention from many prominent economists. The OECD is directing significant resources into a new project, 'New Approaches to Economic Challenges'. A series called 'New Thinking in Political Economy' has been established in London. We desperately need such new thinking, supported by credible empirical analysis, to overturn old beliefs that are all too frequently mistaken. ■

This is an edited and abridged version of the speech delivered at the Golden Series Lecture on 23 October 2013. William White is Chairman of the Economic and Development Review Committee at the OECD.

On the web
For the the full speech, see
www.williamwhite.ca



Learning from global best practices

Need for transforming finance in Arab transition states

Erik Berglöf & Hanan Morsy, European Bank for Reconstruction and Development

The Arab transition countries face the daunting challenge of meeting soaring public expectations for higher job creation and better living standards for rapidly growing populations, at a time of increasing economic strains. The need for external financial support for these countries has increased dramatically as a result of political turmoil.

Higher current expenditures in response to socioeconomic pressures have come at the expense of much-needed public sector investments, especially in infrastructure, but also in education and healthcare. In addition, a surge in domestic borrowing by governments has crowded out private credit.

Establishing new institutions

Governments in the region are showing interest in establishing their own multilateral or national development institutions. Such institutions, if and when they are created, should draw on the extensive, and not always happy, experience of development banks in different parts of the world. New institutions can co-invest with existing banks to ensure sustainable development and greater transparency. They could also invite institutions and governments outside the region to take part in their governing structures.

A lot needs to be done. To prevent macroeconomic collapse and satisfy popular pressures, substantial funds have been transferred from Gulf countries. These flows have done very little to address underlying problems centred around the poor investment climate with entrenched elites and lobby groups, an often overbearing state, rampant corruption and legal uncertainty. The region requires finance capable of transforming its economies, mobilising the private sector, and catalysing reforms. Packages need to be structured for sustainable, long-term projects, requiring skills in short supply in the region's institutions. Large flows from Gulf states have hitherto been anything but transparent; this, too must change.

Multilateral development banks (MDB) can play an important role in mobilising such transformational finance by accompanying private foreign direct investment, as well as long-term institutional investors, like sovereign wealth funds and pension funds. Such financing is typically geared towards projects such as infrastructure, and is focused on less-developed regions, on smaller and medium-sized businesses, and on developing local capital markets and financial sectors. With governments as shareholders, they can provide comfort to private co-investors by lowering the perceived and real risk of projects.

This type of financing can be combined with technical assistance. This ranges from policy advice to legal support and capacity-building. Investments can be geared towards putting these countries on an inclusive and sustainable growth path by supporting long-term structural and regulatory reforms.

Support should focus on profitable projects and should stimulate project standards and risk-sharing in ways that are not yet provided by the market. For MDB support to have a sustainable impact, investments and loans should set high standards of corporate governance, transparency, and social and environmental compliance.

The European Bank for Reconstruction and Development (EBRD) is one such multilateral development bank with a special mission to provide transformational finance. Originally focused on central and eastern Europe and central Asia, the EBRD has turned its attention to Turkey and the Arab transition countries of the eastern and southern Mediterranean. It provides long-term equity and finance, with an important element of its activity supporting long-term infrastructure financing, decentralised financing solutions, and public-private partnerships.

The EBRD supports local financial development by strengthening banking systems and promoting non-bank finance. Investments are channelled partly through credit lines to banks, to finance energy and resource efficiency, facilitate trade, or improve lending to smaller businesses. In addition, the bank engages in policy dialogue, acting as mediator between governments and the private sector to help shape regulatory policies and design reforms.

Empowering the private sector

The Arab transition countries can benefit from a real opportunity to break with the past and adopt new strategies for broad-based, inclusive growth. The transition agenda is large and financing needs are huge, requiring the support of many players. Empowering the private sector should be a cornerstone of this development agenda. Governments must provide an enabling environment. Development banks such as the EBRD are poised to play an instrumental role.

Political uncertainty and macroeconomic fragility have been hampering private investment, with many potential investors sitting on the side lines. For institutions like the EBRD, which often rely on private sector co-investment, investor hesitancy and government paralysis can be important hold-ups. Shareholder governments are understandably ambivalent about developments in the region, and risk levels are very high. However, adopting precepts that have shaped the EBRD's experience over the past 20 years is an important condition for achieving success in the Arab transition states that we hope will soon turn the corner towards better times. ■

Erik Berglöf and Hanan Morsy are Chief Economist and Senior Regional Economist for North Africa and the Middle East at the EBRD.

On the web

See MDBs' principles at www.ebrd.com/pages/news/press/2013/131107b.shtml

The Gulf Cooperation Council countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates

The importance of natural gas

Emerging spot market bringing down energy prices

Nick Butler, Advisory Board

It is impossible to understand the outlook for energy prices – internationally or at the domestic level – without looking carefully at what is happening in the gas market. The simplistic assumption is that because demand is rising, prices must increase inexorably.

This assumption underpins many official forecasts and the business plans of some optimistic producers. But in fact, the reality is much more complicated. The emergence of a spot market suggests that there is a strong chance of prices falling over the next decade.

Historically there have been three regional gas markets – North America, Europe and more recently Asia. In the first two, gas has mainly been supplied by pipeline and prices have been set through long-term contracts tied to the price of oil. In Asia the market has been supplied by liquefied natural gas (LNG) imports.

A scene of North Field, where the majority of Qatar's natural gas is located

Old order breaking down

Over the last decade this orderly market, in which fields were not developed unless the gas was pre-sold, has been disrupted: first by the growth of LNG trading, which can take supplies anywhere in the world, and, more recently, by the development of shale gas in the US, which has cut US imports and raised the prospect of American exports.

Because LNG involves high upfront capital expenditure, projects have predominantly only gone ahead when long-term sales contracts for the gas have been signed, usually still tied to oil.

But now this old order is breaking down. A spot market is emerging which is progressively forcing gas to gas competition for the first time. The link to oil prices is being broken. Despite rising demand in Asia, the market is turning in favour of buyers rather than producers.

Three factors are driving this change. First, supplies of gas are proving to be plentiful. There have been a series of new discoveries of conventional natural gas off east Africa and in the eastern Mediterranean. Supplies from the Caspian and central Asia are gradually being brought to market. LNG trade grows year by year, opening new options for utilities and other gas users across the world.

Further, on the demand side, gas is being squeezed out of the key market for power generation in Europe. Undercut by coal exports from the US and limited by the mandated growth of renewables, especially in Germany and the UK, gas is seeing its market share shrink.

Thirdly, there is technology. Shell, for instance, recently announced that it expects to see a new generation of floating LNG facilities built, which will be capable of tapping the reserves of gas (around 800tn cubic feet according to Shell) known to exist in water metres of more than 200 metres.

Of course demand in Asia continues to rise. But consumers tired of high price differentials are beginning to fight back. The Japanese and Indian governments are talking about coordinating their approach as buyers. Even if the Chinese remain outside the process, the Asian buyers could force a change in pricing mechanisms – linking substantive long-term deals to prices led by the Henry Hub trading market in the US.

In a buyer's market, prices tend to fall. In an increasing open market with multiple buyers and sellers, they also tend to be set through direct competition for supplies with prices determined by trade. The shift is just beginning but the trend is clear.

The impact will be felt by all those involved. Consumers should benefit so long as spot markets do not overshoot and force out marginal production. To limit volatility some importing nations and utilities are likely to agree to floor prices in return for guaranteed supplies. Producers will be forced to think again and to drop the assumption of ever rising prices. From Arctic Russia to Australia expensive LNG projects are on hold with several likely to be postponed or abandoned.

The biggest challenge is for those whose existing contracts are now in jeopardy. In Germany, the emergence of market-based pricing under which prices are set by short-term competition rather than long-term contracts is a direct challenge to suppliers such as Gazprom.

Other major producers including the Qataris who have come to rely on gas for their export earnings and national revenue will have to adapt to the new order. Their hope must be that lower prices along with the increased confidence in supply security which comes from the development of diverse supplies will encourage more and more consumers to switch to gas.

Effective markets shape both supply and demand, and the emergence of a robust spot market which sets prices for all reinforces the view that gas will be the dominant energy business of the first half of the twenty first century. ■

Nick Butler is Visiting Fellow and Chair of the King's Policy Institute at King's College London.

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China's new reform ardour

Balanced economic growth seems on the horizon

Haizhou Huang, China International Capital Corporation

The Chinese economy is set firmly on the reform path, underpinned by economic growth expected to stabilise around 7.5% this year and next, in contrast to earlier fears of a pronounced slowdown caused by setbacks in the international environment.

Despite sluggish export growth and slightly weaker-than-expected consumer activity, aggregate demand is being supported by a combination of fiscal expansion, targeted credit policy and a renewed warming up of the property market. The result is a level of economic balance that is better than many observers had expected. Growth is projected to fall marginally to 7.4% in 2014 from 7.6% this year (see Chart 1). Inflationary pressures will remain under control with the consumer price index rising 2.6% in 2013 and 3% in 2014.

The new administration under President Xi Jinping and Premier Li Keqian is seeking to build on the experience over the past three decades where progressive opening up of the economy has led to a self-feeding reform process, with benefits to both state-owned enterprises and the private sector. This is linked, too, to reforms in the financial, investment, housing and social security fields, boosting both domestic prosperity and the country's international standing.

This process now has to go further, driven by China's participation in global competition and need to abide by international regulations. Further improvement of domestic standards is necessary so that China can adapt to international best practices. Globalisation and internal reforms go hand in hand.

Steps expected in the future include the opening of the Shanghai free trade zone, further measures to reduce monopolies and promote competition, and tax and fiscal reforms.

Interest rate liberalisation and opening of the capital account will be given fresh priority. The capital account can be expected to be liberalised in the next three years or so, delivering a substantial boost to the international use of the renminbi. We are likely to see new urbanisation and land reform and a relaxation of the strict family planning policy, in reaction to growing demographic pressures.

China can draw clear benefits from the world's progressive move to a multi-polar political and economic structure. I believe that the US will experience an economic boom with mild inflation and decent growth. This will restore external demand as a key growth factor for the Chinese economy – but this will come at the expense of a lower growth rate (see Chart 2).

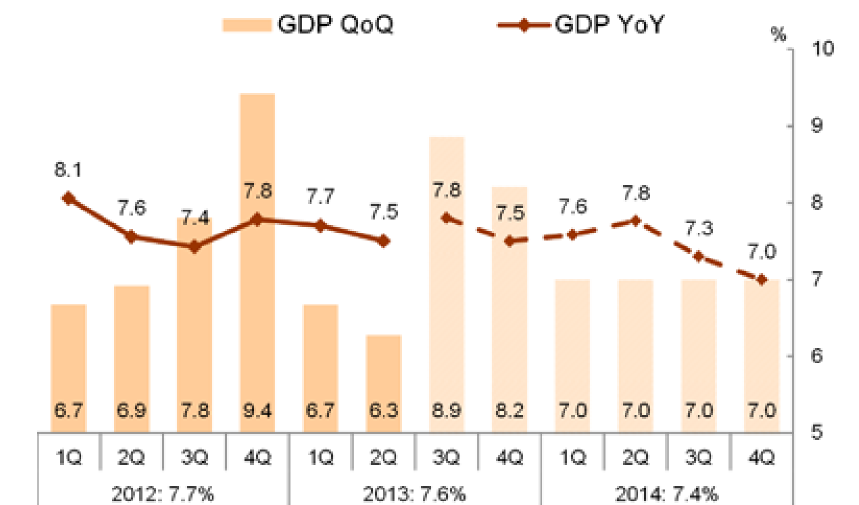
Economic growth in Europe will be far slower, but this still creates opportunity for China-Europe relations, for example in industrial and technological cooperation.

The relationship between China and Japan is prone to sporadic tension, but this should be viewed in a larger context that places due importance on China's relationship with the US and the Korean peninsula. The emerging markets with which China has been building increased economic ties have been under pressure, owing to the strengthening US dollar and market worry of the Fed tapering, but this will have only limited impact on China.

China is likely to weather storms better than emerging economies with heavy reliance on foreign capital or inadequate reforms. The round of major liberalisation and reforms in China, over the shorter and longer run, is expected to deliver a substantial dividend. ▪

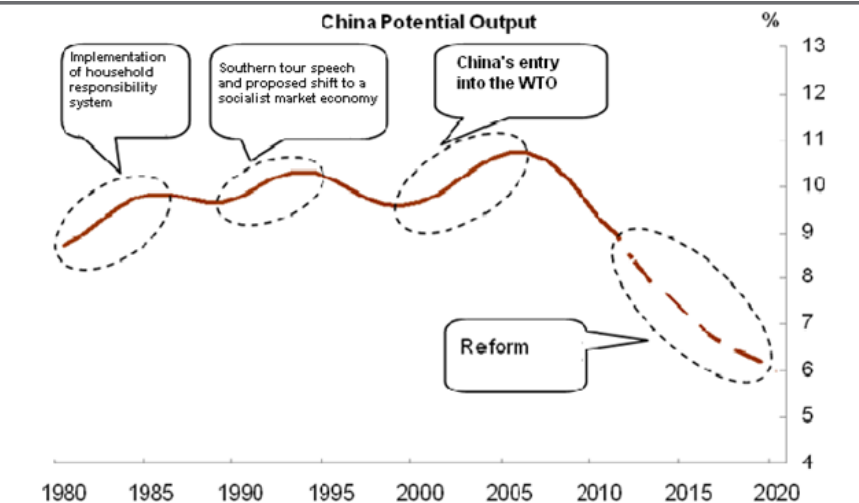
This is an edited and abridged version of the speech delivered at OMFIF's Third Asian Central Banks Watchers Group Annual Meeting in Seoul on 28 October 2013. Dr. Huang Haizhou is Chief Strategist and Managing Director at China International Capital Corporation.

Chart 1: Decline in GDP growth



Source: CEIC, CICC Research

Chart 2: China's long-term potential output



Source: CEIC, CICC Research

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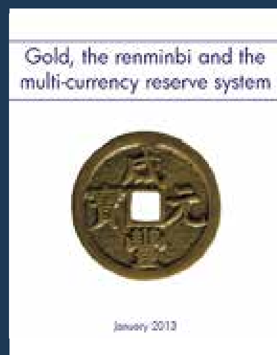

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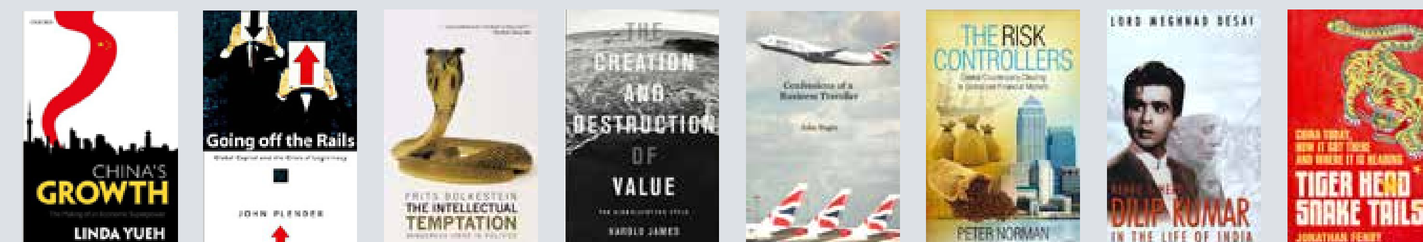


Better understanding on the financial crisis

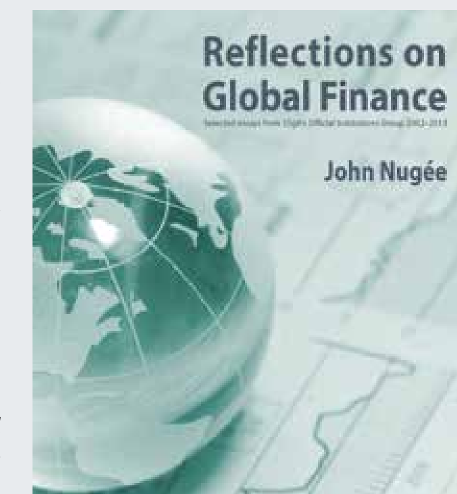
John Nugée's collection of essays, marking his retirement from State Street Global Advisers, forms an array of well-cut gemstones, the overall effect of which leaves the reader reflective rather than bedazzled.

Nugée's intentions here are not so much to bemuse with brilliance and erudition – although anyone who has heard him as a public speaker, often amusingly off the cuff, will know he is endowed with both characteristics – but rather to convince with well-marshalled arguments advancing resolutely to irrefutable conclusions.

He succeeds masterfully, and the reader is left in no doubt that Nugée's retirement musings will by no means be his last. One impressive feature of the range of subjects – from the future of pensions to City regulation, from quantitative easing in the US to the euro – is the deeply ethical, often semi-religious approach he brings to banking and financial markets issues.

Sometimes there's a touch of theological incantation, as in his commandment for policy-makers on the euro: 'Avoid recoiling from arduous and necessary discipline.' Anyone seeking better to understand the financial crisis should peruse this volume. There is much to admire and still more upon which to ponder.. ▪

The December edition of the OMFIF Bulletin will contain an extract from Nugée's book and details on how to acquire it.



Best practice in banking: a clear and comprehensive analysis

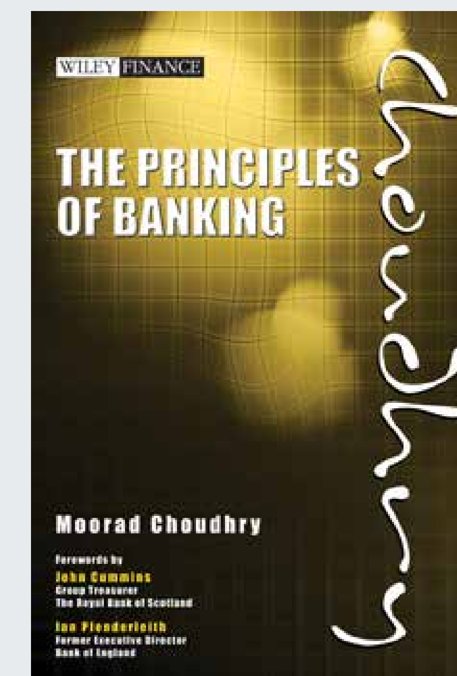
As the financial crisis took hold, most professionals found that spare time was a resource even more precious than liquidity. While many practitioners opined on what went wrong and what banks should (or more importantly shouldn't) do, few have committed these thoughts to any meaningful publication. Fortunately, though, that's what banker and academic Moorad Choudhry has managed to do – and the banking industry as a whole can be pleased about this.

His latest work dissects the complexity of the industry into palatable bite-sized chunks that are understandable. The book progresses from the basics to more complex issues and intersperses the text with analyses as to why some firms needed 'bailing out' in 2008, providing compelling reasoning for putting what has been learned into real life context.

This book considers asset liability management at the heart of a banking industry on the verge of change driven both internally by management and externally through regulatory changes. The holistic coverage of banking provides a compelling read for laymen and practitioners alike if not just to refresh the existing understanding of best practice in this crucial industry.

Choudhry has grasped that there is no universal model that fits all scenarios and institutions, and promotes particular examples of best practice and explains the rationale (and potential pitfalls) of alternatives. The book explores the basic principles of banking, in essence what banks do and, by considering the basic aims of commercial organisations, why they do it. Each section provides the reader with a depth of knowledge and consideration. The section on the yield curve for example, not only promotes a depth of understanding but also provides insight into the passion that has helped Choudhry to compile this book. For anyone who hasn't previously been privileged to see him as a speaker, this piece alone illustrates why Choudhry is the first name you should look for at a treasury practitioners' conference.

Written by an acknowledged expert, 'The Principles of Banking' is a clear and comprehensive book that provides learning and revision in a single place. Look around any treasury function and I am sure you will see Choudhry's work. This book will become a yardstick by which subsequent publications are measured. ▪



Colin Johnson is Head of Asset Liability Management and Liquidity Risk Oversight at Santander UK.

Risk of tax increases and need for tax reform in Germany

From Mr Andreas Meyer-Schwickerath

Sir, The coalition negotiations in Berlin are taking time, and there has been a lot of speculation about tax increases being in the offing as part of the bargaining over forming a new government in Europe's most important country.

That would have the effect, contrary to the wish of European states, that Germany lowers the purchasing power of its inhabitants.

The Germans would then need to step in do to more. What is needed – and after the liberals Free Democratic Party were voted out, that is unlikely to happen – is a tax reform similar to Austria's some years ago, exempting lower income earners widely from taxes.

German taxes in the lower bracket are quite high and any reduction there would support the internal buying power of Germans.

This would be a major positive step for Europe which I heartily support. ▪

Andreas Meyer-Schwickerath
Managing Director
British Chamber of Commerce
Berlin
Germany

What Zhou En Lai really said to Nixon on the French revolution

From Mr Pawel Kowalewski

Sir, When it comes to the famous question posed by President Richard Nixon to the Chinese leader Zhou En Lai in 1972, I must disappoint those who believe he was talking about the French Revolution in 1789 – a subject that has come up in a recent OMFIF briefing. Indeed, the Chinese leader answered that it was too early to judge, but he had other revolution on his mind, since he was speaking about the Paris riots of 1968. Hence, the misunderstanding and the distortion to the whole story of long-term Chinese thinking. ▪

Pawel Kowalewski
Frankfurt
Germany

Kondratieff and Desai get it wrong – economic waves last 1,000 years

From Mr Klaus Wenk

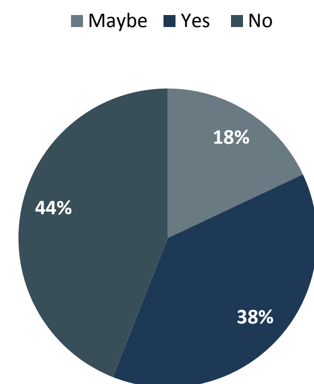
Sir, Lord Desai's exposé on Kondratieff-Waves in the October edition motivated me to reflect on economic waves. I believe that both Kondratieff and Meghnad Desai got it all wrong. In fact the 50 to 60 year Kondratieff waves that he is talking about do not exist. Instead, empirical evidence suggests waves of 1,000 years. 1500 BC marks the start of the Egyptian downfall, which lasted for about 1,000 years.

The Egyptian decline was then followed by an upward movement in about 500 BC, initiated by the Greeks and continued by the Romans, which again lasted 1,000 years. Then came the Dark Ages. This took us economically and otherwise to rock bottom at around 1500. At that time Columbus discovered America, ushered in the era of gold, which set in motion the economic upswing that may last through to 2500. Now, in 2013, we are halfway through the growing part of this 1,000 years wave and we are still going strong. Where the wave is heading to after 2500, I have no idea. ▪

Klaus Wenk
Kuala Lumpur
Malaysia

ADVISORY BOARD POLL

'Is Abenomics working? Do you think the policies being implemented by prime minister Shinzo Abe will return Japan to the path of sustainable economic growth?'



Growth will not be sustainable because Abe's supply side agenda is both weak and flawed. — **John Plender**

After more than 20 years of pussyfooting around with the traditional, consensus way of reaching decisions in Japan – Abe is such a strong individual, his measures so radically substantial, many feared over the top when they were announced – they must have an impact. Nearly 25 years after appearing to be going to overtake the US the Japanese collapse left them with deflation and stagnation. Nothing they tried seemed to work. This range of policy measures is so unexpected that, if it doesn't push them into hyperinflation, it will surely get things moving in a still third largest economy with a tendency for a very high propensity to save, so let's back the brave! — **Jack Wigglesworth**

Abenomics, based on the three arrows of fiscal, monetary and structural policies, certainly looks an exciting modern economic experiment to get Japan out of decades of deflation. But there are limits to both fiscal and monetary easing. The attainment of the 2% inflation target, although meaningful, may prove to be quite problematic. The adoption of an inflation target in no way guarantees rising prices. A change in ingrained expectations about deflation is required. Excessive monetary easing may throw up problems of financial stability. To move to a path of sustained economic growth, Japan should not back off from much needed structural reforms. Does Abenomics address Japan's problems of debt and demography ? So far, the success of Abenomics may have been driven by the weakening of the Japanese yen. And what if the yen stops weakening? And if it continues to weaken, what may be the reaction of Japan's neighbours ? — **Hemraz Jankee**

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