December 2013
Vol. 4 Ed. 11

Bulletin

Global insight on official monetary and financial institutions

China on the move

Search for a new model

The Fed's 100th birthday
Berlin's unambiguous coalition
What Abe must do next
Strong US economy
Europe's growth pangs

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Cover story

Rounding off OMFIF's Year of Renminbi Focus, five authors – Jonathan Fenby, Linda Yueh, Jinny Yan, Gabriel Stein and Songzuo Xiang – examine diverse facets of the reforms announced at the Communist party's November plenum. The state leadership is mixing market economics with state control in a fashion that will keep political observers, investors and financiers guessing about the overall pace and destination. Yet the direction is clear: as it redefines the growth model for the next 10 years, China has embarked on a further reform course with financial and economic repercussions in many fields of capital markets and in every corner of the world. See p. 26-31.

International monetary policy

Europe & the euro

Emerging markets

Fed marks centenary with reminders of upheavals

The Federal Reserve marks its centenary in December 2013, still battling with the legacy of the 2008-09 financial crisis. See p.8-11 for accounts of the pivotal influences and personalities behind its establishment and development.

Official Monetary and Financial Institutions Forum

One Lyric Square
London W6 0NB
United Kingdom

T: +44 (0)20 3008 5262
F: +44 (0)20 3008 8426

www.omfif.org

(See p.20-21 for full details)

Subscription

For subscription details, contact the sales team at:

sales@omfif.org

T: +44 (0)20 3008 5262

OMFIF

Promoting dialogue for world finance

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

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

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

Since its inception in January 2010, OMFIF has held 200 meetings in 40 host countries with the participation of 165 different official institutions.

Advisory Board

OMFIF's 145-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the Bulletin, seminars, and other OMFIF activities. See p.20-21 for names and p.38 for the latest Advisory Board poll.

Bulletin

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

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

Submissions

Contact the editorial team for details on article submissions at editorial@omfif.org.

Advertising & subscriptions

Contact sales@omfif.org.

Letters

Letters provide opinions from our readers with points of view on the subject matter in our Bulletins and Commentaries. See p.36.

Diary dates – past and forthcoming

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

General information

Visit www.omfif.org for member access to more OMFIF intelligence, including commentaries, reports, summaries of discussions and bulletin archives. Readers with queries on the website should contact editorial@omfif.org.

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

Fed centenary marks turning point

US-China tussles ahead on economic and financial power

David Marsh, Chairman

OMFIF completes its fourth year by looking back at the 100 years history of the world's most important central bank, the US Federal Reserve. And we look towards the next 100 years that may be increasingly dominated by China, which will sooner or later catch up the US as the world's leading economy. Our bumper end-2013 edition contains contributions by more than 20 writers – more than ever before.

Probably, to paraphrase Winston Churchill, the Federal Reserve is the worst form of all-encompassing central bank – apart from all the other forms that have been tried. Certainly, coming years will see a tussle between the central banks and other national institutions of the world's two biggest economies over influence and rewards in the worldwide division of financial and monetary power.

Three distinguished international economic historians, Harold James, Forrest Capie and Richard Roberts, examine the vicissitudes that have accompanied and shaped the Fed since 1913. And five authorities on China – Jonathan Fenby, Linda Yueh, Jinny Yan, Gabriel Stein and Songzuo Xiang – investigate what really went on at the November Chinese Communist party plenum – and what may happen next.

Darrell Delamaide takes the temperature of the discussion in the US about when the Fed will cut back its monetary stimulus to the capital markets – a development which, when it eventually comes, may either precipitate a crash or turn out to be a non-event. Looking at the world's other big economies, Kenzo Fujisue writes that Shinzo Abe, the so far high-flying Japanese prime minister, faces the danger of derailment unless he concentrates on economic policy. Trevor Greetham sees the world economy set fair in 2014 and welcomes the return of the 'long cycle'.

Puncturing this optimism somewhat, Michael Stürmer casts an acerbic eye on Germany's 'far-from-grand coalition' under Chancellor Angela Merkel, who maintains her hold on power but seems to have lost her party's soul along the way. Stefan Bielmeier looks at what lies behind the tussle with the US and the European Commission over Germany's current account surplus. Gabriel Stein and Steve Hanke survey the risk of deflation in the euro area. Ewald Nowotny and Miroslav Singer, the governors of the Austrian and Czech National Banks, expound their countries' responses to the crisis.

Moorad Choudhry explains how the sovereign yield curve remains the ultimate indicator of likely forward interest rates. As Britain climbs its way out of the growth doldrums more quickly than euro bloc countries, William Keegan looks at a simmering dispute over the UK government's economic policies.

The OMFIF books section contains sections on four different volumes, including an updated account of the Greek economy by Vicky Pryce, who says that, after six years of austerity, Greece has very little to show for it. We conclude on a sad note, with obituary notices (by William Keegan and John Nugée) on Robin Leigh-Pemberton, the late former governor of the Bank of England. ▪

David Marsh

China could benefit from nervousness in Gulf states over US-Iran rapprochement

There's a common theme between rapprochement between the US and Iran and sabre-rattling between Japan and China over disputed islands in the East China Sea. The message doing the rounds of the Gulf Cooperation Council (GCC) – oil-rich but population-light Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – is to prepare for far-reaching transitions and shifting alliances in the next decade.

There is distinct queasiness in the region over the interim nuclear pact between Tehran and Washington and the prospect of a more comprehensive deal within the next six months, which could pave the way for Iran to become a regional hegemon. Worries over the agreement will have been increased by the statement by Hassan Rouhani, pictured right, Iran's new president, that Tehran will not dismantle its nuclear facilities, as advocated by hardliners in Israel and the US Senate.

Coinciding with possible reduced US political and economic interest in the Gulf as it advances towards energy independence, the next 10 years could see an increase in sparring between the pivotal but vulnerable Gulf oil producers and their muscle-flexing Iranian neighbour.

Recognising these anxieties, US politicians have played down any question of diminished ties with the Gulf and have talked of new defence contracts. However, the outlook for the Gulf states might include an opening of security and defence cooperation with China, including possible purchases of military hardware, as the oil states seek a new equilibrium between east and west. ▪

INTELLIGENCE

OMFIF RENMINBI FOCUS 2013

Meetings on renminbi internationalisation and related matters included as speakers Songzuo Xiang, Agricultural Bank of China; Zhongxia Jin, People's Bank of China; Vítor Constâncio, European Central Bank; Tharman Shanmugaratnam, Singapore Finance Minister; and experts from bodies including the Chinese Embassy in London, China Development Bank, China Investment Corporation, Singapore Institute of International Affairs and ASEAN+3 Macroeconomic Research Office.

As an integral part of OMFIF's Year of Renminbi Focus, we have published four documents on China in 2013, dealing with reserve diversification and gold, financial market settlements, monetary policy decision-making and capital account liberalisation in an international context.

FORECASTS & TURNING POINTS

OMFIF developed further its intelligence arm in 2013 with a new website in July (further developed in December) containing an extensive searchable archive and other features. The Monthly Bulletin was relaunched in a new format in September. The range and volume of Commentaries have been increased. Telephone briefings on international financial and economic topics have become increasingly popular.

Most read commentaries in 2013:

1. Stop the world – Germany wants to get off, 28 October
2. US-German stand-off is all about the euro, 4 November
3. The retreat of the emerging nations, 9 September
4. Steinbrück shows finance minister calibre – but says No to job, 2 September

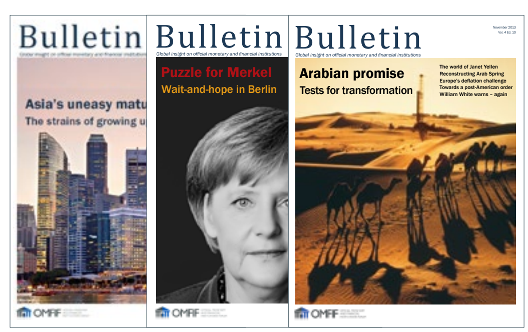
'Janet Yellen is the best bet to head the Federal Reserve when Ben Bernanke steps down as expected in January. She has steady hands and will be a consensus-building chairman.' – Meghnad Desai, June 2013

'If I had to bet on it, I would wager euros (not dollars) that, in this intriguing, seemingly two-horse race, Yellen may finish a nose ahead.' – John Kornblum, August 2013

Shumpei Takemori, Professor of Economics at Keio University, highlights Japanese prime minister Shinzo Abe's prime aim of winning the Upper House election to reinforce his hold on power (January 2013).

Governor Carlos da Silva Costa of Banco de Portugal sets out the case for more efficient European adjustment and improved economic integration as a means of safeguarding the euro's future (February 2013).

Jaime Caruana, General Manager of the Bank for International Settlements, admits modesty among international central bank policy-makers on how to repair the basic problems afflicting the world economy (July 2013).



MEETINGS

The world's Lusophone economies provided a particular focus, covering monetary policy, investment, energy and infrastructure. The Main Meeting in Brasilia hosted by Luiz Awazu Pereira of Banco Central do Brasil, gathered representatives from six of the nine Luso-economies, including the Monetary Authority of Macau. Other meetings included Mozambique High Commissioner Carlos dos Santos; Governor Carlos Costa, Banco de Portugal; and Victor Manuel da Costa e Silva, Executive Board Member, Banco Nacional de Angola.

100 MEETINGS IN 2013

OMFIF held 100 meetings in 17 countries in 2013, up from 60 in 2012, 30 in 2011 and 10 in 2010. Some 2013 highlights are below.

3 MAIN MEETINGS

- Banco Central do Brasil, Brasilia
- Central Bank of Turkey, Ankara
- Qatar Central Bank, Doha

14 GOLDEN SERIES LECTURES

- Charlie Bean, Bank of England
- William White, formerly Bank for International Settlements
- Stanley Fischer, Central Bank of Israel
- Richard Fisher, Federal Reserve Bank of Dallas

10 ECONOMISTS MEETINGS

- Patrick Honohan, Central Bank of Ireland
- Kerstin af Jochnick, Sveriges Riksbank
- Sir Nicholas Macpherson, HM Treasury
- Luis M. Linde, Banco de España

17 EXPERT SEMINARS

- Shigeto Nagai, Bank of Japan
- Gerhard Schröder, former German Chancellor
- Tharman Shanmugaratnam, Deputy Prime Minister, Singapore
- Lord (Norman) Lamont, former UK Chancellor of the Exchequer

33 POLICY GROUP MEETINGS

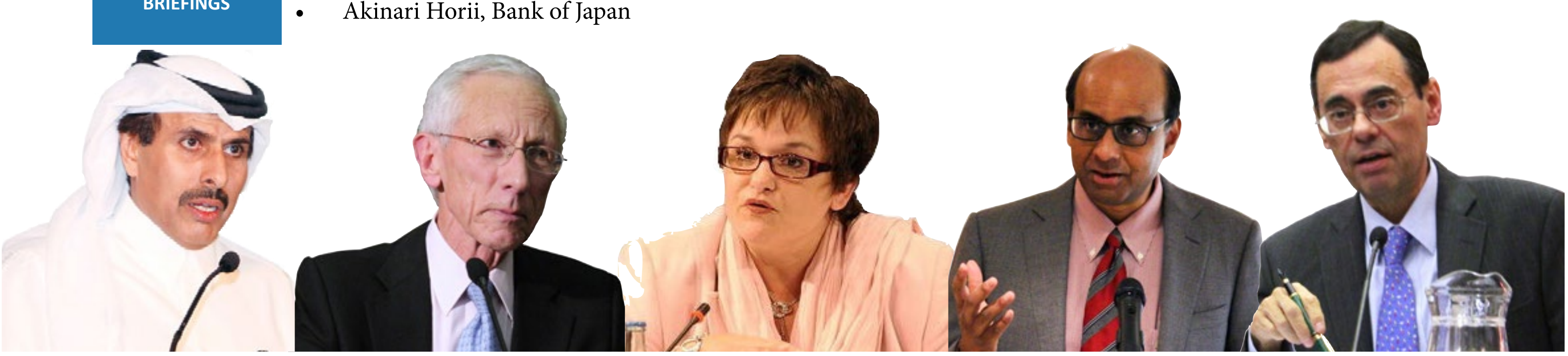
- Rundheersing Bheenick, Bank of Mauritius
- Min Zhu, International Monetary Fund
- Peter Praet, European Central Bank
- Sabine Lautenschläger, Deutsche Bundesbank

23 BRIEFINGS

- Panicos Demetriades, Central Bank of Cyprus
- Lorenzo Codogno, Ministry of Economy and Finance, Italy
- Ernst Welteke, formerly Deutsche Bundesbank
- Akinari Horii, Bank of Japan

An ASEAN+3 reserve management seminar was held in London on 25 April, opened by Bank Indonesia Governor Darmin Nasution.

The Third Asian Central Banks Watchers Group annual meeting was hosted by the Bank of Korea in Seoul on 28 October. The keynote address was delivered by Governor Choongsoo Kim.



Above, left to right: Sheikh Abdullah Saoud Al-Thani, Qatar Central Bank (November); Stanley Fischer, Bank of Israel (June); Sabine Lautenschläger, Deutsche Bundesbank (November); Tharman Shanmugaratnam, Singapore Deputy Prime Minister and Minister for Finance (July); and Jaime Caruana, Bank for International Settlements (May).

Spirit of Warburg guided Fed creation

Parallels with China's search for hegemony in events of 1913

Harold James, Advisory Board

A global financial crisis – almost as bad as the Great Depression – is followed by sustained criticism of the institutional and governance framework of the world. The fast-growing economy that sees itself as the new centre of world finance attempts to devise a mechanism that will give it financial as well as economic hegemony.

That scenario might describe the attempts of the People's Bank of China to move to a convertible currency and a more efficient and deeper financial system that reaches internationally and not just domestically. But it is also the scenario that almost exactly one century earlier produced the demand that the US should have a central bank that might promote New York as an international financial centre.

The panic of 1907 hit the US very badly, but also some countries, notably Italy but also Germany, that were closely tied to the US but not so much to France or Britain. Though New York needed to draw on the London gold market, there was little loss of confidence in Britain. British observers consequently congratulated themselves on their own superiority in a world that was increasingly 'cosmopolitan' as a result of the 'marvellous developments of traffic and telegraphy,' as the Economist put it. 'We have no reason to be ashamed. The collapse of the American system has put our supremacy into relief. … London is sensitive but safe.'

The panic of 1907 showed the fast-growing industrial powers of the day – the US and Germany – the desirability of mobilising financial power to support their own financial systems but also to take over functions previously exercised by the City of London.

The link between the panic of 1907 and the establishment of the Federal Reserve System is often misunderstood. It is not that a new central bank was really needed to manage the crisis. There was already a relatively effective mechanism for crisis management.

In 1907, the fall of the stock market and the incipient financial collapse had been halted essentially by a private institution, the venerable house of J.P. Morgan, acting as a lender of last resort. Morgan's actions were quick and effective, as well as being (eventually) rather profitable.

The J.P. Morgan profits prompted a populist backlash; but the quest for institutional reform was also driven by the realisation that New York – like the US – was financially underdeveloped. Trade, even when the bilateral commercial deal did not involve British importers or exporters, was dependent on bills of exchange that were traded by acceptance houses and ultimately supported by the Bank of England.

American bankers realised that they needed some sort of central bank analogous to the Bank of England, that would always provide a market for trade bills (commercial paper). The experience of 1907 convinced American financiers that New York needed to develop its own commercial trading system that could handle bills on an acceptance market as smoothly London did. At that time, federal legislation actually prohibited trade acceptances as well as foreign banking activity.

The federal government saw in the new activity a prospect for a greater international role of the US. President Taft and his Secretary of State made 'substituting dollars for bullets' the centrepiece of their diplomacy.

The major figure in pushing for the development of an American acceptance market was Paul Warburg, the immigrant younger brother of a great Hamburg banker who was the personal adviser of the German autocrat Kaiser Wilhelm II. Warburg was a critical figure in the bankers' discussions on Jekyll Island and in drawing up the institutional design of the Federal Reserve System.

Meanwhile Paul's older brother Max was warning Kaiser Wilhelm II that Germany would be financially vulnerable in a diplomatic crisis and if military mobilisation were required. The brothers Warburg, Max and Paul, were part of a double act. On both sides of the Atlantic, financial visionaries were energetically pushing for native institutions that would offer an alternative to the British industrial and financial monopoly. They were convinced that Germany and the US were growing stronger year by year while British power would erode.

The eventual design of the Fed was much more complex than that envisaged by Paul Warburg, who wanted essentially a straightforward copy of the British central bank. Resistance came from populists who wanted more democratic control.

One result of the compromise was a much greater policy independence for the 12 regional Federal Reserve Banks. National policy-making as a consequence depended on compromises between the regional Feds, and disagreements produced policy paralysis. The institutional flaw and the policy paralysis are regarded as greatly contributing to the financial collapse during the Great Depression.

The same kind of political pushback will occur as a result of domestic debates in China. Pressures to safeguard traditional heavy industries are likely to be taken into account in designing the new financial architecture. The resulting compromises and inefficiencies may well lead to bad policy – as the analogous pressures did in the case of the Federal Reserve System. ▪

Harold James is Professor at Princeton University.

Pictured left to right at the opening session are: Muhammad Baasiri, Central Bank of Lebanon; Saif Hadef Al Shamsi, Central Bank of the UAE; Sheikh Abdullah Saoud Al-Thani, Qatar Central Bank; David Marsh, OMFIF; Flavia Palanza, European Investment Bank; and Ibrahim Al Ibrahim, Emiri Diwan.

Tapering more likely as employment rises

Pressure to trim bond-buying pits hawks against doves

Darrell Delamaide, US Editor

The surprisingly strong US employment numbers for October prompted some to think the Federal Reserve might start trimming its asset purchases already in December. The release of the minutes of the October meeting of the Federal Open Market Committee (FOMC) in mid-November indicated that policy-makers might consider lowering the interest rates on excess reserves into negative territory – a compensation for lower asset purchases.

On the other hand, the headline rate for unemployment remained stubbornly high at 7.3%, making it difficult to justify tapering when the main purpose of the asset purchases is to get that rate down. The October employment figures were viewed with some scepticism because the government shutdown may have impaired data gathering. Subsequent data showed unemployment falling to 7%, prompting further speculation on imminent tapering.

The October minutes did show a certain amount of nervousness among policy-makers that quantitative easing might have to be abandoned even before the target of 6.5% unemployment, though it was agreed that would have to be clearly communicated ahead of time. In any case, doves continued to defend monetary accommodation while hawks continued to urge an end to the asset purchases.

Philadelphia Fed chief **Charles Plosser**, a hawk who is not currently a voting member of the FOMC but who will rotate into that position in 2014, was particularly voluble. In a speech to risk managers in Philadelphia, Plosser once again criticised the FOMC's failure to start tapering in September, as was widely expected. 'Not dissuading the public from its expectation of a tapering and then not taking action undermines the credibility of the FOMC and reduces the effectiveness of forward guidance as a policy tool,' Plosser said. Also, markets interpreted the decision as a lack of confidence in the economic recovery, undermining Fed credibility and public confidence. 'These were not the messages that I wanted to send,' Plosser said.

Given how difficult it to fine-tune the open-ended asset purchases, Plosser suggested the panel announce a fixed amount for QE3. 'When we reach that amount, we should stop the asset purchases, and then reassess the state of the economy to determine if further action would be beneficial,' he said.

Earlier in the month, Plosser said in an event at the conservative Cato Institute in Washington that monetary policy can influence the real economy only in the long run – by keeping prices stable – a fact too often overlooked by those who expect the Fed to combat short-term unemployment. 'In my view, focusing on short-run control of employment weakens the credibility and effectiveness of the Fed in achieving its price stability objective,' Plosser said.

Fed chairman **Ben Bernanke (voter)** himself defended the quantitative easing. After he finished his prepared remarks at a National Economists Club dinner in Washington, a member of the audience said that QE had benefited investors but wasn't helpful to the man in the street. 'I hate to shock you but I don't agree with that,' Bernanke said. 'The Fed is making an important contribution to middle class and lower income folks' welfare.'

Chicago Fed chief **Charles Evans (voter)**, a strong supporter of QE, told the Illinois Bankers Association in Chicago that the asset purchases, which began in January, will continue to be open-ended and may need to total $1.5tn by January 2015.

Narayana Kocherlakota, the head of the Minneapolis Fed who also rotates into a voting position in January, said the sluggish progress toward meeting the Fed's goals on unemployment meant monetary stimulus will have to continue unabated and the 'public conversation' suggesting the contrary is hard to understand. 'Reducing the flow of purchases in the near term would be a drag on the already slow rate of progress of the economy toward the Committee's goals,' he said at the St. Paul Chamber of Commerce. 'From the perspective of a goal-oriented approach, the timing of this conversation seems puzzling.'

St. Louis Fed chief **James Bullard (voter)** reiterated his belief that the Fed could continue its accommodative policy as long as inflation remained well below its 2% target.

Bullard, who has expressed concern that inflation is too low, suggested in remarks to reporters after a speech in Arkansas that the Fed could allay concerns that it would raise interest rates when it halted asset purchases by setting a floor on inflation.

According to a report in the Wall Street Journal, Bullard said he would like the Fed to say it will not raise rates if inflation goes below 1.5%. The head of the Atlanta Fed, **Dennis Lockhart (non-voter)**, also said the Fed's stance should remain 'very accommodative for quite some time' and cited inflation as one of his concerns. 'Inflation is too low,' Lockhart said at a university symposium in Oxford, Mississippi. 'A persistent low rate of inflation raises concerns about a stalling out of economic expansion.'

He added that inflation is not yet 'alarming,' as there are few signs of either disinflation (slowing down of the rise of prices) or deflation (falling prices). 'But I would like to see the inflation rate rise to around 2% and stay there,' he said. ▪

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

Centralised financial services supervision highlighted at Qatar Central Bank meeting

The favourable impact on Qatar's development as a financial centre of regulatory changes bringing in centralised financial service supervision under the Qatar Central Bank was spelled out by Governor Abdullah Saoud Al-Thani in the opening session of the Main Meeting in Doha on 27-28 November (pictured left). The meeting was attended by 53 people from 20 countries. Among other topics discussed, the negative example of the euro seems to provides a convenient excuse for Gulf states to go still more slowly on their long-term monetary union plan, where the UAE and Oman have already pulled out of the project. ▪

Independence: fragile and fluctuating

History of war and personality conflict sets marker for Janet Yellen

Forrest Capie, Advisory Board

The Federal Reserve was founded 100 years ago, with the signing of the Federal Reserve Act. Financial stability was the prime focus. It was intended that the bank be independent of political influence. The degree of independence has shown important fluctuations, depending on various conflicts between the personalities involved as well as the external environment. As Janet Yellen prepares to take over at the end of January, there are plenty of reminders from the Fed's history that independence, conceptually and in practice, can be a fragile attribute.

Arthur Burns did too much of what President Richard Nixon asked. Paul Volcker went a long way to restoring independence in the 1980s. Reactions to the financial crisis that erupted in 2007-08 may turn out to be another example of loss of independence.

Armed conflict brings even more dire pressures. The Fed was founded after a long period of peace but the First World War broke out soon afterwards. The Fed was almost immediately involved as the Treasury's banker. The Federal Reserve Act was quickly amended so that banks could borrow from the Fed using government securities as collateral. Inflation followed but the Fed could not raise discount rate without Treasury approval. So it did not get off to a good start in terms of either independence or inflation control.

Hardly had the post-war adjustment taken place before new problems arose at the end of the 1920s. The Fed's actions and failures to act were one of the reasons behind the Great Depression. In the wake of criticisms of its shortcomings, the Federal Reserve Act was again amended, by the Emergency Banking Act of 1933, which gave the president powers to regulate credit. Calls for more reforms persisted and a new Banking Act was designed for implementation in 1935.

Initially the principal aim had been to provide for a small but flexible monetary authority with its independence restored. The 1935 Act preserved the Fed's vague mandate of December 1913. However, if the Fed strayed from the Treasury's line, it was readily brought back to heel by the Treasury. The chairman Marriner Eccles failed to defend the Fed's independence under President Franklin Roosevelt. Within a matter of years, war broke out again and the Fed was obliged to support the prices of government securities. Tensions arose immediately with the Treasury seeking low rates to support the sales of bonds for war finance. In 1942 Federal Reserve banks were authorised by government to buy government securities directly from the Treasury. This gave rise to inflationary dangers that continued after the war. Commercial bank reserves and inflationary risks grew hugely.

These tensions over interest rates came to a head in 1950. Allan Sproul of the New York Fed was sufficiently worried in what he saw as a dangerously inflationary situation that he thought it was time to exercise some independence. The Board of Governors announced rate increases and indicated they would take further action if required to restrict credit. A major bust-up followed which some see as a turning point in the annals of central bank independence.

When any kind of emergency appears, the response may well be legislation that seems at the time entirely appropriate to the problem. But it then weakens the central bank's position when normality is restored. Emergency legislation, the scope of which turns out to be greater after the crisis than had been realised at the time, is one of the biggest factors compromising independence. ▪

Forrest Capie is Professor Emeritus of Economic History at the Cass Business School City University.

Fragile independence

After a special meeting in January 1951 of the Federal Open Market Committee, the Treasury released a public statement that suggested that the Fed would do as it was told. This so enraged Marriner Eccles, a Fed board member and former chairman, that he broke confidentiality rules and gave the press the Fed's record of the meeting that suggested no such thing. This led to the Accord of March 1951 which some see as the turning point in the Fed's history, the point at which it became a truly independent central bank. How true that is will continue to be debated. The1951 episode is a reminder of how fragile independence can be. Developments of the last few years exemplify how a crisis can thrust a central bank into the arms of government. The inability to write contingent contracts ensures that independence is compromised in a crisis. ▪

Charles Hamlin, 1914-16

First governor of the Federal Reserve Board, Hamlin served under President Coolidge. A Harvard graduate and lawyer, he formerly served as assistant secretary of the Treasury and was twice unsuccessful candidate for governor of Massachusetts. Appointed in August 1914 he had to cope with the Fed's growing subservience to the Treasury as war broke out in Europe.

Marriner Eccles, 1934-48

Principal author of the Banking Act of 1935, Eccles was the creator of the modern Federal Reserve System. Known as a proponent of Keynesian ideas and a close supporter of President Roosevelt, Eccles was a veteran of the 1931 banking crises and kept his family banks going without a single failure. The Fed's marble Constitution Avenue building is named in his honour.

William McChesney Martin, Jr., 1951-70

Longest-serving Fed chairman under five presidents. Father helped write 1913 Federal Reserve Act. Once considered becoming Presbyterian minister. Restored credibility in Fed independence after Second World War, against President Truman's expectations. Believer in tightening monetary policy as the economy nears a peak, famously defining the task as 'to take away the punch bowl just as the party gets going.'

Financial crises dog the Fed at every stage

Link between Greenspan, Bernanke and the Knickerbocker Trust

Richard Roberts & Anders Mikkelsen, King's College London

The Federal Reserve was the child of the financial crisis of 1907. A run on the Knickerbocker Trust Company, a New York bank that was speculating in copper, was contagious and other banks suspended payments to depositors threatening a systemic collapse. Financial crises are a constant: Ben Bernanke, the successor to Alan Greenspan in 2006, faced a crisis even graver than that which prompted the Fed's creation of the Fed.

Back in 1907, leading banker J.P. Morgan, privately performing the lender of last resort role of a central bank, organised a group of New York commercial banks to provide emergency liquidity to the banking system and the New York Stock Exchange. With assistance from the US Treasury, the panic was contained, though it was followed by a deep recession.

The episode deepened populist suspicion of the powers of the Wall Street 'money trust'. Calls intensified for the creation of a public institution to act in the national interest. From 1908, a National Monetary Commission conducted extensive inquiries including visits to the major European central banks.

The eventual outcome was the Federal Reserve Act. The Fed's goals were 'to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the US, and for other purposes.' There was no mention of macroeconomic objectives such as price stability: these came later.

The Fed was America's third central bank. Central banking was politically controversial in the young US, with persistent opposition to centralised economic institutions from farmers and others in the Jeffersonian tradition.

The First and Second Banks of the United States (1791-1811 and 1816-36) fell afoul of these forces. For almost eight decades America was without a central bank. In 1913, suspicion of centralisation was addressed by the creation of 12 regional Reserve Banks along with the Federal Reserve Board in Washington. The New York Fed quickly emerged as the most important of the regional reserve banks. The Federal Reserve System, which was still under construction, was threatened by the financial crisis at the onset of the First World War. But bold leadership by the Treasury Secretary saved the day.

Fed policy mistakes were blamed for contributing to Wall Street's 1920s boom and October 1929 crash. Moreover, its responses to the Great Depression of the early 1930s were inadequate. Failure to provide sufficient liquidity at the systemic level was a contributory factor to many of the thousands of US bank failures. Pursuit of economic recovery led to closer co-operation between the Fed and the Roosevelt administration, with deference to the Treasury from the mid-1930s. During the Second World War, the Fed became an agent of the government assisting with the war effort.

After the war, confronted by the Fed, which had support in Congress, the government backed down and restored control over interest rate policy to the central bank. With the end of the Korean war inflation receded which enabled rates to remain low defusing potential conflict with government. Economic growth with low inflation during the 1950s and early 1960s meant that there was little cause for friction with administrations. That changed later. The lesson of the Fed's oscillating history is that good times sooner or later come to an end. ▪

Richard Roberts, member of the Advisory Board, is Professor at King's College London, and Anders Mikkelsen is Research Student at King's College London.

Volcker turning point

Inflation became a major issue from the mid-1960s, arising initially from increased government spending on the Vietnam War and 'Great Society' social measures. The turmoil of the 1970s led to soaring inflation and mounting conflict between the Fed and the government. Presidents Lyndon Johnson and Richard Nixon bullied the Fed towards loose money to maintain jobs. The turning point was the assault on inflation by Paul Volcker in 1979. By late 1982 inflation was under control and the Fed reverted to taking a broader view of its responsibilities. Summer 1982 saw the beginning of the long boom that eventually ended with the financial crisis of 2007-09. Fed responses under the 18 ½-year chairmanship of Alan Greenspan helped to put the US economy back on the road to expansion each time, though some argued that cumulatively its actions increased moral hazard. ▪

Arthur Burns, 1970-78

Professor at Columbia University, president of the National Bureau of Economic Research, chairman of the Council of Economic Advisors under President Eisenhower. President Nixon, who chose him for his compliancy after ultra-independent Martin, was not disappointed. Accused by Fed staffers of lacking collegiality and juggling money numbers to get FOMC consensus.

Paul Volcker, 1979-87

Wisecracking authoritarian with massive anti-inflation credibility, curmudgeonly public servant suspicious of bankers. Former New York Fed president and Treasury official, appointed by President Carter in 1979 to combat price rises. Recession brought demise of inflation and Carter presidency. Early adviser to President Obama, promoted reforms to curb banks' proprietary trading.

Alan Greenspan, 1987-2006

Feted as 'maestro', famously Delphic, controlled crises under four presidents, co-architect of 1990s 'feel-good' years. Skirted dotcom bubble, allowed himself to believe in his own legend, which collapsed with Lehman Brothers. In 2013 he said, before 2007, he was 'embarrassed by the adulation – they made me a rock star. So afterwards when I got hammered, it kind of balanced out.'

Abe's danger of derailment

Japanese PM risks being blown off course by security issues

Kenzo Fujisue, House of Councillors, Japan

Some aspects of the economic policy of Shinzo Abe, the Japanese prime minister, have been relatively successful in the 12 months since the start of his second term on 26 December 2012. However, many problems are banking up for the future, not least in areas outside economic policy, where strained security and general relations with China and Korea could eventually become a problem for the economy too.

The experience of Abe's first administration which ended six years ago provides some important warning messages. He neglected considerable popular dissatisfaction over public pensions problems and lagging incomes. Subsequently he suffered a crushing defeat in the upper house election of 2006 because he concentrated on his own personal projects such as constitutional reform, to the neglect of basic economics.

Recognising this legacy, Abe would be wise to focus on economic policy and concentrate on surmounting some major challenges between now and spring 2014.

Trans-Pacific Partnership

Over that time, the tasks include negotiations on the proposed Trans-Pacific Partnership with the US and ensuring approval by the Diet, pushing through the planned increase in consumption tax and ensuring the renewed operation of nuclear power plants. If any of these undertakings run into setbacks, Abe faces the risk that, just as happened with his first administration, he will lose the support of the Japanese people.

In many areas, though, Abe has achieved some successes. Stock prices remain high and the yen has become cheaper, with considerable benefit to the economy. The monetary policy undertaken as the 'first arrow' of Abenomics has been successful. The Bank of Japan set a 2% goal for inflation and has won a measure of credibility.

The policy launched by Haruhiko Kuroda, the Bank of Japan's new governor, of ending a decade of deflation through 'monetary easing in an entirely new dimension' has gained sizeable ground. The policy has included purchases of both long-term government bonds and other assets. The stock market rebound to around the level before the Lehman Brothers bankruptcy shows the degree of achievement.

However, recent statistics display a more sombre side to the story. Abenomics is showing signs of slowing down. According to preliminary estimates for the third quarter, GDP growth fell to 1.9% on an annualised basis, only half the 3.8% increase in April-June.

Consumer spending, which accounts for about 60% of GDP, rose by 0.1%. GDP growth would have been even less impressive had it not been for public works investment, which increased 6.5%, the result of more expansionary fiscal policy, under the so-called 'second arrow' of Abenomics. Of the large supplementary budget of ¥20tn, ¥10tn was devoted to public infrastructure.

Another negative piece of news was that the trade deficit for April-September rose to around ¥5tn, the largest-ever half-fiscal year figure, comparable to the 1979 outturn when Japan was particularly affected by the second oil crisis. The trade deficit has now been continuing for 15 consecutive months, one month longer than after the 1979 oil shock.

The government explains that this trade deficit has been caused by an increase of fuel imported for thermal power generation, as well as the impact of the depreciated yen. This reflects large-scale imports of crude oil and liquefied natural gas after the decision to close all nuclear power plants.

The hoped-for stimulus effect on exports of the weaker yen has not materialised, and increases in exports have remained behind import growth, in line with the well-known J-curve effect under which trade deficits often increase in the immediate aftermath of devaluations.

The trade deficit in October exceeded ¥1tn, taking the April-October shortfall to ¥6tn, the figure which the government had earlier predicted would be the deficit for the whole of the fiscal 2013 year to March 2014. If the seven-month trend continues, the trade deficit for the 2013 fiscal year is likely to exceed ¥10tn, double the 2012 deficit of ¥5.8tn, compared with a trade surplus of ¥8tn in 2010.

To offset the trade deficit, the government had been hoping for improvements in the non-trade balance and in income from investments. But the income surplus in 2013 is likely to remain around the same as in 2012 at ¥14tn, while services record a modest deficit of around ¥2.5tn, so a current account deficit for the fiscal 2013 year cannot be ruled out. This would imply the need for net demand from foreigners for Japanese government bonds, notwithstanding the large purchases by domestic investors. This would have a very large impact on the bond market.

Clearly, much depends on the 'third arrow' of the growth strategy, aimed at rebuilding Japan's industrial competitiveness, partly through supply-side measures. Two elements of this additional component of Abenomics are being discussed in the Diet, the industrial competitiveness bill and the international strategy zone bill. However, these two pieces of legislation would not be sufficient by themselves to revitalise investment by Japanese companies.

Currently, the stock market is supported solely by foreign capital, with net equity purchases by foreign investors around ¥13tn between January and November 2013.

Selling by Japanese individuals and corporations, on the other hand, has each accounted for net sales of ¥6tn. So the future of Abenomics lies to a large degree in the hands of foreign investors. It is far from clear whether they will continue to give approval.

In view of the numerous question marks over growth strategy, Abe must focus on economic issues. Yet the main preoccupation in the Diet is currently not growth but security issues, seen in the legislative tussles between government and opposition on bills dealing with the Japanese national security council and official secrets.

One of the prime minister's advisory bodies is compiling a national security report, expected to endorse the right of collective self-defence. This is expected to attract considerable attention when it is released in December.

These are undoubtedly important questions, but Abe would do well to reflect that his success stands or falls on economics – and here the ground appears to be moving from under him. Abenomics has had a good start, but a lot more remains to be done – and time will soon be running out. ▪

Dr. Kenzo Fujisue is Member of the House of Councillors in the Diet in Japan.

A welcome return of the long cycle

US and Japanese markets will benefit from American recovery

Trevor Greetham, Advisory Board

The world economy is enjoying a sustained US-led expansion after years of stop-start growth. The gradual normalisation of US monetary conditions over the next few years will have profound implications for investors. Multi-asset funds should be tilted away from bonds and towards stocks, a position we have held for more than a year.

The US and Japanese markets stand to benefit from a strong US economy and a strong dollar. A broad-based rise in inflation would signal a more rapid tightening of global central bank liquidity and ultimately a slowdown in growth but there's no sign of it yet. The positive backdrop for stocks could last longer than many expect.

The major economies of the world are likely to see solid growth in 2014. The lifting of fiscal drag and supportive monetary policy from the Federal Reserve will underpin and strengthen what has already been a four-year recovery in the world's largest economy. European austerity is thankfully receding somewhat. Confidence that the euro area will stick together for the time being has lowered peripheral funding costs and put the euro crisis into remission.

The UK is likely to enjoy an old-style housing boom in the run-up to the 2015 general election. Japan is due to raise the sales tax in April but additional offsetting measures can be expected from Prime Minister Shinzo Abe's aggressively pro-growth government.

While global growth is strong, inflation pressures are all but absent. This is very good news for investors. The Investment Clock model is in the equity-friendly Recovery phase of the economic cycle (see chart below). Corporate earnings are expanding but monetary policy is loose everywhere with no immediate sign of tightening.

Quantitative easing

Federal Reserve quantitative easing will continue after Janet Yellen takes the helm in the New Year. US interest rate hikes are not on the horizon. 'Tapering' implies easing the accelerator pedal, not hitting the brakes.

Like the Fed, the Bank of England is promising to hold rates at a record low until unemployment falls substantially. Falling inflation in the euro area is putting pressure on the European Central Bank (ECB) to ease further with negative deposit rates and some form of quantitative easing under discussion.

The Bank of Japan is in full blooded easing mode with the explicit aim of creating 2% inflation. That policy will remain in force to offset modest fiscal tightening. Structural headwinds mean China is no longer the engine of global growth but, even here, there is little appetite to cool the economy.

My leaning has been towards an overweight equities position for a year. Fidelity moved back to a near-maximum overweight position during the summer weakness. Long-term valuations are fair as stocks never priced in artificially low bond yields. Bonds, on the other hand, are likely to lose their safe haven status as stronger growth sees yields ratchet higher. We maintain low fixed income exposures.

Good growth numbers and the expectation of higher interest rates should see a return of portfolio capital to America, driving a sustained trend of dollar strength like that of the 1990s. This will put pressure on emerging market currencies, triggering financial stress in economies reliant on overseas funding. Raw materials exporters will face commodity price weakness in the face of excess capacity and slower trend growth in China.

An underweight position in emerging market equities makes sense. We favour stocks in the US and Japan, where policy is loose and where dollar strength will be a positive. Fidelity remains underweight in Europe although to a lesser extent than at the height of the crisis. A return of confidence has reduced the pressure to complete fiscal and banking union, earnings revisions remain negative and political tensions are likely to return when the world economy next hits a weak patch.

There are two main risks. Global growth could slow, perhaps because of financial stress in China or unexpected developments in Europe. Alternatively, inflation could rise. At some point the Investment Clock model will move into Overheat, triggering a rise in central bank rates that could cause weakness in a wide range of asset classes.

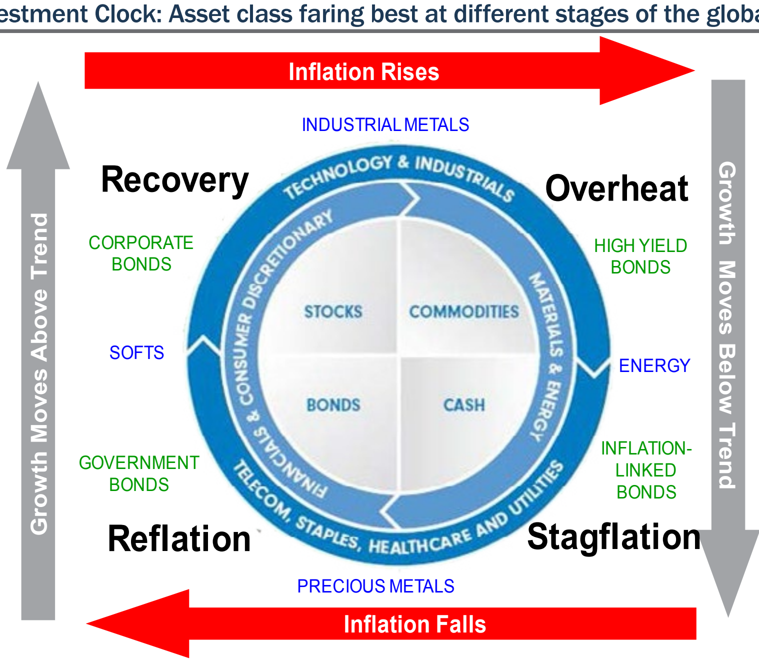
However, with spare capacity still in evidence and unemployment high, inflation pressures remain minimal. Persistent commodity price weakness could keep things this way.

In this sense, a structural slowdown in China and trouble in the emerging markets could be positive for the rest of the world. Lower commodity prices mean higher real incomes, boosting consumer purchasing power and ending the cost of living crisis.

With China playing the disinflationary role of Japan in the 1990s, the positive backdrop for developed market stocks could last for years. ■

Trevor Greetham is Head of Tactical Asset Allocation and Portfolio Manager at Fidelity Investments International.

The Investment Clock: Asset class faring best at different stages of the global cycle



Merkel's far-from-grand coalition

Social Democrat agenda won't help Europe's climb out of crisis

Michael Stürmer, Advisory Board

There's nothing grand about Germany's grand coalition, put together after six weeks of laborious wrangling. It consists of three parties wedded to social democracy, two of them a bit more catholic. Driven by an irresistible ambition to stay in power, Chancellor Angela Merkel's Christian Democratic Union (CDU) and its Bavarian sister party, the Christian Social Union (CSU), have surrendered to the Social Democrats (SPD). The outcome presages a long decline in German economic strength, social cohesion and ability to lead Europe out of the financial and economic crisis.

The SPD has miraculously transformed humiliation in the polls 2½ months ago into a resounding victory. Merkel's previous centre-right coalition was voted out by a narrow margin as a result of the ejection from parliament of her previous partners, the liberal Free Democrats. The previous opposition party has now won most of what it wanted – and robbed the CDU of its convictions.

Minimum wage

The SPD has gained a universal minimum wage (€8.50 an hour), early pensions and fanciful welfare legislation. What remains of the Christian Democrat agenda is an optional child care scheme adopted under the previous coalition, and a promise to make foreigners pay for motorways. The agonisingly lengthy 171-page coalition agreement makes painful reading, mixing platitudes with minutiae, while failing to address urgent questions on managing the switch from nuclear energy or reversing demographic decline.

While preaching austerity for others in the euro area, German politicians are preparing themselves for a good time. The coalition agreement has nothing to say on securing the long-term sustainability of the common currency, cutting back on European red tape and government interference, and doing everything possible to keep Britain, Germany's most important ally in market economics and liberal philosophy, in Europe. Those who look for answers to European security and defence policies, or on resolving the imbalances in the euro area, will search in vain.

Recalling Merkel's past years in the German Democratic Republic, pessimists in Berlin speak, only half-jokingly, of 'GDR-light'. Germany is turning away from country's recent economic success, the Agenda 2010 programme of Merkel's SPD predecessor, Gerhard Schröder. Instead it is opting for excessive welfare budgets, more cumbersome state bureaucracy and an uninspiring administration of the status quo.

Almost certainly, Merkel can attend the 19 December European summit in Brussels as re-elected chancellor, pushing through crucial decisions on banking union. Yet the lack of political leadership and decision-making strength in Europe's pivotal country bodes ill for further steps towards an integrated Europe. The SPD's pro-European sympathies are likely to be outweighed by its anti-bank antipathy and its desire for German income redistribution über alles. Representatives of hard-hit peripheral countries who believe a centre-left government in Berlin will be softer on Europe's debtors face a nasty surprise.

Other countries should resist the temptation for Schadenfreude. Drift and indecision come at a price that Europe will pay. The process reveals the obliviousness of the political class in Berlin to the crucial conditions for Germany's past success and future wellbeing. Europe's 'reluctant hegemon' is apparently ignoring the implications of Berlin's policy paralysis for the rest of Europe, uneasily watching the antics of a country that appears thoroughly daunted by any kind of leadership role.

The greatest reversal is that the CDU, to continue in the drivers' seat, had to slaughter most of its sacred cows. The SPD turned poor results in the September election into rich pickings in terms of both ministerial posts and programmatic presence. The CDU was never a conservative party like the British Tories. But there was always a solid base of catholic family values and liberal economics. Most of this tradition has been sacrificed. The SPD's brutally sophisticated power-play – threatening to install instead a coalition of the Greens and the far-left Die Linke – has proven triumphant.

There is still a 10% chance that the SPD's card-carrying activists will say No in an internal referendum of party members, the results of which will be announced in mid-December. In that case, an altogether different scenario would unfold, with Merkel again the master of ceremonies, the SPD leadership destroyed and, after some wrangling, the dissolution of the new Bundestag elected two months ago. After a long period of waiting for the German elections, an even longer period of uncertainty would ensue.

The 90% assumption is that the SPD rank and file will, as they usually do, follow their leaders. After all, the trade unions achieved, via the SPD, almost 100% of their objectives. The mood among the captains of German industry, when they allow themselves a view unobscured by political correctness, is dismal. Disinvestment waits in the wings. Global players are redirecting their investment towards more welcoming shores. Not so long ago, before the Schröder reforms kicked in, Germany was seen as the sick man of Europe. Now it could return to the bad old ways.

Strong personalities

In the 1980s and 1990s, when strong personalities like Helmut Schmidt (SPD) or his successor Helmut Kohl (CDU) dominated the stage, the lead role in coalition bargaining belonged to the chancellor. He would call upon a small group of political advisors who, within a few days, at most two weeks, provided a consensual framework between the future coalition partners, with details to be filled in through various ministries and their future principals.

In 2013 we have seen an arduous and unpredictable imbroglio. Like in a surrealist play, the coalition talks have been driven by 75 people from the two parties sitting around a large horse-shoe shaped table.

SPD leaders have promised the ex-communist far-left an upgrade along the lines that, for the time being, the party would remain untouchable, but it might be suitable as a coalition partner in the future. This flirtation with the far-left – the equivalent, according to a prominent CDU figure, to visiting a brothel on the eve of marriage – was the essential lever used by the SPD to hook the Christian Democrats into an uneasy betrothal. If, for a multiplicity of reasons, the alliance comes under strain in coming years, the Social Democrats and Christian Democrats will have plenty of opportunity to show how little love they have for each other. ▪

Prof. Michael Stürmer, a former speechwriter for Helmut Kohl, is Chief Correspondent at Die Welt.

What's at stake behind surplus spat

Reforming weaker countries, not weakening Germany, is the key

Stefan Bielmeier, Advisory Board

The International Monetary Fund, the US government and the European Commission have pointed to Germany's high current account surplus and warned of possible structural imbalances in Europe. At first sight, this warning seems justified. Germany's current account surplus is high compared with the rest of the world, at around 7% of GDP. China, with a current account surplus of just short of 3% of GDP, lags well behind Germany.

Germany's high current account surpluses are the result of relatively low domestic demand. Germany has seen below-average consumer spending trends and capital investment ratios in recent years. The insipid investment trend has been caused partly by many years of very weak investments in construction. The consumer spending ratio, below average compared with the US, is primarily the result of very restrained German wage increases.

Competitive edge

The relatively low growth in wages in Germany – and the associated increase in German business' competitive edge – is among the main reasons why its companies are doing so well. In the wake of the 'Hartz reforms' under previous Chancellor Gerhard Schröder, measures were introduced to render the labour market more flexible, above all by liberalising temporary and other short term types of employment.

A combination of wage restraint and greater labour market flexibility led to a great improvement in Germany's competitive position in the period 2002-07. Previously, Germany consistently posted a current account deficit. Without the labour market reforms, this deficit would have expanded still further in the early years of the 2000s, given that Germany entered the euro in 1999 at an unfavourable exchange rate.

The wage restraint and labour market reforms gave Germany what amounted to an internal devaluation at a time when the competitiveness of other euro member states fell, a development reflected in their current account trends. While Germany's current account surplus rose markedly at this time, most other euro members started to face deficits.

With the introduction of the euro, interest rates fell sharply in most the new members of monetary union, triggering a boom in construction and in credit-financed private consumer spending. These trends led to a pronounced acceleration in growth rates. So the social gains from the introduction of the euro went into consumer spending and not into these economies' structural advancement.

Germany's competitiveness has been more or less stagnant since 2008 and, of late, even fell slightly. The other euro members that have been forced to carry out rigorous reforms in the wake of the sovereign debt crisis (with an unfavourable impact on employment) have greatly increased their competitiveness. Correspondingly, their current account deficits have fallen significantly. However, competitiveness has not improved in France or Italy – as a result of a combination of fading reform zeal and a difficult political environment.

Germany's high current account surpluses are a sign of an economic imbalance that, in a monetary union, can give rise to immense centrifugal forces. However, it would be counterproductive to call for a weakening of Germany's economic strength as the euro bloc's powerhouse. Instead, the countries that have lost ground in reforms must now urgently take necessary steps to avoid falling further behind trading partners inside and outside the euro area. At the same time, the phase of economic expansion in Germany is now boosting wage growth.

Employment is at an all-time high. This positive development, not to mention demographic trends such as a lack of skilled labour, is slowly spawning higher pay. This should persist in the years ahead and thus lead to increased private consumer spending. Whether investments increase sustainably depends primarily on the future economic policy framework.

Germany's economic strength should not blind politicians and policy-makers into thinking that the Germans can relax. Otherwise, a few years down the line, Germany may find itself facing weak consumer spending and investment and a current account deficit. Reforms need to be pushed ahead across the euro bloc. Waiting for Germany to weaken would be a recipe for hamstrung growth across the euro – bringing benefits for no one. ▪

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

Germany's responsibilities in euro bloc under scrutiny in Berlin

Germany's responsibility to help pull hard-hit euro members out of recession was one of the main themes at a joint seminar between OMFIF and the British Chamber of Commerce in Germany (BCCG) at the British embassy in Berlin on 12 November. Bundesbank board member Joachim Nagel gave the keynote speech, on British-German cooperation and the planned European banking union. Participants included OMFIF Advisory Board members Michael Stürmer (left) and John Kornblum.▪

Deflationary threat haunts Europe

ECB must take responsibility for broad money growth slide

Gabriel Stein, Chief Economic Adviser

The European Central Bank's November interest rate cut shows that the bank is finally taking the threat of deflation in the euro area seriously. But the ECB also bears substantial responsibility for letting broad money growth slide to a level where broad money developments point to a risk of a sustained fall in prices.

In November, euro area consumer prices rose by 0.9% according to the ECB's flash estimate. That was up from the 0.7% registered in the year to October; but that was the lowest number in four years and the November number was the second-lowest since early 2010. Underlying inflation in the year to October (excluding energy and unprocessed food) was 1%, a three-year low. The trimmed mean rate, possibly a better guide to underlying trends than a core rate that strips out the same items every month, was 0.8%, a 3½-year low (Chart 1).

Mario Draghi, the ECB president, has repeatedly stated that deflation – which he defines as 'a self-fulfilling fall in prices across a very large category of goods and across a very significant number of countries' – is not actually happening. Yet Draghi has also repeated that low inflation, well below the ECB's targeted level of 'close to but below 2%', is likely to remain in place for an extended period. However, Draghi's definition of inflation is slightly misleading. The usual definition is that deflation is a sustained fall in the general (or overall) level of prices. Deflation on this basis is not yet occurring on a euro area-wide basis. But it is equally true that it is getting perilously close to occurring. This was the main reason why the ECB Governing Council overrode opposition (including from Germany) to cut its repo rate from 0.5% to 0.25% on 7 November.

Following the cut, there were some strident attacks on the ECB and on its President for allegedly having cut interest rates to benefit southern European countries at the expense of returns to German savers. These are misguided. If anything, the ECB should have acted more forcefully to avert any risk of deflation.

This would not be the euro area's first brush with deflation. The level of consumer prices fell from May to November 2009, before accelerating to close to 3% in the autumn of 2011. However, the concern is that the euro area could be headed for more sustained falls in the level of consumer prices. At the moment, the only euro area country that is actually in deflation is Greece, where prices have been falling since March. However, in every euro area country inflation is lower than both twelve and six months ago.

It is generally accepted that deflation, certainly when prolonged, is undesirable. This is even more the case in an excess debt situation, like that of the euro area. However, since deflation, like inflation, is over any sustained period of time a monetary phenomenon, it is at least in theory easy not only to cure, but to avert by accelerating the growth of broad money.

The main argument supporting a deflationary outlook for the euro area is that the area-wide output gap remains negative and large. With output growth through most of 2014 likely to remain below trend, the output gap will remain negative. What matters for the change in the rate of inflation is the level of the output gap, not the change. As long as the output gap is negative, then – assuming generally unchanged economic parameters – the rate of inflation will tend to fall, or even turn negative.

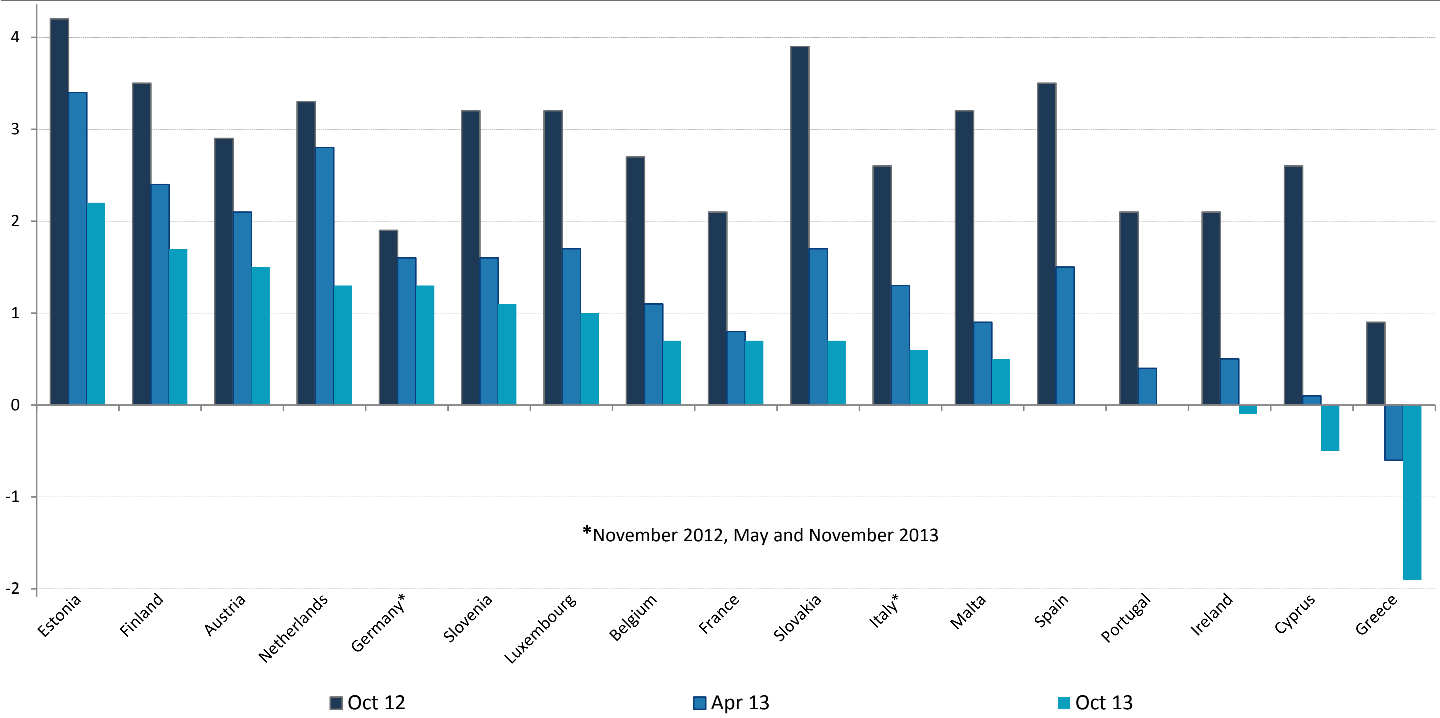
According to the IMF's latest World Economic Outlook of October 2013, the euro area this year has a negative output gap of 2.8% of GDP. Although the IMF is forecasting that the output gap will narrow, it will not close over the next five years. During the previous episode of falling prices, in 2009, the IMF estimated a 2.9% negative output gap. Furthermore, the IMF estimates that output gaps in all euro area member countries are negative. Continued spare capacity in the euro area implies that disinflationary pressures will

Chart 1: Euro area inflation, 12-month change

* A trimmed mean inflation measure strips out the fastest and slowest increases every month, but is not tied to specific categories. The euro area trimmed mean inflation measure was developed by Stein Brothers.

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

Chart 2: National inflation rates, year to respective date, %



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

continue; the more so as further tax increases and rise in administered prices, which would push up inflation, are less likely.

The euro area output gap has been negative throughout the period from 2009 until 2013, but inflation did not turn into deflation over that period. This was because this was a time of a general rise in commodity prices. It coincided, too, with overall (if erratic) euro weakness (which increased import prices) and sharp rises in taxes and administered prices by euro member governments.

One factor that makes the risk of deflation more controversial is the perception that certain elements on the ECB may actually welcome a deflationary bias, at least in the most hard-hit deficit countries – as part of a necessary component of the shift towards a lower cost base (the 'internal devaluation'). Since sustained inflation and deflation are monetary phenomena, recent broad money trends are worrying. The previous deflationary episode came after a sharp slowdown in M3 growth, from 12.4% in the year to November 2007, to less than 4% by May 2009.

Recent broad money data are also discouraging, with M3 growth slowing from 3.9% in October 2012 to 2.3% in August 2013. The decline is not as precipitate as in 2009, but broad money growth remains well below rates consistent with medium-term euro area trend rate output growth. (Around 6% M3 growth appears necessary to achieve 1.5% GDP growth. Although the ECB has a 4.5% medium-term reference value for M3 growth, research from serious sources such as the Banque de France has implied that this is too low.)

The ECB ultimately controls the euro area quantity of money. If it was worried about deflation, it could inaugurate an asset purchase programme similar to that of the Bank of England to boost broad money growth. The ECB has sporadically discussed quantitative easing of different kinds since the beginning of the financial crisis. But it has shown a marked resistance to engaging with this policy, since it would run up against the considerable institutional constraints of the euro area. This reflects reasons of principle as well as technical difficulties. The problems concern not only the type and volume of different public and private sector assets that could be acquired, but also fundamental constraints on monetary financing of deficits and 'bail-out' assistance by creditor governments towards debtor countries.

Along with the still somewhat slender possibility of QE, the ECB has several different options for action. One concerns a possible further cut in the refinancing rate to zero, which was discussed at the 7 November meeting. The impact of this on borrowing would probably be limited. But, in conjunction with other measures, such a cut could be helpful.

The ECB could introduce negative interest rates on banks' deposits with the central bank. But, unless the negative interest rates are high enough, banks may yet find that, for reasons of safety and for lack of credit demand, they would take the loss involved and keep the money where it is. Nevertheless, in theory this could have a substantial impact. Although banks' reserves with the ECB have fallen since peaking in the wake of the two three-year LTRO bank financing operations in 2011 and 2012, they still amount to close to €470bn. Pre-crisis, the sum was about €200bn. If the entire excess could be shifted towards credit, the stock of broad money (since credit is usually the most important counterpart to broad money) would show a one-off rise of about 1.7%.

Moreover, the ECB's latest bank lending survey shows banks are planning to ease their lending standards. Loan demand is rising in the current quarter, both for the first time in years, demonstrating scope for some credit growth. So the likelihood is that the ECB will introduce negative interest rates on deposits in the near future.

A further strong possibility – linked to the general issue of softening euro monetary policy – is to attempt to talk down the euro. Recent comments by Fabrizio Saccomanni, Italy's finance minister, point in that direction. In relation to this, there is a general perception at the ECB that a further rise in the euro, perhaps back to the $1.38 level, would give a direct, unhelpful push to lower consumer prices. A depreciation of the euro, by contrast, would raise import prices (and would also further help the euro area's export performance), offsetting the impact of the negative output gap.

Ultimately, the ECB will escape the risk of deflation only when activity is strong enough for the output gap to close. That is not likely to happen for some years yet. Deflation remains a threat. Until the ECB comes up with a clearer road-map to avert it, the threat seems likely to stay. ▪

Gabriel Stein is Managing Director of Stein Brothers.

Austria's response to financial crisis

Challenge of avoiding repercussions from public finance upsets

Ewald Nowotny, Oesterreichische Nationalbank

Typically, the root cause of a public finance crisis is a financial crisis (or one in the banking sector, to be more specific), which then moves on to the real economy and ultimately impinges on public finance. The big challenge we face today is to prevent a negative feedback loop from carrying the public finance crisis back into the banking sector.

The crisis that hit the US, the UK, Spain and Ireland indeed followed the pattern of 'banking crisis turned real economy crisis turned public finance crisis'.

In Austria, things were somewhat different. With regard to a financial crisis, my assessment is that we never actually had a general crisis of the domestic banking system.

While we do have banks that have run into problems, those problems are rooted in unsound and fraudulent management practices and have been limited to two particular banks. The general perspective of Austrian banks has been a rather positive one.

That said, the Austrian banking system is characterised by a strong exposure to central, eastern and south-eastern Europe. Yet this exposure has been a success story. It has been a success for the host countries, as it helped them develop a functioning banking infrastructure in a rather short period of time; and it has been a success for Austrian banks, which have grown into major European players.

The exposure of the Austrian banking sector to central, eastern and south-eastern Europe did, though, impair confidence vis-à-vis Austrian banks at times. Yet we managed to overcome this confidence crisis with a number of measures now associated with the 'Vienna Initiative'.

At the height of the first wave of the global crisis in January 2009, the Vienna Initiative brought together all the relevant public and private sector stakeholders of EU-based cross-border banks active in emerging Europe, which own much of the banking sectors in the region and hold a significant part of government securities.

The Vienna Initiative is a real-world example of solving the prisoner's dilemma, used in game theory to demonstrate the necessity of cooperation and coordination. If every single bank had followed its own short-term interest at this time of nervousness, the quasi-rational approach would have been to withdraw as fast as possible. That would have created a catastrophic situation.

But banks readily cooperated because they had the assurance that other banks would retain their commitments, and that the EU, the International Monetary Fund (IMF) and international institutions like the European Investment Bank and the European Bank for Reconstruction and Development (EBRD) would provide funds for stabilisation. The Vienna Initiative prevented abrupt deleveraging and sudden meltdowns. It may serve as a blueprint for the future.

The Austrian banking system's exposure to central, eastern and south-eastern Europe is highly diversified. On the one hand, Austrian banks are exposed to strong and sound economies in the region, and Austrian subsidiaries in those countries – such as the Czech Republic – are important pillars of the Austrian banking system.

But we are also exposed to less sound and more unstable countries, such as Hungary, where we do indeed observe a certain deleveraging of Austrian banks. Yet in my opinion such deleveraging is a rational response to fundamental policy-related weaknesses in these countries.

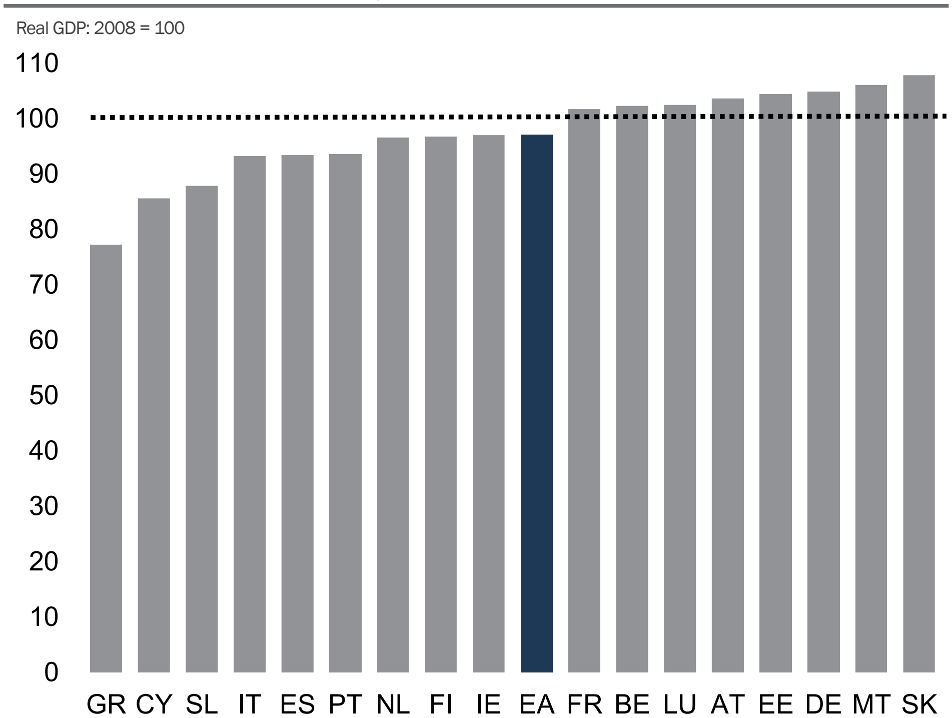
With regard to the real economy in Austria, we were affected only in a relatively mild way. We had negative growth in 2008, but Austria is projected to be one of the few countries in Europe where real GDP will be higher in 2014 than in 2008 (see Chart 1). Austria has the lowest unemployment in the euro area, and almost the lowest youth unemployment (see Chart 2).

Long periods of unemployment greatly increase people's difficulties of fitting back into the labour market. A low youth unemployment rate today will help prevent future structural unemployment. This is something we can claim for Austria.

I would like to stress two aspects with regard to the real economy. First, the progress of the Austrian economy has been export-led to a large extent. We have a very close economic relationship with Germany; significant input factors to German export production come from Austria.

Second, Austria pursues a 'balanced approach' to consolidation. When we implemented austerity measures in Austria, we avoided overreliance on front-loading. Rather, we follow a moderate pace of fiscal adjustment, anchored in a credible medium-

Chart 1: Gross Domestic Product, 2014 vs. 2008



Source: IMF WEO, October 2013

term strategy and supported by a structural budget balance rule that is binding for all levels of government. This has helped to consolidate consumer demand and prevent shocks.

Austria's medium-term fiscal strategy requires achieving a structural deficit of -0.45% of GDP by 2017 at the latest. However, there are risks to the announced budgetary path, stemming from pensions and the banking sector. According to the EU rules, public aid for the banking sector would not affect the structural deficit.

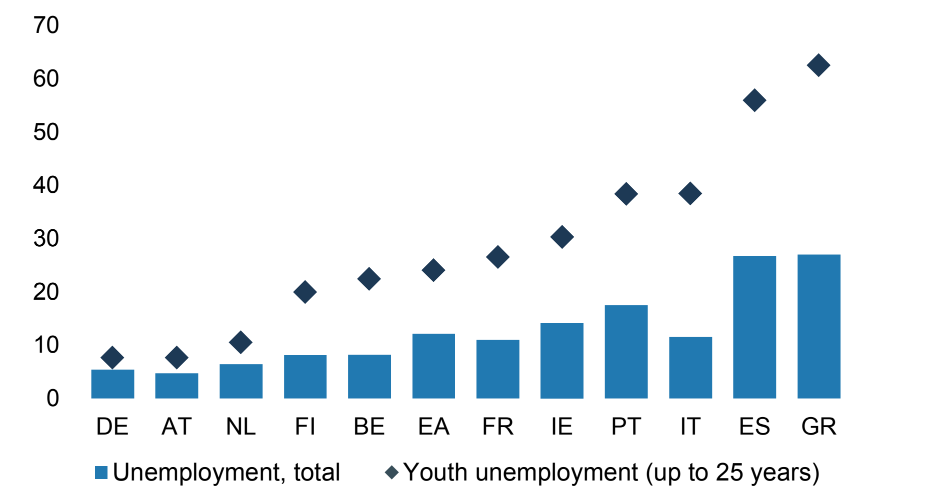
At the same time, a number of recent studies highlight quite substantial risks in our budget, stemming from pensions and the banking sector. According to the new rulings of the EU Commission, public aid for the banking sector does not affect the structural deficit.

Overall, the role of the government in Austrian banks is relatively small, and the outlook for public finances is stable. Austria has retained Triple A ratings with Moody's and Fitch and an AA+ rating with Standard & Poor's.

At the same time, there's no room for complacency. We are well aware that Austria is a small, open economy. We are not an island. But let me quote Karl Kraus, the famous Austrian author, who is reported to have said that he would want to be in Austria when the world comes to an end, because in Austria everything happens years later. ■

This is an edited and abridged version of the speech delivered at the First OeNB-OMFIF Economists Meeting in Vienna on 4 November 2013. Ewald Nowotny is Governor of the Oesterreichische Nationalbank and Member of the Governing Council of the ECB.

Chart 2: Unemployment in selected euro area countries



Latest observation September 2013 Source: Eurostat

The real villain in Europe is monetary austerity

The US Treasury Department has blamed Germany for a weak euro area recovery, a criticism echoed by International Monetary Fund First Deputy Managing Director David Lipton in a speech in Berlin. A full blitzkrieg was launched when Paul Krugman penned his latest German-bashing New York Times column, *writes Steve Hanke in Baltimore.*

The claims against Germany revolve around nebulous terms like 'imbalances' and 'deflationary biases.' The primary complaint is that Germany's exports are too strong and domestic consumption is too weak. In short, the country is producing more than it consumes. Critics argue that 'excess' German exports are making it harder for other countries (including the US) to recover in the aftermath of the financial crisis.

The ire against Germany comes down to one thing: austerity. If only Germany would crank up government spending, then Germans would buy more goods, and all would be right in the euro area, and around the world. The anti-austerity crowd has found a convenient way to slam austerity and identify as a scapegoat one of few countries to rebound from the crisis. We hear the one-dimensional argument that fiscal stimulus is the only way to save struggling economies. This follows the standard Keynesian line: to stimulate the economy, expand the government's deficit (or shrink its surplus); and to rein in an overheated economy, shrink the government's deficit (or expand its surplus).

We ought to focus on what really matters – money. When we look at the euro area's money supply, more specifically the portion created by the private banking sector, the German austerity scapegoat begins to look more like a red herring. To do this, we revert back to John Maynard Keynes at his best. Specifically, we must look at his two-volume 1930 work, A Treatise on Money – a work that no less than Milton Friedman wrote about approvingly in 1997.

Keynes separates money into two classes: state money and bank money. State money is the high-powered money (the so-called monetary base) that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in the Treatise dealing with bank money. As Keynes makes clear, bank money was much larger than state money in 1930. Not much has changed since then. Today, bank money accounts for 91% of the total euro area money supply, while state money accounts for only 9%, measured by M3.

A careful examination of the money supply, broadly measured, shows why the euro area economies have been on the brink of recession ever since Lehman Brothers collapsed in September 2008. From 2002 until Lehman, the money supply was growing at an 8.7% rate. Since then, it's slowed to 1.07%.

At first glance, this might seem surprising. The European Central Bank been pumping out state money – but state money is only a small part of the total money supply. The big elephant in the room is bank money. And, banks have not been producing much bank money in Europe.

Credit to the private sector in the euro area is actually lower now than it was when Lehman collapsed in September 2008. Faced with intense regulatory pressures, banks in Europe have been deleveraging big time. Credit is the life-blood for business in Europe. Excessive bank regulations like Basel III have made it scarce. Sadly, things are only going to get worse.

Over the next year, the ECB will be scrutinising the balance sheets of more than 120 euro area banks. This promises more mandatory bank deleveraging, which will result an even tighter squeeze on bank money and private credit in Europe. These are cold hard economic facts of Europe's bank money blues. Forget fiscal austerity. The real villain is monetary austerity. ■

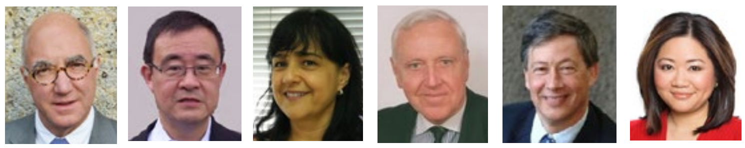
Steve Hanke is a Professor at The Johns Hopkins University and Director of the Troubled Currencies Project at the Cato Institute.

EDUCATION & RESEARCH

José Roberto Novaes de Almeida, University of Brasilia
Iain Begg, London School of Economics
Gottfried von Bismarck, Körber Stiftung
Harald Benink, Tilburg University
Michael Burda, Humboldt University, Berlin
Nick Butler, King's College, London

David Cameron, Yale University
Forrest Capie, CASS Business School
Jon Davis, Queen Mary University, London
Haihong Gao, Institute of World Economics and Politics
Steve Hanke, Johns Hopkins University
John Hughes, former UK Ambassador to Argentina

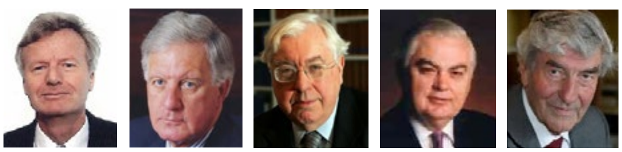
Ray Kinsella, University College, Dublin
Mariela Mendez, Escuela Superior Politecnica del Litoral
Rakesh Mohan, International Monetary Fund
Michael Oliver, ESC Rennes School of Business
Danny Quah, London School of Economics
Abdul Rahman, International Academy of Retail Banking



Richard Roberts, King's College, London
Shumpei Takemori, Keio University
Maria Antonieta Del Tedesco Lins, University of São Paulo
Niels Thygesen, University of Copenhagen
Daniel Titelman, Economic Commission for Latin America and the Caribbean
Linda Yueh, BBC
Peter Walton, ESSEC Business School

PUBLIC POLICY

Frits Bolkestein, formerly European Commission
Laurens Jan Brinkhorst, University of Leiden
Otavio Canuto, World Bank
Desmond Cecil, Areva UK
Neil Courtis, Sensible Media
Natalie Dempster, World Gold Council

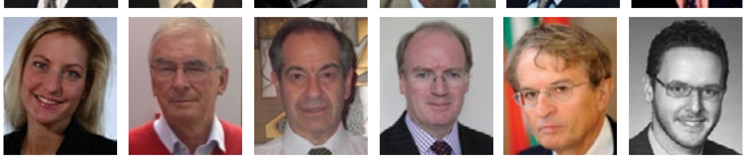


Willem van Hasselt, Netherlands Ministry of Foreign Affairs
Peter Heap, formerly British Embassy
John Kornblum, former US Ambassador to Germany
Norman Lamont, House of Lords
Ruud Lubbers, former Dutch Prime Minister
Sahoko Kaji, Keio University

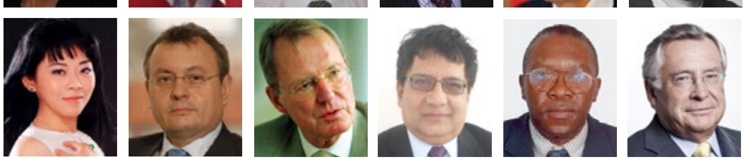
Bo Lundgren, formerly Swedish National Debt Office
Denis MacShane, former British Minister for Europe
Kishore Mahbubani, Lee Kuan Yew School of Public Policy, Singapore
Luiz Eduardo Melin, Brazilian Development Bank
Philip Middleton, Ernst and Young
Murade Miguigy Murargy, Community of Portuguese Speaking Countries

David Owen, House of Lords
Jukka Pihlman, Standard Chartered Bank
Poul Nyrup Rasmussen, former Danish Prime Minister
Paul van Seters, Tilburg University
Christopher Tugendhat, House of Lords
Paul Wilson, De La Rue

ECONOMICS & INDUSTRY

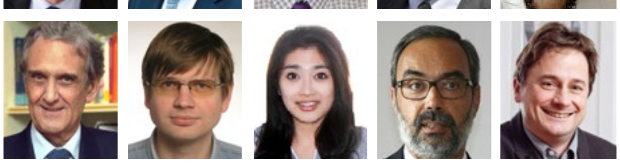


Katinka Barysch, Allianz
Robert Bischof, German-British Chamber of Industry and Commerce
Eduardo Borensztein, Inter-American Development Bank
Paul Boyle, formerly Financial Reporting Council
Albert Bressand, European Commission
Efraim Chalamish, New York University



Shiyin Cai, Dialogue in the Dark
Vladimir Dlouhy, former Czech Industry Minister
Hans-Olaf Henkel, University of Mannheim
Hemraz Jankee, formerly Central Bank of Mauritius
David Kihangire, formerly Bank of Uganda
Robert Koehler, SGL Carbon

Pawel Kowalewski, Deutsche Bundesbank
Gerard Lyons, Greater London Authority
Stuart Mackintosh, Group of Thirty
Winston Moore, Moore Asociados
Vicky Pryce, formerly UK Department for Business
Takuji Tanaka, Innovation Network Corporation of Japan



Pedro Schwartz, CEU San Pablo University
Vilem Semerak, Charles University, Prague
Song Shanshan, SDIC CGOG Futures
Jorge Vasconcelos, New Energy Solutions
Philip Whyte, Centre for European Reform

The benefits of having your own currency

Two decades of Czech experience yield positive results

Miroslav Singer, Czech National Bank

The Czech Republic's two decades of experience with the koruna show that, at key stages of development, an economy enjoys clear advantages in having its own currency. However the events of 1997, 2002 and 2008 provide harsh reminders of what can happen when economic policy-makers slip up.

The economic transformation of the former Czechoslovakia began in 1991. The macroeconomic measures included a series of devaluations followed by a peg to a currency basket. The peg became a crucial nominal anchor for an economy undergoing massive changes. The koruna devaluation provided exporters with an exchange rate buffer. The main advantage to the economy of having its own currency was that the peg helped stabilise inflation in single figures for several years.

Czechoslovakia was divided at the start of 1993. Its successor countries – the Czech Republic and Slovakia – initially used a common koruna in a currency union. The two economies, however, had long differed significantly in competitiveness. These differences had been partly offset (and masked) by massive fiscal transfers from the Czech to the Slovak lands. After the fall of communism, the economic differences widened further. The currency union between the Czech Republic and Slovakia lasted just 38 days.

The Slovak koruna weakened quite substantially against the Czech koruna (with various swings) until Slovakia adopted the euro at the start of 2009. But the successor states' separate currencies gave them a vital macroeconomic adjustment mechanism. Keeping the common currency would have harmed the Slovak economy by saddling it with too strong an exchange rate. And it would have led to overheating of the Czech economy, with a currency that was too weak.

In 1997, the same currency peg that had previously provided the economy with a vital nominal anchor became the cause of a currency crisis. Since the mid-1990s, the fixed exchange rate – accompanied by money targeting – had been increasingly undermined by liberalisation of capital flows. The right moment to exit the currency peg was missed. Inconsistent and indecisive policies prompted a speculative attack on the koruna in May 1997. Despite resisting for several days, the Czech National Bank was unable to fend off the assault.

The forced exit from the peg and the switch to a managed float caused the koruna to weaken. Monetary and fiscal restrictions proved necessary, helping restore equilibrium. The switch to inflation targeting at the start of 1998 provided the economy with a monetary framework suiting a floating exchange rate.

The lessons are that having one's own currency requires a suitable macroeconomic and monetary framework, and that predictable economic policy actions have lower costs than unpredictable ones.

After the currency crisis was overcome in 1999 and inefficient state-owned banks had been sold to foreign banks, the Czech economy began a period of buoyant growth, stimulated by large inflows of foreign direct investment. The economy grew more open, with the ratio of total exports and imports to GDP rising from 107% in 1999 to 150% in 2012 – a process that switched the Czech economy from net importer to net exporter in 2005 with a subsequently growing trade surplus. Amid growing correlation between the Czech and German business cycles, and rising productivity and competitiveness, the koruna appreciated in real and nominal terms in a low-inflation environment.

The country became a relatively advanced market economy. It is hard to imagine how these fundamental changes could have proceeded smoothly under a non-floating exchange rate regime. The independent currency provided an essential adjustment mechanism. None the less, in 2002 and 2008 the koruna came under speculative appreciation pressures in the form of exchange rate bubbles.

After the appreciation bubble burst in July 2008, the koruna started to return gradually to its long-run trend. This correction continued after the financial crisis erupted in autumn 2008. Nevertheless, the substantial year-on-year depreciation of the koruna acted as a stabilisation mechanism and a buffer against the external shock which hit the Czech economy primarily via foreign trade. The sharp decline in export revenue due to the fall in physical exports was at least partly offset by higher koruna income per unit of exports.

The 1997 currency crisis took a heavy toll in the shape of an economic contraction due to inconsistent macroeconomic policies and late exit from the currency peg. The 2002 and 2008 appreciation bubbles were associated with costs, but they were far lower.

The message for other countries is clear. Having your own currency can bring advantages – but only if you follow the right policies. ▪

Miroslav Singer is Governor of the Czech National Bank.

Participants at the Economists Meeting, 'The road ahead for the Czech Republic in Europe,' hosted by Czech National Bank governor Miroslav Singer on 1 October in Prague.

Moderate pace of global growth

Emerging market economies cast shadow over world prospects

Michael Holstein, DZ BANK

DZ Bank Economic Forecast Table

GDP change (%)	2011	2012	2013	2014	2015
US	1.8	2.8	1.7	3.0	2.8
Japan	-0.6	1.9	1.9	1.8	1.6
China	9.3	7.7	7.5	7.9	7.2
Euro area	1.6	-0.6	-0.4	1.2	1.6
Germany	3.3	0.7	0.6	2.3	2.6
France	2.0	0.0	0.2	0.8	1.3
Italy	0.6	-2.6	-1.8	0.4	1.3
Spain	0.1	-1.6	-1.4	0.6	1.5
UK	1.1	0.1	1.4	2.1	1.6
Addendum					
Asia excl. Japan	7.6	5.8	5.7	6.5	6.3
World	3.8	2.9	2.6	3.6	3.6
Consumer prices (% y/y)					
US	3.2	2.1	1.4	2.1	2.5
Japan	-0.3	0.0	0.3	1.8	1.6
China	5.4	2.7	2.7	3.6	4.1
Euro area	2.7	2.5	1.4	1.4	1.9
Germany	2.5	2.1	1.6	2.1	2.5
France	2.3	2.2	1.0	1.2	1.7
Italy	2.9	3.3	1.3	1.3	1.2
Spain	3.1	2.4	1.5	1.5	1.9
UK	4.5	2.8	2.6	2.5	3.1
Current account balance (% of GDP)					
US	-2.9	-2.7	-2.5	-2.6	-2.8
Japan	2.0	1.0	1.4	1.6	1.7
China	1.9	2.3	2.1	2.2	1.7
Euro area	0.2	1.3	2.3	2.5	2.5
Germany	6.2	7.1	6.8	7.2	6.5
France	-2.5	-2.1	-1.7	-1.8	-1.5
Italy	-3.1	-0.5	0.9	1.1	1.2
Spain	-4.8	-1.1	1.0	2.0	2.3
UK	-1.5	-3.8	-4.2	-4.6	-4.5

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

The world economy is recovering at no more than a moderate pace. The global growth rate in 2013 is likely to end at just a little over 2½%, the lowest since the height of the crisis in 2009. While the economies of the biggest industrialised countries have strengthened, several large emerging market economies have suffered setbacks.

Global growth will pick up again in the next two years. The world economy will expand at annual rates of 3½ -4%, around one percentage point faster than this year. Growth rates of around 5%, as were recorded in the pre-crisis years from 2004 to 2007, are inconceivable for the time being.

Consolidating their finances will keep many countries' private households, companies and governments busy for years to come, and most will see paying down debt as a higher priority than new investment. Although the leading industrial countries' ultra loose monetary policy will assist the necessary process of cleaning up the national balance sheet, it can never be the solution to their widespread structural problems.

In the euro area, the economies of the crisis countries have begun to recover following a stubborn recession. Greece, Ireland, Portugal and Spain have made considerable progress in consolidating their budgets and implementing necessary reforms, although they have still to get on top of all their structural problems.

However, the two heavyweight economies in France and Italy have pushed themselves to the centre of attention in recent months. Although their economic difficulties are nowhere near as dramatic as those of the peripheral nations, their evident lack of political will to undertake reforms suggests that new problems are in the pipeline in the years ahead.

Germany will continue to stand out in the next two years: its growth will accelerate sharply. As a result, the wide performance differential between Germany and most of the other euro area economies will persist.

This will continue to make it harder for the European Central Bank to perform its role of devising a single monetary policy for a highly diverse currency union.

The implications for Germany are thought-provoking. Interest rates will stay very low for the foreseeable future, much too low for Germany's circumstances, bringing a risk of potential overheating in some sectors.■

Michael Holstein is Head of Macroeconomics at DZ BANK.

Economists Meeting at Oesterreichische Nationalbank

Participants at the First Oesterreichische Nationalbank-OMFIF Economists Meeting, hosted by Governor Ewald Nowotny on 4 November in Vienna.

The key indicator for forward guidance

Sovereign yield curve is the ultimate crystal ball

Moorad Choudhry, Advisory Board

The US Federal Reserve instituted a vogue for 'forward guidance' on the likely future level of interest rates, and – in different ways – both the Bank of England and the European Central Bank have followed suit. The Bank of England, with certain caveats, has linked a cut in interest rates to a fall in unemployment to 7%.

From an econometrics point of view, this is a problematic analysis, given the two-way causal relationship between these two parameters. This introduction of forward guidance had something of a troubled start, when it appeared that the markets were not entirely convinced about its intended message. Commentators suggested that actual market interest rates, and what these implied for forward rates, were presenting a different picture.

Sovereign bond yield

This is understandable. The robustness and reliability of the sovereign bond yield curve represent ultimately the preeminent forward guidance indicator, on which market observers should base their investment and risk assessment.

The factors that influence the shape and level of the curve include a term liquidity premium as well as an anticipation of expected inflation rates. (The analysis assumes that sovereign debt is default risk-free, although the situation is complicated by the steadily diminishing population of genuine AAA-rated sovereign authorities.)

An understanding of the term structure of interest rates helps to clarify why it is such an excellent forward indicator. The unbiased expectations hypothesis states that current implied forward rates are unbiased estimators of future spot interest rates. It assumes that investors act in a way that eliminates any advantage of holding instruments of a particular maturity.

Therefore, if we have a positive-sloping yield curve, the unbiased expectations hypothesis states that the market expects spot interest rates to rise. Equally, an inverted yield curve – when longer-maturity yields are lower than shorter-term ones – is an indication that spot rates are expected to fall.

If short-term interest rates are expected to rise, then longer yields should be higher than shorter ones to reflect this. If this were not the case, no one would ever lend funds for longer than the shortest possible period. Lenders would simply roll over the investment when it matured.

We can consider the expectations hypothesis in terms of inflation expectations. Where inflation is expected to remain roughly stable over time, we normally see a positive yield curve, not – as might have been expected – a flat one. This is explained by the liquidity preference theory, which states that the yield curve should almost always be upward sloping, reflecting bondholders' preference for the extra liquidity and lower risk of shorter-dated bonds. This is because, generally, borrowers prefer to borrow over as long a term as possible, while lenders will wish to lend over a shorter term. Lenders have to be compensated for lending over the longer term with a premium for a loss in liquidity, which increases in line with maturity.

The liquidity preference theory combined with the unbiased expectations hypothesis shows that an inverted yield curve ensues as a result of a reduction in term liquidity value when the market expects short-term rates to drop, for example ahead of an recession, when investors expect the central bank to cut base interest rates.

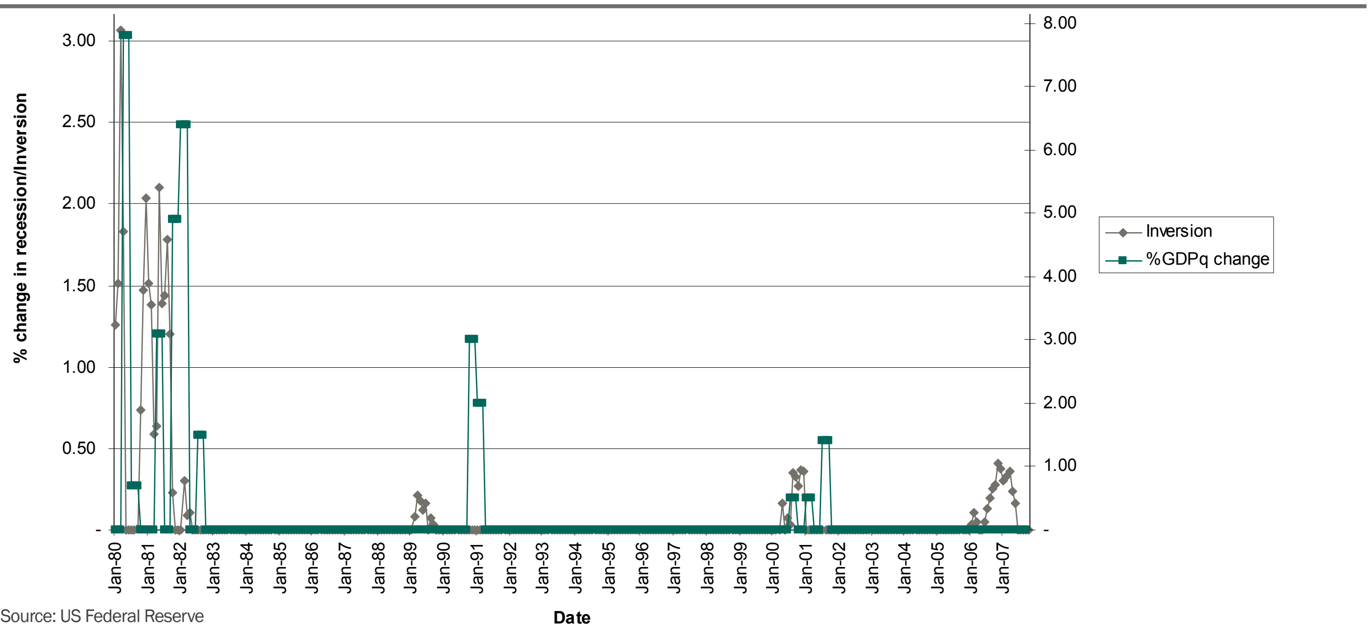
Curve inversion

Chart 1 shows the extent of curve inversion for the US Treasury yield curve ahead of recessions since 1980-81. The Treasury curve has inverted, to a greater or lesser extent, ahead of each recession. This is strong empirical evidence of the predictive qualities of the Treasury curve.

If one observes the dates when inversion first occurred, it is apparent that this was before any 'official' view had formed that the

Continued on page 25...

Chart 1: Inverted US Treasury curve versus recession periods, 1980-2007



Source: US Federal Reserve

Applying 1914 lessons to recovery plan

Austerity still to blame as UK climbs back to growth

William Keegan, Chairman, Editorial & Commentary Panel

It was my old friend 'Steady' Eddie George, former governor of the Bank of England, who once observed that unbalanced growth was better than no growth. The apparent return to growth in the British economy is to be welcomed, but its composition is not, relying as the government has done so far on a consumer revival made possible by a return to the bad old habits of consumer debt, reductions in savings and a nakedly political boom in house prices.

In his desire to justify the period of austerity in the UK, Chris Giles, economics editor of the Financial Times, has gone over the top, arguing that Labour's shadow chancellor Ed Balls had 'undermined his own credibility' by blaming the UK coalition government's austerity policies for recent economic weakness. Giles prefers to believe that the weakness was caused by 'the chilling effects of the euro crisis on confidence and higher oil prices on incomes.'

Of course these factors played a part. But so did the policy of austerity. The British economy was emerging from the depression in the summer of 2010 until the new Chancellor George Osborne came in and, egged on by the Bank of England, raised taxes, announced a dramatic 'deficit reduction programme' and knocked business and consumer confidence on the head. Giles accused Balls of 'analytical failure' in predicting that the economy would 'flatline'. In fact, in a speech in August 2010, Balls did indeed predict a period of lean years, and he was absolutely right. As for the accusation that shadow ministers – and by implication, Keynesian critics such as myself and some of Giles's own FT colleagues – 'neither wanted nor expected a return to growth': this would be libellous if it were not so laughable.

However, it is precisely when other factors, such as the euro area's woes and oil prices, are inhibiting growth that the government should take countervailing action, not reinforce the squeeze with ill-timed policies of higher taxes and public spending cuts. Incidentally, Bank of England director Andy Haldane revealed at the recent launch of Richard Roberts's book Saving The City – The Great Financial Crisis of 1914 that, in their desperation, when trying to come to grips with the more recent banking crisis, bank officials found that, if their economic history had been better, they could have applied the lessons of the 1914 crisis.

Indeed, when they eventually did dust down the archives, they apparently found some useful guides. But the economics of austerity have not been confined to the UK. The euro area is mired in the consequences of deeply-mistaken economic policies. And in the US retiring Federal Reserve Chairman Ben Bernanke is known to believe that the US recovery – much better than the UK's of course – would be a lot more impressive if fiscal policy were not operating in the opposite direction.

I make no apology for emphasising what I believe, in common with Larry Summers, Paul Krugman, Sir Samuel Brittan, Martin Wolf and David Blanchflower – to name but five – that recent economic policies have been fundamentally misconceived and hugely damaging, especially to the poor, who suffer the brunt of the welfare cuts.

However, at heart your correspondent is an optimist, and I find myself reluctant to join the good Professors Summers and Krugman in their recent speculation that we may be in for a long period of economic stagnation in the developed world.

As Keynes wrote in the 1920s, there is work to be done and there are men (and women) able to do it. Summers and Krugman know that there is a chronic shortage of demand in the world economy, and that the crisis was caused not by excessive public spending, but by a breakdown in the financial system.

There is huge scope for investment in green technology, and transport and other public sector infrastructure. This applies to the US, the UK and the euro area. The UK in particular needs a serious drive to build more houses, not a policy of driving existing house prices up further. ▪

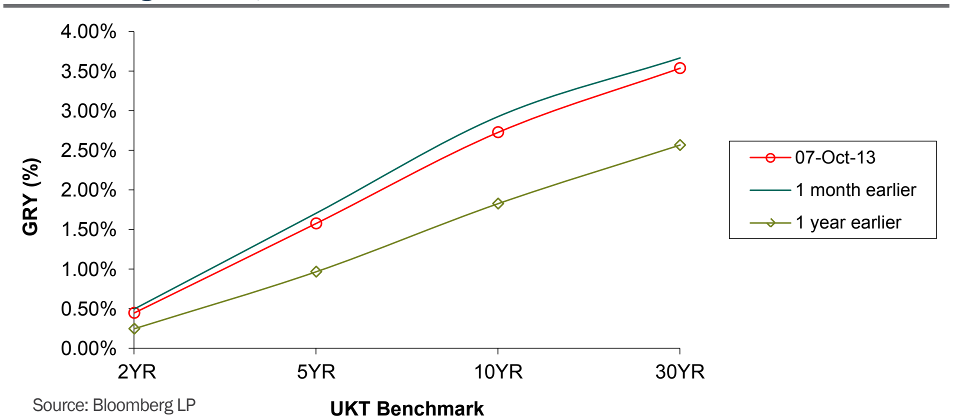
William Keegan is Senior Economics Commentator at the Observer.

(...continued from p.24)

economy was indeed in a downturn. Investors, particularly bond market investors, invariably look at the sovereign curve first and foremost when making long-dated assessments.

A similar picture is emerging in the UK. Chart 2 shows the change in the UK gilt curve during the year to October 2013, covering the period when the Bank of England first announced its adoption of forward guidance. The changes in the curve counter the suggestion – based on expected unemployment rates – that UK rates will not rise until 2016.

Chart 2: UK gilt curves, 2012-13



Source: Bloomberg LP

Instead, the curve implies that an earlier rate rise looks more likely. It is debateable whether this reflects the reaction to recent positive economic statistics or less fundamental factors, but the message from gilt yields is clear: markets expect a rate rise somewhat earlier than in the second half of 2016. The conclusion is that those attempting to gauge interest rates should look primarily at the sovereign yield curve. The bond market is still the ultimate crystal ball. ▪

Prof. Moorad Choudhry is IPO Treasurer at RBS Group Treasury.

China's search for a new model

Politics in the vanguard as reform process unveiled

Jonathan Fenby, Advisory Board

When the so-called Fifth Generation leadership took over in China a year ago, there were widespread expectations of change. There has, indeed, been a steady evolutionary process since Xi Jinping became general secretary of the Communist Party and chair of the Military Commission last November and a new government was constituted under Li Keqiang as prime minister in March at the meeting of the legislature which named Xi as state president.

But the process has not been quite what was hoped for by those who believe the world's second biggest economy requires more radical change if it is to continue the progress of the last 35 years.

Having paid attention to politics in the early months of his leadership, Xi turned to the economy at the party plenum held in November. The 'Sixty Decisions' announced at the end of this four-day meeting of the Central Committee were an important stage in defining where he and the new leadership wants their country to head. The time-scale is long, stretching to 2020. Some of the language was vague. Some major structural reform issues were not dealt with. The key question of implementation has not been settled. But the commitment to reform was highly significant; if the proposals are put into effect, one major long-term risk – of stagnation – will have been removed.

The measures face resistance from strong vested interests which can be expected to oppose reforms because they will undermine the benefits they draw from the status quo. Some liberalisation measures will reduce political control of the economy by the Communist party and the state, which may itself lead Xi and his colleagues to take a measured approach to putting the programme into practice.

In his initial actions after the March changes, Xi's first priority was political. As befits the top man in a Leninist system, he set out to strengthen the political party he heads with a crusade against corruption and a drive to get officials to live more frugal lives to bring them closer to the people. Xi had some high-profile targets, including the maverick politician Bo Xilai, who got a life prison term, and the railways minister, who was handed a suspended death sentence.

The head of SASAC, the umbrella body overseeing the big state-owned enterprises, is under investigation as are half-a-dozen senior executives at the energy company PetroChina and several prominent provincial cadres. There is a political element in the choice of targets, but the campaign serves a dual purpose of meeting, in part at least, public anger at corruption and of showing Xi's determination not to see the present regime go the way of imperial dynasties brought down by malfeasance and graft.

To buttress his position, Xi stressed the need for party unity and wheeled out slogans from the Mao Zedong era about the importance of the 'mass line' while warning that China must not go the way of the Soviet Union.

The past year has seen a strengthening

Capital account liberalisation: cross-country lessons for China

In today's globalised and integrated world, the position of China is somewhat of an anomaly, *writes Gabriel Stein in London*. It is the second largest economy in the world and will at some stage become the largest. It is the world's biggest importer of a number of commodities and it is the world's biggest exporter of various categories of manufactured goods. Yet its financial markets remain heavily regulated and underdeveloped and its capital account remains closed.

In both cases, there has been substantial reform. The Chinese leadership continues to show that it remains committed to financial market and capital account liberalisation. Reforming an economy the size of China's is fraught with difficulty. Yet China has an immense advantage in that this is a path trodden by many other countries in the past.

There have been plenty of reports and conferences discussing how to reform and liberalise the capital account, with examples from other countries and conclusions drawn for the Chinese situation. An OMFIF report this month looks at a number of countries – developed markets (the UK and Sweden), emerging markets (Malaysia, Mauritius, Mexico and South Africa) and one that has moved from being an emerging economy to being a developed one (Israel). We focus on what happened to a number of factors – primarily the exchange rate, capital flows and inflation – after a country liberalised its capital account.

One important lesson from this cross-country analysis is that liberalising financial markets while keeping the capital account closed is likely to lead to a domestic asset price bubble. Credit becomes more freely available but opportunities for investment remain unchanged. This was a key reason behind the Swedish bank crash in the early 1990s.

Conversely, attempting a 'big bang' liberalisation, without having domestic institutions ready, will cause a crisis, as shown by Israel's first failed attempt at capital account liberalisation in the 1970s.

Both the Mexican and the Israeli experiences show that capital account liberalisation can lead to large inflows and outflows of capital. What matters is not the flows but how the authorities react to them. The key lesson from the Mauritian experience – which is highly relevant as Mauritius is attempting to position itself as a financial centre – was the adoption of a flexible exchange rate regime. Notwithstanding this – or perhaps because of it – the Mauritius rupee weathered liberalisation well, appreciating somewhat in 1995 and 1996 and then moving sideways.

A common experience from all the countries is the impossibility of predicting which way the exchange rate will move following capital account and exchange rate liberalisation. Even Britain, whose post-Second World War history was punctuated by sterling crises, saw its currency rise after removal of exchange controls.▪

This is an edited extract from the OMFIF Report 'Capital account liberalisation in China' published this month.

of the crackdown on dissidents and attacks on 'constitutionalism' – the campaign by some liberals who have given up hopes of democracy but say that at least the country's constitution should be respected.

Commentators in official media have lambasted that as an attempt by pro-western forces to undermine the regime. Xi has been active abroad, holding talks with the US and Russian presidents in California and Moscow, touring south-east Asia and attending the APEC summit in Bali and the meeting of leaders of the BRICS nations in Durban. His proclamation of a 'China Dream' provides for national rejuvenation, including a strengthening of the military. There is a clear connection with the confrontation with Japan over the disputed Senkaku/Diaoyu Islands and with the Philippines and Vietnam over sovereignty in the South China Sea.

On a more populist note, Xi has shown himself to be adept at public relations and projected a more human face for the leadership than his predecessor. He allowed himself to be photographed for newspapers holding his own umbrella as he inspected the new river port at Wuhan with his trousers rolled up to show his socks.

In the economic sphere, for all its caution the November Plenum is an important step in refashioning the Chinese economy to move beyond the model installed under Deng Xiaoping in the 1980s, which led to the strong growth that has changed the world. It signifies a readiness to accept the need for change which was absent under Xi's predecessor, Hu Jintao. All the same, quick and radical progress should not be expected.

Internationalisation of the currency will continue, but the liberalisation of the capital account and the end of capital controls will take time. Financial sector reform has deep implications for the economy as a whole and needs to be carefully prepared.

Reform of land ownership rights and the granting of urban rights to migrant workers will require an overhaul of the fiscal system to give local authorities greater revenue-raising opportunities. Increases in factor pricing, especially of water and energy, will add to inflationary pressures. After jumping by around 5% on the announcement of the Sixty Decisions, Chinese stock markets and the Hang Seng index in Hong Kong flattened out as investors anticipated a long haul ahead.

The state sector is to remain dominant, according to the Plenum. But market mechanisms will be used to try to make it more efficient. That will bring complications. There will have to be careful management of the much-needed reduction of industrial excess capacity to avoid a spike in unemployment. China aims to breed national champions in the state sector. But that leaves open what happens to companies which do not qualify for that status.

A major environmental clean-up and measures to spur efficient use of energy are projected. The snag here is that the first

Echoes of Deng's 1978 reforms with 'crossing river' talk to emphasise gradualism

China's Third Plenum ended much as it started: with a brief word from the official Chinese media that the meeting had begun and a communiqué announcing its conclusion, *writes Linda Yueh in London.*

Among the few phrases in the short communiqué, the key ones are 'comprehensively deepening reform' and 'crossing the river by feeling the stones'. The reference to 'comprehensive' reforms fits with the billing in the Chinese state media that the meeting of top Chinese Communist Party officials will result in significant reforms under the new president and premier during their decade in power.

Scant details

The details of their economic policies are scant. In coming weeks and months, the official media may divulge more. So far, allowing the market to play a 'decisive' role in the economy has emerged above all as a message in the state media.

This sums up the aims of the Chinese leaders which are to introduce more market forces into the economy. It would be key to achieving the 'breakthrough' reforms that were discussed in the '383' plan that was circulated beforehand by the government's top think tank, the Development Research Centre of the State Council.

Furthermore, they implied that this roadmap for the next few decades will be based much more on productivity, innovation and institutional reforms – tying in with the overarching emphasis on market mechanisms.

The three breakthrough reforms involved reforming capital markets, labour in the form of improving social welfare and land. Basically, the factors of production all need reform and much of it requires raising productivity in order to support growth. That's no easy task for any economy, much less one where powerful state-owned enterprises dominate the financial sector and key parts of the economy. So the the key point is how these reforms will be implemented. And these details are lacking.

Deliberate echo of 1978

The invocation of the phrase 'crossing the river by feeling the stones' is a deliberate echo of the December 1978 Third Plenum which ushered in the reform era. The story goes that the phrase is attributed to Deng Xiaoping. When he was asked how he planned to introduce market forces into the centrally-planned economy and achieve his reform aims under such difficult circumstances, he reportedly said that it's by 'crossing the river by feeling the stones'. In other words, step by step in a pragmatic manner.

It's worth bearing in mind that China's economic reforms under Deng were considered gradual and not radical. This is in contrast to the radical dismantling of the command economy undertaken in much of the former Soviet Union.

Deng's reforms

In retrospect, the 1978 reforms were transformative and highly significant for China. By invoking the spirit of Deng's reforms, Xi Jinping and Li Keqiang are signalling that, in time, their multi-pronged reforms will be similarly transformative as China faces the next era of growth. This parallel may have been too subtle to be fully understood by the financial markets.

For now, we are likely to hear mostly disappointment over the lack of transparency of the economic policies of the world's second biggest economy. This has implications for the rest of the world, which is condemned to watch and wait. ▪

Dr. Linda Yueh is Chief Business Correspondent at the BBC and Director of the China Growth Centre at the University of Oxford.

On the web

See Linda Yueh's BBC blog on China, Linda's Line, at www.bbc.co.uk/news/correspondents/lindayueh/

development is a long-term project while the second will increase costs and needs effective implementation. Both are essential. A study this year showed that toxic air pollution cuts life expectancy by 5-½ years in cities in northern China, including Beijing. Low water quality affects life throughout the country. The north is becoming dangerously short of water as aquifers dry up and the water table drops. Energy prices are creeping up and there will be a drive to use more natural gas and less coal, even though the latter will remain the principal source of energy for a long time to come.

The new leadership has many other challenges ahead. These range from food safety and the need to push ahead with a much better health service to its global relations and the continuing opposition to Chinese rule in Tibet and Xinjiang.

Xi Jinping is clearly in charge. Though it dealt with economic policy, the Plenum document did not bear the name of the prime minister, who is usually the man who deals with such matters. The larger questions are how Xi will deploy his political strength in the cause of economic reform, and how the Fifth Generation will handle growing popular unhappiness with the effect on urban life of pollution, food scandals and poor-quality water.

The economic outlook is quite benign. China has moved away from the volatility seen between 2007 and 2011. Growth has levelled out at a lower but more sustainable level. Inflation has been contained for the time being, though potential problems in food price levels and supplies constantly pose an incipient threat to prices.

The great rebalancing away from fixed asset investment and property towards consumption is underway though it is a long-term process. Exports have been surprisingly strong but they represent a diminishing element in the country's expansion.

The problem is that real reform, affecting sectors ranging from farmland to state enterprises, from financial markets to the labour market, would risk cutting growth and fuelling inflation.

Xi Jinping is likely to prove a cautious manager. Those who want quick results will be disappointed. The outcome of the Plenum will be apparent only in the middle of this decade.

Having aroused shock and awe with its first three decades of growth, the last major state ruled by a Communist Party is starting off a long-term search for a new model. ▪

Jonathan Fenby is China Director at Trusted Sources. He is the author of the Penguin History of Modern China and Tiger Head; Snake Tails; China Today and will publish a new book in early 2014 – Will China Dominate the 21st Century?

On the web

See Jonathan Fenby's Blog on China at www.trustedsources.co.uk/blog/china

Shanghai Free Trade Zone paves the way for greater openness

In his introductory note on the plenary decisions, President Xi Jinping states that the 'market is the most efficient way to allocate resources', *writes Jinny Yan in London.* The document underlines the commitment to 'accelerate and materialise capital account convertibility'. One area to watch is the importance assigned to establishing the China Shanghai Free Trade Zone (SFTZ) as a major initiative in the Communist party's reforms.

The document heralds wide-ranging financial sector reforms as part of a plan to build an open economic system. This includes accelerated interest rate liberalisation, introduction of privately-held banks, and greater freedom for companies to issue foreign debt and conduct cross-border transactions. The SFTZ will become a critical policy testing-ground. Upon success, it will be replicated across China.

The zone will encourage foreign investment in four industries – finance, education, culture and health services. Rather than focusing on the lengthy 'negative list' of sectors prohibited from foreign investment during early stages, strategy should surely prioritise the 'positive list'.

For both Chinese and foreign investors, capital account opening plays a crucial role. The plan is to make the renminbi freely convertible by 2020. The currency should leave China more easily and flow back with the same ease. Europe is in a leading position to provide this osmotic process. London appears to be in the driving seat, for now. Development of the renminbi offshore market is now supported by policy-makers in both Beijing and its key trade partners worldwide who see clear advantages from developing this market. Europe, in aggregate, is already reaping the benefits. But the key to success is multifaceted.

London has been an early adopter of the renminbi, but a series of agreements in autumn 2013 could act as a catalyst for renminbi internationalisation across the continent. September saw the signing of a three-year reciprocal currency swap agreement between the People's Bank of China and the Bank of England worth Rmb200bn ($32bn).

This was followed by a Rmb350bn swap line announced by the ECB in October. Recent SWIFT data show that renminbi customer payments in Europe – a proxy for trade settlement – grew 163% over the past year. This was much faster than the 109% growth observed in Asia (excluding China and Hong Kong). Europe's absolute value of renminbi customer payments is now almost on a par with Asia.

The global renminbi market will inevitably expand, with more cities competing for a share. The currency has already become the world's second most-used currency in global trade finance, overtaking the euro, according to SWIFT. Other economies, notably across Asia, are fast adopting the Chinese currency for trade settlement, cross-border transactions, capital raising and storage of wealth. This is borne out by the Standard Chartered Renminbi Globalisation Index, which measures the international adoption of the currency and has risen almost 12-fold since tracking started in December 2010.

According to SWIFT, 62% of renminbi trading conducted outside Greater China now takes place through London, up from 54% in January. London was granted the first Renminbi Qualified Foreign Institutional Investor (RQFII) quota – Rmb80bn – outside Greater China. This represents a passport for using offshore renminbi deposits to invest in mainland China securities and bonds. London's quota is less than one-third the size of the current Rmb270bn (expanded from Rmb70bn in May). But size is not everything. Hong Kong has so far only utilised Rmb140bn of this quota. Despite other barriers around remittance and liquidity, RQFII paves the way for London-based portfolio investment flows into China. ▪

Jinny Yan is an Economist at Standard Chartered Bank

China plots moves for reform

Experts point to renminbi milestones ahead

Songzuo Xiang, Deputy Chairman & Linda Yueh, Advisory Board

Following China's Third Plenum in early November, an OMFIF telephone briefing was held on 14 November with two expert commentators: Songzuo Xiang, and Linda Yueh, moderated by Gabriel Stein. They discussed China's plan to deepen reforms, to 'decisively introduce market forces' and 'cross the stream by feeling the stones.'

The following excerpts provide an overview of the subjects discussed.

Market forces

'While market mechanisms have been emphasised in the past in the context of economic management, the communiqué referred to their crucial role in almost every aspect of the Chinese economy. This carries important implications. It means the leadership is serious about proceeding with interest rate liberalisation and reducing barriers to entry for private capital.'

Vested interests

'The central committee addressed setting up a high-level party to coordinate, design and push forward reforms in the future, but the implementation process is expected to be difficult. Reforms will be contested by China's important and powerful interest groups, such as monopolistic state-owned enterprises (SOEs), strongly opposed to any reform or change in their structure.'

State ownership

'The communiqué reinforced the role of state and communal ownership, revealing that land reform will not be privatisation, but instead a more tradable system of leaseholds.'

Shanghai Free Trade Zone

'There are expectations for progress, especially in the Shanghai free trade zone (SFTZ) as an experimental place where reforms of interest rate liberalisation, greater capital account opening, internationalisation of the renminbi and deepening of the financial market are taking place. There may be some progress in these areas, but the financial sector will be both the hardest and one of the most crucial areas to reform.'

Reform without ownership change

'There was no sense that the state will relinquish any ownership of key industries. Rather, the state wishes these industries to be infused with more competition. In other words, there will be reform without ownership change, but with an injection of competition. SOEs account for about 30% of industrial output and the SOE financial sector is very dominant.'

Innovation and technology

'There is an important challenge in trying to move towards an era of innovation and technological upgrading. This has big implications for capital markets. In the future, SOEs are likely to continue to dominate strategic industries, but private enterprises will be encouraged to do more in new industries, such as in services, business-to-business and new technology.'

Second-tier Chinese banks in London

'The authorities will limit permission for banks to "go global" predominantly to the Big Four (Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agricultural Bank of China). Operations in London initially will be to support the internationalisation of the renminbi, with London positioning itself to have greater access. Eventually, the participation of private and smaller Chinese banks would help to increase competition in the UK banking sector. Britain would welcome this, but it may not be high up on China's priority list.'

Renminbi internationalisation

'Internationalising the renminbi has several steps. The authorities want to encourage renminbi trade settlements, which has made great progress in the last four years, and to develop offshore markets in Hong Kong, London and other financial centres. In addition, plans are being laid for Shanghai – where the SFTZ has been launched and where renminbi-denominated products will be launched.'

Capital controls

'Many officials still worry about the potential risks of speculation or capital flight, and are still quite cautious. However, there is now increasing pressure for Chinese authorities to streamline and simplify the procedure for Chinese enterprises and individuals to invest overseas.'

Appreciation against the dollar

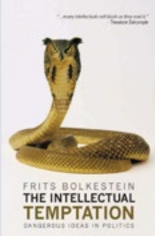
'One important question is the extent to which the renminbi will continue to appreciate against the dollar. China has run a trade deficit in some recent months. The overall current account is still in surplus, but as that surplus begins to narrow there will be less currency intervention. Part of the internationalisation of the renminbi is to increase its use offshore. And greater flexibility around the pricing may not come as a surprise.'

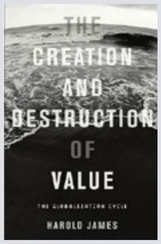
Question of convertibility

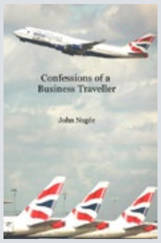
'The question is whether China can achieve its aim of having the renminbi a widely-used currency, without having opened the capital account. One historical precedent is the eurodollar market that developed in London. It is unusual for a country of this size to not to have a currency that is convertible and certainly unusual for the world's biggest trader not to have a currency that is in high demand. And so far it looks like the currency is in demand.' ▪

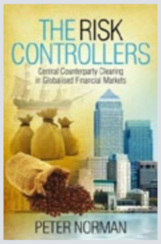
Dr. Songzuo Xiang is Chief Economist at the Agricultural Bank of China, and Dr. Linda Yueh is Chief Business Correspondent at the BBC and Director of the China Growth Centre at the University of Oxford.

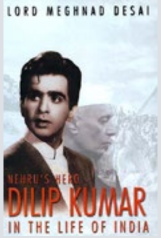
Books & the Advisory Board section features books written by members of the OMFIF Advisory Board, across finance, economics, history, arts and culture.

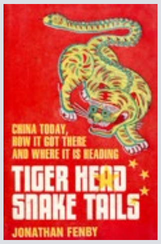












Turning point in global economic history

Comparisons between 2007-08 and war breakdown loom large

Richard Roberts, Advisory Board

Saving The City: The Great Financial Crisis of 1914 narrates and analyses the financial crisis around the outbreak of the First World War. It focuses principally on the crisis in London, at the time the world's foremost international financial centre, but also surveys the European and global repercussions.

It was the City's gravest financial crisis featuring the complete breakdown of its financial markets, yet the episode is virtually unknown. The reason is straightforward: it is simply absent not only from general texts but also from most of the specialist literature.

Vivid testament

In its day, the financial crisis certainly did not go unnoticed in the press or in people's lives. Several participants kept crisis diaries that provide vivid testament. It features in some general diaries, contemporary novels and the press.

Keynes, who was marginally involved, published three journal articles on it in 1914. And three journalistic accounts appeared in 1915 – but thereafter, very little. The reason, presumably, is because it was overshadowed by the existential military crisis. Moreover, there was crisis resolution through unprecedented government intervention and wartime controls. Saving the City is the first book-length account of the crisis in London since 1915 and the most comprehensive study.

The financial markets took the assassination of Archduke Franz Ferdinand of Austria in Sarajevo on 28 June in their stride. After all, the diplomatic crises of the previous three summers had been defused. But Austria's presentation of an ultimatum to Serbia on Thursday 23 July transformed perceptions of the risk of a major European war. This 'Minsky moment' triggered a scramble for cash. Continental stock exchanges were deluged with selling orders and banks besieged by depositors. They closed their doors. Governments mobilised for war and imposed drastic controls to safeguard the banking system and national finances.

The week beginning Monday 27 July saw the breakdown of the City's foreign exchange and discount markets, and culminated in the closure of the London Stock Exchange on Friday 31 July. It stayed shut for five months. Long queues formed at the Bank of England as people changed Bank notes for gold sovereigns. It appeared that a run on the Bank was underway. And it was believed that a run on the banks had begun.

There had been no pre-war planning for such a crisis. Time was bought by the declaration of an unprecedented four-day Bank Holiday. During that hiatus, on Tuesday 4 August, Britain went to war. The initial emergency containment measures were massive infusions of liquidity by the central bank plus a hike in the discount rate from 3% to 10%, following established crisis management doctrine.

Then came novel policy measures: a 'general moratorium' on contracted payments (which allowed banks to refuse to pay out deposits), and the introduction of hastily-printed small denomination currency notes issued by the Treasury (not the Bank of England). When the banks reopened on Friday 7 August there was no run. The crisis had been contained.

Now it was time to try to restart the markets. It was believed that the key was the revival of London's discount market in which bills of exchange were traded. To facilitate the creation of new bills the government offered to purchase any outstanding pre-war bill.

This 'cold storage' scheme resulted in it buying 40% of the discount market, equivalent to 6% of GDP. This was state intervention in the financial markets of unparalleled scale and boldness. Special measures were also taken to revive the operation of the foreign exchanges. Finally, on 4 January 1915 the London Stock Exchange reopened.

The crisis was over. A handful of stockbrokers and some small savings banks were casualties, but the City money machine was unbroken. But now, instead of financing world trade and investment, it focused on Allied war finance.

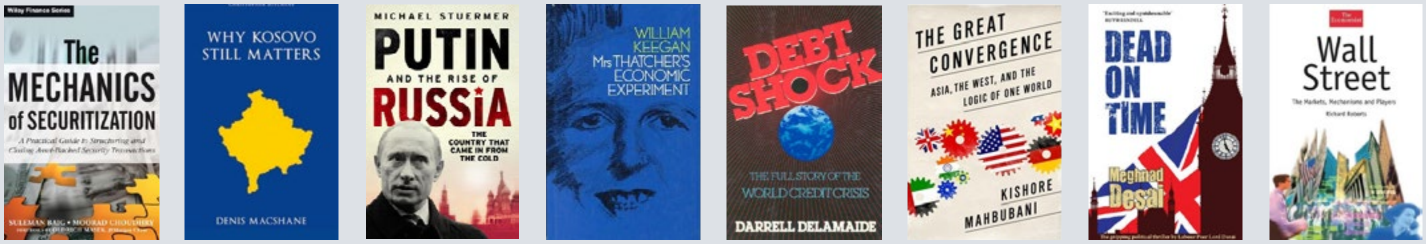
The financial crisis of 1914 was a global crisis. More than 50 countries or colonies experienced bank runs and asset crashes. For six weeks from August to mid-September every stock exchange in the world was closed, with the exception of New Zealand, Tokyo and the Denver Colorado Mining Exchange.

It was an extraordinary and unique moment in global economic history. Policy responses featured moratoria of one sort or another, and suspension of the gold standard accompanied by the issuance of state currency notes. It is notable how similar the policy responses were, though there was no time or mechanism for international consultation and no evidence that it occurred.

Comparisons between the financial crisis of 1914 and that of 2007-08 are made in the final chapter and in the foreword by Mervyn King, former governor of the Bank of England.

While the origins of the crises were plainly very different, there are some distinct parallels in crisis dynamics and management that will be of interest to central bankers and other financial professionals and practitioners. ▪

Richard Roberts is Professor at King's College London.



Linkages from fluctuations down the ages

Lessons retold from Argentina to the renminbi

John Nugée, Deputy Chairman, Advisory Board

It is Mark Twain who was reputed to have said 'History doesn't repeat itself, but it does rhyme'. In this book, a collection of essays that were written over the period 2002-13 for the clients of my then employer, State Street Global Advisors, I have observed the world of global finance in one of the most dramatic periods of crisis and change in recent times.

I have tried to analyse the shifts through the prism of what history can teach us, in an attempt to 'catch the rhymes' down through time.

In many of the essays the link was relatively indirect. Not everything that has happened in the last 10 years has a historical precedent, though there is more for the economic historian to reflect on than one might think. The travails of the dollar and the apparent threat from the renminbi are linked together.

One can look back to the period between the world wars when the dollar replaced sterling as the world's reserve currency, as I did in an essay written in 2004. The choice of currency for a potential independent Scotland is a potent subject for examination.

As I found in my analysis done in 2012, there are many examples one can draw on, from the Czech and Slovak velvet divorce in 1993 to the less harmonious break-up of the Austria-Hungarian currency in the 1920s. The role of the financial system in economic growth is a constant issue of preoccupation.

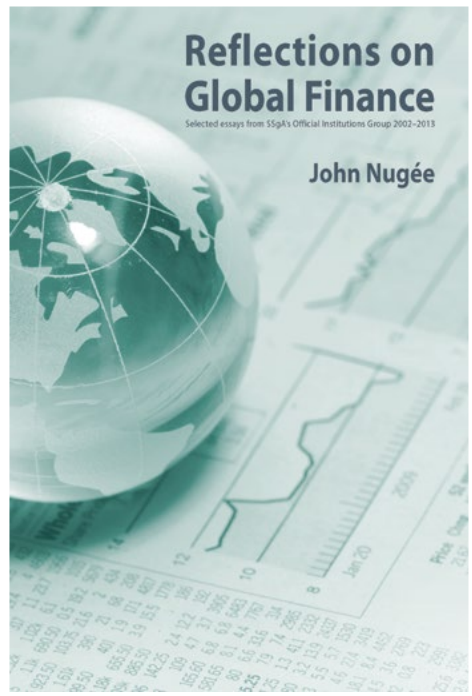
An essay from 2007 explores this question from the ancient Egyptian economy of 2000 years ago through to the development of the Chinese economy, starting 1000 years ago.

But sometimes this link to history was much more direct. In an essay that examined the collapse of Argentina's fixed currency peg in 2002, I assessed it as 'a major embarrassment for the international advisers who urged ever more austerity on the government in Buenos Aires as the price for successive rounds of support. But is it merely embarrassing for the international community, or are they guilty of the far more serious crime of failing to learn from earlier mistakes?'

My summary continued: 'For the student of history it is impossible to avoid a strong sense of déjà-vu. Argentina's spiral into recession and debt, and the collapse of the exchange rate, is all too reminiscent of the crises that rocked the world's financial system in the 1930s.'

The essay – appropriately enough entitled 'Lessons from History' – not only looked back to the 1930s in seeking to explain and understand fixed exchange rate systems under stress, but looked forward too:

> Economic historians may not have been bold enough and quick enough in drawing the parallels with the 1930s to save Argentina from its fate. But there are other countries, closer to the heart of the developed world, where the same spiral may be about to start.
>
> For the various countries of Euroland, there is the same 1930s combination of fixed exchange rates (to the euro), and so no independent interest rate freedom, and international commitments, via the Stability and Growth Pact, to ensure countries run balanced budgets.
>
> And for countries facing fiscal shortfalls, the pressure is on to cut their deficits, to rein back their public expenditure, to reduce the imbalances in their economy – all likely to exacerbate the economic slowdown that every country is currently facing.
>
> For Euroland countries faced with rising unemployment, and with neither monetary nor fiscal freedom to act, it would be unwise to draw too much comfort from the fact that this time it is different, that political leaders would never make those mistakes again, that the euro is not the gold standard, and that anyway it couldn't happen to us.

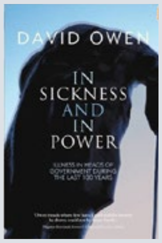


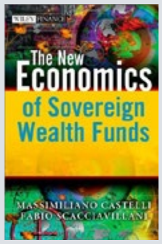
Reflections on Global Finance: selected essays 2002-2013 is available from Amazon, price £20.

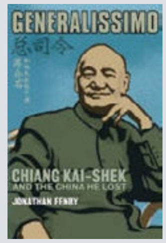
Remembering the past

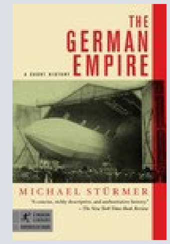
As that essay concluded, 'History does repeat itself for those who allow it to. Ask the people of Buenos Aires'. Or, in the better known words of George Santayana, writing in 1905: 'Those who cannot remember the past are condemned to repeat it'. This book attempts to help the reader avoid that fate. ▪

Books & the Advisory Board section features books written by members of the OMFIF Advisory Board, across finance, economics, history, arts and culture.









Debt restructuring still likely after the pain

Greek output falls for six years, yet not much has changed

Vicky Pryce, Advisory Board

As I was updating my book on the euro area crisis in the summer of 2013, data started to emerge suggesting Greece had turned the corner. The public sector in 2013 witnessed a swing to a primary surplus (excluding debt interest payments), with a surplus of at least 2% of GDP forecast for 2014. GDP in the second quarter, though still 4% below the level a year earlier, rose quarter-on-quarter, helped by a substantial rise in tourism receipts.

Greece became the tourist destination of choice as the political situation seemed to stablise, hotels and restaurant cut prices to attract customers, and other destinations looked less safe. Following the abatement of worries about a Greek exit from the euro, Greek sovereign bond yields have fallen considerably. So is the crisis over? And has austerity worked? Close inspection of the data suggests that nothing much has changed after six years of output decline.

The improvement in public sector finances was helped by payments of structural funds from the EU and reimbursement of profits on Greek bonds made by the European Central Bank and other sovereign creditors. Even if Greece miraculously manages to achieve hoped-for 1.4% growth next year, no amount of structural change will enable Greece to recover sufficiently fast in a weak, deflationary Europe, still enmeshed in a banking crisis, to reach pre-recession levels while struggling with a huge overhang of debt. Few people doubt that significant further debt restructuring is needed to achieve a sustainable debt-to-GDP ratio of 120%, against the current 175% (and rising).

There have been continued cutbacks in government spending, mainly on investment. Greece's finances have been flattered by the government's delays in settling accounts.

Privatisation receipts are running well below target. There has been very little underlying improvement in revenue collection. Sharply higher taxes forced by the troika of the European Commission, the International Monetary Fund and the ECB have in some areas resulted in people just stopping spending, so less revenue is being raised. Recent fuel tax and VAT increases for example have made petrol in Greece prohibitively expensive. Energy costs have risen sharply. Property tax increases (more are planned) have raised the cost of living, coinciding with a 30% fall in wages. The minimum wage is now a pitiful €480 a month.

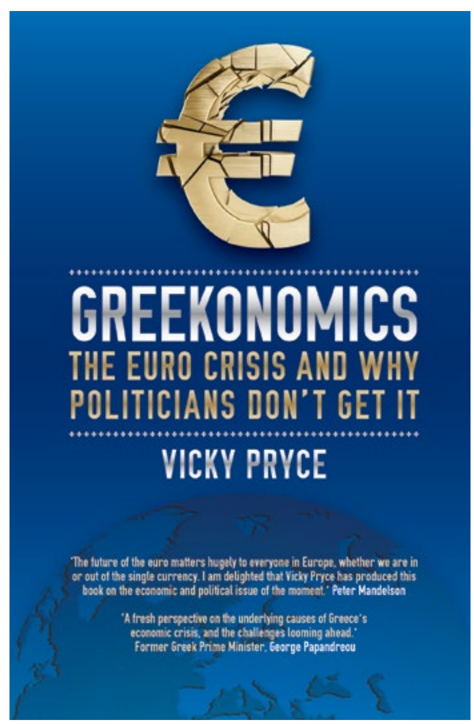
The authorities cut VAT on restaurant meals to 13% from 23% on 1 August. But the Greek consumer has retrenched and the narrowing of the current account deficit, hailed as a sign that the austerity remedy has worked, owes much to falls in imports, reflecting a weak economy that is suffering an unemployment rate of 27%, a youth unemployment of 64% and a huge drop in asset prices.

The IMF, in its mid-2013 Fourth Evaluation Report, said Greece had made important progress in rectifying pre-crisis imbalances 'and that the economy was 'rebalancing'. But the Fund noted that 'the gains had come as a result of recession which has suppressed imports 'and not through 'productivity-enhancing structural reform'. The IMF has admitted it made mistakes by tightening too much in the first instance. Yet the language remains one of austerity. The result is that thousands took to the streets to demonstrate in Athens when the troika returned in early November to continue its inspection of progress on the Greek budget for next year.

As Italy and France have just realised, even though neither of them are under a bail-out package, recent agreements give the power to the European Commission to scrutinise and criticise next year's draft country budgets. Even Ireland, which is now exiting its bail-out programme will be visited by the IMF twice a year to review progress.

Greece has to meet even more conditions to ensure the release of funding under the bail-out memorandum. So a great many question marks remain as the euro conundrum continues.

Greece has delivered a laboratory-like example of the effects of austerity. It may have turned a corner, but where and how the journey will end is still far from clear. ▪



Pryce's updated Greekonomics, The Euro Crisis And Why Politicians Don't Get It, was published by Biteback Publishing at £9.99.

Good news on European banking union
From Prof. Laurens Jan Brinkhorst

Sir, Some OMFIF commentaries on the euro area problems are far too negative. OMFIF sometimes seems to specialise in describing all the worst scenarios which could occur. Undoubtedly things may turn worse than foreseen, but geopolitics plays a larger role in Europe than Britain can believe. I believe we may have a rather more positive outcome on the banking union before the Christmas holidays, if only because some weak presidencies will follow. Chancellor Merkel does not want to start her new term with a cloud hanging over her government. The same goes for the Social Democratic Party.

Some positive changes are taking place against a very negative political climate and hypocrisy by politicians preaching the virtues of nationalism at home, while deciding positive policies in Brussels. These decisions in Brussels are taken in the national interest. The world outside is forcing Europeans to rethink their reduced status in the world at large. That attitude of hypocrisy is to my mind the main reason of the general public's growing adversarial attitude on European integration. National and European politics have become inseparable. Making artificial distinctions is simply dishonest.

Laurens Jan Brinkhorst
Former Dutch Minister
Economic Affairs and Minister of Agriculture
The Hague

Why the age of the US is not over, whatever Asian intellectuals say
From Mr Klaus Wenk

Sir, Bashing the US and the west by many of our Asian friends appears to be en vogue again. This seems popular among many Asian intellectuals. I can't have been the only one to notice that, when Typhoon Haiyan hit the Philippines, help was led by the US, with China, for all practical purposes, nowhere to be seen.

The essays by Kishore Mahbubani and Meghnad Desai in your November edition reveal that, in reality, the dollar will not soon lose its dominant position, that China is still not in a position to pick up the slack left by the US, and that – although China the likely new hegemon – it is reluctant to take on the role. It remains Messrs Mahbubani's and Desai's well-guarded secret how to reconcile these statements with their questionable comments about confidence in the US and the dollar allegedly being eroded, and about more trades being done in other currencies, especially the renminbi, and so on. One fact worth mentioning: 2013 renminbi daily trading volume was $120bn against $4.65tn for the dollar, i.e. the Chinese currency has a share of 2.6% of that of the dollar.

I do not believe that American perceptions are out of line with global realities and I don't think the American age is over. The attitude of Chinese/Asian people is often not geared to creativity and assuming responsibility. Hardly any major invention has come out of Asia since the beginning of the 17th century. When it comes to leadership structures, Asians prefer to be followers rather than leaders. In history, China never was a world leader. There is no evidence that China will ever become one, given the responsibilities and costs that this would entail.

Klaus Wenk
Kuala Lumpur

The future of the European Union lies in complete integration
From Mr John Nugée

Sir, With reference to the debate over the future of Europe, the argument that even a partial dis-integration of the euro area is very difficult is surely right. Indeed I would go further and argue that the 'dis-integration' of Europe would inevitably lead to its 'disintegration'. Which is why I believe that ultimately, there is no stable end-point except full federal union. And that because of this, there is no end to the drive to an 'ever closer union' until Europe gets there. Note that this does not mean we will get there any time soon: Europe is on a Long March every bit as long and every bit as momentous as Mao's Long March was 70 years ago. But at some point in the next 20, 30, 40 years there will be on the continental European land mass a federal state with one common federal government and one common currency. Today's EU countries will either be fully part of it as component states or fully not.

There is no longer any escape from full federal union, the lack of political or electoral desire for this ending notwithstanding. The image in my mind is the astronomical one of a black hole: once one has passed the event horizon there is no escape, and whether one wishes to or not, one falls, slowly at first but with gathering speed, towards the centre of the black hole.

Two years ago I posed the question: 'What will happen when the irresistible force driving Europe's countries closer together meets the immovable object of the complete lack of political and electoral desire for a federal state?' I think now that it is ever clearer that the irresistible force will eventually triumph. What that will mean for democracy in Europe I do not know.

On too many occasions in the last few years, the political class in the EU has overridden the democratic process – most obviously in the technocratic governments foisted on Italy and Greece, but in other ways too. They have claimed their hands are forced by circumstances – the 'needs must' argument. But this is both lazy and a terrible habit to fall into. The 'I know best' argument of the technocrat, the 'I don't have time to explain it to you now' argument, has undertones of 'And you would not understand anyway.'

I used to think that democracy died when the people were so desperate that they traded in their votes for something more immediate: peace, perhaps (e.g. the imposition of order, often through martial law) or bread. What is happening in the EU is rather different. The leadership is slowly disenfranchising the people and the people appear to be acquiescing.

Democracy is a very laborious way to run a country. The work required to keep the people informed and onside is not trivial. But to not do it risks the political class becoming estranged from the people – and that way leads to revolutions.

John Nugée
London

Scottish National Party 'quit-Britain-but-stay-in-pound' policy is implausible.
From Mr Colin Robertson

I could not agree more with David Marsh's point (Commentary, 8 December) about the implausibility of the Scottish National Party (SNP) currency policy set against the backdrop of euro area periphery disasters. Interesting aspects are, first. why the press has not made more of this and the other unacceptable policies in their 667-page independence white paper and, second, why Alex Salmond, the SNP leader, who is not stupid, set forth these policies in the way he has. One story is that this is part of his negotiating tactics, seeking concessions ahead of an expected No vote.

One might have thought Mr Salmond would have been told where to go but this has not really happened except by the Scottish Secretary who was badly mauled in public by the SNP deputy leader. The rumour is that the strategy is working and David Cameron, the prime minister, is already making concessions. Personally, I cannot see where this ends. Scotland has little option but to remain part of the sterling bloc. But the terms on which it would be acceptable to the English for the Scots to use sterling would lead to an unacceptable definition of independence for the Scots. Is Scotland allocated sufficient reserves for a Scottish pound to track credibly an English pound?

Colin Robertson
London

The last of the central banking gentlemen

Tussles over monetary union support for Bundesbank president

I last saw Lord Kingsdown, who has died at the ripe old age of 86, at the memorial service a couple of years ago for Sir George Blunden, *writes William Keegan in London*. Kingsdown, or Robin Leigh-Pemberton as most of us remember him, was Governor of the Bank of England from 1983 to 1993, in succession to Gordon Richardson, Governor from 1973 to 1983.

George Blunden was a lifelong Bank of England official, who had retired as Executive Director in 1984, but was brought back as Deputy Governor from 1986 to 1990.

At the reception after George's memorial service, Leigh-Pemberton was in fine reminiscent form. His appointment had been controversial. Thatcher, then prime minister, had rejected such obviously qualified candidates as the then Deputy Governor Sir Kit McMahon and Sir Jeremy Morse. The latter was then chairman of Lloyds Bank, having been an executive director of the Bank of England, with, like McMahon, considerable international experience.

The iron law of such appointments is that the better known a candidate is, the more enemies he has acquired. Although many people thought Leigh-Pemberton had been a close friend of Thatcher's, the former Governor told me: 'I had actually only met her twice before the appointment.'

He was as astonished as everybody else. But Thatcher knew that Leigh-Pemberton, then chairman of NatWest, was a true blue Conservative. Furthermore, the prime minister had a weakness for handsome men such as Leigh-Pemberton and the former Cabinet Minister Cecil Parkinson, who resembled the 'matinee idols' of the film world.

Kingsdown had a baptism of fire, with a hostile press, and quite a lot of hostility within the Bank, where he had to fight back against pre-emotive moves to curtail the Governor's powers. It did not help that Richardson, who had wanted a third term, stayed on at the Bank for a time. It was a stormy period, which included the Big Bang in the City (1986) and some embarrassing failures of banking supervision, most notably the collapse of Johnson Matthey Bankers in 1984 and BCCI in 1991. Also, there was the anomaly of the way the new Governor insisted on retaining his ceremonial duties as Lord Lieutenant (the Queen's representative) of Kent, the country where he possessed his version of a Downton Abbey estate.

He told me at the Blunden memorial reception that one of the best things that happened to him was when, during his early troubled times, Thatcher said 'Would it help if I brought George Blunden back?' The answer was a firm yes, and the experienced, skilful and wily Blunden returned, joking to me on one occasion: 'I have been brought back from the dead. I can do anything I like.'

But Thatcher was to find that matinee idols have minds of their own. Kingsdown backed Chancellor Nigel Lawson in his support for British membership of the European exchange rate mechanism and, even worse for the prime minister, 'went native' after she appointed him to the Delors Committee on the single currency. She had told him to follow the example of Karl Otto Pöhl, then President of the Bundesbank, who was also on the Committee. She had not bargained for

Pöhl's unexpected support for the idea of the euro, provided the statutes of what became the ECB were even tougher than those of the Bundesbank. Kingsdown's support for the euro project meant that for a time Thatcher and he were not on speaking terms.

And then there was the humiliation of Bank and Treasury on Black Wednesday. Lord Kingsdown was a good, kind and unfailingly courteous man, an old style British gentleman. He was aware of his limitations, which were fewer than critics imagined, and he knew how to manage and delegate. He once implied to me that one of the reasons for the BCCI fiasco was that if he intervened there might be accusations of racism. Incidentally, his death leaves only one surviving Bank Governor, namely Mervyn King. By contrast there are five surviving Governors of the Bundesbank. I am not reading anything into this… ▪

William Keegan is Senior Economics Commentator at the Observer.

A governor with a kind heart – even for the bees

Many people have commented that Lord Kingsdown was one of the world's true gentlemen, *adds John Nugée in London*. And indeed he was unfailingly well-mannered and polite to all. Not least his own staff, of whom I was one in the 1980s, acting as his junior private secretary for a couple of years when he was Governor of the Bank.

They were busy years, coinciding with the aftermath of the Latin American debt crisis and the collapse of Johnson Matthey. But the Governor was an object lesson in maintaining a good work-life balance: he always had time for his other interests and duties. Not the least of these was that he was a keen bee-keeper, even keeping some on the roof of one of the Bank's City premises.

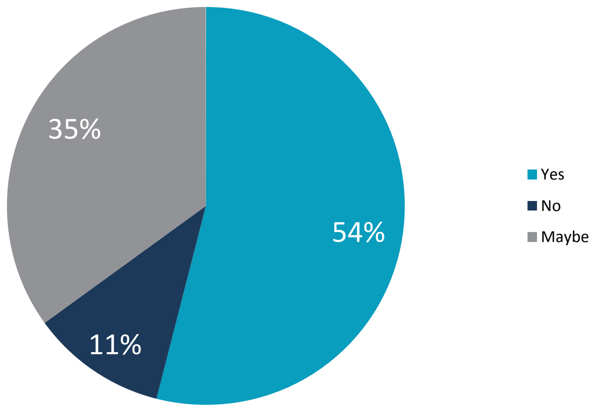
One year they swarmed while he was away on a business trip. Noticing a certain froideur in the office as he returned, he asked what had happened. 'Your bees, Mr Governor, have unfortunately swarmed,' he was told. Not only that, but they had found an open window and gone in, much to the understandable consternation of the members of Bank staff inside. A rapid evacuation had been ordered, and the office was closed for the day and all work suspended.

He was genuinely concerned, and not only for his lost bees. He enquired what office had been invaded and what work so rudely interrupted.

'The Unclaimed and Dormant Dividends Office,' came the reply. 'Ah', he said, 'perhaps not the most urgent and time-critical of offices…' ▪

John Nugée is Deputy Chairman of the OMFIF Advisory Board.

'Do you think Janet Yellen will do a good job in exiting unconventional monetary policy and presiding over a return to non-inflationary US growth?'



Stuart Mackintosh – 'Yellen has the ability to handle a difficult transition well. But she must contend with what will surely be market swings and nervousness even if she succeeds in clearly communicating her plans. We may still experience a bumpy exit from unconventional monetary policy, accompanied by attacks on the Federal Reserve from those in Congress who distrust the central bank's approach and who will use any perceived problems as an opportunity to attack the new chair and the central bank's independence.'

Hemraz Jankee – 'A change of guard at the Federal Reserve is unlikely to result in a change in approach in the conduct of monetary policy by the Fed. Going by her recent testimony in front of the Senate Banking Committee, she appears quite wedded to the accommodative monetary policy pursued by Bernanke. Although she has not given any clear clues on Fed tapering, the timing of which is likely to be data-dependent, we can expect her to do a good job to normalise monetary policy as the economy recovers and gets back to normal.'

Andrew Large – 'The question is whether anyone can manage the exit. "The Bernanke Put" has shown that market forces will make it very difficult, such is their appetite for cheap credit, and their ability to force rates up to choke off recovery.'

Sahoko Kaji – 'There is no reason to rule out Dr. Yellen's being able to: 1) discern the right timing for "exiting", 2) actually exit at that time without succumbing to political pressure, and 3) bring about increased economic activity without inflation. But this does not ensure stable growth, because the dilemma of one tool (monetary policy) and two goals (price stability and market stability) remains. Even if 1 to 3 were achieved, a bubble could develop and then burst again. Furthermore, the US labour market, which Dr. Yellen shows concern over, has structural problems that cannot be resolved by 1 to 3 alone. Minimum wage "hamburger-flipping" jobs are taken not by students but bread-winners who sustain an entire family. If children from such families grow up without opportunities, social immobility and income disparity will continue to plague the US and many people would feel she is not doing "a good job".'

The advisory board poll was conducted from 15 to 19 November 2013.