The Bulletin

November 2016
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Eastward shift
World looks to Asia

FOCUS on renminbi swap arrangements
Yaseen Anwar on China's One Belt One Road project
Javier Guzmán Calafell on multicurrency reserves
Shaoki Fan on gold's growth in Asia
Abdul-Nashiru Issahaku on African mobile banking
Marsha Vande Berg on America's global role

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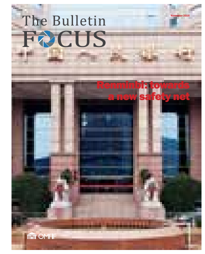
The Bulletin FOCUS



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The Official Monetary and Financial Institutions Forum is an independent platform for dialogue and research. It serves as a non-lobbying network for worldwide public-private sector interaction in finance and economics. Members are private and public sector institutions globally. The aim is to promote exchanges of information and best practice in an atmosphere of mutual trust. OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries.

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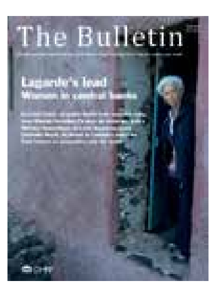
The OMFIF 169-strong Advisory Board, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors, including banking, capital markets, public policy and economics and research. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership can change owing to rotation.



EDITORIAL

China's economic shifts and the Asian pull

The world's centre of economic gravity is shifting east. Asia now makes up over a third of global GDP, up from 24% only a decade ago. Following impressive rates of economic development, the continent's influence is spreading to areas beyond trade and investment, including financial flows, global currency reserves and matters of banking and capital market supervision and regulation. Asia, in all its many facets, exerts a considerable pull on world economic and financial affairs. It seems appropriate then that 16 November marks the opening of OMFIF's first overseas office in Singapore.

October saw the inclusion of the renminbi in the International Monetary Fund's special drawing right, making it the first emerging market currency to join what has become a small group of currencies with international reserve asset status. While the dollar's dominance will take a long time to fade, as Steve H. Hanke and Javier Guzmán Calafell write, a move towards a multicurrency system where the renminbi will be a protagonist is inevitable. Central banks around the world are taking notice. This month's Focus with contributions from Le Xia and Yaseen Anwar highlights the systemic nature of the renminbi's currency swap network.

The outlook for the renminbi will be driven by China's economic trajectory. Following fears of a hard landing earlier in the year, this month's Advisory Board Poll sets a calming tone: only 6% of respondents expected China to experience a recession over the coming five years. However, this share rose to 22% for the extended forecast horizon of the next decade. China faces the challenge of transitioning to a period of slower growth with a greater focus on services and domestic consumption. So far, its growth has been achieved through a push on investment, something that other economies in the region can emulate. Ashfaque H. Khan discusses lessons for Pakistan. However, to manage its own transition, China will need to shift its focus away from investment, which is reaching diminishing returns domestically. It can now apply its expertise and resources in infrastructure investment to other regions. Yaseen Anwar, former governor of the State Bank of Pakistan, outlines the benefits of the 'One Belt, One Road' project. Additionally, China's move to a service-based economy will make room for other Asian economies to move up the value chain. Shaokai Fan of the World Gold Council examines gold demand from Asia's rising middle class.

One notable exception to Asia's economic dynamism remains: Japan. John Plender, OMFIF's chairman, outlines three problematic scenarios for Japan's debt trap. While not as high as Japan's, the debt-to-GDP ratio in Greece is also highly problematic. Danae Kyriakopoulou warns that expectations for an economic rebound in 2017 rest on questionable assumptions regarding debt sustainability. The economic outlook for the rest of the euro area remains anaemic too, while the US economy is constrained by structural supply-side factors. Despite relatively low growth, concerns over inflation are likely to encourage the Federal Reserve to raise rates at its December meeting, argues Darrell Delamaide. Marsha Vande Berg adds that the US is expected to assume a more protectionist attitude whoever wins the 8 November election.

This shift to protectionism is, however, not mirrored in the new forms of establishing trade relationships. Modern preferential trade agreements go beyond just tariff cuts, and increasingly address non-tariff barriers such as harmonising regulations for services trade, argue Alberto Osnago, Nadia Rocha, and Michele Ruta of the World Bank. Ben Robinson examines this case for Europe, focusing on the outlook for a single market for services following Britain's EU referendum result. The UK itself would have benefited from a more deregulated environment for services trade, but also from a weaker pound. Roger Bootle's and John Mills' book *The Real Sterling Crisis* earns a glowing review from Brian Reading. In a second book review, Danae Kyriakopoulou casts a sceptical eye on the proposal to bring control of sovereign wealth to the people.

OMFIF looks east with Singapore office

Launch pad for activities in region of economic growth

Adam Cotter

As OMFIF moves from its seventh (auspicious in India and Japan) to its eighth (auspicious in most of east Asia) year of operations, it seems fitting that we are opening our first overseas office in Asia, a key milestone in OMFIF's global expansion. Southeast Asia is moving towards a pivotal role in global finance and politics. The office will provide OMFIF with a platform to play a truly global role in monetary and financial affairs.

Growth has been sustained in developing Asia, notwithstanding the tough external environment. According to the Asia Development Bank, the region is expected to grow well above the global average, at a pace of just under 6% in 2016 and 2017. China remains strong, and India is on track to grow by 7.3% in 2017.

The most rapid shift in the economic centre of gravity in world history – from the West to the South and East – occurred in 2000-10, according to McKinsey Global Institute. MGI expects this trend to continue, with its 2025 projections reflecting the shift brought on by the rise of emerging markets in Asia and elsewhere.

Since OMFIF's inaugural Asia Main Meeting, held at the Bank Negara Malaysia in 2010, and its initial Asian Central Banks' Watchers Group annual meetings, first in Malaysia and then at Bank Indonesia in 2012, OMFIF has extensively covered the Asia Pacific region and worked hard to bring its regional coverage in line with that of Europe. OMFIF has held meetings in China, Japan, South Korea, Australia, Hong Kong, the Philippines, Laos, and Singapore.

Singapore is one of Asia's leading financial centres and an engine of economic growth, with strong and growing importance both in Asia and globally. Close to many of OMFIF's partners, it will be a launch pad from which to expand our commercial presence in the region.

OMFIF would like to thank its associates in Asia for their active support. We have benefited greatly from co-operation with central banks and other official institutions, and we look forward to developing our activities further, together with friends and partners throughout the region.

Adam Cotter is Head of Asia and Chief Representative Singapore, at OMFIF. For details see p.VIII of this month's Focus.

Advisory Board

OMFIF has appointed Lord (Robert) Skidelsky to the Advisory Board. Niels Thygesen has been appointed chair of the European Fiscal Board. For the full list of members, see p.24-25.

Lord (Robert) Skidelsky is Emeritus Professor of Political Economy at the University of Warwick. His three-volume biography of the economist John Maynard Keynes received many prizes. He is a director of the Moscow School of Political Studies and was the founder and executive secretary of the UK/Russia Round Table. In 2010, he joined the Advisory Board of the Institute of New Economic Thinking. He has been chairman of the Centre for Global Studies since 2002. In the 1980s, he was a founder member of the Social Democratic party and remained in the party until its dissolution in 1992.

Niels Thygesen, Professor Emeritus of International Economics at the University of Copenhagen and a Senior Adviser at OMFIF, has been appointed chair of the European Fiscal Board. The board, set up by the European Commission as an independent advisory board on fiscal matters, was created following last year's Five Presidents' Report on completing Europe's economic and monetary union. The board's role is to evaluate the implementation of EU fiscal rules, to advise the Commission on the fiscal stance appropriate for the euro area and to co-operate with member states' national fiscal councils.

Argentina reforms to restore confidence

Argentina is applying economic therapy through a mix of policy shocks and gradualism to restore confidence and growth, Alfonso Prat-Gay, Argentina's minister of the economy and former president of the Central Bank of Argentina, told an OMFIF-Columbia University audience on 10 October in New York. He emphasised that public support for the new administration, combined with a gradual and realistic approach to reforms, had allowed the government to lay new foundations for Argentina's economic growth. The reforms included changes to monetary, fiscal and trade policies, dismantling of exchange rate controls and settling debt disputes.

Structural factors 'suppressing rates'

Structural factors, such as the rise in savings in emerging Asia and commodity exporters, weak demographics, and increasing economic inequalities, have suppressed long-term real interest rates globally, Øystein Olsen, governor of Norges Bank, told an OMFIF City Lecture in London on 1 November.

Central bankers need to adopt a more flexible approach to inflation targeting. While unconventional policies carry important risks, the counterfactual of no monetary reaction to recent economic troubles would have been a worse alternative, he added.

The responsibilities of central bankers

Ignazio Visco, governor of the Banca d'Italia, told an OMFIF-Columbia University lecture in New York on 10 October that monetary policy alone could not guarantee balanced and sustained growth or financial stability. Euro area banking union represented a major step towards preventing systemic financial crises that should be completed. Investment is key to returning to sustained and balanced growth, he added, though this is being held back by policy and geopolitical uncertainty.

The future of multicurrency reserves

The future of developing a system of multicurrency reserves management was put under the spotlight at a seminar held jointly by OMFIF and the World Bank Treasury on 6 October in Washington in the presence of experts from Europe, the US and Asia, with opening remarks by Arunma Oteh, World Bank treasurer.

For the speech given by Javier Guzmán Calafell, deputy governor of the Banco de México, see p.15.

More competitive role for Europe

Economic experts from around the world, led by President of the European Investment Bank Werner Hoyer, discussed how to make Europe more competitive at an OMFIF-DZ Bank breakfast debate at the IMF annual meeting in Washington on 8 October. Hoyer called for concerted EU efforts to realise the full benefits of Europe's internal market and reduce Europe's vulnerability to shocks. He voiced disquiet about the impact of Britain's EU withdrawal.

Mastering flows, strengthening markets

OMFIF and BNY Mellon presented a joint report on 6 October in Washington on how international sovereign institutions are increasing their efforts to mitigate liquidity shortages on world capital markets following the global financial crisis. Speakers included Brian Ruane, chief executive officer of broker-dealer services at BNY Mellon, Manmohan Singh, senior financial economist at the International Monetary Fund, and Fabrizio Saccomanni, former Italian finance minister.

Emerging signs of recovery

Millison Narh, first deputy governor of the Bank of Ghana, told an Africa Public Investor Meeting on 18 October in Accra that despite challenging geopolitical and economic times there are emerging signs of recovery for the African continent. A key point of discussion was that, though naturally endowed with vast amounts of resources and a growing labour force, the continent has also gained significantly from the evolution of financial market infrastructure.

Reforms 'help Italian economy'

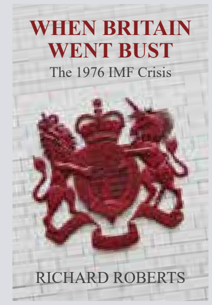
Italy's public sector and pension reforms will continue whatever the result of the December referendum on constitutional changes, according to Vinzenzo La Via, director of the Italian treasury, speaking at an OMFIF meeting in London on 20 October. He reiterated the progress that these programmes had achieved supporting the economy, in addition to the effects from quantitative easing which were creating fiscal space. However, he said, key European challenges remained.

Mexico: pre-emptive action

Manuel Sánchez González, deputy governor of the Banco de México, told an OMFIF briefing on 21 October in London that Mexico needs urgently to buttress its macroeconomic fundamentals, including its fiscal stance. Global economic factors have hampered Mexico's economic performance. As a result, pre-emptive monetary policy action has been required to keep inflation at the target level of 3%.

Book launches

When Britain Went Bust



An evening panel discussion on 5 December at the UK Treasury with Johannes Witteveen, former IMF managing director, Lord (David) Owen, former UK foreign secretary, and others. This marks the launch of *When Britain Went Bust – The 1976 IMF Crisis* from the OMFIF Press by Richard Roberts, professor of contemporary financial history at King's College London. A breakfast discussion on the book with Lord (Nick) Macpherson, permanent secretary of the Treasury from 2005-16, will take place on 8 December.
5 and 8 December, London

The Man Who Knew

A breakfast round table discussion of Sebastian Mallaby's new book, *The Man Who Knew*, an authorised biography of former Federal Reserve Chairman Alan Greenspan. The meeting will be attended by past and present policy-makers.
29 November, London

For details visit www.omfif.org/meetings. To buy *When Britain Went Bust* visit www.omfif.org/shop.

The future of emerging market growth

Emerging market economies must learn from global best practice to generate investment and remain abreast of a competitive world, according to speakers at an OMFIF-Barings seminar held in Washington on 7 October. Speakers included Ricardo Adrogué, head of emerging market debt at Babson Capital Management; Valentin Araneta, member of the monetary board at the Bangko Sentral ng Pilipinas; and Heung Sik Choo, director, Investment Management Division, World Bank.

Overcoming 'secular stagnation'

Jan Mischke, senior fellow at the McKinsey Global Institute, told an OMFIF-MGI joint seminar on 6 October in Washington that a fundamental rethink of structural, fiscal and monetary policies was needed to address more than three decades of declines in net investment in Europe and the US. He outlined three options for improvement: increasing public, business and residential investment; raising consumption and reducing savings; and exporting excess capital.

Potential models for UK-EU relationship

Potential models for a new UK-EU relationship were discussed at a discussion on Brexit's impact on the financial services industry 100 days after the UK's European Union referendum, held by OMFIF and Mazars on 20 October in London. The panel, including senior representatives from Mazars, City of London Corporation, the British Bankers Association, and St James's Place Wealth Management, examined the issues facing the financial services industry as the UK negotiates its exit from the EU.

Britain's strategy for leaving the EU

John Redwood, Member of Parliament for Wokingham, and Charles Grant, director of London-based Centre for Economic Reform sparred in a well-balanced OMFIF debate on Britain's roadmap for leaving the European Union in London on 20 October. Topics discussed included trade agreements and the complications of negotiating, passporting for financial services, the position of the automotive industry, the current account deficit, the drop in the pound and GDP prospects.

Japan's problematic monetary future

Turning the tide against an incipient debt trap

John Plender, Advisory Board

Economic theory offers no definitive answer to the question of when burgeoning government debt becomes unsustainable. But by exploring the extreme limits of debt sustainability, Japan – with a gross public sector debt to GDP ratio approaching 250%, the highest in the world – threatens to cast light on the question.

Historical experience shows that there are three main ways of reducing debt to GDP ratios. GDP can be propelled upwards through economic growth, or debt can be reduced by fiscal consolidation or, less respectably, by default, whether formally through debt reconstruction or informally, via inflation.

Abenomics, the radical economic reform programme introduced by Prime Minister Shinzo Abe, aims to tackle Japan's debt overhang through a combination of growth, fiscal consolidation and inflation. Yet the programme, with its famous 'three arrows', has stalled. The first arrow, expansionary monetary policy, has failed to wrest the economy out of deflation, having initially provided a spur to growth. It has mainly worked through the exchange rate channel, but this has begun to prove ineffective as the US Federal Reserve has hesitated to raise interest rates. Increasing uncertainties at the global level have intensified this trend by lifting demand for the yen as a safe haven asset.

An elusive inflation target

More worryingly, declining market confidence in the Bank of Japan's policies of quantitative and qualitative easing, accompanied by negative interest rates, has contributed to the yen's appreciation. The central bank has revamped its monetary policy by imposing a cap of 0% on the 10-year bond yield and vowing to overshoot its 2% inflation target for a period.

To many market observers this appears worryingly like more of the same. Consumer prices have continued to fall, making the BoJ's 2% inflation target look ever more elusive. In the meantime, a balance between the second arrow of fiscal stimulus and the need for budgetary discipline has been difficult to find. A rise in the consumption tax in April 2014 slowed growth, while gains from the third arrow, structural reform, have been modest. Productivity remains a concern.

Part of the problem is that Japan's economy suffers from huge structural imbalances as well as adverse demographics. The corporate sector runs the biggest financial surplus in the developed world, close to 8% of GDP. As a result, Japan suffers from a deficiency of consumer income, reflected in weak consumer demand, even though the household savings rate has fallen to near zero. Too much cash is trapped in the corporate sector, where it languishes unproductively, rather than being channelled to other parts of the economy.

If the corporate sector runs a surplus, other sectors must run offsetting deficits. In Japan's case, the government has performed this function, mitigating the contractionary effect of excess corporate savings. Yet it has done so at the cost of ballooning public sector debt. And in one particular respect, Abenomics has been counterproductive. The policy of devaluation has transferred income from the household sector to an already cossetted corporate sector.

> ***"Declining market confidence in the Bank of Japan's policies of quantitative and qualitative easing has contributed to the yen's appreciation.***

Japan's atypical debt mountain

Japan is not, strictly speaking, in a debt trap. Even at today's very low underlying growth rate, debt servicing costs are even lower. And as long as the BoJ continues to buy assets at the rate of ¥80tn a year, there is unlikely to be any financial strain. Japan is therefore atypical in the extremity of its government debt mountain and the ease of its financing. The debt trap appears forever incipient, but ever more daunting.

There are three potential ways out, all problematic. Japan could adopt an 'extend and pretend' approach, continuing its policies of quantitative and qualitative easing, in the hope that this will help kick-start growth and reduce the debt to GDP ratio. However, this carries important risks, not least what happens to interest rates on exit from these unconventional policies. It also weakens incentives for the government to pursue rigorous structural reforms, effectively guaranteeing demand for bond issuance.

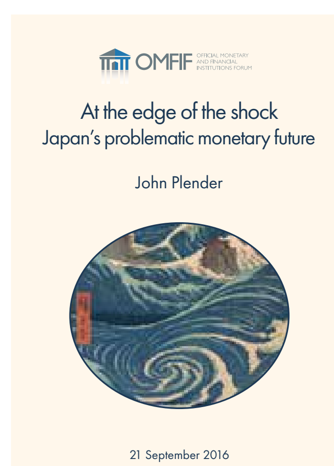
The second scenario involves a debt write-down to address the deflationary threat related to the alternative of running primary budgetary surpluses to service the debt. Again, this option has its drawbacks. Notably, financial instability and capital flight could cause an important shock to economic growth. Such a policy would also be difficult to implement owing to political constraints, following the huge losses savers have incurred since Japan's great bubble burst in 1990.

'Monetary financing-lite'

The third and final scenario calls for debt monetisation through a *de facto* write-off of the BoJ's holdings of Japanese government bonds. Given the difficulties, or even impossibility, of selling JGBs back to the private sector, there is a clear case for leaving government bonds on the BoJ's balance sheet and converting them into irredeemable, non-interest bearing government IOUs. This 'monetary financing-lite' option could help shrink the debt to GDP ratio, but it could also be hard to control. As well as raising concerns over inflation, the principles of central bank independence and intergenerational fairness could be brought into question.

Herb Stein, the US economist who chaired the Council of Economic Advisers under Richard Nixon and Gerald Ford, famously remarked: 'If something cannot go on for ever, it will stop.' That is surely right in relation to Japan's extraordinary accumulation of public sector debt. Stein's dictum does not, and cannot, extend to the issue of timing. But it does tell us that Japan's monetary and financial system is living on the edge of a shock that could rock a global financial system still worryingly fragile following the global financial crisis. ■

John Plender is Chairman of OMFIF and the author of the OMFIF report 'At the edge of the shock: Japan's problematic monetary future'. To request a copy of the report contact editorial@omfif.org.



Gold's new frontiers in Asia

Islamic finance route bolsters metal's accessibility

Shaokai Fan, World Gold Council

As the world's centre of economic gravity shifts eastward, Asia's importance to the world gold market continues to grow. While east Asia and India combined accounted for 35% of global demand in 1970, China alone accounted for 29% in 2015, and India 25%.

Asian consumers' rising prosperity has increased demand for both jewellery and gold as an investment. Moreover, much official sector demand for gold is originating in Asia as regional central banks build and diversify their reserve holdings. Asia has transformed global gold demand, and new opportunities could strengthen the continent's role further.

Islamic investors

Gold remains popular with global investors as a result of unconventional monetary policies, political uncertainty and market volatility. However, several investor groups, for differing reasons, have had limited contact with gold as an asset class. Islamic investors, who historically have had little exposure to gold investment, represent one such group. Gold is subject to special Islamic rules, while existing guidance is limited and fragmented.

To address this, the World Gold Council and the Accounting and Auditing Organisation of Islamic Financial Institutions, the global standard setter in Islamic finance, are developing a new Sharia (Islamic law) standard for gold, to be launched before the end of 2016. The standard will provide definitive guidance on Islamic rules pertaining to gold investment and the permissibility of individual products.

Asian gold demand could benefit significantly. Malaysia, already a vanguard in Islamic finance, has a prosperous middle class seeking greater investment options. Indonesia, the world's largest Muslim country, is beginning to promote Islamic finance, making it ripe for new investment opportunities. Standardising gold transactions will bolster gold's accessibility to Asian investors seeking Sharia-compliant products and asset classes.

Gold can offer sovereign funds an important solution as they seek to diversify their investments in a low rate environment. The metal's role as a long-term store of value complements sovereign funds' mandate to sustain intergenerational wealth. There is also an opportunity to present gold's benefits through direct engagement, as sovereign funds are increasingly making their investment decisions internally.

> ***"Asia's reserve managers are finding it increasingly difficult to find suitable assets in which to invest the region's significant reserve stockpiles.***

Asia's sovereign funds are largely funded through foreign exchange reserves or fiscal surpluses, and require a different investment approach to resource-based funds. They have been less affected by the decline in oil prices, giving them more flexibility to determine their investment mix. Gold can be a useful portfolio component because of its diversification benefits.

Changing macro trends are deepening the case for gold holdings by central banks. Unconventional monetary policies have rendered almost 40% of developed country sovereign debt either zero- or negative-yielding, limiting central bank investment options. Asia's reserve managers are finding it difficult to find suitable assets for the region's reserve stockpiles.

Reserve diversification

Aside from the impact of negative interest rate policies, central bank gold-buying goes hand-in-hand with reserve diversification away from the dollar. This is particularly relevant in Asia, where the renminbi's internationalisation has had a pronounced impact on trade and reserves.

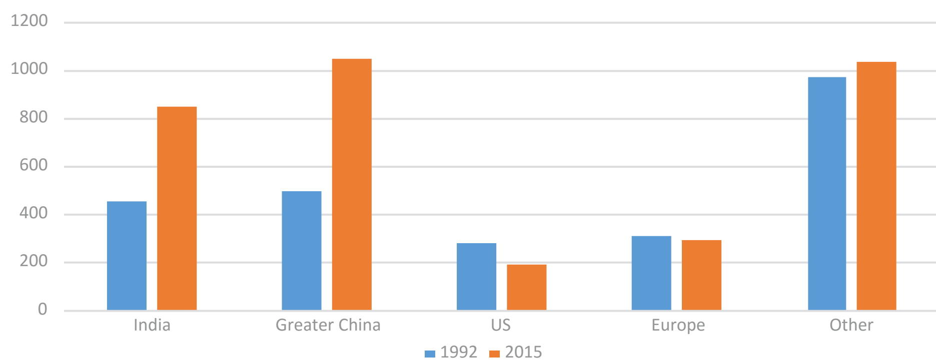
Research by the World Gold Council indicates that, for every one percentage point increase in renminbi reserve holdings, central banks should increase their gold holdings by 0.5 percentage points, to hedge their portfolios against uncertainty stemming from structural changes in currency allocations. As Asian central banks embrace the renminbi, official gold holdings are likely to increase.

Demand for gold is likely to continue to rise as Asia becomes more prosperous. However, the narrative for gold is shifting too, as investors contend with continuing global political and financial uncertainty. Gold's unique qualities offer a safe haven for new Asian investor groups such as Islamic investors and sovereign funds, while Asian central banks can be expected to continue to turn to gold. ■

Shaokai Fan is Director, Central Banks and Public Policy, at the World Gold Council. Disclaimer: This article is for information only and does not constitute investment advice. The World Gold Council is not responsible for any losses.

China leads global gold demand

Consumer gold demand, tonnes



Source: World Gold Council, OMFIF analysis

Gold in Sharia law

Under Sharia law, gold, along with silver, barley, wheat, and dates, is considered a 'ribawi' item. Such items can be exchanged only by weight and measure, and the transfer of goods must occur immediately, meaning that they cannot be traded for some future value or for speculation. In addition, while Muslims under Sharia law are allowed to own gold, there is disagreement over whether gold can be traded as a commodity or used only as a currency.

China's reform lessons for Pakistan

Rooting out corruption, improving education are key tasks

Ashfaque H. Khan, NUST School of Social Sciences and Humanities

China's emergence as a global economic power within a generation is unprecedented in modern history. Pakistan has the potential to emulate China's economic achievements of the past 35 years. But this will require fundamental changes at all levels of government, structural and sectoral economic reforms, and a determined drive to combat corruption.

China's growth since 1980 has been sustained, broad-based and impressive. Real GDP grew at an average annual rate of 9.8% in the 1980s, 10.0% in the 1990s, and 10.3% in the 2000s, before slowing to 8.3% in 2010-15. China has maintained this rate of growth for several reasons, including policy consistency and continuity, a gradual and experimental opening up of its economy, and saving and reinvesting a large proportion of GDP.

The country has allowed local administrations to compete to attract investment, develop infrastructure and improve local business environments. Other reasons include the appointment of senior personnel based on qualifications and experience, and a 'zero tolerance' stance towards corruption.

Major investment programmes

China undertook major infrastructure investments to connect different and previously remote parts of the country. The development of a large and integrated national market allowed businesses to achieve new economies of scale and improve profitability, while dismantling regional barriers to the movement of goods and services contributed to the creation of a single national market.

The state's investment in its human capital has been substantial, particularly in education, health, and vocational training. Between 1978-2015, 2.8m Chinese students completed their higher education abroad. Of these, as many as 2.2m, almost 80%, have returned to China.

> ***"Facing frequent bouts of inflation, asset price bubbles and a vanishing demographics dividend, Chinese policy-makers recognised the need to engineer the country's transition to slower and more sustainable growth.***

Realising that global dynamics were changing after the 2008 financial crisis, Chinese policy-makers began transitioning from an investment and export-led growth model to a consumption-led model. The previous strategy is viewed as having resulted in over-investment, cycles of excessive credit expansion, and a large trade surplus. Facing frequent bouts of inflation, asset price bubbles and a vanishing demographics dividend, Chinese policy-makers recognised the need to engineer the country's transition to slower (though still strong by global standards) and more sustainable growth.

Pakistan economic reform

Pakistan has maintained all-weather strategic relations with China since independence in 1947, and is likely to benefit significantly from the country's rapid economic rise. But while it may be ready to emulate China, it needs to reform its economy to do so. Reforms are required in sectors including agriculture, industry, energy, and banking and finance, as well as in the spheres of taxation, the civil service and the judiciary.

Pakistan must change its spending priorities. Substantial investment in infrastructure, including in energy, ports, shipping and telecommunications projects, and human capital, are key to higher economic growth.

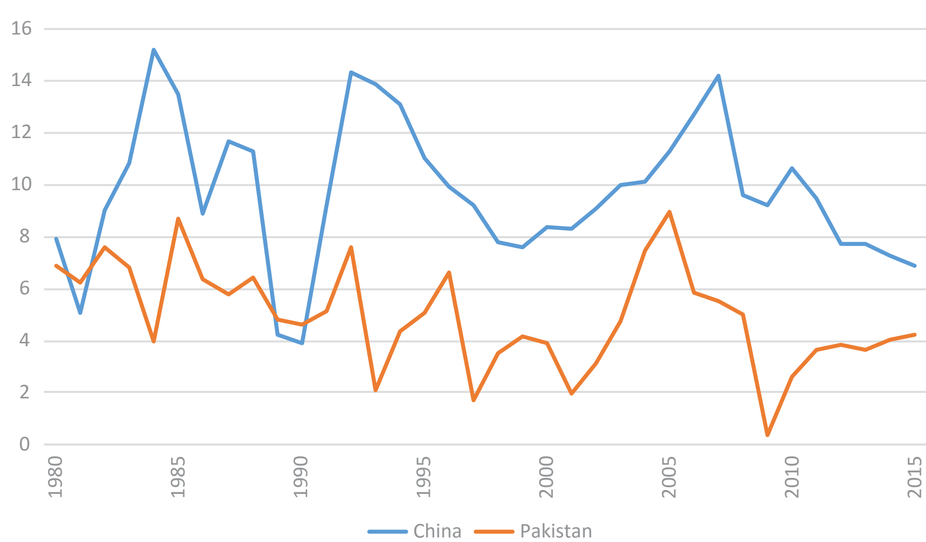
Savings and investment are crucial to this equation, but here too Pakistan's performance leaves much to be desired. Saving and investment rates are low, and the country's reliance on foreign savings is rising to maintain higher levels of investment, resulting in the accumulation of debt. Moreover, the government needs to avoid spending more than it earns. Doing so will require a prudent fiscal policy in which resource mobilisation takes centre-stage.

Other necessary reforms include addressing corruption and cronyism. A key aspect of China's success has been its crackdown on corruption, and Pakistan must ask itself whether it is ready to fight corruption to achieve higher economic growth. Honest, competent and well-paid civil servants are the backbone of any country's development, but the quality of Pakistan's civil servants is falling for a number of reasons, including declining standards of university education. Pakistan needs urgently to reform its state administration.

China's rise has been due in great part to the quality of its leadership. Pakistan needs leaders who are honest, independent, visionary and intelligent. If it can find leaders of such quality, it too can experience an economic rise on par with, if not exceeding, that of China. ■

Pakistan's growth recovers as China's economy slows

China and Pakistan annual real GDP growth, %



Source: International Monetary Fund, OMFIF analysis

Dr Ashfaque H. Khan is Principal and Dean, NUST School of Social Sciences and Humanities, Islamabad, Pakistan.

A long march to dethrone the dollar

Renminbi's role in an unstable 'anti-system'

Steve H. Hanke, Advisory Board

At a monetary conference in Vienna in 2014, Jacques de Larosière, the former managing director of the International Monetary Fund and a former governor of the Banque de France, proclaimed that the current world monetary order should be termed an 'anti-system'.

Such a system, he said, had been characterised by an explosion of credit and leverage, encouraged by low interest rates, deregulation, and persistent external imbalances and inflation targeting. This led to a rapid expansion of credit and money supply in the run-up to the global financial crisis. Each country was free to float or peg its currency, while the dollar's role as the primary international currency gave the Federal Reserve a dominant influence on world monetary conditions. The result had been volatility, persistent imbalances, disorderly capital movements, currency misalignments and, eventually, currency wars and a move to apply capital controls.

He has a point: such a system invites a significant level of instability. It also attracts uninformed 'loose talk' influencing public opinion and policy.

Renminbi misinformation

The renminbi has been at the centre of much misinformation and disinformation surrounding currencies. During the first US presidential debate on 26 September, Donald Trump described China as the world's 'best practitioner of currency devaluations', which he claimed powered Chinese exports. Clinton did not object to Trump's thesis.

While Chinese exports have steadily risen since 1995, they have not been powered by a depreciating renminbi. In fact, the renminbi has slightly appreciated in both nominal and real terms. But Trump's renminbi theory was no debating slip. Rather, it reflected disinformation spread by mercantilist unions and US politicians, Republican and Democrat.

Shortly after the first debate, the renminbi entered the IMF's special drawing right basket of top-tier currencies, allowing China to claim that it had entered the same league as fellow SDR currencies the dollar, euro, pound and yen.

But the dollar remains king. And when it comes to currencies, kings are hard to dethrone. Even after the euro's introduction in 1999, the dollar has maintained its position as the leading currency in official reserves, accounting for 63% of the total. It is even more dominant in terms of foreign exchange trading, accounting for almost 88% of the turnover. Dollar notes are widely used, with up to two thirds of all greenbacks in circulation overseas. The dollar has increased its dominance in terms of transactions handled by the Society for Worldwide Interbank Financial Telecommunication, accounting for almost 52% of the total.

> ***"The dollar remains king. And when it comes to currencies, kings are hard to dethrone.***

As with the euro's introduction in 1999, claims that the renminbi will dethrone the dollar are wide of the mark. On average, dominant currencies have retained their position for 300 years. This suggests that the dollar, barring unforeseen developments, is likely to reign for a while longer.

In a study of the world's dominant currencies over the past three millennia, Nobel prize-winning economist Robert Mundell found that one currency had always dominated. He found that each such currency had five characteristics associated with it: the currency's transactions domain was large; monetary policy inspired confidence; exchange controls were absent; the currency was linked to a strong state; and it was convertible into gold or silver.

Vulnerable currencies

Today's fiat currencies have no fallback factor, and all are vulnerable to a challenge. A new disruptive technology could allow the production and efficient use of a private currency with a fallback factor. If deemed legal, this could challenge the dollar.

When viewing the twists and turns of the dollar in de Larosière's 'anti-system', there is no better place to start than the 2008 global financial crisis. The dollar-euro exchange rate fell by 19.1% in four months. Linked to the soaring dollar, gold and oil prices fell by 19.1% and 57.0% respectively. Unsurprisingly, the annual inflation rate in the US fell from 5.5% in July 2008 to minus 2.0% a year later.

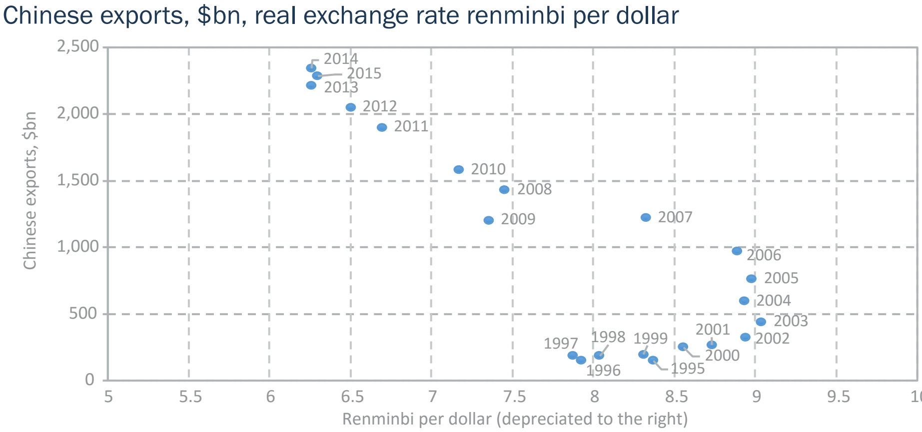
Contrary to the Federal Reserve's claims, the dance of the dollar and related changes in commodity prices and inflation indicated that monetary policy was far too tight in late 2008. This caused significant instability from which the global economy has yet to recover.

To reduce instability in the current 'anti-system', the dollar and euro should, through a formal agreement, trade in a zone (for example, \$1.20-\$1.40 to the euro). The European Central Bank would be obliged to maintain this zone of stability by defending a weak dollar through dollar purchases. The Fed would be obliged to defend a weak euro by purchasing euros. Such an intervention mechanism would represent a major political as well as economic step.

Stability might not be everything. But when radical instability is the alternative, it is a goal worth pursuing. ■

Chinese exports increase despite appreciation since 2013

Chinese exports, $bn, real exchange rate renminbi per dollar



Source: Board of Governors of the Federal Reserve System and International Monetary Fund. Calculations by Prof. Steve H. Hanke, The Johns Hopkins University

Steve H. Hanke is a Professor of Applied Economics and Co-director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise at The Johns Hopkins University in Baltimore.

Infrastructure route to global stability

Renminbi role in boosting regional financing opportunities

Yaseen Anwar, Advisory Board

Infrastructure development has a vital role to play in helping to stabilise the global economy. The question now is how major gaps in financing will be filled and from where those resources will come. China's $1.8tn 'One Belt, One Road' initiative, which focuses on infrastructure investments, is one strategy that addresses this challenge.

The global economy is still suffering the effects of the 2008 financial crisis. In the first half of January 2016, global stock markets saw $2.2tn worth of capital destruction, while commodity prices are yet to recover from the steep declines of 2014-15. Political events in the US, western Europe and the UK have injected uncertainty into global markets and the international monetary system.

The decades following the second world war witnessed the recovery of the US, Europe and Japan, with huge outlays on infrastructure to support this growth. Asia today is growing faster than the US and Europe, but has yet to harness its considerable potential.

Regional and global integration

OBOR provides the catalyst for the infrastructure investments needed to achieve regional and global integration. Large-scale developments will reduce global imbalances, and allow Asia to absorb shocks from other parts of the world and manage systemic risk.

China's CITIC Bank has announced plans to invest in 300 projects extending from Singapore to Turkmenistan. Projects include railways, highways, pipelines, power grids, and other infrastructure links stretching from Asia to Greece, Russia, and Oman. These initiatives will create new jobs and markets, impart skills, and generate self-sustaining prosperity.

To help OBOR fulfil its potential, the Chinese authorities have paid attention to important financing gaps. The Asian Infrastructure Investment Bank is a key part of the solution: 57 countries – including many south Asian countries, as well as the Organisation for Economic Co-operation and Development – are signatories to the AIIB charter. To leverage financing needs, a dedicated 'Silk Road fund' of $40bn, and capital injections of $32bn and $40bn for China Development Bank and Exim Bank of China respectively, have been established.

Several AIIB projects have been approved for financing in Pakistan, Bangladesh and central Asia. Each project is co-financed by multilateral organisations including the World Bank. These partnerships are evidence of the collective commitment needed to rejuvenate the global economy through the infrastructure sector.

Infrastructure development can generate plentiful employment opportunities as long as there are corresponding government interventions at the federal, provincial, and district levels to manage urbanisation. Infrastructure investment will boost national small and medium-sized enterprise sectors, increase employment, and provide banks with opportunities to diversify their portfolios.

New roads, bridges, and railroads will improve transport networks and reduce delivery costs. Improved telecommunications networks are vital. Investment in power is essential for manufacturing, both for domestic needs and for exports, to ensure a stable trade and current account.

> ***"Infrastructure development can generate plentiful employment opportunities as long as there are corresponding government initiatives to manage urbanisation.***

China's resources and capability to support infrastructure should not be exclusive. Other multilateral institutions will need to mobilise and leverage their capital. The World Bank has increased its staff in Singapore to around 300 from around 70 five years ago, a declaration of intent that it will meet regional demand. Japan has established a $100bn fund in support of infrastructure. The Asian Development Bank has stepped up its co-financing activity in tandem with the AIIB. The European Bank for Reconstruction and Development has formally expressed an interest in collaborating with the AIIB.

Renminbi – an alternative reserve currency

A related, though rarely talked about, opportunity to finance infrastructure is the renminbi as a new alternative reserve currency.

With a more than 10% weighting in the IMF's special drawing right basket of reserve currencies, the renminbi can be used to facilitate trade under the 36 currency swap

agreements executed with China. This would boost regional financing opportunities, provide comfort to Chinese manufacturers invoicing in renminbi and reduce foreign exchange risk and exposure.

Opportunity of 'dim sum' and 'panda' bonds

As a further example of the Chinese currency's acceptability, around 15% of German trade with China is now renminbi-denominated. In 2015 the Industrial and Commercial Bank of China became the first institution in Singapore to issue a renminbi instrument. Numerous other issues of 'dim sum' and 'panda' bonds provide a significant opportunity for multinationals to finance their operations.

As the world's second largest economy, China will serve as a fulcrum for the rest of Asia. Notwithstanding the headwinds that will generate some dislocations and volatility, the authorities' strong commitment to addressing those vulnerabilities will contribute to sustained growth in the country.

The advantages of infrastructure development initiatives such as OBOR in stimulating global growth are clear. Ample resources and financing opportunities are available. It is up to the world community to ensure that such opportunities are taken wisely. ■

Yaseen Anwar is former Governor of the State Bank of Pakistan.

Service industries key to Asean growth

Strong intra-regional flows counterbalance external risks

Adam Cotter

After three years of lacklustre growth, 2017 looks set to be an important turning point for the 10-member Association of Southeast Asian Nations as it celebrates its 50th anniversary.

Following an economic slowdown reflecting more muted growth in China, declining commodity prices and lower levels of global trade, the International Monetary Fund expects average growth in 2017 to recover to rates seen before the commodity price downturn, supported by rising investment and stable inflation. However, domestic political risks and external economic shocks continue to cast a pall over the region's economic outlook.

Facilitating intra-regional investment was Asean's priority before the Asean Comprehensive Investment Agreement was adopted in 2008. However, most of the region's foreign direct investment still comes from non-Asean economies such as the US, Japan, the European Union, and, increasingly, China and South Korea.

Intra-regional capital flows

Several other initiatives have helped generate capital flows in the region. These include the Asian Bond Markets Initiative, the 2010 Credit Guarantee and Investment Facility, and the $240bn Chiang Mai multilateral currency swap arrangement, supported by a strengthened 'Asean+3' (the 10 Asean countries plus China, Japan, and South Korea) and the supranational macroeconomic research office (Amro) set up in Singapore. The formation of the Asean Exchanges, aimed at promoting growth in Asean capital markets, represents a major step towards further liberalising capital flows and offering more investment opportunities.

Asean in the last 10 years has benefited from closer intra-regional investment relationships, as well as FDI from outside the region. Economic weakness in Asean's partners boosted the share of intra-regional flows, which now account for almost one fifth of total net inflows. Flows from traditional sources of investment, namely Japan and the EU, have failed to keep pace. Meanwhile, flows from the US have been markedly stronger as a result of the Obama administration's 'pivot east' policy, and by 2015 accounted for more than 11% of investment.

It is Asean's economic performance that ultimately makes it attractive to investors. This is despite the region's uneven liberalisation of capital markets, and concerns over the high cost of doing business.

Growth rates have been recovering since the global financial crisis, but have yet to reach the levels seen in the middle of the last decade. Opportunities are most abundant in Cambodia, Laos and Myanmar, where growth rates in 2017 are expected to be around 7%, according to the IMF.

There is growing interest in Myanmar's economy from within Asean, as the country begins to look outwards following decades of isolation. Reforms allowing greater foreign ownership of companies will attract FDI.

> ***"Asean's economic performance makes it attractive to investors, despite uneven liberalisation of capital markets and concerns over the high cost of doing business.***

The IMF expects GDP growth to reach 8.6% in 2016, making Myanmar the world's fastest-growing economy. Meanwhile, Vietnam continues to outperform its neighbours. Growth rates across Asean's six founding members – Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand – are expected to remain relatively subdued in 2017, at 4.1%, though they are forecast to improve dramatically from 2019.

While on an upward trend, levels of intra-regional trade remain low compared with other regional blocs. More than 70% of intra-Asean trade incurs no tariffs, while less than 5% is subject to tariffs of more than 10%. The services sector has grown in importance, but trade in services has not been liberalised to the same degree, partly because it has a much shorter history than trade in goods.

A series of free trade agreements between China, India, Japan, South Korea, Australia and New Zealand have improved conditions for trade between these economies. Over the past 10 years, Asean has concluded five FTAs, with Australia and New Zealand, China, India, Japan and South Korea respectively.

Balancing pressure on Asean exports

These FTAs may be superseded by the Regional Comprehensive Economic Partnership, an agreement between Asean and China, India, Japan, South Korea, Australia and New Zealand. RCEP member countries account for 48% of the world's population. Vietnam, meanwhile, is pinning its hopes on FTAs with the US, the EU and South Korea. Increasing levels of intraregional trade could counterbalance pressure on Asean exports as a result of China's economic slowdown.

Asean would benefit from increasing exports to India. Its share of Asean exports has significantly expanded, from 1.5% in 1999 to 5% in 2014. Much of the additional demand has come from commodities – palm oil and coal – from Indonesia and Malaysia. The creation of the Asean Economic Community in 2015 has been viewed as an important milestone in promoting the growth of trade in regional services in particular.

Asean's outlook in 2017 is mixed. Headwinds from China and other major trading partners, increasing political tensions, and potential external shocks are downside risks. Many more traditional areas of growth are no longer as propitious as they once were. Infrastructure spending will help, but growth will slow in the larger Asean economies.

As a result Asean will have to turn to new fields to renew dynamic expansion in coming years – with trade and investment in services likely to play a key role. ■

Adam Cotter is Head of Asia and Chief Representative, Singapore, at OMFIF.

The Bulletin
FOCUS

November 2016

Renminbi: towards a new safety net

OMFIF

FOCUS: RENMINBI SWAP NETWORK

Possible path to global financial safety net

This Focus report assesses the increasingly important role of Chinese swap agreements in the global financial system. Currency swaps, which allow central banks to exchange a set amount of local currency with another central bank at a fixed rate, are an important stabilising factor in financial markets. Access to foreign currency allows central banks to lend those funds to domestic banks and companies, ensuring they have access to short-term capital for their foreign currency activities.

Swap lines are predominantly accessed when countries face funding constraints or are suffering exchange rate fluctuations or market shocks. After the global financial crisis, the US Federal Reserve swap network helped prevent dollar liquidity shortages from turning into insolvency problems that would have exacerbated the post-crisis fallout. The importance of Fed swap lines highlights the dominant role of the US economy in the international financial system as the issuer of the global reserve currency, the largest participant in financial markets, and a key trade and investment partner for most countries.

Since 2008 the European Central Bank and People's Bank of China have created their own swap networks, driven by the importance of these currencies to international payments and financial market activities. This reflects the gradual shift towards a multicurrency reserve system. The economic growth of regions outside the US has resulted in greater amounts of non-dollar financial transactions, from bilateral trade and investment to local currency bond issuance. This has created a growing need for many countries to hold non-dollar currency reserves.

> ***"Since 2008 the European Central Bank and People's Bank of China have created their own swap networks, driven by the importance of these currencies to international payments and financial market activities.***

China sees benefits in lower dependence on dollar

China is the second largest economy, a principal trade partner for most countries, and an important source of global capital and investment flows. However, the international use of its currency has remained limited. Since late 2008 the Chinese authorities have sought to change this, seeing benefits in lower dependence on the dollar and in greater international pricing in renminbi. The currency's inclusion in the International Monetary Fund's special drawing right, alongside the dollar, euro, sterling and yen, was an important milestone, enshrining the renminbi as a reserve asset. This could spur further development of the SDR as an international payment and accounting instrument, with the expansion of SDR-denominated bonds and other financial market instruments.

The use of a basket of currencies that includes the renminbi could help mitigate exchange rate risks and price fluctuations of securities denominated in SDR. It would also reduce overreliance and excess demand for the dollar, while boosting demand for renminbi. These have been long-term goals of the Chinese authorities. In addition to increasing the use of SDRs, the PBoC has established a network of swap agreements worth almost $500bn to boost the use of its currency in financial transactions.

There are questions about the continued trajectory of the renminbi, given risks to the Chinese economy in the medium term. However, as a political as much as an economic tool, China is likely to continue expanding the international use of renminbi. This includes initiatives to price energy and other commodities in the currency, and the expansion of multilateral investment banks that use renminbi.

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'Renminbi Swap Network Focus' forms part of the OMFIF Bulletin for November 2016. It is not to be distributed separately without permission of OMFIF. The same disclaimer applies as on p.4 of the Bulletin.

Renminbi SDR inclusion boost to liquidity

David Marsh

The much-heralded entry of the renminbi into the special drawing right, achieved after a successful 18-month Chinese campaign to win international acceptance for its currency, has a range of systemic effects that go well beyond the technical matter of an additional unit in the International Monetary Fund's composite currency basket.

> ***"Bringing the renminbi into the SDR transforms previously agreed bilateral Chinese swap lines into a large potential source of dollar liquidity.***

One of these consequences could be to generate an important boost to global liquidity, adding to China's arsenal of international financial instruments outside established western-guided policies. The significance could unfold gradually in the next 10 to 15 years.

A liquidity-generating device, enabling the Chinese authorities to turn their own currency into dollars that could be used by foreign central banks, adds to other Chinese measures to build influence beyond the US-dominated IMF and World Bank, the two Bretton Woods institutions set up in 1944. The main importance of the SDR move on 1 October has been to enshrine the renminbi as a reserve currency alongside the dollar, euro, sterling and yen. This is a major landmark for a developing nation now in the elite 'club' of countries at the heart of world finance.

The renminbi joins the SDR with a share of 10.9%, making it the third most important currency in the unit, behind the dollar and euro. Its inclusion transforms a string of previously agreed bilateral Chinese swap lines with 36 central banks into a large potential source of dollar liquidity for countries that may run into payments constraints. Of these agreements, three have since expired and one with Nigeria has yet to be finalised.

Swap lines over the past seven years between the People's Bank of China and countries from every continent add up to more than Rmb3tn ($500bn). Most of these deals were agreed to help boost bilateral trade invoiced in renminbi, as well as to provide sources of renminbi liquidity for local trading. Only a small fraction has been drawn. Now that the renminbi is part of the SDR, these arrangements take on more systemic significance, forming a kind of 'renminbi safety net' outside the formal network of the Bretton Woods institutions.

Potential to bypass the existing Federal Reserve swap network

Under existing SDR arrangements with the IMF and a range of countries, central banks that draw renminbi under swap agreements can potentially convert them into SDRs and then into dollars through a series of official transactions.

Countries which have signed swap agreements with the PBoC now have possible access to dollars. This could allow them to bypass the existing Federal Reserve swap network – which the US authorities have taken care to maintain on a highly restrictive basis – as well as the IMF as an alternative source of institutionalised multinational finance.

Among those concluding swap deals with China are the European Central Bank as well as central banks from Australia, Canada, Hong Kong, Qatar, Singapore, Switzerland, the United Arab Emirates and the UK. These are all highly unlikely to use such arrangements as a route to an alternative source of dollar liquidity. Other swap counterparties such as Albania, Argentina, Belarus, Mongolia, Pakistan, Sri Lanka, Thailand, Turkey and Uzbekistan are more likely to make use of such a mechanism.

> ***"In October, the US administration took a step towards dropping China from the Treasury's annual currency manipulation watchlist.***

There is no suggestion that the US regards the possible liquidity significance of the new arrangements with any qualms. In October, the US administration took a step towards dropping China from the Treasury's annual currency manipulation watchlist.

This is partly because the renminbi appreciated significantly in the prelude to the IMF's decision on SDR inclusion in November 2015. However, since then it has been on a downtrend against the dollar. Additionally, Washington's relative satisfaction with Beijing represents China's success in lowering the size of its current account surplus, previously seen as destabilising the world economy.

Among the conditions for Beijing's designation last year as running a 'freely usable currency', China has liberalised parts of its domestic financial market and provided the international community with more details of hitherto secret financial information. This is despite the risk that a move towards relative openness could cause economic setbacks for the Chinese leadership. Adding the currency to the SDR basket was expected to create demand for as much as $30bn of renminbi from institutions that use SDRs as a unit of account. Yet the renminbi has been steadily losing ground, based on a general feeling that Beijing would relax its grip on the currency now that its premium status has been confirmed.

The SDR move forms part of an amassing of Chinese monetary influence that one day could represent a serious challenge to the international supremacy of the dollar and American financial markets. China has further promoted new international financial organisations such as the Asian Infrastructure Investment Bank, and espoused reserve-sharing arrangements with other major emerging market economies.

These steps amount to a shot across the bows of the western-denominated financial establishment. A renminbi-based swap network encircling the world will, in time, be another important element of this gradual accrual of influence. ■

David Marsh is Managing Director of OMFIF.

Trade ties fuel renminbi's appeal

Danae Kyriakopoulou and Ben Robinson

The growing use of renminbi in international financial transactions over the last eight years has made access to the currency an increasingly important consideration for banks and companies globally. A total of 36 central banks have signed currency swap agreements with China since the end of 2008, totalling Rmb3.3tn (around $500bn), although some of these have expired (see Chart on pVII).

This reflects China's growing economic influence. Starting off as one of the world's poorest economies, it has followed an unprecedented growth path and is now on course to become the world's largest. As a result, it has assumed a prominent role in global capital and commodity markets. As the map below shows, China is now the largest or second-largest trading partner for most of the world's economies. This creates important incentives for China's trade partners to hold greater amounts of renminbi in their foreign reserves. Mitigating exchange rate risks and reducing trade costs and transaction times are important considerations, as are ready access to renminbi liquidity and the ability to withstand balance of payments pressures.

With diminishing returns on domestic investment forcing China to look abroad, the country has become an important source of funding for both developed and emerging economies. Access to renminbi liquidity is becoming a vital component of financial stability. In terms of the renminbi's use in payments, however, China still punches below its economic weight. Although the currency's importance has risen over the past decade, it is still only the fifth most used in payments, making up just 2% of global payments. But even where trade is conducted predominantly in dollars or euros, holding renminbi can be useful for hedging currency risks and achieving reserve diversification.

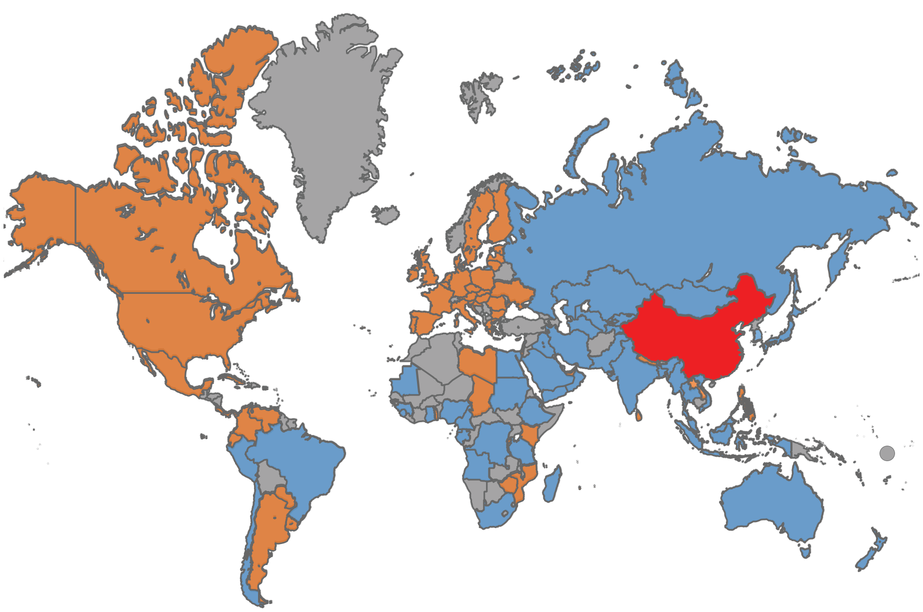
Impressive expansion of China's economy

According to partial data from the IMF, 38 countries held renminbi in their official reserves at the end of 2014. The amounts represented 1.1% of total official reserves, equal to around $75bn. In a live poll held at the Asian Development Bank 2016 Asian Regional Forum on investment management of foreign exchange reserves in November, 46% of representatives from global public investors expected 1% to 5% of their reserves to be held in renminbi by the end of 2018, with a further 17% expecting the share to be between 5% and 10%. Although China's economic performance has weakened over the past two years, in absolute terms the economy has expanded at an impressive rate and the global share of reserves held in renminbi is likely to be higher now. The IMF will release the first Cofer data with renminbi as a separate currency in March 2017.

The opening up of renminbi-denominated investment options for foreigners has continued since the IMF's last report on renminbi holdings, further boosting the currency's international use. Qualified foreign institutional investor and renminbi-qualified institutional investor status has been granted to more countries during 2015-16, while the People's Bank of China's swap network has been expanded to eight new countries since end-2014.

China dominates as global trading partner

China's trading partner status, by country*, measured by total merchandise export and import volumes in 2015**



China is the largest trading partner | China is the second largest trading partner | Other countries

*Source: International Monetary Fund, OMFIF analysis. *China is the second-largest trading partner for the EU as a trading bloc, and not for all individual EU economies. **Data for 2014 have been used for some economies where there are data gaps.*

Euro uncertainty holds back reserve use

Meanwhile, political and economic uncertainty has continued for the euro, the second largest reserve currency behind the dollar. This has weakened the currency's appeal as a reserve asset, one of the factors, along with lower valuation, reducing its share of total official reserves from 28% in mid-2009 to around 20% in mid-2016.

The euro's challenges are expected to persist given a lack of progress with necessary reforms to Europe's monetary architecture. Elsewhere, the UK vote to leave the European Union is putting pressure on sterling, while a victory for Donald Trump in the US presidential election could set the dollar on a similar path. This sets the stage for a continued rise in the renminbi globally.

> ***"The UK vote to leave the European Union is putting pressure on sterling, while a victory for Donald Trump in the US presidential election could set the dollar on a similar path.***

Majority of renminbi reserves held in Asia Pacific

While a country-by-country breakdown of renminbi reserve holdings is not available, the large amount of trade between Asian economies and China suggests that most renminbi reserves are held in the region. Asia Pacific accounts for 47% of all trade with China, of which 45% is denominated in renminbi.

This close relationship is further reflected in the prominence of Asia in renminbi swap agreements. The Hong Kong Monetary Authority, Bank of Korea and Monetary Authority of Singapore have swap agreements of Rmb400bn, Rmb360bn and Rmb300bn respectively. Hong Kong's particularly large swap size reflects the territory's role as the base for offshore renminbi activity. This allows the onshore rate to remain subject to capital controls, while providing international liquidity to facilitate offshore renminbi activities. The European Central Bank has a further Rmb350bn agreement (renewed in September 2016 for three years). This reflects Europe's position as the second largest renminbi payments area, with 31% of its trade with China denominated in renminbi.

The entry of the renminbi into the IMF's special drawing right on 1 October allows central banks to exchange SDR holdings for renminbi liquidity, cementing the currency's role as an official reserve asset. However, the extent to which countries use SDRs in this way will depend on the amount of trade and investment they conduct with China. Resort to this mechanism will probably be low in the next few years, given the dollar's still dominant role in international transactions and the relatively small amount of renminbi activities.

The renminbi's international role is rapidly expanding, as evidenced by the increasingly sophisticated use of the currency in international transactions. As well as being used to settle trade in goods between China and some of its partners, and direct investment into China, foreign access to Chinese A-shares and China's corporate and sovereign bond markets have increased the options for international investors.

Nevertheless, confidence among international investors in China's stock and bond markets remains weak, and has suffered periodic setbacks due to periods of high volatility, notably in mid-2015 and the start of 2016. Although fears over a hard landing for China's economy appear to have abated for now, financial market participants remain wary of Chinese policy-makers prioritising growth over reforms and credit-fuelled expansionary policies to stimulate the economy.

The latest quarterly report by the Bank for International Settlements warned that China's credit to GDP gap, a key early warning indicator for credit vulnerability, had reached dangerously high levels. At 30.1, the gap is the highest to date and more than double that of Canada, the second-highest score for a country examined by the BIS. Corporate indebtedness is seen as a big risk. China's corporate debt stock stands at around $18tn, equivalent to 170% of GDP.

> ***"The rapid expansion of renminbi trading hubs in Asia, Europe and the US has been facilitated by the growth in PBoC-designated clearing banks in these regions, improving access to renminbi liquidity.***

Short-term risks for China's economy

To address these concerns, in October the Chinese authorities outlined a range of measures, including encouraging mergers and acquisitions, bankruptcies, debt-to-equity swaps and debt securitisation. But even if successful, these measures will create short-term risks for China's economy, with repercussions for the renminbi. China has $3.2tn in foreign reserves, but these can be depleted quickly if the currency came under pressure, for example if fears grew of a hard landing.

Despite these potential problems, progress on expanding the infrastructure for the renminbi's internationalisation has continued unabated. The rapid expansion of renminbi trading hubs in Asia, Europe and the US has been facilitated by the growth in PBoC-designated clearing banks in these regions.

The renminbi is becoming increasingly important in international pricing too. To avoid exchange rate risks and to protect the Chinese economy from shocks in commodity-exporting regions, Beijing is seeking to expand the pricing of oil in renminbi. This will further cause the amount of renminbi held by oil exporters to rise. China has already launched a renminbi-denominated benchmark price for gold, and other commodities could soon follow.

Policy-makers face the difficult task of navigating China's rebalancing away from an export-driven industrialising economy towards a mature services-orientated one. However, even accounting for the inevitable cyclical swings and structural slowdown in China's growth, China's global role can only increase. This creates the imperative for countries to increase their access to renminbi, via larger official reserve holdings, increased swap agreements, and potentially a greater resort to SDR conversion. ■

Danae Kyriakopoulou is Head of Research and Ben Robinson is Economist at OMFIF.

Swap deals to ride renminbi wave

Le Xia, BBVA Research

As an important part of China's efforts to internationalise its currency, the People's Bank of China since December 2008 has signed 36 renminbi-denominated bilateral swap agreements with foreign central banks (the agreement with Nigeria is yet to be ratified). Currently 33 renminbi BSAs are still effective.

The BSA concept is not new. Following the 1997-98 Asian financial crisis, the 10 members of the Association of Southeast Asian Nations signed BSAs with the three largest east Asian economies – Japan, South Korea and China (including Hong Kong) – under the Chiang Mai Initiative to prevent such crises from recurring. During the 2008-09 global financial crisis, the US Federal Reserve signed several temporary BSAs with central banks to secure their access to dollar liquidity, in a bid to stabilise international markets.

But these new Chinese entrants have a distinct objective. As the PBoC's 2012 annual report revealed, renminbi BSAs are signed to promote the currency's use in bilateral trade and investment activities. This differs from BSAs' traditional use as a precautionary measure to provide liquidity in case of financial crisis.

> ***"Academic research into how the Fed selects its emerging market partners has found that it tends to sign temporary bilateral swap agreements with countries that have close financial and trade ties with the US.***

China and US criteria for BSA partners

China's authorities are applying a new set of criteria when selecting BSA partners. For example, the Chiang Mai Initiative has formed a regional network of BSAs between its members, all of whom were affected by the 1997-98 Asian crisis to varying degrees.

By comparison, the Fed displayed a strong preference for choosing developed economies as BSA partners following the 2008-09 upheavals: central banks of developed countries accounted for 10 of the central bank's 14 temporary BSA partners. In October 2013, it announced that it had converted temporary BSAs with five developed economies into standing arrangements, namely those with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, and the Swiss National Bank.

> ***"The PBoC prefers countries which already have free trade agreements with China, consistent with its objective of harnessing BSAs to promote renminbi usage in cross-border trade and investment activities.***

Academic research into how the Fed selects its emerging market BSA partners has found that it tends to sign temporary BSAs with countries that have close financial and trade ties with the US. A high degree of financial openness increases the likelihood of a BSA being signed. The Fed has cautiously avoided countries with a history of sovereign default, to minimise associated credit risks.

Unlike the Fed, the PBoC seemingly favours developing countries as BSA partners. Among its 33 effective BSAs, just six are with foreign central banks of developed economies. The PBoC prefers countries which already have free trade agreements with China, consistent with its objective of harnessing BSAs to promote renminbi usage in cross-border trade and investment activities.

The PBoC does not appear to pay much attention to the financial openness of its BSA partners, and several countries with a sovereign default history have signed BSAs with the central bank. This could be explained by a 'demand-side' factor – these countries are keen to establish financial arrangements to improve their defences against external shocks. For such countries, the renminbi BSA is a positive option as long as China has no concerns over their default history.

Open selection for renminbi internationalisation

There is no clear evidence to suggest that decisions to sign BSAs have been driven by geopolitical considerations or institutional similarities. In pressing ahead with renminbi internationalisation, China's authorities have sought to make the selection of BSA partners as open as possible.

Two global economic powers are missing from the list of China's renminbi BSA partners: the US and Japan. This in part reflects the two countries' wariness of renminbi internationalisation and the consequences for their own currencies' positions in the international monetary system.

Renminbi internationalisation can be perceived as a normalisation process in which the Chinese currency obtains a status that matches the country's global economic influence. Policy-makers from other countries are likely to choose to 'ride the renminbi wave'. Signing a BSA with China would be a positive point from which to embark on this new journey. ■

> ***"Renminbi internationalisation can be perceived as a normalisation process in which the Chinese currency obtains a status that matches the country's global economic influence.***

Le Xia is a Hong Kong-based economist at BBVA Research. He is also a Senior Research Fellow at the International Monetary Institute of Renmin University of China.

Systemic importance of SDR entry

Yaseen Anwar, Advisory Board

The renminbi's official entry into the International Monetary Fund's special drawing right bestows on it credibility as a reserve currency, and brings it closer to being freely usable. Systemically, the renminbi can now take its rightful place in the diversified asset allocation strategies of central banks and money managers.

This will mitigate the potential depreciation of local currencies and the value of a country's reserves when monetary policy developments linked to a dominant reserve currency cause sudden fluctuations. This risk was realised in 2013 when the US Federal Reserve disturbed markets by voting to taper its asset purchasing programme. The 'taper tantrum' that followed triggered a significant depreciation in the currencies of Turkey, Brazil and India, among other countries. As the renminbi gains more traction in the international monetary system, any future flight to safety and search for yield may create less volatility and uncertainty.

Countries with low reserves and which have no or limited access to global debt markets owing to poor ratings would be able to ease balance of payments pressures by drawing under the currency swap agreement. In such cases, those countries could maintain stable reserves under the watchful eyes of rating agencies. Thanks to renminbi liquidity through the swap line, Pakistan has been able to meet the conditions of net international reserves targets under the IMF facility.

"Thanks to renminbi liquidity through the swap line, Pakistan has been able to meet the conditions of net international reserves targets under the IMF facility.

Greater acceptability for the renminbi

In the light of projected growth rates for China and the rest of Asia, the renminbi is likely to continue to attract greater acceptability and usage over the next 10 years. This should help it become the second official reserve currency behind the dollar, albeit with a large gap. This recognition will be enhanced by the development of Chinese capital markets, as a large working population begins to retire and seeks higher returns than deposits can offer.

Correspondingly, the Chinese authorities will promote the growth of mutual funds, insurance products and fixed income instruments. Such developments will help lift the Chinese economy into the No.1 position globally.

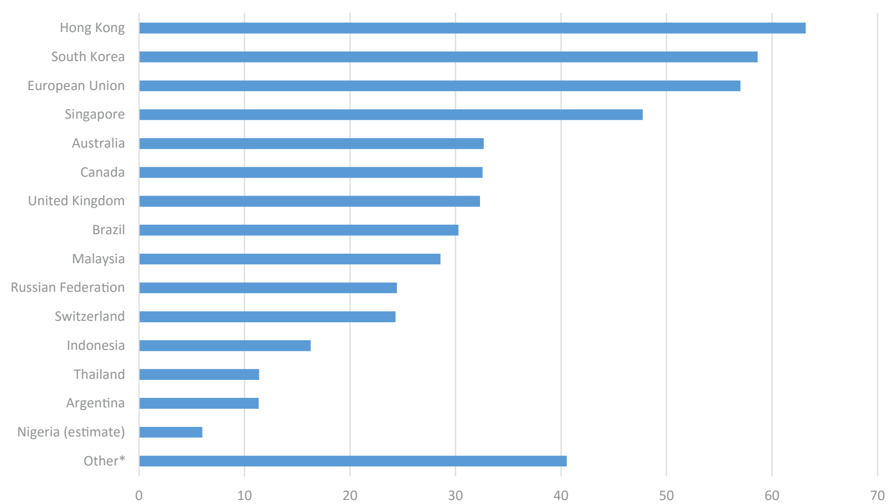
Asia's projected economic dominance in the coming decades is likely to see greater and more active interaction between central banks in the region, along with more transparency and higher corporate governance standards. This is the philosophy of the Chinese leadership, and it will become the hallmark for central banks actively engaged with China's economy.

However, the SDR is unlikely to become a pivotal unit of account in the near term. Markets must first digest the renminbi's entry into the international monetary system, and accept China's position on the global stage as it establishes its leadership role, both economically and politically, beside the US. ■

Yaseen Anwar is former Governor of the State Bank of Pakistan.

Asia leads renminbi swap network

China's bilateral swap lines, $bn



Source: People's Bank of China, OMFIF analysis.

**Other includes Albania, Belarus, Chile, Hungary, Iceland, Kazakhstan, Mongolia, Morocco, Nepal, New Zealand, Pakistan, Qatar, Serbia, South Africa, Sri Lanka, Suriname, Tajikistan, Turkey, UAE, Ukraine and Uzbekistan. The swap agreements with Brazil, Ukraine and Uzbekistan have expired. The size of Nepal's swap agreement is unknown. Nigeria's swap agreement is agreed but not ratified.*

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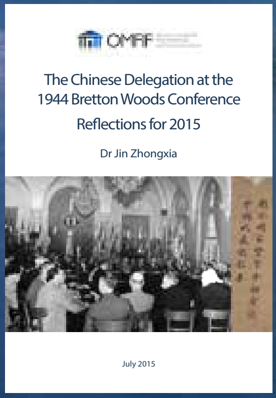
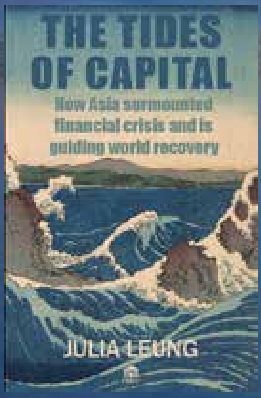
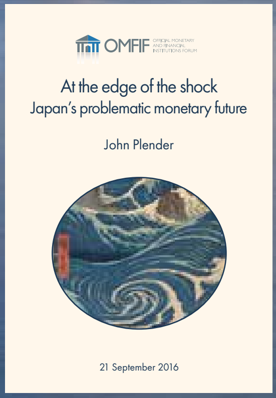






Why a multicurrency system is stronger

Emerging markets' role in new economic order

Javier Guzmán Calafell, Banco de México

Central banks have shown increasing interest in investing their international reserves in assets denominated in a wider array of currencies. This reflects a more active search for yield in a low interest rate environment and is partly motivated by a desire to diversify.

To attain international status, a currency must be seen as a reliable store of value by private and official non-residents, implying that they are willing to hold assets in that currency. It has to be considered an efficient medium of exchange for international transactions, reflected in its active use in the settlement of global transactions. It should be widely regarded as a unit of account, whether for commercial or financial flows.

Dollar 'most important' currency

At present only a few currencies are treated as undoubtedly international assets, the dollar being the most important. According to the International Monetary Fund, the dollar accounts for 63% of all allocated foreign exchange reserves, more than three times its nearest competitor, the euro. As the Bank for International Settlements has noted, the dollar is involved in around 90% of all foreign exchange transactions.

While new currencies have been added to the stock of international reserves, most do not meet the requirements to be a global currency. Excluding the dollar, euro, pound and yen, the share of other currencies in global international reserves amounts to around 7%. When the Swiss franc, the Australian dollar and the Canadian dollar are excluded, other currencies account for just 3%. Out of the remaining reserves, half are in renminbi.

The predominance of a handful of currencies appears incompatible with developments in the world economy. Emerging market economies account for as much as 60% of world GDP. Growth rates are expected to remain significantly higher than in advanced economies. It therefore seems reasonable to expect emerging market currencies to play a more important role in the composition of international reserve assets.

2016 YEAR OF THE MULTICURRENCY SYSTEM

The economic size of an issuing country is only one determinant of a currency's internationalisation. An economy's role in trade networks, the liquidity and openness of national markets, and the stability and convertibility of its currency are also major contributing factors.

Among emerging market currencies, the renminbi appears most likely to secure a significant role. This is partly in view of China's position in the world economy, but also because of the Chinese authorities' interest in renminbi internationalisation. This has been illustrated by the gradual opening of Chinese financial markets to foreign participation, the renminbi´s inclusion in the IMF's special drawing right basket, and China's negotiation of currency swap agreements. However, China is still far from meeting all of the conditions to provide the renminbi with international status.

The race to consolidate the renminbi as a global currency should be viewed as a marathon rather than a sprint. Moreover, the question remains whether a monetary system with more international currencies would be stronger than the present one. I believe it would be.

A sound and efficient system

The more economies with macroeconomic stability which are open to trade and have liquid capital markets, the more the system as a whole will be sound and efficient. A greater number of international currencies entails greater possibilities to diversify overall portfolio risk. A multicurrency reserve system may reduce the risk of persistent overvaluation of assets, including exchange rates.

Countries' role as reserve issuers will also gain a more evenly distributed range of benefits. These include seigniorage gains and lower interest rates on debt, as well as a reduced risk of major and persistent global external imbalances.

Nevertheless, a multicurrency reserve system is not free from difficulties, as the case of renminbi internationalisation illustrates. The process requires a comprehensive opening of China's financial markets to foreign transactions, as well as a floating exchange rate. Such moves may have unintended consequences for both the domestic economy and the global financial system. Financial and exchange rate liberalisation in other countries may be accompanied by periods of turbulence.

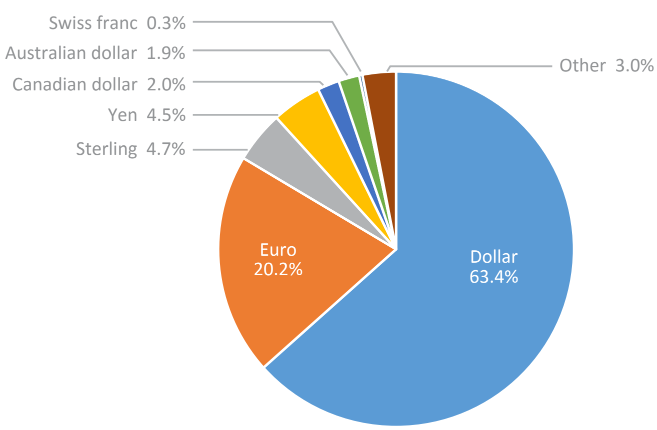
Irrespective of the challenges of a transition towards international status, the risks of sudden portfolio shifts and exchange rate volatility will not disappear under a multicurrency reserve system. Such a system may lead to greater short-term capital flow volatility and exchange rate adjustments as a result of the increased substitutability of currencies. Currency internationalisation may give rise to other risks, such as reduced control over monetary aggregates.

Notwithstanding these challenges, the benefits of a wider availability of global currencies will outweigh the potential costs in the long term. ■

Javier Guzmán Calafell is Deputy Governor of the Banco de México. This is an edited extract of his speech given at the OMFIF-RAMP discussion in Washington on 6 October.

Dollar dominates world currency reserves

Allocated reserves by currency, %, Q2 2016



Source: International Monetary Fund Cofer

Easing the global flow of trade

Preferential trade agreements becoming deeper over time

Alberto Osnago, Nadia Rocha, and Michele Ruta

Two economic developments have brought the relationship between preferential trade agreements and global value chains to the forefront of research and debate on trade policy. First, technological innovation in communication and transportation has enabled the unbundling of stages of production processes across time and space, resulting in an increase in offshoring. Second, since the end of the 1990s, an increasing number of countries have signed bilateral and regional PTAs.

Offshoring can be carried out either within or outside a particular company's operations. When firms outsource the production of some stages outside their boundaries – when they engage in foreign outsourcing – they generate 'arm's length trade'. When they offshore within their boundaries through (vertical) foreign direct investment, they generate 'within-firms trade'.

Traditional and modern PTAs

Traditional PTAs mostly consist of reciprocal market access exchanges involving tariff cuts and the reduction of other border measures. Modern-day PTAs frequently contain provisions covering a wide array of non-tariff measures, both at and behind the border. These new trade agreements are referred to as 'deep' to distinguish them from traditional PTAs focused solely on market access commitments – sometimes referred to as 'shallow' agreements.

With preferential tariffs approaching the zero lower bound, the coverage of PTAs in terms of policy areas has widened over time. The WTO documented this development in its 2011 report, 'The WTO and preferential trade agreements: from co-existence to coherence'.

Modern PTAs increasingly contain provisions covering a wide array of non-tariff measures, both at and behind the border. For example, several PTAs include provisions covering technical barriers to trade; sanitary and phytosanitary measures; rules on investment; protection of intellectual property rights; anti-corruption provisions; competition policy; and labour regulations.

The WTO mapped a total of 52 disciplines across 100 PTAs signed between 1958 and 2011. Chart 1 shows that PTAs became deeper over time. Agreements signed between 1987 and 1991 included nine provisions on average. Agreements signed between 2007 and 2011 included an average of 15.

Chart 2 lists the 20 most common provisions included in the set of agreements mapped by the WTO. As expected, all agreements include reductions in tariffs on manufacturing goods. At the same time, more than 50% of agreements include deeper provisions such as anti-dumping and countervailing measures, rules on competition, movement of capital, and intellectual property rights. Technical barriers to trade, investment disciplines, sanitary and phytosanitary measures are often included.

Trends in production networks trade

The recent wave of PTAs and the surge in offshoring have raised the question of how trade agreements relate to the international organisation of production. The key insight of the theoretical literature is that the 'depth' of trade agreements is associated with the international fragmentation of production. Econometric studies are scarce but suggest a positive relationship between production networks trade and deep integration. According to a 2014 paper, signing deep trade agreements increases trade in parts and components. At the same time, higher levels of trade in production networks increase the likelihood of signing deeper agreements.

In terms of the relationship between deep PTAs and offshoring within the boundaries of the firm, the key question is whether the depth of trade agreements between two countries is correlated with more vertical FDI. Our research indicates that this relationship can go in both directions. Deep PTAs may stimulate the creation of global value chains by facilitating trade of intermediate goods and FDI flows between potential members of a production network. However, firms involved in intense vertical FDI may lobby for deeper trade agreements to secure and increase the profitability of investments in partner countries.

> ***"Signing deeper trade agreements can increase the flows of vertical foreign direct investment between countries.***

Designing better trade agreements

A better grasp of the relationship between PTAs and offshoring is important in a world where countries are signing a growing number of trade agreements and firms increasingly seek to engage in international production networks. We have found new evidence to suggest that the depth of PTAs is related to the mode of offshoring.

In particular, signing deeper agreements can increase the flows of vertical FDI between countries. In 2015 we found evidence that the positive link between the depth of PTAs and vertical FDI is driven by the provisions that improve the contractibility of inputs provided by foreign suppliers, such as regulatory provisions. While more work is needed, this line of research contributes to an understanding of how policy-makers can design trade agreements to support firms' integration into global value chains. ■

Alberto Osnago is a Consultant and Nadia Rocha is a Senior Economist at the World Bank. Michele Ruta is a Lead Economist at the World Bank Group.

Evolution of depth over time and most common provisions

Chart 1

Average number of provisions in PTAs

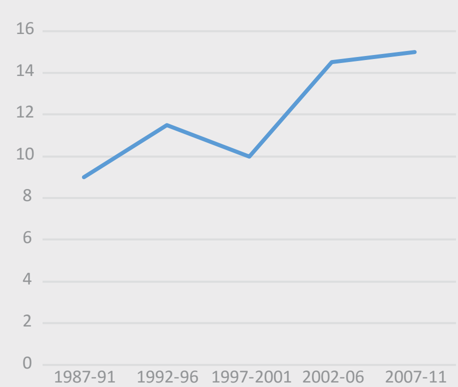
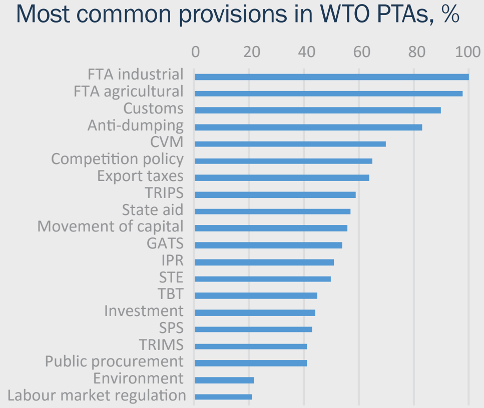


Chart 2

Most common provisions in WTO PTAs, %



Source: World Trade Organisation data, Osnago, Rocha and Ruta calculations

Building stable banks for Africa growth

Mobile technology encouraging financial inclusion

Abdul-Nashiru Issahaku, Bank of Ghana

A sound banking sector is critical for sustained growth in Africa. Despite notable progress since the 1990s in terms of the sector's depth, access and stability, policy and institutional gaps must be addressed to cement its developmental role. We must maintain sociopolitical and macroeconomic stability, along with expansive financial sector reforms.

In the 1980s, deteriorating economic conditions pushed a number of countries to embark on significant structural adjustment programmes alongside financial sector reforms, with support from the International Monetary Fund and the World Bank.

These involved changes to the supervisory and regulatory frameworks. They further included elimination of credit ceilings and directed credit, interest rate liberalisation, removal of barriers to bank entry and exit, and the privatisation of most state-owned banks. This helped foster growth in a number of countries.

'Lions on the move'

In the 2000s growth was further boosted as countries with vast natural resources benefited from the commodity boom. The rebound in economic growth and the implementation of successful measures for poverty reduction led to the continent being referred to as 'lions on the move'.

But the narrative changed with the global financial crisis, while some of Africa's largest economies faltered under the burden of slumping commodity prices. In the process, growth fell considerably.

Post-1980s financial sector reforms in most African countries concentrated on developing the architecture required for stable banks.

The banking sector has been transformed as a result. The financial depth, coverage and efficiency indicators have improved. Banks' performance across the continent has reflected stronger balance sheets and capital bases, while risk management has been enhanced. The liberalisation of the market also facilitated the influx of foreign and pan-African banks, attesting to the sector's scope for expansion.

> ***"Information and communication technologies have helped to address the problem of bank penetration and paved the way for the development of alternative financial services.***

Banking's technology revolution

Growth in Africa's banking sector has been underpinned by expanded economic activities and strengthened supervisory and regulatory oversight, while innovative financial products have emerged.

However, banking penetration is low compared with global averages and large segments of Africa's population lack access to financial services.

Information and communication technologies have helped to address the problem of bank penetration and paved the way for the development of alternative financial services. Mobile banking has contributed significantly to financial inclusion and job creation.

Pioneered in Kenya and Tanzania in 2007, real-time mobile money transfer technology and agency banking models continue to gather momentum across the continent, enabling customers to transfer money without necessarily owning a bank account. The fusion of banking and ICT provides a framework for growth in domestic savings and investment.

Mobile money technology has made significant progress in other large economies such as Ghana and Nigeria. A 2015 survey produced by the Consultative Group to Assist the Poor on access to and usage of digital financial services illustrated that Ghana is the most 'DFS-ready' country in Africa.

Facilitating economic growth

The growth of mobile banking presents opportunities for financial institutions to expand their operational reach to facilitate comprehensive economic growth. New competitors, in the form of telecommunications companies, will also be introducted to the market.

But while these developments provide significant benefits, they pose challenges regarding financial stability and consumer protection. These have led to deposit insurance schemes to ensure stability and protect small depositors. In Ghana, a deposit protection bill is expected to boost domestic savings and investor confidence.

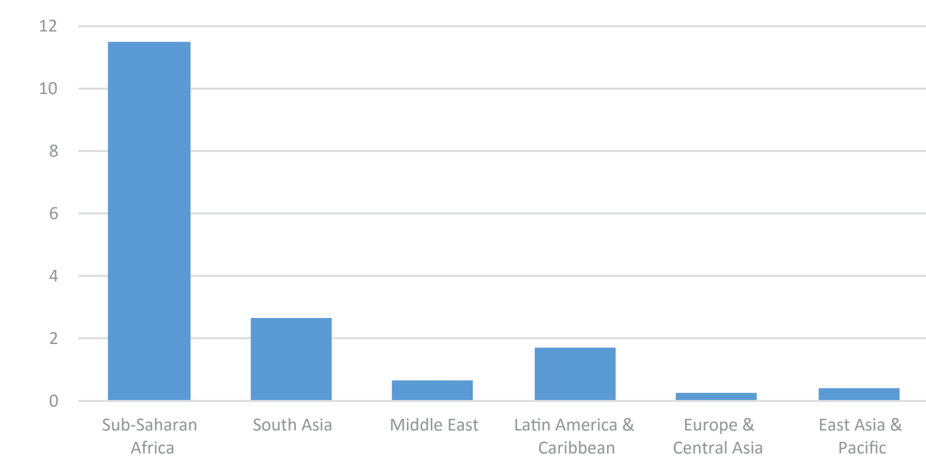
A focus on infrastructure development and institutional capacity is required to enhance financial services delivery and consumer protection. We need advances in ICT to facilitate the inclusion of Africa's large unbanked population, and a secure legal and regulatory framework to facilitate long-term savings.

In spite of its uneven economic record, Africa remains, undeniably, the world's next growth frontier. The banking sector is a key part of the continent's future. Building a sound, stable and efficient banking sector will be crucial to Africa's economic growth. ■

Dr. Abdul-Nashiru Issahaku is Governor of the Bank of Ghana.

Sub-Saharan Africa leads in mobile financial services access

Mobile money accounts held, % of population (above age 15)



Source: Global Findex database, World Bank, OMFIF analysis

US becomes less outward looking

Election emphasis on growth through fiscal stimulus

Marsha Vande Berg, Advisory Board

If Hillary Clinton is sworn in as 45th US president in January, she will face a series of immediate challenges. The political opposition is likely to control at least one chamber of Congress. And there are few, if any, signs that congressional Republicans who eschewed Donald Trump's candidacy will put valid initiatives ahead of bipartisanship.

Clinton would also be scrutinised for how closely she adheres to the demands of supporters of Bernie Sanders, her main rival in the Democratic primary, to which she acceded in exchange for their support. These focus on affordable higher education for low-income households and increasing the federal minimum wage. Her prospective legislative calendar includes a decision by March on the US debt ceiling and filling a Supreme Court vacancy.

Clinton's primary focus will be the economy and how to boost growth above this year's anticipated 2% average. Both presidential candidates have emphasised a transition from growth via monetary policy to growth through fiscal stimulus. The key question is how much new government spending Washington can afford.

Fiscal stimulus to fight 'secular stagnation'

Clinton's economic plan reflects a view of the US economy as being in a state of 'secular stagnation'. In this condition, fiscal stimulus is needed to unshackle the private sector while simultaneously increasing the share of resources going to the middle class and away from the upper 1% of earners.

Tackling insufficient demand and excess savings requires raising the income of lower and middle earners. High-income households tend to save disproportionately more than poorer ones. Greater wealth accruing to well-off groups leads to lower overall demand unless offset by higher borrowing among lower-income households.

This sets the context for Clinton's tax policy, which sees rates increasing for the wealthy and remaining low for those in the lower and middle-income brackets. She would set the top income tax rate at 43.6% (up from 39.6%) and implement a 'fair share surcharge' on those earning more than $5m. She advocates increasing the federal minimum wage from $7.25 an hour to $12 by the end of her first presidential term.

Clinton's plan is Keynesian in its response to slow growth and seeks to create fairer conditions for the working class. This may expose her to Republican criticism that her policies will lead to a continued decline in the US relative economic power, which they argue has occurred over the past decade. While economic support programmes worth $1.4tn have been implemented during Barack Obama's presidency, there has been a lack of mobility between socio-economic groups, and output and employment growth have been subdued.

Challenges for monetary policy

Monetary policy stimulus implemented since the 2008 crisis has contributed to increasing inequality, creating difficulties for the Federal Reserve and raising questions over its independence. Improving matters will be complicated. Clinton's plan to raise the federal minimum wage will encounter the reality of lower structural demand for low-skilled labour as a result of globalisation and technological change.

> *“Clinton's economic policy places a focus on boosting services and the knowledge economy, in which the US excels.*

Clinton's economic policy places a focus on boosting services and the knowledge economy, in which the US excels, in contrast to Trump's preoccupation with protecting low-wage, low-skilled manufacturing jobs. Trump's proposals are hugely popular among large parts of the electorate, but are unlikely to provide the boost to GDP and productivity needed to sustain the US recovery and raise living standards. However, Clinton's plans do not appear to have placated voters in low-wage sectors facing competition from China and Mexico.

As a result, trade and immigration have become the key issues in this election. Clinton proposes significant reform to immigration laws to address the 11.5m undocumented immigrants living in the US. Estimates indicate that these policies will increase the US population by 3% over 10 years. This is a key method of expanding growth under her economic plan: a bigger labour force boosts tax receipts and adds to demand and consumption.

Trump's plan to expel immigrants would result in around 3.5m fewer jobs and an unemployment rate of around 7% by the end of his presidency, reflecting lower overall demand due to a smaller working population and aging demographics.

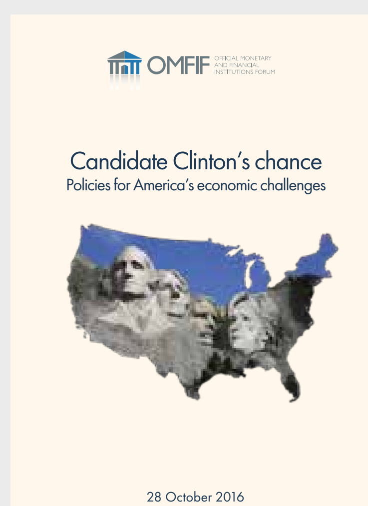
Moreover, Trump's proposed tax cuts for the wealthy are assumed to be offset by stronger economic activity. But if his immigration policies constrain growth and negatively affect the labour market, these supposed tax cut gains will not materialise. The outlook for trade is a further cause for concern under both candidates, though perhaps less so under Clinton.

Limiting the effect of globalisation

This campaign marks a substantial departure from previous elections, which have tended to focus on how best to achieve economic growth or redistribute economic gains most equitably. Instead, the focus has shifted to how to limit globalisation's negative impact on the US economy. This has resulted in a significant rethinking of America's role in the global economy and a less outward-looking approach for the country's politics and economics. This may make it more difficult to secure and strengthen US economic influence both at home and abroad.

Abrogation of global leadership is not an option in the absence of an alternative to the US international role. The next president needs to change the system without irreparably damaging it. Successfully addressing these challenges will require leadership and flexible thinking, rather than isolationism and confrontation. ■

Marsha Vande Berg is a Distinguished Career Fellow at Stanford University. This is an edited extract from the OMFIF report 'Candidate Clinton's chance – Policies for America's economic challenges'. To request a copy of the report contact editorial@omfif.org.



Consensus grows on December rate hike

Policy-makers question traditional assumptions

Darrell Delamaide, US editor

As the US Federal Reserve continued in its holding pattern until the presidential election, impatient market participants were looking for signs even more closely than usual in October. They were seeking affirmation that a rate hike at the last Federal Open Market Committee meeting of the year in December was indeed inevitable. They even scoured the minutes of the discount rate meeting, which usually receives scant attention as the discount rate itself is fairly notional.

Alert analysts discovered that nine of the 12 regional banks in September wanted to increase the rate at which the Fed makes emergency loans to banks by a quarter of a percentage point, to 1.25%. That number was up from eight in August and July, and six in June. The board of directors at each regional bank makes its recommendation, but this is subject to 'review and determination' by the Federal Reserve Board in Washington. So far, the board has determined not to raise the discount rate.

Federal funds rate hike in the offing

However, the minutes of the much more important FOMC meeting in September indicated that a hike in the key federal funds rate is in the offing. 'Several members judged that it would be appropriate to increase the target range for the federal funds rate relatively soon if economic developments unfolded as the committee expected,' the minutes said.

The record added, 'It was noted that a reasonable argument could be made either for an increase at this meeting or for waiting for some additional information on the labour market and inflation.'

New York Fed President William Dudley, who is vice chair of the FOMC and a permanent voting member, fanned that flame in mid-October remarks. 'If the economy stays on its current trajectory,' he told a dinner in New York, 'I do expect to see an interest rate rise later this year.'

However, he played down the significance of a possible hike. 'If we raise the federal funds rate a quarter of a point, that's not really that big of a deal,' he said in a question and answer session. 'This idea that it's this incredible fork in the road, I think people are exaggerating the significance of that.'

Other speeches from policy-makers just before the communications blackout ahead of the FOMC meeting on 1-2 November did little to clarify matters. St. Louis Fed chief James Bullard kept to his line of recent months that there should be one more rate hike, probably this year, and that rates should then remain low for two or three years, as the US remains in a period of low productivity growth.

'Real safe rates of return are exceptionally low at present and are not expected to rise soon,' Bullard, a voting member this year, told an audience of academic researchers in Arkansas. 'This means, in turn, that the policy rate should be expected to remain exceptionally low over the forecast horizon.'

In Bullard's view, the question is out of the Fed's hands. 'While the Fed is thought to be able to influence real rates over short periods of time, perhaps a few quarters, over longer-term periods real rates are determined by market forces,' he said.

> ***"Yellen questioned the pre-crisis assumption that a decline in aggregate demand would not have a lasting effect on supply.***

But Charles Evans, head of the Chicago Fed, maintained his stance that the Fed needs to be patient. Disinflationary forces in the global economy are keeping US inflation too low, he said in a presentation at the University of Chicago. There is a 'need to demonstrate commitment to achieving the inflation target sustainably, symmetrically, and sooner rather than later,' he said.

This could mean undershooting on unemployment, now 5%, and overshooting on the inflation target of 2%, he added. Any increase in interest rates should be linked to progress in achieving the inflation target.

Nonetheless, Evans, who rotates into a voting position on the FOMC next year, told reporters after the presentation that he expects as many as three hikes between now and the end of 2017, though not necessarily one before the end of this year.

Earlier in the month, Fed chair Janet Yellen raised some more fundamental questions about how to navigate the US economy in the wake of the financial crisis.

'Extreme economic events have often challenged existing views of how the economy works and exposed shortcomings in the collective knowledge of economists,' Yellen told a Boston Fed conference.

The Fed chair posed several questions on economic assumptions that may have to be reviewed following the crisis and slow recovery. 'For example, the influence of labour market conditions on inflation in recent years seems to be weaker than had been commonly thought prior to the financial crisis,' she said.

James Bullard, President, St. Louis Fed

The decline in inflation during the recession was 'quite modest' considering how high unemployment rose, but wages and prices rose comparatively little as the labour market recovered.

Decline in aggregate demand

Yellen also questioned the pre-crisis assumption that a decline in aggregate demand would not have a lasting effect on supply. The slow recovery 'suggests that changes in aggregate demand may have an appreciable, persistent effect on aggregate supply – that is, on potential output,' she said.

She went on to question 'whether it might be possible to reverse these adverse supply-side effects by temporarily running a "high-pressure economy", with robust aggregate demand and a tight labour market'.

Fed Vice Chair Stanley Fischer, speaking a few days later in New York, was less sanguine about the impact of leaving interest rates low. Low long-term interest rates may be indicating that economic prospects are 'dim', he said. He added that low rates make it difficult for central banks to combat adverse shocks, and may threaten financial stability as investors reach for yield and banks have little capacity to build capital.

Even so, he said, there may be little the Fed can do. 'Changes in factors over which the Federal Reserve has little influence – such as technological innovation and demographics – are important factors contributing to both short- and long-term interest rates being so low at present.' ■

Darrell Delamaide is a writer and editor based in Washington.

Light at the end of the Greek tunnel

Despite IMF's forecasts, debt sustainability still an issue

Danae Kyriakopoulou

October saw the release of the International Monetary Fund's latest World Economic Outlook report. Amid downward revisions to global growth, Greece strikingly found itself in the minority of economies to see their forecasts revised upwards for the remainder of 2016 and for most years through to 2021.

The IMF is at the optimistic end of a forecasters' spectrum that includes the European Commission, the Organisation for Economic Co-operation and Development, and the Greek finance ministry and central bank.

Despite some divergences, a general pattern is evident: the light at the end of the Greek tunnel is expected to appear in 2017, with GDP growth forecasts averaging around 2.5% for that year.

Improved relationships

Looking at the IMF's track record, one is entitled to be sceptical. As the chart shows, the Fund has miscalculated the timing of Greece's rebound throughout the country's economic crisis. This time could be different.

The most positive development concerns the improved relationship between the government and the so-called troika of creditors – the European Central Bank, the European Union and the IMF.

Gone are the days of Yanis Varoufakis, the former finance minister, and his flair for confrontation. Although anti-troika sentiment still forms part of its internal rhetoric, the government realises that its political future is tied to the success of the assistance programme.

A potential delay in the conclusion of the programme's second review, due to begin this month, risks fuelling uncertainty. At the 11th Athens Stock Exchange Roadshow held in London last month, there was a shared feeling among officials from the Greek government, the European Investment Bank and the European Bank for Reconstruction and Development that the programme's second review will be completed successfully.

But a closer look reveals that, while political risks have abated, the real economy faces important challenges. Notably, the thorny issue of debt sustainability is outstanding, with IMF participation in the programme far from secured. Moreover, disagreements remain between the European institutions and the Fund over the fiscal surplus targets for the indebted economy, while pressure from the IMF board to join the programme has weakened.

Greece's domestic economic challenges

A huge stock of non-performing loans, excessive rates of taxation and Greece's poor record on tax collection add to domestic economic problems. Non-performing loan levels are around 60% of GDP. Unlike Italy, a market for non-performing loans hardly exists.

On taxes, Greece was the only EU country to increase its corporation tax rate in 2015. Collection remains a challenge, with tax arrears standing at more than €80bn – equivalent to around half of GDP. Moreover, not only are taxes set suboptimally high on the tax rate-tax base nexus, creating disincentives to invest and work in the formal economy, but they have also been frequently revised. This makes the predictability of taxation almost impossible, weakening incentives to invest.

There are external risks too. Spending by British tourists fell by 36% in July following the UK vote to leave the EU and the accompanying fall in sterling. As a result of strong feeling on some parts of the ECB council that quantitative easing has run out of steam, the ECB will probably decide in December to start tapering its bond buyimg programme.

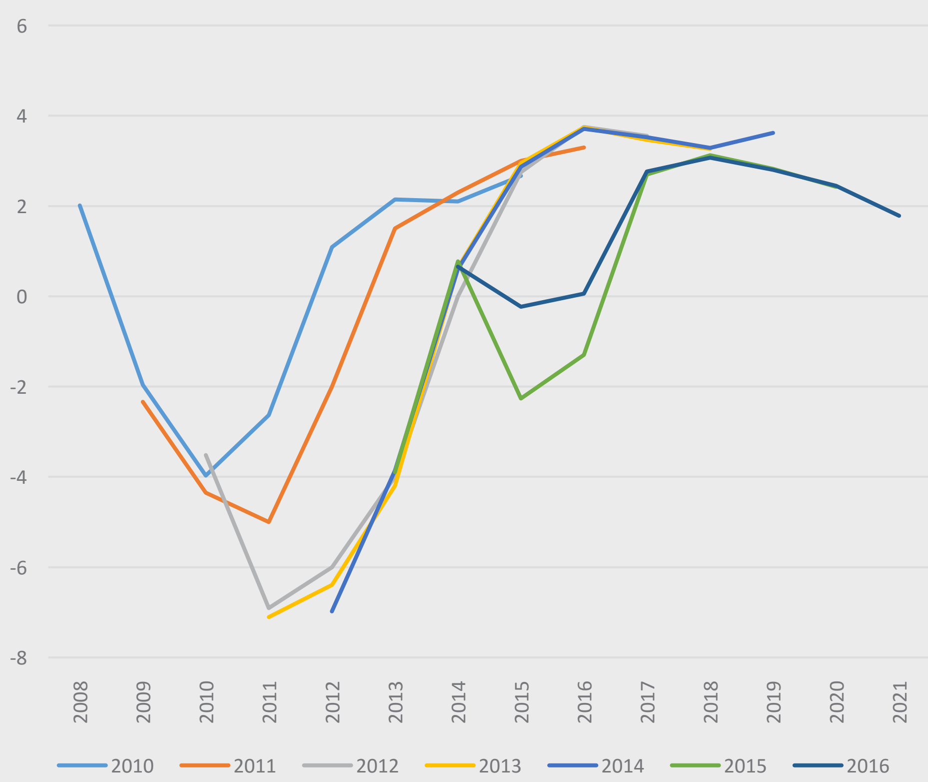
In these perilous domestic and international circumstances, the light at the end of the Greek tunnel forecast by the IMF may soon start to flicker. ■

Danae Kyriakopoulou is Head of Research at OMFIF.

> ***"Disagreements remain between European institutions and the IMF over the fiscal surplus targets for the indebted economy, while pressure from the IMF board to join the programme has weakened.***

Forecasting Greek economy's rebound has proven difficult so far

Annual real GDP growth projections, %, by date of WEO publication (Autumn edition)



Source: International Monetary Fund World Economic Outlook, OMFIF analysis

Central Europe's challenge to the EU

Services liberalisation will test appetite for reform

Ben Robinson

The economies of central and eastern Europe, led by Poland, have been forging ahead. This is in contrast with many western and southern European countries which continue to struggle with low growth, unemployment and the financial constraints of the single currency.

The key concerns raised by participants at the National Bank of Poland's annual conference in October focused on two main points. These were avoiding shocks to central European economies emanating from the European core and liberalising the single market to overcome barriers to intra-European Union services provision, in which central and eastern Europe have a comparative advantage.

The UK has championed both issues within the EU, making it an important partner for reform-minded central and eastern European economies. Following the UK's Brexit, Poland and others will have to clamour for stronger competitiveness, simplified regulations and increased integration of European markets. If successful, the results could improve the prospects for the European economy as a whole, though substantial challenges exist.

Mateusz Morawiecki, Poland's deputy prime minister, stated, 'Three of the EU's four freedoms – goods, capital and labour – work well, but the freedom of services is essentially non-existent.' The main hindrance is non-tariff barriers. These include varying regulations, insurance requirements and standards across European countries, as well as differing rules on qualifications and industry association membership. This makes expanding the presence of local companies into western Europe prohibitively difficult and expensive, reducing the ability of central and eastern European firms to benefit from economies of scale and larger markets.

EU's 'two markets'

As a result, according to Morawiecki, the EU is 'essentially two markets – one for central and eastern Europe and another for western Europe'. Just 14% of small and medium-sized enterprises sell their goods cross-border in the EU, while only 4% of EU services are provided cross-border, according to the European Commission. Domestic firms provide 42% of services and US firms a majority of the remainder.

Increasing the integration of central and eastern European service providers into the rest of the European economy would yield significant catch-up growth and an increase in per capita wealth. This would support higher domestic consumption and investment. The region's strengths include transport and logistics, information technology and internet-based firms, and back office support functions. However, the relatively closed nature of western European markets to services results in substantial rents accruing to large incumbents, creating challenges to liberalising these sectors.

Digital single market benefits

Improving access to western European markets for central and eastern European services and technology companies could bring benefits to a broader EU economy suffering from sluggish growth and low productivity improvements. Full implementation of the 'digital single market', which aims to improve business conditions for internet-enabled firms, could raise EU growth by €415bn a year according to the European Commission.

> ***"Integrating central and eastern European service providers into the rest of the European economy would yield significant catch-up growth and an increase in per capita wealth.***

According to the World Bank, liberalising services trade by reducing non-tariff barriers could increase productivity within the EU by 5%. Part of this boost would come from the greater competition that western European firms would face, forcing them to ensure productive use of capital and human resources.

Although the potential gains are substantial, the UK's longstanding attempts to push services reform in the EU suggests that achieving these gains will be difficult for central and eastern European economies. EU trade liberalisation suffered a setback after a free trade deal with Canada was blocked in October, before being salvaged at the last minute.

If the EU cannot achieve internal liberalisation, it is unsurprising that external deals, including the EU-US Transatlantic Trade and Investment Partnership, are prone to difficulties. This bodes ill for UK attempts to maintain access to the single market, particularly for financial services, once it leaves the EU probably in 2019.

While non-tariff barriers account for some of the challenges that central and eastern European companies face, deeper issues over the ability to raise capital to support small and medium-sized enterprises and start-ups are also limiting progress.

Poland is vulnerable to changes in foreign capital flows, on which it depends for a large part of its domestic investment. It has a negative net international investment position of around 70% of GDP and runs a current account deficit, though this has narrowed from 5% of GDP in 2011 to a projected 0.1% this year.

The impact of bank regulations

At the same time, stricter bank regulations requiring higher capital ratios have had some impact on lending and growth rates, affecting the ability to raise debt, although the extent to which this has limited access to bank financing is contested. Benjamin Weigert, director general of financial stability at the Deutsche Bundesbank, has highlighted the role of higher bank capitalisation in increasing resilience and mitigating shocks, thereby improving the stability of bank lending.

Implementing the capital markets union is one potential improvement, but it is not a cure-all. The more significant challenge for European fundraising is improving local firms' access to venture capital and private equity, which could boost non-listed companies' access to funding.

While this is a problem for Europe in general, central and eastern Europe is particularly affected. EU non-tariff barriers limiting the access of services-related SMEs and start-ups to western European markets also deter venture capital and private debt funds on account of the limited scalability of central and eastern European companies.

As political dynamics begin to shift in the run-up to the UK's EU departure, Poland and other central and eastern European economies could play a greater role. Their support for liberalisation, particularly of services, carries significant potential. But the impact on productivity, economic growth and intra-EU convergence will depend primarily on the political will of western European nations. The evidence so far suggests it will be a long battle. ■

Ben Robinson is Economist at OMFIF.

Where the UK leads, others follow

Offshore wind moves into the financial mainstream

Shaun Kingsbury, Green Investment Bank

The offshore wind industry has come of age as a mainstream asset class, driven by rapid improvements and falling costs in technology, installation, supply chain, operational maintenance and financing. In the last five years, offshore wind has moved from a highly niche and specialist interest into the financial mainstream.

A very small number of specialist investors – including the Green Investment Bank – have accelerated the market adoption of offshore wind. For the past four years, the bank has been working at the heart of the world's largest and most advanced offshore wind market: the UK.

Laying the foundations

The foundations of the UK offshore sector were laid by energy utility companies and largely funded on-balance sheet. First movers in UK waters included companies such as RWE, Statoil, Centrica, E.ON and Denmark's DONG Energy, undertaking a series of projects between 2004 and 2010.

This initial phase of the sector's development came under pressure on two fronts. First, the long-term finance requirement for the growth of offshore wind was greater than the balance sheet capacity of these utility firms, even in the best of times. And second, these were not the best of times. Liquidity was in short supply following the 2008 banking crisis and utility companies faced limitations on their borrowing capacity. A solution was required to maintain momentum in the construction of new projects.

That solution was to allow those utilities to refinance their existing investments in operating wind farms. This created an attractive investment opportunity for new investors in the lower-risk stages of the project lifecycle. Capital would be returned to the small band of investors prepared to commit to development and construction, freeing them to reinvest in new projects.

Early stage investors

By 2014, it was evident that debt liquidity was returning and that banks' appetite for offshore wind was increasing. However, balance sheets in the utility sector remained under pressure. With their growing experience and capability, many of these utility companies were best placed to lead development and construction, but lacked the financial capacity to build out their project pipelines.

"Offshore wind in the UK has firmly entered the mainstream, both as a source of reliable and increasingly competitive energy, and as an investment class.

The solution was to introduce non-utility and infrastructure investors at an earlier stage of the project development cycle. This approach allowed utilities to sell down a stake in the assets while retaining an important presence in projects through construction, commissioning and early stage operations.

The offshore wind sector's long-term growth prospects – alongside attracting sufficient capital – depend on its ability to reduce costs, and introducing debt earlier in the project lifecycle was key to lowering the cost of capital. By bringing more cautious debt lenders into construction financing, a project's gearing could be improved, reducing the proportion of more expensive equity finance.

A sustained need to bring greater volumes of capital into the sector has prompted efforts to diversify the investor base. This includes the opportunity to connect long-term, low-risk investors such as pension funds and life assurance funds with a scale of transaction, risk profile and, most importantly, yields that meet their investment objectives.

Low carbon infrastructure projects

The UK government launched GIB in 2012 with a mandate to invest in low carbon infrastructure projects such as offshore wind. As the bank passes its fourth anniversary and approaches a move from government ownership into the private sector, offshore wind remains its largest sector.

By acting as a narrowly focused but flexible expert investor, GIB has been able to demonstrate the commercial opportunities in the market. The bank has been involved in a number of financing innovations and 'firsts', helping the market to quickly transition through the phases outlined above. It has raised a £900m offshore wind fund through its Financial Conduct Authority-regulated subsidiary, a dedicated investment vehicle for unlevered, operating assets.

Offshore wind in the UK has firmly entered the mainstream, both as a source of reliable and increasingly competitive energy, and as an investment class. Where the UK leads, other countries are rapidly following.

The next phase of the market's global expansion will see growth in north-west Europe, Asia and the north American eastern seaboard. Under private ownership, GIB expects to play a key role in the development of some of these markets, as it has in the UK.

Offshore wind's 'coming of age' could not be better timed. The sector is perfectly poised to make a major contribution to realising the policy ambitions of the Paris climate agreement. Moreover, it is ideally placed to realise the investment returns required to build the infrastructure to turn the agreement into reality. ■

Shaun Kingsbury is Chief Executive of the Green Investment Bank.

Taking ownership of sovereign wealth

Reconciling state objectives and citizen preferences

Danae Kyriakopoulou

From protests on the streets of Athens to Brexit and the rise of Donald Trump, political affairs have been awash with cases of disillusioned citizens, disappointed in establishment politicians and inspired by a desire to take control of decisions made on their behalf. At the same time, weakening demographics and diminishing investment opportunities are contributing to the likelihood of 'secular stagnation' – a dismal economic outlook of low growth and low returns, with commodity prices feeling the strain.

Occupying the nexus of these important political and economic debates, *Citizens' Wealth* focuses on the governance, management, and distribution of sovereign wealth, and is a timely contribution to the scholarship on sovereign funds.

Angela Cummine, a political theorist at the University of Oxford, introduces a principal-agent framework for understanding the relationship between citizens and the state in respect of sovereign wealth. Under this approach, based on John Locke's theory of the state, citizens are the rightful owners of sovereign wealth. The government is entrusted to manage this wealth in their interests.

Contradiction between returns and values

In practice, this underlying aim is not always realised. Cummine skilfully employs political theory, empirical case studies, and primary research to show when, how, and why this happens. At times, there is an obvious contradiction between the best ways to achieve financial returns and the collective values of the citizen-owners. Cummine cites the example of Australia's Future Fund holding tobacco shares when Australians were cheering their government for being a global leader in the fight against 'Big Tobacco'.

Such contradictions are often more nuanced. When attacked for its investments in mining giants with questionable human rights records in Papua New Guinea, the New Zealand Superfund's response was that engagement can be more effective in changing behaviour than divestment or exclusion. An emphasis on the potential for sovereign funds to succeed on such occasions and defend citizens' values through engagement would have been a welcome addition to the book.

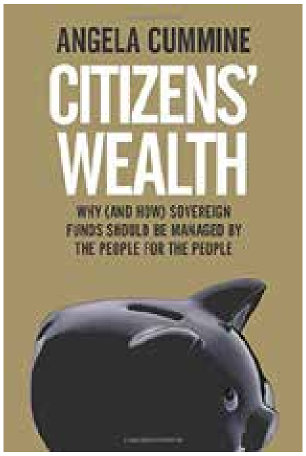
Democratic control of sovereign wealth

In fact, the author's proposed solution to the disconnect between state objectives and citizen preferences is imposing ethical constraints on investments to reflect citizens' concerns; increased transparency to improve accountability; and, more radically, direct influence on sovereign funds, such as elections to their boards, and the distribution of returns to citizens as cash dividends.

> ***"At times, there is an obvious contradiction between the best ways to achieve financial returns and the collective values of the citizen-owners.***

That sovereign funds should be investing ethically, aspire to more than just financial return, and use their power to address intergenerational and economic inequalities are all important issues which are raised in this book. More systematic thinking is required, and Cummine makes a good start in setting the terms for the debate.

The book introduces the bold proposition that democratic governance can transform sovereign funds from potential agents of corruption and destabilising forces in the global economy to vehicles for economic development. At a time of challenges to technocratic governments, and central bank independence, this may be an idea whose time has come. But it is also dangerous. The criteria under which democratic control can work are selective. To her credit, Cummine addresses some of these challenges.

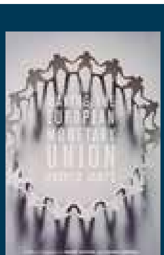


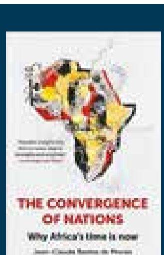
The proposal for directly distributing the benefits from sovereign investments is more problematic. Even in the case of Alaska's direct dividends, hailed as the exemplary case, focus group participants in the author's research said that it was sufficient to be living in Alaska to be entitled to the benefits. From an economic perspective, it is unclear why direct dividends, the same for all citizens and unchanged across time, as the author advocates, is the optimal way to achieve redistribution and intergenerational fairness, let alone basic macroeconomic management of cyclical booms and busts.

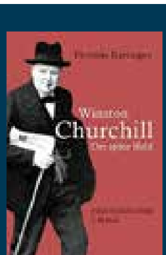
Contentious conclusions

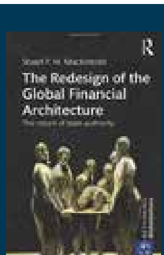
Citizens' Wealth contains powerful arguments. 'No accumulation without representation!' reads the title of one of its chapters. Cummine reaches several contentious conclusions, many of which this reviewer disagrees with. Nevertheless, it contains timely analysis, well-argued challenges to accepted wisdom, and innovative ideas. It is recommended reading, not just for sovereign fund managers and practitioners, but for citizens across the world in countries with sovereign wealth, from Norway to Saudi Arabia. ■

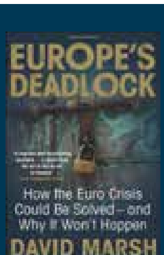
Danae Kyriakopoulou is Head of Research at OMFIF.









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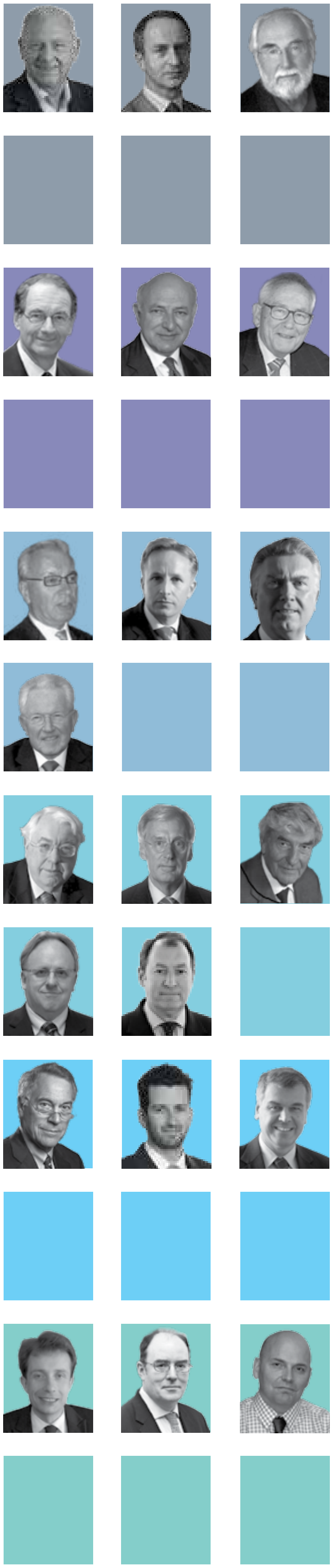

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A Brexit *deus ex machina* for sterling

Sound economic analysis of overvalued exchange rate

Brian Reading, Advisory Board

This splendid book from Roger Bootle and John Mills should be on the curriculum for all school and university economics students. *The Real Sterling Crisis* is sound economics. It challenges the consensus. It is founded on history and makes helpful policy proposals. It is clear, readable, and only 133 pages long.

A reviewer must summarise then criticise. Bootle and Mills do this admirably with their executive summary and back cover. This reviewer faces a problem criticising, being in agreement with the authors' main contentions. That said, some arguments lack the emphasis that could have been given them. The subtitle *Why the UK needs a policy to keep the exchange rate down* almost says it all. Sterling has been overvalued for much of the past 100 years, with deleterious effects on British growth.

For most of this time policy has been dominated by the desire to keep the pound strong and a fear of the inflationary consequences of weakness. But in recent years the exchange rate has suffered from 'malign neglect' by UK policy-makers. The pound has consequently been overvalued. The post-Brexit depreciation is to be welcomed and needs to be sustained.

Over-valuation hampers growth

The theoretical argument hinges on three propositions. First, there is an equilibrium real exchange rate that balances the economy. Free markets cause nominal rates to over- or under-shoot the equilibrium. Over-valuation erodes competitiveness, leads to trade deficits, and hampers investment, productivity and income growth.

Second, persistent current account deficits increase the foreign ownership of British assets and financial debts to foreigners. The deterioration in the balance of payments in the trade of goods and services has been dwarfed by the swing from foreign investment income surplus to deficit. This explains why the UK is now running a record peacetime current account deficit.

Third, sector financial balances sum to zero. A foreigners' financial surplus means the domestic public and private sectors collectively run deficits. Unless the surplus is reduced, any attempt to reduce the government's deficit increases the private sector's, and vice versa.

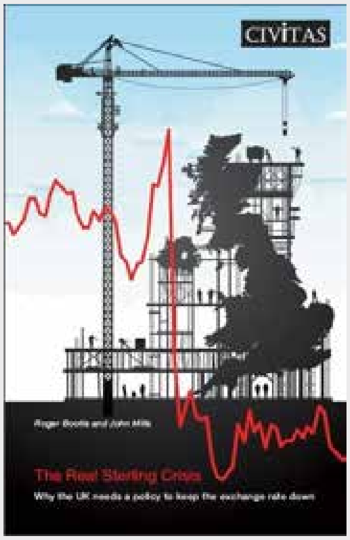
When both are over-indebted, retaliation follows. Fiscal prudence reduces private incomes and spending unless offset by monetary profligacy that pushes private debt higher. The fiscal and monetary policy mix alone cannot address this problem. Any current account improvement is due to slower growth. An exchange rate policy is required.

> ***"In recent years the exchange rate has hardly figured in UK policy. The pound has consequently been overvalued. The post-Brexit depreciation is to be welcomed and needs now to be sustained.***

Currency depreciation can be a blessing in disguise. A falling pound has adverse and favourable consequences. The authors powerfully argue that in today's circumstances the favourable well outweigh the adverse. But how to engineer it? The Brexit vote was a *deus ex machina*.

Exchange rate intervention

Several suggestions have been made to keep the exchange rate down, These include exchange rate intervention, official pound sales for foreign currencies, breaks from the G7 agreement to reject competitive depreciation and currency warfare. The UK, US and Canada are victims of others' non-observance, hence over-valuation. The UK ought to respond in kind.

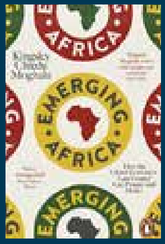


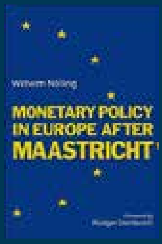
Capital inflows are implicitly recognised as pushing up exchange rates, leading to over-valuation and consequently current account deficits. They are benign when creating additional real investment assets, and malign when the purchases exploit acquired ownership of existing assets or volatile financial claims. Foreign acquisitions of existing UK assets require regulation and tax treatment that make them less attractive.

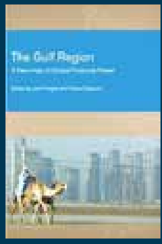
More could have been made in this book of undesirable foreign investment. A sterling crisis is inevitable as long as the pound continues to be over-valued while current deficits and international debt increase. More could be made of unfair currency manipulation and the rise in protectionism.

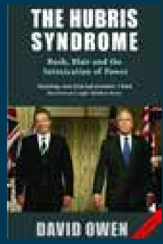
The authors could have looked closer at Keynes' contention that the deflationary international system places the obligations on debtor countries, not creditor countries, to adjust. But then the book would be twice as long, and much less instructive. ■

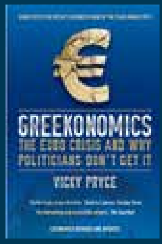
Brian Reading was an Economic Adviser to Prime Minister Edward Heath. His OMFIF column, 'Global Reading', can be viewed at www.omfif.org/analysis/global-reading.









Soft landing predicted for China's economy

Recession danger dim in next five years, Advisory Board says

This month's Advisory Board poll focused on China, specifically the outlook for its economy over the coming five and 10 years and the significance or otherwise of the renminbi's inclusion in the International Monetary Fund's special drawing right basket. Advisory Board members were asked first whether China's economy would experience a hard landing and recession, a hard landing but not recession, or a soft landing over the next five and 10 years; and what they thought of the renminbi's inclusion in the SDR basket.

The majority of respondents – 60% – expected China's economy to experience a soft landing over the next five years. A further 34% expected a hard landing but not recession, while 6% saw China experiencing a hard landing and recession. This view was broadly reflected in Advisory Board members' assessment of China's prospects over the coming 10 years, with 53% expecting the economy to experience a soft landing, though a higher proportion of respondents – 22% – envisaged a hard landing with recession; 19% foresaw a hard landing without recession. Remaining respondents stated that the 10-year timeframe was too protracted to provide a meaningful forecast.

On the question of the renminbi's incorporation into the SDR basket, 50% of respondents said that the development was an important milestone but that the currency 'still had some way to go' to become a global currency on a par with the dollar, euro and yen. A further 41% said that it was largely a ceremonial seal of approval, while 7% said that it would make an essential difference to the international monetary system.

'I anticipate significant financial difficulties leading to a growth slowdown at some point in the next few years, followed by a gradual recovery that does not come close to attaining previous growth rates.'
Jeffry Frieden, Harvard University

'China's economy will experience a soft landing over the next five to 10 years. The renminbi's inclusion in the SDR basket is largely ceremonial, but the move will put some pressure on the Chinese authorities to accelerate financial sector reform.'
Marek Belka, former prime minister of Poland

'All the official indications suggest that China will pursue reforms to enhance the quality and efficiency of growth. Beijing is likely to continue to promote interest rate liberalisation and undertake reforms aimed at achieving a more market-based determination of the renminbi exchange rate.'
Hemraz Jankee, formerly Bank of Mauritius

'China's economy will most probably experience a hard landing but not recession over the coming five years. Adjusting excessive debt in the state-owned enterprise sector will be painful for (mostly) public banks, suppress investments and severely dent confidence.'
Olivier Rousseau, Fonds de reserves pour les retraites

'The renminbi's gradual take-up as a reserve currency is a profound event and, over time, the Chinese bond market could prove an attractive investment for global savings, particularly in an era of low nominal returns.'
George Hoguet, CFA Research Foundation

These additional statements were received as part of the October poll, conducted between 11 and 21 October, with responses from 32 Advisory Board members.

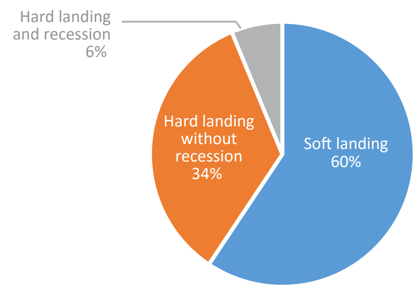
December's questions

How will the result of the US election influence the Fed's decision to raise interest rates in December?

Will Matteo Renzi win the 4 December referendum and how will the outcome influence the political and economic outlook for Italy and the euro area?

Soft landing over five years, say 60%

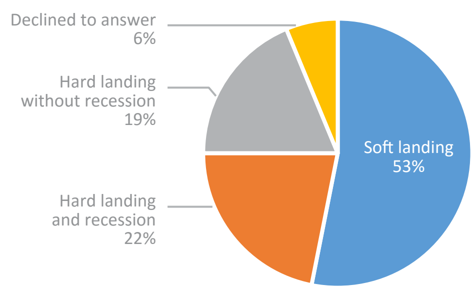
Percentage of responses



Will China's economy experience a hard landing or recession over the coming five years?

One in five expects recession over next 10 years

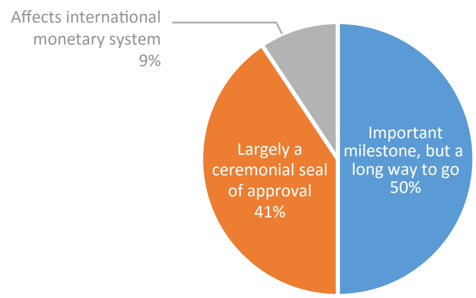
Percentage of responses



Will China's economy experience a hard landing or recession over the coming 10 years?

Renminbi's SDR inclusion seen as milestone

Percentage of responses



What are your thoughts on the renminbi's inclusion in the IMF's SDR basket?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