# The Bulletin

November 2014
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Official monetary and financial institutions   Asset management   Global money and credit


## Germany and Europe
## Divided in unity, 25 years on

Otaviano Canuto on the challenges facing Brazil
Bronwyn Curtis on the Australian economy
Norman Lamont on Britain's position in Europe
Kingsley Chiedu Moghalu on Nigerian monetary policy
Celeste Cecilia Lo Turco on Italy's future
William White on imbalances in monetary system

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## Cover story

The Berlin wall crumbled 25 years ago, on 9 November 1989. Since then European leaders have struggled to forge, in Thomas Mann's words 'a European Germany, not a German Europe'. However the fault lines, centred on divergence among Germany and its partners in monetary union, are becoming more apparent. And this is happening at a time when world monetary arrangements are increasingly burdened by large disparities among the four leading economic blocs: the US, China, Europe and Japan. All this spells risks and possibly confrontation ahead.
See p. 12-13

## Money and regulation

Written by a prominent British Catholic, *Just Money* should be of broad interest, writes William Keegan. See p.32.

Anyone interested in the history of banking, financial crisis prevention and regulatory policy should read *Fragile by Design*, according to George Hoguet. See p.33.

## International monetary policy


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## ECB signals further easing – and a weaker euro

Mario Draghi, the ECB president, has added further to expectations of a weaker euro by backing fresh easing – on the condition that inflation remains low. 'Should it become necessary to further address risks of too prolonged a period of low inflation, the governing council is unanimous in its commitment to using additional unconventional instruments within its mandate,' he said on 6 November. Papering over cracks in the council, and indicating the ECB's balance sheet could rise, under certain circumstances, by €1tn, should be enough to maintain an uneasy euro area truce at least until February-March next year.

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5
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Bronwyn Curtis (centre) with William Baunton, Liisa Vainio, Sacha Moreira and Sophie Lewisohn

# EDITORIAL

## Europe's disparities, 25 years after Berlin Wall collapses

**Helmut Kohl, the former German chancellor, has chosen the 25th anniversary of the fall of the Berlin Wall to launch a broadside against his successor Gerhard Schröder for alleged failures leading to the present parlous state of economic and monetary union.**

In a book entitled *Worrying about Europe*, Kohl also sides with Schröder, a noted supporter of Russian President Vladimir Putin, over European policies on Ukraine, saying it is a mistake to isolate Moscow over the issue. Kohl inadvertently puts his finger on a substantial reason for Europe's malaise: rightly or wrongly, Germany is often seen as marching out of line with the rest of the continent.

John Nugée ranges over these issues in a survey of how Germany has responded to the widely held hope that, once again, it should become a 'normal' nation. Steve Hanke and Michael Holstein focus on the reasons for the European slowdown. Mojmír Hampl looks at regulation and supervision after the European review of banking balance sheets. Paul Betts and Celeste Cecilia Lo Turco investigate the uphill struggles in the other two biggest euro members, France and Italy. Stewart Fleming looks at Jean-Claude Juncker's new team at the European Commission while Norman Lamont outlines how the formation of the euro has left the UK with no choice but to renegotiate its position with the EU. As William White observes in an analysis of the threat of world economic imbalances, disequilibria in the euro area (with Germany closely behind China in terms of its overall net creditor position) have provided a persistent source of worry. 'The global economy is dangerously unanchored – a problem that cries out for a global solution.' Yet, as we point out, the industrialised world's leading monetary powers, the US, Japan and Europe, are all pointing in different directions in their latest policy actions.

There are few signs of successful co-ordination in the emerging market economies. Otaviano Canuto writes on the tasks awaiting re-elected Brazilian President Dilma Rousseff. Kingsley Chiedu Moghalu dwells on challenges facing the Central Bank of Nigeria under Godwin Emefiele, its new governor, while Peter Bruce spells out the agenda facing Lesetja Kganyago, the new incumbent at the South African Reserve Bank. John West looks at the perennial problems facing China as it adjusts to slower growth. All of those mentioned above should find the time to read the two books (by Clifford Longley, and Charles Calomiris and Stephen Haber) on fundamental aspects of capitalism and economics presented by our reviewers, William Keegan and George Hoguet. ▪

# Finding new recipe for the magic pudding

## Uncomfortable transition as China-Australia links change

Bronwyn Curtis, Chief Economic Adviser

**A couple of months ago, I attended the Australian Leadership Forum, a mini-Davos event where much of the discussion centred on Australia's future. In fact, the scene-setting opening panel discussion was entitled 'Australia's Future: the end of the magic pudding?' Some readers may not have been exposed to this icon of Australian children's literature written by Norman Lindsay. It tells of a magic pudding which no matter how often it is eaten it re-grows and re-forms itself in order to be re-eaten.**

The idea may be charming, but for Australia, this is a serious question. Australia's economy can boast more than two decades' uninterrupted annual growth, combined with low inflation and unemployment. Strong demand from Asia, especially China, for Australia's mineral and energy resources played a role. So did structural reforms in the early 1980s and the good financial position of both the banks and the government. Whether it was luck or good judgement that saw Australia through the financial crisis in such good shape is largely irrelevant. In the eyes of the world, Australia's fortunes are inextricably linked to China. So can Australia still flourish if China slows?

In the decade to 2012-13, mineral exports to China jumped from 8% of resources exports to 52%. The share of mining in total output doubled. China overtook Japan as Australia's largest trading partner in 2007 and, in 2013, trade between the two countries totalled $120bn. It has been a massive structural change. This year has been a watershed. Commodity prices have fallen further than economists anticipated due to the slowdown in China and the multiple downward revisions in global growth. But increasing supply, built on investment made as the global economy recovered from the financial crisis, has also contributed. Capacity is coming on stream just as demand slows.

Iron ore prices are down around 40% so far in 2014. Even so, the low-cost Australian and Brazilian producers have expanded their output. Rio Tinto alone raised iron ore output by 12% in the third quarter. As higher cost mines elsewhere are displaced, it has become a battle for market share. Australian producers should be among the winners replacing high-cost domestic supplies in China.

China may see it differently. The Chinese have reinstated tariffs on imported coal to prop up China's domestic coal industry. Iron ore could be next. Australia's coal industry has lost more than 10,000 jobs since 2011. Prices for thermal coal have fallen 40%. A weaker Australian dollar would cushion the impact of falling commodity prices but, at least until recently, it has remained stubbornly high despite policy-makers trying to talk it down. Australia will benefit from the investment it has made in liquid natural gas, as well as exports of high end food, services and tourism. But if surveys of investment intentions in the non-mining sector are borne out, investment there will not be nearly enough to offset the fall in mining investment. Falling real wages and rising unemployment will be the result.

For a country which has one of the highest per capita incomes in the world, it will be an uncomfortable transition. We may look back and judge that Australia's most serious error was the failure to put in place a resource-rent tax to keep the 'magic pudding' intact. ▪

## ADVISORY BOARD

**OMFIF has appointed Fabrizio Saccomanni as senior adviser and welcomes Boyd McCleary, Michael Cole-Fontayn and Ben Knapen to the Advisory Board. For the full list of members see p.26-27. OMFIF is pleased to announce the birth of Emil Nikolai Burkhart, the first baby born to a serving member of the Advisory Board, Marina Shargorodska.**

Boyd McCleary is a business consultant with many years' experience in the British Diplomatic Service. He served as director of trade and investment in Turkey and Germany, economic counsellor in Canada, British high commissioner to Malaysia and governor of the British Virgin Islands.

Michael Cole-Fontayn is executive vice-president of BNY Mellon and chairman of Europe, Middle East and Africa. He is a member of the bank's corporate executive and operating committees and chairs the European executive management committee.

Ben Knapen is Brussels representative of the European Investment Bank. He was state secretary for foreign affairs in the Netherlands responsible for European co-operation and development. Knapen began his career as a journalist and was editor in chief of Dutch newspaper NRC Handelsblad.

Fabrizio Saccomanni, former Italian minister of economy and finance and director general of the Banca d'Italia, has been appointed senior adviser. He will contribute to OMFIF's efforts to enhance monetary and financial co-operation in Europe and the global economic system.

OMFIF congratulates Marina Shargorodska and Andreas Burkhart on the birth of their son Emil Nikolai. Born in Zollikerberg Hospital in Zurich on 17 September, Emil Nikolai weighed 3.5 kg. He is 52cm tall and is the first baby born to a serving member of the Advisory Board.

## BRIEFINGS

### Renewed zest for reform following China's fourth party plenum

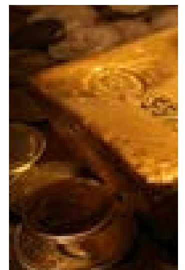
In a telephone briefing following the fourth plenum of the Communist Party of China on 23 October, the BBC's Linda Yueh and John Adams of China Financial Services analysed latest Chinese economic and political developments. Moderated by Gabriel Stein, the discussion focused on the shifting balance between the rule of the party and rule of law, the anti-corruption drive and efforts to rebalance the economy ('it's hard to mend the roof while it's pouring with rain'). Areas for future reform include improving consumer protection, slimming down the civil service, enhancing the social role of banks and making the economy more competitive and open.

### Banks escape major reaction in ECB Asset Quality Review

Following the European Central Bank's audit of major banks, Folker Hellmeyer of Bremer Landesbank, Philip Middleton of Ernst and Young and moderator Moorad Choudhry discussed the results in a telephone briefing on 27 October. The ECB identified a €25bn capital shortfall across 25 banks, but there were no great surprises and 'the market reacted with yawns and relief'. The stress tests were not as onerous as they might have been, but as a confidence-building exercise they appear to have worked. Still to be dealt with are non-performing loans and Europe's debt mountain. According to Hellmeyer, 'Countries which apply structural reforms will win in the end.'

## EXPERT SEMINARS

### Gold and renminbi in tandem in reserve management



Together with the World Gold Council, OMFIF hosted a breakfast seminar on 10 October at Hay Adams Hotel, Washington, focusing on the role of gold and the renminbi in central bank reserve management. At a time of transition for the world monetary system, gold tends to increase in significance as an alternative asset to the dollar and standard currencies – a development now underway as the renminbi rises in importance as a new reserve currency. This is especially so in times of political and economic uncertainty as the world moves towards a multicurrency reserve system. Speakers included Ashish Bhatia of the World Gold Council, Bashar Alsharif of International Finance Corporation, François Haas of Banque de France, Turalay Kenc of the Central Bank of the Republic of Turkey and Kenneth Sullivan of the International Monetary Fund.

### Poland's Marek Belka on problems facing euro area

Marek Belka, president of the National Bank of Poland and a former Polish prime minister, was the guest of honour providing the keynote address at the fourth OMFIF international statesman dinner on 13 October at Armourers Hall in London (pictured right: pre-dinner drinks). He discussed problems facing the euro area, particularly risk from deflation, slow growth, high unemployment and shortcomings in the overall functioning of monetary union. Belka suggested that Poland – although politically committed to join monetary union – would take time to make up its mind on membership. He provided a range of ideas on how Europe could improve its economic governance.

### Reigniting world-wide capital investment

The Fifth Annual DZ BANK-OMFIF international monetary breakfast at the Park Hyatt, Washington on 11 October, coinciding with the autumn IMF/World Bank meetings, focused on capital investment. Moderated by David Marsh, Rakesh Mohan, India's IMF executive director (left), joined Joachim Nagel, Bundesbank board member (right); Benoit Cœuré, European Central Bank; Gerassimos Thomas, European Commission; Bertrand de Mazières, European Investment Bank; and Thierry de Longuemar, Asian Development Bank.

### Step forward for renminbi-isation

International Monetary Institute of Renmin University in Beijing and the Bank of Communications joined forces with OMFIF to present Europe's first fully-fledged academic and financial seminar on the Chinese currency on 14 October at the Mandarin Oriental hotel in London. The seminar coincided with the issuance of renminbi bonds by the UK Treasury, helping the Chinese currency on its way to international reserve status. Speakers included Yao Yulin of Bank of Communications, Tu Yonghong and Ben Shenglin of IMI and David Marsh. OMFIF will be carrying out further similar seminars with its Chinese partners in 2015.

## POLICY GROUP

### Benoit Cœuré on restoring Europe's momentum

Over lunch at the Travellers Club in London on 20 October, Benoit Cœuré, executive board member of the European Central Bank, remarked on the economic situation in the euro area and ECB initiatives to raise the inflation rate. The bank will expand its balance sheet through various unconventional monetary policy programmes including purchases of asset backed securities and covered bonds, though full-scale quantitative easing is not yet on the menu. A key issue was the lack of demand and output in the euro area. Germany needs to stimulate aggregate demand by incentivising investment through fiscal policy, while France and Italy need to stimulate supply.

## MAIN MEETING

### Stabilising the euro area amid deflation concerns

Together with the Deutsche Bundesbank in Frankfurt, OMFIF held its 12th Main Meeting on 16-17 October. Hosted by Bundesbank President Jens Weidmann, around 70 participants from around the world discussed the future of unconventional monetary policy, the stabilisation of the euro area and the development of a multicurrency reserve system. Accommodative monetary policies have improved financial market conditions and gradually restored confidence. But as central banks debate exiting unconventional monetary policy, greater coordination is necessary to mitigate potential instability. Europe's focus is on producing sustainable growth and improving competitiveness and productivity. Germany continues to be a role model for monetary and fiscal soundness, although lags in infrastructure spending and the lower retirement age are holding back competitiveness and contributing to worries about the health of the euro area as a whole.

# Yellen emphasises 'data dependent' stance

## Fed ends asset purchases, keeps future options open

Darrell Delamaide, US Editor

**The October buzzword for the Federal Reserve was 'data dependent,' as Fed officials took their cue from Chairman Janet Yellen (voter), who used the phrase repeatedly in her September press conference.**

So when The Wall Street Journal asked Boston Fed chief Eric Rosengren **(non-voter)** about the likely timing of the first interest rate increase, he had his answer ready.

'I haven't given a precise date,' he said. 'I won't now, because I have been focused on data dependence. What I have said is that we should start raising short-term interest rates when we're one year away from being at full employment and at 2% inflation target.'

Recent volatility in the markets has not prompted him to change his forecasts at this point, he said, but if he did change them then that would push back the timing of 'lift-off,' as the Fed terms the first rate increase nearly six years at virtually zero.

'So the reason I've highlighted in a number of my talks I'd rather be data dependent is precisely for this reason,' Rosengren told the Journal. On the other hand, he backed the Fed's decision to end its asset purchases as planned in October – a decision that has now been taken.

The Federal Open Market Committee has been tapering these purchases, known as QE3, by $10bn a meeting from $85bn.

'At current levels I think the impact is rounding error,' Rosengren said. If deflation emerges as a real threat, then the Fed should embark on a new, more robust programme.

San Francisco Fed chief John Williams **(non-voter)** used a variation of the term, saying in a separate Wall Street Journal interview that 'obviously our decisions are data driven.'

Federal Reserve Chairman Janet Yellen

He said his baseline forecast is for the Fed to reach its dual targets of full employment and 2% inflation by 2016, implying an end to asset purchases in October and an increase in interest rates 'sometime' in 2015.

'That [forecast] hasn't changed for some time,' Williams said. 'International developments have not been significant enough to really move that in a really meaningful way.'

The FOMC did in fact decide at its late October meeting to end the asset purchases, citing favourable development in the data.

'The Committee judges that there has been a substantial improvement in the outlook for the labour market since the inception of its current asset purchase programme,' policy-makers said in their statement. 'Moreover, the Committee continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability.'

### 11th-hour confusion

James Bullard **(non-voter)**, head of the St. Louis Fed, had injected some 11th-hour confusion when he suggested ahead of the meeting that the Fed might consider continuing its asset purchases for the time being.

'Inflation expectations are dropping,' he said in an interview with Bloomberg Television. 'For that reason, I think a reasonable response for the Fed in this situation would be to invoke the clause on the taper that said that the taper was data dependent. And we could go on pause on the taper at this juncture and wait until we see how the data shakes out into December.'

Bullard clearly believed it would be easier to maintain the QE programme at its current low level and ramp it up again if necessary than to shut it down and then try to start another one if needed. 'It would keep the programme alive and keep the optionality for the committee going forward,' he said.

Bullard didn't have a vote in the October meeting, but Minneapolis Fed chief Narayana Kocherlakota **(voter)** did vote in dissent from the consensus statement, saying that continued sluggishness in the inflation outlook and a downward turn in inflation expectations argued in favour of keeping asset purchases at their current level and a longer time frame for raising rates. Chicago Fed chief Charles Evans **(non-voter)**, for his part, remained more focused on interest rates and said it would be preferable for the Fed to err on the side of caution. 'I believe that the biggest risk we face today is prematurely engineering restrictive monetary conditions,' he said at a conference in Indianapolis before the FOMC meeting.

'In this scenario, the FOMC could misjudge the presence and magnitude of economic impediments and misread the recent progress we have made as evidence of sounder economic trends,' Evans said. 'If we were to presume prematurely that the US economy has returned to a more business-as-usual position and reduce monetary accommodation too soon, we could find ourselves in the very uncomfortable position of falling back into the [zero lower bound] environment.'

As Fed officials continued to provide nuance to their monetary policy intentions, a conference at the New York Fed regarding the ethical conduct of US banks was decidedly un-nuanced. The Fed is the primary regulator for the big US banks, with the New York Fed in particular responsible for Wall Street institutions.

New York Fed chief William Dudley **(voter)** raised eyebrows last November when he expressed concern that an 'apparent lack of respect for law, regulation and the public trust' persisted in Wall Street banks.

In the October meeting, Dudley warned those attending that if they did not push 'forcefully' for change, this pattern of ethical failure was bound to continue.

'If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively,' Dudley said. 'In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively.'

Governor Daniel Tarullo **(voter)**, who heads up regulatory activity for the Federal Reserve Board in Washington, echoed this threat.

'My expectation is that if banks do not take more effective steps to control the behaviour of those who work for them,' Tarullo said, 'there will be both increased pressure and propensity on the part of regulators and law enforcers to impose more requirements, constraints, and punishments.' ▪

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

# Persistent imbalances, persistent threat

## We are still seeking an international monetary system

William White, Chairman of the Economic Development and Review Committee

**Current account imbalances in the euro area have contributed to the crisis atmosphere in recent years. Large scale capital flows from core countries to peripheral ones cumulated from the mid-1990s until the euro area crisis became apparent in 2010.**

Interest rates converged on German levels in spite of member countries having widely different levels of both domestic and international debt. This may have reflected the mistaken analytical assumption that countries in currency unions cannot have balance of payments problems. It might, too, have reflected the view that private sector creditors would always be bailed out by the public sector.

### Capital inflows

In the event, capital inflows to the peripheral countries led to a massive loss of competitiveness and large current account deficits. The crisis erupted when investors (and financial regulators) began to evaluate counterparty risk more carefully.

When the previous capital inflows started to reverse, massive recessions set in as domestic 'absorption' had to be dramatically reduced.

This episode clearly illustrates that current account imbalances should still be a source of concern to policy-makers, although evidently not the only concern. As latest IMF figures indicate (see table below), net foreign assets and liabilities have been rising.

The euro area crisis – where the basic factors that caused unrest in 2012 have manifestly not disappeared – provides just one example of a persistent global malaise. One of the other symptoms is a lack of confidence in the International Monetary Fund to help individual problem countries.

If governments feel they cannot rely on the Fund for adequate liquidity support during crises, it is not surprising that they seek 'self-insurance' through foreign reserve accumulation.

The problem is that such accumulation contributes to holding down the value of appreciating currencies which in turn raises the likelihood of rising inflation, other imbalances and subsequent crisis. Reserve accumulation increases the capacity to deal with crisis, but makes such a crisis more likely.

Countries are tempted to resort to regional 'mutual support' exercises (like the Chaing Mai initiative in Asia) which erodes the sense of global solidarity and could, in practice, lead to significantly less conditionality.

More moral hazard, in a world awash with moral hazard, hardly seems optional. In short, the global economy today is dangerously unanchored, a problem that cries out for a global solution.

Both at the global level and in the euro area, it is worth investigating the underlying causes of the crisis that erupted in 2008-09.

I suggest that both crises had their roots in too-easy monetary conditions in most of the advanced market economies but especially in the US. The effects of this on rates of credit growth, and its increasingly low quality, were exacerbated by the growing elasticity of the financial system.

Behind each of these developments lurked a false belief. Central bankers believed that the economy was essentially self-stabilising and that, as long as there was price stability, the stability of the broader economy was essentially guaranteed.

Credit-driven bubbles were thought neither likely nor dangerous, and the residue of a possible 'bust' could be easily cleaned up afterwards. Similarly, there was a widespread view that financial markets were inherently efficient and that financial market deregulation was fundamentally desirable.

It must be added that the emerging market economies also contributed to the crisis. As their currencies tended to appreciate, even prior to 2007, most resisted vigorously in response to a variety of motives including fears of a loss of competitiveness and disorderly and excessive exchange rate movements.

Resistance took the form of both foreign exchange rate intervention and monetary easing. The former eased credit conditions in advanced market economies (as accumulated reserves were reinvested), while the latter eased credit conditions in the emerging markets themselves.

The onset of the crisis should have put a big dent in both sets of false beliefs referred to above. However, observed behaviour since 2007 casts doubt on this hypothesis.

### World's largest debtor and creditor economies (net foreign assets and liabilities)

| Largest debtor economies | $bn 2006 | $bn 2013 | % of GDP 2006 | % of GDP 2013 |
|---|---|---|---|---|
| US | -1,973 | -5,698 | -14.2 | -34.0 |
| Spain | -862 | -1,400 | -69.7 | -103.1 |
| Brazil | -349 | -750 | -32.1 | -33.4 |
| Italy | -453 | -739 | -24.1 | -35.6 |
| Australia | -462 | -746 | -59.2 | -49.6 |
| France | -29 | -578 | -1.3 | -20.6 |

| Largest creditor economies | $bn 2006 | $bn 2013 | % of GDP 2006 | % of GDP 2013 |
|---|---|---|---|---|
| Japan | 1,793 | 3,056 | 41.2 | 62.4 |
| China | 476 | 1,686 | 17.0 | 17.8 |
| Germany | 782 | 1,678 | 26.9 | 46.2 |
| Saudi Arabia | 513 | 1,063 | 136.4 | 142.1 |
| Switzerland | 495 | 939 | 122.3 | 144.3 |
| Taiwan | 504 | 933 | 134.0 | 190.9 |

Source: IMF World Economic Outlook, October 2014

While there has been a great deal of regulatory restraint, and indeed fiscal restraint in some cases, this has unfortunately left monetary policy as the 'only game in town' to help restore global aggregate demand.

As a result, monetary policy in the advanced economies has continued to be enormously expansionary, albeit through unconventional policy instruments. Moreover, faced with perceptions of a 'currency war', the resistance of emerging market authorities to exchange rate appreciation was even more ferocious than before.

**Global imbalances**

The results have been relatively predictable. While inflation has not been a recent problem in the advanced market economies, there has been a resurgence of inflation in many of the emerging market economies.

Further, many imbalances seen before the crisis have either not diminished or have actually worsened. The ratio of non-financial debt to GDP in the G20 was 20 percentage points higher in early 2014 than it was in 2007, with much of the post-crisis increase happening in Asia and Latin America.

In short, we continue to have serious global imbalances, using the broadest definition, which I take to mean not just global current account imbalances and the associated build-up of international debt imbalances, but also large and potentially destabilising gross international capital flows as well as sustained deviations of macroeconomic variables from traditional norms. This would not have happened had there been some set of international rules to govern the behaviour of national governments and national central banks. If the US had been forced to respond to its ever widening pre-crisis trade deficit, tighter US monetary, fiscal and regulatory policies would have helped avoid the worst of the global imbalances that threaten us.

Similarly, had China been forced earlier to let the renminbi rise, this would have been helpful in stimulating consumption and curbing exports and investment.

In principle, countries with large external debts and/or current account deficits should face downward market pressures on their currencies, encouraging a shift of production to the satisfaction of foreign demand.

Policy measures should then be used to reduce domestic 'absorption' to make room for such a shift. The opposite set of forces should be in evidence for large surplus countries. But none of these forces appears very visible.

Exchange rate movements seem to have little to do with respective debtor/creditor relationships. Indeed, driven by momentum trading, exchange rates can deviate for years from levels consistent with underlying fundamentals. Post-crisis 'risk on, risk off' behaviour has had particularly unfortunate consequences.

It has implied a stronger dollar during long periods of 'risk off', which is inconsistent with external rebalancing. Further, exchange rate changes do not always, or at least not quickly, induce the shift in production capacity desired.

The recent depreciation of the yen seems to have had little real effect. Nor need domestic policies reflect a country's external position in any way. For example, the US is the world's biggest international (net) debtor, with its position deteriorating over time, as Chart 1 shows. Yet there is no impediment to it responding to periods of weaker overall demand with still more domestic demand stimulus, again interfering with the desired external adjustment.

**International creditor**

Similarly, Japan is the world's largest international creditor (with China second) while Germany has the world's largest current account surplus in dollar terms.

Relative to GDP, Japan and Germany have increased their net creditor positions while China's has fallen (see Chart 2). There is no impediment to all three countries responding to weaker overall demand with efforts to expand exports even further.

With Chinese investment (particularly in property and construction) now weakening, it will be interesting to see whether the authorities respond by increasing export subsidies and by encouraging the renminbi to depreciate.

It cannot have escaped Chinese attention that the yen's depreciation, in the context of 'Abenomics', attracted no international criticism. The Fed's easy money policies would traditionally have been described as the exporting of US deflation to others via a lower dollar. Yet it has been suggested more recently that the Fed's policies have actually been exporting inflation and other credit-driven imbalances, through various mechanisms.

First, with low rates in the US and many international loans denominated in dollars, longer term rates in other countries are increasingly correlated with US rates. Thus there is a direct, stimulative effect on spending in other countries which affects the prices of goods and services as well as asset prices.

**Monetary stimulus**

Second, monetary stimulus reduces perceptions of risk, and this lowers the Vix volatility index. This induces more leverage by banks with global reach. Banks respond to interest rate differentials with capital inflows into countries with higher yield.

Increasingly, international capital flows are dominated by asset management firms which buy emerging market corporate bonds.

These inflows, together with policies designed to hold down the exchange rate, threaten to exacerbate both inflation and imbalances. Third, easy monetary policies in the large advanced countries may directly raise commodity prices, based on the assumption that commodities are increasingly treated as a financial asset class whose returns have low correlations with other financial assets. Energy and food in poor countries are a large part of the consumption basket.

And when these products are subsidised by governments, higher prices cause fiscal deterioration. There are several ways in which affected countries can protect themselves. First, use regulatory means to reduce the use of leverage by banks with global reach.

Closely related, use regulatory means to control the outflows of capital by large asset management firms. Second, let the exchange rate rise more. Third, use capital controls to prevent inflows. Fourth, mitigate the implications of such inflows through macroprudential policies.

In recent years, the IMF has endorsed many of these suggestions – not least, the recourse to capital controls and more vigorous use of macroprudential policies.

The practical use of such measures demands enormous technical skill. Generally speaking, such skills are lacking. In any event, all of these measures smack of 'sauve qui peut' and 'chacun à soi'.

This is hardly a systemic response to persistent global imbalances, each with the potential to end in crisis, either for individual countries or for the global economy. While domestic authorities might be thought capable of monitoring the build-up of imbalances, and doing something about them, in practice such preventative feedback is generally absent. Net debtors, or those receiving large scale capital inflows, often lack the will to do what needs to be done.

Net creditors, or those that are the source of large capital outflows, often contend that they have no interest in the matter (and certainly no responsibility) since any eventual crisis will emerge elsewhere.

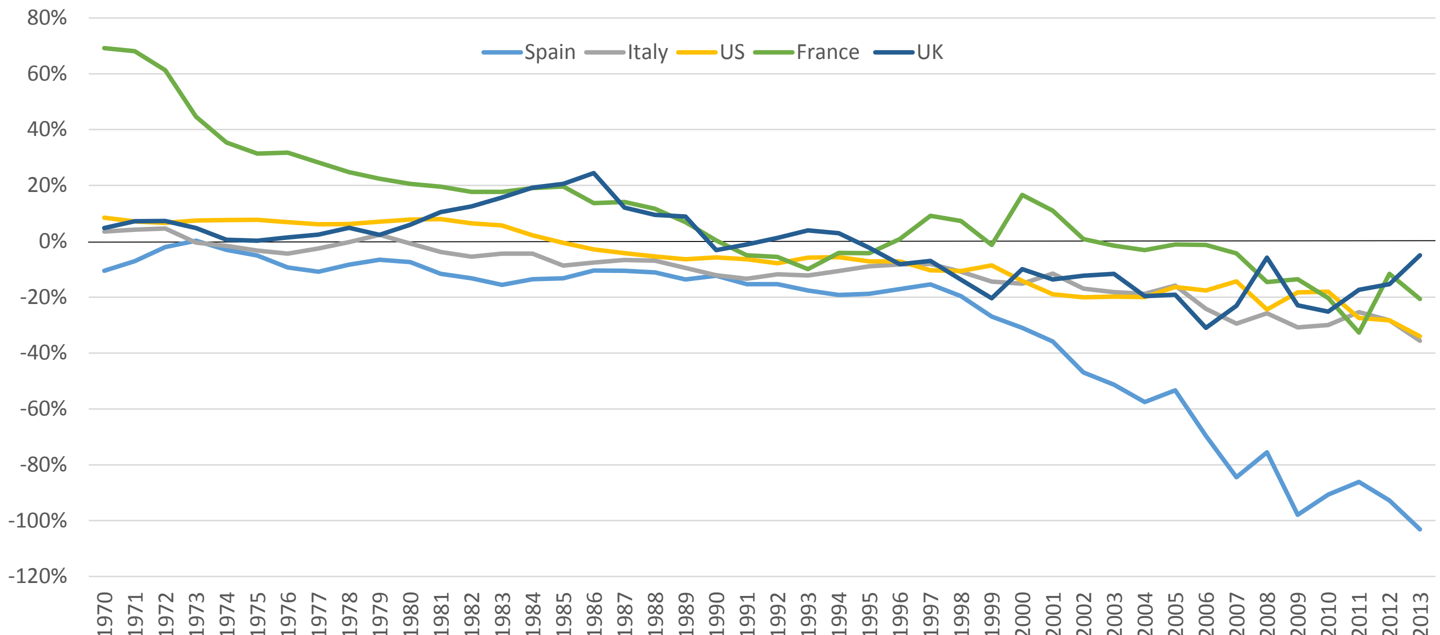
**Systemic international response**

An international monetary system that imposed responsibilities on everyone could play a significant role in reducing these dangers. Net debtors, or those receiving large scale capital inflows, would effectively import the will to do what needed to be done. Creditors too would be forced to play a role. When those with liabilities cannot pay, those with assets do not get paid.

This incontestable fact underlines the need for a systemic international response to what has become a dangerous set of systemic problems. ▪

William White is Chairman of the Economic & Development Review Committee at the OECD and former Economic Adviser, Bank for International Settlements. This is an edited and abridged version of White's speech, 'Global imbalances and the need for an international monetary system', delivered at OMFIF's Fifth Main Meeting at the Bundesbank in Frankfurt on 16 October 2014.

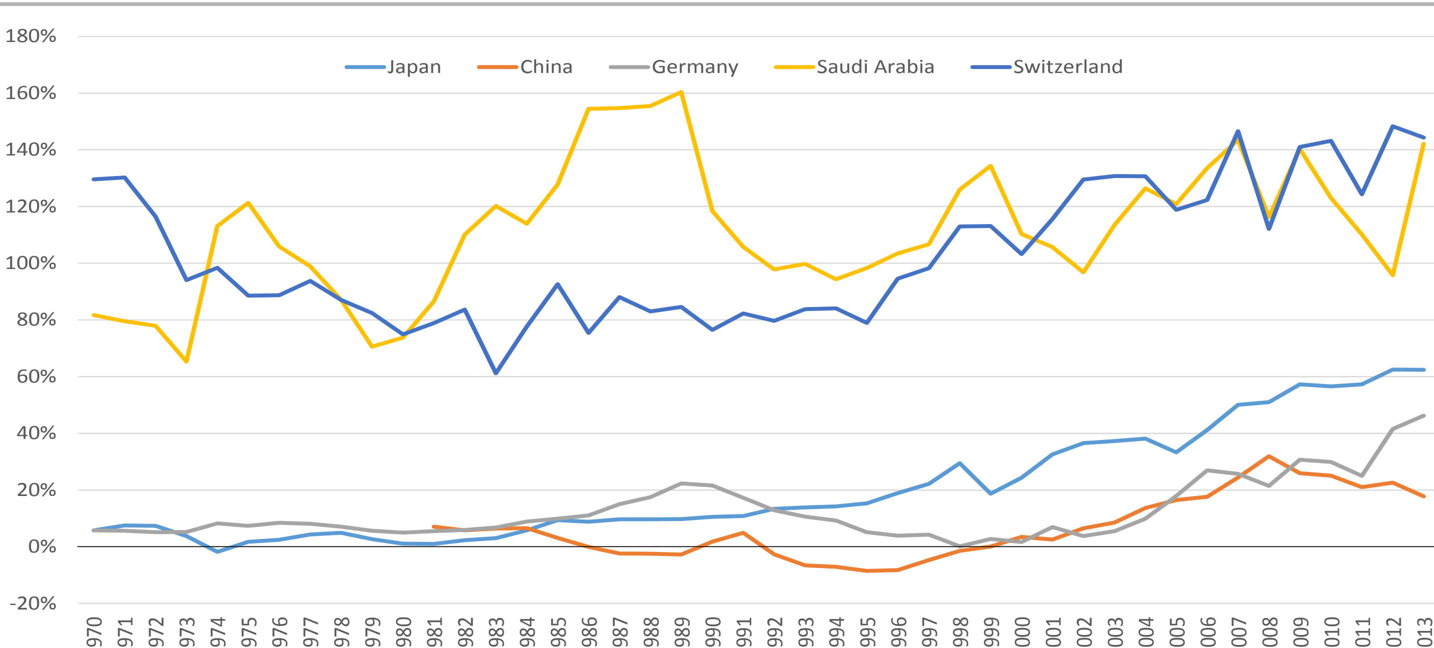
**Chart 1: Largest debtor economies – Net foreign assets 1970-2013, % of GDP**




Source: IMF, World Economic Outlook database; External Wealth of Nations Mark II data set (Lane and Milesi-Ferretti 2007); and Lane and Milesi-Ferretti 2012.

One of the biggest transformations in the creditor-debtor balance has been a deterioration in France since 1970. Formerly one of the world's significant creditor economies, with net international assets of nearly 70% of GDP 35 years ago, France has seen its position deteriorate drastically to a net foreign liability balance of 20% in 2013. Spain has also seen a dramatic worsening.

**Chart 2: Largest creditor economies – Net foreign assets 1970-2013, % of GDP**




Source: IMF, World Economic Outlook database; External Wealth of Nations Mark II data set (Lane and Milesi-Ferretti 2007); and Lane and Milesi-Ferretti 2012.

Japan and Germany have increased their net creditor positions while China's has fallen. Saudi Arabia and Switzerland have been large net creditors since the 1970s. West Germany was a modest net creditor during most of its period of division but built up its net foreign credits to 20% of GDP by 1990. United Germany ran them down again up to 2000, and has since gained substantial net foreign assets.

Europe & the euro

# The unmaking of the European Union

## How the events of the last 25 years are coming to a head

John Nugée, OMFIF Director

**These are difficult times for the European Union. Few member states are happy with the direction the union is going, and they are making their disagreement public after years of manufactured consensus.**

Economic and monetary union and the single currency are under attack as never before, and their chief advocate, Germany, is more isolated and more on the defensive than it has been for years.

When Angela Merkel became chancellor in 2005, she made it clear that in her view, Germany was now a 'normal nation', entitled to have a national interest and no longer content always to put the interests of the EU first. Germany would no longer do everyone else's bidding and foot all the resulting bills.

Given that it has been German policy since the 1950s to bury itself and its identity deep within the workings of the European Dream, how have we reached this point? To answer this we must look back 25 years, to the momentous year of 1989 when Europe's political ice age started to thaw.

### Aiming for unity

In the late 1980s Europe was taking shape. The single market was agreed and well under construction. The original Community of Six – France, West Germany, Belgium, Italy, Luxembourg and the Netherlands – had been expanded three times: first in 1973 to admit Denmark, Ireland and the UK and then in 1981 and 1985, slightly more challengingly but it seemed no less successfully, to include the southern trio of Greece, Spain and Portugal.

The European monetary system was providing a zone of relative currency stability in a volatile world.

German Chancellor Angela Merkel speaks under a portrait of former German Chancellor Helmut Kohl during Girls' Day at the Chancellery on 23 April 2008 in Berlin.

Most important of all, France and Germany enjoyed a well-established partnership of equals, with respected political leaderships and equivalent population sizes. Germany, or rather West Germany, had seemingly succeeded in overcoming its past and creating for itself a safe environment in which it could live and prosper at peace with its neighbours, channelling all its nationalism into *Die Nationalmannschaft*, Germany's highly successful national football team. There were still issues, both internal and external. German trade surpluses have been a constant theme for 50 years or more, and the role and value of the dollar was as much in the news then as now. But by and large, in the late 1980s the EU was a stable union in a stable world.

### Co-operation and recuperation

The collapse of communism and the fall of the Berlin wall in November 1989 challenged all this. As the certainties of post-war European politics started to evaporate, West Germans faced events moving with lightning speed.

Chancellor Kohl surprised some of his fellow-citizens – and took the French and British governments, in particular, completely off balance – with his '10 point plan' for closer co-operation with East Germany*, but even he did not expect to see full reunification in less than a decade.

Yet under a year later Germany was reunified and the former East Germany was incorporated into the new Federal Republic as well as the EU.

The new Germany, at 80 million people, was no longer equal in size to the three other big EU states of France, Italy and the UK but one-third larger again. Europe's political dynamics were changing.

The strain of incorporating and resuscitating the backward and bankrupt East German economy taxed first of all German finances and then, via the Bundesbank's monetary policy, the whole of the EU. Europe reeled under successive currency crises in 1992 and 1993 as the Bundesbank strived through high interest rates to contain the convulsions of economic reunification.

The main response of other member states, led by France, was to seek a way to neutralise this power of the Bundesbank to export Germany's monetary policy regardless of how inappropriate it was for other states. This led directly to EMU and the introduction of the euro at the end of the 1990s.

Meanwhile, the EU had expanded again, bringing in Austria, Finland and Sweden in 1995. Although incorporating three small rich states was economically fairly easy, it further upset the political balance between the southern Latin member states and the northern and more Germanic ones.

With the focus of much of Europe's energy being towards the former states of the communist East, the centre of gravity of the EU was moving, both literally and metaphorically, towards Berlin.

This move was complete when in 2004 – less than 15 years after the fall of the Berlin wall – eight former communist states were admitted into the EU, along with Malta and Cyprus. From being on the eastern extremity of a largely westward-facing union, Germany was now geographically and politically at the heart of European affairs.

Events have a way of taking a politician's words and turning them back on them.

The global financial crisis of 2007-09 tested the new German political will in a way that Merkel cannot have anticipated when she pronounced Germany at last a 'normal nation'. America, wounded both abroad in its military engagements and at home by the financial crisis, has under President Barack Obama been looking more and more to Asia rather than Europe with what energy it retains.

The UK has been similarly hard hit by the crisis and has withdrawn ever more into its shell, its government consumed by domestic austerity and battling rising euro scepticism.

And most seriously of all for Berlin, France, long-time ally and partner of Germany, is badly weakened by an economic malaise which neither former president Nicholas Sarkozy nor his successor François Hollande has been able to resolve.

### Existential crisis

Europe's existential crisis has thus been building for 25 years. German reunification removed Germany's safe anonymity; the exchange rate mechanism turmoil forced the pace on the single currency which was as a result introduced too quickly and for too many countries; the global financial crisis has found out the resulting weaknesses in the euro's construction; and in the aftermath, the burden of leadership of the EU, a role Germany always sought to avoid, falls ever more on Berlin's unwilling shoulders.

Merkel has said that the euro is essential for the union – if the euro fails, she has warned, then the EU itself will be at risk. What she has not said, both because she dare not but also because it is so self-evident, is that Germany's relationship with its partners is no less critical.

The EU can take disagreements with a small member state like Hungary in its stride. It can even overcome tensions with a large member state like the UK. What it cannot afford is a major gulf between Germany and the rest of the EU.

Much of the first half of the 20th century revolved around Germany's struggle to find its place in Europe. At the start of the 21st century, Berlin is once again at the centre of events, pursuing an increasingly unpopular policy and seeking to impose its will on its partners.

The fear is that Germany's dilemma – too large to be an equal to other European states, too small to be a hegemon – will once again play out, and that Europe will once again find the struggle too much.

But this time if they fail, if it ends in disaster, it is not just the euro which is at risk, but perhaps the whole of the 60-year project of European unity and peace. ▪

John Nugée is a Director of OMFIF. He is the author of Reflections on Global Finance: Selected Essays 2002-2013. *Helmut Kohl, Zehn-Punkte-Programm zur Überwindung der Teilung Deutschlands und Europas (Ten Point Programme for Overcoming the Division of Germany and Europe), 28 November 1989.

### David Marsh on the fall of the Berlin Wall, Financial Times, 11 Nov 1989

**The division of Germany has been a historical accident, born of Hitler's war and the post-1945 superpower confrontation, waiting one day to be undone. At breakneck pace that day now seems to be approaching.**

Yesterday's wave of humanity washing through the Berlin Wall marks the crumbling away, almost literally overnight, of the ugliest symbol of the post-war world – and the pushing into place of the building blocks of a new Europe.

Rarely in history can an event desired by so many, deemed possible by so few, happened with such remarkable speed. The build-up of protests over the past month in East Germany, culminating in the decision on Thursday evening to open the emigration floodgates unleashes a torrent of questions over the future of central Europe to which neither East nor West has ready answers.

After 40 years of entrenchment in eastern Europe, Communist hegemony is beating a retreat almost everywhere. The reformist policies of Mr Mikhail Gorbachev, the Soviet leader, have broken through into Poland and Hungary, and are now invading the state set up in 1949 as the Stalinist mirror-image of the capitalist, US-inspired West Germany.

At the same time, with the shift to the East in West Germany's preoccupations, the forces binding Bonn to the European Community and Nato are almost inevitably changing and perhaps losing their strength.

The partition of Germany was the result not of a concrete policy by the victors of the Second World War but, rather, of the absence of one, as the anti-Hitler coalition split in cold war acrimony.

The phase of apparently stable division has coincided with unparalleled peace and prosperity in the Western half, repression and constant pressure to emigrate in the East.

That era now appears to be passing. In 1945, the tide rolled in over Germany; now it is going out again. And shimmering on the sands of Europe is the outline, as yet barely discernible, of a new resurgent German nation.

FT writers on the implications of the heady pace of change in

# Marching in the vanguard of history

David Marsh

# German opposition could delay Rome respite

## Swelling Italian debt revives fears for euro area stability

Ryan Shea, Black Swan Economic Consultants

**Despite some positive noises from euro area policy-makers about improving growth prospects, European economic data show that recovery remains elusive. Most worrying is Italy, an economy once more in technical recession.**

Since peaking in the third quarter of 2007, Italian real activity has contracted by one-tenth, leaving nominal GDP effectively stagnant for six years – a performance reminiscent of Japan's lost decades.

Worse macroeconomic performances have been observed in other euro area countries – notably Greece and Ireland. However, Italy should be much more worrying for one simple reason: the sheer size of the market for Buoni del Tesoro Poliennali, the credit instruments issued by the Italian Treasury with maturities from three to 30 years.

### Government debt

Since the start of the recession, Italian gross government debt has surged more than 30 percentage points to around 135% of nominal GDP. At €2.2tn, Italy's debt is €300bn more than the outstanding government debt of all the other troubled peripheral countries combined.

Such a rapid increase in the debt-to-GDP ratio has occurred despite significant fiscal tightening; Italy runs a primary budget surplus of 2% of GDP.

The supposed solution to the euro area crisis, which at heart is one of sustained intra-regional imbalances, was one in which the periphery regained competitiveness versus the core through internal price devaluation.

Governments were encouraged to implement a mix of tighter fiscal policy to restrain aggregate demand and structural reform to boost aggregate supply. In theory this combination would generate lower domestic prices without sacrificing real GDP. Unfortunately, the reality is markedly different.

The problem is that budget austerity hits economic activity, which in turn generates disinflation – which could develop into outright deflation. Add the cost of servicing the existing debt stock and this thwarts any attempt (in Italy or elsewhere) to lower debt-to-GDP ratios.

In addition, positive pay-offs from structural reforms typically take a long time to materialise.

More immediately, when aggregate demand is being depressed by tight fiscal policy, structural reforms exacerbate the downturn.

This is particularly toxic for politicians, even those as popular as Italian Prime Minister Matteo Renzi, especially when the adopted policies are viewed as externally imposed and therefore undemocratic.

Despite evidence to the contrary, politicians in the core remain of the view that the region's debt crisis can be solved only via the rigid application of tough fiscal rules.

Indeed, Wolfgang Schäuble, German finance minister, was recently quoted as saying: 'The only problem that some countries have is that they have to stick to the rules.'

Mario Draghi, president of the European Central Bank, has attempted to gain policy leeway by arguing for more flexible implementation of fiscal policy, and has explicitly left quantitative easing on the policy table.

However, Schäuble has publicly expressed concern about the ECB engaging in QE, worries shared by Jens Weidmann, the Bundesbank president. The German position is understandable. No German government wants to put taxpayers on the hook for the debts of foreign governments. Moreover, there is concern about the long-run effects on the German economy if the ECB calibrates monetary policy based on the requirements of the periphery.

### Policy cohesion

This lack of policy cohesion is awkward. It may not necessarily stop the ECB from eventually choosing the QE option; Germany has, after all, only two votes on the governing council. The ECB has already shown it is prepared to implement policy changes on the basis of a simple majority, even though it would prefer unanimity.

However, such political dissonance will delay the implementation of QE, and time is in short supply. Cracks have already begun to re-emerge.

Over the past two months Target-2 debits for Banca d'Italia have risen markedly, indicative of capital being exported to other parts of the euro area. It would appear that Italy is suffering 're-fragmentation'.

For now, private capital moving out of Italy is relatively small, but the trend change is worrying as it could easily be a precursor to greater capital flight. Another European eruption may lie ahead. ▪

Ryan Shea, former Head of Macroeconomic Research and Currency Portfolio manager of Abu Dhabi Investment Authority, is Managing Director of Black Swan Economic Consultants.

## OBITUARY

### The man of the world behind West German Chancellor Helmut Schmidt

Klaus Bölling, 86, the spokesman of the West German government under Chancellor Helmut Schmidt in the 1980s, who died in October, was an outstanding journalist who gained acclaim for his partnership with one of Europe's most celebrated post-war statesman. Bölling built up great authority through his sober, concise and sovereign statements on behalf of a leader who remained steadfast in the face of enormous strains, *writes Markus C. Kerber*. Always elegant in his prose with a deep conviction that Germany is part of the western alliance, Bölling was much more than a mere mouthpiece for Schmidt. He drafted important government dossiers, managed governmental dramas with great theatrical impact and, finally, after Schmidt's ousting by Chancellor Helmut Kohl in 1982, advised him to withdraw from further political tussles to become an elder statesman.

Bölling's career took off quickly when he pioneered Weltspiegel, a TV format giving Germans greater access to the world, and became celebrated as Washington correspondent. Bölling was considered unworthy to serve in the Wehrmacht in the second world war. His Jewish mother narrowly escaped from Auschwitz. He epitomised the revival of post-war Germany, became a man of the world in the Schmidt years and remains a monument to a spirit of constructive trans-Atlanticism at a time of sometimes troubled US-German relations.

# Testing time ahead for Renzi

## Italy faces headwinds on long path to recovery

Celeste Cecilia Lo Turco, Advisory Board

**Matteo Renzi, the Italian prime minister, appears to have achieved a measure of stability after two short-lived governments under Mario Monti (17 months) and Enrico Letta (10 months).**

His Democratic Party won a surprisingly high 40% of the votes in the May European parliament elections, but otherwise he remains untested, and unconfirmed, in a nationwide Italian poll. The country's position is not helped by the relatively poor performance of Italian banks in the European banking assessments – the asset quality review and the stress tests – unveiled on 26 October and by the world economic slowdown.

Renzi has achieved some successes in his first eight months, but his honeymoon is over. The milestones include reforms of the education and labour systems and the passing of an 'Unblock Italy' decree to improve Italian infrastructure and exports. On the European level, Italian minister for foreign affairs Federica Mogherini was appointed EU representative for foreign and security policy. Italy headed off a clash with the European Commission when the government adjusted its 2015 budget by making extra fiscal tightening measures.

### Economic reforms

But there has been no substantial progress on economic reforms expected by many Italians and the wider business and financial community. These are becoming more urgent.

Unemployment is 12.3%, and a third of under-25s are jobless. Sovereign debt has increased to more than €2tn, 135% of GDP, with deflation and recession (GDP will fall 0.1% this year) adding to the debt in real terms. Much needs to be done, from radical reform of the judicial system to reshaping the public administration, from improving labour market opportunities to the creation of a sustainable pension system.

Many of these issues were being addressed by the finance ministry's spending review led by Carlo Cottarelli. But after his recommended cuts fell on deaf ears, he is returning to Washington where he will take over the vacant Italian executive directorship at the International Monetary Fund.

In considering solutions, many Italians would like to think of Italy not as a single country, but as one element in a larger monetary union with tools to support countries in difficulty.

Unfortunately, not all countries in the euro area – especially Germany – see things that way. The problem is that debtor countries in Europe such as Italy would like confirmation that Europe is a union providing equal benefits to its members, and use this understanding as a springboard for radical structural and cultural change. With the creditor countries, led by Germany, the direction of causality is the other way around. There will be no further solidarity between debtor and creditor countries – and probably a great deal less – unless and until countries like Italy can show they are capable of genuine reform.

### Expansionary monetary policy

After an improvement in confidence which lasted until spring, the Italian economy has begun to weaken again. Fiscal adjustment is required to avert a recessionary spiral of demand, and expansionary monetary policy is needed to prevent excessively low inflation.

But favourable elements remain. Despite recession and deflation, the Italian market is still considered potentially attractive. Last year Italy benefited from an overall reallocation of sovereign wealth funds' portfolios that prioritised investments in Europe. Italy attracted SWF investments of $1.5bn, more than double the $0.7bn attracted in 2012, according to a report by Bocconi University. Household consumption has improved and difficulties in obtaining bank credit have eased, even though they still persist for smaller businesses, according to latest findings from the Banca d'Italia.

Italy has the second-highest sovereign debt in the euro area after Greece. Economists often make the point that much of this debt is owned domestically and is supported by a high level of sovereign assets and gold reserves. On the other hand, Italy's net foreign debt position has worsened alarmingly as latest IMF figures show.

Renzi's government has tabled plans to encourage growth and reduce sovereign debt. One idea is to increase the international presence of 22,000 Italian companies to boost exports and increase GDP by 1% in coming years.

Another is to give new mothers and low-income workers €80 a month, and provide employee severance pay – Trattamento di Fine Rapporto – directly to workers. Furthermore, Renzi wants to reduce the number of public service companies controlled by city and regional governments, including around 1,500 local utilities, by offering incentives for privatisations and mergers. The planned reduction of state-owned enterprises from 8,000 to 1,000 over three to four years and the divestment of government-owned real estate assets are designed to reduce costs, improve profitability and increase attractiveness for domestic and foreign investors.

### Debt restructuring

However, a long and tortuous journey, not least the battle to reduce unemployment, lies ahead. Italy has not been forced by the crisis to adhere to formal European debt alleviation and austerity programmes, nor has it considered other ways to restructure the sovereign debt.

According to Italian businessman Marco Carrai, the sovereign debt could be reduced through the creation of an Italian Maxi Fund able to turn the non-profitable assets owned by the Italian government into profitable ones, attractive for institutional long term investors.

The expected reduction of sovereign debt through this mechanism is €2-3bn, a small amount compared to overall foreign debt.

Ashoka Mody, Princeton professor and former deputy director at the International Monetary Fund, and Lucrezia Reichlin of the London Business School, have proposed debt restructuring to incentivise growth and recovery.

According to Mody, the nation's mounting debt, coupled with a shrinking economy, is close to unsustainable. Without an extraordinary fiscal effort, economic growth or currency depreciation, Renzi should start restructuring Italy's debt. According to Reichlin, Italian sovereign debt should be partially restructured through the depreciation of treasury bonds or the postponement of their terms of payments.

This mechanism would affect mainly banks and bond owners. It would require collateral intervention by the European Central Bank, as well as more international policy co-operation in addressing excessive global leverage.

Italy's recovery will take time, and will depend on efforts at multiple levels contributing to the stability of international financial markets.

All this will require great patience – including from international capital markets. ▪

Celeste Cecilia Lo Turco, member of the OMFIF Advisory Board, is a sovereign wealth fund expert for the SWFs Strategic Committee of the Italian Ministry of Foreign Affairs and the SWFs Law Centre.

# French government's pro-business crusade

## Valls and Macron court problems with Socialist left

Paul Betts, Advisory Board

**French socialist Prime Minister Manuel Valls seems too good to be true. In the past few months he has managed to charm the French and European business elite with his surprisingly vigorous pro-business and reformist economic policies.**

He has sought to reassure his European partners that France is committed to putting its economic and financial house in order.

### Rothschild banker

Valls forms an impressive tandem with his young economy minister Emmanuel Macron.

The former Rothschild banker is pushing forward with reforms to make the domestic economy more competitive. These include measures cutting the hefty social charges paid by employers, easing the rules on Sunday trading, ending monopolies in certain professions such as notaries and pharmacists, simplifying labour laws and reducing some of the red tape that has hampered development, especially for small and medium-sized companies.

Valls and his economy minister want to cut €50bn in public spending over the next few years starting with €21bn next year. As for business big or small, Valls has publicly said he 'loves' them – a sentiment that enraged many of his more left-wing Socialist colleagues.

While many in France openly admit that the country needs reform and that a pragmatic centre-left social democrat may be well equipped to do this, many socialists still hang on to their old ideological roots and are out to sabotage Valls' efforts. In a recent vote of confidence, 31 socialist deputies abstained.

At the end of October 39 abstained, including two former ministers in the previous socialist government, in the vote on budget spending (important in trying to persuade Brussels that France should be allowed a couple of years to reduce its budget deficit below 3% of GDP).

As for President François Hollande, who appointed Valls in the first place, he has been keeping to the sidelines to see if Valls can provide him with a political boost to help improve his dreadful popularity ratings.

Valls is wary of the president. His mentor was after all Michel Rocard, the reformist centre-left prime minister, who was systematically outmanoeuvred politically by old-style socialist President François Mitterrand. And Mitterrand was in many respects the political mentor of Hollande.

Valls, just as Michel Rocard once did, nurtures presidential ambitions. To be associated too closely with the unpopular Hollande is unlikely to improve his chances in the 2017 presidential election race. So it was only a simple political calculation that he needed to differentiate himself from his president to stand any hope of running as the socialist candidate in the next presidential election.

Even then he has to win over the harder left elements of his party in a contest that is likely to see in the ring one of the old political elephants of the right – either Nicolas Sarkozy or Alain Juppé – as well as the increasingly popular National Front leader Marine Le Pen.

So how can Valls make a difference and boost his chances? One controversial answer might be to recruit Dominique Strauss-Kahn to Valls' cause to give weight to his programme and reinforce his reformist commitment.

### Lying low

Strauss-Kahn these days is lying low after a series of scandals that interrupted his impressive career that at one stage seemed likely to be crowned in 2012 by becoming president instead of François Hollande.

The former IMF boss was one of the most popular post-war French economy ministers. Under his watch GDP increased and unemployment and public debt fell. He is involved with a hedge fund in Luxembourg, and is on the board of both the Russian Regional Development Bank and the Russian Direct Investment Fund. Strauss-Kahn has been acting as an economic advisor to the Serbian government and helped set up a bank for the South Sudan government. Unfortunately the suicide of a business accomplice in October has added a further scar to Strauss-Kahn's recent record.

In France, voters have short memories for sexual misbehaviour and longer memories for career accomplishments and economic competence. Valls has long known Strauss-Kahn and they see eye to eye on most political and economic issues.

Strauss-Kahn as a key adviser, or perhaps in a more formal role, would certainly bring heavyweight status to Valls' likely presidential bid. The former finance minister's elevation would make it much harder for Hollande to run again as the socialist candidate for a second mandate.

The big question is whether Valls could take the risk of bringing into his team a man who in a few short years has run the gauntlet of more unsavoury episodes than most politicians might experience in decades. ▪

**French economy: bad news on unemployment and growth**
GDP, unemployment and gross government debt, 2004-14

Source: IMF World Economic Outlook database, October 2014. 2014 figures are IMF estimates for the whole year.

Paul Betts, member of the OMFIF Advisory Board, is a former Financial Times correspondent in Paris and writes on international economics.

# Guarding against regulatory procyclicality

## Commission can help mitigate unintended consequences

Mojmír Hampl, Czech National Bank

**From a bird's-eye perspective, it seems that regulatory policy is usually procyclical. In bad times we try to tighten the reins. In good times we tend to leave them too loose.**

This is probably just human nature; monetary policy fortunately exhibits different behaviour. It is good to be aware of these tendencies, even if we don't know how to avoid them.

I sometimes use the metaphor of a patient. Our patient – the financial intermediation sector – suffered a severe heart attack in 2008 and was close to cardiac arrest. We managed to bring him round, but since then we have frantically been stuffing him with various medicines, drugs and medications at the same time in an attempt to cure him of every known, apparent or even hypothetical disease.

### Cumulative effects

Like doctors, we are entirely unable to predict the overall cumulative effects of all these drugs, pills and treatments. A single drug used in isolation may be effective, but we cannot know what effects our combination of treatments will have in the long run once the patient is back on his feet.

At the very least, this should make us stop and think before administering any more new drugs. Bear in mind that the European Union's Capital Requirements Regulation and Capital Requirements Directive IV alone run to 400 pages of dense text.

Many related technical standards and guidelines are being drawn up at European Banking Authority level. The new regulations were only recently recast – or are still being recast – into secondary legislation in EU countries. The EBA alone has received more than 2,400 single queries on the application of specific provisions from supervisory authorities and market participants. And that is just one – albeit significant – element of the new regulatory architecture in the EU. Sometimes it is good to be aware of the scale of the treatment.

We know implicitly that, regardless of our efforts, financial intermediation will always be inherently risky in our monetary system. It is hard to eliminate all its risks once and for all. Unfortunately, the financial sector suffers from a similar trilemma as the health sector.

No health care system can ever be cheap, good and universally available all at the same time. Only two of these three conditions can be satisfied simultaneously.

Likewise, no financial sector can be perfectly efficient, totally safe for depositors and investors, and simultaneously free of moral hazard and public support. Again, you can only ever satisfy two of these principles entirely.

### Financial intermediation

We are currently trying to go down the path of greater security (with banks more like post offices and less like hedge funds). Yet is hard to estimate the toll this will take in terms of moral hazard and the efficiency and smoothness of financial intermediation.

These side-effects are visible in the Czech Republic. Europe has introduced a single deposit insurance scheme for credit institutions up to a national currency-equivalent of €100,000. This insurance covers not only bank deposits, but also deposits in smaller credit institutions such as credit unions, which are subject to the same regulations.

Until the deposit insurance legislation was harmonised, the Czech Republic had a system of co-insurance where savers would get no more than 90% of their deposits back.

After harmonisation, which we had some concerns about, something interesting happened. The Czechs – like the Germans – are a nation of small savers. Households are net creditors and the loan-to-deposit ratio is under 100%.

Consequently, the policy of low interest rates is unpopular and is motivating traditionally conservative Czech savers to seek alternatives to normal savings deposits. Czechs have worked out where they can make their savings work harder without losing the state guarantee.

### Accrued interest

The introduction of 100% deposit insurance of up to €100,000 including accrued interest has led to a surge in interest in credit unions, which have an inherently riskier business model than banks and offer higher rates of return on deposits.

All that savers are thinking about is the 100% deposit guarantee. The surge has at times been strong enough to cause the credit union business model to collapse, and we have been forced to close down several of these institutions. This, in turn, has had an impact on the funding sources of the deposit insurance fund.

I'm not trying to say that many of the trends in regulatory thinking are unworkable or wrong. I do believe, however, that we should move slowly away from creating more and more new regulations towards thinking about all the unintended cumulative effects of what we are doing.

I have high expectations that the new European Commission will make a positive impact here. ▪

Mojmír Hampl is Vice Governor & Board Member of the Czech National Bank.

**Transformation of the economy and financial system in Hungary and the CESEE region**

György Matolcsy

**1 December 2014**
**Central Bank of Hungary, Budapest**

The first Economist Meeting jointly held by the Central Bank of Hungary (MNB) and OMFIF in Budapest, features contributions by Governor György Matolcsy and senior officials of the Bank. Local and international delegates discuss the outlook for Hungary's economy and the broader region in central, eastern, and south-eastern Europe.

For more information, please contact Anne Scherer: meetings@omfif.org.

# Monetary austerity explains everything

## Markets should examine money and credit data

Steve H. Hanke, Advisory Board

**In attempting to decipher the state of the European economy, many financial analysts have failed to keep their eyes focused on money and credit — the metrics that dominate. Continental Europe's three largest economies are in the grip of monetary austerity.**

Germany, Europe's economic locomotive, surprised everyone, with GDP shrinking by 0.2% in the second quarter of the year.

Data on German money and credit tell the tale. Since early 2012, the money supply, broadly measured, has registered very anaemic growth and credit has been declining.

### Tight monetary stance

This tight monetary stance, coupled with the repercussions of economic sanctions on Russia over the Ukrainian dispute, has taken the steam out of the German powerhouse.

In France, the euro area's second biggest economy, growth was flat in April-June for the second consecutive quarter.

With no growth in sight, Michel Sapin, the finance minister, threw in the towel and announced that France would not be able to meet its fiscal deficit target of 3.8% of GDP for 2014. The explanation is relatively clear – money and credit growth has been flat since early 2012.

In Italy, Prime Minister Matteo Renzi's honeymoon ended abruptly in early August, when Italy entered a triple-dip recession, contracting for two successive quarters for the third time since 2007.

Money growth in Italy has been flat for some time, and credit has been slowly shrinking since early 2009.

To find explanations for all this, we must revert to John Maynard Keynes at his best. Specifically, we must look at his two-volume 1930 work, *A Treatise on Money* – a work that Milton Friedman wrote about approvingly in 1997. Keynes separates money into two classes: state money and bank money.

State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation. Keynes spends many pages in the Treatise dealing with bank money.

This isn't surprising because bank money was much larger than state money in 1930.

Today, bank money accounts for about 90% of the total euro area money supply, measured by M3.

Anything that affects bank money dominates the production of money. And here we have to look at the issue of bank regulations – courtesy of the Basel regulatory procedures, backed by every political forum in Europe.

These new regulations have been ill-conceived, pro cyclical, and fraught with danger. And, by keeping bank money tight, they provide the main reason for the sluggish money and credit data.

The authorities have around 6,000 bureaucrats combing over 135,000 loan files at 130 of Europe's largest banks, aiming to make Europe safe from banks and bankers.

Bankers who have been covering up bad loans will be found out and taken to the woodshed; zombie banks will be liquidated or recapitalised. The Single Supervisory Mechanism, the pan-European mechanism for banking supervision under the aegis of the European Central Bank, started on 4 November. This will usher in stress tests as far as the eye can see. Bank money will remain tight.

### Poor economic performance

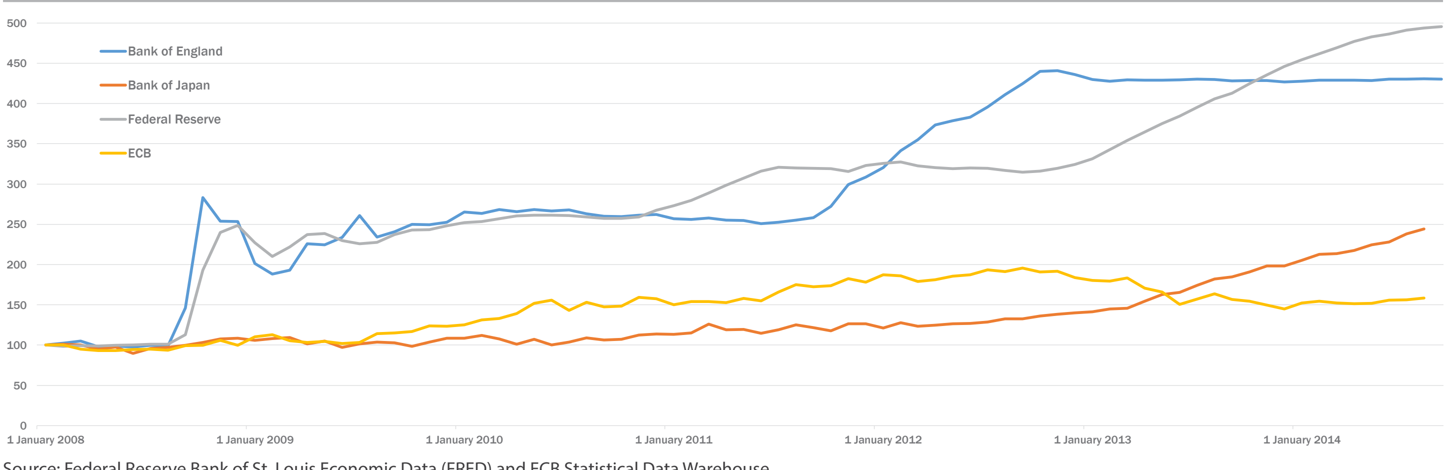
Continental Europe's poor economic performance is not only a problem of banks failing to produce money and credit. Europe's stagnation and slump are also the result of major structural economic rigidities, in other words, lack of free markets. Mario Draghi, the ECB president, has repeatedly called for structural reforms.

If market-liberating reforms were implemented, that would give the euro area much-needed confidence boost. But that would not be enough. Money and credit fuel economies. Without enough fuel, economies stall. Moreover, money dominates fiscal policy.

Until Draghi and his colleagues start to release the regulatory squeeze on banks, bank money and credit – and the euro area as a whole – will remain in the doldrums. ▪

Steve H. Hanke, member of the OMFIF Advisory Board, is Professor of Applied Economics at the Johns Hopkins University in Baltimore, and Senior Fellow and Director of the Troubled Currencies Project at the Cato Institute in Washington.

### How ECB balance sheet has fallen – Central bank assets, national currencies, 1 Jan 2008=100




Source: Federal Reserve Bank of St. Louis Economic Data (FRED) and ECB Statistical Data Warehouse.





# Time to respect German prudence

## The case against European quantitative easing

Tim Young, former Bank of England Market Operations Official

**Ever since the Bank of England and the Federal Reserve responded to post-crisis sluggish recovery with quantitative easing, the European Central Bank has been under pressure to follow suit.**

An unholy alliance of lobbyists rarely misses a chance provided by weak inflation or economic activity to exhort the ECB to adopt QE. They include indebted euro area governments hoping to forestall politically difficult structural reform, banks with large holdings of the lower-rated countries' government bonds, investment banks hoping to structure and trade the riskier assets into which QE typically displaces investors, and established economic commentators on the right side of QE-inflated property and stock prices.

Opposition to QE has emanated from the more conservative members of the ECB governing council, particularly its German members. Concerned that government bond QE comes too close to monetary financing, they are also wary of the potential for disputes over the allocation of purchases of bonds of the various member states of the monetary union.

### Monetary policy

Until now, the standoff has meant that the ECB has largely abstained from QE, albeit with the exception of a couple of closely-related schemes. In May 2010 the ECB began to buy modest amounts of peripheral country government bonds under its 'securities markets programme' to 'restore an appropriate monetary policy transmission mechanism'.

Then it introduced its Outright Monetary Transactions backstop programme, which set such stringent conditions for deployment that it has yet to be used at all.

Since he became ECB president in November 2011, Mario Draghi has been remarkably successful at steering the ECB between the clamour for easier monetary policy including QE, and the resistance of his more hawkish governing council colleagues.

No doubt Draghi has gauged the political viability of proposed actions in private discussions with euro area politicians.

He acquired a reputation as a magician with his 26 July 2012 pledge to 'do whatever it takes to preserve the euro', backed up with the prospect of OMT, which succeeded in rapidly lowering peripheral country bond yields without need for any ECB action. So successful has that trick proved that the once-troubled 10-year bonds of countries like Spain and Ireland now trade at similar or lower yields than those of QE-embracers the UK and US.

Unfortunately, the return of euro area economic weakness this year, together with tension over Ukraine, lower growth in China and below-target inflation, revived calls for extreme easing measures.

### Innovative easing initiatives

The ECB responded with a couple of innovative easing initiatives, including a cut in policy rates which set the deposit rate at a negative level, and an offer to banks of long-term funding conditional on business lending (Targeted Long Term Repo Operations).

These had insufficient market impact, so Draghi tried the QE-hint trick again. Straying from his prepared speech at the Jackson Hole conference on 22 August, he promised to 'use all the available instruments needed to ensure price stability over the medium term'.

This was followed on 2 September with a plan to expand the ECB balance sheet by about €1tn, using a combination of increased TLTROs and, significantly, outright purchases of asset backed securities and covered bonds.

While this package has weakened the euro, which will counteract falling inflation to some extent, it is failing either to satisfy the QE-lobby or to reassure the ECB hawks. One problem is that it is unclear that sufficient ABS and covered bonds exist to operate the programme at an acceptable cost.

Moreover, the pressure on size has been exacerbated by the disappointing take-up of TLTROs since the plan was launched.

The ECB has responded by trying to broaden the eligibility criteria to include corporate bonds, but this has generated a second problem, which is that it is becoming doubtful whether Draghi will be able to command sufficient political support to deliver such an extended programme.

German Finance Minister Wolfgang Schäuble has been critical of a proposal that euro area governments guarantee the riskier tranches of ABS to allow the ECB to buy them.

Naturally, the QE lobby would argue that the answer to the bond supply problem is for the ECB to buy euro area government bonds, of which there are about €6tn outstanding. But Germany's patience with endless chivvying to accept expanded ECB easing, and now to undertake fiscal stimulus too, is wearing thin.

The Germans worry about their near-80% government debt to GDP ratio. And they know that as the largest ECB shareholder, when the next two shareholders have debt ratios of over 90% for France and 130% for Italy and climbing, there is a real prospect that if unconventional monetary policy generates substantial losses for the ECB, Germany will be left holding large losses.

France and Italy show no sense of urgency to undertake the structural reforms that would improve their fiscal positions, repeatedly promising and failing to deliver on EU fiscal targets. And to dispel any sense of solidarity that the German people might feel with the French and Italians, it appears that while French and Italian citizens are reluctant to pay tax, their households, thanks to higher property ownership, are richer than Germans'.

### German public attitudes

So far, the only significant action reflecting this hardening of German public attitudes to ECB adventurism has been the referral of the OMT programme to the German Constitutional Court. It considered OMT to be beyond the ECB's mandate and referred it to the European Court of Justice. This case has the potential to result in chaos, if the ECJ approves OMT but the German constitutional court forbids the Bundesbank to participate.

If Draghi continues to cajole the Germans to go along with riskier easing measures than they feel comfortable with, there is a danger of provoking a backlash in which the Germans assert their power as the ECB's effective bagholder regardless of the niceties of voting rules, exposing some uncomfortable truths about the monetary union.

Instead, Draghi would be wiser to back off, and respect the concern for risk management that explains German resistance to both further monetary and fiscal easing, declaring that monetary policy has done all it can to mitigate falling economic activity and inflation. ▪

Tim Young is former Market Operations Official of the Bank of England and Lecturer in Finance and Economics at the University of York.

# Weakening of the powerhouse

## Economic policy restrains corporate investment

Michael Holstein, DZ BANK

**DZ BANK Economic Forecast Table**

**GDP change (%)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| US | 1.6 | 2.3 | 2.2 | 2.2 | 2.8 |
| Japan | -0.4 | 1.5 | 1.5 | 1.0 | 1.2 |
| China | 9.3 | 7.37 | 7.7 | 7.3 | 7.2 |
| Euro area | 1.6 | -0.6 | -0.4 | 0.6 | 0.8 |
| Germany | 3.6 | 0.4 | 0.1 | 1.3 | 1.0 |
| France | 2.1 | 0.4 | 0.4 | 0.3 | 0.7 |
| Italy | 0.7 | -2.3 | -1.9 | -0.3 | 0.5 |
| Spain | 0.1 | -1.6 | -1.2 | 1.2 | 1.7 |
| UK | 1.6 | 0.7 | 1.7 | 3.0 | 2.3 |

**Addendum**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Asia excl. Japan | 7.4 | 6.2 | 6.2 | 6.2 | 6.4 |
| World | 4.0 | 3.3 | 3.1 | 3.3 | 3.8 |

**Consumer prices (% y/y)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| US | 3.2 | 2.1 | 1.5 | 1.7 | 1.9 |
| Japan | -0.3 | 0.0 | 0.4 | 2.9 | 2.2 |
| China | 5.4 | 2.7 | 2.6 | 2.1 | 2.6 |
| Euro area | 2.7 | 2.5 | 1.4 | 0.5 | 1.0 |
| Germany | 2.5 | 2.1 | 1.6 | 0.9 | 1.5 |
| France | 2.3 | 2.2 | 1.0 | 0.6 | 0.8 |
| Italy | 2.9 | 3.3 | 1.3 | 0.2 | 0.6 |
| Spain | 3.1 | 2.4 | 1.5 | 0.0 | 0.4 |
| UK | 4.5 | 2.8 | 2.6 | 1.6 | 1.9 |

**Current account balance (% of GDP)**

| | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| US | -2.9 | -2.7 | -2.4 | -2.4 | -2.4 |
| Japan | 2.1 | 1.0 | 0.7 | 0.5 | 0.7 |
| China | 1.9 | 2.6 | 2.0 | 1.8 | 1.5 |
| Euro area | 0.1 | 1.4 | 2.4 | 2.5 | 2.5 |
| Germany | 6.1 | 7.1 | 6.8 | 6.9 | 6.2 |
| France | -2.2 | -2.2 | -1.3 | -1.4 | -1.0 |
| Italy | -0.5 | -0.5 | 1.0 | 1.2 | 1.3 |
| Spain | -4.4 | -1.2 | 0.8 | 1.5 | 2.0 |
| UK | -1.4 | -3.6 | -4.1 | -4.3 | -4.0 |

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

**The German economy slowed appreciably during the summer. The Ifo business climate indicator companies, which started 2014 at the highest for 30 months, has fallen significantly.**

The cooling was even more pronounced in the monthly ZEW financial analysts survey. The key figure for economic expectations, which at the beginning of the year hit a seven-year high of over 60 points, turned negative in October, with pessimists exceeding optimists for the first time since end-2012.

The 'hard' economic data tell a similar story, even compared with the decidedly weak second quarter. Interpretation of July and August production data is complicated by holiday effects, since school holidays in 2014 were very late in many federal states.

The median for both summer months shows that industrial output eased 0.5% compared with the second quarter average, with the fall most pronounced among intermediate goods producers.

Following good figures in July, incoming manufacturing orders plummeted in August. The July-August balance was roughly unchanged compared with the spring, with domestic orders down 1.5%, while foreign orders were up 0.5%, thanks to an above-average big-ticket intake in July.

The construction sector performed disappointingly, with the July-August figure only just matching the weak prior quarter level. German industry as a whole can be expected to make a slightly negative contribution to third quarter output.

In July and August, foreign trade likewise fluctuated sharply. Exports rose 2% in the summer months compared with the spring quarter, while imports dipped slightly. The third-quarter foreign trade balance remains positive, rising even to a multi-year high due to relatively low imports. The current account surplus for 2014 as a whole is expected to rise slightly as well, from 6.8% of GDP in 2013 to 6.9% in 2014.

Retail sales showed a positive trend. Consumer spending is still benefiting from strong growth in employment and rises in real wages. Employment has risen by an average 35,000 a month since January 2014, and in September was 0.8% higher than a year previously at a total of 42.7million. The rise was greater for jobs subject to social insurance, where growth was 1.8%.

However, the labour market is starting to cool. Seasonally adjusted unemployment has risen in four of the last five months.

Overall, third quarter output will probably show at best stagnation. Following the small contraction in the prior quarter, the German economy will only just avoid a 'technical' recession, a bitter disappointment after the optimistic growth expectations at the beginning of the year.

Since then, foreign trade conditions have developed less favourably. Neighbouring European countries, led by France and Italy, are recovering more slowly than expected.

Neither has demonstrated necessary willingness to reform. Global economic momentum has been disappointing, reflecting various geopolitical upheavals as well as weak growth in key emerging economies.

Germany's domestic policy, too, has held back corporate investment. The government's pension reforms and the introduction of a national minimum wage from 2015 will depress growth. Lowering the pensionable age to 63 with unchanged social benefits sets inappropriate incentives and counteracts the goal of raising the proportion of older employed persons. The minimum wage may boost structural unemployment.

For 2014 growth is expected to be just 1.3%, with momentum gradually picking up again in 2015, buttressed by somewhat improved foreign trade. German exports should grow slightly faster in 2015 and private consumer spending will remain a positive factor. Investments in plant and equipment will remain subdued, with the lacklustre outlook depressing investment spending.

All in all, and taking into account the lagged effect of the buoyant start to 2014, 2015 GDP growth is projected at just 1.0%.

The German inflation rate will edge back up, from 0.9% in 2014 to 1.5% in 2015. Partly as a result of the minimum wage, unit labour costs will rise more quickly and residential rent increases will continue above all in urban areas. ▪

Michael Holstein is Head of Macroeconomics of DZ BANK.





# European trade trends

## Structure of foreign trade

**Structure of foreign trade: Germany**

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 63.4 | 57.6 | 65.0 | 57.6 | 61.4 | 57.7 | 4.3 | 4.3 | 4.2 |
| Euro area(18) | 43.8 | 37.5 | 44.8 | 36.8 | 42.5 | 38.3 | 3.7 | 3.7 | 3.7 |
| EMU core (BE,NL,AUS) | 17.3 | 17.0 | 17.6 | 15.8 | 16.9 | 18.5 | 4.8 | 4.4 | 5.3 |
| France | 9.7 | 8.2 | 10.2 | 9.0 | 9.1 | 7.1 | 3.1 | 3.6 | 2.3 |
| EMU periphery (IT,ES,PT,IRL) | 13.4 | 9.1 | 13.7 | 8.9 | 13.0 | 9.5 | 2.0 | 2.2 | 1.9 |
| Poland | 2.8 | 4.1 | 2.5 | 4.0 | 3.0 | 4.2 | 9.0 | 8.6 | 9.5 |
| Turkey | 1.5 | 1.6 | 1.5 | 1.8 | 1.4 | 1.4 | 7.4 | 9.0 | 5.3 |
| UK | 7.2 | 6.0 | 8.3 | 7.1 | 5.8 | 4.7 | 3.2 | 3.8 | 2.2 |
| Russia | 2.2 | 3.7 | 1.9 | 3.0 | 2.6 | 4.5 | 12.3 | 14.0 | 11.1 |
| Brazil | 0.7 | 1.0 | 0.6 | 1.0 | 0.8 | 1.0 | 6.5 | 6.2 | 6.9 |
| India | 0.4 | 0.8 | 0.4 | 0.8 | 0.5 | 0.8 | 12.0 | 11.3 | 13.1 |
| US | 8.2 | 6.9 | 9.0 | 8.3 | 7.2 | 5.4 | 3.1 | 3.8 | 1.9 |
| China | 3.9 | 7.2 | 2.9 | 6.3 | 5.1 | 8.1 | 13.6 | 16.3 | 11.8 |
| Asia | 13.7 | 17.2 | 11.7 | 16.5 | 16.3 | 17.9 | 7.4 | 8.9 | 6.0 |
| Eastern Europe (PL,CZ,HU) | 7.6 | 9.3 | 6.9 | 8.5 | 8.7 | 10.3 | 7.7 | 7.5 | 7.9 |

Germany increased its trade with the rest of the EU by an annual average of 4.3% during the period 1999-2013, and with the euro area by 3.7% – compared with 13.6% in the case of China and 12.0% in the case of India.

**Structure of foreign trade: France**

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 65.5 | 59.2 | 67.3 | 59.3 | 63.6 | 59.1 | 2.8 | 2.1 | 3.5 |
| Euro area(18) | 52.8 | 47.7 | 52.1 | 46.4 | 53.5 | 48.8 | 3.0 | 2.2 | 3.7 |
| EMU core (BE/LUX,NL,AUS) | 13.1 | 13.3 | 13.0 | 12.6 | 13.3 | 13.9 | 3.5 | 2.7 | 4.3 |
| Germany | 17.4 | 17.0 | 15.9 | 16.5 | 18.8 | 17.5 | 3.7 | 3.2 | 4.2 |
| EMU periphery (IT,ESP,PT,IRL) | 20.5 | 15.6 | 18.6 | 15.5 | 22.5 | 15.7 | 1.7 | 1.9 | 1.6 |
| Poland | 1.1 | 1.6 | 1.2 | 1.6 | 0.9 | 1.6 | 9.1 | 6.3 | 12.7 |
| Turkey | 1.1 | 1.3 | 1.2 | 1.4 | 0.9 | 1.2 | 6.7 | 5.4 | 8.3 |
| UK | 8.0 | 5.5 | 9.4 | 7.0 | 6.5 | 4.2 | -0.2 | 0.1 | -0.6 |
| Russia | 1.4 | 1.9 | 0.9 | 1.6 | 2.0 | 2.1 | 10.5 | 12.6 | 9.2 |
| Brazil | 0.6 | 0.8 | 0.5 | 1.0 | 0.8 | 0.6 | 5.9 | 7.0 | 4.6 |
| India | 0.4 | 0.8 | 0.3 | 0.6 | 0.5 | 1.0 | 8.8 | 7.6 | 9.6 |
| US | 6.4 | 6.4 | 6.6 | 6.3 | 6.3 | 6.6 | 1.9 | 1.6 | 2.1 |
| China | 3.0 | 6.1 | 1.5 | 3.5 | 4.5 | 8.4 | 11.7 | 11.0 | 11.9 |
| Asia | 10.3 | 14.0 | 7.6 | 12.1 | 13.1 | 15.6 | 6.3 | 6.9 | 5.9 |
| Eastern Europe (PL,CZ,HU) | 2.3 | 3.3 | 2.5 | 3.1 | 2.1 | 3.5 | 8.6 | 6.5 | 10.8 |

France increased its trade with the rest of the EU by an annual average of 2.8% during the period 1999-2013, and with the euro area by 3.0% – compared with 11.7% in the case of China and 8.8% in the case of India.

## Structure of foreign trade: Italy

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 63.0 | 55.4 | 63.4 | 54.6 | 62.6 | 56.3 | 2.7 | 2.7 | 2.7 |
| Euro area(18) | 51.0 | 44.0 | 49.0 | 41.6 | 53.0 | 46.6 | 4.2 | 4.1 | 4.3 |
| EMU core (BE,NL,AUS) | 10.4 | 9.8 | 7.6 | 7.5 | 13.2 | 12.4 | 3.4 | 3.4 | 3.4 |
| Germany | 16.3 | 13.7 | 14.2 | 12.5 | 18.4 | 15.0 | 1.9 | 1.8 | 1.9 |
| France | 12.0 | 9.6 | 12.7 | 10.7 | 11.4 | 8.5 | 1.8 | 2.5 | 0.9 |
| EMU periphery (ES,PT,IRL) | 8.1 | 5.6 | 9.2 | 5.5 | 6.9 | 5.8 | 1.9 | 0.8 | 3.2 |
| Poland | 1.5 | 2.2 | 1.9 | 2.5 | 1.2 | 1.9 | 7.9 | 6.9 | 9.6 |
| Turkey | 1.6 | 2.0 | 2.0 | 2.5 | 1.3 | 1.6 | 8.4 | 8.8 | 7.7 |
| UK | 6.0 | 4.0 | 7.4 | 5.1 | 4.5 | 2.7 | 0.1 | 1.4 | -1.8 |
| Russia | 2.4 | 3.9 | 1.6 | 2.6 | 3.3 | 5.2 | 11.6 | 13.0 | 11.0 |
| Brazil | 0.7 | 1.1 | 0.6 | 1.2 | 0.9 | 0.9 | 4.6 | 5.1 | 3.8 |
| India | 0.5 | 0.9 | 0.4 | 0.7 | 0.7 | 1.1 | 8.7 | 9.4 | 8.2 |
| US | 5.7 | 5.3 | 8.0 | 7.1 | 3.5 | 3.4 | 1.6 | 1.8 | 0.9 |
| China | 2.7 | 4.5 | 1.5 | 2.6 | 3.8 | 6.6 | 11.1 | 11.9 | 10.8 |
| Asia | 2.8 | 2.8 | 3.2 | 3.8 | 2.5 | 1.7 | 3.4 | 4.8 | 1.0 |
| Eastern Europe (PL,CZ,HU) | 3.2 | 4.4 | 3.9 | 4.6 | 2.5 | 4.3 | 7.7 | 6.6 | 9.2 |

Italy increased its trade with the rest of the EU by an annual average of 2.7% during the period 1999-2013, and with the euro area by 4.2% – compared with 11.1% in the case of China and 8.7% in the case of India.

## Structure of foreign trade: Spain

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 69.8 | 57.8 | 74.9 | 63.3 | 66.1 | 52.7 | 3.2 | 4.4 | 2.1 |
| Euro area(18) | 57.4 | 45.9 | 60.4 | 49.7 | 55.2 | 42.5 | 2.9 | 4.0 | 1.9 |
| EMU core (BE,NL,AUS) | 7.9 | 7.1 | 7.4 | 6.6 | 8.2 | 7.5 | 3.4 | 4.5 | 2.6 |
| Germany | 14.5 | 11.0 | 11.8 | 10.3 | 16.5 | 11.7 | 2.6 | 3.7 | 1.8 |
| France | 17.0 | 13.3 | 19.0 | 15.8 | 15.5 | 11.0 | 2.5 | 4.2 | 0.7 |
| EMU periphery (IT,PT,IRL) | 16.3 | 12.9 | 19.7 | 15.1 | 13.8 | 10.8 | 3.2 | 3.6 | 2.7 |
| Poland | 0.9 | 1.5 | 1.0 | 1.6 | 0.9 | 1.4 | 12.2 | 10.7 | 14.6 |
| Turkey | 1.3 | 1.7 | 1.7 | 2.0 | 1.1 | 1.5 | 10.6 | 9.9 | 11.6 |
| UK | 7.5 | 5.3 | 9.4 | 6.8 | 6.2 | 4.0 | 2.1 | 4.1 | -0.2 |
| Russia | 1.3 | 2.6 | 0.7 | 1.4 | 1.8 | 3.7 | 15.4 | 15.8 | 15.3 |
| Brazil | 0.8 | 1.3 | 0.6 | 1.4 | 1.0 | 1.1 | 6.8 | 7.2 | 6.4 |
| India | 0.4 | 0.7 | 0.2 | 0.5 | 0.6 | 1.0 | 10.6 | 13.5 | 9.6 |
| US | 3.8 | 4.0 | 4.0 | 3.9 | 3.7 | 4.1 | 3.1 | 4.4 | 2.2 |
| China | 2.6 | 4.5 | 0.8 | 1.7 | 3.9 | 7.1 | 11.7 | 15.8 | 11.0 |
| Asia | 10.3 | 13.4 | 5.5 | 9.0 | 13.9 | 17.5 | 7.1 | 8.9 | 6.4 |
| Eastern Europe (PL,CZ,HU) | 2.3 | 3.5 | 2.4 | 3.2 | 2.2 | 3.7 | 11.7 | 10.2 | 13.2 |

Spain increased its trade with the rest of the EU by an annual average of 3.2% during the period 1999-2013, and with the euro area by 2.9% – compared with 11.7% in the case of China and 10.6% in the case of India.





## Structure of foreign trade: Netherlands

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 66.4 | 63.4 | 75.4 | 73.5 | 56.3 | 52.0 | 4.9 | 5.2 | 4.5 |
| Euro area(18) | 60.5 | 57.0 | 71.7 | 71.1 | 47.8 | 40.8 | 6.5 | 7.0 | 5.7 |
| EMU core (BE,AUS) | 12.4 | 11.3 | 13.0 | 12.4 | 11.7 | 10.1 | 4.0 | 3.8 | 4.2 |
| Germany | 22.1 | 20.6 | 24.0 | 24.4 | 19.9 | 16.4 | 4.9 | 5.3 | 4.2 |
| France | 7.8 | 6.4 | 9.9 | 8.3 | 5.5 | 4.3 | 3.5 | 3.9 | 2.7 |
| EMU periphery (IT,ES,PT,IRL) | 9.8 | 7.2 | 11.9 | 8.5 | 7.3 | 5.7 | 3.5 | 3.9 | 3.0 |
| Poland | 1.2 | 2.8 | 1.4 | 3.3 | 1.0 | 2.1 | 13.0 | 13.0 | 13.0 |
| Turkey | 1.1 | 1.3 | 1.2 | 1.6 | 0.9 | 1.0 | 9.7 | 10.4 | 8.5 |
| UK | 8.6 | 7.8 | 10.2 | 8.5 | 6.8 | 7.0 | 3.6 | 4.0 | 3.1 |
| Russia | 1.8 | 3.3 | 1.2 | 1.5 | 2.5 | 5.3 | 16.6 | 12.2 | 19.0 |
| Brazil | 0.7 | 1.0 | 0.2 | 0.6 | 1.2 | 1.5 | 8.7 | 9.1 | 8.6 |
| India | 0.5 | 0.9 | 0.3 | 0.5 | 0.7 | 1.4 | 12.6 | 9.3 | 14.2 |
| US | 6.3 | 5.3 | 4.8 | 4.0 | 8.0 | 6.9 | 3.8 | 5.1 | 3.0 |
| China | 3.1 | 5.2 | 0.8 | 1.8 | 5.8 | 9.0 | 15.7 | 16.8 | 15.4 |
| Asia | 13.6 | 15.4 | 6.8 | 10.1 | 21.3 | 21.3 | 6.8 | 9.1 | 5.8 |
| Eastern Europe (PL,CZ,HU) | 2.8 | 5.5 | 3.1 | 6.5 | 2.5 | 4.4 | 12.8 | 13.5 | 11.8 |

Netherlands increased its trade with the rest of the EU by an annual average of 4.9% during the period 1999-2013, and with the euro area by 6.5% – compared with 15.7% in the case of China and 12.6% in the case of India.

## Structure of foreign trade: UK

| Countries/regions | Share in total trade in % | | Share in total exports in % | | Share in total imports in % | | Average annual growth rates 1999-2013 | | |
|---|---|---|---|---|---|---|---|---|---|
| | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | H2-2003 - H1-2004 | H2-2013 - H1-2014 | total trade | exports | imports |
| EU(28) | 58.5 | 52.2 | 58.9 | 50.6 | 58.2 | 53.3 | 3.9 | 2.8 | 4.8 |
| Euro area(18) | 53.4 | 46.0 | 54.6 | 44.8 | 52.5 | 46.8 | 3.1 | 2.0 | 3.9 |
| EMU core (BE/LUX,NL,AUS) | 12.2 | 12.2 | 13.0 | 13.2 | 11.6 | 11.4 | 4.2 | 3.8 | 4.6 |
| Germany | 13.0 | 12.5 | 11.3 | 10.2 | 14.3 | 14.1 | 4.2 | 2.6 | 5.2 |
| France | 9.0 | 6.3 | 9.8 | 6.6 | 8.5 | 6.1 | 1.7 | 1.6 | 1.9 |
| EMU periphery (IT,ES,PT,IRL) | 15.2 | 11.3 | 17.1 | 12.8 | 13.8 | 10.3 | 2.7 | 2.1 | 3.3 |
| Poland | 0.8 | 1.7 | 0.8 | 1.3 | 0.7 | 1.9 | 13.2 | 8.4 | 17.9 |
| Turkey | 1.1 | 1.5 | 0.9 | 1.3 | 1.2 | 1.6 | 10.0 | 8.4 | 11.4 |
| Russia | 0.9 | 1.7 | 0.8 | 1.7 | 1.1 | 1.7 | 13.0 | 15.2 | 11.8 |
| Brazil | 0.5 | 0.7 | 0.4 | 0.7 | 0.6 | 0.7 | 7.9 | 9.4 | 6.7 |
| India | 1.2 | 1.7 | 1.4 | 1.7 | 1.0 | 1.6 | 10.0 | 9.4 | 10.6 |
| US & Puerto Rico | 11.6 | 9.2 | 15.2 | 13.1 | 8.9 | 6.4 | 2.2 | 3.3 | 0.9 |
| China | 2.8 | 7.1 | 1.3 | 4.5 | 4.0 | 9.0 | 16.2 | 16.6 | 16.1 |
| Asia | 10.7 | 15.4 | 6.7 | 7.9 | 13.8 | 20.9 | 9.4 | 7.5 | 10.1 |
| Eastern Europe (PL,CZ,HU) | 1.9 | 3.1 | 1.9 | 2.4 | 1.9 | 3.7 | 11.6 | 7.6 | 14.8 |

UK increased its trade with the rest of the EU by an annual average of 3.9% during the period 1999-2013, and with the euro area by 3.1% – compared with 16.2% in the case of China and 10.0% in the case of India.

Source: DZ BANK Economics Department.

# Juncker assembles strong Commission team

## UK takes lead on financial reform

Stewart Fleming, Advisory Board

**Jean-Claude Juncker, the former Luxembourg prime minister and head of the Eurogroup of finance ministers, was not everybody's first choice to succeed José Manuel Barroso as president of the European Commission.**

The European parliament backed Juncker to the hilt and won, underpinning its growing political influence. Germany's Chancellor Angela Merkel was said to be lukewarm, but this, perhaps, was just a tactical stance. Foolishly, British Prime Minister David Cameron stridently opposed him. He lost.

### Team Juncker

In the past weeks as Juncker assembled his team of commissioners, those who argued that Juncker's great strength is that he is a man who knows how to get things done in the EU's shadowy corridors of power have been proved right, at least in the short term.

Juncker has correctly identified some of the big issues Europe needs to tackle. This is perhaps not the most difficult task. Beyond this, and more importantly, Juncker has put together a strong team of commissioners.

One signal that, in Juncker, the EU has got itself a top political professional was his unexpected choice of a Briton, Jonathan Hill, a political ally of David Cameron, as commissioner for financial stability, financial services and capital markets union.

Giving the UK and its justifiably maligned City of London financial sector so central a role in continuing the process of financial regulatory and structural reform raised eyebrows. But this choice was a sign that Juncker is a political realist.

He was not going to pick a fight with the UK government because of its campaign against his appointment.

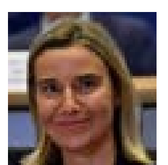
Merkel, it is said, may have had a quiet word in his ear too. So Juncker has carefully balanced the appointment of Hill to the financial sector job by giving a former French finance minister, the knowledgeable and forceful Pierre Moscovici, the role of commissioner for economic and financial affairs, taxation and the customs union.

Given past precedents, Moscovici might have embraced some of the responsibilities which Juncker has passed to Hill.

### The new structure of the European Commission

Frans Timmermans (Netherlands) **First Vice-President**

Jean-Claude Juncker (Luxembourg) **President**



Federica Mogherini (Italy) **High Representative**

**Vice-Presidents**

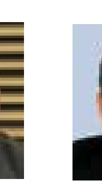
Kristalina Georgieva (Bulgaria)

**Budget and Human Resources**

Andrus Ansip (Estonia)

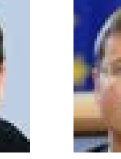
**Digital single market**

Maroš Šefčovič (Slovakia)



**Energy Union**

Valdis Dombrovskis (Latvia)



**Euro and social dialogue**

Jyrki Katainen (Finland)

**Jobs, growth, investment and competitiveness**

**Plus 20 Commissioners**

Source: European Commission

Brussels insiders are watching to see how this decision plays out. The world has changed dramatically in the past two decades. Economic and financial policy cannot be separated – they increasingly overlap.

### Rising to the challenge

But Juncker has given himself the job of himself ensuring the smooth co-operation of these officials, even though they may come from nations that do not always see eye to eye. If that does not work out as he plans, this will cast a dark cloud over the Commission and his leadership.

Re-jigging the economic and finance portfolios is just one of several such changes he has introduced to the responsibilities of the commissioners.

The goal is to try and break up the silo mentality which has plagued the Commission itself for decades. He has, for the first time, appointed seven vice-presidents. One is Juncker's impressive right hand man Frans Timmermans, formerly Holland's foreign minister.

Six vice-presidents, significantly, are from smaller member states, and will be charged with coordinating the work of other commissioners, some from much larger nations.

Valdis Dombrovskis, the former finance minister of Latvia, will be responsible for coordinating much of the work of Hill and Moscovici's directorates general.

Juncker has to play his role of Commission president under the shadow of big member nation states like Germany, France and the UK, which are increasingly pressing for greater clout.

He must also work with an increasingly influential group of smaller states, a more activist Parliament, and the European Central Bank as it takes on a more active role in both monetary and supervisory policies.

Not just Juncker's political skill but also his mental and physical endurance will be tested. Europe and the world must hope he can rise to the challenge. ▪

Stewart Fleming is a journalist and writer on international economics. His latest publications include 'Europe, China and the Group of Twenty' (in 'China, the EU and Global Governance', Edward Elgar, 2012).

# Euro area policies may threaten UK growth

## Britain must renegotiate its position in the EU

Norman Lamont, Senior Adviser

**If there is a Conservative victory in the next general election in 2015, a referendum on Britain's renegotiated membership of the EU will follow.**

David Cameron, the British prime minister, until recently has been remarkably coy about what the renegotiations will be about, but immigration and the issue of the free movement of labour feature increasingly in his speeches. Also on the agenda will be labour market flexibility, crime and justice provisions and the EU goal of 'ever closer union'.

### Europe à la carte

No country can just pick and choose which parts of the EU membership it wants. Europe à la carte should not be available. But there is a logical reason why a renegotiation is unavoidable for Britain. Quite apart from British public opinion, Britain's relationship with Europe has altered because of the coming into existence of the euro area.

The latter acting as caucus constitutes a qualified majority in voting within the EU. There is a danger that laws passed to shore up the euro and encourage the financial integration of the euro could be passed and have an effect on the UK, even though they were not strictly speaking relevant to the UK.

For this reason, the UK does need to have specific provisions to protect itself from decisions made by the euro area spilling over to apply to the UK without good reason.

This, of course, is one of the issues that affect the City of London, a key British interest.

Many Europeans argue that Britain would be mad to leave the EU because of the City of London's need for access to the single market in financial services.

That argument cuts less ice in the UK than might be imagined because Britain already feels that many measures taken now, while we are members of the EU, have been very much against the interests of the City of London.

We have lost many battles on issues like the Alternative Investment Directive and the provisions on bankers' bonuses, which many policy-makers in Britain believe to be erroneous and counter-productive.

To Britain, the current state of the euro area looks like a threat, not only to Britain but the whole world economy.

Many commentators are worried that, if Germany slows down, possibly as a result of slowing Asian markets or the headwinds from sanctions against Russia, this could be even more serious for the euro area as a whole.

For this reason, there has been much interest in the debate within the euro area about the prospects of full scale quantitative easing. The markets seem to have been expecting this ever since Mario Draghi's famous promise 'to do whatever it takes'.

Despite the markets, I have considerable sympathy with the position taken by the Bundesbank on this issue. Of course, as the person who negotiated Britain's non-participation in the euro at Maastricht, I remember very clearly the German fears and warnings of monetisation of debt.

### Competitive adjustments

Then there is the argument over deflation and whether what we are seeing in the euro area is indeed deflation, or as the Bundesbank prefers to call it 'competitive adjustments'. It seems to me rather a semantic argument.

To go on with an extremely low or negative level of inflation for many years will seem very like deflation.

The problem is that the lower German inflation becomes, the greater the adjustment that the peripheral countries in the euro area have to make. There have been remarkable adjustments in the peripheral countries of the euro area.

But in order to restore competitiveness through the mechanism of 'internal devaluation', this process has to go on for many years, perhaps a decade.

To British eyes, the extreme austerity in peripheral Europe has increased the real burden of debt and made it more difficult for the peripheral countries actually to grow their way out of indebtedness.

In Britain, by allowing the automatic stabilisers to work, we have reduced expenditure and in doing so we have gradually allowed more growth in the economy.

It seems to me more probable than not that the euro area faces a very long period of low growth. It is difficult to say that the euro has achieved anything positive for those who live in the euro area. It probably would be in the interests of some of the countries to leave the euro but that is extremely problematic.

When I think of the euro, I am reminded of the design of a lobster pot. A lobster pot is designed so that it is very easy for the lobster to crawl into the pot or trap. But once it is in it, it is very difficult for it to turn around and find the exit.

So, for this reason, I have always avoided predicting the early demise of the euro area. Probably it will persist but I remain sceptical that it is capable of functioning well. ▪

Lord (Norman) Lamont, OMFIF Senior Adviser, is a former Chancellor of the Exchequer. This is an extract from an address at the OMFIF Main Meeting at the Bundesbank in Frankfurt on 16 October.

Millennium Bridge and St. Paul's Cathedral, London

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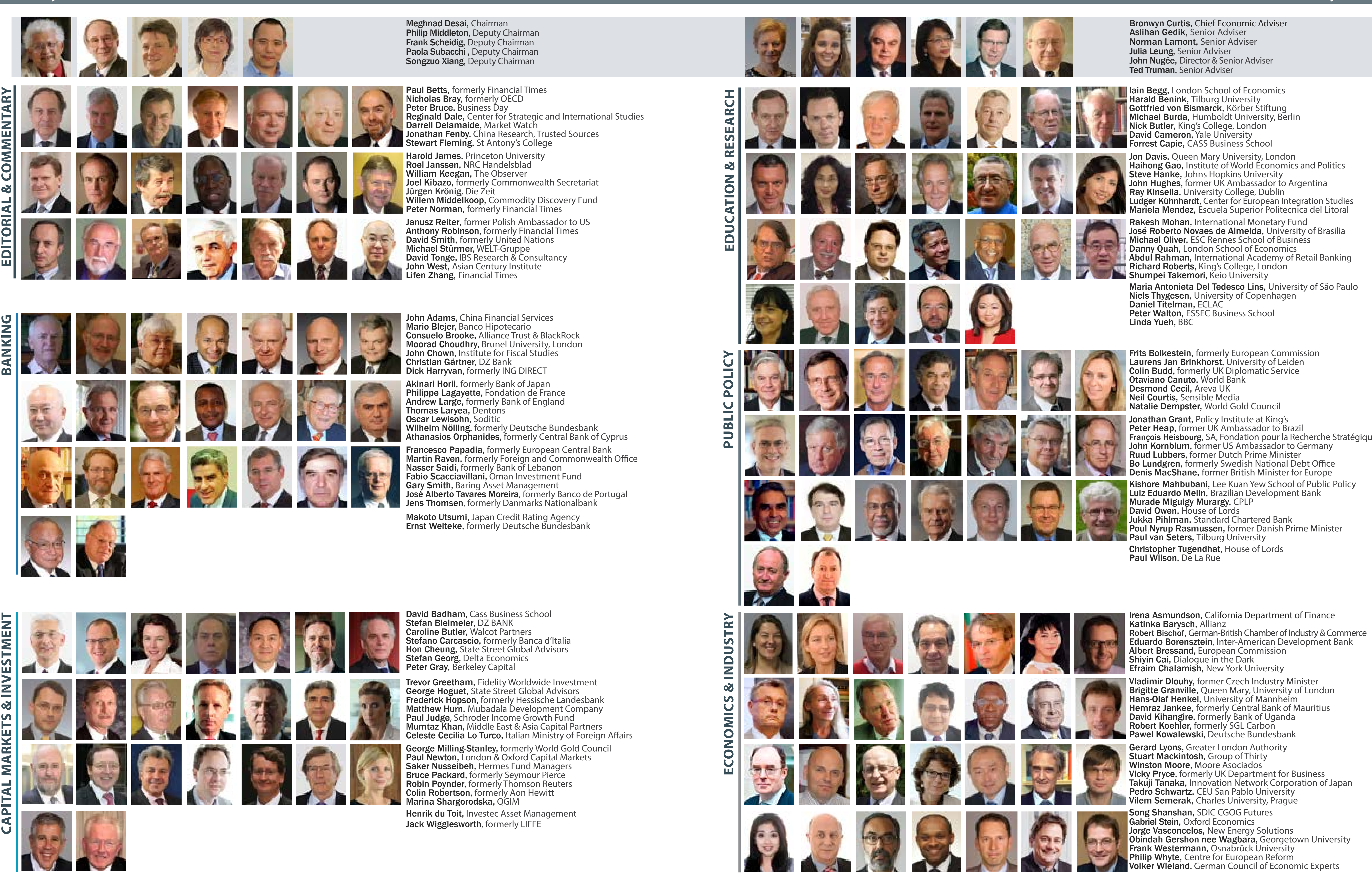

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# Navigating Brazil's path to growth

## Four big challenges for re-elected Dilma Rousseff

Otaviano Canuto, World Bank

**After a dramatic election campaign, President Dilma Rousseff is tasked with restoring the Brazilian economy. She faces four challenges.**

The first will be raising domestic regulated prices in the context of high inflation. Inflation has remained near or above 6.5% per annum, the upper limit of the inflation target, since the second half of 2012.

The main inflationary factors in recent years – services and non-tradable goods – appear to be slowing down, but the ongoing correction of regulated prices, until recently repressed, still has some way to go.

Second, the difficulty of bringing down inflation will be compounded by local currency depreciation. With an increase in US interest rates expected in 2015, Brazil's interest and exchange rates will become more volatile, and that tends to lower the attractiveness of Brazilian securities.

In fact, the real would already have fallen more were it not for the foreign currency hedge transactions which the central bank has offered since last year's 'taper tantrum' (the notional value of which has reached $100bn).

Flows of foreign direct investment have remained stable since 2011, but they have no longer been sufficient to cover the current account deficit, which surpassed 3.5% of GDP last year. The pressure towards devaluation will mount.

This may present an opportunity for partial recovery of industrial competitiveness, eroded in recent years, as long as the effects of nominal devaluation are not unwound by subsequent inflation acceleration.

The third test will be to respond to inflationary pressures without resorting to further doses of monetary tightening. The Brazilian economy is in its fourth year of low growth, with industrial production stagnating at levels close to 2010.

Bank credit has not slowed more sharply only because of the expansion of public banks' portfolios, which today exceed total lending by private banks.

### Fiscal policy

Fiscal policy will be the key to addressing this challenge, insofar as it can reduce the burden of responsibility placed on monetary authorities.

The primary public sector surplus has shrunk since 2012 and is unlikely to reach its goal for this year. A reversal of fiscal expansionism would ease the requirement in terms of higher interest rates to control inflation, as would the injection of funds by the Treasury to public banks.

The fourth challenge is to reverse the perception of fiscal deterioration to help preserve the investment grade rating of Brazilian public debt. Given the limits to ambitious changes in fiscal targets in the short term, establishing multi-annual targets for primary balances and caps on public spending-to-GDP ratios would enhance the credibility of the fiscal adjustment effort.

If Rousseff's solutions are seen as credible, improvements in confidence and expectations of private agents will help Brazil master these turbulent times. This will be the case particularly if private investment, in decline since the middle of last year, starts to reflect optimism about future macroeconomic performance.

### Return to growth

Therefore a plan for a return to growth must be presented upfront. Systematic increases in Brazil's total factor productivity will be needed if the growth-with-social-inclusion model that prevailed in the 2000s is to return. Continuing education of workers is essential.

While educational improvements materialise, there are other areas where Brazil can increase productivity. The first is infrastructure. Sustainable investment would alleviate increasingly tight bottlenecks. Reducing the waste of resources would yield widespread productivity gains as well as robust private investment in other sectors.

The key here will be to fine-tune the division of responsibilities between the public and private sectors in the investment and operation of infrastructure services, according to their different capacities to manage risks. Transaction costs and the difficulty of accessing technologies, equipment and supplies from outside have limited the local scope for innovation, productivity increases and competitiveness.

Horizontal productivity gains could be achieved through reforms in various operating parameters of the private sector business environment. Simplifying the tax system and improving the legal and tax framework in which the labour market operates should be immediate priorities, along with a review of public spending.

For an economy with a high tax burden and high proportion of public spending-to-GDP such as Brazil, improvements in the quality of the latter would have significant direct and indirect impacts.

Fixing short term problems while preparing the foundations for long-term growth is the way to return to sustainable development and social inclusion. ■

Dilma Rousseff receiving the presidential sash from Luiz Inácio Lula da Silva, 1 January 2011

Otaviano Canuto, member of the OMFIF Advisory Board, is Senior Adviser on Brics Economies and former Vice President and Head of the Poverty Reduction Network (PREM) at the World Bank.

# With reforms, long-term outlook is bright

## Strained by oil price fall, Nigeria tackles monetary dilemma

Kingsley Chiedu Moghalu, Central Bank of Nigeria

**The recent fall in the price of crude oil – on which Nigeria relies for over 70% of its revenues – is cause for concern, but should not induce panic over Nigeria's longer term economic prospects.**

Nigeria, Africa's largest economy with a GDP of $510bn, is on a path towards diversification over the next five years and has in place contingency plans to ride out the present turbulence.

Nigeria's Bonny Light crude oil declined from over $100 a barrel to $86 by mid-October. A rebound to $100 or a further decline below $80 looks unlikely. Key players in the global oil market such as Saudi Arabia, which contributes 45% of the output of the Organisation of Petroleum Exporting Countries, appear comfortable with the current price range.

OPEC secretary general Abdullah al-Badri has confirmed the organisation's satisfaction with a price level of $85 because high-cost shale oil supplies will come down if the price hovers at this level. Meanwhile OPEC producers enjoy lower production costs and will experience higher demand for their crude in the longer term.

The global average break-even cost of shale oil production is $55-$78 a barrel. Further oil price declines will hurt the economic interests of the US, making its investment in shale oil uneconomic.

China and Russia, which are also endowed with shale oil deposits, will calculate that extraction does not make sense at prices below $80. The downward price trend is likely to trigger a US reaction to arrest further declines to protect America's shale production and so decrease its dependence on importing oil from OPEC countries. It has already stopped importing oil from Nigeria.

There are significant implications for Nigeria in the oil price drops. For monetary policy, it complicates the Central Bank of Nigeria's efforts to boost accretion to the country's external reserves.

### The value of the naira

Increasing reserves is necessary as a buffer to support the value of the naira, which has come under some pressure in recent weeks. The central bank remains committed to defending the value of the naira through interventions in the currency markets.

The oil price drop further complicates monetary policy because the new central bank governor Godwin Emefiele has expressed a desire to loosen monetary policy, though not before the presidential and other elections scheduled for the first quarter of 2015.

Lowering the policy rate from its present 12% may affect portfolio investment inflows that have helped prop up the value of the naira.

While monetary policy should not give too much consideration to the carry trade, that benefit is part of a Faustian dilemma in which a stable exchange rate is seen as essential for economic stability in an import-dependent economy powered largely by crude oil revenues.

To exit this dilemma, non-oil exports need to overtake crude oil exports to provide real support for the value of the naira, and domestic refining capacity must increase so that Nigeria need import fewer refined petroleum products and thus would need to purchase less foreign currency. To discourage the carry trade by reducing policy rates would require a significantly higher level of external reserves, which nevertheless remain healthy at $39bn.

For Nigeria's fiscal policy, the oil price drop will result in significant revenue losses that could affect current spending on infrastructure, currently at $10bn per annum.

But Nigeria's fiscal and monetary authorities are not simply watching the oil price. They are planning to increase the rainy-day savings Excess Crude Account, a buffer against oil price shocks that protected Nigeria from the global ravages of the 2008 global crisis, from its current $4bn to $5-6bn, the recommended minimum of the International Monetary Fund.

Beyond the immediate responses, President Goodluck Jonathan's government has launched a number of reforms to increase electric power supply and revitalise industrial manufacturing over the next five years.

The aim is to restyle the Nigerian economy through structural changes into a truly industrial economy, creating jobs and inclusive wealth over the next decade.

Nigeria's economic prospects remain ultimately bright, provided the government maintains a disciplined execution of its strategic plans. ■

Kingsley Chiedu Moghalu is the Central Bank of Nigeria's Deputy Governor for Financial Stability and the author of Emerging Africa: How the Global Economy's 'Last Frontier' Can Prosper and Matter (Penguin Books, 2014)

### Brazil's president wins over the poor, but losing candidate speaks for 80% of GDP

**Brazilians used to describe their country as Belindia, half Belgium half India. This election showed each half voting with their wallets: The poorest 51% voted to return Dilma Rousseff to the presidency for the next four years, while nearly 49% living in economic powerhouse regions voted for Aécio Neves *writes David Smith*. Dilma, as she is known, won with her brand of the big, interventionist state regulating everything from banks to energy to vast welfare programmes, in the name of the Workers Party that has ruled Brazil for 12 years.**

The victory was surprisingly narrow over centre-right opponent Senator Neves, whose campaign raised the corruption scandals that have already sent members of the ruling party to jail. Brazil has a serious opposition in place, with the industrial economic heartland of the country firmly behind better administration and a pro-business government.

Politically, Dilma won in the poor rural north and northeast of the country with a message focused on the huge anti-poverty programmes that have put cash in the hands of the neediest and lifted tens of millions out of poverty. In the final days of a bitter campaign, her party worked overtime to tell its natural constituency that Neves would dismantle the welfare plans that guaranteed their family income, the Bolsa Família. No matter that Neves had promised not to do so. The scare strategy proved the key to survival, according to the exit polls.

Yet Neves and his Social Democratic Party swept the regions which represent the economic future of the country. With landslide numbers in São Paulo province and southern and central-western Brazil, Neves speaks for the people who generate more than 80% of GDP, produce 85% of exports and pay 90% of taxes.

# China's economic predicament

## Reforms for long-term prosperity may slow short-term growth

John West, Advisory Board

**The Chinese economy is slowing despite government stimulus, anti-corruption efforts and attempts at financial reform. Turning itself around will not be easy.**

After the Lehman shock of 2008, China's economic growth was impressive, especially compared with sluggish developed economies.

Growth was around 10% from 2009-11. It has since slipped down to the 7-8%, and is likely be around 7% over the next year. This is consistent with economic maturation, and appears more sustainable.

The problem is that these good growth rates have been induced by heavy doping from fiscal and monetary stimulus. The government is keen to maintain steady employment growth to maintain 'social stability'.

Short term stimulus to maintain economic stability makes sense. But six years after Lehman, the government is still prodding and nudging the economy forward with mini-stimulus packages.

The consequence has been excess capacity in some sectors (notably real estate), wasteful infrastructure projects, bad debts, and financial fragility in the corporate, banking and local government sectors.

Combined government, corporate and household debt has jumped from 150% to 250% of GDP these past six years. This cannot go on forever.

One year ago at the Third Plenum, the government announced a much-needed and impressive reform agenda.

The objective was to unleash new sources of growth and improve its quality: Growth should be more consumption-driven, less reliant on investment, and more balanced and sustainable.

Market forces will be programmed to play a decisive role in the economy. This should involve market liberalisation and deregulation, progress in the internationalisation of the renminbi, capital account convertibility and policies for greener growth.

### Reform programme

However, for reform to be effective it must also entail creative destruction – that is, letting some firms and financial institutions fail. Productivity, growth and innovation require that the old must make way for the new. Capital should be allocated to efficient and dynamic enterprises, not to keeping troubled enterprises afloat.

The reform programme is challenging and may slow growth in the short term, but it is unavoidable if China is to continue climbing the development ladder. The government's goal is to implement changes by 2020, but execution to date has been slow.

Well-connected vested interests are lining up to block reforms, though some are neutralised by the anti-corruption campaign. And it can seem safer for the government to postpone making changes while the economy remains fragile.

But delaying reform runs great risks. The ultimate risk is not so much one of financial crisis, as China's immense foreign reserves protect it from externally generated tumult (while unfortunately insulating it from international market discipline).

The main risk is prolonged stagnation due to failure to quickly deal with a large build-up of domestic debt, the very inefficient allocation of resources, the lack of productivity-stimulating structural reforms and wide income inequality.

This is what happened to Japan following its financial upheaval in the 1990s, and stagnation was then exacerbated by Japan's rapidly aging population.

It is often called the Japanisation syndrome. Japan's Abenomics is a belated and tame attempt to tackle this illness.

But Japan was already a very prosperous country when Japanisation struck. In China's case, there is a severe risk of Japanisation combined with a rapidly aging population, while the country is still much poorer in terms of GDP per capita.

Today, the Chinese economy stands at a turning point. Radical market-oriented reform is urgently needed to boost productivity and innovation, to continue economic catch-up and avoid falling into a 'middle income trap'.

We can only hope that President Xi Jinping still has sufficient political capital left when the anti-corruption campaign is completed.

In China, economic prosperity is not only important in itself. It is key to social and political stability. ▪

John West, member of the OMFIF Advisory Board, is Director of Asian Century Institute.

HKIMR

**Internationalisation of the renminbi: implications for world finance**

12 December 2014
Hong Kong

The Fourth Asian Central Banks Watchers Group (ACBWG) meeting is co-hosted by OMFIF and the Hong Kong Institute for Monetary Research (HKIMR).

The seminar will look at the following themes:

- The growing importance of renminbi internationalisation for the world economy
- The renminbi's role in international reserve management and official-sector financial transactions
- The renminbi's role in international capital markets, trade financing and investment
- Future challenges, opportunities, and recommendations for renminbi internationalisation

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

Eddie Yue
Deputy Chief Executive, Hong Kong Monetary Authority

William White
Chairman, OECD Economic Development and Review Committee

Xiang Songzuo
Chief Economist, Agricultural Bank of China

# Kganyago has no option but to stand strong

## Gill Marcus' successor must fight on several fronts

Peter Bruce, Advisory Board

**For a while, the future integrity of the South African Reserve Bank, one of the best-respected institutions not just in the country itself but in the whole of Africa, hung in the balance. There was a chance that Jacob Zuma, the embattled South African president, would choose an acolyte, qualified or not, as the successor to Gill Marcus, the outgoing central bank governor – and pass over the obvious candidate – as he has at numerous other core national institutions.**

In the end he chose wisely, appointing 49-year-old Lesetja Kganyago, one of Marcus's senior deputies, to the job. The country heaved an audible sigh of relief.

Not only is Kganyago a fiercely independent man, he knows the workings of both the government and the ruling African National Congress intimately.

He is connected and experienced. He ran the National Treasury while Trevor Manuel was finance minister and did a stint in the economics 'department', such as it might be, of Cosatu, the trades union umbrella aligned with ANC. He will be open, barbed and candid in his assessments of policy and the economy.

Typically, Kganyago prepared his ground, making publicly clear before being appointed that he fully supported the Bank's inflation-targeting strategy and the targets themselves of 3%-6%. Putting down that marker will serve him well.

### Strength and stability

The ANC appears to fragment a little more every day, it can sometimes seem. And the most popular call from its fringes and from a growing but hopelessly chaotic Left is to chase growth rather than to target inflation or, at least, to widen the target bands.

Under successive governors in the democratic era, the Reserve Bank has attracted bright people and it remains, along with the Treasury, a haven for thoughtful public servants to think aloud.

That is a critically important function in South Africa because it keeps policy thinking protected from quickly-launched attacks that the State is spending recklessly and to no effect.

Kganyago will have to stand strong. His former Treasury colleague and now minister of finance Nhlanhla Nene tabled the latest of a rolling three-year budget forecast last month

in which he had to tell parliament that he had no new money to spend on anything.

State-owned enterprises, many run into the ground by incompetent Zuma acolytes, would be rescued by selling off state assets that are still worth something. Real spending would have to fall.

The budget deficit will take another three years (making it almost a decade) to get back to 3%. And Nene halved the Treasury's growth forecast this year to 1.4%.

Even that might be difficult and the trouble is that even though Nene's assessment was real, not many people believe he will be able to meet his goals. He will have to put real numbers in his annual budget in February 2015.

The more ANC finance ministers talk about belt tightening, the more ministers and MPs spend on themselves. The more precarious the party's position becomes, the more extravagant its election promises turn out to be.

The ANC is under real threat. To the left a former youth firebrand, Julius Malema, took his rag-bag party to a stunning result in the general elections last May. Malema wants to nationalise the mines and the banks and to expropriate white land and give it to the black poor.

Meanwhile Cosatu, the union ally, is falling apart, with its biggest affiliate, the National Union of Metalworkers (Numsa) threatening to form its own political party to fight the coming elections (local government in 2016 and national again in 2019) on a socialist ticket.

Worse, perhaps, for the ANC is the palpable discontent from the large middle class its policies of black empowerment have created. Nene warned last month that he would have to raise new tax revenues in the 2015 budget and that it would 'not be on the backs of the poor'.

But if he does it by making the newly wealthy black middle classes poor, he may get into even more trouble.

The new Reserve Bank governor has a tough job in all of this. South Africa is no Argentina, whose central bank is periodically raided for funds. But it is hard to see how the ANC can afford, politically, to turn the taps off now.

There is too much to lose and the president is desperate to protect himself. He has to ensure he has enough clout (and how else but with expensive patronage?) to survive out of office from 2019 when his second term ends.

He still faces a raft of fraud charges which were suspended so he could become president in 2009, but which his opponents want reinstated.

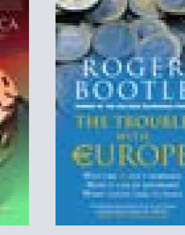
The other source of pressure on Kganyago steams from inside the bank. While Marcus was there, the top tier looked strong. Now he has only one strong central banking deputy.

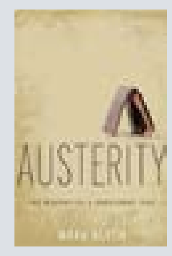
Daniel Mminele is a bond market specialist, a German-educated technocrat who was a serious candidate for the top job but lacked Kganyago's political credentials. The governor needs to keep him in the Bank. A third deputy, Francois Groepe cuts a persuasive figure but is not a banker.

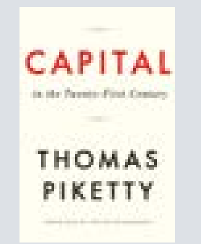
Kganyago's own former position, with responsibility for banking stability, is as yet unfilled. ▪

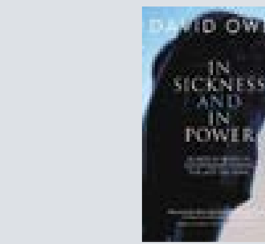
Peter Bruce, member of the OMFIF Advisory Board, is Editor-in-Chief of Business Day & Financial Mail in South Africa.

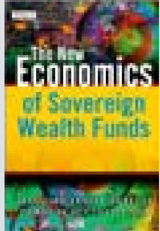
Book review

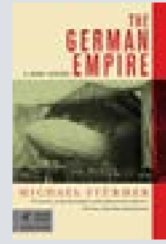








# Capitalism for the common good

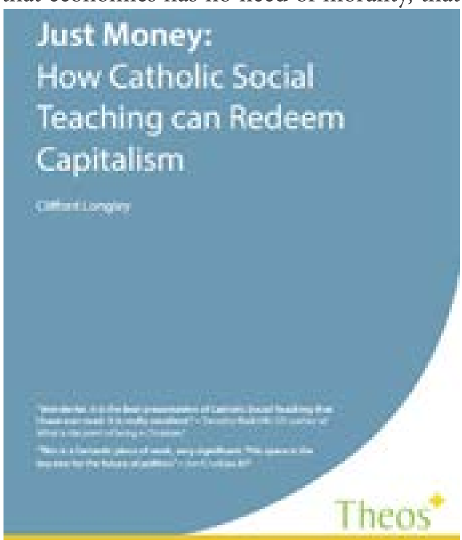
## A Catholic's cry to humanise finance

William Keegan, Advisory Board

**Written by a prominent British Catholic who frequently figures on the BBC Radio 4 Thought for Today programme, *Just Money: How Catholic Social Teaching can Redeem Capitalism* should be of interest in the broad meaning of 'catholic': of universal interest, not just to Catholics.**

I read it fresh from the recent annual meetings of the World Bank and International Monetary Fund in Washington, where the Archbishop of Canterbury Justin Welby and the governor of the Bank of England Mark Carney expressed their concerns about the threat from 'market fundamentalism' to the long term successful functioning of the capitalist system.

Clifford Longley begins this slim volume by stating: 'Market fundamentalism, sometimes called neoliberalism, drove the world economy to the edge of the precipice in the crash of 2008… The basic flaw in the system was not just about personal greed, but about the idea that free market forces need not be, and should not be, deflected by scruples about their consequences; in other words that economics has no need of morality, that 'the business of business is business', and that what matters is the short-term maximisation of shareholder value.' His basic thesis is that ethics need to be brought back into economics and finance.




### Ethics of economics

Historians will know that there was a time, many centuries ago, when economics was a branch of ethics. Such distinguished economists as the Nobel laureate Amartya Sen have for some time been taking a more ethical approach to economics, reminding us that Adam Smith, god of the neoliberals, was actually far from the apostle of unfettered markets that they like to maintain.

The reductio ad absurdum of the unfettered approach was epitomised by the work of the American Ayn Rand, of whom the former chairman of the Federal Reserve Alan Greenspan was a devoted follower.

As Longley notes, she published a collection of essays under the provocative title *The Virtue of Selfishness* in which 'she rejected altruism and applauded egoism as an ethical ideal.'

I say Greenspan was a devoted follower. As Longley observes, the central banker whom so many people in the market almost worshipped, and who believed in the self-correcting tendencies of 'market fundamentalism', has had a change of mind and heart. In his book *The Map and the Territory*, a humbler Greenspan has decided that 'there must be a better way.'

Neither for Greenspan nor for Longley does the better way begin with a rejection of capitalism itself. On the contrary. As Longley states: 'Unlike Marxism, Catholic Social Teaching does not reject wealth creation, or assume that "all property is theft" – though someone who has plenty of it has obligations to someone with none.'

Markets are invaluable for the efficient distribution of goods, services and resources generally, and competition helps efficiency and innovation.

The problem was that 'the type of financial capitalism that resulted in the 2008 crisis was damaging to the common good.'

This is the crux of the matter. Neoliberals and the bankers and executives who rewarded themselves far too handsomely lost sight of the common good, an ethical goal emphasised by thinkers from Aristotle to Pope Francis.

Longley quotes the present managing director of the IMF, Christine Lagarde, who has tried to relate the message of the common good to the financial sector: the financial sector's goal, she says, ought to be 'to put resources to productive use, to transform maturity, thereby contributing to the good of economic stability and full employment – and ultimately to the wellbeing of people.'

### Well-intended regulation

Lagarde, Carney and many others are now drawing attention to research findings that the increase in inequality – resulting from the fact that the pickings from the neoliberal order did not 'trickle down' – is a major constraint on economic growth.

But reversing this trend is more easily said than done. Again, Longley complains that there is a problem with well-intended regulation, namely that it produces a situation where 'compliance' becomes the objective, whereas practitioners should be asking 'is this right or wrong?'

In sum, Longley wishes to humanise economic and financial practices. This is a tall order, but he can be congratulated on a beautifully written cry for help. ▪

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

# The keys to financial stability

## How five nations built their banking systems

George R. Hoguet, State Street Global Advisors

Anyone interested in the history of banking, financial crisis prevention and regulatory policy should read *Fragile by Design – The Political Origins of Banking Crises and Scarce Credit* by Charles Calomiris and Stephen Haber. Calomiris is Henry Kaufman professor of financial institutions at Columbia Business School in New York. Haber is the A.A. and Jeanne Welch Milligan professor in the School of Humanities and Sciences at Stanford University. Together they have produced an important and carefully researched work on the political economy of banking.

*Fragile by Design* chronicles and compares the evolution of banking systems and regulatory frameworks in five countries: the UK, US, Canada, Mexico and Brazil. Why do some countries have stabler banking systems than others? The answer, the authors suggest, is to be found in the structure of a country's fundamental political institutions. States make banks, Calomiris and Haber suggest, and banks make states. The authors call the process of deal-making between banks and the political system 'The Game of Bank Bargains'. If one can understand this game better, it is easier to identify potential financial fragilities.

The analysis starts with the evolution of the British banking system and the 'Grand Bargain' in various eras from the Glorious Revolution of 1688, the Napoleonic wars and the industrial revolution right through to the present day. What began as a financial system serving the interests of the state broadened out as society became more democratic.

The discussion then moves on to the history of banking in the US. Suspicion of large financial institutions has been a powerful strand of US political thought right from the start of the Republic. The Bank of the United States (BUS), whose charter President Andrew Jackson did not renew, resulted from a deal.

The fledgling nation got credit, and a select group of bankers got a lucrative concession. But the various states, with their own financing needs, opposed the BUS. Multiple financial crises following the Civil War led to the creation of the Federal Reserve. (Nowhere in the Federal Reserve Act, as Reinhardt and Rogoff remind us, does the word inflation appear.) The Fed, which at times has been subservient to the interests of the US Treasury, 'reflects the political compromises [which] sustain its existence'.

The subprime crisis, the authors argue, finds its origins in another Grand Bargain. Congress and the Federal Reserve would let banks merge and expand business lines if they implicitly agreed to provide credit to poor and inner city borrowers. The fiscal system could not meet the needs of the poor, so cheap credit – via the Community Reinvestment Act and other measures – was one way to meet the needs of the poor. As Raghuram Rajan called it, 'let them eat credit'. Further, Fannie Mae and Freddie Mac were subject to constant political pressures. And weak regulation was pervasive.

For Calomiris and Haber, the subprime crisis was, first and foremost, the outcome of a political bargain. They believe that the subprime crisis will not be the last.

Why has the Canadian banking system suffered far fewer crises than the US? Since 1840, the US has had 12 major crises, while Canada has had none. To begin with, the US banking system was historically fragmented, whereas Canada from the start favoured larger national banks and nationwide branches.

Every five years, the Canadian parliament carries out legislative reviews and recharters banks. This practice undoubtedly sharpens the minds of bank managements admirably. And, via their branch networks, Canadian banks have held on to their traditional depositors and relied much less on wholesale deposits than US banks.

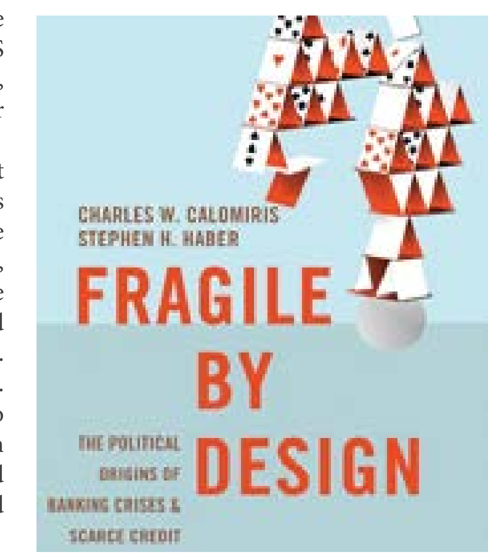
Mexico's tumultuous history is instructive. Mexican bankers' wariness of the Partido Revolucionario Institucional led to the creation of a state development bank, Nafinsa, which had a penchant for financing politically favoured money-losing firms.

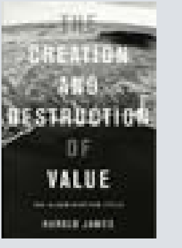
And then there is Brazil, where inflation hit 2,447% in 1993. In the 19th century Brazil's banking system was run for the planter merchant elite, who favoured a minimalist approach to national governance. After Brazil's democratic transformation of 1989, banking underwent vast changes. Disinflationary measures were popular, but even today the Brazilian federal government directs credit and uses its power over banks to generate employment.

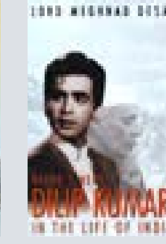
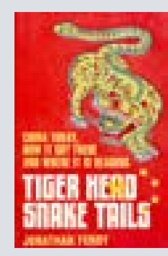
The authors draw three conclusions. First, democracies are more conducive to a broad distribution of bank credit than autocracies. Second, government safety nets tend to destabilize banking systems. And third, democracies with liberal institutions that make it difficult for bankers and populists to form coalitions are more conducive to crisis-free stability. Initial conditions matter.

There are many fascinating historical tit-bits, and the authors have a puckish sense of humour. In the subprime crisis chapter they quote the American humorist Will Rogers: 'If stupidity got us into this mess, why can't it get us out?' ▪

George R. Hoguet is Global Investment Strategist in the Investment Solutions Group of State Street Global Advisors.





# Why secular stagnation fears are overdone

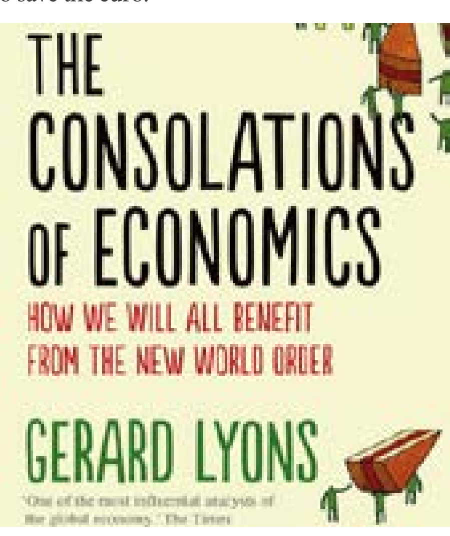
## Reasons to be optimistic about the world economy

Gerard Lyons, Advisory Board

**Over the next 20 years the world economy could enjoy one of its strongest periods. That may be hard to envisage now, as in the near-term the global economy faces major uncertainties.**

Indeed, in the wake of the financial crisis it has been a divided and disconnected world economy that has faced major policy dilemmas. Policy has evolved dramatically. Lest we forget, before the crisis, US policy was often referred to in terms of the three T's: timely, targeted and temporary. It worked. Then, as the crisis hit, western governments stood behind their banking sectors and global policy-makers sought to correct the collapse in world trade. Policy then became the three S's: synchronised, sizeable and successful as it prevented depression.

Since then monetary policy has become a shock absorber and has transformed into the three U's: unlimited, unclear and unknown. The action taken by western central banks, lead by the US and UK, has been unlimited. The impact has been unclear, other than sending a clear statement of intent, highlighted by European Central Bank President Mario Draghi's commitment to do 'whatever it takes' to save the euro.




How exit strategies will work, and what the longer-term policy impact will be, is unknown. Whichever economy one looks at, the outlook depends on the interaction between the fundamentals, policy and confidence. They point to steady though not spectacular recovery in the US and UK. The biggest worry remains Europe, where there remains a lack of demand, lending and confidence. Meanwhile, recent developments across the emerging world should not be a surprise.

### Emerging economies

Emerging economies are not decoupled from the west. Though often overlooked, the business cycle does exist in economies such as Brazil, China and India, and slowdowns there should not be misinterpreted as the end of their growth story. For these, the longer-term trend is clearly up, though we should expect setbacks along the way. Many of the institutional features taken for granted in developed economies are still evolving across many emerging countries.

Economic and financial power is shifting. Although many of the factors driving this are familiar, their combined impact cannot be overestimated. The biggest worry facing developed economies is a combination of high youth unemployment, low wages and sluggish productivity. But there are signs of recovery in the US and UK and many factors pointing to solid future demand across the emerging world.

Population is growing, with one in 12 people in the world an Indian under 27. The global middle class is expanding as new economic powers led by China emerge. And two-thirds of global growth in the next two decades is expected to come from the biggest 600 cities, only 20 of which are expected to be in the west.

This flies in the face of the idea of secular stagnation. Some argue that major inventions are behind us. That may be true for things like air travel but in many other areas there are reasons to be optimistic as investment and innovation boost productivity.

Prof. Nick Stern, chair of the Centre for Climate Change Economics and Policy, talks about a new green revolution as seen in clean-tech and bio-tech. Peter Marsh, former manufacturing editor at the Financial Times, has written about the emerging trend of carrying out high-quality manufacturing in smaller units across the world. 3D printing is a reflection of this.

Advances are being made in other areas too, such as genomics, artificial intelligence, robotics, nanotechnology, connectivity and even in addressing problems such as how we deal with waste. We may be about to see another industrial revolution.

In addition, there are new trade corridors between Asia, Africa, the Middle East and Latin America as more goods, commodities and people move across the globe. There are more financial flows, with increased remittances, portfolio and direct investment. These links will grow and flourish in a cat's cradle of mutually supportive transactions and pathways.

Developed economies, far from fearing such change, should embrace it. Indeed, they still dominate many of the factors driving the global outlook: economic and financial clout; soft power, which is the importance of brands and the power of persuasion; hard power, based on military strength; and global political institutions and policy. Overall, the combination of these drivers points not only to a changing world economy but also to a growing one. The net effect is that the global economic cake will get bigger.

The slice of that cake that goes to developed economies may be smaller, but there will be more cake. Even at its current growth rate of around 3.5%, the world economy, in real terms, will double over the next two decades to \$147tn and average global income per head will rise by two-thirds. ▪

Gerard Lyons, member of the OMFIF Advisory Board, is Chief Economic Adviser to Boris Johnson, the Mayor of London.





# Germany's questions over euro area slowdown

## OMFIF's Advisory Board weighs up the options

The International Monetary Fund believes that there is a 40% possibility of a new recession in the euro area. Leaving aside the perennial question of whether the ECB should take more aggressive easing action, there have been many suggestions that Germany, as the leading economy with a relatively strong budgetary position, should stimulate expansion through fiscal measures.

OMFIF asked the Advisory Board whether Germany should do more – and if so, whether action take the form of tax cuts or spending increases or both. A quarter favoured spending increases; 15% preferred tax cuts; and nearly half voted for a combination of the two. 15% believe there is no need for Germany to alter its policies.

Germans I speak to feel that expansionary policies are no way to improve economic fundamentals. There are many structural inefficiencies in Mediterranean countries, and expansionary policy merely benefits the status quo in countries that need to reform their labour practices. Germans don't believe a weak currency is necessary to drive exports. History suggests they are right – a strong D-Mark did not hinder German exports.

**Bruce Packard**
Independent consultant

Germany's huge trade surplus should influence the way it boosts growth in its neighbours through fiscal expansion. Increased government investment spending would take longer to have an impact and would be likely to increase imports by less than cutting taxes. This would be less true of increased social or welfare payments but cutting consumer taxes would seem to be the most effective option.

**Colin Robertson**
Former global head of asset allocation, Aon Hewitt

no need for Germany to do more 15%
tax cuts 15%
spending increases 25%
both tax cuts and spending increases 45%

More than China, Germany is the source of the biggest imbalances of the world's economies in terms of fiscal and current account surpluses and deficits. One sympathises with the government's desire to maintain pressure for structural reform and greater efficiency and competitiveness in the weaker euro area member states. But the current stance will lead to social and political disturbances in those countries. Any German tax cuts and fiscal expansionary measures which boost the country's private sector spending and general domestic and personal consumption should be applied forthwith.

**Jack Wigglesworth**
Former chairman of LIFFE

The options offered are not sufficient. If Germany were to stimulate domestic demand through public expenditures or lower taxes that would benefit mainly other surplus countries in Europe. The German budgetary situation is relatively solid, but public debt is high. Germany should be encouraged to invest more abroad, particularly in the EU periphery and outside the euro area. Taxes and expenditures should be shifted in a more growth-friendly direction without any change in the overall effort of balancing the budget, but that should be supplemented by more longer-term capital exports from Germany.

**Niels Thygesen**
Professor Emeritus, University of Copenhagen

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# BANK ON GERMANY

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