The Bulletin

December 2014
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Official monetary and financial institutions • Asset management • Global money and credit

Revitalising Abenomics

Japan brings on fresh arrows

Gary Smith on demography
Shumpei Takemori on Japan's reforms
Kishore Mahbubani on Asia's golden age
William White on banking independence

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GLOBAL PUBLIC INVESTOR 2015

DRIVING WORLD ECONOMIC GROWTH

Global Public Investor (GPI) 2015 advances understanding of the underlying investment behaviour and performance of different categories of public entities owning assets equivalent to 40% of world output.

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Release date: Spring 2015

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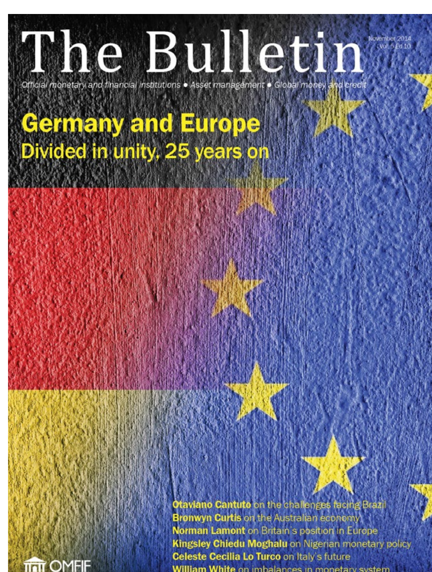
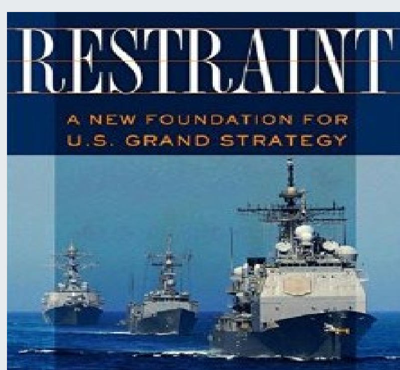
Cover story

For two years, the world has watched, with sympathy and trepidation, as Shinzo Abe, Japan's prime minister, confronts the demons of deflation with radical monetary, financial and structural measures. Having unleashed his arrows without yet hitting the bull's eye, Abe is resetting his targetry and reloading his quiver by calling early elections for 14 December, gambling on garnering support before Abenomics loses its shine. As the Bank of Japan intensifies monetary stimulus, the US minimises it and the ECB agonises over it, squalls are near-inevitable. See p.10-13.



America's world role



George Hoguet reviews a book on the scope and limitations of US power, a subject that will remain at the forefront of attention in 2015. Barr Posen's *In Restraint – A New Foundation for U.S Grand Strategy* focuses on the debate over what truly constitutes 'security'. See p.30.

International monetary policy

Mining investment depletes Australian coffers	Bronwyn Curtis	5
Leading on US, over-optimistic on Japan	Bronwyn Curtis	8
Exports more important than consumption	Shumpei Takemori	10
Uncomfortable ride for Abenomics	John Plender	11
Overdue change to outdated system	John West	12
Reinvigorated Abenomics good for world	Grant Lewis	13
A golden age looms for Asia	Kishore Mahbubani	14
Washington shapes the summits	Stewart Fleming	15
The new landscape of central banking	John Nugée	16
Sovereign notes	Pooma Kimis	17
Independence lost is hard to regain	William White	18
Questioning the bail-in mechanism	Harald Benink & Clas Wihlborg	19
Population trends and sovereign funds	Gary Smith	21
Fed officials debate inflation impact	Darrell Delamaide	22

Europe and the euro

Juggling Europe's energy governance	Ruud Lubbers & Paul van Seters	23

Global asset allocation

GPIF selling bonds and doubling equity	William Baunton	24
The A-share market and foreign investors		25

Emerging markets

China, Japan rivalry tests Obama	Jonathan Fenby	26
Carrying on regardless	David Smith	27
Currency news	Jamie Bulgin	27

Book review

The scope and limitations of US power	George R. Hoguet	30

ECB disappoints operators expecting radical action – again

Not for the first time, the European Central Bank has disappointed market operators expecting red-blooded action to quell low inflation. Lack of decisions at the ECB's 4 December meeting on bringing in radical quantitative easing reflects continued doubts about whether QE is either necessary or legal, or whether it would work – uncertainties that are well-broadcast by the Bundesbank (and others). The latest statement – 'Should it become necessary to further address risks of too prolonged a period of low inflation, the governing council remains unanimous in its commitment to using additional unconventional instruments within its mandate' – contains plenty of ambiguity about what the ECB may (or may not) do next.

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The Official Monetary and Financial Institutions Forum (OMFIF) is an independent research and advisory group and a platform for 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 – including private equity and infrastructure – and financial supervision and regulation.

OMFIF co-operates 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 280 meetings in 42 host countries with the participation of 200 different official institutions.

The 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.

Submissions

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

Letters

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

Diary dates

OMFIF Meetings take place within central banks and other official institutions. The frank and confidential nature of meetings provides for a deep-seated exchange of views and best practice.

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For queries on the website, contact editorial@omfif.org

OMFIF moves to Crown Place, City of London

The OMFIF team moves from west to east: relocating from Hammersmith to Moorgate

EDITORIAL

Abe's poll ploy: garner support before popularity dips

Bronwyn Curtis dwells on OMFIF's predictions for 2014 and gives generally high marks for prescience, although we were too pessimistic about debt restructuring in Europe and slightly too optimistic about Japan. The next stage of Shinzo Abe's economic experiment takes place on 14 December in the early general election the prime minister has called to cement support for reforms.

A more cogent reason, as Shumpei Takemori explains, is to shore up his support before his popularity almost inevitably starts to decline as the programme meets fresh hurdles. All the same, Takemori – like Grant Lewis, writing separately –is optimistic on Abe's legacy, declaring: 'Abe won't be a popular prime minister, but he can accomplish great structural reforms.' Japan is of pivotal importance, reflecting the pioneering nature of quantitative easing, stepped up again at the end of October in the face of Japan's unexpected fall into recession, as well as the simmering tension with China in both the military and economic fields. Meanwhile Moody's has added to unease by downgrading Japan's credit rating.

Despite all this, Kishore Mahbubani sounds a hopeful note, pointing out the symbolic importance of the (unsmiling) handshake between Abe and President Xi Jinping at the Asia Pacific Economic Co-operation meeting in Beijing – marking one reason why he postulates a 'golden era' for Asia in the next 10 years. Jonathan Fenby analyses the Abe-Xi meeting from a psychological and political point of view, and is not totally convinced that the two countries have eradicated the threat of confrontation. On Japan, John West takes a confident line, citing Abe's corporate governance changes and a salutary spur from China. William Baunton notes the link with corporate governance in the new asset strategy of the Japanese Government Investment Fund. John Plender adopts a slightly more sceptical tone, underlining that Japan's move into current account deficit and the debt overhang make the country much more dependent on foreign financing.

John Nugée and William White look at diverse pressures faced by central banks in 2015, Harald Benink and Clas Wihlborg examine progress in European banking union, while Paul van Seters and Ruud Lubbers analyse the prospects for another ambitious step in European co-operation, the move towards a full-scale energy union in Europe to lower the continent's dependence on outside sources, especially Russia. In our global capital markets round-up, Gary Smith examines whether sovereign funds should take demographic trends more into account, while we look, too at the fillip for the Chinese equity market engendered by the opening of the Shanghai-Hong Kong stock link-up.

We round off 2014 with a melancholy look at Argentina with David Smith, while George Hoguet reviews a subject that is likely to preoccupy us in 2015 as in 2014: the scope and limitations of US power. ▪

Mining investment depletes Australian coffers

Export strength needed to shrink foreign debt

Bronwyn Curtis, Chief Economic Adviser

Australia has been running up substantial liabilities with the rest of the world since the 1970s resources boom. The debt has risen ever since, surging in the early 2000s when Australia invested heavily in mining capacity to feed China's insatiable demand for iron ore, coal and other commodities. Australia was the world's sixth largest net foreign debtor in 2013 in dollar terms, and that's for a population of just 23 million. It has recorded sizeable current account deficits almost every decade for at least the last 150 years.

Every so often policy-makers agonise over this deficit and the net foreign debt. Will it result in a loss of investor confidence and capital outflows, or productive investment and stronger economic growth? In October, the IMF said there may be good economic reasons for countries to run current account surpluses or deficits. However it says, 'Large deficits – and associated large net foreign financial liabilities – expose the country to the risks of a sudden cessation in financing or the rolling over of those liabilities.'

In 1986, Treasurer Paul Keating called Australia a 'third rate economy, a banana republic' as net foreign debt soared after he deregulated the Australian dollar. Investors dumped the dollar and it fell below 50 US cents for the first time. Rating agencies slashed Australia's credit rating. When Keating made that speech, the ratio of net foreign debt to GDP had risen sharply from 20% to 30% in just over five years. Inflation was 9%, government debt was 7% of GDP and commodity prices were sinking. Now, 28 years later, the ratio of net foreign debt to GDP has risen to around 60%, but creditworthiness is hardly discussed. Net foreign debt in June 2014 stood at A$865.5bn ($736bn). About 80% of that is held by private investors and around 20% has a maturity of 90 days or less. Many economists would argue that the level doesn't matter as the money has been borrowed for productive investment in the mining sector rather than as a result of insufficient domestic savings or to fund consumption.

Australia is in transition. As Reserve Bank of Australia economist Alexander Heath said on 21 November, 'We have seen the peak in mining investment and over the near term we expect that the fall in mining investment will be a significant drag' on Australia's economic growth.

A substantial fall in the Australian dollar is needed, and the Reserve Bank has been trying to engineer one. However, despite falling commodity prices, the depreciation of the Australian dollar since 2013 leaves it well above most estimates of its fundamental value. And relatively high interest rates and the Bank of Japan's monetary easing may keep the Australian dollar higher than fundamentals warrant for some time to come.

The hope is that the huge investment in resource projects will soon make a positive contribution to economic growth through exports of liquid natural gas, iron ore and coal. Australia hasn't had a current account surplus since 1973, but the US demonstrates the possibility of a turnaround. In 2006-13, the US current account deficit halved in dollar terms. Some optimistic Australian economists are predicting that exports will earn enough income over the coming 20 years to turn the current account deficit into a surplus and shrink the pile of foreign debt. ▪

ADVISORY BOARD

New members

Kingsley Chiedu Moghalu was a deputy governor of the Central Bank of Nigeria from 2009-14.

He led reforms to enhance financial stability and manage systemic risk to Nigeria's banking system. He joins the Banking panel.

Moghalu worked for the United Nations for 17 years, becoming a Director, and is the author of *Emerging Africa*.

Lord Andrew Adonis is a reformer, writer and Labour peer who was minister for schools and transport secretary under Prime Ministers Blair and Brown. He joins the Capital Markets panel.

Adonis began his career as a journalist before joining Tony Blair's policy staff in 1998. He sits in the House of Lords as the shadow infrastructure minister.

BRIEFING

Australia's economic outlook

In a telephone briefing on 11 November, Jenny Wilkinson and Brenton Goldsworthy of the Australian Treasury discussed Australia's economic outlook. Moderated by OMFIF's chief economic adviser, Bronwyn Curtis, the discussion focused on falling commodity prices and the downturn in demand for resources, and how they may impact Australia's growth prospects and efforts to shrink its national debt.

The slowdown of the Chinese economy, as part of China's economic rebalancing towards a more consumption driven model, has dampened demand. The declining prices of iron ore and coal were a particular worry. Previous investment in the mining industry should put Australia in a strong position to expand exports. However, the strength of the Australian dollar is hampering the country's export competitiveness, something the Treasury is aware of. A further topic of discussion was the controversial budget put to the Senate this year.

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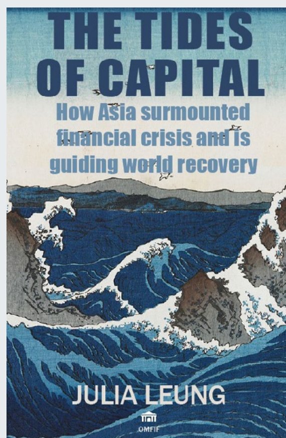
Asia's capital travails



OMFIF Press launches its first book in January 2015, *The Tides of Capital* by Julia Leung, undersecretary at the Hong Kong Treasury until December 2013. Her book, written while senior adviser to OMFIF, details how Asia surmounted two spells of financial crisis – in 1997-98 and 2008-09 – with economic and financial measures that are increasingly setting standards in the US and Europe. Hong Kong-born Leung has been a public servant in the financial sphere for two decades. She was executive director (external) of the Hong Kong Monetary Authority and worked on crisis prevention with international financial organisations and central banks. Her book is the first account by a senior Asian policy-maker of sometimes acrimonious financial manoeuvrings between the west and Asia. The 1997-98 unrest led to bitter policy exchanges between Asian countries and the west as the world's de facto monetary rulers in Washington imposed draconian austerity programmes on Thailand, Indonesia, Korea and Malaysia that many Asians resented as damaging.

POLICY GROUP

London debate on Italy

Pier Carlo Padoan, Italian minister of economy and finance, shared his views on Europe, Italy's reform efforts and the path forward for a more balanced European macroeconomic position over dinner at the Institute of Chartered Accountants in London on 20 November.

Speaking to an audience of investors, financial professionals and past and present policy-makers, Padoan gave an upbeat assessment of Italy's reform efforts under Prime Minister Matteo Renzi, but said the important issue now was to implement legislative action. He ranged over economic prospects for Europe, with general worries over lack of growth forming an important topic of discussion.

The debate touched on the right mix of monetary and fiscal policies in Europe, the outlook for infrastructure investment in Italy and the rest of the continent, and Italy's role in its current presidency of the European Union in spurring more political and economic cohesion across the continent.

Monetary and macroprudential policy after the crisis

10 December, London

Lord Adair Turner, former chairman of the UK Financial Services Authority, will give a City Lecture on how monetary and macroprudential policy has evolved since the financial crisis. He became the watchdog of the UK banking system on the eve of crisis in September 2008, and played an active role in trying to control the subsequent turbulence. He then had a part in shaping shadow banking regulation in the International Financial Stability Board. Lord Turner has become a principal advocate of further unconventional measures to quell financial instability and raise global growth, including through challenging some major central banking taboos.

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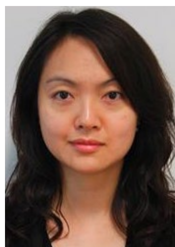
Internationalisation of the renminbi: implications for world finance

12 December, Hong Kong



Together with the Hong Kong Institutue for Monetary Research, OMFIF presents a day-long seminar on China's financial liberalisation and the internationalisation of the renminbi. The meeting will address moves to make the renminbi widely accepted and freely convertible; liberalisation of China's capital account; development of the IMF's Special Drawing Right and the valuation of the renminbi and its developing role as reserve currency. Speakers include Lillian Cheung (left) of the Hong Kong Monetary Authority; Julia Leung, former undersecretary of the Hong Kong Treasury; William White of the OECD; and Satoru Yamadera of the Asian Development Bank.

Contact: adam.cotter@omfif.org

Crises in the monetary system: learning from experience

27 January, London

Masaaki Shirakawa, former governor of the Bank of Japan, will outline the lessons learned from the monetary crises he has dealt with during his long and distinguished career. As chairman of the central bank's policy board from 2008-13, Shirakawa directed the monetary policy of the world's third-largest economy. He was vice-chairman of the Bank for International Settlements. The talk will provide an opportunity to assess Japan's changing economic position and the impact of Prime Minister Shinzo Abe's reform efforts.

Contact: meetings@omfif.org

Fifth Bundesbank Economists Meeting

28 January, Frankfurt

OMFIF returns to the Deutsche Bundesbank for the Fifth Bundesbank-OMFIF Economists Meeting. Chaired by Joachim Nagel, member of the executive board of the Deutsche Bundesbank, it will feature a half-day roundtable for economists from official and private sector organisations within Europe and further afield. Participants will exchange views on monetary policy developments in the euro area, the international economic outlook and the next steps in banking union. A significant discussion is expected on the ECB's strategy on increasing its balance sheet by up to €1tn in the next two years

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Second Banco de Portugal Economists Meeting

26 February, Lisbon

The roundtable discussion with Governor Carlos Da Silva Costa is the second such gathering hosted by Banco de Portugal in Lisbon. Following the first Economists Meeting in 2012, the half-day roundtable will focus on the outlook for European growth and investment in spite of headwinds from low inflation, poor credit and an unfavourable international economic environment. It will bring together senior economists and policy-makers from Portuguese and other European public and private financial institutions.

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Leading on US, over-optimistic on Japan

How OMFIF's predictions for 2014 fared

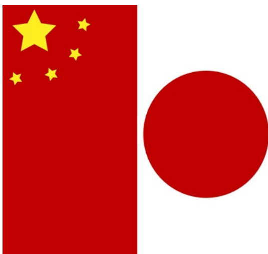
Bronwyn Curtis, Chief Economic Adviser

OMFIF turned in a reasonable, though not stellar, performance in its 2014 forecasts, published last January. See below the actual New Year predictions, together with a star rating I have assigned them on the basis of their accuracy.

We were right about the US and emerging market economies (including China), too optimistic about Japan, nearly right about the UK (right on the strength of the economy, faulty on interest rates), prescient about euro area gloom. We thought Greece would want debt relief. This looks like next year's story. We were wrong that Sigmar Gabriel would efface the still-feisty Wolfgang Schäuble, an impressive (wheelchair-bound) figure in Germany and Europe in spite of his 72 years. Islamic unrest is a huge problem, yet few foresaw Isis. And we missed (like others) two of the biggest stories – Ukraine-Russia unrest and the fateful rise of Ebola. Overall I would award OMFIF an average score of 3.6 stars. The 2014 forecasts were the work of colleagues. In the 2015 predictions, published next month, I will reveal my hand.

'US to lead on economic growth as Yellen eclipses "secular stagnation" Summers'.

Janet Yellen made a near-seamless transition at the Federal Reserve. Falling unemployment allowed the Fed to stop its bond buying programme even though GDP growth underwhelmed due to bad weather and the expiration of tax incentives among other factors. As anticipated, the dollar moved higher as the economy performed better than the rest of the western world, except the UK. US treasury yields headed closer to 2% than 4%, surprising many forecasters. Disinflation and deflation are more of a concern.



'East China Sea claims could unhinge stability, 100 years after start of the first world war'.

Tensions have been high, as anticipated. Chinese incursions into territories claimed by other countries have caused tensions, particularly with the Philippines and Japan. Japan's Shinzo Abe and China's Xi Jinping shared an unenthusiastic and unsmiling handshake at the Asia Pacific Economic Co-operation summit in Beijing in November. This was a small step towards improving bilateral relations, but overcoming the nations' history of tension and rebuilding trust will not be easy.

'Japan's aim of ending deflation comes in sight as yen slide continues and bond yields rise'.

After two lost decades, Prime Minister Shinzo Abe announced in June that his government had finally defeated deflation: 'Through bold monetary policy, flexible fiscal policy and the growth strategy, we have reached a stage where there is no deflation.' The yen plunged to Y119 to the dollar and stock prices received a boost. But the celebration was short-lived. The fear of deflation continues to haunt Japan as it slips back into recession. Bond yields, though sedated by quantitative easing, rose to their highest in over a year.

'China enjoys an economically prosperous 2014, possibly attempting to try North Korea rapprochement'.

The first part has come true with growth expected to be above 7%, despite dire predictions about bad debts and the housing market. The internationalisation of the renminbi continues apace. The Shanghai-Hong Kong Stock Connect, which allows Chinese and Hong Kong retail investors to trade shares on each other's bourses, finally got the green light. It is a major step towards opening up China's tightly controlled capital markets. There are no links with North Korea yet, though.

‘Instability in Islamic world worsens as fresh discord looms between Iran and Saudi Arabia’.

Instability in the Middle East has worsened, but not quite in the way we expected. The tension between Sunnis and Shias has been a key factor behind the conflicts. The rise of Isis was unexpected by nearly everyone, as was their command of social media to spread their propaganda message. The annexing of parts of the Ukraine by Russia or Russian-backed elements has brought turmoil to Europe’s door, and the sharp fall in the oil price created further divisions and uneasy alliances.

‘Imbalances in euro area will persist, deflationary pressures impede debt reduction’.

Current account imbalances have diminished for the deficit countries, with Spain making credible reform efforts. But the surpluses are as large as ever, and debt imbalances persist. Germany has become the world’s second biggest net foreign creditor in dollar terms, while Spain, Italy and France are respectively the second, fourth and sixth largest debtors. The deterioration has been particularly striking for France with its stubbornly low inflation. The ECB certainly doesn’t have an effective strategy to deal with it.

‘Greek prime minister, poised between statesman and spoiler, wants speedy relief’.

Greece has been one of the euro area’s better performers after six years of recession. The government is running a primary budget surplus after deficits as high as 10-12% in the years before 2009. Despite this, general government debt as a proportion of GDP had risen to 174% as a result of years of low growth and low inflation. The long-promised debt rescheduling did not happen in 2014. With political jitters preventing a smooth exit from the international bail-out, debt relief will be on the agenda in 2015.

‘SPD heavyweight Gabriel to bid for lead over euro bargaining, pushing Schäuble onto sidelines’.

Finance Minister Wolfgang Schäuble has retained his position alongside Sigmar Gabriel, minister for economic affairs and energy. Schäuble is sticking to the line that euro members must make maximum reform efforts before Germany (or the ECB) can step in with extra help. Although he takes a sceptical line on quantitative easing, there is little doubt that Schäuble would back further ECB unconventional policies – provided the debtor states move first (which would then possibly make ECB action unnecessary). For the time being, Gabriel is broadly supporting these tactics.

‘Britain to raise interest rates as growth spurts ahead of euro area and sterling remains strong’.

Britain’s growth is the strongest in the G7. Sterling has weakened against the dollar, but so have most other currencies. Unemployment continued to fall and there are nascent signs of wage inflation picking up. There has not been an interest rate hike, and the monetary policy committee is divided on whether to raise them. Europe is the UK’s largest export destination. Fears that low European growth will stifle demand for UK exports have added to policy-makers’ nervousness about tightening policy.

‘Many larger emerging market economies will have another bumpy ride’.

As expected, it has been a tough year for emerging markets and the hope that they will be the growth engine for the world has dissipated. The stronger dollar and a sharp drop in commodity prices exposed their vulnerabilities. Of the Brics, only India seems upbeat in the hope that badly needed reforms will be implemented. The rest of the group face inflation concerns. As we said in our predictions, ‘The appellation “Brics” to denote a mythical group of up-and-coming countries has never been less useful’.

Exports more important than consumption

Abe's plan: weaken yen, liberalise agriculture

Shumpei Takemori, Advisory Board

Prime Minister Shinzo Abe has called a snap election on 14 December to let Japan pass judgment on Abenomics. A more important consequence of the poll, which most observers expect the prime minister to win, could be to propel Japan towards significant liberalisation of agriculture, which could make a big difference to the country's economic prospects.

Abe won't be a popular prime minister, but he can accomplish great structural reforms.

The recent sequence of negative economic news might be seen as relatively insignificant, with the main objective for Abe to try to keep economic policy on course. But Abe's decision is based on political calculation rather than indirect response to the after-effects of the consumption tax hike from 5% to 8% which saw the economy slump for the second and third quarters of 2014.

Markets expected GDP to rebound 2% in the July-September quarter; instead it declined 1.6%. In response, the Abe administration postponed the next tax rise, from 8% to 10%, for eight months. I do not take these numbers too seriously. GDP dropped rather than rebounded, but why were people so sure about GDP rising in the first place? Economic theory is no help here.

Psychology matters

There is a proposition of economic theory, known as the Ricardian Equivalence, which states that if people rationally expect that the government will eventually have to plug the fiscal hole by raising tax, then the timing of the actual tax rise does not matter (because the timing won't affect the present value of total tax burden). In fact, the Japanese people do not seem to be rational because they have reacted strongly to the actual tax hike. Clearly psychology matters. But there are no psychological theories to predict how long the trauma of a tax hike will persist among the Japanese population.

Claims that the consumption slump demonstrates the failure of Abenomics, too, can be discarded. Everyone agrees that the fall in consumption was the result of the higher tax. More monetary policy stimulus is needed – and this is exactly what Haruhiko Kuroda, the Bank of Japan governor, is offering with a further drastic recalibration of Japanese-style quantitative easing. The only reason a government calls a snap election is that it expects a better outcome now than later. In other words, Abe expects that, once the election is out of the way, his own popularity, as well as that of his Liberal Democratic Party, will carry on sliding. Some criticise the wisdom of Abe's opportunism.

His aim is clearly to boost stock prices with the Bank of Japan's quantitative easing and a weaker yen, thus obtaining a mandate for four more years from the Japanese electorate without embarking on serious structural reform.

Long-term questions

I myself put the matter another way. Abe started his administration with a strong dose of money printing. For a while he derived his authority from buoyant stock prices. But this cannot go on forever. If Abe wins this election on 14 December, he can spend less energy boosting stock prices and instead concentrate on long-term questions. Chief among these is the Trans-Pacific Free Trade Agreement involving the US.

After the Republican success in the mid-term US elections, US political gridlock looks set to continue. But there are a few areas in which President Barack Obama and the Congress can work together. The free trade issues are the most urgent. The Trans-Pacific Partnership is at the top of the list and needs to be concluded in 2015, as any progress will be impossible in 2016, the presidential election year.

The timing is a strain for US politics – but it will strain Japanese politics too. This is because the advantages to the US of a FTA with Japan reside in the opening up of Japanese markets to the US service and agricultural sectors.

In the past, the strong resistance of the Japanese agricultural sector has been an enormous obstacle. If the Japanese election had taken place in 2016, as initially scheduled, rather than in December, as scheduled, it would have been overshadowed by agricultural liberalisation. This might have become the key theme: not the route Abe's party wants to take.

Thus a snap election has a useful political function. Agricultural liberalisation – the most contentious subject in Japanese politics – will be a non-issue. If Abe can consolidate his authority through this election, he can embark on wide-scale agricultural liberalisation that none of his predecessors dared to imagine.

Besides giving Japan the opportunity to restructure agriculture, a big area of Japanese weakness, TPP has the additional benefit of improving access to foreign markets for Japanese manufacturers, still a great Japanese strength.

From now on the Japanese government should concentrate not on stock prices but on long-term prospects. From the outset of the new Abe term in December 2012, I have observed that the objective of the prime minister and his central bank governor is to promote economic growth through exports. Scaled-up QE is key to success because it lowers the yen.

Japanese exports, however, did not react quickly to the stimulus of yen depreciation. Under the impact of previous rises in the currency, many Japanese exporters have shifted their production facilities overseas. So yen depreciation naturally has had only a limited effect on exports.

The negative impact of outsourcing has been visible for a while. A Japanese export-led economic boom can be nothing more than a long-term goal. It won't happen until Japanese firms increase investment in expanding exports. This will take a long time, but already there are some hopeful signs.

Export volumes

Japanese export volumes have finally started to pick up, with volumes increasing 2% a month for two months in a row. Moreover, Japanese exporters have started to lower their product prices in the hope of capturing more market share. According to data released by Japan's Ministry of Finance on 1 December, the investment in plant and equipment in the third quarter of this year has risen 5.5% overall and 10.8% in manufacturing compared to the third quarter of 2013

The scaling up of the Bank of Japan's bond buying at the beginning of November has succeeded in changing Japanese exporters' sentiment. They finally understand that the low value of the yen is here to stay. Three years from now the yen will be still weak. This is the good news I have been waiting for, vindicating the designs of Abe and Kuroda.

Compared with this all-important reality, the latest drop in Japanese consumption is irrelevant. Japan's future lies in exports. ▪

Shumpei Takemori, member of the Advisory Board, is economics Professor at Keio University and senior research fellow at the Ministry of Finance and the Policy Research Institute.

Uncomfortable ride from Abenomics

Japan's debt overhang and increased reliance on foreign capital

John Plender, Chairman

In the quarter century since the bursting of the great Japanese bubble the existence of imbalances in the Japanese economy and the extraordinary growth of Japanese government debt have been largely a matter of indifference to the rest of the world.

The ups and downs of what for most of that period was the world's second largest economy had little external impact because of a benign combination of high domestic savings and a persistent current account surplus.

Continuing budget deficits and a gross stock of public sector debt that now amounts to some 230% of gross domestic product were financed almost entirely by domestic investors who showed a marked home bias.

Virtuous circle

Yet this virtuous circle is now coming to an end and Japan's capital markets are about to become more closely connected with the wider world. Japanese household savings, phenomenally high back in the 1980s, are today negligible, which is why the Japanese national savings rate has fallen from 33% in 1990 to 19% last year. Only because companies have become substantial savers have government budget deficits continued to be financed at very low nominal interest rates. At the same time the current account has gone into deficit and has derived diminishing support from foreign investment because of the prevailing low level of interest rates, most importantly on US Treasuries which constitute the bulk of Japan's huge $1.3tn cache of official reserves. The advantages of being the world's biggest creditor country are not what they were.

The conventional wisdom about Japan is that it is a victim of deflation and that the economy has been blighted by lost decades.

The reality is rather that the ageing of the Japanese population is more advanced than elsewhere and that in an apparently stagnant economy the country's growth in per capita income has outstripped that of the US over the past decade and a half.

Deflation has been marginal, while the decline in household savings hardly suggests that people have been holding back consumption in the expectation of falling prices. Japan's real problem is the debt overhang. And the likelihood is that the country will become increasingly dependent on foreign capital to finance government debt.

The economic programme of Prime Minister Shinzo Abe involves more deficits and increased debt. And if Abenomics succeeds in boosting consumption, household savings will turn negative.

The substantial competitive devaluation since late 2011 might have been expected to provide a big boost to exports and thus to corporate savings and investment. Yet the export response to devaluation has been flabby. At the same time the lack of external criticism for this retreat into 1930s-style beggar-thy-neighbour exchange rate policy means that other countries are now following suit.

Corporate sector

The corporate sector thus faces a slow growth, increasingly mercantilist world. And its biggest trading partner, China, is reducing an excessive level of capital investment that has until now been a boon to Japanese exporters.

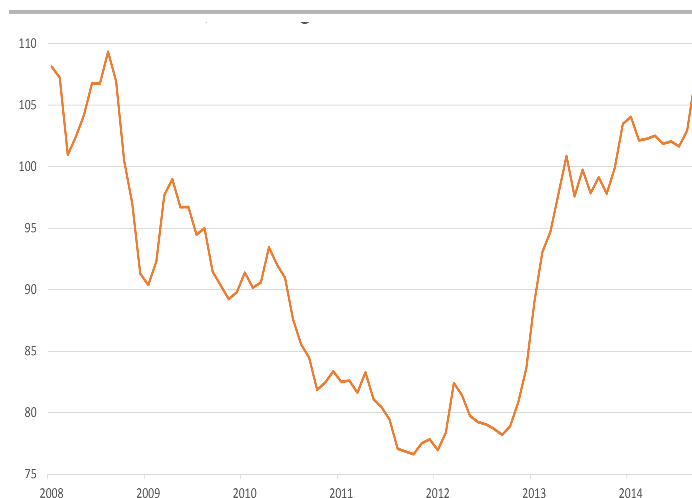
The risk is that a combination of yen weakness and the Bank of Japan's huge bond buying programme will cause inflation-wary investors both at home and abroad to demand a bigger risk premium on the government's IOUs. That could lead to a dangerous vicious circle of rising yields, falling market confidence, a more vulnerable financial system and a contraction in the real economy.

Of course Japan's foreign reserves could be mobilised to support the yen and the government bond market. Yet that is potentially destabilising for the rest of the world.

Whether it succeeds or fails, the brave new world of Abenomics could be uncomfortable for those outside Japan. ▪

How Abenomics has driven down the yen...

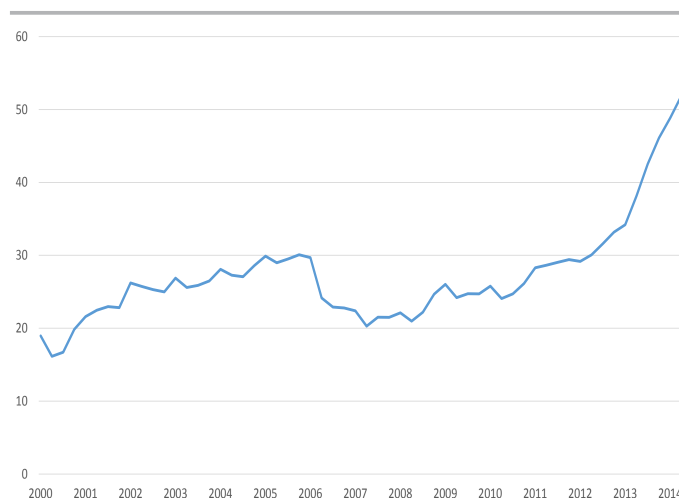
$/¥ exchange rate Jan 2008 - Oct 14



Source: Oanda

... and accelerated Japanese QE

Bank of Japan balance sheet 2000-14 (¥tn)



Source: Bank of Japan

Overdue change to outdated system

Bright prospects for corporate governance reform

John West, Advisory Board

The evidence from the first two years of Japan's Abenomics experiment is clear. Monetary expansion and fiscal stimulus, the first two arrows of Abenomics, provided a useful short-term fillip to the economy and stock market. But a revitalisation of Japan's deflationary economy requires much greater efforts in structural reforms, Abenomics' third arrow.

The list of areas for reform is long: liberalisation of foreign direct investment; international trade (especially for agriculture and services) and labour markets; regulatory reform and lifting bureaucratic barriers to entrepreneurship; opening the way for greater participation in Japan's economy and society by women ('womenomics') and youth. And progress has been painfully slow.

One area with bright prospects is corporate governance. Reforms underway promise to improve the business climate and help break Japan's deflationary cycle – even if implementation will be a long road.

Unique system

Japan has always had a unique system of corporate governance. Close relationships between 'main banks' and large corporations provided long term stability, as did cross shareholdings within corporate groups.

Company board members were typically 'insiders', coming from the main bank, the corporate group and the corporation itself.

It has described it as a system of 'cosy back-scratching', even collusion, among the management of Japan's large industrial companies, financial institutions, and the government bureaucracies.

Management was weakly supervised, and companies were substantially protected from mergers and acquisitions, especially from overseas.

This system seemed to serve Japan well during its high growth period, until financial crisis struck in the early 1990s. In reality, poor corporate governance contributed to some of the bad lending that led to the crisis, as well as the chronically weak profitability over the past two decades.

Reform of Japan's corporate governance, especially for better disclosure, transparency and accountability, has been on the agenda for over two decades.

To the great surprise of many observers, Prime Minister Shinzo Abe has now placed reform of Japan's corporate governance (along with 'womenomics') at the centre of the government's revised growth strategy.

The government is concerned that Japanese companies have lower productivity than their western counterparts (around 30% lower on average than the US), they are struggling to respond quickly to market changes, and this is dragging down the Japanese economy.

The government asked the Tokyo stock exchange and the Financial Services Agency to draft a corporate governance code for publicly-traded companies by spring next year. Japan has been virtually alone among advanced and emerging economies in not having such a code.

The code will be based on the OECD's principles of corporate governance, which stipulates that the board should have a sufficient number of non-executive members capable of exercising independent judgment.

Only half of the Tokyo stock exchange's top-tier companies have outside directors, and mostly just one. Outside directors must make up at least one-third of boards in Hong Kong and Singapore. The code will look at cross-sharing holding voting rights, and will require companies to 'comply or explain'.

Stewardship code

The government has called on companies to 'link their proactive utilisation of outside directors to the evolution of their business strategies', a virtual war cry to the cosy boardrooms of corporate Japan.

These promised corporate governance reforms come on top of the creation of a 'stewardship code' to impose accountability on companies having no outside directors.

Growing numbers of institutional investors and the huge Government Pension Investment Fund have decided to participate in the code.

Will reform really happen? The government realises that it must 'do something' to revive Japan's economic fortunes, especially in light of the country's poor demography and low productivity.

The recent poor economic results only strengthen the case for urgent action. Improving productivity is the only means to grow the economy, now that the population is declining and could fall by one-third by the end of the century. Counter-intuitively, the politics of corporate governance reform may be less complex than some other big ticket reform issues like agricultural reform.

Japan's poor relations with China is another spur for reform. To be able to stand up and be respected in its neighbourhood, Japan realises that it must have a strong economy.

Better corporate governance could also help Tokyo in its quest to become a more important regional financial centre. Both Hong Kong and Singapore have an edge on Tokyo.

Another pressure for change has been the rising foreign investment in Japan's stock market, especially over the past year or so.

Stock market

Foreign investors hold around one-third of the stock market and much more in certain companies. They trade stocks more frequently than local investors, and may even account for two-thirds of market trading. They seek high rates of return, and have been pushing for better corporate governance.

The government is conscious that the stock market has been seen as something of a barometer for how people view the 'Abenomics' programme. The Nikkei index rose by around 60% in 2013, driven substantially by foreign investors, but has been see-sawing in 2014.

Some Japan-watchers are predictably sceptical of the proposed corporate governance reforms. In the past, Japan has promised reform without delivering. And Japan's peak industry lobby organisation, Keidanren, is resisting the reform agenda.

But Japan's political landscape has changed dramatically from the revolving door of prime ministers of recent years. In the five years prior to Abe's re-election, there were five different prime ministers.

Despite some recent waning in popularity, Abe still enjoys support for his reform ambitions. And likely success in the 14 December election means that he could well be in office for some years to come. This augurs well for the full implementation of corporate governance reform.

In short, there is a sense in Tokyo that this time corporate governance reform might be for real, even if it will be a long road home. ▪

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

Reinvigorated Abenomics good for world

After mid-year faltering, Japan is back on track

Grant Lewis, Daiwa Capital Markets Europe

For a while, it looked as if the three arrows of Abenomics, by far the boldest attempt to shock the Japanese economy out of its decades-long economic malaise, were just what the country needed.

Massive and unprecedented monetary easing from the newly-emasculated Bank of Japan was supported by a fiscal stimulus, which together produced remarkable results.

The stock market took off, the previously uncompetitive yen plummeted and the economy, led by private consumption, staged an impressive recovery. The rolling back of the economic orthodoxy that had held the Japanese economy back for so long seemed to be working.

But the strategy had its limits. Long-running (and as yet unrealised) fears about Japan's fiscal position remained prominent and led Shinzo Abe to consent to an increase in the consumption tax earlier this year.

That, unfortunately, was all it took to push the economy back into recession. And with a further increase in the consumption tax slated for October 2015, risking another downturn, Abenomics looked to have lost momentum.

Policy hyperactivity

But a couple of weeks of policy hyperactivity have changed the position again. First, the end of October saw the BoJ increase anew what was already an enormous programme of quantitative easing, raising government bond purchases by 60% over what had been announced, and tripling purchases of real estate investment trusts and equities via exchange-traded funds.

In addition, the government showed that it had learnt the lessons of previous consumption tax increases. It postponed the next planned hike in October 2015, and bolstered fiscal policy further with plans for extra public spending. This represented a welcome victory of economic sanity over fiscal orthodoxy.

This relaunch of Abenomics shows that Abe is not going to give up easily. It also shows that when the Japanese political establishment wants to, it can act swiftly and decisively.

As recently as mid-October, the second consumption tax rise looked a near-certainty, while the BoJ had given no hint of additional easing. The decision to call an early election demonstrates that Abe is seeking to cement his place as first among equals among Japan's politicians and eclipse Junichiro Koizumi as Japan's longest-serving prime minister in over 40 years.

The broad thrust of Abenomics is Japan's best (and perhaps last) chance of economic rehabilitation. Before the increase in the consumption tax in April, Abe's policies were working. Growth had been kick-started and, after stalling in mid-year, looks set to return in the final quarter of 2014. Inflation, meanwhile, has returned to positive territory, even when the impact of the consumption tax increase is stripped out.

The labour market has seen the most beneficial effects. Numbers in work have risen by more than one million since Abe took office, while the unemployment rate stands around 3.5%, its lowest level in 17 years (see Chart).

Importantly for efforts to defeat deflation, wages are on the rise again. The desired virtuous circle of higher output leading to higher incomes and higher spending looks in reach.

The new revamp to Abenomics is designed to make that virtuous circle spin faster, which should make the economy sufficiently resilient to withstand the further increase in the consumption tax now slated for April 2017.

Above all, higher medium-term inflation should increase nominal GDP growth, helping improve Japan's long-term fiscal sustainability. Yet there are still problems.

There is some merit to criticism that the third arrow, structural reforms necessary to halt the slide in Japan's trend growth rate, has delivered too little.

But considerable progress has already been made including improvements to corporate governance, reallocation of the investment portfolio of the government pension scheme, reduction in the corporation tax burden and promotion of higher levels of female employment.

Indeed, women have accounted for around two-thirds of the increase in employment since Abe took office in December 2012. And the stronger the economy, the easier it will be to implement reforms, particularly with a prime minister at the height of his powers. The prospects for more vigorous policy action on the third arrow look promising.

The new, improved version of Abenomics, coupled with a prime minister with less to fear from his foes, creates better prospects for Japan's economic rehabilitation than at any point over the past 25 years.

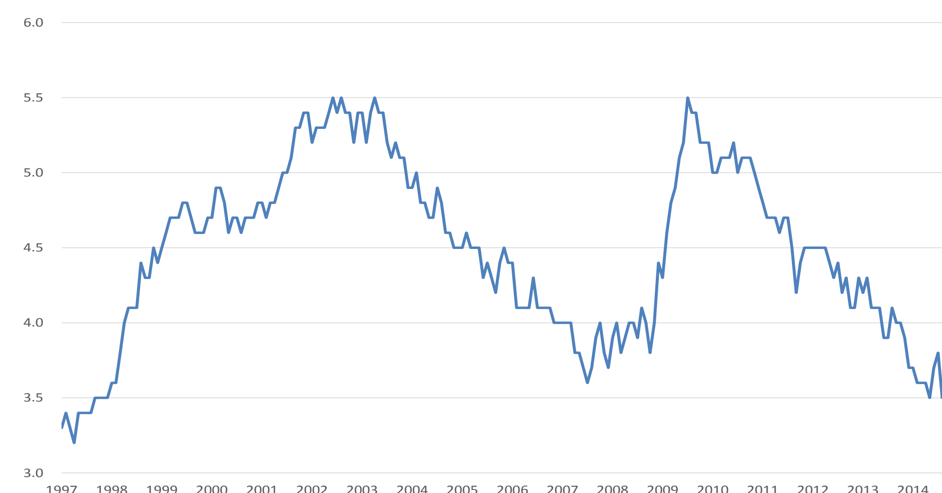
Meanwhile, the global environment remains uncertain, not least with the euro area economy looking increasingly as though it could emulate Japan's slide into deflation.

So the reinvigoration of Abenomics is good not only for Japan, but also for the global economy. ▪

Grant Lewis is Head of Research of Daiwa Capital Markets Europe Ltd.

Japan's labour market has benefited from Abenomics

Unemployment rate 1997-2014



Source: Statistics Bureau, Ministry of Internal Affairs and Communications

A golden age looms for Asia

Accident of history bolsters co-operation and self-belief

Kishore Mahbubani, Advisory Board

Asia will experience a new golden era of peace and prosperity over the next 10 years. This is not only a result of economics but also reflects a remarkable underlying political consensus drawing Asia together.

It is true that the export-led growth model of the past will no longer work for the major Asian economies. Hence, we are unlikely to see a return to double-digit growth. If leading economies, especially China, India and Indonesia, are able to maintain annual growth rates of around 7%, this will be a major achievement. Fortunately, this is within their reach. Three factors are driving this.

The first factor is an almost unbelievable accident of history. The three most populous Asian countries, China, India and Indonesia, have simultaneously put in place dynamic and reform-minded leaders who can be expected to transform their countries over the next decade.

Second, we have seen the consolidation of the 'Deng Xiaoping-Lee Kuan Yew consensus' on national development. Three important leaders meetings have just taken place in east Asia: Apec in Beijing, the East Asia Summit in Nyapyidaw and the Group of 20 in Brisbane.

Handshake breakthrough

Many new agreements were signed. There was also a breakthrough with a (unsmiling) handshake between President Xi Jinping of China and Japan's Prime Minister Shinzo Abe, laying to rest fears of a China-Japan war.

What was the key underlying factor that explains the success of these meetings? The simple answer is that, North Korea excepted, there is a remarkably wide and deep consensus among regional leaders that they should focus on modernisation and pragmatic development.

This explains why East Asia is functional while the Middle East remains dysfunctional. Our region has been infected by a silent, healthy virus of modernisation. Because it is silent, the western media has not noticed and continues to predict doom.

The third factor is the explosion of the Asian middle-class population from 500 million in 2010 to 1.75 billion in 2020. Multinational corporations have spotted this trend. Many are ahead of their governments and have stepped up their presence in the region. Singapore has the potential to be the biggest beneficiary of this big shift to Asia. Pessimistic western consumers will not drive global demand. Instead, optimistic Asian consumers will gradually pick up global demand. It would be foolish to pretend that all will be rosy in the region. Several geopolitical clouds will continue to affect the region. Five deserve mention. The most important geopolitical relationship is always between the world's No.1 power (now the US) and the emerging No.1, now China.

In theory, US-China relations should hit a new peak of rivalry in the next decade, because, this year, China will surpass the US and become the world's biggest economy in purchasing power parity terms. Curiously, the US-China relationship is stable. Indeed, there is even some sun showing through what should be the darkest geopolitical cloud, as demonstrated by the US-Chinese climate change agreement.

Dangerous relationship

The most dangerous relationship this year was that between China and Japan. Many feared that they would go to war. Instead, they shook hands.

If Abe can restrain his nationalistic tendencies and focus on firing economic arrows to jump-start Japan's economic growth, this troubled relationship can remain under control. Chinese leaders may have realised that China went overboard in browbeating Japan in recent years.

The most important future geopolitical relationship is between the world's next No.1 and No.2 economies, China and India. When Narendra Modi became prime minister of India, there was hope of a major breakthrough.

However, the border issue continues to bedevil this relationship. The world hopes Modi and Xi will wisely overcome this nagging issue.

Logically, Russia should have been drifting closer to Europe and the west to balance a rising China. Instead, the opposite has happened. The episodes in Ukraine have disrupted geopolitical logic. If western leaders were as pragmatic as Asian leaders, they would have found a compromise. Instead, the west went back to its usual self-righteousness and imposed sanctions.

This geopolitical loss by the west has been a gain for Asia, as seen by the $400bn Russia-China energy deal.

Finally, the Islamic State in Iraq and Syria emerged as a complete surprise. It would have been ignored if innocent westerners had not been killed. The decapitations forced the west, especially the US, to react. However, Isis does not pose a great global threat. It is an isolated tumour.

To understand how these five geopolitical clouds will affect Asia, observers should not rely on the dominant Anglo-Saxon media. Some of their editors are trapped in a narrow and often ideological Anglo-Saxon mental universe.

For example, the Anglo-Saxon media has been predicting the collapse of the Chinese Communist Party for almost 25 years. I predict that they will continue to do so in the next 10 years. There is a great global demand for an authoritative voice on Asia's resurgence.

When the British Empire reigned supreme, the Times of London served as the newspaper of record. When the American century began, the New York Times emerged as the newspaper of record. As the Asian century unfolds, the Straits Times is well poised to be the newspaper of record for the Asian century. Asean will have to play a critical role in the coming decade.

Few in the world have given Asean enough credit for the culture of musyawarah and mufakat ('consultation and consensus' in Bahasa Indonesia) developed in southeast Asia.

Asean has spread a similar culture to the rest of east and south Asia. This is why all the major regional powers, including the US and Russia, 'trust' Asean to provide a credible neutral platform to enable them to engage each other.

To play this leadership role credibly, Asean must retain its cohesion (and avoid incidents like the breakdown in the Asean consensus in Phnom Penh in July 2012) and ensure that the Asean Economic Community is a success. Asean countries must overcome their schizophrenic attitude towards Asean economic co-operation.

The only way to overcome this attitude is to use the force of reason. Any rational economic analysis will show that no Asean market, not even Indonesia's, is big enough to compete with China and India if they take off.

Asean companies need a bigger playing field if they are to become competitive. Hence, next year, led by Malaysia, Asean leaders must push economic co-operation to the next level.

To understand their own futures, the Asians must believe in themselves and develop new positive global narratives to supplement the dominant negative western narratives. ▪

Prof. Kishore Mahbubani, member of the OMFIF Advisory Board, is Dean of the Lee Kuan Yew School of Public Policy. This is an excerpt from his keynote address at the Straits Times Global Outlook Forum in Singapore on 21 November 2014.

Washington shapes the summits

Economic revival and global prestige are reassuring factors

Stewart Fleming, Advisory Board

Like puffed up sumo wrestlers, the US and China circled each other warily when their leaders faced off twice in November, first at a summit of the 21-member Asia Pacific Economic Co-operation forum in Beijing and then, just days later, at the Brisbane meeting of the G20 largest economies.

In the end it was the global priorities of a resurgent US, pivoting adroitly towards Asia, which shaped both summits, lending much-needed support to its troubled Japanese ally.

In Beijing, Japan's Shinzo Abe had to endure an uncomfortable two days. His nation shares a cultural affinity, a tortured history and, today, deep commercial ties with its restless neighbour to the west. But Japan spent much of Abe's first two years in office in China's equivalent of the diplomatic ice box.

Economic initiative

Tensions rose again late last year when Beijing ratcheted up maritime claims in the South and East China Seas and Japan turned to, and received, US support. Although at Apec's Beijing summit hairline cracks appeared in the ice as China's President Xi Jinping and Abe shook hands awkwardly in public before a private meeting, Abe had come to Beijing with a weak hand.

Just before the summit he had to tear up a key part of the economic platform on which he was elected and launch a new, even more aggressive, round of monetary easing before subsequently, as widely predicted, calling a snap election, a sure sign that the political tides are turning against him.

His latest economic initiative was not universally welcomed. William White, the former economic adviser to the Bank for International Settlements, is warning that it is unnecessary, even 'foolhardy.' Japan's economic performance has not been as dire as Abe seems to think or its critics claim, he says.

Worse, a policy of even looser money and currency devaluation could send already stirring inflation 'to very high levels' and trigger a vicious financial spiral.

The Apec summit's host, President Xi, has similar woes. The foundations underpinning China's economy badly need shoring up.

Not only is China's growth rate officially predicted to be down from the double digits of the past 30 years to single digits – perhaps 7.0% – this year, the outlook is uncertain. So, as soon as the summits were over President Xi, like Prime Minister Abe, was also forced to announce a sudden and unexpected shift in economic policy.

On 19 November China's state council disclosed further administrative steps to try and reduce high financing costs for business. The next day came a shock easing in the People's Bank of China's benchmark lending rate, described by economists at Nomura, the Japanese bank, as a 'step up in the intensity of monetary policy easing.'

The big picture here is that China is running into difficulties in its efforts to manufacture a safe landing for the economy by curbing a bloated property market, reining in reckless local authority spending, and trying to contain the explosion of 'shadow' banking that followed its massive 2010 economic stimulus programme. This is deeply worrying for China's ambitious leaders.

The fact that, in the past, they have succeeded in fine tuning the economy is no guarantee that they will be able to do it again, especially now that its structure is so much more complex and its excesses so extreme.

Only the agreement which Xi and US President Barack Obama were able to reach on climate change distinguished the Apec summit, and even this, in practice, committed neither country to steps that it would not have taken anyway.

At the G20 in Brisbane, however, with one very damaging exception, America's failure to fulfil its promise to help reform the International Monetary Fund, it is US diplomacy and US growth which are oiling the wheels of Pacific diplomacy, not China's assertion of its regional ambitions.

So, on international trade liberalisation, it is the American proposal, backed by Japan, the Trans-Pacific Partnership, which is making headway, rather than China's favoured, but distant, idea of a Free Trade Area of the Asia-Pacific.

The G20 communique was able to boast about the progress that its advanced economy-dominated Financial Stability Board is making in strengthening the global financial system. In reality, even in the trans-Atlantic region, progress here is limited. And it was not just on regional Pacific issues that Washington came out ahead. Russia and its leader, President Vladimir Putin, who has been actively stitching together closer commercial and geopolitical ties with China, was first justifiably mocked for turning up in Brisbane with a flotilla of warships in tow, and then brutally and publically rebuked.

Putin is a man who, worryingly, is showing increasing signs of authoritarian paranoia.

After a four hour, largely private, meeting with German Chancellor Angela Merkel – they speak each others' languages perfectly and need no translators – Merkel showed plain speaking.

Referring directly to Russia and its invasion of Ukraine she said, in a speech at Australia's prestigious Lowy Institute, that it would not be allowed to 'trample international law underfoot.' No matter how 'arduous' the process, aggression would not be allowed to prevail she insisted.

Putin left the G20 early, but only to return to a country whose economy is eroding under the cumulative pressures of structural stagnation, corruption, tumbling commodity prices and now Nato's American-led, and increasingly damaging, economic sanctions.

America's revival

Underpinning Washington's ability to occupy the high ground at the G20 and readily endorse its vague and unconvincing Brisbane Action Plan for growth is America's economic revival.

Alone among the trans-Atlantic allies, the US has now put the global financial crisis it triggered well behind it. It is well into a near two year long economic expansion.

The OECD, in its latest forecast, says US growth will accelerate from 2.2% this year to 3% in both 2015 and 2016. Managing its exit from its vast monetary stimulus without damaging global repercussions presents a daunting challenge, not least to Washington's international economic diplomacy.

But, as the US knows well, with growth, and now virtual energy independence, comes global prestige, and growing influence.

This is reassuring to Asian allies enduring times of challenge, including India and Japan. ▪

Stewart Fleming is a journalist and writer on international economics.

The new landscape of central banking

Large questions loom over capacity and accountability

John Nugée, OMFIF Director

Since the global financial crisis erupted, central banks in the developed world have faced similar challenges and employed similar policy responses.

Confronted with weak economic activity, malfunctioning and impaired banking systems and constrained fiscal policy, central banks have cut interest rates and expanded their balance sheets.

This period of uniformity is drawing to a close. As we look forward to 2015, it is likely that central bank actions will start to diverge quite markedly, as some begin to withdraw from their unconventional monetary policy (commonly called quantitative easing) while others are still at an earlier stage and not yet ready to do so. This will present market participants with some interesting issues as they negotiate the changing stances of the official sector.

The central bank furthest from ending QE is the Bank of Japan. Its balance sheet as a percentage of GDP is already the highest in the G7, and it is increasing its activity even further with net new purchases of assets expected to be around ¥80tn (around $730bn) a year, up from ¥60-70tn.

This will propel its balance sheet above 80% and perhaps even close to 100% of GDP, significantly more than any of the other major central banks (see Chart 1).

Government bonds

The European Central Bank, too, is far from normalising its policy stance. Its president Mario Draghi has publicly said he aims to increase the bank's balance sheet by up to €1tn. The big question for the ECB is whether this can be achieved without buying government bonds, and if not, whether a consensus can be reached to start a euro area-wide programme of such purchases.

The Federal Reserve and Bank of England preside over stronger economies and with very limited risk of deflation. Both have stopped their asset purchases (the Fed earlier this quarter and the Bank of England some time before that). Their balance sheets will shrink slowly as a proportion of GDP as their respective nominal GDP increases. The question for these two central banks is when and how fast to raise interest rates.

The market expects the Fed to move first, perhaps in the middle of the coming year – but market expectations have been wrong before (see Chart 2).The combination of two central banks looking to normalise interest rates while two press on with more QE will change market dynamics in more ways than one. The most direct response will most likely be from bond markets in the UK and US, where bond yields could move higher as official rate rises are anticipated.

But there could also be knock-on effects in equity markets (which may lose some of their relative attraction as bonds start to yield significantly positive real rates) and foreign exchange markets (which could see euro and yen weakness persist as the dollar and pound offer better yields). As a result, 2014's comparative calm in foreign exchange markets may not continue into 2015 (see Chart 3).

Uncharted territory

What continues to link the four central banks is that they are all still in uncertain and uncharted territory. The longer term effects of very large scale balance sheet expansion, both on the way markets work and the way central banks interact with them, are still far from clear.

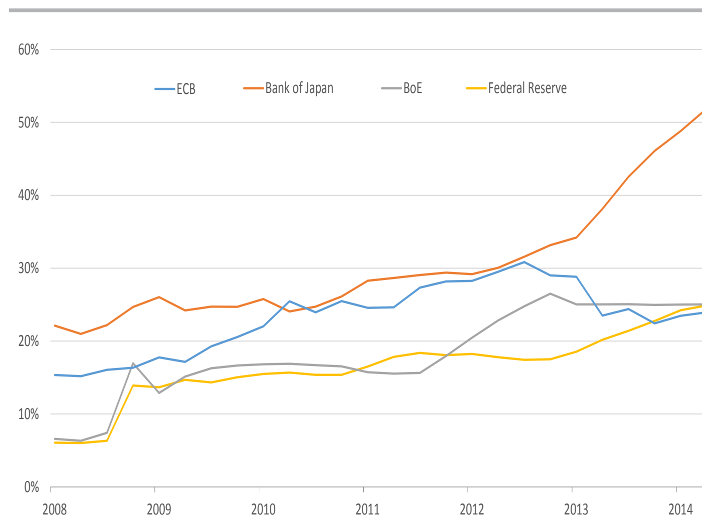
In many markets, the central bank has changed from being the lender of last resort to something more resembling the funder of first resort. How the private sector responds when the central banks withdraw will be crucial. Will the interbank market resume its former existence, or is it now too atrophied (and too beset with regulations and capital requirements) to return to full vitality?

All this is against a backdrop of central banks being asked to undertake far more of the work of restoring financial stability and strengthening financial systems than they expected or perhaps wanted.

There are certainly advantages of communication and coordination in having all of the authorities' financial forces – monetary, regulatory and supervisory – gathered under one roof and one command. But this concentration of power and duties at the central bank poses a number of questions.

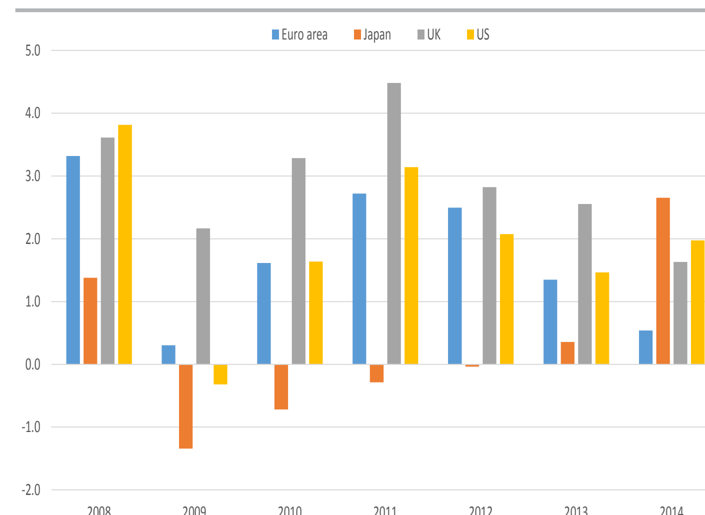
First, are governments employing central banks to ensure financial stability because they are the best institution available or simply because they are the easiest to press into service?

Chart 1: Central bank balance sheets, % of GDP



Source: Federal Reserve Economic Data - St. Louis Fed, ECB

Chart 2: Inflation rates 2008-2014, % change in CPI



Source: IMF World Economic Outlook, October 2014

Second, given that central banks have finite capacity, are governments sure that the extra tasks related to financial stability that central banks have been given are the optimal use of the institutions' capacity?

Third, since central banks did not find it entirely straightforward to manage policy when they had just one main instrument (interest rates) and one main target (low inflation), how will they cope across at least three instruments (interest rates, balance sheet size and macro-prudential tools) and perhaps as many as four or five targets (retail price inflation, asset price inflation, financial stability, functioning of the banking system and economic activity)?

Fourth, if the central bank is responsible for monetary and financial stability (and much else besides), how does it resolve conflicts of interests between its multiple duties?

Fifth, given that one of the central bank's most powerful assets is its reputation, is it optimal to put that at risk in so many new and difficult fields? One would not want mistakes in macroprudential regulation – a challenging field where much is untried – to undermine a central bank's reputation in the monetary or payment system spheres.

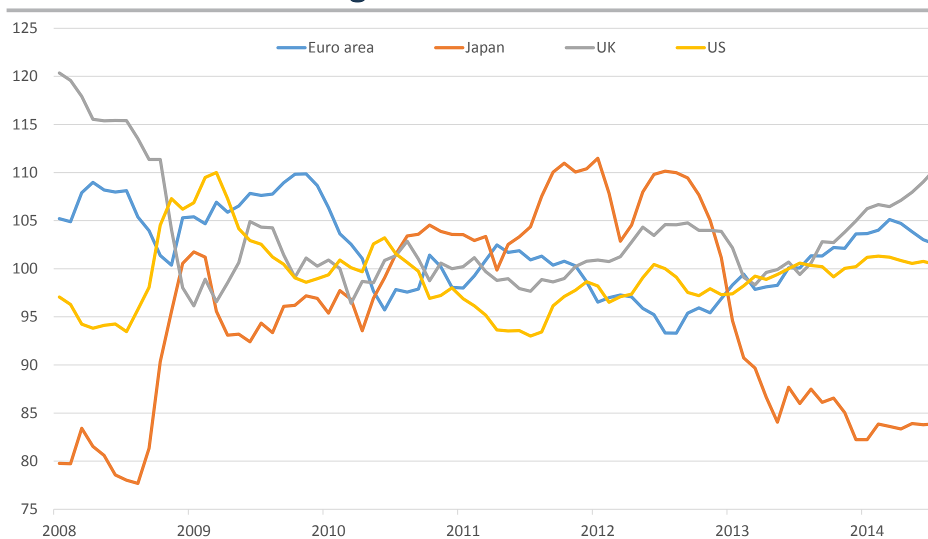
And finally, if a central bank is asked to do everything, what do the authorities do if it fails? It is this last question that haunts central bankers, not least those in Tokyo and Frankfurt.

The fear is that the authorities have put all their eggs in the one basket labelled 'central bank' and they have simply no plan for what to do if the central bank does not or cannot deliver.

As we look forward to 2015, the pressures on central banks remain considerable and are likely to diminish. 'Normality' is as far away as ever. For central banks the path to this destination remains highly uncertain. ▪

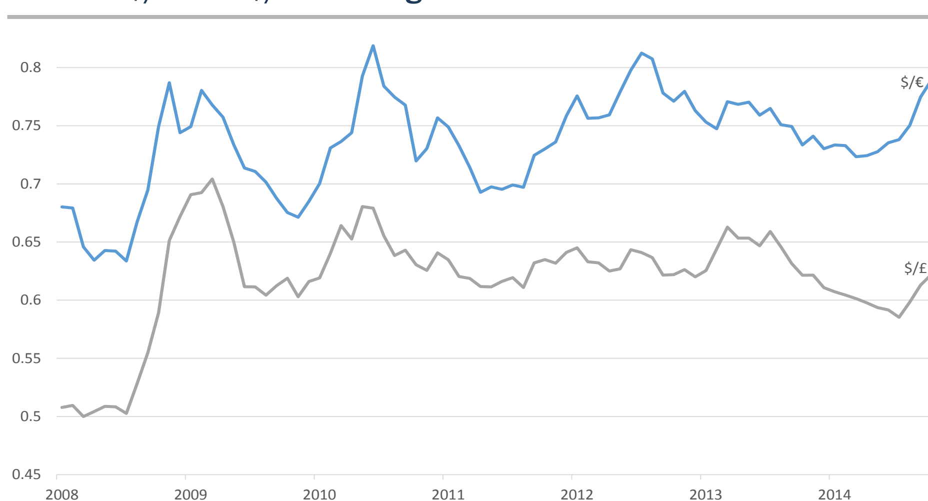
John Nugée is a Director of OMFIF and a former senior executive at the Bank of England and Hong Kong Monetary Authority. He is the author of Reflections on Global Finance: Selected Essays 2002-2013.

Chart 3: Effective exchange rates



Source: Bank for International Settlements. The BIS effective exchange rate (EER) indices covers 61 economies. The weights are based on trade in 2008-10 and the indices' base year is 2010.

Chart 4: \$/€ and \$/£ exchange rate Jan 2008 - Oct 14



Source: Oanda

SOVEREIGN NOTES

Public private partnerships in infrastructure went through a jittery stage in the global financial crisis, but this is stabilising now. Given its high dependence on debt, many banks were forced to exit the asset class following Basel III and other regulatory measures.

This enabled sovereign funds to shop for infrastructure assets sensitive to the state, in a more politically acceptable fashion.

Europe has a pipeline of good quality PPPs available and non-traditional lenders with high levels of liquidity are piling in.

The High Speed 2 railway infrastructure project advocated by British Prime Minister David Cameron, drew bids and interest from many global public investors.

However even some of the more experienced sovereign funds struggle in securing greenfield projects.

This is due to limited experience in ground-up construction of assets, as opposed to cosmetic changes to existing brownfield projects they have participated in historically.

High market liquidity is stoking excess demand as more GPIs jostle for the same projects.

In the real estate asset class, especially in European cities like London, Paris and Frankfurt, this had a negative impact, driving up property prices as GPIs outbid each other. Not so in infrastructure which involves close supervision from government.

A big theme for sovereign funds has been co-investment, particularly in infrastructure projects which require long term stable capital. This mantra is now repeated with more mature sovereign funds.

The more experienced GPIs are benchmarking themselves against peers in terms of resources and asset allocation.

But this process is impossible with less experienced funds. There is continued divergence between these two groups of GPIs.

The less experienced funds need to focus on the Santiago principles which got new support in the sovereign funds meeting in Doha on 19-20 November, encourage solid structures, good governance and efficient investment processes. ▪

Pooma Kimis is Director of Markets and Institutions of OMFIF.

Independence lost is hard to regain

Central banks facing trial of policy and confidence

William White, Chairman, Economic Development and Review Committee, OECD

Since the beginning of the global economic and financial crisis in 2007, expansionary policies by central banks have been 'the only game in town'. Fiscal and regulatory policies have generally been pulling in the opposite direction.

This sense, that central banks are no longer capable of choosing their own monetary policies 'independently', has raised concerns in some quarters. These concerns have been exacerbated by the recognition that central banks are being drawn ever further into the pursuit of financial stability, diluting their earlier focus on price stability. Longer term investors are wise to be concerned but they must keep the issue in perspective.

Central bank 'independence' is a very recent phenomenon. The term first came to be used in post-second world war Germany and some other central European countries.

After the hyperinflation following the first world war, and the very serious inflationary experience after the second world war, it seemed important to establish an institutional bulwark against this ever happening again.

Elsewhere in advanced market economies, the post-war period was characterised more by the domination of central banks by their respective Treasuries. This was certainly the case in the US and the UK, a punishment for what many felt was the contribution of central bank errors to the Great Depression.

Cult of 'independence'

As the analytical model shifted towards a belief in a self adjusting economy and efficient financial markets, central banks began again to assert some autonomy. It took the inflationary experience of the 1970's to foster (albeit somewhat later) the cult of independence in the central banks of the major countries.

Given a mandate of price stability, these institutions would ensure that the costs of high inflation, not least the painful need to reduce it eventually, was never again repeated. Nor has the appetite for central bank independence been global in scope.

While many emerging market economies have inflation targeting regimes and are independent in principle, in practice many of them still work very closely with their respective Treasuries. Indeed, in many countries, not least China, the core decisions about monetary and financial matters are still taken by the government. One important reason for this, as international capital flows have increased substantially, is that a country can have an 'independent' or autonomous monetary policy only if it is willing to let its exchange rate float quite freely.

In many countries, governments are unwilling to let this happen. Many have export orientated growth strategies and worry about a loss of competitiveness. Others are worried about momentum trading and large and disruptive exchange rate movements.

Faced with monetary expansion in the major advanced economies, many emerging market economies have countered currency appreciation by foreign exchange rate intervention and easier monetary policies. This is hardly 'independence'.

The term 'independence' itself bears closer scrutiny. Central banks, like all government institutions in democracies, need to be governed by three things; their mandate, their assigned powers, and their need to be accountable for meeting their mandate.

The mandate of central banks has in recent years been focused more on price stability, but the mandate of many of them is formally much broader than that. There are a wide variety of procedures for governments setting the mandate.

The European Central Bank is essentially unique in doing this itself. There are a wide variety of procedures to hold central banks accountable to governments for what they do.

In fact, there now seems general agreement that what people really mean by independence is the capacity of central banks to use the policy instruments under their control without any political influences. This might seem limited but it remains of great value.

Perhaps the greatest contribution that can be made by central banks is to have a longer term policy perspective than many governments, politicians and even electorates. Thus, they must avoid following polices that have short-term benefits that are more than offset by longer term costs.

In the lead up to the global crisis that began in 2007, the longer term cost to be avoided was generally that of the instability of the price level.

Both significant inflation and deflation were thought costly, though Europeans tended to be more worried about the former and North Americans more about the latter.

Since the crisis broke, there has been a greater willingness to admit that expansionary monetary policies can also have other longer term costs.

Price stability is not a panacea. By encouraging monetary and credit expansion, easy monetary policies can encourage the accumulation of debt to levels that prove to be unsustainable.

Ironically, as this perception has been sinking in, central banks everywhere have been following similar policies to those that led to the crisis in the first place.

Today the combined level of debt owed by the government, corporate and household sectors in the G20 is now 20 percentage points of GDP higher than it was in 2007. Similarly, although some deleveraging has taken place, leverage in the financial sector remains very high by historical standards.

Threats and implications

What are the threats to what remains of central bank 'independence'? Looking first at the recent past, central banks have, in the process of crisis management, engaged in operations that could threaten their capital adequacy. In particular, the purchase of assets or the acceptance of collateral whose value could fall over time might force central banks to recognise losses.

Strictly speaking, a central bank could continue to carry out its normal functions without capital, since it is the ultimate provider of the domestic means of payment. In the event of serious losses, central banks could suffer a reputational blow that could have much broader implications for public confidence.

Were recapitalisation by the government to be necessary, it is also hard to imagine that certain conditions would not be imposed on how central banks behaved in the future.

Many of the actions carried out by central banks in the recent past have also had distributional implications. Some issuers of liabilities have benefited from central bank purchases while others have not. Some firms have been deemed solvent, others not.

Perhaps most important, the broad stance of monetary policy has had important implications for income distribution. Not least, debtors have benefited at the expense of creditors, an issue that is receiving increasing public attention.

Since distributional issues are quintessentially political, all of this implies that central banks and governments have already begun to work

more closely together. Some central bank 'independence' has already been lost and history suggests that, once lost, it will be hard to get it back again.

Looking forward to a time when the current crisis has been resolved, it now seems generally accepted that some policy response will be required to restrain the growth of imbalances that could potentially lead to future crises. Both monetary policy and regulatory measures (so called macroprudential policies) would seem to have a role to play.

However, monetary policy tools and macroprudential tools each affect both aggregate demand and systemic stability. They do not then satisfy the assumptions required to allow the allocation of one instrument (in pursuit of price stability) to the central bank and the other instruments (in pursuit of systemic financial stability) to some other agency.

Regardless of agreements on 'who does what', there will also have to be communication to agree on what needs to be done, how it should be done, when it should be done etc. In this way 'independence' will be still further constrained.

The preceding paragraph looked forward to a time when the current crisis has been resolved. However, it has not been resolved. This constitutes the greatest threat to central bank 'independence'. If easy monetary conditions lead to still more debt accumulation then an unsustainable and deflationary dynamic process is set in motion.

Headwinds of debt

The headwinds of debt lead to slower growth, but slower growth leads to more debt accumulation and still more headwinds.

Associated misallocations of both real and financial resources contribute to reducing the level and perhaps even the growth rate of potential output. Clear signs of this process are already evident, not least very slow growth and growing concerns about deflation. On the one hand, the unsustainability of this monetary process could be admitted and governments could take alternative steps to restore sustainable growth. These would include both supply side and demand side measures to raise growth, but explicit measures to restructure and write off unsustainable debts. Evidently, recognising losses would hurt creditors, but perhaps less than not recognising them. On the other hand, and more likely, governments will turn to some combination of financial repression and inflation to reduce the real burden of debt service.

This could well work smoothly, again to the significant cost of creditors, as it did in many countries after the second world war.

However, the process need not be smooth. Governments with both big deficits (say due to slow growth) and big debts need to borrow but could find lenders increasingly unwilling to lend. In these circumstances, direct financing of the government by the central bank would be inevitable and potentially highly inflationary.

Economic history provides examples of such processes, including cases where deflation was quickly transformed into inflation. In such circumstances central bank 'independence', however defined, is simply swept aside. ▪

William White is Chairman of the Economic & Development Review Committee at the OECD and former Economic Adviser, Bank for International Settlements.

Questioning the bail-in mechanism: Strengthening bank capital should be the focus

Banking union is a major step forward in the design of European financial integration ***write Harald Benink and Clas Wihlborg.***

The first pillar, single supervision, became a reality on 4 November with the European Central Bank firmly at the helm of the single supervisory mechanism. The second pillar, the single resolution mechanism, is a valuable effort to solve the problems of too big and too interconnected to fail and cross-border crisis management in the euro area.

We regard the SRM as work in progress, since we have serious doubts about the credibility and effectiveness of this mechanism.

Instead of expecting too much from the implementation of the SRM, we recommend that regulators and supervisors, including the Financial Stability Board, whose proposals for global systemically important banks to hold additional total loss-absorbing capacity were endorsed by the G20 leaders at their summit in Brisbane in November, should focus more on strengthening bank core capital ratios.

The ultimate success of the SRM requires that its procedures establish credibility with respect to implementation of the bail-in mechanism, predictability of bail-in (priority) rules for creditors, public acceptance of these rules, and prevention of contagion from a bank's failure.

Fear of contagion and lack of public acceptance would undermine the credibility and thus ultimately also the effectiveness of the SRM.

During a systemic crisis there may be fears that the resolution of a large bank or several smaller banks will exacerbate the crisis.

The European Regulation dealing with the SRM explicitly states that a bank is only resolvable if any significant adverse consequences for financial systems of the member state in which the entity is situated can be avoided 'to the maximum extent possible' when resolution powers are exercised.

The adverse consequences include circumstances of broader financial instability or system-wide events. There are good reasons for such a systemic crisis exemption, but we are concerned that this exemption can be used to avoid resolution of a large bank even if there is in fact no clear systemic threat. Moreover, authorities can delay resolution by, for example, practising forbearance with respect to valuation of assets or by recapitalising a bank as a precaution. The SRM regulation explicitly states that extraordinary public financial support should not automatically trigger resolution in a situation when a bank complies with capital requirements but, nevertheless, requires recapitalisation that it is unable to obtain privately in markets.

An additional concern is that clauses in the SRM regulation open the door for subjective interpretation and, thereby, reduce the predictability of the values of claims on banks. For instance, it is stated that in exceptional circumstances, where the bail-in tool is applied, certain liabilities may be excluded or partially excluded from application of the write-down or conversion powers.

The issues we have raised with respect to the credibility and effectiveness of the bail-in mechanism implies that unexpected losses may be not be absorbed by unsecured debt holders as envisaged under the SRM and the Financial Stability Board's proposal of total loss-absorbing capacity.

Lack of credibility implies continued implicit subsidisation of banks' creditors and lack of market discipline on banks. As a result, the need for relatively high core capital buffers remains strong.

Following previous recommendations by the European Shadow Financial Regulatory Committee, we advocate a minimum tier 1 capital requirement (leverage ratio) of at least 10%.

This non-risk weighted capital requirement may consist of at least 5% common equity while the remaining 5% may take the form of additional tier 1 capital instruments such as contingent convertible bonds which automatically convert into equity when the financial position of the bank deteriorates.

The 10% leverage ratio could be implemented gradually during a transitional phase of five to seven years. ▪

Harald Benink is professor of banking and finance at Tilburg University in the Netherlands. Clas Wihlborg is Fletcher Jones Professor of International Business at Chapman University in California. They are also, respectively, chairman and member of the European Shadow Financial Regulatory Committee, a group of professors from 10 European countries, which regularly issue policy statements on current issues in financial regulation and supervision.

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Population trends and sovereign funds

Why demographic change should take centre stage

Gary Smith, Baring Asset Management

The International Forum of Sovereign Wealth Funds has enlarged its size and scope, with ever-growing impetus given to the implementation of the Santiago principles covering funds governance. The initial idea for a regular meeting of sovereign funds dates back to 2008. The IFSWF, which held its sixth annual meeting in Doha on 19-20 November, is the current vehicle for facilitating these meetings.

An initial primary objective of the group was to counter protectionist sentiment in the west. Before the global financial crisis there were concerns that state-owned foreign investors might not always have the best interests of host nations at heart. The Santiago principles and the establishment of a club of funds that has now become the IFSWF represented the response.

The global financial crisis changed the economic landscape. Previously reticent host destinations became more welcoming. However, the sovereign funds agreed to continue to meet, and the IFSWF meetings are a legacy of the 2008 decision.

Fundamental shift

The original purpose of the grouping has undergone a fundamental shift, and the make-up has expanded. The forum has grown from a group representing 27 nations (the original 24 signatures to the Santiago principles plus three observers) to one of 37 nations in Doha. However there are strong elements of continuity, represented by the Santiago principles.

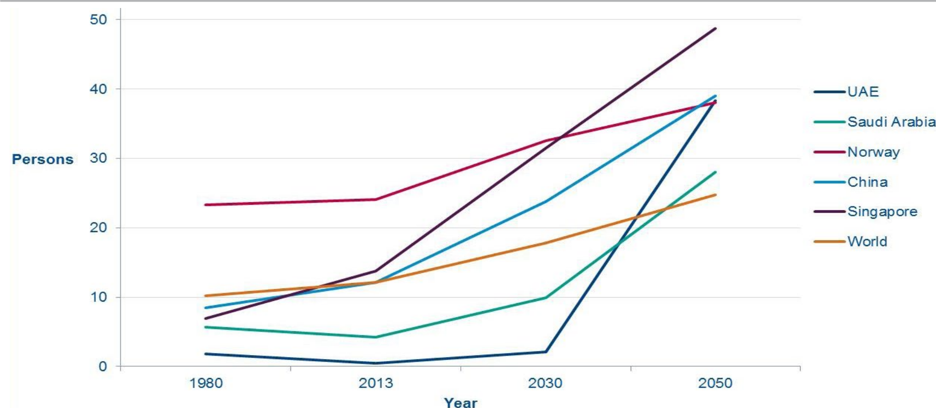
Recent new members of the wider community include sovereign funds from Cyprus, Nigeria, Angola, and Italy. According to the IFSWF, there are 82 sovereign funds in the world, and a further 21 are at the planning stage.

For many nations, especially those from the developing world, joining a high profile organisation that is not run by the traditional western powers may well have attractions.

However, this proliferation of new sovereign funds is a challenge. Formulating an appropriate and relevant agenda for a club that is adding new members representing an increasingly diverse range of nations is a difficult task. Perhaps this one reason why one of the largest sovereign funds in the world, Norges Bank Investment Management, was a high-profile absentee from the Doha meeting.

How ageing populations exert differing effects around the world

Dependency ratio (per 100 working-age persons)



Source: UN Department of Economic and Social Affairs

The IFSWF may be of more use to sovereign funds from smaller nations and aspirant members, which benefit from peer-to-peer discussions, sharing investment experiences, and exploring co-investment opportunities.

This point on diversity is important. In general sovereign funds do not have clearly defined liabilities. They may have long dated obligations, but this is not quite the same thing. This example of NBIM is a good one. Despite being referred to as a pension fund, it does not have measurable pension liabilities in the conventional (corporate pension fund) sense. However, it is clear that the primary purpose of the Norwegian fund is to provide for future generations, in line with the explicit or implicit commitment of most sovereign funds.

The implicit liability profile of most sovereign funds will (or should) be influenced by demographics. Indeed for most nations the single biggest future spending liability is likely to be determined by the costs associated with ageing. And national population pyramids vary enormously for the nations with sovereign funds. These differences require different investment strategies.

The Chart shows the predicted evolution of old age dependency ratios for a variety of nations with sovereign funds, and for the world as a whole.

The ratio shows the increasing burden that an ageing population will present. The number illustrates how many old people are supported by 100 of working age.

The line representing the world economy shows that in 1980, 100 workers supported 10 elderly people. That dependency ratio rises to around 12 in 2013, 18 in 2030, and 25 in 2050.

Diversity of experience

The diversity of expected national experience is striking. In the countries shown in the chart, the dependency ratio in 1980 was below the world average, but it is now rising quickly and will top the world average in 2050.

The wide disparities in dependency ratios between 2013 and 2030 are eye catching, a period of approximately one generation. In 2030 the old age dependency ratio for the UAE is forecast to be around 2, compared to 24 in China, 32 in Singapore, and 33 in Norway. Saudi Arabia, by contrast, has a ratio of 10 for 2030.

These differences in dependency ratios point to different implicit liability profiles. This should be a powerful factor driving differing long-term asset allocation preferences.

The Doha meeting did not have issues of this nature on the agenda. Arguably, population ageing, evolving liabilities, and consequent asset allocation analysis should be centre stage when sovereign funds gather. To maintain relevance the IFSWF should put demographics at the heart of its discussions. ■

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Fed officials debate inflation impact

Some see danger in prolonged undershooting of target

Darrell Delamaide, US Editor

Federal Reserve policy-makers continued to debate the prospects for inflation in the US and what that should mean for the move to finally lift interest rates, now widely expected to come in the middle of next year.

Members of the Federal Open Market Committee believe the sharp decline in energy prices will further dampen inflation, according to the minutes of the October meeting released in November.

'Participants anticipated that inflation would be held down over the near term by the decline in energy prices and other factors, but would move toward the Committee's 2% goal in coming years,' the minutes recorded, 'although a few expressed concern that inflation might persist below the Committee's objective for quite some time.'

This is precisely the sticking point for some policy-makers. Minneapolis Fed chief **Narayana Kocherlakota (voter)** dissented from the FOMC statement in October because of continued low inflation (running at about 1.4%) and the 'slide in market-based measures of longer-term inflation expectations.'

He reiterated his concerns in a pair of speeches in November, complaining that the Fed does not set a time frame for achieving its inflation objectives.

'Right now, although the FOMC has a 2% inflation objective over the long run, it has not specified any time frame for achieving that objective,' he said in a speech in Eau Claire, Wisconsin. 'This lack of specificity suggests that appropriate monetary policy might engender inflation that is far from the 2% target for years at a time and thereby creates undue inflation (and related employment) uncertainty.'

He hinted that he may dissent again at the December meeting if there is no clarification about inflation prospects.

Using similar language about the need for the Fed to be 'symmetric' in its approach to inflation – that is, to be as concerned about combating low inflation as it is with high inflation – Boston Fed president **Eric Rosengren (non-voter)** outlined the risks of too-low inflation in a speech at Washington and Lee University in Lexington, Virginia.

'When the starting point is very low inflation, an unexpected weakening of the economy could push inflation down even further, into a situation of outright deflation,' Rosengren said. 'When households and firms expect that prices in the future will be lower than they are at present, they tend to postpone expenditures, awaiting the lower prices.

Historically, under such circumstances, economic activity has tended to remain depressed.' Also, he said, too-low inflation restricts interest rate policy, forcing central banks to keep rates close to zero, which also has costs to the economy.

Consistently undershooting the target, as central banks worldwide have done, erodes the credibility of monetary policy, Rosengren said. 'Confidence that a central bank can achieve its goals helps to keep expectations well anchored,' he said. 'Failure to achieve these goals can cause expectations about inflation to become unstable.'

Concerns about inflation

Other FOMC members feel that inflation is not worrying enough to delay an increase in interest rates. St. Louis Fed chief **James Bullard (non-voter)**, who was among the first last year to express concern about inflation, more recently has advocated action on interest rates, as soon end-March.

'While a low inflation rate may suggest a somewhat lower-than-normal policy rate, that effect is not large enough to justify remaining at the zero lower bound,' he said at a presentation to a business group in St. Louis.

Philadelphia Fed president **Charles Plosser (voter)** has repeatedly called for rate increases regardless of the low inflation rate, given that inflation expectations seem well anchored. He warned in a London speech that failure to act in a timely fashion could lead to more disruptive action later.

'I would prefer that we start to raise rates sooner rather than later,' he said. 'This may allow us to increase rates more gradually as the data improve rather than face the prospect of a more abrupt increase in rates to catch up with market forces, which could be the outcome of a prolonged delay in our willingness to act.'

Plosser is a voter this year and welcomed the end of monetary stimulus when the Fed ended its programme of asset purchases in October. However, he has announced his retirement for March, and the question of his replacement and that of Dallas Fed chief **Richard Fisher (voter)**, who is also retiring, were the object of an unusual protest by community groups seeking wider input on the choice of regional bank presidents.

These groups, led by the Center for Popular Democracy, maintain that the macroeconomic data on economic recovery and joblessness belie a situation where many people are still unable to find work and wages have stagnated or declined to the point that even those with jobs have trouble making ends meet. They argued for wider community input in the choice of policy-makers.

Fed chairman **Janet Yellen (voter)** and other members of the Board of Governors met with about 30 of these protesters to discuss their concerns. The regional bank presidents are selected by the non-bank directors of each regional Fed bank, with final approval from the Board in Washington.

The Fed also came under criticism from Congress as law-makers took the New York Fed to task for what they see as repeated failures in regulating Wall Street banks.

A Senate staff report said the Fed has been slow in responding to the risks in increased bank involvement in physical commodities, even though it had acknowledged the problem.

Meanwhile, the Senate Banking Committee grilled New York Fed chief **William Dudley (voter)** in a contentious hearing where at least one senator, Democrat Elizabeth Warren of Massachusetts, suggested the former Goldman Sachs managing director might not be the right person for the job.

This verdict came as Dudley argued that the Fed as regulator should not be seen as the 'cop on the beat' watching out for criminal or unethical behaviour, but more as a fire warden, seeking to make sure buildings were up to code and weren't going to burn down.

After several reports, including secret recordings of bank examiners, suggested that Fed regulators might be too cosy with the banks and that they were incentivised not to rock the boat, the Fed announced two separate reviews of its regulatory procedures to make sure that examiner concerns were not stifled. ▪

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

Juggling Europe's energy governance

Relations with Russia and Ukraine are crucial

Ruud Lubbers and Paul van Seters

The European Council concluded a year-long process of deliberation about the 2030 climate and energy policy framework at its most recent meeting on 23 October. The official conclusions of the Council run into 10 pages and refer to a long list of intricate issues.

It is only at the end of these conclusions, in the very last sentence, that the Council reminds us of the fact that all the new climate and energy decisions taken together amount to the long-awaited European energy union.

Now what is this new energy union going to do? Most reports in the media focused on a planned 40% reduction in greenhouse gas emissions; a 27% increase in renewable energy; and a 27% rise in energy efficiency.

Among commentators, there was much ado about these figures being only 'indicative targets'. But we think these figures within a few years will be outdated.

Emissions trading

What then is noteworthy about the energy union? The Council introduces a number of measures to reform the emissions trading system and make this into the most important European instrument to achieve the 40% target. However, the Council fails to state explicitly that ETS can function as intended only if the price of CO_2 goes up from the current €5 per tonne to at least €40; the sooner the better, we think.

The most remarkable feature of the energy union is its governance system. The central role is for national climate plans and national plans for renewable energy and energy efficiency. This is to allow the 28 member states the 'necessary flexibility' and to respect 'their freedom to determine their energy mix.'

The primary role for the Commission is to coordinate these national plans and to foster regional co-operation between member states. The obvious risk such a governance system runs is that we end up with 28 separate climate and energy plans instead of an energy union.

This risk is aggravated by the role the Council envisions for itself: 'The European Council will keep all the elements of the framework under review and will continue to give strategic orientations as appropriate, notably with respect to consensus on ETS, non-ETS, interconnections and energy efficiency.'

Four years ago Notre Europe, Jacques Delors' think tank, published a report with a strong recommendation: create a European energy community. The report argued that this was necessary because EU climate and energy policy had become fragmented. 'A Bridge to 2025', a recent report by the Agency for the Co-operation of Energy Regulators, confirms this dire state of affairs.

The Council emphasises that the EU should play a key role in the negotiations that have to lead to a global climate deal at the UN climate conference in December 2015 in Paris.

But that seems to require a much more assertive EU role then is suggested by this decentralised and loose governance system.

The big question remains of how the energy union will cope with this inherent weakness.

In the meantime the US and China surprised the world by taking the lead in the process to Paris. After the failure of Copenhagen 2009, one can understand why the EU this time chose a strategy of wait and see. But, given the urgency of the climate change problem, this is too risky. The EU needs a strong energy union now. The next meeting of the European Council is on 18 December. This meeting will be attended by Jean-Claude Juncker, the new Commission president, and will be chaired by Donald Tusk, the new Council president. Both Juncker and Tusk have indicated that a strong energy union is a top priority. On 30 October, on his last working day as Commission president, José Manuel Barroso announced a gas deal between the EU, Ukraine and Russia. While the war in eastern Ukraine has continued since then, this deal does offer a window of opportunity – but only for six months.

Healthy relationship

So the energy union has to act fast well before the climate conference in Paris if it wishes to contribute to a healthy relationship between Kiev and Brussels, and to strike an energy accord with Moscow. To act fast effectively means to accept a Russian Crimea as a fact of life, comparable to the American naval station of Guantanamo Bay in Cuba, or the British overseas territory of Gibraltar adjoining Spain.

A Russian Crimea could be part of a federal republic of Ukraine. That sovereign Ukraine will not become a member of the EU or of Nato, but it should be allowed to associate with the European energy union. ▪

Ruud Lubbers is a former Netherlands Prime Minister and Paul van Seters is Professor at Tilburg University.

Donald Tusk and Jean-Claude Juncker will have to work hand-in-hand.

GPIF selling bonds and doubling equity

New policy mix for the world's largest public pension fund

William Baunton, Economist

Japan's Government Pension Investment Fund has moved to catch up its lag with the global public pension fund industry by deciding dramatically to increase its equity holdings and reduce its bond portfolio.

The $1.3tn global public investor, the biggest publicly-owned pension fund and the world's third largest sovereign investor (after the People's Bank of China and Bank of Japan/Japanese Ministry of Finance) is set to double its holdings of equities from the current target allocation of 24% to 50% (split equally between Japanese and foreign stocks), while reducing its domestic bond allocation from 60% to 35%.

Yasuhiro Yonezawa, head of GPIF's investment committee, confirmed that GPIF had even begun selling Japanese government bonds before the official announcement of the new policy, and would continue doing so to reach the new allocation.

The move puts GPIF more in line with the strategies of its international counterparts.

The $300bn California Public Employees Retirement System (CalPERS), the world's fifth largest public pension fund, is widely watched by the pension fund industry, holds 52.5% in equities, with the remainder in fixed income and alternatives (see Chart 1).

CalPERS announced in September it was eliminating its $4bn position in hedge funds, a possible market-leading move. CalPERS achieved total net investment returns in 2013-14 of 18.4%, outstripping GPIF's 8.6% and Norges Bank Investment Management's 16.0%. As noted in the October edition of The Bulletin, NBIM is one of the most important benchmarks among global public investors with $880bn of assets under management (projected to reach $1tn in the next five years) and owner on average of 1.3% of the world's stocks.

NBIM holds 60% in equities, 35-40% in fixed income and the remainder in real estate. NBIM has, on average, over the last 10 years achieved returns of 6.5% while GPIF achieved only 3.2%.

GPIF needs to achieve higher rates of real return. In view of Japan's ageing population and low birth rate, relying solely on the current working population is not possible.

Higher returns must come from equities as the emphasis hitherto on government bonds with historically low yields, is restricting potential returns.

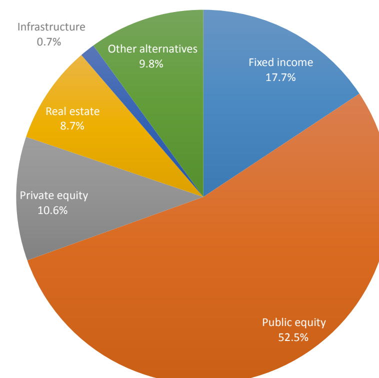
Significant shifts

The new asset allocation policy will trigger significant shifts, with roughly $200bn moving from the fixed income to the equity portfolios. Some of the world's largest fixed income asset managers, currently mandated by GPIF, are set to lose out, such as Pimco, Prudential Investment Management and ManuLife.

Overall shifts could grow further, with other public pension funds in Japan, such as the Pension Fund Association for Local Government Officials, with $170bn in assets, expected to follow GPIF's lead.

Alternative investments will also be made 'in accordance with development of a dedicated team' which will include infrastructure, private equity and real estate.

Chart 1: CalPERS asset allocation



Source: CalPERS (30 Sep 2014)

These investments will be assigned to the equity or fixed income allocations based on their risk and return profile, perhaps to outmanoeuvre legislation.

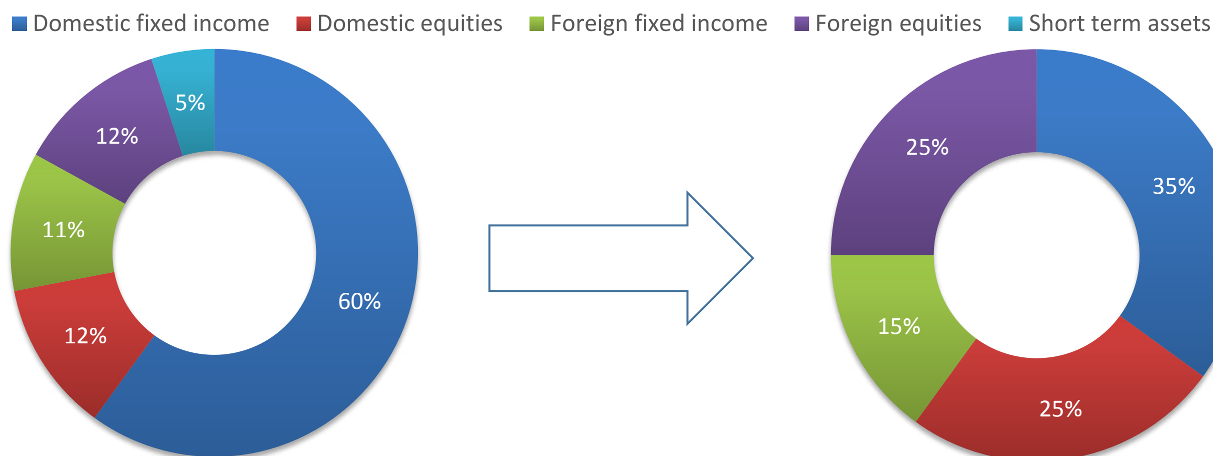
There are also expectations of changes to the corporate governance and decision-making structure of GPIF, thought to be based off the Bank of Japan's policy board.

In line with moves to change corporate governance in Japan, GPIF will reduce passive equity investments in its new portfolio structure, such as funds which track the Topix index.

The fund will be moving into indexes, such as JPX-Nikkei 400, to encourage investments in stocks with high return on equity to use the market to change corporate governance.

The government has asked the Tokyo stock exchange and Financial Services Agency to create a 'corporate governance code' for listed companies to start next year. ▪

Chart 2: GPIF's new asset mix policy – starting April 2015



Source: Government Pension Investment Fund (GPIF)

The A-share market and foreign investors

Accessing the Chinese domestic growth story

The long awaited Shanghai-Hong Kong Stock Connect opened for business on 17 November and showed early positive signs, quickly reaching the $2bn quota of A-shares just after lunch.

However, the Shanghai Composite Index had fallen 0.2% by close, and in the following days demand from foreign investors slumped.

On 19 November, just two days after opening, only 20.1% of the daily quota was used by foreign investors (northbound trade) and Chinese investors used a paltry 2.4% of theirs (southbound trade).

A-shares, the renminbi-denominated stocks of companies incorporated in China, are the largest share class listed on the Shanghai and Shenzhen exchanges, and are available only to domestic Chinese investors at present.

Foreigners have been able to purchase B-shares, with inferior voting rights and denominated in foreign currencies.

The Shanghai-Hong Kong Stock Connect allows easier access to mainland shares and removes the need for a licence, such as the Qualified Foreign Institutional Investor designation.

The Stock Connect was heralded by many as the biggest step so far towards China opening up its markets to foreign investors, with Charles Li, chief executive of Hong Kong Exchanges and Clearing, claiming it was 'the beginning of a new era'.

Capturing growth

A-shares are crucial for accessing and capturing growth in China, one of the largest, most liquid equity markets in the world.

China contributes 12% of the world's GDP, but only accounts for a small proportion of world equity (2% of Morgan Stanley Capital International's world equity index).

Li has since said the scheme has been 'hyped' by brokers and the investment community. He was quoted by the Financial Times saying 'This is a bridge, it's going to be here for years. There is really no fundamental rush. Some of the hype needs to find a way to digest itself out.'

There were many questions surrounding the scheme and whether foreign investors will be enticed to participate straight away before it began. Many were taken by surprise with only a week's notice given for the start of the scheme after the original launch was delayed and tax issues were reportedly only resolved the Friday before it opened.

Low reporting standards and dubious corporate governance in mainland China continue to be an issue, adding to the risks associated with asymmetric information in the market.

Fears that the Chinese economy will experience a 'hard landing', with growth slowing and credit bubbles, are another factor.

In the first week of the Stock Connect being open, the Shanghai Composite Index for example fell during the week (see Chart), as did trading volumes.

The markets' only saving grace was the People's Bank of China's decision to cut interest rates on the Friday to 5.6%, helping the index close on the Friday above just above its closing level on the Monday.

The question is whether, as Li said, investors are hesitating from entering the market because they know it is now durable and they are taking their time – or whether they are holding back because they are not convinced by the market and its constituent. ■

Three month performance of Shanghai Composite Index

Source: Shanghai Stock Exchange (SSE). Grey area denotes first week of Stock Connect (17-21 Nov).

China, Japan rivalry tests Obama

Moscow's weakness creates opening for Beijing

Jonathan Fenby, Advisory Board

The handshake told the story. Japan's Prime Minister Shinzo Abe, visiting Beijing for the annual 21-nation Asia-Pacific Economic Co-operation summit in November, met Chinese President Xi Jinping for the first time against the backdrop of the confrontation between the two nations over the Senkaku/Diaoyu islands.

Xi, who used the summit to bolster his position as a global figure, was in no hurry and ignored his guest's attempts at small talk. The handshake was at arms' length with none of the usual smiles for the cameras.

Crisis management mechanism

There was the positive news that the two countries had agreed to set up a crisis management mechanism for the dispute, designed to prevent an accidental brush between their naval or air forces escalating into something more serious.

Despite this, the governments of the world's second and third largest economies remain far from settling their dispute, which is nominally over sovereignty of the disputed Senkaku/Diaoyu islands but, in reality, reflects a much wider and deeper contest for influence. This quickly became apparent after the Beijing meeting.

The agreement by Tokyo to create such a mechanism implied, at least in Chinese eyes, that Abe's government accepts that there is a dispute. This would represent a change of position since Japan has always insisted that the islands are its sovereign territory – and so there is no basis for a discussion. Immediately after the summit ended, Foreign Minister Fumio Kishida told reporters there was no territorial dispute over the 'Japan-controlled' islets in the East China Sea and that Tokyo's position remained unchanged. To which, China's embassy in Tokyo responded, 'We are seriously concerned and strongly dissatisfied.'

The islands were Chinese, the embassy insisted in pursuance of Beijing's policy – applied also in its quarrels with countries in the South China Sea – of 'establishing facts on the ground' (or at sea) by establishing positions in the disputed areas.

Inseparable bound

'Japan and China, we need each other,' Abe told reporters. 'We are in a way inseparably bound with each other.' Xi put a rather different gloss on things when he said that the onus for improving relations lay with Japan, referring to its historical offences against the Chinese. 'It is Tokyo that cast the ice spell on China-Japan relations,' the official Xinhua news agency wrote after the meeting. 'Now that Abe has talked the talk, he needs to walk the walk.'

The outlook is not particularly promising. New Japanese investments in China have fallen sharply this year. In both countries, nationalism has risen, leading one to wonder if their dispute is one of those disagreements which neither side really wants to settle, so long as escalation can be avoided. Xi was certainly in confident form at the Apec meeting and in his bilateral session with regional leaders.

Handshake without feeling – the scene at Apec meetings in Beijing, 10 November 2014

Some observers saw him as being in imperial form, receiving visitors as if at court. Abe is now going into a general election and still has to draw the hoped-for dividends from the 'three arrows' to stimulate Japan's economy.

China and Japan are engaged in a competition for influence in southeast Asia and Beijing has been playing on anti-Japanese feeling in South Korea to try to woo Seoul.

Xi has also championed a new 'Silk Roads' policy with large parcels of aid for central Asia and the construction of 'String of Pearls' on the maritime route between China and the Gulf.

In place of multilateral agreement, bilateral trade deals are sprouting – between China and Australia in November and probably between China and South Korea soon on top of an Australia-Japan accord earlier this year.

Weaker position

With big deals for Russian gas supplies to China (on favourable terms for Beijing) and joint infrastructure projects as well as growing military co-operation, Xi has pushed the rapprochement with the big neighbour, apparently feeling that the crisis in Ukraine has put Moscow in a weaker position.

It remains unclear as to how the US, the strongest single military presence in the region, will push the 'Pacific pivot' proclaimed by President Barack Obama.

His Trans-Pacific Partnership free trade project, whose rules would exclude China, is now faced with a rival, looser scheme backed by Beijing. Major regional states may be unwilling to move out of the strategic umbrella provided by Washington since 1945. But the reality of China's economic weight is a powerful counterbalance.

Testing times lie ahead for the region which has to play a significant role in any global growth revival.

The key test for the China-Japan relationship is whether its evolution can be managed for mutual benefit or whether confrontations will get in the way. ▪

Jonathan Fenby, member of the OMFIF Advisory Board, is China Director of emerging markets research service Trusted Sources.

Carrying on regardless

What 2015 holds for Argentina

David Smith, Advisory Board

Some 13 years since its last Christmas Eve crisis, Argentina is between default and final payment of those still owed from its last collapse in December 2001. Argentina persists in trying to teach the world that a country can default and carry on regardless.

In the process, Argentina has created economic, political and diplomatic tumult. In early November, Argentina's president Cristina Fernandez de Kirchner excoriated her US counterpart Barack Obama, accusing him of siding with Argentina's financial enemies via a five-page letter on her website. She even suggested in a speech that the US might want her dead.

Kirchner sent a team to the G20 meeting in Brisbane (she herself was in hospital with a colon infection) to push the gathered nations to find a way to prevent Argentina's de facto default becoming the fate of others.

Boycotting restructuring

The language was cautious, omitting specific mention of the country. Nevertheless, China, Russia, Brazil and even France lined up to prevent Argentina's 2014 debt crisis being repeated. Taking the hint, Mexico framed its latest bond issue in language designed to prevent debt holders from boycotting restructuring accepted by a clear majority of creditors, and so forcing a nation's default.

Not that President Fernandez de Kirchner's government accepts the term default. Rather, she argues, Argentina cannot reach agreement with those holding out for full payment of 7% of the 2001 debt, amounting to $1.3bn on paper, as stipulated by New York Judge Thomas Griesa.

At the same time, the country is prevented from paying its 2014 instalment to the 93% of creditors holding debt-restructured bonds from 2005-10, worth $539m.

In truth, however, the Argentine government has been running out the clock, knowing that at year's end those 93% of creditors lose the right to seek parity with any deal cut with the holdouts next year. It is trying to forestall moves by those within that majority to seek more money up front like the hold-outs.

Behind the language of confrontation, voices within the government, significantly central bank chief Alejandro Vanoli, have suggested that a deal with the holdouts is inevitable, indeed part of the 2015 budget.

The Argentine media have feasted on a narrative provided by lawyers for the holdouts: of money trails stretching from Santa Cruz province in south Patagonia, long since the political domain of the de Kirchner family, to Argentine-owned companies in Nevada.

Follow the money, say the lawyers, and it leads all the way to the top, via the president's late husband, Nestor, her predecessor and longtime governor of Santa Cruz. Keep following the money, the opposition lawyers add, and it may well lead to the president's son, who could yet be the president's political heir after she leaves office at the end of next year.

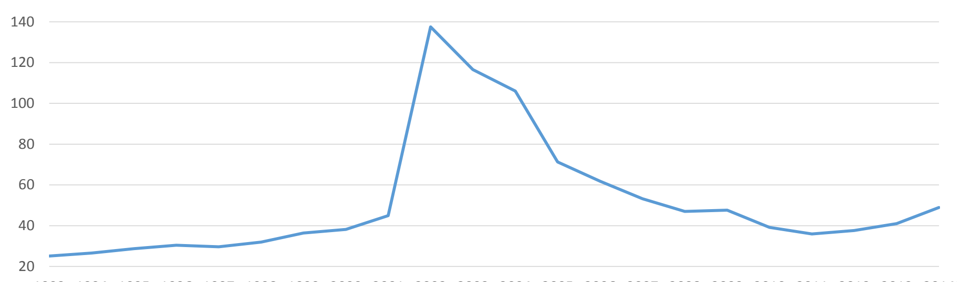
Finance Minister Axel Kicillof has hinted that 1 January 2015, the day that 93% of creditors lose the right to seek any revision of their payment terms, changes the game-plan.

'At the end of the year, when the instruments the holdouts have used for extortion disappear, there will be better possibilities for dialogue,' he said.

Argentina continues to remind the world of its undimmed capacity to perform the improbable, to shock, and then to carry on as though nothing has happened. ▪

David Smith, a member of the OMFIF Advisory Board, is a writer, professor and adviser to NGOs based in Buenos Aires.

Argentina's general government gross debt 1993-2014 (% of GDP)



Source: IMF World Economic Outlook Database, October 2014. *IMF estimate

CURRENCY NEWS

The International Finance Corporation, investment arm of the World Bank, last month issued a new 10-year, 10bn rupee bond (equivalent to $163m) in London. The so-called 'Masala bonds' are the first rupee-denominated securities to be listed in London, and will seek to mobilise international capital markets to support local infrastructure development in India.

The bond issue coincides with Prime Minister Narendra Modi's ambitious new campaign to bolster Indian manufacturing, a move which will require significant improvement in the country's roads, railways, motorways and power stations, and is to this point the longest-dated offshore issue. Carrying a yield of 6.3% and rated AAA, the bonds target insurance companies, pension funds and asset managers, and are the latest in a series of IFC rupee and renminbi bond issues.

The issue comes at the end of a sluggish year for emerging market economies, with emerging market stocks having trailed the developed world's since year-end 2013. Currencies of larger emerging markets, such as Turkey and Brazil, have weakened, while emerging market equities trail those in the US. Fed tapering and the subsequent end of QE, the drop in commodity prices, growth fears in Europe and China and a strong dollar have all contributed to this.

The IMF recently downgraded its forecasts for emerging markets by more than for rich countries. But India seems to remain the most buoyant of the emerging markets. Modi's pro-growth government stokes optimism, while the rupee has stabilised and the Indian stock market healthy. Global economic problems have a greater effect on other emerging market economies than they do on India. China's slowdown doesn't impact India as only 5% of India's exports are bound for the world's second largest economy. India is no great exporter of industrial commodities, unlike Brazil, and the euro area woes are of greater concern to its key trading partners such as Turkey and Russia. So the outlook in India remains bright, and the IFC will hope the bond issue can make a real impact in India as it considers which emerging market it might target next. ▪

Jamie Bulgin is Deputy Director, Markets and Institutions of OMFIF.

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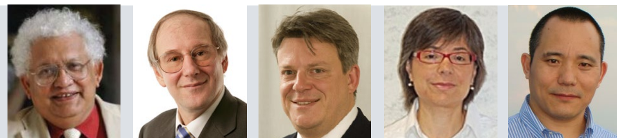

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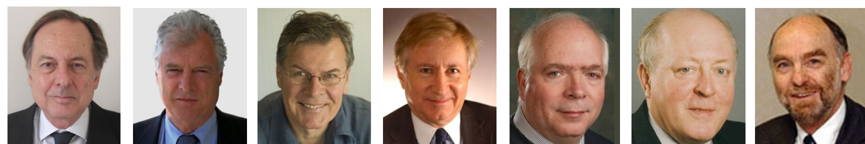

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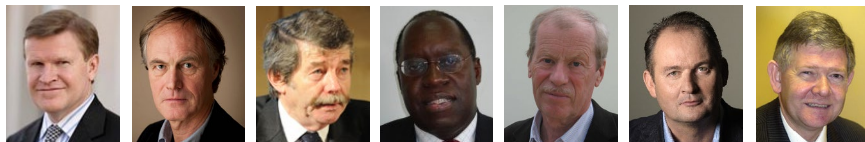

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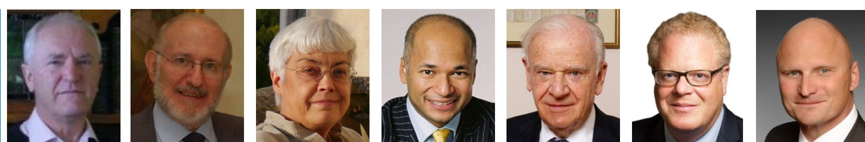

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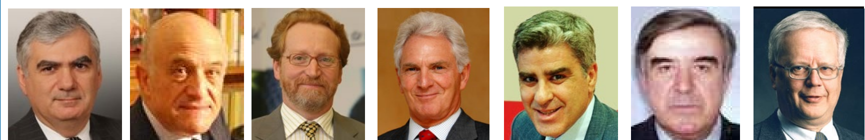

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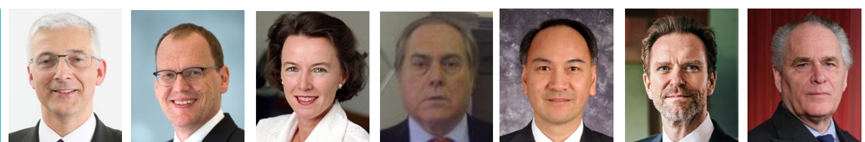

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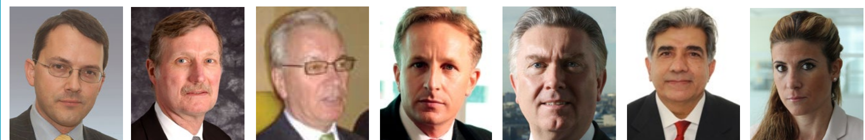

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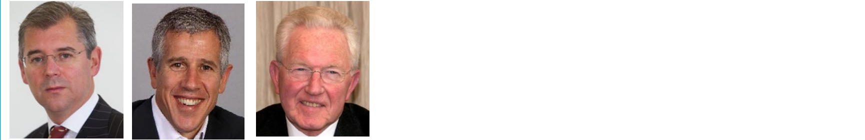

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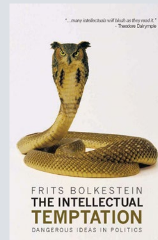

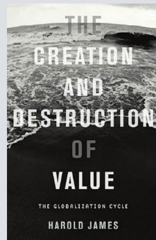

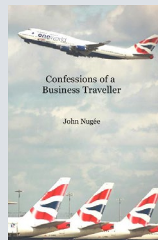

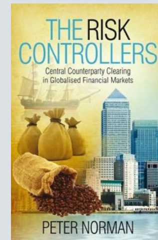

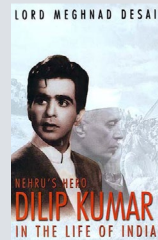

The scope and limitations of US power

Recognising the role of nationalism

George R. Hoguet, State Street Global Advisors

Imagine a world in which the US carefully limits its global military interventions, reduces its defence spending as a percent of GDP from 4.5% to 2.5%, and gradually pulls its 70,000 troops out of Europe. Would US citizens in fact be richer and more secure?

In Restraint – A New Foundation for U.S Grand Strategy, Barry Posen, director of the security studies programme at MIT, argues a resounding 'yes'.

Posen situates himself squarely in the realist tradition: the world is anarchic; states should primarily preoccupy themselves with the external – not internal – behaviour of other states; a central goal of policy should be to promote the balance of power. The US needs to re-examine its national security priorities.

This admirably brief and carefully argued monograph will be controversial. But Posen has struck upon a theme that is sure to resonate with a portion of the American electorate in 2016. Anyone interested in the debate over what truly constitutes 'security' should read this book.

Liberal hegemony

Posen defines grand strategy as 'a nation-state's theory about how to produce security for itself'. Since the collapse of the Soviet Union, both political parties in the US have coalesced around a grand strategy of what Posen calls 'liberal hegemony'. It promotes democratic governance within nation states, individual rights, free markets, a free press and the rule of law. These goals are laudable, but have led the US to spend hundreds of billions of dollars on unnecessary engagements with marginal gains for US security.

Of the four major US armed interventions (Serbia, Afghanistan, Iraq and Libya) since 1999, only the invasion of Afghanistan can be seen as a necessary response to a clear national security threat. (The book came to press before the US bombing of Isis).

Liberal hegemony, in the author's view, suffers from many defects. It is costly and inherently expansionist. It promotes 'cheap riding' among our allies. (Japan's defence spending as a percent of GDP is just 1.2%; Nato's 1.6%). It leads to 'reckless behaviour', notably in the case of Israel. It makes it too easy for others to blame the US for their problems. And, ultimately, it leads to imperial overstretch and does not promote true security.

Grand strategy of restraint

As an alternative to liberal hegemony, Posen proposes the 'grand strategy of restraint'. He defines national security as sovereignty, territorial integrity, power position (the sum total of a state's capabilities relative to other states), and safety (the ability to deter and defend against direct, imminent and plausible military threats).

Noting America's favourable geography, and the tendency for US exceptionalism to lead to long and inconclusive ground wars, Posen argues that the US must recognise the power of nationalism and 'the inclination of self-aware peoples to resist direction by outsiders'.

The US must focus on the most important dangers to its security. First among these is the emergence of a hegemon on the Eurasian land mass. Posen finds this unlikely. None of the major pretenders – Russia, Germany, Britain and France – have sufficient military power. And three are nuclear weapons states.

China, despite its growing power, will be a less potent competitor to the US than the Soviet Union was. Its geography is less favourable; it does not have ideology working for it; and China's neighbours are a natural buffer zone.

The US should promote a balance of power in the region. A strategy of containment is premature. Withdrawal of US troops from Japan is necessary to convince Japan that it must spend more on its defence. The commitment to Taiwan is both 'perilous' and the 'least strategically necessary' of US commitments. The US should reduce, not increase, its military commitments in the region and promote self-defence.

The strategy of grand restraint would have at its core US command of the global commons – sea, space, and air. It would be best served by a 'maritime' military strategy that seeks to control global 'choke-points'.

As of 31 December 2012, the US had 173,000 active duty troops and roughly 600 major sites around the world. Posen would gradually reduce this presence, including the removal of almost all US troops from Europe. And 400,000 soldiers (versus 490,000 called for by Pentagon cuts) would man the US Army.

Security blueprint

Energy security and nuclear non-proliferation are key interests in the Middle East. The US can promote these interests from offshore. In terms of the Israel-Palestine conflict, 'the US should return to its policies prior to the 1967 Arab-Israeli War.' In south Asia, US objectives are 'probably unachievable.'

Efforts to defeat Al-Qaeda are enhanced if US military activity in Pakistan – a country of 190 million – is reduced. All over the world, the US military presence reduces the willingness of states to devote adequate resources to their own national security.

Posen's thesis is sure to be challenged by beneficiaries of the status quo. But the 'domino theory', which led to the disastrous US intervention in Vietnam (and collapse of the Bretton Woods system), reminds both policy-makers and investors that convenient heuristics are constantly challenged by inconvenient facts.

As the bombing of Isis in the Middle East gains momentum, Posen outlines a blueprint for US security policy in the 21st century. ▪

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

Japan heading for low growth

OMFIF's Advisory Board predicts poor GDP and low inflation

As Japan nears a snap election, all eyes are on the economic data. Poor growth figures for the third quarter suggest that Japan has slipped into its fourth recession since 2008. In April, Japan's consumption tax was raised with worrisome results. Gross domestic product shrank an annualised 7.3% that quarter, and Prime Minister Shinzo Abe cancelled plans for a further tax rise.

Rating agency Moody's downgraded Japan one notch from A1 to Aa3, citing uncertainty over the achievability of fiscal deficit reduction goals. The agency further noted that the erosion of credibility and policy effectiveness could undermine debt affordability as investors lose confidence in government plans for growth.

With this deferred tax hike and continued stimulus in mind, OMFIF asked the Advisory Board where they see Japan's inflation and growth in a year's time. Almost four-fifths foresee poor growth and inflation below Japan's 2% target. One in 10 shared the view that growth would be below 1.5%, but expected it to be accompanied by higher inflation. 14% of respondents expected growth to exceed 1.5%, with inflation expectations evenly split.

Outcome	Share
GDP growth above 1.5%, inflation above 2%	7%
GDP growth above 1.5%, inflation below 2%	7%
GDP growth below 1.5%, inflation above 2%	10%
GDP growth below 1.5%, inflation below 2%	76%

The 'shock' from the tax hike will gradually peter out, which will be positive for growth but negative for inflation. Wage increases will begin to encourage consumption, but not enough to raise inflation above 2%.

- Sahoko Kaji

I hope that I am wrong, but I feel that more friendly government policy to encourage Japanese companies to invest is required. Companies continue to hoard cash.

- Paul Newton

Japan's track record of successful stimulus is not good.

- Boyd McCleary

A year ago, I thought the unprecedented boost to money creation would get things moving after nearly a quarter century of stagnation, deflation and pusillanimous efforts to sort out the banks. I now have to conclude that Abe was not forceful enough. The economy needs deeper and far reaching measures to change attitudes, customs and governance. All that makes me pessimistic that Abe can succeed a second time. He may already be a busted flush.

- Jack Wigglesworth

BANK ON GERMANY

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