December 2015
Vol. 6 Ed. 11

The Bulletin

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

Strongman returns
Wanted: national saviours

Jean-Claude Bastos de Morais on Africa
Haihong Gao on China's landmark steps
Elliot Hentov & George Hoguet on renminbi
Michael Stürmer on rise of the Leviathan
OMFIF Advisory Board on 2015 review

The Convergence of Nations
Africa book launch
10 December 2015

OMFIF

INVESTED

You don’t thrive for 230 years by standing still.

As one of the oldest, continuously operating financial institutions in the world, BNY Mellon has endured and prospered through every economic turn and market move since our founding over 230 years ago. Today, BNY Mellon remains strong and innovative, providing investment management and investment services that help our clients to invest, conduct business and transact with assurance in markets all over the world.

BNY MELLON | Invested

bnymellon.com

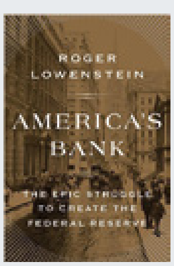
Strongman returns

From Russia to Hungary, Turkey to Poland, the era of the strong leader is returning across a broad swathe of Europe. Russian president Vladimir Putin, parleying with embattled French President François Hollande, has gained in stature – posing another problem for German Chancellor Angela Merkel and for the stewardship of the euro. This is worrisome given the ascent of France's National Front leader Marine Le Pen, whose views on Europe are decidedly un-communautaire. ■

Book review

George Hoguet reviews *America's Bank – The Epic Stuggle to Create the Federal Reserve* by Roger Lowenstein, a 'masterful' overview of the history of the US central bank – 'a gripping story, rich in historical detail and Informative minutiae'.

Hoguet says the book is 'highly relevant to today's world'. He writes that Lowenstein's analysis captures many debates resonating in American political and economic history: centralised authority versus local control; Wall Street versus Main Street; Washington versus the financial services lobby; and East versus West. ■

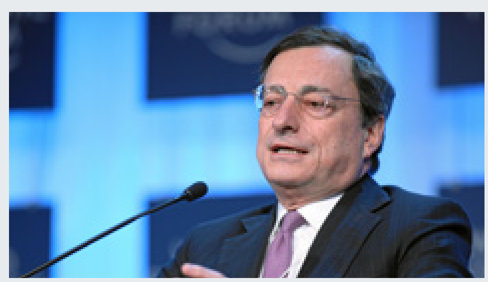


Vol. 6 Ed. 11

Draghi: the new mortality

Central bank governors deemed imbued with unusual helpings of wisdom or power should beware: pride goes before a fall. Mario Draghi, the European Central Bank president, dubbed 'super' just a little too often by a media and financial fraternity that likes to believe in heroes, may be about to descend to the ranks of mortality.

Financial markets expected somewhat too much from the ECB on 3 December. The bank cut its deposit rate deeper into negative territory and decided to extend its quantitative easing to April 2017. More swingeing action was turned down by the Bundesbank and the more conservative central banks. German public opinion regards even the more moderate QE action as far too aggressive for the health of the financial system. The likelihood that the US will raise interest rates on 15-16 December has strengthened the hand of the ECB hawks.



History throws up myriad cautionary tales. Hjalmar Schacht, the pre-1939 Reichsbank president, who was known as 'The Magician' after his stabilisation of the Mark in 1923, ended up in a concentration camp towards the end of the second world war. Another psychologically painful, though less dire, fate befell the Federal Reserve's Alan Greenspan (the 'Maestro'), lauded while in office yet ultimately forced to recognise that his unduly accommodating monetary policies helped pave the way for the 2008-09 crisis. ■

Official Monetary and Financial Institutions Forum

30 Crown Place
London
EC2A 4EB
United Kingdom

T: +44 (0)20 3008 5262
F: +44 (0)20 7965 4489

www.omfif.org
@OMFIF

Company Number: 7032533

OMFIF

Promoting dialogue for world finance

The Official Monetary and Financial Institutions Forum is an independent platform for dialogue and research. It serves as a non-lobbying network for worldwide public-private sector interaction in finance and economics. Members are private and public sector institutions worldwide. The aim is to promote exchanges of information and best practice in an atmosphere of mutual trust.

OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries.

Advisory Board

OMFIF's 171-strong Advisory Board, chaired by Meghnad Desai, provides contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities.

Analysis

OMFIF Analysis includes research and commentary. Contributors include in-house experts, Advisory Board members, and representatives of member institutions and academic and official bodies.

Meetings

OMFIF Meetings take place within central banks and other official institutions and are held under the Chatham House Rule, where the source of information shared is not reported.

Advertising & subscriptions

For advertising and subscription details, contact: sales@omfif.org

Diary dates and meetings

A full list of past and forthcoming meetings is available on www.omfif.org/meetings

For more information on meetings, contact: meetings@omfif.org

General information

See www.omfif.org for access to more OMFIF analysis, including commentary, reports, summaries of discussions and bulletin archives

Membership

Membership, open at an annual fee to institutions (from both the public and private sector) and individuals, offers services through two complementary channels

For more information about OMFIF membership, contact membership@omfif.org

Submissions

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

Website

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

EDITORIAL

As nationalism rises in Europe, Athens is a side-show

Across central and eastern Europe, the phenomenon appears inescapable. The strongman returns. Yet whether, for the countries in question, and those who invest in them, the smack of firm government generates 'strongman returns' remains a potent debating point.

Western sanctions and the otherwise debilitating effect of the oil price decline have appeared to give President Vladimir Putin a new lease of life as Russians rally towards a leader who appears to know what he wants in an uncertain world. Yet this is no guarantee that investors can secure worthwhile income on their investments; there may, indeed, be an inverse correlation between the domestic strength of the leadership figure and the economic return for international investors. Life may not be too pleasant, too, for the citizens within these countries. As Michael Stürmer notes, 'Nations will rather surrender some of their cherished freedoms than part with physical security'.

Angela Merkel, the German chancellor, still afloat as Europe's pivotal figure in a sea of growing extremism, must be particularly worried about the rising influence of France's National Front which won 28% of the vote in the first round of the regional elections on 6 December and 27% in the second leg on 13 December, when it was beaten into third place. The party is unlikely to win the presidential poll in April-May 2017, but France – whatever its leader – does not appear to be moving towards the traditional Franco-German mantra of 'more Europe'. Instead, those holding the reins in Paris in coming years appear likely to embody more nationalism, less room for free markets, more state control and much weaker fiscal and monetary credibility within the euro.

Make no mistake: the continuing travails of the Greek economy, such a large feature of the year gone by, is a comparative side-show. The real tests for the euro now stem not from Athens but from Paris.

In the wider world, the US looks likely to intensify international monetary polarisation by raising interest rates on 16 December for the first time for nearly a decade. We analyse what this means for the US and the rest of the world. Significantly, several noted Fed hawks – James Bullard (St. Louis), Esther George (Kansas City) and Loretta Mester (Cleveland), of whom the first two spoke at separate OMFIF meetings on 13 November – are rotating into voting membership of the rate-setting Federal Open Market Committee next year – along with one notable dove, Eric Rosengren. Darrell Delamaide analyses the delicate balance of forces in the Fed ahead of the mid-December meeting and the uncertainties prevailing in 2016, underscoring Bullard's prediction that next year is likely to bring financial volatility.

Haihong Gao in Beijing, together with Elliot Hentov and George Hoguet from State Street Global Advisors, assess the long-term effects of the much-trailed move by the International Monetary Fund to bring the renminbi into the special drawing right. Kevin O'Nolan of Fidelity puts the decision and China's continuing growth path into a worldwide economic context. Looking back at the past year, we assess the – on the whole rather high – accuracy of predictions for 2015 made a year ago by Bronwyn Curtis, our then chief economic adviser. In addition, 15 OMFIF-affiliated experts record their individual highlights and reflections of the past 12 months in fields ranging from India to infrastructure, from refugees to reserves. George Hoguet assesses a seminal work on the Federal Reserve by Roger Lowenstein. In total, a record 18 members of the OMFIF advisory board have contributed to this month's Bulletin. We would like to wish them, and all other readers, a peaceful Christmas and New Year holiday period. ■

Business-friendly policies and peso devaluation

Argentina president confronts poisoned chalice

David Smith, Advisory Board, in Buenos Aires

President Mauricio Macri has taken office in Argentina, opening a new era of business-friendly policies after 12 years under left-wing power couple Nestor and Cristina Kirchner. In the short term, Macri and his team have to hope that the Peronist party machine does not replay history, and seek to undermine the new government with strikes and demonstrations. Macri has achieved an historic victory, but he will face challenges to govern from day one.

Macri, a businessman who converted his presidency of the Boca Juniors Football club into a new political movement, with the slogan 'Let's Change', on 22 November won the first run-off in the history of Argentina's modern democracy.

'We've done the impossible with this election,' Macri told supporters at a massive rally on the banks of the River Plate. His Peronist opponent, Daniel Scioli, claimed, 'We leave them a country stronger than ever.' With that rather limp defence of the status quo, the 12 years of the Kirchner dynasty came to an end. However, the legacy of the previous government represents a poisoned chalice for Macri. Now comes the hard part, and in the words of one of Macri's lead advisers: 'There are no good options here, only brutal choices, if we are to take the country out of steep decline, and back to growth.'

The handover of outgoing President Cristina Fernández de Kirchner is stark in economic terms. Inflation running at 25%, unemployment rising, a budget deficit approaching 6% of GDP, foreign currency reserves depleted, and the value of the peso unknown, with an official rate at less than 10 to the dollar, the parallel market rate well over 15 pesos.

Macri-economics will revolve around a devaluation sooner rather than later. Macri has suggested letting the peso float to between 15-16 to the dollar). Next on the list will be cuts in subsidies, particularly of the energy and transport sectors, coupled with instant breaks for farmers, to stimulate an agricultural sector that has been holding on to food exports because the Kirchners imposed crippling taxes.

But given his narrow victory, Macri has served notice that he will not stop welfare programmes that mean almost half the population receives government aid. Nor will he attempt to reverse the nationalisation of the state oil giant YPF, and the national airline, another major drain on government revenue. ■

David Smith represented the UN Secretary-General in the Americas, 2004-14.

BRIEFINGS

Europe 'must make serious structural changes'

The European Union must make serious structural changes to convince its member states' electorates that it can overcome its formidable problems, according to Lord (David) Owen, a former UK foreign secretary and a member of the OMFIF advisory board. Speaking in a telephone briefing on 30 October with other European experts, Owen proposed restructuring the EU into two distinct but interrelated elements: the euro area and a non-euro area grouping, which would include the single market of the existing European Economic Area – all EU member states plus Norway, Iceland and Liechtenstein.

Tsakalotos holds out better Greek prospects linked to debt relief

Euclid Tsakalotos, the Greek finance minister, held out positive prospects for a resumption of Greek growth and capital market borrowing next year, provided Greece's international creditors agreed debt restructuring early in 2016. In a briefing with OMFIF and international banks in London on 10 November, Tsakalatos struck an upbeat note on Greece's 'road map' for reforms in the next six months and on a creditors' review of the government's economic restructuring measures at the start of 2016. This was a crucial part of efforts – including bank recapitalisation – to get Greece back on its feet.

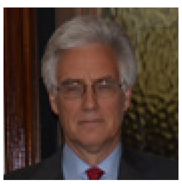
Kansas City's George outlines prospects for at 'lift-off' London meeting

Esther George, President of the Kansas City Federal Reserve Bank and one of the noted 'hawks' on the Federal Open Market Committee, used an OMFIF meeting in London on 13 November to outline her policy stance on a 'lift-off' in Fed interest rates at the next FOMC meeting on 15-16 December. George, who rotates into a voting position on the FOMC next year, has made no secret of her desire to see a steady move towards interest rate normalisation, given the buoyant pace of US recovery. Her views seem to be gaining prominence in line with the improvement in jobs data.

Merkel 'under strain' over immigration as Schäuble waits in wings

Michael Stürmer, a veteran commentator on the European political scene and a member of the OMFIF advisory board, expounded the pressure points on Chancellor Angela Merkel in a joint telephone briefing with OMFIF and Autonomous Research on 23 November. In her policies welcoming mass immigration of displaced persons from wars and conflict in Asia, the Middle East and Africa, Merkel has engendered considerable opposition. Although she was in no immediate danger of ejection, Wolfgang Schäuble, the 73-year-old finance minister, was ready to take over should Merkel be fatally wounded.

Financial crisis 'caused by addiction to private debt'



Lord (Adair) Turner, former chairman of Britain's Financial Services Authority, outlined his views on redesigning global financial regulation in a briefing to OMFIF members in London on 23 November. Turner set out some of the principal precepts in his book *Between Debt and the Devil*: the financial crisis was caused not by banks being too big to fail, but because society as a whole is 'addicted' to private debt. Turner challenges the belief that economies need credit growth to fuel growth. In fact, most credit drives real estate booms and busts and leads to financial crisis and depression.

SINGAPORE MEETING

China's challenges over international use of the renminbi

China is adjusting to the tribulations of promoting the international use of the renminbi – entering the special drawing right next year after the 30 November approval by the International Monetary Fund – at a time of significant domestic economic transition.

The Chinese shift was one of the main themes of a one-day asset management seminar – 'Trends and expectations for 2016 and beyond' – on 1 December in Singapore, organised by OMFIF and the Lee Kuan Yew School of Public Policy of the National University of Singapore. The seminar discussed how investment managers at central banks, sovereign funds and public pension funds face challenges centred on diverse developments in the world's largest economies. Monetary policies display unusual polarisation, as the US, China and UK approach inflection points, while Europe and Japan continue easing.

OMFIF ECONOMISTS NETWORK

OMFIF has appointed Dr Nagpurnanand Prabhala to the Economists Network. Prabhala joins honorary chairman Prof. Ben Shenglin and vice-chairmen José Manuel González-Páramo, Kevin Urama and William White.

Dr. N R Prabhala is chief mentor and head of research at Centre for Advanced Research and Learning (CAFRAL), set up by the Reserve Bank of India. He has been a finance professor at University of Maryland, College Park and Yale School of Management and visiting faculty at Indian School of Business and National University of Singapore. Prabhala has a degree in chemical engineering from IIT Delhi, PGDM from IIM Ahmedabad, and a PhD in finance from Stern School of Business, New York University. Prior to his PhD, he worked in the corporate banking area with Bank of America.

ATLANTA MEETING

Economy 'can withstand rate rise,' Bullard tells Atlanta Fed group

The US and international economy should be able to withstand a modest increase in Fed interest rates, according to James Bullard, president of the Federal Reserve Bank of St Louis (below left), in a lunchtime address at the OMFIF Main Meeting in Atlanta on 12-13 November, held in association with the Federal Reserve Bank of Atlanta.

The second Main Meeting in North America, hosted by Dennis Lockhart, the Atlanta Fed president (below right), brought together 70 public and private sector officials from around the world. The gathering focused on the Fed's balancing act in achieving equilibrium between quiescent inflation and the buoyant jobs market, where on latest data the US has returned to full employment.

Another significant feature of the discussions was the international energy market, in particular the boom in US shale production and the policies of Saudi Arabia that have been a contributory factor behind the sharp decline in oil prices. Bullard, a well-known proponent of monetary rigour on the Federal Open Market Committee, who returns to a voting position next year, played down the impact of potential US rate rises on the international economy. He indicated that Fed sensitivities on the global repercussions of rate rises – notably in the statement after its September meeting that decided to keep rates on hold – had been overdone. Like other FOMC members in recent weeks, Bullard underlined relative confidence in the Chinese economy and financial markets after the bout of turbulence in August caused by Beijing's move to bring in greater flexibility in day-to-day setting of exchange rates.

Assessing the global context for US fiscal and monetary policy, participants gave a downbeat assessment of prospects on Europe in spite of the pick-up in growth, with Germany beset by conflicting pressures over the surge in immigration and European and American monetary policies continuing to diverge. Ernst Welteke, a former president of Germany's Bundesbank, said his country could withstand the refugee problems but Chancellor Merkel's migration policies – which he basically supported – were putting her government under great strain.

Other highlights included an address by Otaviano Canuto, executive director for Brazil at the International Monetary Fund, on prospects for Latin America's largest economy and the rest of the region. There was a further discussion on perspectives for tightened financial sector regulation around the globe.

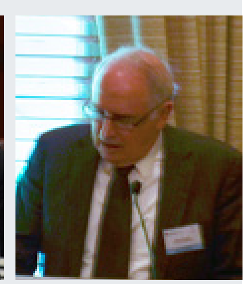
AUSTRALIA MEETING

Garnaut spells out changing Chinese growth model

China's changing economic growth pattern, with more weight on consumption and less on heavy investment, should help promote international development and higher Chinese incomes.

That was the principal message from Ross Garnaut, professorial research fellow at Melbourne University (pictured right), in a lunchtime talk at a Reserve Bank of Australia and OMFIF meeting in Sydney on 4 December. The gathering on 'Asia-Pacific and the global financial system: outlook for 2016 and beyond', part of OMFIF's annual Asian Central Banks' Watchers Group (ACBWG) seminars, attracted 50 participants largely from Australia and Asia.

Previous partners have been central banks from Malaysia, Korea, Indonesia and Hong Kong. The gathering was co-chaired by Guy Debelle, assistant governor for financial markets at the Reserve Bank (far left, with, left to right, Mark Burgess, former managing director, Australia's Future Fund and Andrew Cross, deputy treasurer, International Finance Corporation) and David Marsh of OMFIF. Malcolm Edey, assistant RBA governor for financial stability, also took part.



The great Leviathan back on the stage

Would-be saviours will again dominate the affairs of nations

Michael Stürmer, Advisory Board

A ring of fire surrounds Europe. Lee Kuan Yew, Singapore's former prime minister, predicted the essence of the present discontent two decades ago. The wise old man saw what was coming after the implosion of the Soviet Union. And he recognised the long-term consequences of the revolution in Iran, the destruction of Iraq and the overstretching of US might.

As the old continent experiences a transformational crisis of unknown proportions, political leadership is being brutally tested. The sole certainty is that, in a few years, Europe will be a very different place. The legitimacy of governments will depend on their ability to provide reassurance when existential fear is spreading. The face, the faith and the fate of Europe are all changing – and not for the better.

Easy-going style

The easy-going style of the post-cold war epoch is over. Nations will rather surrender some of their cherished freedoms than part with physical security. The leaders who respond forcibly and first will be the winners. All over Europe, we see the hallmarks: the era of the strongman is back again. Western democracies will have to adapt to the new contingencies or lose support of the citizenry.

Is this the Churchillian moment of 'blood, sweat and tears'? Is it de Gaulle's alternative: 'Moi ou le chaos'? Or is it simply a matter – as Margaret Thatcher's down-to-earth successor John Major once put it – of 'hard pounding', or, less energetically, 'muddling through'? Whatever the answer, the time for appeasement and illusion is over.

Refugees and terrorism add up to more than the usual crisis, defined by a lot of noise and then return to the status quo. The intersecting geometries form a challenging combination: a Middle East arc of instability meets a US pivot to nowhere and the pernicious cycle of European Angst. This is a toxic mixture.

'A hornet's nest of Arab tribes': with this admonition Herbert Asquith, British prime minister a century ago, warned his military top brass to stay clear of the Greater Middle East – to no avail. Under the Ottoman Empire, the region was halfway at peace with itself for the last time. What followed, as historian David Fromkin famously observed, was nothing durable, in fact: 'A peace to end all peace'.

The Greater Middle East will remain in the interminable process of falling apart. The exceptions are, possibly, the state of Israel – now reinventing its strategy, military posture, and internal equilibrium – and Turkey under President Recep Tayyip Erdogan attempting, however improbably, to position himself as an islamist Atatürk on the neo-Ottoman map.

Internal and external balance

What is left are only a few elements of stability: Egypt under President Abdel Fatteh al-Sisi, the Hashemite Kingdom of Jordan, the Kingdom of Morocco at the western tip of the Arab world. The leaders strong enough to maintain internal and external balance are less than picture-book democrats; western countries should not be too choosy in cultivating allies where they can find them.

Foreign powers are struggling to contain radical Islam in its many variations, from IS to Al Qaida, Al Nusra and the like. With little certainty about who is friend and who is foe, the reservoir of terror recruits is virtually inexhaustible. What happens next could be the start of an unravelling of the European project. Or we could see a more co-operative security relationship with Russia. The outcome depends on western leaders' ability to realise the seriousness of the challenge and the irreversibility of change.

Two wars are being fought. Western leaders have mostly failed to understand that the conflict is one of hardware and software – hardware in terms of weaponry, supplies and finance; but software also in terms of propaganda, recruitment, religious fanaticism and primeval bloodlust. The attackers cannot hope to seize the reins of power. But they can pursue a strategy of denial – and in this they have scored successes, whether in generating carnage in Paris, stopping an international football match in Hannover or closing down Brussels. All this is unpleasant for Chancellor Angela Merkel. Once again, Germany's central position in Europe has become a source of vulnerability.

Horsemen of the apocalypse

Two decades ago, when the bad news came from Nato's Belgian HQ, the hoofbeat of the horsemen of the apocalypse could already be heard. More recently they have come much closer to the citadels of Europe, and some are already inside the walls. In future, physical security will be more highly valued than in the past. The agenda will switch from rhetoric to substance. To fight off its demons, western democracy will have to find strength, empathy and resolve. Yet leadership remains in perilously short supply. The Great Leviathan (or men and women aiming to be such) will bestride the stage. Those who strive to be saviours will again dominate the affairs of nations. ■

Michael Stürmer is chief correspondent of Die Welt and a former adviser to Chancellor Helmut Kohl.

Happier days: A younger, less troubled Merkel with a portrait of Helmut Kohl, her earlier mentor, in the background.

Monetary polarisation set to widen

Central bank divergence could spark unrest

David Marsh and Ben Robinson

The Great Monetary Polarisation between the US and Europe is underway. After a period of close alignment since the collapse of Lehman Brothers in September 2008, US and European monetary policies are about to diverge in dramatic fashion. The message from 70 years of monetary history is that, in the next few months, there is a roughly 50% chance of large-scale foreign exchange upheaval.

With the US more or less back to full employment, the Federal Reserve at its policy meeting on 15-16 December is likely to raise interest rates for the first time in nine years. On the other hand, in response to persistently low inflation and output growth, the European Central Bank on 3 December cut its negative deposit rate for banks holding funds in its facilities and extended until April 2017 its €60bn a month quantitative easing programme of bond purchases.

Seven periods of divergence

Since the second world war, US and European interest rates (first as the German Bundesbank's key Lombard rate, then from 1999 the ECB policy rate) have experienced seven periods of divergent policies. On roughly half of those occasions, this resulted in financial and sometimes political disruption.

These episodes included, notably, the late 1960s run-up to the break-up of the Bretton Woods system of fixed exchange rates, the early 1980s upheavals in Germany caused by the dollar's strength and the D-mark's weakness, the early 1990s near-death experience of the European Monetary System (the forerunner of economic and monetary union), and the economically disastrous climb in the euro exchange to $1.60 in 2008, one of the reasons for the unduly severe slump in euro area output after the global financial crisis.

Rise in D-mark

Episode 1 was between 1966 and 1969, when the Bundesbank reduced interest rates from around 6% to 3.5%, while the US federal fund rate increased from 4.4% to 6.3%. This reflected weaknesses in European domestic economies and a desire in the US to stem an outflow of capital caused by the US trade and current account defects. These imbalances had caused a rise in the D-mark against the dollar and had forced the sterling to devalue in 1967 – the first major shock wave in the build-up to the collapse of Bretton Woods in 1971-73.

Episode 2 came between 1980 and 1982 when the Fed under Paul Volcker, its chairman, raised rates to above 19% (in 1981) to bring down inflation exacerbated by the 1979 oil shock, forcing the Bundesbank after initial hesitation to follow suit. This generated a slowdown in Germany that was one of the reasons for the ousting of Chancellor Helmut Schmidt in 1982.

Episode 3 was in 1991-92 when the Bundesbank raised interest rates sharply as the Fed was easing – part of a rearguard action by the German central bank to counter the inflationary effects of the fall of the Berlin Wall in November 1989 and German reunification in October 1990. The result was considerable disruption in the EMS, in particular the withdrawal of the UK and Italy from the scheme in September 1992 and upsets in the French franc-D-mark exchange rate in 1992-93. Episode 4 came in 1993-98 when the Fed raised rates from 3% to 5.5% while the Bundesbank rate fell from 8% to 4.5%. The outcome, for once, was benign as European countries needed a weaker curency to boost exports and overcome the effect of the early 1990s recession.

Episode 5 saw the euro fall between 2000 and 2001 as an eight-year run of dollar strength accelerated, the result of strong US growth of around 4% a year. The nascent ECB was forced to increase interest rates while the Fed was easing, leading to the euro falling below $1. Episodes 6 and 7 surfaced in 2008 and again in 2011 when the ECB raised rates while the Fed was maintaining easy money. These divergences boosted the euro at a time when Europe was already suffering competitive problems, further depressing euro area growth. The ECB speedily reversed the interest rate hikes (made before the November 2011 accession of Mario Draghi), but the damage had been done.

Similar patterns

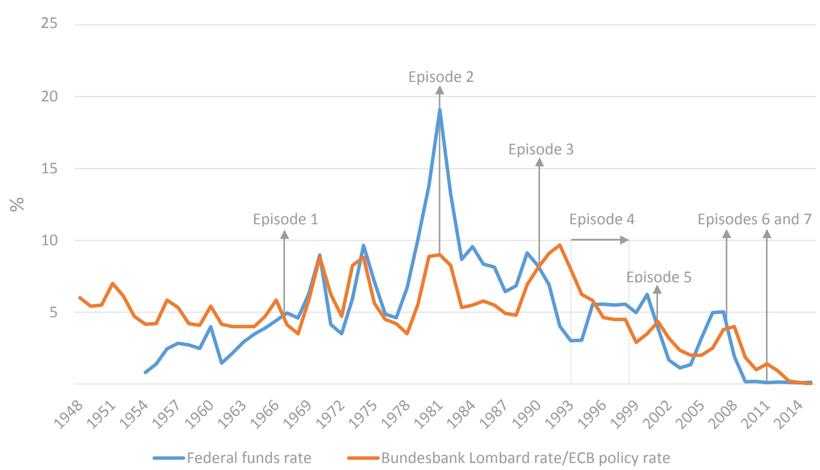
The seven periods of divergence display some similar patterns. US rates tend to move in more extreme manner than in Europe, with overcorrection on both the upside and downside. European rate movements eventually mirror US rates, with a variable lag of between several months and a year.

After the expected Fed rate rise, the divergence may be deeper and longer-lasting than in previous cases. The ECB is extending its quantitative easing at a time when the Frankfurt bank as well as several non-euro European central banks are already offering negative interest rates on deposits.

This has clear implications for the euro exchange rate. Japan is maintaining very loose monetary policies, but seems unlikely to accelerate further its quantitative easing. The Bank of England is likely, like the Fed, to tighten rates in the coming year. So the Great Monetary Polarisation is affecting a wider spread of countries, over a longer period of time, than in the past. The results may be correspondingly broad too. ■

Seven episodes of European and US monetary policy divergence

Federal funds rate vs. Bundesbank/ECB policy rates, 1948-2015



Source: Federal Reserve Economic Data, ECB, Bundesbank

David Marsh is managing director and Ben Robinson is economist, OMFIF

China's landmark step

Special drawing right shift towards multilateral currency

Haihong Gao, Advisory Board

The decision by the International Monetary Fund to introduce the renminbi into the special drawing right is a landmark move that changes the international monetary system both symbolically and practically. This is the first time that a developing country currency has joined the reserve currency 'club'.

The present SDR shares – dollar 41.9%, euro 37.4%, sterling 11.3% and yen 9.4% – reflect neither the make-up of currencies in world trade nor diversification of reserve assets. The rebalancing decided by the IMF board on 30 November will reduce the dollar's dominance from 1 October 2016 and take the SDR closer to its original purpose of a multilateral currency unit that is independent of any one country's current account or debt issuance. The dollar will remain the biggest currency with a 41.7% weighting followed by the euro with 30.9%. With a 10.9% share, the renminbi moves beyond the yen (8.3%) and sterling (8.1%). Global investors can take advantage of more issues of renminbi-denominated bonds.

Greater internationalisation creates fresh pressure for further liberalisation, which should help economic development. There may well be drawbacks, since currency internationalisation may increase financial market volatility, which China previously avoided by capital controls. Instead Beijing must now use macroprudential policies to curb excessive capital flows. Beijing must learn to manage market expectations, as domestic monetary policies will face market pressures. This will require enhanced international communication efforts by the Chinese monetary authorities. ■

Haihong Gao is professor and director at the Research Centre for International Finance, Chinese Academy of Social Sciences.

Costs and benefits

Reserve currency growth and Chinese reforms

Elliot Hentov and George Hoguet in London

The speed with which China attains major reserve currency status is directly linked to the pace and credibility of China's macroeconomic reforms. Reserve currencies are generally characterised by broad and deep capital markets, floating exchange rates, scale, credible policy frameworks, voluntary private holdings of the currency, and liquidity. This list brings responsibilities as well as benefits.

The first important benefit is better financing through China's ability to borrow internationally in its own currency, removing an exchange rate risk that could suddenly trigger a balance of payments crisis. Second, a reserve currency country gains seignorage: income earned by issuing currency that others wish to hold. Third, Chinese companies and individuals gain from lower transaction costs by paying for purchases in their own currency. Fourth, this brings enhanced policy flexibility, since reserve currency countries are generally subject to less market discipline. Fifth, reserve currency countries have less need to build large foreign exchange reserves. Sixth, this status confers geopolitical prestige and influence.

There are some costs. First, a reserve currency is one that both public and private agents want to hold, creating demand pressure and a higher exchange rate that may depress export competitiveness. Second, exchange rate volatility can complicate monetary policy. Third, China will have to shoulder greater responsibility for international monetary arrangements, which can lower monetary policy autonomy. Fourth, less fiscal discipline, over time, can lead to excessive debt. Moral hazard can arise from favourable funding conditions, potentially exacerbating future fiscal problems. ■

Elliot Hentov is head of policy and research, at the Official Institutions Group and eorge Hoguet is Global Investment Strategist in the Investment Solutions Group, State Street Global Advisors.

SDR move comes at turning point for Chinese economy

China is committed to rebalancing towards consumption-driven growth, but the Communist party still needs to deliver higher living standards to justify its leadership, writes *Kevin O'Nolan in London*. So the SDR move comes at an important turning point for the Chinese economy.

Fiscal easing represents an important part of policies required to realise the government's goals, and there are signs that this is coming through. Stabilising the economy will be a greater priority over the next 12 months – a factor likely to bring positive news out of China in the short term.

Politics will be geared to maintaining growth, with five of the seven members of the Politburo standing committee changing in 2017. China-related assets, along with investments relying on a weak dollar, have performed poorly during 2015, a continuation of trends since 2010, with China gradually moving to structurally lower growth and the dollar appreciating, owing to a stronger US economy. The Chinese adjustment has taken place with little or no impact on developed markets. However, as the turbulence in August showed, a slowdown in emerging market economies can have repercussions in developed markets, especially as the former now account for a larger share of global GDP and make up the lion's share of global growth. To feel confident that the risks from emerging market economies are receding, investors will need to see signs of a manufacturing pick-up globally (which would probably be China-led), a commodity supply turnaround, or a peak in the dollar.

General prospects for the world economy remain reasonably good: a better environment for equities than for bonds. Even those central banks which may tighten in 2016, including the Federal Reserve and the Bank of England, are likely to maintain a loose stance overall, with any tightening slow and shallow.

Within equity regions, emerging markets should be given an underweight position, with a positive outlook on the UK, Europe and Japan. Long dollar positions may not be appropriate for too long. After the expected interest rate rise in December, the focus will shift to future hikes. This is likely to be a gradual cycle. Any further dollar appreciation would slow the process. ■

Kevin O'Nolan is portfolio manager at Fidelity Worldwide Investments.

Fed balancing act over rate hike

Market volatility will extend beyond lift-off

Darrell Delamaide in Washington

For many market participants, the mid-November release of the minutes from the late October Federal Open Market Committee meeting clinched the deal – the Federal Reserve will finally start raising rates at its December meeting of 15-16 December.

A further pointer came with the release of a further set of buoyant jobs data on 4 December, showing US employment increased at a healthy pace in November, in another sign of the economy's resilience.

Confidence in the jobs market

Non-farm payrolls rose 211,000 in November, while September and October data were revised to show 35,000 more jobs than previously reported. The unemployment rate held at a 7½ year low of 5%, as people returned to the labour force in a sign of confidence in the jobs market. The jobless rate is in a range, as Janet Yellen has made clear, that many Fed officials see as consistent with full employment, and has dropped 0.7% this year.

The closely watched employment report came a day after the Fed chair struck an upbeat note in congressional testimony in Washington, describing how the latest numbers had largely met the criteria for the Fed's first rate hike since 2006.

The account of the FOMC's 27-28 October meeting of the monetary policy panel seemed clear enough. 'Most participants anticipated that, based on their assessment of the current economic situation and their outlook for economic activity, the labour market, and inflation, these conditions [for policy normalisation] could well be met by the time of the next meeting.'

But Fed statements are rarely as clear as they seem. As a sign of the intricate balancing act the Fed has to master, two words jump out of this statement – 'most' and 'could.' Backing this up, 'several' participants said they were still worried about how global economic developments would affect the domestic economy.

That was, of course, before additional signs, after the October meeting, of domestic economic strengthening. In recent weeks public Fed statements have reinforced the notion that higher rates are on the way. 'In the relatively near future probably some major central banks will begin gradually moving away from near-zero interest rates,' Fed Vice Chair Stanley Fischer (voter) said at a mid-November conference at the San Francisco Fed. Echoing comments made in Lima in October, Fischer said, 'We have done everything we can to avoid surprising the markets and governments when we move, to the extent that several emerging market (and other) central bankers have, for some time, been telling the Fed to "just do it."'

> **Fischer: 'We have done everything we can to avoid surprising the markets and governments when we move, to the extent that several emerging market central bankers have, for some time, been telling the Fed to "just do it."'**

New York Fed chief William Dudley (voter), too, anticipated action in the near future. 'We hope that relatively soon we will become reasonably confident that inflation will return to our 2% objective,' he said at a panel discussion at Hofstra University in New York. He said it would be 'very logical' to expect that the Fed's inflation and employment criteria for lift-off would be met 'soon.'

Same formulation

The same formulation was used by Atlanta Fed President Dennis Lockhart (voter). 'I'm comfortable with moving off zero soon,' he told a business group in Atlanta.

'Assuming that we continue to get good data on the economy, continue to get signs that we are moving closer to achieving our goals, and gaining confidence getting back to 2% inflation,' he told an audience at the University of California-Berkeley, 'there's a strong case to be made in December to raise rates.'

Other voting members have expressed caution. Chicago Fed President Charles Evans (voter) once again said he preferred a 'later' lift-off because he doesn't expect inflation to near the Fed's 2% target until late 2018, he told a leadership forum in Chicago. 'Inflation has been too low for too long.' He described his view in mid-November as follows: 'Before raising rates, I would like to have more confidence than I do today that inflation is indeed beginning to head higher.'

Two other voters, Daniel Tarullo and Lael Brainard, both board governors, have expressed reservations about lift-off this year. Tarullo said in late November that the Fed is 'not close' to meeting its inflation target.

Many policy-makers are already looking beyond lift-off, seeking to reassure markets that continued tightening would be gradual and flexible. St. Louis Fed chief James Bullard (non-voter) stressed after a meeting in Fort Smith, Arkansas, that subsequent hikes would be strictly data-dependent. Bullard, who rotates into a voting position in January, said the return of some uncertainty into rate moves would be welcome.

Bullard almost certainly has in mind that the Fed may prove to be more hawkish in raising rates than many market analysts anticipate. Backing up this notion, in 2016 two further hawks, as well as Bullard, will rotate into voting positions – Esther George of Kansas City and Loretta Mester of Cleveland – with only one dove, Eric Rosengren of Boston.

Newcomers replace doves

The newcomers replace two doves, Evans of Chicago and Williams of San Francisco, along with moderate bellwether Lockhart and the hawkish Jeffrey Lacker of Richmond.

However, there are also two pending appointments to the board of governors in Washington – Allan Landon and Kathryn Dominguez – who would bring the board to its full complement of seven. Governors almost always follow the lead of the chair, and Yellen has tended dovish so far.

So the basic issue remains: should the US economy prove unduly sensitive to December's minor tightening, the Fed's rate hikes could soon peter out in 2016 – or even be reversed. Whatever Yellen announces on 16 December, uncertainty and volatility, as Bullard says, look set to persist next year. ■

Darrell Delamaide is a writer and author based in Washington.

Soft landings amid divergence and crisis

US confirms growth leadership, Europe and Japan disappoint

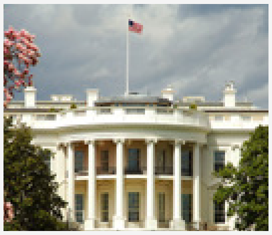
OMFIF's predictions for the past 12 months, made by Bronwyn Curtis (then OMFIF's chief economic adviser) and published in the January 2015 Bulletin, emphasised divergence and crisis as two outstanding themes for the year. (See list below and on p.13.) The predictions stood up well to reality. OMFIF has awarded itself maximum marks of five stars for one of the predictions – on the Federal Reserve's patience on raising interest rates and on the end-year value of the dollar. We give four-star marks to a range of other predictions – on the US recovery, on Prime Minster Shinzo Abe's growth programme, on Chinese reforms, on President Vladimir Putin's policy stance and on the euro crisis. We did less accurately on the issues of oil prices and the length of the Ebola crisis. One of the most important developments to hit Europe this year – the influx of refugees from war-torn areas – was absent from the OMFIF predictions, as it was from most other forecasters' assessments at the turn of 2014-15.

The US has solidified its role as the global growth engine, while emerging markets have faced economic and financial challenges. QE in Japan has failed to bring the country closer to its inflation target, while the ECB has expanded its own programme, creating divergence with the US Fed's policies. China's policy-makers have avoided a hard landing for now, while Greece and Europe have muddled through, overshadowed by the migrant crisis, and, latterly, by the terrorist atrocities in Paris. Meanwhile conflict within Europe over the direction of the Union, as well as between Europe and Russia over Ukraine and Syria, have added fresh challenges.

★★★★

Prediction (Jan 2015): 'The current level of QE in Japan may not be enough to return inflation to a sustainable level, while growth will be closer to 0.5% than 1.5%.'

Outcome (Dec 2015): Global disinflationary pressures limited the effectiveness of Japan's QE programme. Structural reforms failed to provide a stronger basis for longer-term upward inflation pressure. The yen hit its lowest point of 125.6 in June and is currently 123 against the dollar. Inflation fell to 0.3% in October, far below the 2% target. Japan entered its fifth technical recession in five years, and Abe's second recession since he returned to office three years ago, although latestfigures are being revised. However Japan did not expand its QE programme beyond the existing ¥80tn a year package, as had been expected.



★★★★

'The biggest threat to the US recovery is that it has become the sole driver of global growth, which is expected to be close to 3%. Weak global growth will harm exports and create an over-strong dollar.'

As anticipated, the US recovery has remained strong this year, with high employment figures and strong consumer spending, boosted by the strong dollar and low oil prices. Growth has been below the 3% forecast, however, and is closer to 2.2%. This reflects weak global growth and a slowdown in America's trading partners. The dollar's strength has made it less competitive, while deflationary pressures in Europe and Asia have been driven, in part, by the growing demand for US assets – particularly treasuries – over domestic investment. This has contributed to global financial imbalances which threaten the US's future growth.

★★★★★

'Declining inflation is an important factor in the Fed's decision to be patient about changing its policy stance. Expect the euro to trade at 1.10 to the dollar by year end and the yen closer to 130.'

The strong dollar and low oil price resulted in disinflationary pressures and economic slowdown in many countries which contributed to the FOMC's decision to push back the interest rate rise towards the end of this year or into next year, as expected. Both the euro and the yen fell against the dollar to 1.10 and 125 respectively. US 10 year bond yields traded higher than the expected 1.5%, and significantly higher than the yields on euro government bonds, both resulting in part from the ECB's continued commitment to QE. At year-end, US 10-year bond yields were 2.25%, while German bonds were at 0.58%.

★★★★

'From China expect monetary and fiscal easing and a wide range of reforms to head off the growth headwinds and contain disinflation.'

China has managed a slowdown in its growth rate to below 7% without major disruption. As forecast, this was in part the result of Chinese policy-makers' interventions. In August the renminbi was adjusted downwards as part of attempts to maintain financial stability, while the central bank used money to prop up share prices during the rapid fall in the stock market during the summer. Domestic reforms including the repeal of China's one child policy and the easing of restrictions on Chinese directly buying overseas assets were part of structural reforms introduced to boost growth in the longer-term.

★★★

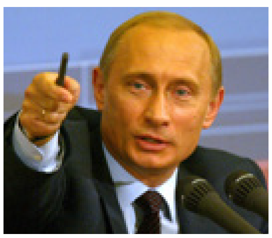
Prediction (Jan 2015): 'Low oil and commodity prices, armed conflicts, and disease will continue to affect poorer African countries and harm tourism.'

Outcome (Dec 2015): Ebola-hit countries have recovered despite the absence of a widely-introduced Ebola cure, suggesting a success for international crisis response measures. However, the crisis highlighted the poor state of public healthcare provision in sub-Saharan Africa, just one of the public policy issues affecting the region's growth prospects, alongside education, infrastructure, and electrification. While the commodity slump has affected Africa's net exporters of these goods, it has also created a boost to net importing countries whose consumer power has increased and which have been able to attract increased inward investment.

★★★

'Oil prices may hit $40 but will bounce back to a range of around $60-$80 per barrel as lower prices boost demand and contributed to higher global growth.'

With US shale producers and Opec members maintaining production levels this year, prices have remained in the $45-55 per barrel range. At the end of the year, prices trended downwards once more as a result of Opec's inability to decide coherent policies.The IMF's downgraded global growth projection this year – from 3.5% to 3.1% – highlights the failure of low prices to boost growth. Despite geopolitical tension in the Middle East, production there has remained relatively stable, while the oil glut of the last 18 months has filled oil storage facilities to record highs, smoothing the futures curve as investors anticipate lower prices will persist.



★★★★

'The dire state of the Russian economy will make President Putin more determined to show his strength. Russia will test Europe over Ukraine and the Middle East, but be central to working with Iran.'

As predicted, Russia was central to reaching a deal with Iran over its nuclear programme. Greater divergence has however emerged between Russia and the West over Moscow's support for the Syrian regime, which has evolved into active military engagement. Putin has been keen to show Russia's military strength, though the focus of this aggression has shifted from Ukraine, which was the main target at the beginning of the year, towards the Middle East. This reflects a further development anticipated at the beginning of the year – that overreach and weaknesses within Russia would lead it to seek a way out of direct western confrontation.

★★★★

'The euro crisis will become more intensive. A deflationary nightmare compounds the dangers from political fragmentation and the rise of populist anti-EU parties.'

Greece has not left the euro, which was a distinct possibility at the start of the year. The government won a parliamentary vote of confidence in October and has agreed to an economic reform programme that has unlocked an €86bn bail-out package from Greece's creditors, giving the government a stronger mandate for structural reform. Beyond Greece, the euro area has entered into disinflationary territory, with the ECB extending its QE programme. The political success of populist parties – in particular the National Front in France – reflects these economic tensions and weaknesses.

★★★★

'Greek debt will need to be restructured, and we will witness ugly scenes as different groups of public sector creditors in Europe and elsewhere jostle to recover their money.'

While the unsustainable size of Greek debt means the need for restructuring remains, it has not yet been agreed. With most of the debt held by European public institutions, there is significant opposition to such proposals. Given the low interest and long repayment schedule for Greek debt, however, much of Greece's repayment has already been pushed back, limiting the effect of further restructuring. With the IMF not yet committed to contributing to the €86bn bailout, while insisting on its status as a 'preferred creditor', divergence between Europe and the IMF on Greek debt has intensified.

★★★

'Pessimism is pervasive, so all the bad news is priced in and we will see more upside than downside surprises. China may reverse its one-child policy; Europe may introduce fiscal stimulus.'

Despite the IMF's reduced global growth forecast and anaemic trade figures, upside forces have also been growing. Efforts to tackle structural weaknesses have increased, with the ECB announcing quantitative easing. The US economy remains strong and Indian growth and Chinese stability have all persisted, while the commodity price slowdown has given some respite to consumers and to net importing countries. One issue not factored in to the predictions was the growing divergence between interest rates and monetary policy in the US and UK on the one hand, and the ECB, BoJ and PBoC on the other, which may add to imbalances.

Global optimism in short supply

Welcome realignment in banking

Louis de Montpellier and Elliot Hentov, State Street Gloval Advisors

The past year could be viewed from a prism of despair. It's hard to be an optimist. Geopolitical disasters included the worsening of the Syria and Iraq wars, sparking flows of refugees and violence into neighbouring countries and continents.

Financial market turbulence over China's economic slowdown and the parallel collapse in commodity prices overshadowed global economic conditions. Fragility swirled around Greece. Worries mounted over the build-up of an emerging market debt bubble, as well as about the Federal Reserve's first rate hike for nearly a decade. Growth forecasts were marked down, in line with the pattern every year since the 2008-09 financial crisis.

There is little evidence of a major bullish turnaround around the corner. However, we should reflect on subtle, gradual changes that are making the world more resilient. From the perspective of central banking and financial market supervision, the global community is in a stronger position than a decade ago.

Large and small central banks – sometimes controversially – have dared the unthinkable to prevent the unimaginable. There is tighter scrutiny on banking systems. Macroprudential regulation has been brought into play to limit excesses. Regulators and supervisors are gradually understanding and tackling risks in non-bank finance.

Central banks and governments have defined the lender of last resort function and reintegrated it into the banking system on a global basis to mitigate unacceptable taxpayer subsidy and realign the banking industry's risk behaviour. There's no justification for a false sense of security, but we should have some confidence that our policy toolbox is more coherent and robust than previously. ■

US hawks held at bay

Yellen maintains rates consensus

Darrell Delamaide in Washington

Since she took the US Federal Reserve chair in February 2014 Janet Yellen has managed to maintain an overall Fed consensus favouring a highly cautious stance on interest rate hikes.

Under the terms of the central bank's dual mandate espousing the goals of full employment as well as price stability, she has used the lack of any evidence of accelerated inflation as a good reason not to raise rates. However, the progressive tightening of the jobs market seems to have accelerated towards the end of 2015 as the US recovery takes hold, making it more difficult to keep the hawks on the Federal Open Market Committee at bay.

After the expected December rate increase away from the 'zero bound', whether this consensus remains in force in 2016 remains a moot point, especially as several hawks who have been non-voters this year rotate into voting positions.

The minutes to the FOMC's October gathering indicated how a December rate increase hung in the balance. 'Several' participants said they were still worried about global economic developments. 'They were concerned about a potential loss of momentum in the economy and the associated possibility that inflation might fail to increase as expected,' the minutes said. 'Such concerns might suggest that the initiation of the normalisation process may not yet be warranted.' This opens up room for conjecture over how many are 'several', as only 10 of the 17 FOMC members get to vote. The hawks v. doves struggle next year will depend on whether the December rate hike slows the economy. ■

Europe under strain

Common solutions elusive

John Nugée in London

The European Union has been wracked by crises. The fragile nature of the Union – and the difficulty of finding consensus solutions to difficult issues – has become ever more apparent. At the start of 2015 Europe faced a challenge on its eastern border from Russia and its activities in Ukraine. A strong and effective common response proved and is proving still very hard to craft.

In spring and summer, the tragedy of Greece unfolded, pitting the northern and southern states of the euro area against each other. In late summer, the migrant crisis exploded. The flaws in the Schengen agreement and in overall EU co-operation were brutally exposed.

In all these areas, the maxim that 'What you see depends on where you stand' has never been more true. The newer eastern member states judge the threat of Russia differently from the old pre-2004 EU-15. Creditor nations judge the Greek crisis differently from the debtors.

Germany sees the opportunity of migration; other nations see more the costs. Yet unity may flow from atrocity. The single worst event of 2015, the November terrorist attacks in Paris, may perhaps remind the nations of the EU how much they have in common, not what divides them. The states and peoples of the EU have no choice but to defeat the evil of militant jihad by working together. ■

ADVISORY BOARD'S 2015 REVIEW

John Nugée is a director of OMFIF. Louis de Montpellier, deputy chairman of the advisory board, is global head, and Elliot Hentov is head of policy and research, at the Official Institutions Group of State Street Global Advisors. Darrell Delamaide is a writer and author based in Washington.

Stefan Bielmeier is chief economist, DZ Bank. Trevor Greetham is head of multiasset at Royal London Asset Management. Linda Yueh is fellow in economics, St Edmund Hall, Oxford.

Jonathan Fenby is China director at Trusted Sources. John West is executive director, Asian Century Institute. Gary Smith is head of sovereign wealth funds and official institutions, MassMutual.

Otaviano Canuto is executive director for Brazil and other countries, International Monetary Fund. Hon Cheung is Regional Director APAC, Official Institutions Group, State Street Global Advisors. Eugene Zhuchenko is executive director, Longterm Infrastructure Investors Association.

Meghnad Desai, chairman of the advisory board, is emeritus professor, London School of Economics and Political Science. David Smith represented the UN Secretary-General in the Americas, 2004-14. Kingsley Chieda Moghalu is professor, Fletcher School of Law and Diplomacy.

World growth remains strong

Doubts over direction of investment cycle

Trevor Greetham in London

The Federal Reserve is embarking on a monetary tightening cycle for the first time since 2006. Assessment of three possible scenarios, taking account of the present economic cycle, leads to the conclusion that gradual and drawn out tightening is most likely, with stock markets continuing to do well for the time being. A more synchronised and inflationary upturn would trigger more concerted rate rises and an increase in financial market volatility.

There are some confusing messages about what may happen after the US starts to normalise interest rates. The 'investment clock' model, linking the global business cycle to the performance of different assets, shows an indeterminate picture.

Falling unemployment in the major economies indicates that the period of above-trend growth that began in 2009 is intact. Yet confidence surveys relating to the global manufacturing sector are weak. While the global inflation trend has been downwards since China started to slow and commodity prices peaked in 2012, base effects suggest a rise in measured inflation rates heading into 2016.

The notion that the coming Fed rate hike will be 'one and done' is misplaced. Consumer strength is driving the US unemployment rate lower and consumers are benefiting from lower energy prices. But, among major central banks, the Fed is a lone hiker, pushing the dollar still higher but with tightening moves gradual enough to keep stock markets on a positive trend.

Meanwhile, euro area growth could surprise positively, with the monetary base and credit measures expanding rapidly even before the European Central Bank extended its stimulus. Even China could see better activity as monetary and fiscal easing measures take effect. In this scenario a series of Fed rate hikes and increased financial markets volatility seem likely. ■

Call for solidarity rebounds on Berlin

Refugee flood poses problems for Merkel

Stefan Bielmeier in Frankfurt

The flood of refugees into Europe and Germany seems to be growing. The figure for Germany for 2015 is estimated at above 1m. Germany's local authorities are reaching capacity limits. The initially very positive sentiment of the German population is ebbing, with fears and worries growing.

For many governments in Europe, the issue is a welcome opportunity to postpone necessary reforms and to forego budget consolidation.

The discussion has become far more strident. Although the media shows still widespread sympathy for refugees, extremist voices are rising, uttering controversial opinions that are deliberately fuelling the population's fears. After some hesitation, the German government has decided to carry out rapid deportation of economic migrants, freeing capacity urgently needed for war refugees.

There is a lack of necessary structures for implementing these decisions on the borders. It is doubtful whether politicians can find effective solutions in the near future.

The debate has far-reaching political implications. Chancellor Angela Merkel and her Christian Democrats have lost electoral favour. If this trend continues Merkel's decision-making capacity will be diminished. At the EU level, the German government is calling for European solidarity. While fully justified, this weakens Germany's negotiating position in other areas – at a time when Berlin's standing has been damaged by the Volkswagen diesel scandal.

In the last few years during the debt crisis, faced with other countries' calls for further-reaching solidarity, Germany has generally been able to get its own way, seen in its resistance to stimulus for hard-hit economies. So it is not surprising that Germany's call for collective action over refugees is falling upon deaf ears. ■

New central banking model

Changes will lead to greater public oversight

Linda Yueh in Oxford

The past year has emphasised the changes in central banks' remits since the financial crisis. The era of pure inflation-targeting is over, as central banks begin to play more of a role in liquidity management and macroprudential regulation.

The European Central Bank is moving towards a more active role in stimulating European demand through attempting to attract greater private sector investment in European infrastructure. This strays closer towards assuming a fiscal policy role – opposed by many central bankers.

The Fed's dual mandate, geared to price stability as well as unemployment, looks more appealing as the world's main central banks move in different directions in considering increasing interest rates (the US and the UK) or undertaking more quantitative easing (the euro area and Japan). The Bank of England is at the forefront of this expanded central banking model, with a financial policy committee operating alongside the monetary policy committee. The challenge is to define 'financial stability' as well as to identify the tools to reach that target.

China and other emerging markets offer some lessons. For countries that peg their currencies, intervening to influence the money supply is essential when interest and exchange rates move in step. Emerging markets' measures such as reserve ratios, macroprudential steps and countercyclical interventions may become more familiar in the West. If such methods of greater financial market control become more prevalent in coming years, improving oversight over the technocrats responsible for implementing them will become a pressing task. ■

Taking over from investment

Chinese consumption boost needed

Jonathan Fenby in Beijing

As China's GDP growth slows, the Beijing authorities regard it as ever more urgent for consumption to take over from investment in fixed assets as the main source of economic expansion. This has been a core policy aim since 2010 when the current Five Year Plan – which ends this year – was drawn up. With some provinces dependent on heavy industry and mining in or near recession, rebalancing towards consumption is vital to China's continued economic development.

During 2015 Chinese retail sales continued to rise at relatively high rates by global standards. However consumption growth is not increasing. While targeted stimulus programmes from government this year mitigated the effects to some extent, the impact was lower than with previous stimulus packages. Sustainable consumer demand growth is needed if consumption is to make up for the decline in industrial activity and the slowdown in construction. The 6.5% growth target implicit in the new Five Year Plan, beginning in 2016, will require a bigger input from consumption. Failing this, the only course to hit that objective looks like being a big increase in leverage in an economy that is already carrying rising levels of debt.

The state council announced in late November a string of measures to encourage consumption. Among promising signs of growth potential, major cities show evidence of a smart phone-enabled increase in consumer service demand. But, for consumption significantly to pick up, the Chinese authorities will have to offset reasons for precautionary saving – above all for healthcare and old age – by building convincing safety nets in these areas. ■

Two children instead of one

Multi-pronged strategy to face demographic challenges

John West in Tokyo

A landmark event in 2015 was the Chinese government's confirmation that it is transforming its one-child policy into one than allows two per family. Most observers have welcomed this effort to counter the effects of a rapidly ageing population and a declining working age.

Closer scrutiny by analysts like Nobel prize-winning economist Amartya Sen suggests that the one-child policy may have had only a modest impact, despite Chinese government claims that it resulted in 400m fewer births. China's fertility rate was already on a downward trend at the time of the policy's implementation in 1979. So the new policy, too, may have less effect than anticipated.

There have already been exceptions to the one-child policy. Some groups have long been allowed to have two children: categories like ethnic minorities, rural families whose first child was a girl, and couples where both parents came from one-child families. Economic development and education would have seen China's fertility rate continue to fall even without the one-child policy, just as elsewhere in East Asia.

Tackling China's demographic challenges requires a multi-pronged strategy, not just easing the one-child policy. When in 2013, the Chinese government relaxed laws to enable couples where just one member comes from a one-child family to have a second child, this did not elicit a strong response: the cost and availability (or lack thereof) of education, healthcare and social security remain obstacles to larger families. On top of these considerations, China's demographic strategy should involve policies like raising its retirement age, increasing productivity, and contemplating selective immigration. Modernising government policy, business practices, and social customs to enable women to combine a fulfilling career with a happy family life must play a strong role. ■

Beijing lifts veil on foreign exchange

Rebuilding of foreign exchange holdings expected

Gary Smith in London

China has begun providing information to the International Monetary Fund about the currency make-up of its foreign exchange reserves, helping to make the Fund's so-called Cofer data on the size and composition of global foreign reserves more accurate and representative. Inclusion of China's statistics confirms the patterns in foreign exchange reserves that have emerged over the past 20 years.

World foreign reserves increased for 58 out of 60 quarters between 2000 and the end of 2014. During this period perceptions have changed about the uses of foreign reserves. A key theme for reserve managers in recent years has been building reserves to offset an increasing list of potential problems. The days when a nation might use its entire stockpile of foreign exchange to achieve one objective (as the UK did when defending sterling in 1992, in a vain attempt to keep it inside Europe's exchange rate mechanism) are probably gone forever. In 2015 reserves are too important to be depleted in the pursuit of just one objective.

Although Cofer data for 2015 have been showing continued quarterly declines in global foreign exchange reserves, the growing importance of such reserves suggests that countries are likely to start rebuilding reserves once the present phase of emerging markets and commodity price weakness is overcome. Informal conversations with reserve managers support this view.

It appears that a '30-70 rule' has evolved. Only 30% of reserves are likely to be spent on dealing with a problem such as a bout of currency weakness; 70% is a reasonable estimate of the desired proportion to conserve, to deal with other problems that may arise. So a further reserves build-up can be expected at some stage in the future. ■

Competitive devaluation threat

Supply chain weakness behind trade slowdown

Otaviano Canuto in Washington

World trade suffered another disappointing year in 2015. Merchandise trade registered a contraction during the first half, and only low growth during the third quarter. This follows a similar pattern since the onset of the financial crisis, in which the responsiveness of trade to global growth (its 'elasticity') has declined.

Between 1990 and 2008, world trade volumes expanded at 6% per year, while global real GDP grew at an annual rate of 3.2%, suggesting an elasticity of around 2:1. Since 2008, world trade has been rising more slowly than GDP, at around 0.8:1, leading to a fall in the share of exports in global GDP.

Several factors help explain this change. The end of the commodity 'super-cycle' which began in the early 2000s has brought lower prices, representing an important limitation on the contribution of commodity exports to world GDP.

Furthermore, the feebleness of the investment recovery of advanced economies, particularly Europe, has suppressed an important source of trade volume, given the higher-than-average cross-border exchanges that characterise investment goods.

Another explanation is the slowdown in the expansion of cross-border supply chains, the growth of which during the 1990s led to the previously high trade-GDP elasticity, owing to the fragmented nature of production processes that these entail. This combination of cyclical and structural factors which have contributed to weak trade in 2015 likely to persist into 2016. As a result, a resurgence in government policies that favour domestic production, or competitive currency devaluations that attempt to boost exports at the expense of other countries, are real threats for the 2016 outlook. ■

Infrastructure to the fore

Asia provides new model for governance

Hon Cheung in Singapore

The creation of the Asian Infrastructure Investment Bank represents a notable milestone for infrastructure development in Asia. It provides, too, a pointer for the direction of Asia's investment philosophy and for future global power alignments. In the post-2008 world, environmental, social and governance principles have become an essential element for asset owners and managers. The AIIB's mantra of 'lean, clean and green' puts the new institution at the forefront of this drive.

With 50 founding members signing the articles of agreement in Beijing, the bank's establishment underlines China's increasing prominence on the international financial and geopolitical stage. Prominence is not necessarily the same as dominance. Collaboration will be critical to the AIIB's success. The text of the articles of agreement contains mechanisms (including super-majority votes, rules regarding the composition of the board of governors and board of directors) to meet the objectives of openness and inclusiveness.

Beyond the articles, the report on the agreement by the chief negotiators offers a tantalising glimpse into how other economies are balancing China's ascendancy, on the one hand, with the need for an equitable basis for international relationships, on the other. Negotiators seem to accept GDP as the basis for capital allocation, even if this may not be explicit in the articles. China says a non-resident board will help make the AIIB less bureaucratic and more cost-efficient than existing mutual development institutions such as the Word Bank. Although the US initially opposed the AIIB's establishment and put pressure on other governments not to join, there have been signs of a change of heart in Washington. Asia's new development bank is likely to set new standards well beyond infrastructure. ■

Progress on Solvency II

Infrastructure becomes an asset class

Eugene Zuchenko in Paris

The European Commission has announced important new treatment of infrastructure under the Solvency II regulations that, first and foremost, recognise infrastructure as an asset class.

In the absence of objections from the European parliament and the council, the amendments will come into force on 1 January, along with application of the Solvency II framework.

The amendments define infrastructure's characteristic features – a long overdue development following more than 20 years of public-private partnership and infrastructure investing by financial institutions in Europe and globally. Most significantly, infrastructure investments will benefit from lower risk charges than equity and debt investments in general.

This means that regulated institutional investors, such as insurers and pension funds, can maintain lower reserves when funding their infrastructure portfolios, which sets a powerful and badly needed incentive for increasing capital allocations to infrastructure.

Assets qualifying as infrastructure under the new legislation must feature highly predictable cash flows and low exposure to construction, operational, financial and political risks.

A dialogue between the investor community and European institutions on this legislation will continue, but the key feature of the amendments – recognition of infrastructure as a low-risk, separate asset class – will no doubt be welcomed by many infrastructure investors and developers around the world. This should help investment in the sector and, more generally, act as a fillip to economic recovery in Europe. ■

Macri boost for Rousseff

Brazil, Argentine woes could spur trade pact

David Smith in Argentina

The economic numbers from Latin America's heavyweight economy, Brazil, make nightmarish reading. With opposition politicians opening formal impeachment proceedings against President Dilma Rousseff, the rest of the region will suffer as the lead player faces its worst recession in almost a century.

Such is the sense of crisis that Mauricio Macri, the new president of neighbouring Argentina, is insisting that Brazil's economic meltdown creates opportunity. It could provide a chance finally to seal a deal between the fractious Argentina-Brazil-led Mercosur trade bloc and the European Union, a pact that has been years in the making.

As Brazil spirals downwards, Argentine exports to Brazil have plummeted 25% in a year, devastating industry and leading to large lay-offs. Brazil's GDP is down 4.5% over the past 12 months. Inflation is running at more than 10%. Unemployment has almost doubled within a year, to 8%. And the real is moving closer to a record low of $R4 to the dollar, a fall of almost 50% over 12 months.

Macri and Rousseff make unlikely compañeros. Macri is a multi-millionaire businessman who prides himself on his lack of ideology. Rousseff is a one-time urban guerrilla who leads the Workers' Party. Rousseff, and her predecessor Luiz Inacio Lula da Silva, made it abundantly clear they did not favour Macri in Argentina's recent election, preferring the anointed heir proposed by President Cristina Fernández de Kirchner. Yet Rousseff and Macri agree that desperate times call for urgent action, starting with a proposal to take the proposed EU trade pact to a Mercosur summit before Christmas. At the same time, Macri will be pushing for Argentina and Brazil to open negotiations with the Trans-Pacific Partnership, the US-led Pacific Basin club embracing Chile, Peru, Mexico. ■

Lot done, lots more to do

Modi chalks up governance successes

Meghnad Desai in New Delhi

India under Prime Minister Narendra Modi has traversed 16 months of one party-dominated coalition government. The headline numbers are excellent with India's GDP rising 7-7.5% this year, the highest in the G20. But inflation remains puzzling.

The wholesale price index has been falling, while consumer price inflation is stubbornly high at 5%-plus. The gap of 8 percentage points is unusual.

Whatever the explanation, the political impact of higher retail prices, especially of items of daily consumption, is always adverse.

Furthermore, inflation prevents the Reserve Bank from cutting interest rates.

Modi has registered some successes. He can point to improvement in efficiency of governance in a variety of fields, ranging from better mobile telephone services, improvement in 'ease of doing business', toilets built in all girls' schools and a success for his Clean India campaign.

The railways are being modernised with a massive investment programme with money from outside. A rupee bond for the Indian railways is to be launched in London, heralding rupee internationalisation.

Yet legislative reform is proceeding slowly. Indian parliaments are often held to ransom by misbehaving MPs who disrupt proceedings. While the government enjoys a majority in the lower house it lacks one in the upper house. The 'goods and services tax' – a most important piece of legislation that would harmonise multiple local taxes – is pending in the upper house. The inexperience of the government and the clout of the old political establishment, now in opposition, will determine this political battle. The GST may pass this winter session but progress will not be quick. ■

Nigeria seeks new investor interest

Buhari crackdown on government spending

Kingsley Chiedu Moghalu in Boston

Nigerian President Muhammadu Buhari's allocation of ministerial portfolios, long delayed following his election victory at the end of March, places emphasis on efficiency improvements and a crackdown on government spending. The outcome should revive business sentiment and investor interest in Africa's largest economy.

In a solid cabinet of capable players, key figures include Babatunde Fashola, former governor of Lagos, minister of an enlarged power, works and housing infrastructure ministry. Ibe Kachikwu, the former Exxon-Mobil executive, who is head of the country's state oil corporation, will also be minister of state for petroleum resources. Geoffrey Onyeama, the urbane former deputy director-general of the World Intellectual Property Organisation, a UN agency, becomes foreign minister.

Kemi Adeosun, a former investment banker and finance commissioner in the southwestern state of Ogun, takes the crucial role of finance minister. She was articulate and clear-headed during her parliamentary confirmation hearings and will grow in stature. She has set the objective of saving $5bn a year through better-directed government spending and efforts to combat corruption and waste, setting up an 'efficiency unit' modelled on UK government practice to improve efficiency.

The task ahead is to transform Nigeria towards a productive, largely self-reliant economy, weaned away from import dependence. Buhari must accomplish a difficult task: maintaining fiscal prudence and a welfare-oriented state, despite constraints from declining oil revenues. ■

Harnessing African savings

Pooling of reserves could be crucial

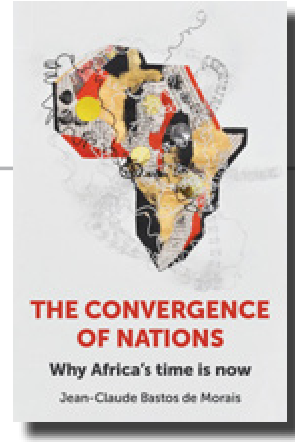
Jean-Claude Bastos de Morais

Africa needs to find manageable, reliable and innovative ways of harnessing the sizeable volumes of wealth and savings inside the continent, making it less dependent on external financial sources. Africa can channel funding from home and abroad towards profitable and useful investments that promote African people's social wellbeing, and that can also build a sustainable basis for development and growth.

Moves are afoot to make national markets larger and less illiquid by improving deal flow, enhancing activity beyond the standardised financial sector, and improving regulatory and supervisory practices. Slowly, a more interconnected pan-African investment industry is being built through the emergence of African institutional investors. Many different players need to engage in these activities – from governments, treasuries, central banks and development agencies to pension funds, commercial banks, other savings organisations, private equity groups, venture capitalists and brokers – as well as myriad individuals across the spectrum, whether small savers or larger family investors. In finance, Africa can benefit from a pioneering spirit that learns from the rest of the world. For example, African central banks and other public sector asset managers should give more thought to providing liquidity to try to vitalise a genuine inter-banking and pan-African capital market.

Pooling of reserves and other liquid assets could facilitate additional financial backing for industry and services. African central banks, while giving up illusory ideas on forging continent-wide monetary union and a single currency, could adopt an evolutionary approach towards forging better cooperation.

One such example could perhaps be in the form of an African-style Bank for International Settlements, along the lines of the international central bankers' bank headquartered in Basel, Switzerland. In setting up such structures, it would be better to build on existing arrangements and work closely with bodies such as the African Development Bank and the African Union.



More widely, amid a swing towards negative interest rates in the developed world, institutional investors searching for yield can find it in Africa by increasing the risk appetite for the continent through African-focused private equity. Mirroring ideas for more creativity on the financial markets, similar initiatives are needed in infrastructure, industry, energy and transport. ■

Jean-Claude Bastos de Morais is founder of the Quantum Global Group. This is an extract from The Convergence of Nations – Why Africa's Time is Now, published by OMFIF Press. The extracts below are contributions from some of the 31 individual authors.

Continent on journey to 'African capitalism'

'The question is whether the rise of African capitalism and of free markets will do for Africa what it has done for the West and large parts of Asia. I favour emancipation from a foreign aid culture, better frameworks for financial market innovation and foreign trade and investment, and an African 'world view' about our place in the global political economy.' – Kingsley Chiedu Moghalu, former Deputy Governor, Central Bank of Nigeria

'Using advances in technology, communications and design processes, Africa's cultural designers and creators are working out the best ways of developing and selling brands across the global marketplace, as Malawian, Nigerian or Kenyan products – and producing overall gains for Africa's creative economy. Return of US- and Europe-based African artistes is bound to generate a renewed impact on the creative scene.' – Abena Annan, Founder, Obaasema Magazine

'Declining resource prices present opportunities and challenges. Low oil prices present a chance for subsidy reform. But central banks of oil-exporting countries will have to balance supporting growth against maintaining stable inflation and investor confidence. Political will is needed for structural policies such as energy tax reforms and economic diversification – all conditions for productive investment.' – Gerard Lyons, Chief Economic Advisor, Mayor of London

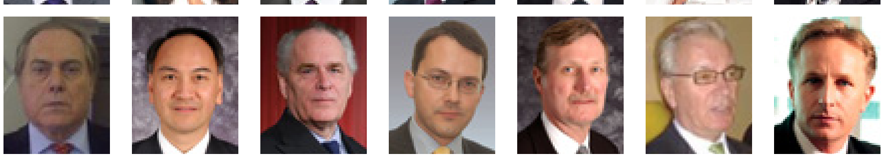
'Africa's demographic development, the rate of urbanisation and adoption of new technologies underpin long-term growth. A rising middle class signals job creation as well as growing financial intermediation and a deeper financial system. Africa's low-cost infrastructure should enable expansion of financial services and access to credit, insurance and savings products for low-income populations.' – Razia Khan, Regional Head of Economics, Africa, Standard Chartered Bank

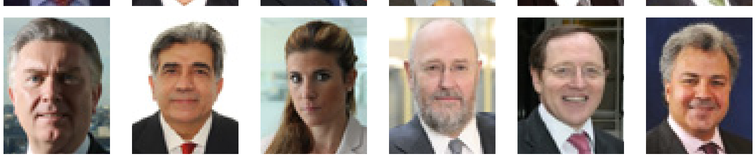
'The challenge of declining resource prices presents opportunities and challenges. Low oil prices are a chance for subsidy reform. But central banks of oil-exporting countries have to balance supporting growth against maintaining stable inflation and investor confidence. Policies such as energy tax reforms and economic diversification are needed – all conditions for productive investment.' – Kevin Chika Urama, Managing Director, Quantum Global Research Lab

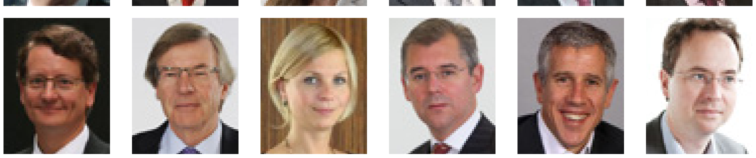
EDITORIAL & COMMENTARY

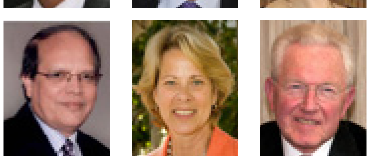
BANKING

CAPITAL MARKETS & INVESTMENT









Aslihan Gedik, Senior Adviser
Norman Lamont, Senior Adviser
John Nugée, Director
John Plender, Director
Fabrizio Saccomanni, Senior Adviser
Ted Truman, Senior Adviser
Pete Wilkin, Director

EDUCATION & RESEARCH

Iain Begg, London School of Economics
Harald Benink, Tilburg University
Gottfried von Bismarck, Körber Stiftung
Michael Burda, Humboldt University, Berlin
Nick Butler, King's College, London
David Cameron, Yale University
Forrest Capie, CASS Business School

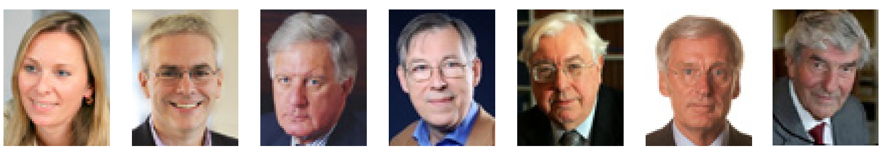
Mark Crosby, Melbourne Business School
Jon Davis, Queen Mary University, London
Haihong Gao, Institute of World Economics and Politics
Steve Hanke, Johns Hopkins University
John Hughes, former UK Ambassador to Argentina
Ray Kinsella, University College, Dublin
Ludger Kühnhardt, Center for European Integration Studies

Mariela Mendez, Escuela Superior Politecnica del Litoral
Rakesh Mohan, International Monetary Fund
José Roberto Novaes de Almeida, University of Brasilia
Michael Oliver, ESC Rennes School of Business
Danny Quah, London School of Economics
Abdul Rahman, International Academy of Retail Banking
Richard Roberts, King's College, London

Shumpei Takemori, Keio University
Maria Antonieta Del Tedesco Lins, University of São Paulo
Niels Thygesen, University of Copenhagen
Daniel Titelman, ECLAC
Peter Walton, ESSEC Business School
Linda Yueh, BBC
Hans Genberg, SEACEN

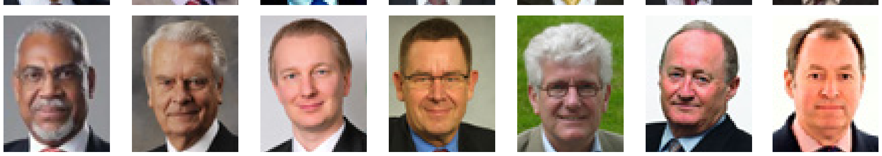
PUBLIC POLICY

Antonio Armellini, former Abassador, OSCE
Franco Bassanini, Cassa Depositi e Prestiti
Frits Bolkestein, formerly European Commission
Laurens Jan Brinkhorst, University of Leiden
Colin Budd, formerly UK Diplomatic Service
Otaviano Canuto, World Bank
Desmond Cecil, Areva UK



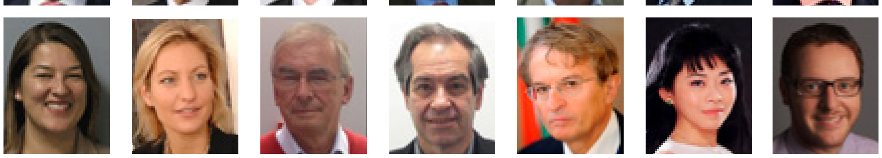
Natalie Dempster, World Gold Council
Jonathan Grant, Policy Institute at King's
Peter Heap, former UK Ambassador to Brazil
François Heisbourg, Fondation pour la Recherche Stratégique
John Kornblum, former US Ambassador to Germany
Ben Knapen, European Investment Bank
Ruud Lubbers, former Dutch Prime Minister

Bo Lundgren, formerly Swedish National Debt Office
Denis MacShane, former British Minister for Europe
Kishore Mahbubani, Lee Kuan Yew School of Public Policy
Boyd McCleary, former HM Diplomatic Service
Luiz Eduardo Melin, Brazilian Development Bank
Célestin Monga, UNIDO
John West, Asian Century Institute

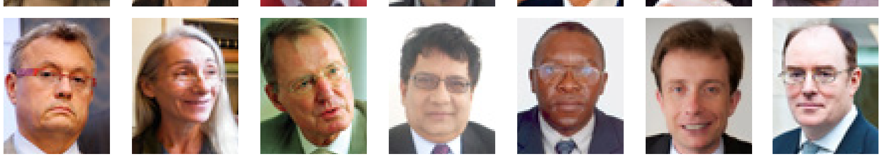


Murade Miguigy Murargy, CPLP
David Owen, House of Lords
Jukka Pihlman, Standard Chartered Bank
Poul Nyrup Rasmussen, former Danish Prime Minister
Paul van Seters, Tilburg University
Christopher Tugendhat, House of Lords
Paul Wilson, De La Rue

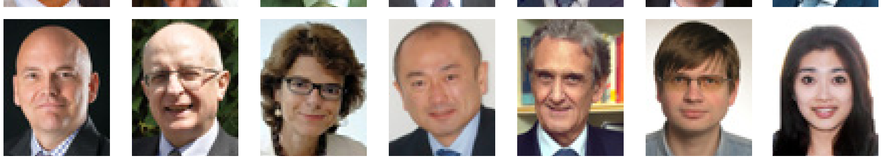
ECONOMICS & INDUSTRY



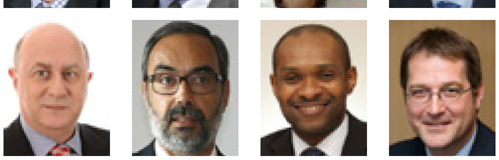
Irena Asmundson, California Department of Finance
Katinka Barysch, Allianz
Robert Bischof, German-British Chamber of Industry & Commerce
Eduardo Borensztein, Inter-American Development Bank
Albert Bressand, European Commission
Shiyin Cai, Business Adviser
Efraim Chalamish, New York University



Vladimir Dlouhy, former Czech Industry Minister
Brigitte Granville, Queen Mary, University of London
Hans-Olaf Henkel, University of Mannheim
Hemraz Jankee, formerly Central Bank of Mauritius
David Kihangire, formerly Bank of Uganda
Pawel Kowalewski, Deutsche Bundesbank
Gerard Lyons, Greater London Authority



Stuart Mackintosh, Group of Thirty
Winston Moore, Moore Asociados
Vicky Pryce, formerly UK Department for Business
Takuji Tanaka, Innovation Network Corporation of Japan
Pedro Schwartz, CEU San Pablo University
Vilem Semerak, Charles University, Prague
Song Shanshan, SDIC CGOG Futures

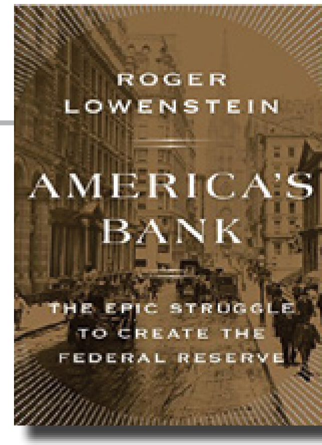


Gabriel Stein, Oxford Economics
Jorge Vasconcelos, New Energy Solutions
Obindah Gershon nee Wagbara, Georgetown University
Volker Wieland, German Council of Economic Experts

A Bank for America

The making of the Federal Reserve

George Hoguet, Advisory Board



Perplexed foreigners trying to understand the American Tea Party and 'Audit the Fed' Movement may be interested to learn that, far from being aberrations, these phenomena have deep historical roots and reflect concerns that date right back to the founding of the Republic. At bottom lies a deep suspicion of centralised authority and large banks.

In his masterful book, *America's Bank – The Epic Struggle to Create the Federal Reserve,* Roger Lowenstein, the American journalist and author, chronicles the events leading up to the creation of the Federal Reserve, and the political compromise that led to its current structure – a centralised board of governors and 12 decentralised regional banks. It is a gripping story, rich in historical detail and informative minutiae.

Few people know, for example, that while Federal Reserve notes (dollar bills) make up more than 99% of US currency in circulation today, there are still outstanding some US notes (greenbacks), National Bank Notes, and silver certificates, all of which remain legal tender.

The first part of the book provides a brief monetary history of the US up to the Panic of 1907. Alexander Hamilton, the first secretary of the Treasury, was able to persuade George Washington, over the intense objections of Thomas Jefferson, to establish the first US central bank – the First Bank of the United States, chartered in 1791. The charter lapsed in 1811. President Andrew Jackson, a soldier and Indian fighter, reflecting the deep suspicion of federal power among the pioneer settlers of the American West, vetoed in 1832 legislation rechartering the Second Bank of the United States. For a formative period in its history, America was without a central bank.

In the ensuing decades after the veto, the American economy witnessed violent booms and busts, financial panics, and a proliferation of currencies – some 8,370 varieties of notes in the Union states alone at the time of the Civil War. The National Bank Acts of 1863 and 1864 unified the currency but did not provide for the pooling of bank reserves. And America experimented with both a gold and combined gold and silver standard. From 1867 to 1897 prices fell relentlessly, imposing particular hardships on farmers and debtors. The financial panics and bank failures of 1893 and 1907 gave impetus to the creation of an institution that could serve as a lender of last resort and provide an 'elastic' currency (a currency that automatically increases or decreases in volume with the demands of business).

Policy positions and compromises

In the second part of the book, Lowenstein outlines the policy positions and compromises of five principal architects of the Federal Reserve Act of 1913: Paul Warburg, a German banker (and later naturalised American citizen); Nelson Aldrich, a self-made man, Rhode Island Senator and Chairman of the Senate Finance Committee; Carter Glass, son of a Confederate soldier, ardent 'states' rights' activist, and Congressman from Virginia; William Jennings Bryan, 'The Great Commoner', Nebraskan, three times Democratic nominee for President, and champion of farmers and working class Americans; and Woodrow Wilson, the only President in American history to hold a Ph.d, and who astutely observed that, 'Every nation is renewed out of the ranks of the unknown men.'

Lowenstein also outlines the contributions of many other thinkers who influenced the debate: for example, Victor Morawetz, a railroad man and the first to propose a system of independent regional banks; Congressman Charles Lindbergh (father of the aviator), who called for an investigation of JP Morgan and the 'Money Trust', 'a vast and growing concentration of control of money and credit in the hands of a few men'; and Robert Owen, chairman of the Senate Banking Committee, who demanded that control over the Federal Reserve rest in the federal government. And many others.

After extended study trips to Europe to understand central bank practices, and after a secret meeting on Jekyl Island in Georgia with three top bankers, Aldrich came up with the 'Aldrich Plan'. This was designed to create a more unified banking system as well as a more logical basis for the currency and liquid markets for bank paper. The legislative debate raised many objections and counter-proposals, including a Glass-Owen proposal. Wilson cited three principles for banking reform. These included an elastic currency, mobilisation of reserves (effectively a lender of last resort function), and abolishing the concentration of monetary resources in just a few banks. After an intense period of horse-trading, the legislators agreed on the current structure of the Federal Reserve. On 23 December 1913, Wilson signed the Federal Reserve Act into law. Not long afterwards the dollar began its ascent as the world's principal reserve currency.

This book is highly relevant to today's world and captures many debates that resonate throughout American history: centralised authority versus local control; Wall Street versus Main Street; Washington versus the financial services lobby; and East versus West. ■

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