The Bulletin

December 2016
Vol. 7 Ed. 11

Power of personality

Tides turning on central banks

Carlo Cottarelli on financial repression
Mojmir Hampl on multiple mandates
Norman Lamont on Iran nuclear deal
Øystein Olsen on inflation targeting
DeLisle Worrell on benefits of dollarisation
Linda Yueh on currency volatility

FOCUS
2016 in review

OMFIF

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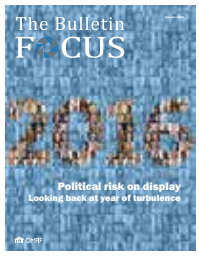

2016 in review

OMFIF OFFICIAL MONETARY AND FINANCIAL INSTITUTIONS FORUM

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

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EDITORIAL

Central banks, under fire, prepare for new leadership

Central banks are under fire, not for the traditional reason of high interest rates, but because of low ones. After the expected US rate rise in mid-December – only the second formal Federal Reserve credit tightening in 10 years – the heat is not likely to die down. OMFIF's November edition was dedicated to an international shift to tighter monetary and looser fiscal policy. The December Bulletin focuses on another tide that is turning: greater constraints on central banking independence. Central banks are guided not just by statute and practice, but by the power of personality. As David Marsh notes, governments have an unusual opportunity to stamp their mark on monetary decision-making. In the next three years, governors of the top six worldwide central banks – the Fed, People's Bank of China, Bank of Japan, European Central Bank, Bank of England and Germany's Bundesbank – will reach the end of their terms and may be replaced by new faces.

In the US, criticism of Janet Yellen, the Fed chair, by President-elect Donald Trump has generated headlines even before he moves into the White House. The auguries for transatlantic monetary relations are poor. In circumstances bearing some resemblance to today, US monetary policies after the election of two past Republican presidents – Richard Nixon in 1968 and Ronald Reagan in 1980 – led to squalls (the first when the dollar was weak, the second when it was strong) with significant international political impact. Possible tensions between two female heads of government in Europe – Angela Merkel in Germany and Theresa May in the UK – and their respective central bank governors, Mario Draghi and Mark Carney, are points of vulnerability in the months ahead.

We devote the monthly Focus to a review of the past 12 months, measuring the OMFIF advisory board's 2016 New Year predictions against the course of events. The forecasts in the January 2016 edition highlighted political risk. Overall, OMFIF comfortably beat the consensus. We forecast that Hillary Clinton might not make it to the White House (we predicted Trump's popularity but not his victory); the Fed funds rate would not rise above 1%; the UK would vote narrowly to leave the European Union; and the oil price would recover to $45 to $50 a barrel by end-2016. Furthermore we foresaw the renminbi would fall against the dollar; Angela Merkel would resist her political adversaries; emerging market currencies would recover; the US and Russia would achieve no rapprochement over Syria; and South African President Jacob Zuma would narrowly hang on. We were on less sure ground in predicting yen weakness, a fall in overvalued equity prices and another euro crisis – but all these topics remain on the agenda for 2017.

On the travails of central banks, Andrew Large, former deputy governor of the Bank of England, investigates the problem of enlarged mandates, while Mojmir Hampl, deputy governor of the Czech National Bank, stresses the importance of communication. Øystein Olsen, governor of Norges Bank, explains the complications from lack of support in other policy areas. Focus on weakening the exchange rate raises the risk of currency wars, warns Linda Yueh. Carlo Cottarelli addresses the danger of negative returns for savers through 'accidental financial repression'. Peter Warburton highlights the risk of accidental tightening through QE's liquidity effects. DeLisle Worrell, governor of the Central Bank of Barbados, writes that the benefits of dollarisation outweigh the costs for small open economies. Meghnad Desai reflects on India's demonetisation experiment.

December's 40th anniversary of the UK's 1976 sterling crisis, marked by the OMFIF Press with Richard Roberts' *When Britain Went Bust*, represents a watershed not just in the balance between Keynesian and monetarist policies, but also for central bank independence. As William Keegan writes in his review of the book (being launched on 8 December at the UK Treasury, with Johannes Witteveen, former IMF managing director), 'The book could hardly have appeared at a more appropriate moment.'

Paradox of European central banking

Limits of independence: markets depend on ECB easing

Stefan Bielmeier, Advisory Board

At the peak of the euro crisis, classical central bank policy became ineffective. The European Central Bank decided in January 2015 to implement large-scale asset purchases to rekindle credit and narrow lending spreads among euro member countries.

After several rounds of escalation, including a rise in monthly purchases to €80bn and a broadening of the range of asset purchases, the total size of the quantitative easing programme has reached €1.4tn. Yields across EMU have fallen dramatically and are even partially negative, while the spreads between member states have narrowed considerably. The effect has been paradoxical. On the one hand, the ECB under Mario Draghi, its president, has manifestly failed to meet its targets either in accelerating loan demand or in markedly increasing inflation. On the other it has inadvertently surrendered its independence by making market participants dependent on its actions. If the central bank were to wind down its asset purchases soon this would probably trigger a financial market crisis. So the governing council's hands are effectively tied. We must hope that the ECB manages to wean financial markets off its easing actions over time and can restore its independence gradually.

One might have expected that, in view of the size of its QE programme, the ECB would have achieved its goal. But inflation and inflation expectations remain well below target, principally as the result of oil price weakness. Latest credit surveys reveal a decline in the number of banks expecting an acceleration of loan demand. The ECB had pinned its hopes on euro bloc countries using low interest rates to shift their economies to a higher gear through radical reforms. This has been only partially fulfilled. Growth-enhancing reforms can often be painful in the short term, encouraging populist parties. So member states on the whole have decided to take the line of least resistance by devoting more or less the entire 'Draghi dividend' generated by the ECB's easing not to cutting debt but to electoral sweeteners.

The ECB is plainly frustrated at the euro area's inability to develop self-reinforcing recovery. What's left is a financial sector battered by negative interest rates, countries overly dependent on favourable refinancing and a financial market overly reliant on the ECB as structural buyer of government debt. With US rates about to rise and an unpredictable incumbent heading for the White House, this is a hazardous time.

Stefan Bielmeier is Head of Research and Chief Economist at DZ BANK.

Briefings

Co-operation 'key' in OMFIF Asia push

Co-operation between East and West may be more necessary and difficult in the new global constellation after the election of Donald Trump, guests were told at a reception at the National University of Singapore on 16 November, marking the establishment of OMFIF's Asia office on the campus of the university's Lee Kuan School of Public Policy.

The launch was presided over by Lord (Meghnad) Desai, chairman of the OMFIF advisory board, who said that the new office 'is in close proximity to many of OMFIF's regional partners which have shown great support for the expansion'. David Marsh, OMFIF managing director, said of the launch, 'A presence in Asia is the next step for the continued development of strong ties with public and private sector institutions in the region.'

The 100 guests were addressed by Prof. Kishore Mahbubani, dean of the LKY School, Ravi Menon, managing director of the Monetary Authority of Singapore, and Adam Cotter, head of Asia at OMFIF. 'In developing our coverage and understanding of Asia, we will also bring policy-makers from the US, Africa, Latin America and Europe to the region,' said Cotter.

Role of Asia savings in world economic system

Greater use of Asian currencies and savings for funding infrastructure investments in the region are key elements of future Asian growth, attendees were told at the annual Asian Central Banks' Watchers Group meeting, organised by OMFIF and the Monetary Authority of Singapore on 17 November in Singapore.

The meeting considered the themes of Asia's role in the world economic system; challenges and opportunities in a multicurrency financial and reserve system; the strategic and geopolitical outlook; and Asia Pacific's prospects after the US elections. Senior representatives of official and private sector institutions from Asia Pacific and beyond discussed critical policy and investment issues affecting the region and its links with the rest of the world.

Trichet on euro, Italy referendum

Jean-Claude Trichet, former governor of the Banque de France and former president of the European Central Bank, addressed an OMFIF lunch discussion on 18 November in London on the fate of the euro area, the impact of Britain's European Union withdrawal and the US election, and questions of central bank independence. Trichet also spoke about the 4 December Italian referendum, and developments in the French presidential election campaigns, as well as the outlook for the next stage of the ECB's quantitative easing.

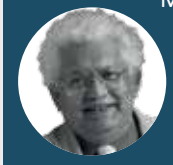
US Treasury points to resilience

Nathan Sheets, US Treasury under secretary for international affairs, underlined market resilience in the face of global upsets such as the aftermath of the US election, the Brexit decision and other geopolitical challenges at an OMFIF meeting on 18 November in London. The discussion dealt with the increase in political uncertainty surrounding the UK's EU negotiating position and the policies of President-elect Donald Trump, particularly in relation to infrastructure spending in the US and proposed reforms to corporate tax law.

Buti on Europe's economic outlook

Marco Buti, director-general for economic and financial affairs at the European Commission, addressed an OMFIF lunch discussion on 21 November in London examining macroeconomic influences and stability issues facing the euro area and wider Europe. Buti discussed concerns relating to financial fragmentation, further progress on banking union, and how monetary and fiscal policy ought best be deployed to support the European Union.

Markets 'will adjust' to Trump win



Markets will adjust to Donald Trump's victory as realisation grows that some of the US president-elect's policies will be tempered by Congress, and others will be good for the economy, said Meghnad Desai, OMFIF advisory board chairman, in a telephone briefing on 9 November. Desai was joined by a panel of speakers including Marsha Vande Berg of Stanford University, Sebastian Mallaby of the Council on Foreign Relations, and John Davies of Standard Chartered Bank.

Japan debt monetisation call

Japan should explore partial debt monetisation in view of the rise in Bank of Japan government debt holdings, low growth and zero inflation, delegates were told at a seminar organised by the Japan Centre for Economic Research and OMFIF on 21 November in Tokyo.

The seminar was attended by representatives from major public and private financial institutions and academic bodies from Japan, US, Australia and Europe.

Speakers addressed macroeconomic and regional concerns, including the role of Japan in the world financial system, the future of the Bank of Japan's aggressive monetary easing in the light of the rise in bond yields after the US elections, and the repercussions of Chinese economic rebalancing.

Banks 'must avoid overreach'

Central banks must avoid policy overreach and expand transparency and accountability to respond to threats to their independence, according to speakers at a financial stability seminar by South East Asian Central Banks (Seacen) Research and Training Centre and OMFIF in Kuala Lumpur on 23 November.

Attendees discussed refining policy frameworks to meet the needs of a global economy affected by large-scale political and financial uncertainties. Speakers, including officials from government ministries and central banks from Asia, Europe and Japan, addressed conflicts between financial stability and monetary policy mandates and international effects requiring cross-border safety nets.

Forthcoming meetings

Prudent debt management
City Lecture at Columbia University's School of International and Public Affairs with Daleep Singh, acting assistant US Treasury secretary for financial markets. Singh previously served as the Treasury's deputy assistant secretary for Europe and Eurasia.
6 December, New York

When Britain Went Bust
An evening discussion at the UK Treasury with Johannes Witteveen, former IMF managing director, Tom Scholar, permanent secretary to the Treasury, and Lord (David) Owen, former UK foreign secretary, marking the launch of *When Britain Went Bust – The 1976 IMF Crisis* from the OMFIF Press by Richard Roberts, professor of contemporary financial history at King's College London.
8 December, London

Monetary policy challenges during the great transition
City Lecture with Veerathai Santiprabhob, governor of the Bank of Thailand, on Southeast Asian and global macroeconomic trends, monetary policy, challenges for the Thai economy and the influence of the US elections, the Chinese slowdown and other geopolitical developments.
10 January, London

For details visit www.omfif.org/meetings.

Curry on US banking regulation

Thomas Curry, US comptroller of the currency, administrator of the federal banking system, outlined developments in US and international bank regulation and co-operation between the US and Europe at an OMFIF meeting on 3 November in London. Attendees discussed the relationship between law enforcement agencies and prudential authorities in the US, prospective developments in the banking sector and banking regulations under President-elect Donald Trump.

How Trump will affect Abenomics

Etsuro Honda, Japanese ambassador to Switzerland and economic adviser to Prime Minister Shinzo Abe, gave a presentation to an OMFIF meeting on 15 November in London, relating to the reinvigoration of Japan's economy, monetary policy, growth prospects, and the next stages of Abenomics. Attendees were told about the effect of Abenomics on the labour market, along with the Bank of Japan's inflation targets and the implications of Donald Trump's presidency for Japanese monetary policy.

Flug on reserves, sovereign fund

Karnit Flug, governor of the Bank of Israel, addressed an OMFIF breakfast meeting on 10 November in London on macroeconomic and geopolitical trends affecting Israel and the Middle East, the effects of the US elections and challenges that lie ahead, including from fluctuating energy prices and uncertainties in the overall outlook. The discussion covered international issues such as Israel's relations with US and UK trade partners, reserves management and the future of its sovereign fund.

Brexit challenge 'could delay timetable'

A legal challenge against the withdrawal of the UK from the EU could delay the exit timetable set out in Article 50 of the Lisbon Treaty by several months, according to one scenario explored in an OMFIF telephone briefing on 16 November with experts from the City of London, World Trade Organisation and University College London. The discussion explored the impact of the High Court ruling that Parliament should be included in the process, as well as trade agreement concerns facing the UK.

Governments could take away powers

Making clear what central banks can and cannot do

Andrew Large, Advisory Board

Central banks have been in the firing line lately – and the challenges will grow more severe, especially in the US, after the election of Donald Trump. In retrospect central bankers would have been wiser, upon taking on increased mandates after the global financial crisis, to be more assertive about what they could and could not achieve. They should have been firmer in pointing out where structural or governmental fiscal measures would have been preferable to monetary actions.

If central banks fail these challenges, they risk governments stripping them of their enlarged powers.

Central banks need to demonstrate some humility. Although much has been achieved in monetary policy, and since the global financial crisis in financial stability as well, there is much that neither central banks nor the rest of the world understand. Moreover, central banks need to improve their communications strategies. They must inspire confidence. To do this they should be careful to communicate only what they know they can achieve.

Trade-offs for central bank mandates

In democracies, there is always tension over placing power in the hands of unelected officials. This extends to the authority exercised by central banks. However, the delegation of powers has long been regarded as legitimate for the traditional central bank function of acting as lender of last resort.

In the latter decades of the 20th century, monetary policy came within central banks' remit, and was accorded political legitimacy, for two basic reasons. First, central banks could be held accountable, since the results of policy actions in terms of inflation and price stability were observable and measurable. Second, it was understood that monetary policy would improve if conducted by those with the requisite economic expertise.

The inconsistency of giving central banks delegated powers, with objectives set by politicians, was seen as preferable to politicians or any other party trying to do the job. However, this consensus has come under strain in many jurisdictions including the US, the euro area, Japan, and the UK.

Targets for perceived failures

The No.1 reason concerns the widening of central banks' mandates. 'Too much power' raises hackles and makes central banks targets for perceived failures. Although varying across jurisdictions, policy areas now within the formal ambit of central banks include prudential regulation of a complex financial sector; conduct of both customers and markets; and, most significantly, responsibility for underpinning financial stability.

The latter requires policies for macroprudential activity designed to provide early warnings and mitigate threats; being satisfied that banks and other financial institutions and infrastructure are stronger and more resilient; and ensuring that, if there are failures, the mechanisms are in place to reduce their impact and cost.

One big problem here is that financial stability outcomes cannot be measured as price stability and inflation can. Central banks don't know if they have failed until it is too late. The costs of avoiding failure can be substantial. Additionally, where central banks are dealing with complex financial systems, the danger of confusion and policy conflict is ever-present – threatening damage to central banks' overall credibility.

A second reason for the strains is the complications stemming from interest rates at zero or below. Policy actions intended to get inflation back to target have demonstrated that central banks are finding difficulty in achieving their remit. Quantitative easing has introduced asset price distortions that have benefited some at the cost of others. Moreover, QE comes ultimately closer to a fiscal dimension which is normally the prerogative of politicians, not central banks.

> ***"Central banks need to improve their communications strategies. They must inspire confidence. To do this they should be careful only to communicate what they know they can achieve.***

Third, macroprudential policy choices inevitably have selective impact, perhaps more so than interest rates in the case of monetary policy. For example, home-buyers, or their lenders, may be selectively affected. And where people object, in the absence of hard evidence that the actions were necessary, politicians will listen.

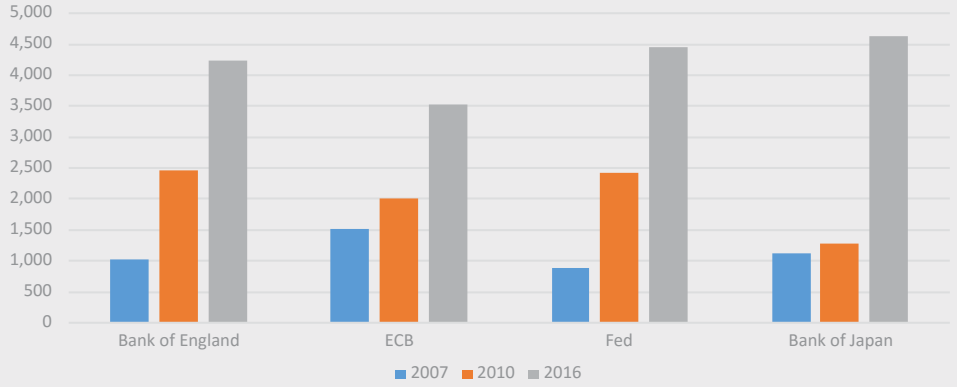
The fourth reason is the rise of populist politics. Such movements tend to denigrate the establishment, decry its expertise, and suggest that its policies are politically motivated. Central banks with their delegated powers are not exempt from these rebukes.

One big nagging question remains: Who could do a better job? No one is suggesting that price stability, inflation and financial stability do not matter: quite the opposite. Politicians may feel that they can somehow do better, but the historical record is not on their side.

Central bankers need to continue with their central mandates, while becoming more adept at mastering the challenges that accompany their increasingly complex jobs. ■

Major central banks' balance sheets expanding since global recession

Total central bank balance sheet assets, in local currency (£100m, €bn, $bn, ¥100bn)



Source: Bank of England, Federal Reserve economic data, OMFIF analysis

Sir Andrew Large was Deputy Governor of the Bank of England and a Member of its Monetary Policy Committee from September 2002 to January 2006. He is a Founding Partner of the Systemic Policy Partnership.

Creating money: public-private partnership

Central banks must explain their changing roles

Mojmir Hampl, Czech National Bank

Central banks in the developed world have had one thing in common since 2008: they have been a target of criticism and a source of frustration for the general public. The criticism is often shallow and unconstructive. Politicians, pundits and academics complain but rarely offer alternative suggestions or plans for reform of the monetary order. Even when one asks the more erudite critics what they think the base rate should be in the euro area or the US, the usual reply is an awkward silence.

Sophisticated monetary system reform proposals such as those presented in recent years by Mervyn King, former governor of the Bank of England, or Adair Turner, former chairman of the UK Financial Services Authority, are thin on the ground. There is no doubt that, for many people, monetary policy has become almost a showcase for the ills of the modern western world. That is a problem for central bankers, no matter how much they believe their work to be meaningful and their decisions to be right.

Misunderstandings of money creation

After 2008, central banks started to tell a different 'monetary story' to the one people were used to. By contrast, public confidence in and understanding of the monetary system are still grounded in the previous narrative, which was based on three building blocks.

First, the central bank is the sole creator of money and therefore has perfect control over the quantity of money. Money is thus exogenous, to use the language of economics. Second, commercial banks do not create money but merely convert existing deposits (or loanable funds) passively into loans. And third, the lower the growth in the price level, the better.

This narrative did a good job of reconciling public preferences and central bank decisions when bankers were fighting inflation before 2008 and working successfully to stabilise it. However, this simplified story stopped functioniong as a bridge between the public and central banks when central bankers started to combat weak demand and the risk of deflation. They have also moved into new policy areas through expanded mandates, measured in a number of academic studies (see Chart). It is difficult to explain that the building blocks of the previous narrative are not working in practice. They never did.

> ***"Central banks have been warning about the risk of flooding for so long that they are now unable to explain that drought can be just as big a problem.***

They were merely part of a myth that no one wanted to bust for fear of throwing a spanner in the works.

In a fractional reserve system, commercial banks (not just the central bank) create a large part of the money in circulation. Commercial banks therefore do not merely convert loanable funds passively into loans, but also create new deposits. The central bank does not and cannot have full control over the quantity of money in the system.

Money creation is a public-private partnership between the central bank and commercial banks. And the quantity of money in the system varies; in fact it must vary if the purchasing power of money is to be kept broadly constant over the cycle. Furthermore, deep and persistent deflation is just as disruptive to the economy as high inflation, often more so.

So the previous widely communicated story of 'good money' has been undermined. This gives rise to a growing lack of understanding and a communication gap between central bankers and the public. Most significantly, and paradoxically, they are stoking fears of a fall in the purchasing power of money at a time when inflation (the key measure of purchasing power) in developed countries is lower on average than it has been for years.

Escaping the monetary drought

To put it simply, central banks have been warning about the risk of flooding for so long that they are now unable to explain that drought can be just as big a problem. They are also unable to explain that at times of drought you should water the garden, not keep draining it dry. And if the hosepipes are blocked, you must use other means to water the plants.

In tough economic times, it is difficult to describe quickly such a story to a public which is inattentive to the mysteries of complex systems. This is particularly true in the case of financially conservative and wealthy populations who strongly prefer future consumption to present consumption (and even more so in populations of net lenders rather than net borrowers like Germany, Austria or many other countries in central Europe).

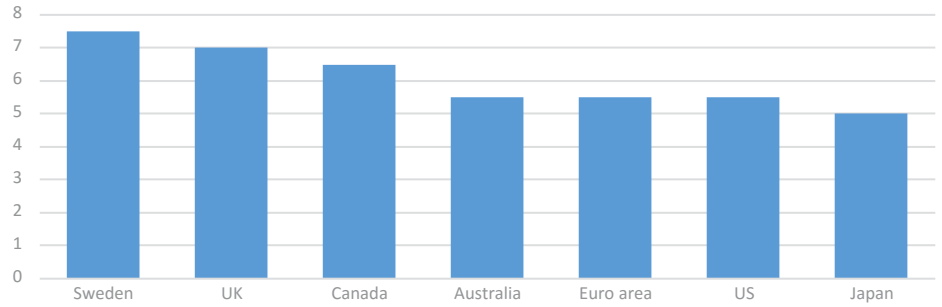
This is the challenge which we, as a community of occasionally tedious central bankers, now face. We should hurry up. There is a risk that, in addressing this challenge, someone will come along and tear down the current system without understanding its foundations and the consequences of the alternatives they want to usher in.

The US presidential campaign and the political attacks on central bankers in the UK show how easily an atmosphere might emerge in which central bankers could ultimately lose their operational independence. A system under which the volume of money is controlled according to price stability goals is under threat. It needs to be defended – and the time for doing so is running out. ■

Mojmír Hampl is Vice-Governor of the Czech National Bank.

Sweden, UK and Canada lead way in enlarged spheres of operations

Scorecard of new functions of modern central banks, 2016



Source: Ed Balls, James Howat and Anna Stansbury, 'Central Bank Independence Revisited' Harvard Kennedy School, November 2016. Scoring index (out of 12) measuring: Systemic risk monitoring, macroprudential crisis management, monetary-debt management coordination and monetary-fiscal coordination, taken from case study characteristics.

Central bankers' shake-up imminent

Monetary policy leaders must beat political antagonism

David Marsh

A new bevy of international monetary policy-makers will have to cope with the upheavals of Donald Trump's move into the White House, amid expectations of rising inflation, a stronger dollar, and a switch to higher interest rates after eight years of easy money.

By a quirk of economic fate, the world's six top central bank governors all reach the end of their tenures in the next three years – bequeathing to successors the twin tasks of coping with credit strains and defending central banks' independence from increased political encroachment.

Much attention has focused on Janet Yellen, Federal Reserve chair, whose four-year term ends in February 2018. Trump, now president-elect, disparaged her record during the US election campaign as being unduly supportive of President Barack Obama. He is widely expected to replace her with a more pliable candidate of uncertain provenance.

Although Yellen's 14-year board term runs until January 2024, no Fed board member has stayed on after stepping down from the top post, with the exception of Marriner Eccles who resigned as chairman in 1948 but stayed on the board until 1951. Yellen would almost certainly leave the central bank at the same time as quitting the chairmanship.

The new president's ability to change the Fed's composition is unusually high. Trump has the chance of nominating, and securing congressional approval for, new additional appointees to fill two vacant posts on the seven-person Fed board, as well as replacing Vice Chair Stanley Fischer, whose four-year term ends in June 2018.

Ritual defences

An impending shake-up goes much wider than this. Zhou Xiaochuan, governor of the People's Bank of China, who has stayed at the bank well beyond the normal retirement age of 65, is expected to leave in March 2018, when he will be 70.

The Chinese authorities are likely to choose as Zhou's successor a more political, less western- and less market-orientated candidate. Among the front-runners are Guo Shuqing and Jiang Chaoliang, respectively governors of the provinces of Shandong and Jilin, member and alternate member of the Communist party's central committee.

Haruhiko Kuroda, governor of the Bank of Japan, at the centre of controversial and so far unsuccessful monetary easing through massive monthly bond purchases, will step down at the same time. Three further top central bankers – Jens Weidmann at the Bundesbank, Mark Carney at the Bank of England and Mario Draghi at the European Central Bank – reach the end of their tenures in 2019, with Carney's term expiry brought forward from 2021 in a compromise with the UK government.

Carney looked vulnerable after a Conservative party conference speech by Theresa May, the British prime minister, in October. May criticised the Bank of England's low interest rates and quantitative easing, which she argued had led to 'bad side-effects' through low returns for hard-pressed savers.

> ***"There is one lesson from successive sterling crises of the past 100 years: when currencies are fluctuating, creating an impression of divisions with central bank governors is a guaranteed source of downward currency pressure.***

Carney – already under fire from Brexit enthusiasts who continue to accuse him of siding with the Remain camp before the UK European Union referendum – was forced to state that he does not 'take instruction' from politicians. Philip Hammond, the chancellor of the exchequer, had to issue a ritual defence of central bank independence.

While there is nothing intrinsically wrong with countries recalibrating from time to time the framework for setting interest rates, May appeared to transgress against a cardinal rule. Hinting at changing the rules of engagement between the executive and the central bank at a time of marked currency nervousness is a highly perilous undertaking.

There is one lesson from successive sterling crises of the past 100 years that governments should not ignore: when currencies are fluctuating, creating an impression of divisions with central bank governors is a guaranteed source of downward currency pressure.

May's October swipe at Carney, which has since been replaced by mollifying statements, follows a pattern of political criticism of low interest rates seen in other countries – not just in the US but also in Germany and Japan. Up to Trump's 8 November victory, neither Kuroda nor Draghi, both exponents of high-volume quantitative easing designed to raise inflation towards 2%, had been thought likely to raise interest rates before the end of their mandates. But these expectations have been modified as a result of probable higher US inflation after the Trump win.

Zhou Xiaochuan, Governor, People's Bank of China

Action to ward off further QE extension

Weidmann vehemently opposes the ECB's QE, but has been constantly outvoted on this issue on the bank's 26-member council. He is still leading a rearguard action to ward off further QE extension beyond March 2017 when the ECB deliberates the issue on 8 December.

In a further twist, Weidmann has been tipped as a possible replacement for Draghi when the latter steps down in November 2019, although much will depend on whether Angela Merkel, for whom Weidmann worked in the chancellor's office until 2011, remains German leader after next autumn's general elections.

In another personnel change, Jaime Caruana, general manager of the Bank for International Settlements, the central bankers' bank in Basel, presently chaired by Weidmann, steps down in summer 2017. One possible replacement is Benoit Coeuré, a French member of the six-person ECB board, who is believed to be open to some of Weidmann's arguments over QE. In future monetary deliberations, there is plenty of room for intricate bargaining. ■

David Marsh is Managing Director of OMFIF.

Threat of currency volatility

Policy-makers unlikely to target exchange rates

Linda Yueh, Advisory Board

For decades under inflation-targeting, currencies were hardly mentioned for fear of disrupting the foreign exchange market. Along with the change in monetary policy regimes to include macroprudential regulation, currencies are no longer taboo, though such discussion still occurs only occasionally as central bankers are rightly concerned about igniting a currency war.

Exchange rate volatility, or even the possibility of a currency crisis, has risen to the forefront of macroeconomic policy concerns. As with all such risks, whether a sufficient policy response exists matters a great deal. Policy-makers face a set of challenges.

Market for renminbi still faces barriers

At the top of the list is China. Until recently, when the ceiling on the benchmark deposit rate and the floor of the lending rate were lifted, there was no market-clearing interest rate. The gap between the two may have helped the net interest margin that raises revenue for the mostly state-owned commercial banks, but it prevented the accurate pricing of risk and the efficient allocation of capital. And it made it difficult, if not impossible, to determine the long-run value of the exchange rate since currency movements are linked to the real interest rate.

Now that the interest rate has been liberalised, the renminbi is beginning to find its footing, helped by a stabilising current account balance, even though global prices provide a challenge. More fundamentally, China's central bank hasn't relied on the interest rate to set monetary policy as a result, so its gradual shift will bear watching.

Meanwhile, offshore currency traders are being wrong-footed during this volatile period. Nearly $600m worth of bets on the renminbi weakening past Rmb6.6 against the dollar – its low point during last year's surprise devaluation – have expired and become worthless.

Divergent monetary policies

The other major global currencies are also being tugged and pulled by divergent monetary policies. Stimulus policies by the European Central Bank and Bank of Japan are juxtaposed against the normalisation of US monetary policy by the Federal Reserve. The resulting weakening and strengthening of their respective currencies, the most traded in the world, are presenting challenges for the rest of the economy.

Most emerging markets have pegged their currencies to the dollar and also to the euro. Some Asian economies, owing to the dominance of regional supply chains, keep a close eye on the renminbi as well as the yen. Yet the Fed is considering raising rates while the ECB has just unleashed a slew of loosening policies, including more cash injections or quantitative easing.

> *"Such divergences among the dominant currencies add to global volatility because they lead to variation among the economies that are pegged to them.*

In Asia, China is cutting interest rates now but it still is sufficiently above the zero bound, while Japanese rates remain in negative territory. Such divergences among the dominant currencies add to global volatility because they lead to variation among the economies that are pegged to them. So, some emerging economies are seeing their currencies rise while others are experiencing devaluation.

For those central banks, the main monetary policy aim is targeting the exchange rate. This has become more challenging. It is especially the case for commodity exporters, which tend to be pegged to the dollar as the currency in which commodities are priced, and are seeing their exchange rate appreciate alongside the dollar when they could use a weaker currency.

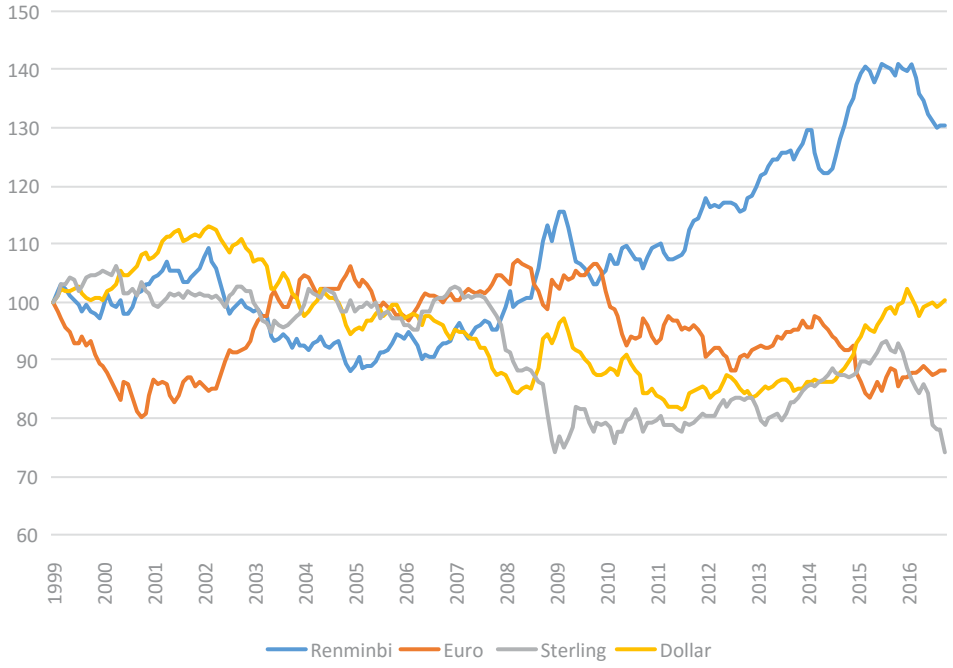
Lack of tools a key concern

It is even more difficult for major economies with free floating currencies. After all, the notion of a fully flexible exchange rate is that there is no need to manage it. But one of the members of the reserve currency club is now the renminbi. There are those who worry about the Chinese currency's volatility even though the tools to manage this remain limited.

For a variety of reasons central banks rightly remain reluctant to target currencies explicitly. Markets should expect that, at a time of divergent monetary conditions and given the continued uncertainties of Chinese reforms, currencies will remain volatile. ■

Renminbi depreciates following years of strengthening

Real effective exchange rates, Jan 1999=100 (increases are an appreciation)



Source: Bank for International Settlements, OMFIF analysis

Linda Yueh is a Fellow in Economics at St Edmund Hall, University of Oxford, and Adjunct Professor of Economics at London Business School.

Open questions over monetary base

Overhang from absorption of government debt

Carlo Cottarelli, IMF Board

The rise in advanced economies' debt to GDP ratios following the 2008-09 financial crisis has been exceptional in three respects. First, the pace of increase. Between the end of 2007 and the end of 2012, ratios increased by 35 percentage points (a 50% rise), with no sign of decline since then. This came on top of already high debt levels, leading ratios to exceed 100% of GDP in advanced economies on average.

Second, its cause. This was the first time that a surge of this magnitude had occurred because of peacetime economic developments. Third, rather than rising owing to increased supply, government bond rates have declined in both nominal terms and real terms, at least using available measures of inflation expectations. While the first two features were apparent from early on, the third aspect has become clear only over time.

The base money paradox

The absorption of substantial amounts of government paper at declining interest rates, in spite of the large build-up of government debt, appears paradoxical. In fact, this reflects large purchases of government paper by central banks, and the related surge in base money, which has taken place without major negative side effects. This is the result of developments in bank regulation, which have led, as an unintended consequence, to rewarding savers with returns at well below the inflation rate. This 'accidental financial repression' did not arise from a lack of liquidity, since this has been very abundant. Rather, it is because of lack of bank equity, which has become increasingly scarce compared with the increased equity requirements introduced following the financial crisis to strengthen the banking system's resilience. In other words, the base money multiplier – the degree to which base money translates into higher money supply – is low because it is constrained by what can be called the 'bank equity multiplier', which has declined because of tighter regulation.

> *"Bank equity has become increasingly scarce compared with the increased equity requirements introduced following the financial crisis to strengthen the banking system's resilience.*

The problem surrounding the scarcity of bank equity is exacerbated by two factors. The first is uncertainty over future regulatory changes that may involve additional increases in bank capital requirements. The banking community has raised major objections to the further tightening of capital requirements that would arise from what some are calling 'Basel IV'. Given this uncertainty, banks are increasingly cautious in their lending.

The second is a direct consequence of recent expansionary monetary policies. Because banks face practical limits in reducing deposit rates into negative territory, the low level of interest rates is depressing bank profitability – and this makes it harder to attract new equity.

Expansion of monetary policy interventions

These changes in the regulatory landscape are juxtaposed with a spectacular expansion of monetary policy interventions in the bond markets, largely motivated by central banks' need to meet inflation targets.

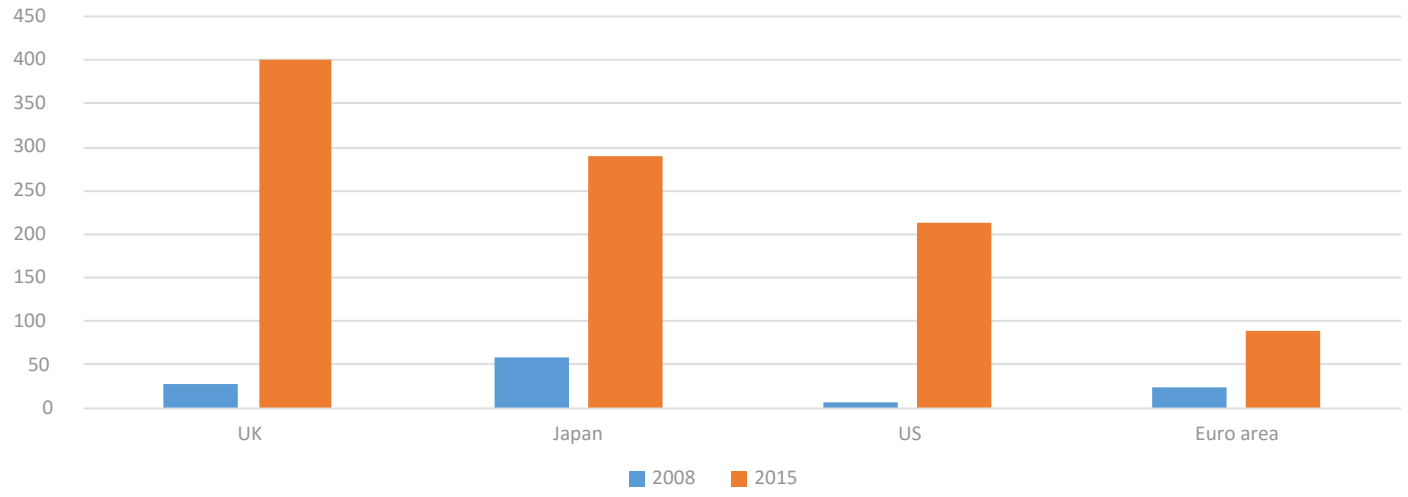
In Japan, the UK, the US and the euro area, central bank purchases of government debt played a key role in expanding the monetary base and financing fiscal deficits in 2008-15 (see Chart 1). Japan's budget deficits averaging around 8.5% of GDP were almost entirely financed by the Bank of Japan. The net public debt to GDP ratio increased by 30 percentage points, but net of central bank purchases declined slightly.

Base money in Japan almost quadrupled over 2008-15 and has since continued to rise rapidly, as it has done in the UK (see Chart 2). More than half of this increase in UK base money resulted from gilt purchases by the Bank of England.

In the US the scale has been smaller, with a doubling of base money in 2008-15. One third of the 33 percentage point rise in the public debt to GDP ratio was matched by increased bond holdings by the Federal Reserve. Bond purchases were more

Chart 1: Central banks have increased their holdings of government debt post-crisis

Net claims on government by central banks, local currency (£bn, ¥tn, $10bn, €10bn)



Source: International Monetary Fund International Financial Statistics

contained in the euro area, amounting to a quarter of the 25 percentage point increase in the public debt to GDP ratio. Up to 2014 the increase in euro area base money was relatively small at around 11%, but has since seen a major acceleration – 54% between end-2014 and July 2016 (equivalent to around €750bn). European Central Bank holdings of government paper rose by more than €900bn.

Time of a substantial 'helicopter drop'

One way of examining the past eight years' absorption of such a large volume of bonds is to look at the balance sheets of the government and the central bank on a consolidated basis. On this yardstick, the increase in public debt is much more contained than the non-consolidated government balance sheet would tell us.

There has been, in a sense, a substantial 'helicopter drop' (to use the phrase coined by Milton Friedman in 1969, subsequently made popular by Ben Bernanke as Fed chair in 2002) associated with the purchase of government paper.

The real puzzle is why this huge liquidity injection did not result in a surge in inflation, which remains well below targeted levels (albeit in the context of a rapid decline in commodity prices).

Banks are still holding huge amounts of idle liquidity in their central bank deposits – and this is not simply because there is little demand for bank lending, as a result of the private debt overhang. The more cogent reason for the slowness of lending, and the concomitant collapse of the base money multiplier, relates to banks' unwillingness or inability to expand credit – and this is related to the issue of financial repression at a time of rising debt ratios.

In a paper published in March 2011*, Carmen Reinhart and Belen Sbrancia dwelled on the interlinkages between the two, arguing that that financial repression was likely to be one way to solve the problem of rising public debt. They noted that restraining measures would come 'in the guise of prudential regulation rather than under the politically incorrect label of financial repression'.

> ***"These are uncharted waters. There are no previous cases of base money quadrupling in real terms in seven years, as happened in Japan and the UK.***

The current combination of very relaxed monetary policies and tighter bank equity regulation was not intended to help finance the government through financial repression; there was no grand design. The tightening of capital requirements was an appropriate reaction to pre-2008 financial excesses. And monetary relaxation was consistent with attaining central banks' inflation targets. But the combination of the two has been effective in making public debt more sustainable, and is therefore benefiting the fiscal accounts.

Bank equity constrained by regulation

One more factor needs to be considered. In the scenario outlined by Reinhart and Sbrancia, financial repression eroded the stock of public debt because it was combined with relatively high inflation. Banks would be forced through regulation to hold government paper at low interest rates through financial repression, while their real value would be eroded by inflation.

Unfortunately for governments, the policy mix is not leading to high inflation precisely because it has resulted in the erosion of the money multiplier. As a result, while the increase in the public debt ratio held outside the consolidated government-central bank balance sheet has been contained, the liability of central banks in the form of base money has surged in real terms.

These are uncharted waters. There are no previous cases of base money quadrupling in real terms in seven years, as happened in Japan and the UK. And there are plenty of clouds on the horizon. It is by no means certain that this base money overhang will be mopped up in a gradual and orderly way when inflationary pressures eventually materialise, with the support of gradual fiscal adjustment once the economy recovers. It is uncertain too, whether the equity multiplier will continue to restrain credit growth for a long period.

Furthermore, it cannot be ruled out that banks will undertake activities to get rid of undesired liquidity in ways that do not absorb equity but end up destabilising the foreign exchange markets – for example by buying foreign government paper or currency. These open questions underline that the large build-up of the monetary base, and the not yet fully clear relationship with economic variables such as banking lending, create much uncertainty about financial market developments. ■

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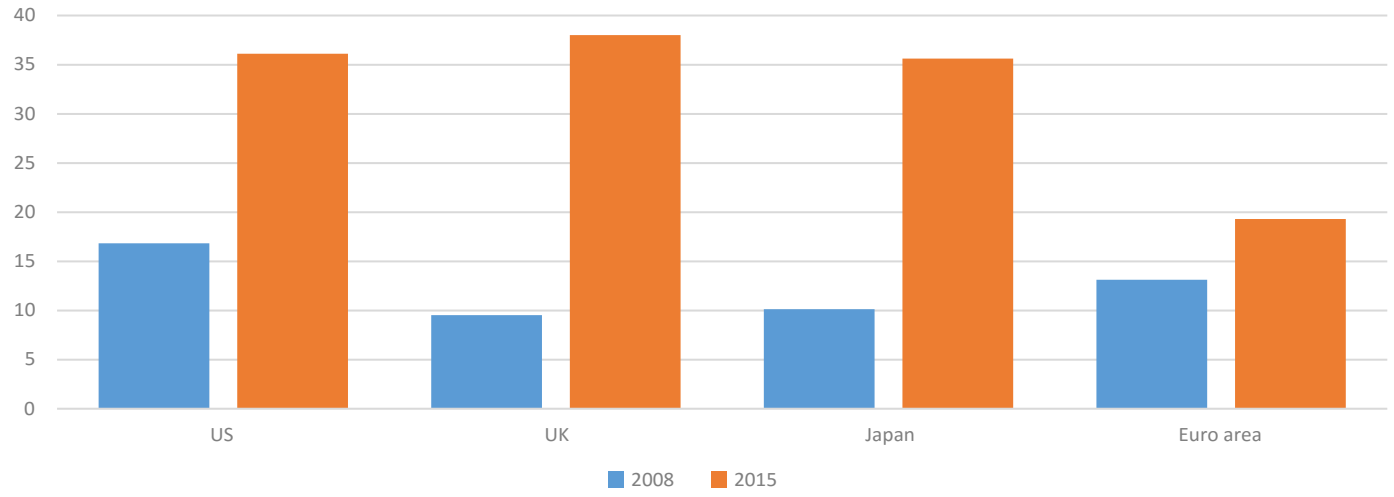
**'The liquidation of government debt', National Bureau of Economic Research.*

Chart 2: Central bank stimulus has significantly expanded the monetary base since 2008

Monetary base M0, in local currency ($100bn, £10bn, ¥10tn, €100bn)



Source: Bank of England, Federal Reserve Economic Data, Bank of Japan, European Central Bank, OMFIF analysis

The case for flexible inflation targeting

Central banks cannot resolve all challenges alone

Øystein Olsen, Norges Bank

Inflation-targeting regimes are a constant reminder that controlling inflation is central banks' main policy objective. At the same time, monetary policy cannot be strictly rule-based – it must be flexible and robust.

Economic models are useful tools for constructing an appropriate interest path. But, as even the most advanced models cannot reproduce the complexity of economic mechanisms or trade-offs, interest rate decisions must be rooted in sound judgement.

As in other inflation-targeting countries, Norway's regime has become more flexible in the 15 years since it was introduced. The operational target of monetary policy is annual consumer price inflation of close to 2.5%. However, according to the bank's mandate, interest rate setting should achieve a balance between inflation and capacity utilisation.

Norway's evolution of inflation-targeting reflects the practical experience gained since its introduction. In the past 15 years, Norway's economy has been exposed to different shocks. The supply side has been influenced by increased labour immigration following European Union enlargement. The legacies of the financial crisis have posed challenges for monetary policy. Not least, Norway has had to contend with wide trade fluctuations following developments in the price of oil, a key export. Taken as a whole, inflation targeting has performed well.

Uncharted monetary waters

More recently, monetary policy has faced a new challenge in many countries. The interest rate level consistent with balanced developments in the economy has fallen. The decline in real interest rates has been particularly marked over the past 15-20 years.

The causes of the decline are complex. The savings glut in emerging economies has been one important factor. Savings have increased in many advanced economies as a result of demographic developments and a more uneven distribution of income. Extraordinary measures by central banks have also pushed down long-term rates.

At the same time, investments in many advanced economies have been low. And while deleveraging has increased savings, uncertainty has dampened investor sentiment. The low level of the neutral rate raises a number of issues.

Much central bank uncertainty concerns conditions beyond the influence of monetary policy. For Norway, these include the oil price and economic developments among trading partners. However, the uncertainty associated with monetary policy is different, in that it relates to the functioning of the economy – and the effect of the policy rate.

> ***"In the years following the financial crisis, the regulatory framework has strengthened. But that does not mean central banks' work is done; today's regulations are not necessarily suited to tomorrow's challenges.***

For the transmission mechanism of monetary policy to function normally, changes in the policy rate must pass through to the bank lending and deposit rates faced by households and enterprises. In Norway, the latest policy rate cuts have had a broad impact on banks' interest rates. Lending and deposit rates for households are around one percentage point lower now than when the key policy rate was reduced in December 2014, from a level of 1.5%.

At the same time, these are uncharted waters. Banks' response to changes in the policy rate may differ from their usual behaviour. Households and enterprises may respond differently to interest rate changes when rates are already low.

There is no clear indication that historical relationships have collapsed, but nor is there experience with such low rates over such a long period. Norges Bank has taken this uncertainty into account over the past years and reacted somewhat less to new information. It has been appropriate to respond with caution.

The threat of financial imbalances

Persistently low interest rates can engender financial imbalances. Growth in property prices and debt could become unsustainably high.

When financial imbalances build up, the probability of a deep recession may increase. Monetary policy can limit vulnerabilities by keeping the interest rate higher than would otherwise have been the case. But this policy entails a short-term cost: capacity utilisation is lower, and inflation may stay below target.

The aim is to achieve an improved path for inflation, output and employment. This is in line with Norges Bank's mandate. Flexible inflation targeting with a sufficiently long horizon should take financial stability into account, if the situation so allows and so warrants.

At the same time, regulation and surveillance of financial institutions are the first line of defence against shocks. In the years following the financial crisis, the regulatory framework has strengthened. But that does not mean central banks' work is done; today's regulations are not necessarily well suited to tomorrow's challenges. We still need more knowledge about the use of macroprudential tools. The prospect of persistently low neutral interest rates makes this even more important.

Effective monetary policy regime

Despite the demanding task monetary policy has faced since the financial crisis, it is difficult to see alternative strategies to today's flexible inflation-targeting framework. The framework did not hinder a powerful response when the crisis began. Inflation expectations were firmly anchored. This enabled central banks to reduce the amplitude and length of the downturn. In Norway, the monetary policy regime functioned effectively in the face of the sharp fall in oil prices.

A lower neutral interest rate level has complicated, but not prevented, monetary policy from fulfilling its role as the first line of defence in countering cyclical economic fluctuations. Recent years have shown that central bank toolkits can contain more than policy rates.

However, central banks cannot do everything. The complex task facing advanced economies of enhancing productivity and promoting employment growth as populations age is beyond the power of monetary policy.

The key is boosting potential output growth. Other policy action is needed to address this task. This would help raise the neutral interest rate and reduce the risk of overburdening monetary policy. ■

Øystein Olsen is Governor of Norges Bank. This is an edited extract of his speech given at an OMFIF City Lecture in London on 1 November.

Challenges for Spain's new government

Brighter news on tourism masks labour market problems

Danae Kyriakopoulou

Mariano Rajoy has been confirmed as Spanish prime minister, after 10 months of political stalemate that included two inconclusive general elections and brought Spain close to Belgium's world record of 589 days without a government.

At first sight, the lack of a fully functioning government does not seem to have constrained the economy. GDP expanded at 0.7% in the third quarter of 2016. According to European Commission forecasts, Spain's GDP will expand by 3.2% in 2016, making it this year's fastest-growing major European economy.

Spain has benefited from strong employment growth and rising real wages, supported by buoyant foreign direct investment as investors took a bullish view.

Hidden low-base effects

This resilience has been widely attributed to the legacy of Rajoy's previous policies and has led many to hail Spain as a prime example of how euro area austerity measures can prove ultimately beneficial to growth and jobs.

However, the improving economy represents a rebound from a low base – both in GDP and for employment, where a focus on growth distracts from the all-important issue of levels.

Even after robust GDP rises in recent years, Spain's economy remains far below its pre-crisis levels. Moreover, a comparison of the evolution of GDP in nominal and real terms reveals that very low levels of inflation (in some months even deflation) are partly responsible for the rapid growth in real terms. This could prove to be an important factor casting further light on the strength of the recovery as the GDP deflator is further revised, which tends to happen often.

Worrying labour market conditions

Meanwhile, unemployment stands at 18.5%, second highest in the euro area after Greece and more than double the pre-2008 levels. More worryingly, the underlying forces behind the improvements in Spain's labour market hardly suggest this is a precursor to a sustainable recovery in living standards. Jobs have been mainly created in low-skill sectors, particularly tourism.

Spain has benefited greatly from political instability and terrorism risk in competitor destinations such as Turkey, Egypt, and Tunisia, as well as the refugee crisis which has diverted some tourism away from Greece. Weak inflation has helped raise real wages and disposable incomes, even while nominal wage growth has been constrained. Productivity growth has been anaemic.

While weak productivity growth is a trend faced by other advanced economies, the prospects for Spain are worse than elsewhere. Youth unemployment has come down significantly over Rajoy's tenure, but this is partly due to a high rate of emigration, evident in the growing community of young Spaniards in London and other parts of Europe. Despite the improvements, youth unemployment remains elevated at 42.6% according to the latest data, again second highest in the euro area after Greece's 46.5%.

Protracted periods of unemployment can result in what economists call hysteresis, the decaying of skills that worsens productivity in the labour force and makes the return to work more difficult. A combination of hysteresis, brain drain, low spending on education (third lowest as a share of GDP in the euro area after Greece and Italy) and weak demographics (Spain ranks 194th in the world in terms of fertility rates) puts significant strain on the country's long-term economic prospects, and – importantly for global financial stability and the future of the euro area – the sustainability of its huge debt pile.

> *"While weak productivity growth is a trend faced by other advanced economies, the prospects for Spain are worse than elsewhere.*

Lack of tools to tackle debt

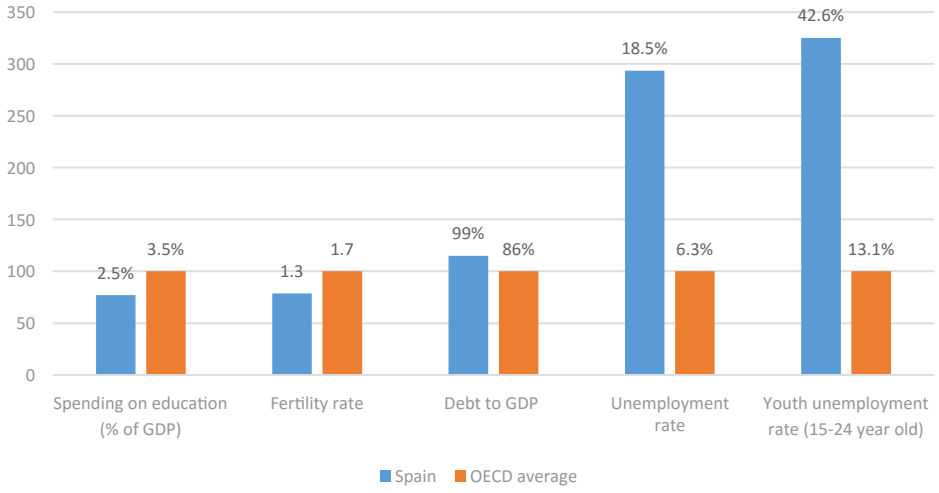
As a share of GDP, debt stands at 99%. This is lower than Greece and Italy (177% and 133% respectively), but well above Spain's pre-crisis average of close to 40%. The reality of low inflation poses additional challenges to debt sustainability as it raises the real cost of debt servicing.

As a member of the currency union Spain is unable to inflate its debt away or use the exchange rate to facilitate adjustment. Fiscal mechanisms are also not an option in the face of the stability and growth pact designed to maintain budgetary orthodoxy. This year saw Spain narrowly avoid a fine by the European Union for breaching fiscal rules, leniency which is unlikely to be repeated.

In view of plentiful uncertainties in the world economy, a renewed downturn relatively soon cannot be ruled out. This would place Spain in an unfortunate position, at a time when the country has still not recovered fully from the last recession and displays low resilience to possible problems ahead, especially in terms of quality of the labour market. ■

Spain lags behind OECD in key metrics

Spain v. OECD average, various indicators, OECD=100, latest available data



Source: Eurostat, OECD, OMFIF analysis

Danae Kyriakopoulou is Head of Research at OMFIF.

IMF still ultimate power-broker

Lessons after 40-year retreat from Keynesianism

Richard Roberts and David Marsh

Britain's autumn 1976 financial crisis marked a low point in the country's relative economic decline. The drama leaped into the headlines in late September with Chancellor Denis Healey's well-publicised turnaround at Heathrow airport, en route to the International Monetary Fund annual meetings, to deal with an unfolding run on sterling.

It culminated in the Labour government's application to the Fund for a record $3.9bn loan in mid-December and its submission to major interference in Britain's economic policies as part of a new and humiliating form of 'conditionality' imposed by foreign creditors. The saga is the subject of *When Britain Went Bust* published by OMFIF Press, being launched at the UK Treasury in London on 8 December. The occasion marking the 40th anniversary of the IMF loan takes place with the participation, among others, of Johannes Witteveen, IMF managing director 40 years ago.

Britain's 1976 upsets stemmed from the big fiscal deficits Jim Callaghan's administration was running to sustain demand and employment in the post-1973 oil-shock recession, prompting massive borrowing. But by autumn 1976 there was a 'buyers strike' among domestic institutional investors in government debt, while the international capital market was firmly shut.

Political costs of currency crises

The lessons of the crisis remain full of relevance today. They reverberate internationally in many contemporary cases where governments and central banks are struggling in an unforgiving global environment, with the painful aftermath of economic shocks and faulty policies. Moreover, the autumn of 2016, just as in 1976, is a period of perturbation for the pound in the wake of Britain's June vote to leave the European Union.

British contemporary history is replete with sterling crises. The 1976 decline and the post-referendum fall in the pound are just two of 10 episodes of substantial sterling depreciation since 1919. The repeated lesson is that Britain has an ingrained propensity for living beyond its means, rectified by periodic adjustments.

Currency crises are bad news for incumbent administrations, doubling the likelihood of a government losing office in the following 12 months; and very bad news for finance ministers, 60% of whom lose their job over the same period.

In Britain's case, all but two of the nine preceding sterling depreciations since 1919 were followed by the electoral defeat of the incumbent political party. There is possibly an uncomfortable lesson here for Theresa May's administration. Despite the comfortable position of the Conservative party in the opinion polls against an internally divided Labour party, few Tory strategists could view an early UK general election with equanimity, in view of the plethora of post-referendum question marks over the economy and the currency.

> ***"British contemporary history is replete with sterling crises. The repeated lesson is that Britain has an ingrained propensity for living beyond its means, rectified by periodic adjustments.***

For all the parallels with today, in the occurrences of 1976, there is no escaping a tinge of anachronism. This was a time of good, old-fashioned balance of payments crises, in some ways a more innocent and straightforward age. The world's most powerful central bankers (even more predominantly than today, white, male and elderly) handled crisis management discreetly, if not always purposefully, in the 'rich man's club' of the legendary Group of Ten and Switzerland.

In 1976, central banks on the whole were dependent on their governments' bidding. They were not averse to carrying out what would be called today 'unconventional' monetary policies, in the form of purchases of their governments' bonds to help ease funding constraints.

In 1976 dollar-sterling was still the world's pivotal currency relationship, despite the post-war ascent of Japan and Germany. Wild gyrations of this exchange rate appeared all the more alarming because the Bretton Woods system of fixed exchange rates had broken down only a few years previously. The single European currency, later baptised the euro – and its quite separate trials – was no more than a gleam in the eye of one or two visionary European leaders.

In the ensuing 40 years, in a world of vastly greater flows of finance, very high liquidity, largely floating exchange rates and a shift in economic dynamism away from Europe and towards Asia, the IMF has lost some of its previous pivotal significance. For countries in balance of payments difficulties, the growth of international financing instruments and substantial accruals in foreign exchange reserves have made recourse to the Fund less dramatic, and less crucial.

The Fund's focus and stature have waxed and waned with world political and economic developments. Yet many of the factors accompanying today's economic tremors – political intrigue in Europe, UK prime ministerial horse-trading with the US president, party political machinations, soul-searching over the effects of international capital flows – run through today's headlines as much as they did in 1976.

IMF: the world's monetary policeman

Developments over the past 40 years have confirmed that the IMF remains the sole institution that can lay claim to being the world's monetary policeman.

In the Asian monetary crisis in 1997-98, the Fund was assailed for prescribing draconian solutions for Southeast Asian countries that advanced economies themselves would find unacceptable. A little over a decade later, the Fund's tangled involvement in massive loan operations for Greece and other crisis-hit euro area countries laid bare near-irresoluble conflicts of interest.

The wrenching chronicle of 1976 sheds light on some wider aspects of world money and finance. In bringing down the curtain on post-war international Keynesianism, the Fund ushered in a period of economic orthodoxy epitomised by a move away from deficit spending, control of the money supply and central bank independence.

Now, 40 years later, an age where budgetary stringency was on politicians' mastheads nearly everywhere seems to be drawing to an end. After much resort to central bank ingenuity since the financial crisis, monetary policy is all but exhausted and the option of more active fiscal policy is again under consideration. This brings many fresh risks, not least in the form of further potential clashes with politicians anxious to test the limits of central banks' 40-year-old experience of independent operations. ■

Richard Roberts is Professor of Contemporary Financial History at King's College London and author of When Britain Went Bust: The 1976 IMF Crisis. David Marsh is Managing Director of OMFIF.

Legislative authority for triggering Brexit

UK parliament deserves a genuine constitutional debate

Jeff King, University College London

The UK High Court judgment of 3 November made it clear that an Act of Parliament is required to give notice under Article 50 of the Lisbon treaty. The government's appeal to the Supreme Court is unlikely to be successful, though Britons must be prepared for that outcome.

Bringing forward the proposed Great Repeal Bill and trying to pass it before 31 March 2017 would be an awful idea. The bill's task is enormously complex and unresolved. Strains on the devolution settlement between the four countries that comprise the UK and the use of Henry VIII powers – which grant the executive some authority to repeal primary legislation – might provoke a crisis. What is needed is a bill limited to granting the authority to give notice and framework conditions concerning parliament's role in negotiations with the EU.

To achieve this goal, something such as an EU Withdrawal (Exit Negotiations) Bill containing a simple clause would start the parliamentary discussion. Section 1 might read, 'Notwithstanding the provision of any act to the contrary, the prime minister shall have the authority to issue notice of the UK's intent to withdraw from the EU under Article 50(2) of the Treaty of the European Union.'

That would be the 'minimalist option'. Still, this bill would be the occasion for parliament to secure a right to exercise genuine input during negotiations – this is the 'conditions option'. The imposition of such conditions has been derided by some as an attempt to prevent Brexit. Whether or not this is the intention of some members of parliament, it is not only possible but also eminently reasonable to accept the referendum result and insist on a role for parliament during negotiations. The referendum decided whether to withdraw, not how or on what conditions.

Principles for parliamentary negotiations

Four principles ought to be respected in any parliamentary imposition of conditions. First, parliament must be given clear rights to notice; to comment on key negotiating positions and draft agreement text; and to a response from the government to its comments. Second, the devolved governments and legislatures of Scotland, Wales and Northern Ireland should enjoy formal participation in the consultation process in rough parity with Westminster. Third, the government's stated notice deadline of 31 March 2017 should be respected. Fourth, there should be no attempt to load the bill with veto points that would have the effect of destroying the possibility of Brexit during negotiations on the exit agreement. If parliament wants to reverse the outcome of the referendum, it must do so openly.

Narrow negotiating window

Many MPs and peers have called for a referendum on the exit agreement. The reason being, as there was a referendum on the general question, there ought to be one on the particulars. Were the UK allowed to revoke notice and commence negotiations again, this might be an acceptable proposition. It could give notice, bargain for an agreement, hold a referendum, and then revoke notice if the people say No. The next day it could give notice again and repeat the process until the correct result was obtained. This scenario, though, is exactly why I think notice is not revocable.

> ***"It is not only possible but also eminently reasonable to accept the referendum result and insist on a role for parliament during negotiations.***

If such an option does not exist, then a referendum rejecting the exit agreement would mean that Britain had no deal on the expiration of the two year period. Such a referendum would take place near the end of the two year timeline. This is due to the narrowness of the negotiating time window, the time that holding a referendum would take, and the inevitable absence of a 'Plan B'. A second referendum on the final package is likely to be problematic and could even derail the best deal Britain could get.

The role of the House of Lords

In respect of this bill, members of the House of Lords will recognise that, whatever the importance of constitutionally appropriate procedures governing parliamentary scrutiny of Brexit, some restraint will be appropriate. This is a matter of plain democratic politics, but there is another reason of a more constitutional nature: the Salisbury-Addison Convention. This is 'an understanding that a "manifesto" bill, foreshadowed in the governing party's most recent election manifesto and passed by the House of Commons, should not be opposed by the second chamber on second or third reading'. It is often interpreted to include a prohibition on so-called wrecking amendments.

The Lords can still amend the bill, provided they do not block it or insist on wrecking amendments. This is compatible with its role as a revising chamber and it would be absurd to exclude its expertise from the process.

Belief that reliance on the Parliament Acts 1911 and 1949 can be sufficient for securing the primacy of the House of Commons would not be appropriate. Under these the Lords may obstruct the bill for up to one year, after which the Commons could present it for royal signature and it would become an act of parliament. This would put the government in an unacceptable position due to delays, and would arguably put the UK in breach of its international obligations to the EU.

No need to fast-track reform

The term 'fast-track legislation' refers to the expedited passage of a bill, often taking all stages in one day. The ordinary course of legislative scrutiny is severely curtailed. It is accepted that constitutional legislation ought not to be subject to such a procedure. Indeed, the Constitution Committee found in a 2011 report that 'parliamentary scrutiny of [constitutional] bills should not be rushed unless there are justifiable reasons'.

The question is therefore whether this notice bill could be regarded as constitutional, and if so, whether there are clearly justifiable reasons for fast tracking. The answer to the former question is Yes. It is far from the Great Repeal Bill in its consequence, but it will trigger a potentially irreversible withdrawal on a tight timeframe and could significantly affect intergovernmental relations within the UK.

The more important point is that there is no need to expedite the enactment of a statute in the way seen with other fast-tracked legislation. There is time for legislative scrutiny of a notice bill. The matter is one that all can expect to be given priority over other business, and it should be noted that the 31 March 2017 deadline is one that suits the EU as much as Prime Minister Theresa May.

It is crucial that the government and opposition put a bill before the House of Commons at the earliest opportunity to enable the start of scrutiny of negotiating terms. ■

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Brexit's fiscal hangover

Autumn statement shows vote's damage to public finances

Danae Kyriakopoulou

As many had feared and warned ahead of Britain's 23 June European Union membership referendum, the Brexit vote has significantly worsened the UK's medium-term economic outlook. This is now confirmed by the independent Office for Budget Responsibility.

The OBR's downward forecast revisions of the UK's pace of economic growth and a worsening outlook for public finances provided a sober backdrop for Chancellor Philip Hammond's debut autumn statement.

Brexit means that the pace of GDP growth will slow despite the expansionary fiscal policy stance presented in the autumn statement. And this is in spite of the benign monetary policy backdrop which still feeds into the OBR's assumptions on the economic outlook. With interest rates widely expected to rise in response to higher inflation, GDP growth could fall further.

Much-needed infrastructure boost

In itself, the chancellor's plan to abandon former Chancellor George Osborne's commitment to return the public finances to surplus by 2020 is good news, and one that Osborne himself had promised in the wake of the Brexit vote. The rise in borrowing enables the government to spend more on much-needed infrastructure. The newly created National Productivity Investment Fund will include £3.3bn additional spending on both traditional forms of infrastructure such as roads, but also on digital infrastructure.

Osborne's strategy for a 'march of the makers' has rightly been replaced by a 'march of the coders', with the chancellor resisting directing support to failing industries that have been hurt by globalisation and instead focusing on the growth industries of the future.

Much like Donald Trump's grand infrastructure plan, the overall shift to fiscal policy and focus on infrastructure outlined in the autumn statement is long overdue. The UK has been underinvesting in its infrastructure for decades, creating a huge infrastructure deficit that the National Infrastructure Commission estimates at £483bn and which independent estimates place much higher. Similarly to the US, however, the government's veer towards fiscal expansion risks destabilising the government bond market. Yields on 10-year gilts jumped from 1.39% to 1.45% during Hammond's statement.

Unlike the US, the UK faces the additional negative impact from Brexit. According to the OBR's analysis, only a very small share of the worsening in the UK's public finances is accounted for by the UK's new growth policies.

The OBR's underlying analysis suggests that around half of the rise in public sector net borrowing compared with the March forecasts (which ranges from £12.7bn in 2016-17 to £31.8bn in 2020-21) can be attributed to Brexit. A fifth is due to non-Brexit forecast changes and a further fifth attributable to the effect of government's decisions in the autumn statement.

> ***"Brexit means that the pace of GDP expansion will slow despite the expansionary fiscal policy stance presented in the autumn statement. And this is in spite of the benign monetary policy backdrop.***

This rise, in combination with declining tax revenues due to slower growth, will raise the overall size of the debt by £220bn to reach just under £2tn by 2021.

And with the decline in sterling, the UK's contribution to the EU budget (which is priced in euros) has actually gone up, putting further strain on the public finances. So much for EU withdrawal creating fiscal room to spend £350m a week on the National Health Service.

Dubious forecast assumptions

Brexit's impact on the UK's public finances as forecast by the OBR, however, rests on some important assumptions. In particular, the forecasts assume that the UK leaves the EU in April 2019, two years after the prime minister has stated that Article 50 will be invoked.

Any complication involving the role of parliament and ensuing legal battles would impact these forecasts. Elevated uncertainty could mean that the cost to the economy is even higher.

Forecasts further assume that the negotiation of new trading agreements with the EU and others slows the pace of import and export growth for the next 10 years. This has been calibrated on external studies with different trading regimes.

Philip Hammond, UK chancellor of the Exchequer

Such forecasts might be thought pessimistic by Brexiteers who supported the UK's exit on the hope that this would open the door to faster-growing export markets – perhaps not immediately but certainly within the next decade.

The OBR's forecasts assume that the UK tightens migration, but not so much as to reduce migration to the tens of thousands. As was proven by the previous government's inability to control migration flows – not just from the EU but also from the rest of the world – this seems an unrealistic assumption.

Economic outlook could change

The OBR admitted that it has 'been given no information regarding the government's goals or expectations for the negotiations that is not already in the public domain'. So the economic outlook could change significantly – for better or for worse – compared with current predictions.

While increased spending, both on traffic jams and 'Jams' (Whitehall's term for families who are 'just about managing'), is a welcome shift from Osborne's austerity, the associated deterioration of the public finances makes the UK less well prepared to weather the next downturn.

Beyond the cheers from the Tory side of the House of Commons, Project Fear has turned into Project Reality. No wonder that Hammond does not want to have to carry out another autumn statement – and has decided to abolish it. ■

Danae Kyriakopoulou is Head of Research at OMFIF.

December 2016

The Bulletin FOCUS

Political risk on display

Looking back at year of turbulence

OMFIF

Global risk: Trump wins, Merkel stays, UK leaves

OMFIF predictions reviewed over a year of turbulence

The past year has been one of the most turbulent of the post-war era. Political risk in both advanced and emerging market economies has been on full display. The OMFIF review of 2016 is in two parts. We bring, first, an analysis of our January 2016 predictions from members of the advisory board and other OMFIF associates; second, a further series of accounts from the advisory board of some of the principal episodes in a year of upsets, with particular reference to the implications for currencies in what OMFIF baptised 12 months ago the 'Year of the Multicurrency System'.

In its predictions, the advisory board acquitted itself well. Of the 20 forecasts for 2016 reviewed here, eight receive marks of five stars for accuracy; four get four stars; seven, three stars; and one, two stars. Marsha Vande Berg rightly assessed that the Federal Reserve funds rate would not move up beyond 1% this year. Denis MacShane said Britain would vote to leave the European Union by a narrow margin. Nick Butler was spot on with his judgement that the oil price would rally to $45 to $50 p/b. Darrell Delamaide pinpointed the popularity of Donald Trump; although he did not predict that Trump would win the presidency, he did say that a victory for Hillary Clinton was 'far from assured'.

Michael Stürmer perceptively (but somewhat grudgingly) foretold that Angela Merkel would withstand opposition over the refugee influx, stay on as German chancellor, and fight the 2017 parliamentary election (which she has just confirmed she will do). Meghnad Desai prophetically wrote that Indian Prime Minister Narendra Modi would overcome 'irrational obstacles in parliament'. However India's growth this year seems likely to be lower than Desai's estimated 7.5% to 8.5%.

John Plender and John Adam both pointed in the right direction with their view that the renminbi was overvalued and would fall on currency markets. Plender overstated the case that this would lead to 'global financial instability', but was correct – as Trump's election has signalled – in warning of a 'protectionist backlash'.

Stefan Bielmeier's assessment that a new euro crisis would erupt in 2016 may have been somewhat over-pessimistic, but – with the 4 December Italian referendum looming – there is still time for that forecast to contain a measure of verity. Few would query Bielmeier's analysis that 'weaker economies insist that further reforms are politically damaging, while Germany maintains these changes are necessary to strengthen the euro system'.

> ***"The assessment that a new euro crisis would erupt on 2016 may have been somewhat over-pessimistic, but – with the 4 December Italian referendum looming – there is still time for that forecast to contain a measure of verity.***

Other precise forecasts were made by Gary Smith, who said emerging market currencies were likely to recover this year, with central banks able to replenish reserves; John Kornblum, who foresaw no rapprochement between Russia and the US over Syria and other key geopolitical issues; Peter Bruce in assessing that South African President Jacob Zuma would 'just survive the year'; and Desmond Lachman in tipping Christine Lagarde to stay on as International Monetary Fund managing director. Meghnad Desai was right to forecast greater financial market volatility, but wider off the mark (or perhaps premature) in asserting that markets would realise they were overvaluing asset prices.

David Smith accurately stated President Mauricio Macri's economic policies would 'return Argentina to the real world', although he was less prescient in believing Dilma Rousseff would escape impeachment as Brazilian president. John Plender pointed to the risk of a significantly weaker yen; although, surprisingly, the opposite happened in 2016, his forebodings of the Bank of Japan's future difficulties in withdrawing from quantitative easing when inflation finally takes off deserve to be taken seriously.

Prediction (Jan 2016): 'Prices and costs will move closer to the 2% target, but declining energy costs, weak exports and an apparent disconnect between wage growth and unemployment are countervailing forces. Interest rates, unlikely to reach the Fed's predicted target of 1.25% to 1.5%, will not climb above 1% this year.' (Marsha Vande Berg)

★★★★★

Outcome (Dec 2016): The December Federal Open Market Committee meeting seems likely to raise the Fed funds target, currently 0.25% to 0.5%, to 0.5% to 0.75%. Wage growth decelerated while unemployment fell further throughout 2016. Inflation rose to 1.6%. Still, the Fed had cause to think twice before raising rates – factors such as the UK referendum shock, US election fluctuations, occasional signs of US labour market fragility and doubts about the strength of the recovery fostered caution. With US Treasury bond yields rising fast after Trump's win, reasons for Fed hesitancy are declining.

'Oil prices will be volatile throughout 2016. Demand is growing modestly but remains outstripped by supply. Barring a Saudi revolution, $45 to $50 a barrel is a reasonable bet for end-2016.' (Nick Butler)

★★★★★

Oil price volatility continued in 2016 with prices ranging from a low of $28 p/b in January, the lowest since 2003, to a high of $54 p/b in September. Pressures have abated with the latest reading at $48, comfortably within the range predicted. The rise of oil prices can be mainly attributed to supply side dynamics. Supply has risen substantially in Iraq (where post-war investments are starting to yield results) and Iran (where sanctions were lifted last year), which are now producing over 2m b/d more than they were at the start of 2013. However, increased production in the Middle East has been counterbalanced by supply disruptions in oil-producing countries in Africa, mainly Nigeria. The net result has been a decline in global oil production, supporting the increase in prices over the year.

'Every referendum this century with the word "Europe" on the ballot paper has been lost. The British press remains anti-European and business won't get involved. A narrow "out" vote looks likely.' (Denis MacShane)

After a rancorous and vituperative campaign around the UK's options for its future in Europe, the electorate narrowly voted 52% to 48% in favour of Brexit. David Cameron, the British prime minister who proposed the referendum and campaigned to Remain, resigned following the result. Theresa May, the former home secretary, took over the government and announced that she will trigger Article 50 of the Treaty of Lisbon to begin the UK's formal exit process by March 2017.

'In an American election year, there will be no rapprochement with Putin over Syria or with his disdain for the principles of democracy. Recent behaviour of both sides leaves little room for optimism over co-operation, even in areas with a common interest such as the spread of Islamic radicalism.' (John Kornblum)

The suspicion that Russia was behind leaks related to the US presidential campaign was a further factor behind a worsening of relations, which started to descend to cold war temperatures in 2016, exacerbated by Vladimir Putin's support for President Bashar al-Assad over the conflict in Syria. With the election of a president-elect with avowedly pro-Russian sentiments, the picture could change – but it is not clear whether Trump can or would want to break through the full Moscow-Washington logjam.

'A lot of bad news is already priced into emerging market currencies. If emerging market currencies are stable or actually rally in 2016, then buffers such as foreign exchange reserves will not be tested, and indeed may be rebuilt in those nations that saw declines in 2015.' (Gary Smith)

Emerging market currencies have performed strongly over 2016, benefiting from stable global growth and some weakness in advanced economies' currencies, notably sterling. The real has seen the biggest rally, mainly a correction to downwards overshooting at end-2015. The rand and the rouble recorded strong gains. The Argentinian peso has continued to fall following President Macri's decision to remove currency controls, but the pace of decline has slackened. The Turkish lira lost value following concerns over domestic political stability. Economies that saw their reserves depleted over 2015 such as Russia or Brazil have managed to rebuild them.

'Angela Merkel will survive 2016 as German Chancellor if only by default and because there is no one in the parliamentary party to wield the dagger. The refugee crisis threatens to be the defining issue for the rest of her tenure. There is unlikely to be any combination of political forces to displace her after the 2017 elections.' (Michael Stürmer)

This year has been tumultuous for Merkel's approval ratings, with refugee controversies culminating in summer terrorist attacks in Germany contributing to regional election reverses for her Christian Democrat party. However, she has never been in danger of losing her party's backing as chancellor. Trump's victory has given Merkel the chance to step up as the de facto leader of western liberalism when she runs for a fourth term next autumn.

'President Jacob Zuma's political muscle weakened over 2015. There is no obvious replacement should the party opt to oust him and so he may just survive the year in power. But he may face a challenge should the party perform poorly in local elections.' (Peter Bruce)

Jacob Zuma has just about survived another year as president of South Africa, following three no confidence votes in parliament. However, his position is looking increasingly precarious. Local election results revealed voters' disappointment with Zuma's African National Congress amid tensions over the government's policy on higher education fees, corruption allegations and a stagnant economy. While the most recent no confidence vote (in November) was defeated by a huge margin (214-126), Zuma's position is far from secure.

'Enjoying an incumbent's advantage, Christine Lagarde's prospects for a second term as IMF managing director are bright. She has proved highly useful to the US and Europe in the IMF's handling of Ukraine's economic crisis. She has pleased China by getting its currency included in the special drawing right. And she has convinced the US Congress to agree to IMF reform.' (Desmond Lachman)

Lagarde was selected by the IMF executive board to serve a second five-year term as managing director. She was praised for providing strong leadership during the past five turbulent years, and for broadening and enhancing the Fund's relationships with emerging market economies. The past year has not been easy, however. The renminbi's special drawing right entry on 1 October has been dogged by the Chinese currency's persistent weakness against the dollar. The Fund's involvement in the euro area debt crisis remains mired in controversy. In a report in July, IMF staff identified political interference as one of the many weakness in the Fund's approach.

'Donald Trump and Paul Ryan are the two most likely candidates for the Republican nomination. Republican uncertainty would give Clinton an edge provided she wins the Democratic nomination, but, in a campaign full of surprises, a Clinton victory remains anything but assured.' (Darrell Delamaide)

★★★★

Trump winning the Republican nomination and then the November election was expected by very few in January. Perhaps both outcomes would have been very different had Paul Ryan entered the race for the Republican nomination. Clinton won the Democratic nomination, as predicted, and even maintained an edge in the presidential election as she won the popular vote by 2m – but her twin handicaps of the downturns in traditional manufacturing and Trump's tactics over her e-mail misdemeanours were ultimately insuperable.

'The scope for China's structural slowdown to create macroeconomic instability is large. Its overvalued currency creates strong temptation for Beijing to devalue. This would lead to global financial instability and a protectionist backlash in the US.' (John Plender)

★★★★

China's official GDP growth rate remained within the target range of 6.5% to 7% in the first three quarters of 2016. This is slower than previous performance, in line with the idea of a structural slowdown. However, this growth is among the highest in major economies, so China remains a potential a source of macroeconomic instability rather than an acute threat. The renminbi underwent a substantial devaluation from Rmb6.5 against the dollar at the start of 2016 to over Rmb6.9 in November, its lowest point since summer 2008. And the protectionist backlash in the US has materialised in the election of Trump, with his threats to impose harsh tariffs on Chinese exports.

'The renminbi will weaken against the dollar in 2016 but timing will be important: China will not want to arouse US passions late in an election year. There could be two bouts of depreciation – March and late 2016.' (John Adams)

★★★★

The renminbi has depreciated substantially over the year, losing 6.2% of its value against the dollar between January and November, and 5.9% on a trade-weighted basis over the same period. The first half of the year was rather volatile, with the renminbi depreciating steeply in January before gaining back some value over the remaining first quarter. Since April, it depreciated steadily until October before a more intense depreciation in November, linked to the general strength of the dollar after the election of Trump in the US.

'In Argentina, watch out for strikes and protests, as Macri seeks to keep wage rises below inflation, and keep an eye out on an opposition that seeks instability. But the early signs for the economy are positive.' (David Smith)

★★★★

Protests were not in short supply this year in Argentina, against government cuts on subsidies for the poor, cuts to the education budget, and the scaling down of subsidies in areas such as utilities. President Macri's adjustment of the social programme inherited from his predecessor Cristina Fernandez de Kirchner has soured relations with unions, and put a strain on the economy. The depreciation of the peso that followed 2015's lifting of exchange rate controls raised imported inflation and domestic consumer prices. Inflation is expected to reach 40% this year. However, investors remain convinced that Macri's economic policies will lead Argentina to the path to recovery.

'Chinese policy-makers have shown they lack the ability to manage the economy's transition smoothly, and so there will be bumps in the road in 2016. India, meanwhile, looks set to achieve growth of around 7.5% to 8.5% with this year being a less disappointing one for Modi.' (Meghnad Desai)

★★★

China's economic growth rate remained within policy-makers' target range over the first three quarters of 2016, largely thanks to policy-driven stimulus, including in monetary and fiscal policy as well as the exchange rate. However, the less bumpy road has an uncertain destination: stimulus-driven expansion has diverted attention from reforms, so policy-makers' ability to manage the transition remains in question. India's economy has been somewhat disappointing, with growth slowing to 7.1% in the second quarter, the weakest in two years. The government's removal of Rs500 and Rs1000 notes from circulation will dampen the economy in the short run.

'Economic reforms in Europe remain unpopular. This is increasing the divergence between debtor and creditor countries. Economically stronger countries could question whether it makes long-term political and economic sense to remain a member of the euro area. This could lead to a fresh euro area crisis in 2016.' (Stefan Bielmeier)

★★★

The euro area crisis was absent from the headlines in 2016, a contrast to upsets over Greece's near-departure in 2015. However, this could soon change. The Target-2 intra-ECB imbalances have been rising. An impasse over Greek debt between the IMF and the German and Dutch governments remains difficult to bridge. Brexit and Trump's ascent could further exacerbate European differences. Matteo Renzi, the reformist Italian prime minister, faces a difficult referendum on 4 December that could unleash new turbulence.

'Equity prices are unsustainably high. Markets are realising they have been overvaluing assets in recent years. Financial volatility is very likely this year.' (Meghnad Desai)

★★★

Financial markets have proven resilient this year. Despite political and economic shocks, most indices stand above where they started at the beginning of the year. The Nikkei is the only exception, but the difference from January's level is far from substantial. Continued easy money policies and the build-up of resilience after geopolitical developments have helped markets stabilise, along with G20 efforts to tighten financial market regulation after the financial crisis. However, measurements of volatility have been rising, and equity risks have by no means been dispelled.

'Lower growth in China and the gradual normalisation of US monetary policy will constrain Latin American central banks' room to adapt to the new environment but the effects will be manageable, especially in countries with flexible exchange rates.' (José Manuel González-Páramo)

★★★

China's growth slowed in 2016 but remained within policy-makers' target range. Rising global economic uncertainty stayed the Fed's hand in raising interest rates, creating relatively benign economic conditions for Latin America, helping Brazil, Mexico, Argentina and Colombia see their foreign exchange reserves rise and their currencies rise against the dollar. Trump's November victory reversed these trends, with the Mexican peso falling 11.9% within five hours on 9 November.

'Higher than expected inflation in Japan is an under-recognised risk. There is pressure on the Bank of Japan to expand QE to reach its inflation target. When inflation finally takes off the BoJ will be hard pressed to manage a safe exit from QE and the yen could suffer an uncontrolled plunge. The scope for financial chaos is not negligible.' (John Plender)

★★★

While the BoJ has been under pressure to expand QE to reach its inflation target, the risk of higher inflation has not materialised. Consumer prices have fallen by an annual 0.5% on latest data. Behind the scenes at the BoJ, yet to reach the public eye, discussion on reining in QE has started. Surprises on global markets in the first half of 2016 bolstered the yen's safe haven status, reversing expected depreciation. However a sharp yen fall following the November Trump victory suggests that Plender's forecast may eventually come true, but later than he thought.

'President Dilma Rousseff will probably survive attempts at impeachment in the short term. But this matters less than the impeachment process weakening her ability to return the country to growth.' (David Smith)

★★★

Following an eight-month impeachment process, the Brazilian Senate removed President Rousseff from office, finding her guilty of corruption relating to the country's budget. However, the uncertainty around the impeachment process did not significantly constrain Brazilian economic growth. While the economy remained in recession, the pace of output decline eased and the currency strengthened. However, there are long-term concerns that the new President Michel Temer – who also faces corruption allegations – will not succeed in bringing the economy towards a sustainable path to recovery.

'Although the trend for a stable real exchange rate for the Brazilian real against the dollar seems clearly established, there could be frequent oscillations in nominal rates as markets test the levels managed by the Brazilian central bank.' (Luiz Eduardo Mellin)

★★★

After losing 30% of its value against the dollar and being the worst-performing emerging market currency in 2015, the real made substantial gains this year. From a rate of over R$4 in January it appreciated to reach R$3.1 to the dollar in October. The rally was pronounced in the summer, when Rousseff's August impeachment helped the currency rise over 20% against the dollar. It has since lost some value following the US election results but remains below R$3.5 to the dollar. This appreciation has further helped build up the value of Brazil's foreign exchange reserves.

'Although growth won't be scintillating, it will be hard to find a much better prospect than Japan around the globe in 2016.' (Shumpei Takemori)

★★

Japan's economy grew by 0.5% during the third quarter of 2016, building on growth rates of 0.2% and 0.5% in the second and first quarters respectively. On an annualised basis forecasters expect 2016 growth to be 0.6%, a marginal acceleration from last year's 0.5%. These are hardly scintillating numbers. Despite the three-pronged Abenomics plan of expansionary monetary policy, a fiscal stimulus programme and structural reforms, growth remains anaemic. It is well below that of other advanced economies. Even the UK has been growing faster than Japan. Estimates for 2016 growth in the US, Canada and the euro area are also higher.

For a copy of the January 2016 Bulletin containing the full list of 'Year Ahead' predictions, please e-mail editorial@omfif.org

Turbulent transition for Crisis Quintet

The five SDR currencies face strains and tribulations

The big question regarding the multicurrency system into which the world is slowly moving is whether this will be more or less stable than the previous set-up. A de facto duopoly has occupied the world monetary centre stage for the past 80 years – first, sterling and the dollar (up to 1945); then the dollar and sterling (1945-76); the dollar and the D-mark (1976-99); and, since 1999, the dollar and the euro.

In 2016, nominated by OMFIF as 'The Year of the Multicurrency System', the world passed a landmark with the entry of the renminbi on 1 October into the International Monetary Fund's special drawing right. This confirmed the new circumstances in which a still-dominant dollar shares its role with several other international currencies. OMFIF said then, 'It seems we are heading for a turbulent transition.' All five of the SDR constituents – which could be called 'the quintet of crisis', the dollar, euro, sterling, yen and renminbi – are subject to their own inherent strains and tribulations.

As currencies jostle for position, the greatest potential for shock stems from America. As Meghnad Desai pointed out in his July report 'The political economy of Donald Trump', the president-elect has an unorthodox policy on debt: 'As a businessman who has amassed a fortune, he views debt not as a burden but as a tool for doing business.' This is just one of the reasons why the dollar may experience a see-saw ride. The authorities behind the renminbi are still learning the rudiments of running an international currency – and this brings much room for upset. Storm clouds are amassing over the euro. Italy's referendum risks breaking the euro area's weakest link. The yen is prone to setbacks as the Bank of Japan's drawn out monetary experiment with massive quantitative easing runs its course. And sterling, up to mid-year the most stable member of the SDR bloc after the dollar, has fallen after the referendum decision to leave the European Union.

TRUMPONOMICS AND BREXIT – HEMRAZ JANKEE

Monetary policy divergence set to re-emerge

The British EU referendum and the election of Donald Trump have been two of the most significant episodes in 2016, both greatly affecting values of sterling and the dollar, two premier constituents of the special drawing right. Like other features of 2016, such as the rise of populist parties in Europe, these upsets reveal the size of the divide between the haves and the have-nots, and highlight a rise in nationalism in the West. This may not augur well for future political developments. With the US Federal Reserve Board gearing up for interest rate hikes, divergence in major central banks' monetary policies may emerge in the new economic environment. Sterling, too, will be affected by the dollar's buoyancy. Brexit and Trumponomics have indeed clouded the future.

GLOBAL TRADE SLOWDOWN – ELLIOT HENTOV

Deglobalisation trend raises doubts over UK position

Oxford Dictionaries chose 'post-truth' as the word of the year, but 'post-trade' would have been equally valid; 2016 was the first non-recession year on record where world merchandise trade grew more slowly than world GDP. The number of protectionist measures introduced in 2016 is nearly four times as high as the 2008-13 average, the strongest sign yet of deglobalisation. The defining contrast between the US election and Britain's referendum was that Brexiteers claimed EU withdrawal would boost trading opportunities. However, the drama around the Canada-EU trade agreement and the expected demise of the Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership should raise concerns about whether the UK can improve trading networks outside the EU.

RENMINBI INTERNATIONALISATION – GAO HAIHONG

IMF SDR move confirms China currency reserve status

China regards the new SDR basket comprising the dollar, euro, renminbi, yen and sterling as a fresh start for Beijing as well as its foreign partners, enshrining the principle of multilateralism at the heart of the world financial system. Actions by the People's Bank of China and growing use of the interbank bond market reflect China's vision of the SDR as an important part of global investment diversification. This accompanies a new phase in renminbi internationalisation: with reserve currency status now confirmed by the IMF, the renminbi is expected to make further inroads into world foreign exchange reserves, and trade and financial transactions. Alongside these developments, China is expected to continue to open up its financial markets and carry out reforms in a sustainable manner.

MERKEL AND THE EURO – DAVID MARSH

German chancellor strengthened by international squalls

Angela Merkel, the German chancellor, has had a difficult 12 months, losing popularity over her controversial policies of welcoming refugees from trouble spots abroad, and suffering a series of reverses in state elections. Yet she has emerged strengthened. She can be expected to be buoyed by an intrinsic German wish for stability in the face of geopolitical uncertainties caused by the impending British EU exit and the election of Donald Trump. More than ever, Merkel has emerged as the most important factor of stability behind the European single currency, which – unusually for the past five years – has survived 2016 without a major crisis, but where basic tensions between credit and debtor countries remain unresolved.

CURRENCY VOLATILITY – LINDA YUEH

Renminbi's rising importance adds to fluctuations

This year has seen exchange rate volatility rise to the forefront of macroeconomic policy anxieties, with the renminbi as a top concern. Now that the interest rate has been liberalised, the renminbi is beginning to find its footing, helped by a stabilising current account balance. Monetary easing by the European Central Bank and Bank of Japan has continued at a time when US interest rates are starting to normalise. Such divergence is mirrored in economies with exchange rate pegs, adding to global volatility. The renminbi's rising importance introduces a new currency risk to be managed – even though the tools to do so are in short supply. At a time of divergent monetary conditions and uncertainties induced by Chinese reforms, currencies are likely to remain volatile.

ONE BELT, ONE ROAD – YASEEN ANWAR

Chance for renminbi-related investments across Eurasia

The entry of the renminbi into the SDR basket, and China's $1.8tn 'One Belt, One Road' initiative to build wide-ranging transport and infrastructure links with its neighbours and across Eurasia, represent an excellent opportunity for policy-makers to incorporate China's currency into their core economic strategies. This could serve the interests both of revitalising economic and trading links in many of China's partners, and of helping to achieve desired global stability. Much work remains in developing China's capital markets. But with the current fast pace work in progress for the capital markets, the combination of a more market oriented renminbi and OBOR represents an opportunity for investors to incorporate Chinese and related Eurasian projects into their long-term portfolios.

LOW-CARBON TECHNOLOGY – NICK BUTLER

China, US will compete for environmental leadership

The December 2015 Paris Agreement and the understanding reached between China and the US on climate change risk being overshadowed by Donald Trump's election. It is too early to tell how serious his climate change beliefs are. He will no doubt relieve some of the pressures on the US coal industry, and seems unlikely to to push decarbonisation. Fortunately for environmentalists, the understanding between China and the US was reached on the basis of science. China's embrace of clean technology is serious and is linked to their desire to sell that technology in exports. The most likely outcome is that both countries will compete for industrial leadership in low carbon technology – not a bad outcome for the world.

INDIA'S DEMONETISATION DRIVE – MEGHNAD DESAI

Modi risks unpopularity to drive radical reform

On 8 November, Prime Minister Narendra Modi announced a radical demonetisation plan for India to combat 'black money'. There are fears that the resulting chaos could slow the economy or reduce its rate of growth, but after the initial shock, there will probably be a negligible impact on national income. If India can be weaned off hard cash in favour of plastic, this will lead to a considerable reduction in transaction costs as well as less corruption. Banks inundated with cash deposits will have to cut lending rates, which will reduce the liabilities of the central bank and can be a dividend to be shared with the government. This bold step shows Modi's willingness to risk unpopularity for radical reform. In due course, this will strengthen the rupee's credentials as an international currency.

ISIS TERRORIST MOVEMENT – FRANÇOIS HEISBOURG

Jihadism prospers, despite dismantling of territorial base

One notable development in 2016 was the dismantling of the territorial base of Isis. This is unlikely to prevent a repetition of this year's terror attacks in Brussels, Istanbul or Nice, although it is undoubtedly good news for the inhabitants of Mosul or Raqqa. Such attacks on foreign soil were supported and encouraged by Isis, but mainly executed by home-grown operatives. Mounting losses of territory for Isis mean foreign terrorists trained in the Middle East may now return to their countries of origin. Increasingly deadly jihadi groups in Pakistan and Bangladesh will continue to threaten the Indian subcontinent. As Isis weakens, a rebranded Al Qaeda is likely to recover. It may have been a bad year for Isis as a quasi-state, but jihadism more broadly is doing all too well.

POWER OF COMMUNICATION – ANTONIO ARMELLINI

Chain of dislocation: from Arabia to the US

The world has seen the collapse of the post-first world war order in the Arabian Peninsula and the demise of Kemalism in Turkey, as well as the rise of 'ummah' or supranational Islamic community as a rediscovered element of revolutionary identity. A further element of dislocation has been the apparent demise of the universal paradigm of liberal democracy, underlined by Donald Trump's extraordinary win. He proved successful in using communication that was designed to make democracy more effective to spread a message that could undermine it. Trump may well decide to go down the road of repression, but what will ultimately win the day is communication capable of exposing contradictions and providing an alternative route to stability.

BRITAIN'S EU WITHDRAWAL – DENIS MACSHANE

UK must rule on visas and work permits

Brexit is the most important development in the history of European co-operation since the European Coal and Steel Community was created in 1950. It has cost the career of a prime minister and brought a second woman leader to No.10. The UK must decide whether or not to go for a total rupture, meaning no more single market, no more customs union, and and withdrawal from other areas of co-operation under EU rules like Erasmus, university funding or the European Arrest Warrant. After years of promoting visa-free travel, Britain looks likely to start imposing visas, work permits and residence permits. There was no preparation for Brexit. It is a massive undertaking for the civil service. Years of political uncertainty stretch ahead.

UK OPPORTUNITIES – GERARD LYONS

Britain can prosper outside EU

The financial Armageddon in the UK that was widely predicted after the referendum decision has not occurred. The British economy has shown resilience and continues to attract inward investment. London will remain the EU's, and one of the world's, leading global financial centres. It is possible that the economy could slow temporarily in the next 12-24 months. Despite this, detailed research shows that leaving the EU and taking a global approach produces higher growth and more employment than remaining in an unreformed union. Brexit is likely to produce a significant economic gain. The UK does not need to be in the single market to have access to it, while being outside returns control over laws and borders and frees the UK from EU regulations and its external tariff.

MICHEL TEMER'S GOVERNMENT – OTAVIANO CANUTO

Brazil plagued by fiscal imbalances and low productivity

Brazil's post-impeachment government of President Michel Temer must reverse the deepest economic contraction in the country's recent history. GDP per capita this year is more than 10% lower than three years ago. Unemployment exceeds 11%, four percentage points higher than in January 2015. Economic recovery hinges on business confidence, which will depend on government measures dealing with structural problems. No fiscal or monetary space is available for counter-cyclical policies. The economic difficulties stem from long-standing vulnerabilities that have intensified in the last few years, particularly fiscal imbalance and anaemic productivity – a 'double malaise' plaguing the Brazilian economy.

GROWTH IN SPAIN – JOSÉ MANUEL GONZÁLEZ-PÁRAMO

Madrid chance to overcome political gridlock

The Spanish economy will grow 3.3% in 2016, double the European average. This reflects the general European benefits of lower interest rates, a weaker euro and lower oil prices; in addition Spain has gained from recent economic reforms. Political uncertainty throughout 2016 has held back potential growth, but, now that Spain has a chance of overcoming its political gridlock, it will need to reduce imbalances accumulated over the past years and discover a new dynamic of employment and productivity. To achieve this quickly, Spain must adopt reforms to realise three goals: reducing the public deficit while ensuring pensions sustainability, tackling high unemployment, and fostering inclusive growth through higher productivity.

PANAMA PAPERS – VICKY PRYCE

Clampdown on offshore financial centres

In April 2016 the world was shaken by the leak of some 11.5m files from the database of Mossack Fonseca, the Panama-based law firm which, among other things, incorporates companies in offshore jurisdictions. The media exposure revealed widespread use of offshore structures by individuals, their families and associates to reduce tax liabilities, including scores of senior politicians and heads of states. It raised serious questions about the functioning of and justification for offshore financial centres, including the way they encourage tax avoidance and evasion, as well as their help in shielding many corporations and individuals by specially devised anonymous structures which may be hiding illegal activities. The result is an extended effort to clamp down on offshore centres.

Renewables key to UK industrial strategy

Low-cost energy offers a post-Brexit boost

Ben Robinson

Following the decision to leave the European Union, the British government has created a new Department for Business, Energy and Industrial Strategy, tasked with improving the business climate to encourage companies to remain in the UK.

One significant part of this approach involves ensuring continued access to low-cost energy for UK companies. The government is using subsidies and price guarantees, among other tools, to achieve this goal. This could provide significant opportunities for renewable energy investments in the UK.

UK has a big energy infrastructure deficit

The government's contracts for difference scheme guarantees a set price per kilowatt hour of energy produced by low carbon projects, ensuring stable returns for renewable investments. When the market price falls below the strike price, the government makes up the difference. When it goes above, the government receives the additional revenue.

Demand in the first round of competitive bids in 2015 was high, with just over 25% of applicants winning a contract. The total investment generated by the first auction could be up to £14bn by 2020. The government has scheduled the second auction for April 2017.

These measures are important for securing new investment in UK energy. According to government estimates in the National Infrastructure Plan, the UK's total energy infrastructure requirements are £275bn between 2015 and 2021. Independent estimates put the needs much higher.

Overseas investors have been responsible for around 40% of total energy and infrastructure projects in the UK since 2010. However, notwithstanding agreement on Hinkley Point – the first nuclear plant to be constructed in the UK in more than 20 years – in which the French and Chinese governments maintain significant stakes, the future of foreign investment after Brexit is in doubt. Approaches like the CFD scheme can help ensure this investment.

Weakened appetite for investment

The sustained decline in sterling since Brexit has raised import prices, increasing costs of new projects and reducing their appeal. Questions over UK growth prospects could limit inward investment in renewables, where foreign firms play a large role.

Renewables make up 25% of UK electricity generation, the second largest component after gas (30%) and ahead of nuclear (22%). Of this renewable energy, wind generates 51%, followed by solar (26%) and biomass (9%).

Over half of all UK wind energy projects are funded by foreign companies. Scottish Power, the main energy provider in Scotland, is owned by Iberdrola, a Spanish firm. It accounts for much of the country's wind energy production, which normally provides around 50% of Scotland's electricity generation (and provided 100% on a trial day in August).

> ***"The focus on renewables is key to the success of ensuring a competitive price for industry inputs. As well as reducing energy costs, greater renewable capacity could offset some of the risks of higher inflation associated with rising oil prices.***

Potential changes to the rules over EU citizens' freedom to work in the UK energy sector, which depends on a multinational workforce, raise concerns for foreign investors. Uncertainties over the future relationship between England and Scotland could delay new investments.

UK may lose access

Following British withdrawal from the EU, the UK may lose access to Europe's internal energy market. Given the dearth of UK-EU interconnectors, and the added distance and infrastructure costs, baseload market prices for electricity are already more expensive than in continental Europe.

This feeds into higher electricity prices for small, medium and large-sized industrial consumers, which are 31%, 41% and 70% higher respectively than the EU28 median. This differential could widen if access to the internal energy market is lost, and could total £500m a year on some estimates.

Rising energy prices would push up production costs for UK-based companies, reducing their competitiveness and harming the government's attempts to persuade businesses to remain in the UK. Ensuring a competitive price for industry inputs, including energy, will therefore be crucial to the government's new industrial strategy.

The focus on renewables is key to the success of this strategy. As well as reducing energy costs, greater renewable capacity could offset some of the risks of higher inflation associated with rising oil prices.

Without offsetting these increased costs, a tightening of monetary policy could be on the cards. According to research from the Bank of England and Swiss National Bank, the fall in oil prices has accounted for around half of the decline in inflation since the end of 2014. Oil prices are forecast to rise from an average of $43 per barrel in 2016 to $51 in 2017. This could lead to higher interest rates which weaken growth.

Greater domestic renewable energy production could reduce reliance on imports and lower electricity costs for households, helping to offset a fall in real wages. Lowering business costs could help mitigate some challenges related to the fall in sterling, providing the BoE with greater monetary policy flexibility.

Industrial policy

Another important element is industrial policy. In the months following the UK referendum, the government has come under criticism for the 'support and assurances' it provided to Nissan, the Japanese car maker, to encourage continued manufacturing at its UK plant. The content of the assurances is unknown, creating speculation that it may include taxpayer-funded guarantees to offset any rise in tariffs on exports to the EU.

There is uncertainty over whether any other companies or industries may receive government support. This makes it appear as though the government is 'picking winners', and may increase pressure to support failing or non-profitable industries such as steel, adding significant costs to the budget.

If the government instead seeks to reduce key input costs by investing in or subsiding renewables, this could improve business conditions without having to pick which industries to support.

As well as increasing aggregate demand and offering some protection against rising costs and inflation, this would create a more stable business climate which could make UK investments more attractive. For the UK, renewable energy will be key to a successful industrial strategy. ■

Ben Robinson is Economist at OMFIF.

Lack of SDR interest in central Europe

Euro, not renminbi, liquidity crucial for foreign reserves

Miroslav Singer, Advisory Board

The renminbi's introduction into the International Monetary Fund's special drawing right basket in October was received with a high level of publicity and attention at the annual autumn World Bank-IMF meetings and in world financial centres. Elsewhere, such as in central and eastern Europe, however, the event has gone largely unnoticed.

This lack of regional interest is in part another expression of the generally minor notice paid by smaller central European countries to foreign policy. For example, many central European countries, including Slovakia and the Czech Republic, have not joined the stampede to become founder members of the Asian Infrastructure Investment Bank.

There are fundamental reasons for this lack of interest, some of which stem from these economies' advances over the past 20 years, and the consequent improvement in their financial standing.

Little foreign policy engagement

For the Czech and Slovak republics a lack of interest in foreign affairs is nothing new.

For centuries, the foreign policy hub of the Austro-Hungarian empire was Austria, joined by Hungary in the 19th century. Furthermore, the relatively small size of most central European economies makes them less likely to play a major role in global events, unlike, for example, Poland.

Despite its increasing role in global trade and foreign investments (see Chart), the renminbi as a reserve currency suffers from some key disadvantages. Chinese capital markets are gradually being liberalised, but China is still, in many respects, a command economy. As a result, renminbi holdings may not prove to be very liquid at times of global financial turbulence.

> *"Despite its increasing role in global trade and foreign investments, the use of the renminbi as a currency in which foreign reserves may be usefully allocated has two key disadvantages.*

Czech and Slovak foreign trade is concentrated on the euro area. For these countries, the most important consideration in reserve management is euro liquidity. Furthermore, while China and central and eastern European economies could eventually become more significant trading partners, China's importance in central Europe often lags well behind that of Taiwan. However, faster liberalisation of Chinese capital markets, coupled with sizable inflows of Chinese investments in central Europe, may change the balance of factors favouring the renminbi for central European reserve managers. China has repeatedly expressed its interest in expanding the role of Chinese companies in the region.

There is no great shortage of international liquidity in central Europe at present. The Czech Republic's foreign reserves are robust, as are those of Poland. Poland also benefits from its access to the flexible facility of the IMF, and Slovakia is part of the euro area. As such, only Hungary may significantly benefit from access to the renminbi, which it has already secured. Regarding renminbi financing, the Czech, Polish, and Slovak authorities could obtain these at reasonable prices, given their current financial standing.

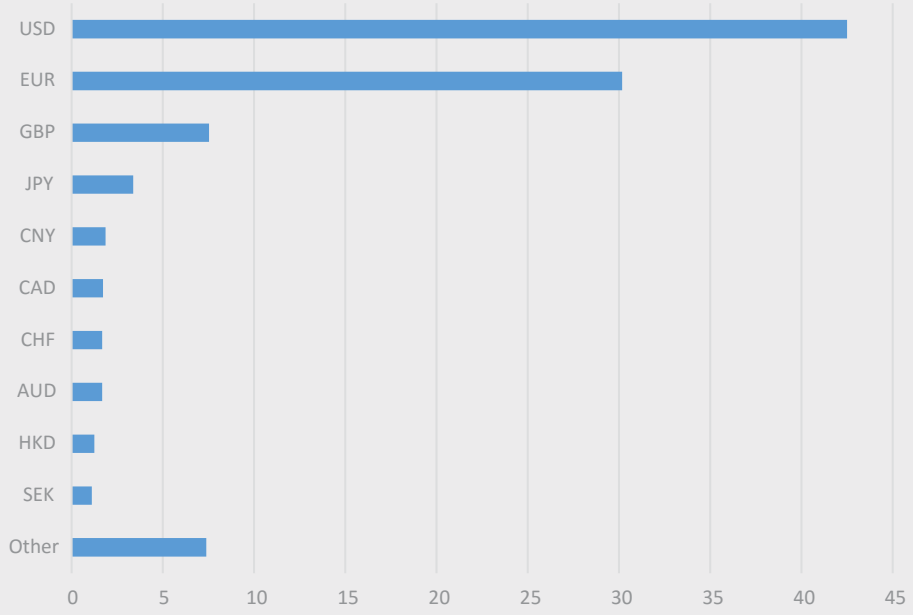
No replacement for the euro

Compared with the advantages of the euro, the SDR is of negligible importance. It is difficult to envisage the development of another currency that could supplant the euro in local economies or which could become a potential entrant to the SDR basket. Russia could be a contender to advance the importance of the rouble, but this can happen only once Russia becomes a strong modern economy – conceivable on the distant horizon.

The SDR was conceived and has developed as an instrument of globalisation. At the same time, some emerging and now developed economies in central Europe are becoming firmly established components of the global financial system. Such economies are able to rely on their own strengths and pursue their own interests, without the need to pay much attention to external developments – a good reason why, for most of central and eastern Europe, the SDR remains a theoretical and not a real consideration. ■

Renminbi fifth most used global payment currency

Share of global payments, %, August 2016



Source: SWIFT

Miroslav Singer is former Governor of the Czech National Bank and a Member of the OMFIF Advisory Board. He lectures at CERGE-EI and Prague School of Economics.

Pros and cons of dollarisation

Benefits of exchange rate pegs outweigh drawbacks

DeLisle Worrell, Central Bank of Barbados

Inflation-targeting remains the dominant fad in central banking circles, but that does not make it appropriate for universal use. For monetary policy-makers in small open economies, headline inflation is an unfair metric. A high dependence on imports, especially on volatile items such as food and fuel, highly distorts the influence of the supply of money on inflation, and thus the perception of central bank credibility.

In today's world where most large international transactions are electronically managed, migration is high, remittances are large and financial relationships opaque, central banks in open economies have lost control of the domestic money supply. These linkages offer possibilities for international financial flows about which there may be no reliable information. Exchange controls, once hailed as the method for central banks to retain control over domestic money, have become an ineffective rationing tool.

Benefits and costs of dollarisation

The conventional view is that the central bank can retain control of the money supply by allowing the exchange rate to be set by supply and demand for foreign exchange. The problem for small economies is that domestic money is always inferior to the dollar or euro as a store of value, and often as a means of payment as well.

Because of this, the demand for dollars and euros by small economies is limitless, compared to the total of foreign earnings and foreign borrowing in any given period. If the relationship between the local currency and the dollar or euro is not assured, the only people who will do business in local currency are those who have no access to foreign exchange.

These realities were part of the reason behind the adoption of the euro by small open economies in Europe. The question arises whether similar economies elsewhere might find it in their best interest to follow the examples of Panama, Ecuador and El Salvador, and abolish their own currency in favour of the dollar. For countries whose currencies have depreciated rapidly, the case for full dollarisation seems compelling.

The obvious counterargument is that the exchange rate should be retained as a tool for improving competitiveness. But in a world where rate fluctuations are governed by uncertain international financial flows, multinational production and strategic investment planning, that tool is of dubious effect, even in large economies. In small open economies the effect of the exchange rate on competitiveness is yet lower. Exporters in such economies are price takers in a competitive international market, and exchange rate pass-through tends to be high.

Despite these caveats, the benefits of dollarisation should not be overestimated. Where currencies have a credible track record of stability, particularly against the dollar, there is merit in maintaining exchange rate independence.

> *"Exchange controls, once hailed as the method for central banks to retain control over domestic money, have become an ineffective rationing tool.*

In this case the local currency stands as testament to sound economics. It acts as a powerful motivation for the implementation of economic policies that are appropriate to the country's productive structure and to changing financial circumstances. The challenge has been to find the way to balance the supply and demand of foreign exchange, at an exchange rate which does not change.

Fiscal tools to support trade

The economic policy framework in use in Barbados is designed to address this challenge. The exchange rate between the Barbados dollar and the US dollar has remained unchanged since 1975, with the help of fiscal tools that are applied to the supply and demand of foreign exchange in the market.

Fiscal incentives of various kinds are used to support tradable activities in which the country has a comparative advantage, such as high-end tourism. The size and financing of the fiscal deficit are calibrated to contain aggregate spending. This limits the demand for foreign exchange to the available supply.

In the short run, any required economic adjustment relies on demand, because it takes time to create new supply capacity. Whenever there is a shock that reduces foreign exchange inflows or increases outflows, expenditure is cut and fiscal policy tightened, whatever the cause. Ideally fiscal tightening should be accompanied by a twist that provides additional support for building capacity in activities where there is an established or potential comparative advantage. Such a strategy helps to accelerate the building of additional foreign exchange supply capacity, which can bring forward the time when the short-term fiscal limits can be relaxed.

Currency impact on investment appeal

The benefits of a credible exchange rate anchor include reduced investor uncertainty, reinforcement of domestic savings habits, and a strong, transparent incentive for sound fiscal policy. The international investor in a small open economy which has a floating exchange rate must deal with an additional source of uncertainty, in comparison with investment in a country with a credible peg. All other things equal, the country with the pegged rate will be the preferred destination for that investment.

The erosion of the external purchasing power of domestic money that comes with a large devaluation has a devastating impact on domestic savings habits. The memory of the loss of value of pension benefits, for example, often destroys the domestic currency pensions business for a generation or more.

On the positive side, fear of devaluation has proven to be a powerful motive for fiscal discipline in small open economies, precisely because of awareness of the uncertainty and inflationary consequences of devaluation. ■

DeLisle Worrell is Governor of the Central Bank of Barbados.

Trump presidency threat to nuclear deal

Western policy could undermine moderates in Iran

Norman Lamont, Advisory Board

There are many known unknowns about President-elect Donald Trump. Few are as important as his view on the Iran nuclear deal, agreed between the Islamic republic and the US, Russia, China, France, Germany and the UK.

To many, the nuclear deal seemed worth having in its own right. The International Atomic Energy Agency has confirmed that Iran has complied with all the conditions specified in the agreement, modifying its reactors, shipping enriched uranium out of the country and reducing the number of centrifuges it operates.

The consequences are that the world is a safer place, the threat of nuclear proliferation is much diminished and, while it was not expected that Tehran would become the West's best friend overnight, the deal held out the prospect of improving relations.

Lifting of sanctions

Since the agreement provided for the lifting of many sanctions against Iran, the economic consequences of the deal were also extremely important.

Iran is often described as the last great emerging market. It has a young and tech-savvy population of nearly 80m. It has the second largest oil reserves in the world and fourth largest gas reserves. It has a much more diversified economy than other oil producers. Its automobile industry is 60% larger than that of Turkey – 90% of the cars in Iran are manufactured locally. There is a long tradition of entrepreneurship and respect for business. Management consultancy McKinsey and Company estimated the cost of setting up a business in Iran as one sixth of that in Turkey.

> *"Iran is often described as the last great emerging market. It has a much more diversified economy than other oil producers.*

Amazon or Uber may not be in Iran but there are local versions. There is Digikala, the biggest e-commerce site in the Middle East, and Esam, a local version of eBay. Technical education is also of a high standard. The chairman of the electrical engineering department at Stanford University described the corresponding department of Sharif University of Technology in Tehran as the 'best in the world'.

For the UK, opportunities can be found in oil and gas, financial services, aviation, water management, transportation, infrastructure, pharmaceuticals, environmental services and retail. Companies like Jaguar Land Rover, Lotus, BP and Shell are all returning, though sadly the UK lags behind European competitors.

Oil production recovery

The Iranians have been surprisingly successful in quickly getting oil production almost up to pre-sanctions levels. Their aim is to produce 5.7m b/d by 2020, a level not seen since 1977. In contrast, despite having the second largest reserves in the world, Iran accounts for only 1% of international trade in gas.

President Hassan Rouhani was elected on a platform of negotiating a nuclear deal and opening the economy to the outside world. In a recent speech, he asked, 'Can a country in today's world progress without relations with the world? The Koran tells us that the world is vast and open and that we should get up and travel through it.'

Trump's inconsistent rhetoric

All these hopeful prospects are now in doubt. During his campaign, Trump made many damning indictments of the Iran agreement, calling it a 'dumb' deal and threatening to tear it up. However, as in many areas, he is not always consistent. He is reported to have said that if Iran were a 'stock' it would be a 'buy' as it was going up five times. On another occasion, he remarked that he had made his money by enforcing deals and that he would make sure that Iran stuck by the nuclear agreement.

Whatever judgements Trump makes, it may not be easy for him to control Congress. If Congress had had its way, they would have imposed additional sanctions, but Obama always made clear his determination to veto any attempts to undermine the deal.

On the other hand, it may not be that easy for the deal to be scrapped or renegotiated. This is not just a US deal with Iran but one that is agreed by China, Russia and various European governments. The agreement has been lodged with the United Nations and some of the sanctions that have been lifted include UN ones.

Since the American election, Iran has reacted with restraint, simply observing that they expect the US to abide by its own agreement. Unfortunately, some Iranians have become increasingly disillusioned with the absence of concrete benefits. As they see it, they have complied with the agreement fully but the West, and in particular the US, has not.

A lack of banking relationships

The problem is that, while Europe has lifted its sanctions, the US has retained primary sanctions. For this reason, many European banks with dollar businesses have been reluctant to finance trade or process payments with Iranian counter-parties for fear of falling foul of US laws. Consequently, even Iranian banks in London have been unable to establish correspondent banking relationships.

> *"In the absence of proper relationships, the nuclear agreement, in the opinion of many Iranians, has not brought benefits to the population. This threatens to undermine the political position of the moderate Rouhani.*

In the absence of proper relationships, the agreement, in the opinion of many Iranians, has not brought benefits to the population. This threatens to undermine the political position of the moderate Rouhani. Hardliners preparing for the presidential election in 2017 are accusing Rouhani of having done a 'poor deal'. Supreme Leader Ayatollah Khamenei has repeatedly confirmed his distrust of the US and his lack of surprise at how the deal has turned out.

This is a difficult state of affairs. The agreement has not been fully implemented by the West – and the incoming US president may tear it up. If that does happen, it will provoke tremendous bitterness in Iran and undermine the modernisers who want to build better international relations. It will reinforce the perception that the West cannot be trusted and will usher in yet more dangerous volatility in the Middle East. ■

Lord Lamont is Chairman of the British Iranian Chamber of Commerce and the Prime Minister's Trade Envoy to Iran.

Long-term gains, but for now chaos

India's move to demonetisation

Meghnad Desai, Advisory Board

On the same day as the election of Donald Trump, India's Prime Minister Narendra Modi announced a radical demonetisation plan for India to combat 'black money', the practice of hiding money and transactions in cash to avoid detection by tax authorities.

Black money has been troubling India since before independence in 1947, when excess war-time profits were hoarded by a few in cash mountains. In a largely poor society, cash payments are the norm.

The thin veneer of modern tax laws and revenue services further encouraged hoarding of cash. Socialists of all parties, whose economics is theoretical rather than practical, compounded the problem by introducing punitive rates of taxation, making hoarding more profitable.

Radical action finds India unprepared

The Indian economy is enmeshed in the black economy. Sending money abroad illegally to a foreign bank is criminal, but does not affect the daily running of the Indian economy. Routine income tax evasion is also common.

The problem is with hoards of cash acquired in a variety of businesses. It is this money which not only circulates in clandestine activities such as drugs, prostitution and gambling, but also enters legitimate sectors such as real estate, jewellery and luxury consumption. This sort of black cash has become not just part of the economy, but a dynamic part. Electoral politics has also been shaped by these hoards of money.

The elimination of this black money at home and abroad has been one of Modi's key policies, and his earlier amnesty scheme for cash hoarders gathered Rs660bn. Around Rs1.5tn has been brought back from abroad, but the bulk of black money and the core of the problem is in India.

In the latest phase of his project, Modi announced the replacement of Rs500 and Rs1000 notes with new Rs500 and Rs2000 notes. By demonetising the old currency, the value of those vast hoards of cash has been wiped out. It is the biggest redistributive policy move of the past 70 years.

> ***"In the long-term, Modi's policy should lead to a more widespread adoption of cashless culture, already popular among India's youth. Small shopkeepers are already adapting to plastic.***

The announcement took citizens and banks alike by surprise. Neither were prepared for such a radical action. There have been chaotic scenes as long queues of Indians wait outside banks to deposit old cash before the 30 December deadline. Restrictions are imposed on how much new money can be withdrawn, but due to the lack of preparation among the banks there are difficulties in supplying the new cash and delays while old ATMs are upgraded for new note sizes. The turmoil has been most acute in rural areas, where bank branches are scarce.

Setting precedent for reform

The scale of the shock has raised questions about an economic slowdown and reduced rate of growth, but this will wear off after a month, following which there should be an upward correction in purchases. The final numbers will show a negligible impact on national income.

In the long term, Modi's policy should lead to a more widespread adoption of cashless culture, already popular among India's youth. Small shopkeepers are already adapting to plastic. If India can be weaned off cash, there will be a considerable reduction in transaction costs as well as corruption.

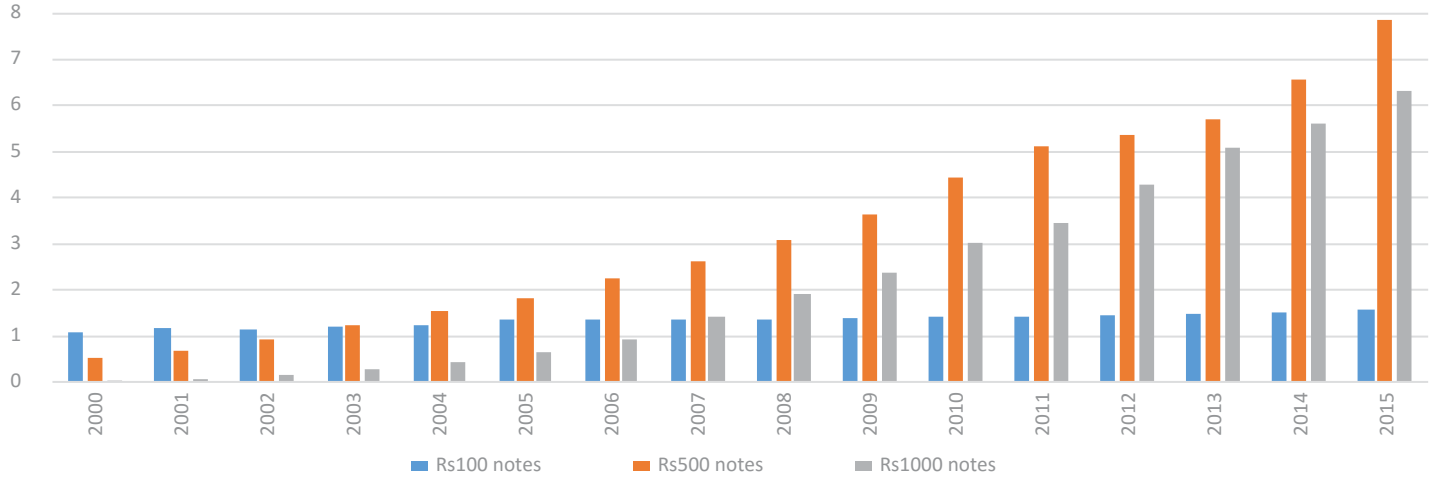
For the meantime, banks inundated with cash deposits will have to cut lending rates, meaning that cash that remains hoarded will lose value. This will reduce the liabilities of the central bank, a dividend it can share with the government.

Demonetisation is the boldest step Modi has taken and, despite some short-term problems, the scheme has plenty of support in India. Modi, who has previously been thought of as risk averse, has shown his willingness to hazard unpopularity for the sake of radical reform. This is promising for future possible projects such as labour market reform. ■

Meghnad Desai is Emeritus Professor of Economics at The London School of Economics and Political Science.

Modi withdraws most widely used notes from circulation

Notes in circulation, Rstn



Source: Reserve Bank of India, OMFIF analysis

DONALD TRUMP MOVES TO WHITE HOUSE

Donald Trump and the new rules of politics

Meghnad Desai, Advisory Board

Conventional wisdom dictates that parties should move to the ideological centre, where polls indicate most voters are. Donald Trump ignored this theory, instead staying on the political and ideological extremes.

The Democrats did not believe that he could defeat a serious politician who maintained the correct combination of liberal tolerant beliefs. Nonetheless, polls were in disarray, and the margin between the two in the popular vote was statistically insignificant.

With Trump's victory, there will have to be a new way of modelling politics. Pollsters must stop asking the standard anodyne questions, and find techniques where voters reveal their true preferences. This is not easy, as economic theorists have discovered.

This has a profound consequence for democracy. Instead of two parties, we may get ideological factions which will bid not for majority but for a seat at the top in some coalition. European politics have been going this way since the euro crisis. In America, Trump has split the Republican Party. Next time around, there may not be a two-cornered contest. ■

Lord (Meghnad) Desai is Emeritus Professor of Economics at the London School of Economics and Political Science.

Testing the separation of powers

Brian Reading, Advisory Board

Is Trump the most powerful president in recent times? Yes and no. Presidential power is limited. The executive's job is to administer the law. Congress makes the law. The Supreme Court throws out unconstitutional laws. This is the separation of powers.

Trump cannot introduce any bill to Congress, he can only recommend them. But his congressional supporters can do so. He can veto any law passed by the legislature. But his veto can be overturned by a two third majority in both the House of Representatives and the Senate. That may prove difficult.

The presidential campaign descended from the gutter to the sewer, determined by hate, not hope. Trump broke all conventional rules by appealing to the alienated. He knew better how to win than the political elite. Trump's battle is now with members of the Republican establishment. For better or worse, Trump will deliver change. ■

> ***"The presidential campaign descended from the gutter to the sewer.***

Brian Reading was an Economic Adviser to Prime Minister Edward Heath.

Grounds for hope in business policies

Reginald Dale, Advisory Board

Despite the shock of Donald Trump's election, some shrewd Washingtonians see three possible grounds for hope. First, his policies of tax cutting, deregulation, and boosting growth may be just what business needs, ushering in a much stronger US economy.

Second, as an entrepreneur who prides himself on deal-making, he should be far better at negotiating and compromising than his predecessor was. When Barack Obama (rarely) negotiated with Congress he simply demanded that it give him virtually everything he wanted, whereas with the Iranians he accepted practically everything they asked. 'The Art of the Deal' this was not. Trump is already adjusting some of his most extreme campaign promises.

Third, the narcissistic Trump will want so much to be 'a great president' that he will pick experienced and sensible advisers. None of this, of course, is guaranteed. And his protectionist trade policies, if implemented, could largely negate the potential bright spots. ■

Reginald Dale is Director of CSIS Transatlantic Media Network.

US uncertainty a boost to UK assets

Ben Robinson

Since Britain's June referendum decision to leave the European Union, sterling has fallen sharply against the dollar and the euro, reflecting pessimism about the UK's economic prospects.

However, the increase in political uncertainty following Trump's victory and upcoming elections across Europe may boost the UK's status as a safe haven and help it regain its position as an attractive choice for investors. It is one of the few core European states not scheduled to hold an election within the next few years, it lacks a populist opposition, and the government has a parliamentary majority.

Trump's election may also help the UK as it seeks to implement post-Brexit trade deals. His rejection of free trade agreements means there is a void which other parties to the now defunct deals are looking to fill.

After America's inward turn, they may take advantage of the opportunities offered by the UK's trade openness. ■

Ben Robinson is Economist at OMFIF.

FOREIGN AND ECONOMIC POLICY TESTS

Tests ahead for dollar, economy, Fed, Europe

David Marsh

A campaign unparalleled in divisiveness and vehemence has finished with Donald Trump, the ultimate contrarian, defeating the odds and winning the race for the White House.

The dollar is likely to fluctuate widely, reflecting post-election geopolitical uncertainties and doubts over Trump's relationship with the Federal Reserve.

America's place in the world is suffering a process of dislocation. Europe, meanwhile, is buffeted by conflicting forces. Parties fighting European policies are resurgent in many countries, often for reasons mirroring the anti-elitist Trumpian tide. No one can be sure whether new Trump-like figures will gain power in European capitals with equal potential to divide.

Trump's stance on many issues has incited suspicions and intrigue. Yet he would not be out of place in a roster of red-meat political supremos that includes the leaders of Russia, China, and Turkey. We will now see a giant real-life laboratory experiment – on a scale that could shake the world. ■

David Marsh is Managing Director of OMFIF.

Why Trump should work with China

Kishore Mahbubani, Advisory Board

US President-elect Donald Trump should cast aside his hawkish instincts on China and seek co-operation with America's number one geopolitical competitor. In particular, he should experiment with a massive infrastructure partnership with China. America and China can jointly show that co-operation can pay off, even as they compete from time to time.

America's number one priority should be economic growth. The only way to meet the expectations of the millions who voted for Trump is to deliver a booming economy with more jobs. In view of America's evident fiscal challenges, Trump will need a strong economic partner to achieve his infrastructure plans – and the superpower in this field is China.

After the China-bashing rhetoric of the campaign trail, Trump will have to suppress his geopolitical instincts and expend significant political capital to explain why greater collaboration between America and China makes economic sense. ■

Kishore Mahbubani is Dean of the LKY School of Public Policy at the National University of Singapore, and author of The Great Convergence. *The views expressed are his own.*

Europe must nurture greater Atlantic unity

John Kornblum, Advisory Board

Donald Trump was not a Republican and has no political philosophy, but he is a fascinating product of a new self-centred public culture. Like Putin and Berlusconi, he learned how to manipulate the post-truth age.

Trump seemed to sense that, for many Americans, the new post-modern culture was arriving too quickly. The political establishment has often neglected this 'real America'. Trump's victory does not mark the end of the march of progress. But we can now see that progress is not to be taken for granted.

The election result is a special challenge for Europeans. Can Europe hold together without the glue provided by America's clout, or will its nations drift off in different directions? Will common sense, innovation and tolerance find a strong refuge here, or will Trumpian ideologies develop in Europe as well?

> ***"Can Europe hold together without the glue provided by America's clout, or will its nations drift off in different directions?***

Trump's election signifies the end of the post-second world war system. Perhaps Europeans will now find the stronger sense of Atlantic responsibility which will be needed to confront the upheavals ahead. ■

John Kornblum is a former US Ambassador to Germany and Senior Counsellor at Noerr LLP.

Memo to Putin: be careful what you wish for

Russia has taken cynical pleasure in the election of Donald Trump. The latter's unorthodox thinking on global issues may have encouraged Putin to believe that a Trump victory would enable Russia to continue its resurgent international role.

Putin should be careful what he wishes for. Trump's campaign was notable for aggressive and uncompromising rhetoric, which caused his rivals to steer their arguments away from policy issues towards countering and retaliating against his inflammatory claims. Applied to the international context, Trump's divisive rhetoric could frustrate many political goals for Putin, who has grown used to a US administration led by the level-headed Barack Obama.

Domestically, Trump is on surer footing than Putin, having secured a Republican Congress. Conversely, Putin's success in elections this year owed much to the barring of credible opposition. He lacks the political capital necessary to suffer a loss of face from a verbal confrontation with Trump or a military stand-off against the US.

Both leaders would be wise to tone down their rhetoric from now on, and it would not be surprising if they do so. ■

US Libor and the money supply

Shadow banking implications for US monetary conditions

Peter Warburton, Economic Perspectives

The world is awaiting the outcome of the US Federal Open Market Committee meeting on 13-14 December. Donald Trump's election victory is likely to spur a significant fiscal expansion and the removal of any remaining obstacles to an increase in the Federal funds rate. However, analysts have been struggling to come to terms with an implied tightening of US monetary conditions that began in the summer of 2015.

Despite the consistent rate of expansion of bank lending to individuals and businesses, US banks' total asset growth has slowed from 8% per annum in mid-2014 to 2.5% in October. The Federal Reserve has not published an official estimate of the M3 money supply since 2006, but private sector estimates suggest a parallel slowing since August 2015. John Williams, author of Shadowstats.com, calculates that annual M3 growth fell to 3.5% in October 2016 from a peak of 5.8% in summer 2015. This deceleration is in marked contrast to the behaviour of M1 and M2, which have accelerated in recent months to 10.3% and 7.8% per annum respectively.

Drivers of non-bank credit

This phenomenon is probably related to the steepening of the US Libor curve. Since June, the one-month rate has drifted up only slightly from 0.45% to 0.57%, but the three-month rate rose more steeply from 0.65% to 0.92%, the six-month from 0.94% to 1.25% and the 12-month from 1.28% to 1.62%.

One potential explanation behind this link is that the rise in Libor has encouraged some institutional investors to deplete their holdings of wholesale time deposits in favour of non-bank money funds. These have been supplying dollars to overseas borrowers, and some domestic corporations as well. Consequently, some US credit flows may have been disintermediated from the banking system, consistent with a decline in both their wholesale deposit base and their cash assets. The drop in cash assets is concentrated in the balance sheets of foreign bank offices.

> ***"The rise in Libor has encouraged some institutional investors to deplete their holdings of wholesale time deposits in favour of non-bank money funds.***

It is likely that the trigger event for this shuffling of assets and rising Libor fixings is the prime money fund reform, the latest phase of which was implemented in mid-October. This phase involved only institutional-class funds and required the bolstering of liquidity buffers in anticipation of outflows. While the SEC requires prime funds to keep at least 30% of assets under management in 1-week liquid assets, their current liquidity buffer is well above 50% and may be closer to 70%.

Accidental monetary tightening

As Zoltan Pozsar of Credit Suisse wrote, 'It is the ramping up of these liquidity buffers that is behind the recent steepening of the US dollar Libor curve. While the money is still in the hands of the prime funds, the growing size of liquidity buffers makes it feel as if term money has already left.'

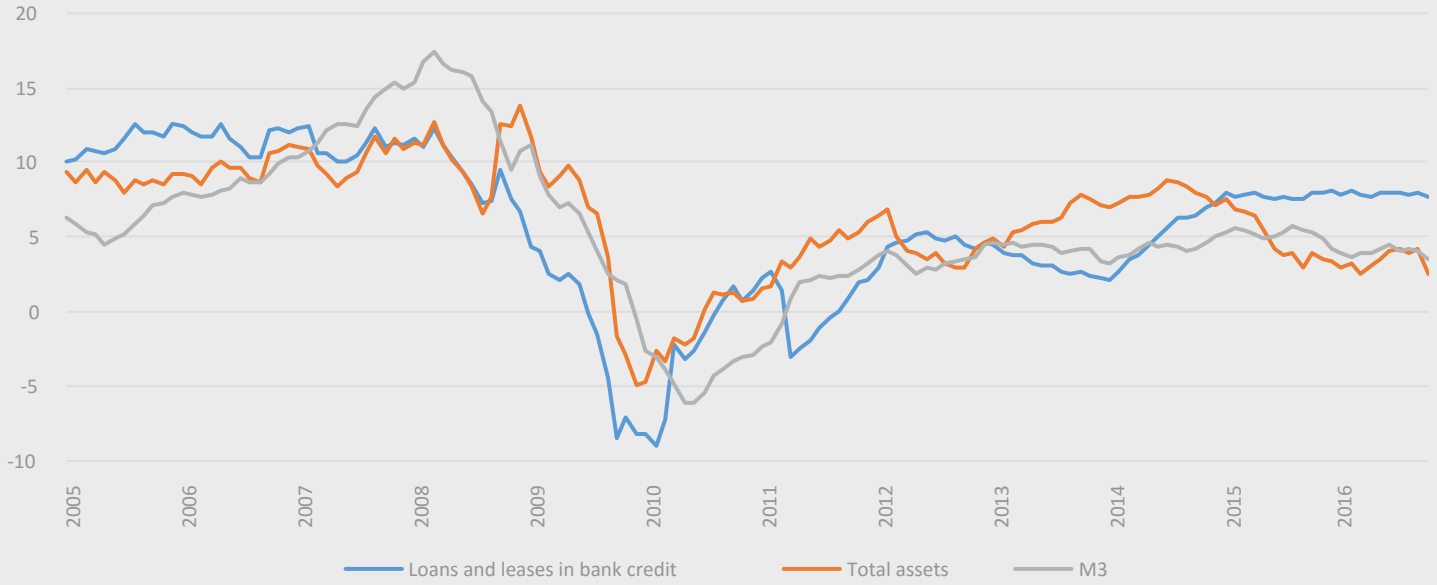
The most favourable interpretation is that banks have merely lost market share in financial intermediation and that the economic impact will be trivial.

More probably, prime money market fund reform appears to have raised the cost of US Libor borrowing for foreign banks, and has tightened US monetary conditions well ahead of the Fed's long awaited funds rate increase. ■

Peter Warburton is Director of Economic Perspectives and a Member of the Institute of Economic Affairs Shadow Monetary Policy Committee.

Post-crisis recovery in money supply growth is waning

Annual growth in assets and liabilities of US commercial banks, %



Source: Federal Reserve System

Trump victory points to Fed tightening

Markets react with record stock prices, higher bond yields

Darrell Delamaide, US editor

After Donald Trump's election victory, the stock market crash forecast by the likes of former International Monetary Fund Chief Economist Simon Johnson failed to materialise.

Investors pushed the US stock market to record highs as they dumped bonds and switched to equities in anticipation of Trump honouring his pledges to cut taxes and increase government spending on the military and infrastructure.

Trump's victory has raised the prospect of higher bond yields and higher inflation. Far from prompting the Federal Reserve to hesitate with another quarter-point hike in the benchmark federal funds rate, it makes action at the December meeting of the Federal Open Market Committee a virtual certainty.

Fischer, Fed vice chair, said the case for tightening monetary policy is 'quite strong' on 11 November, citing favourable employment and inflation data.

'The Fed appears reasonably close to achieving both the inflation and employment components of its mandate,' Fischer said. He added, 'I am reasonably optimistic that the spillovers from ongoing US normalisation will be manageable for the foreign economies,' which includes emerging market economies.

Fiscal boost warrants rate hike

It was thought that October's bullish jobs report would bolster Hillary Clinton's chances, as she had pledged to continue President Barack Obama's policies. The US economy added 161,000 jobs, the unemployment rate dipped to 4.9% from 5% in September, and wages grew 2.8% year-on-year, the fastest since 2009.

But Rust Belt voters devastated by losses of manufacturing jobs weren't impressed, and it was states like Pennsylvania and Wisconsin that had previously voted Democrat which gave Trump his electoral college victory.

Eric Rosengren, chief of the Boston Fed, echoed Fischer's remarks. 'Absent significant negative economic news over the next month, the market's assessment of the likelihood of tightening in December seems plausible,' he said.

Rosengren, a voting member of the FOMC this year, advocated a rate hike earlier this year and dissented from September's decision to wait further.

'I would much prefer that tightening be gradual, and that policy-makers try to avoid circumstances in which we need to tighten more quickly,' he said. 'My concern is that more rapid tightening, were it necessary, could risk disrupting the recovery that is now attaining both elements of the Federal Reserve's dual mandate – full employment and an inflation target consistent with price stability.'

Richmond Fed President Jeffrey Lacker addressed the election more directly, referring to the fiscal stimulus Trump promised during his campaign.

'If a more stimulative fiscal stance would materialise, that would bolster the case for raising rates,' Lacker said. 'As a general matter, doing monetary policy with a more stimulative fiscal outlook usually warrants higher policy rates.'

> ***"The president cannot fire the Fed chair, and Yellen's two immediate predecessors, Alan Greenspan and Ben Bernanke, remained in office while a different party took over the White House.***

James Bullard, head of the St. Louis Fed, said in November that the US economy might get a boost in the medium term if Trump followed through on his plans for infrastructure spending and tax reform. He added that his outlook for growth in the short term hasn't changed.

'A single policy rate increase, possibly in December, may be sufficient to move monetary policy to a neutral setting,' he said.

Reshuffle at the Fed

Some Trump advisers have stressed that he respects the Fed's independence, despite his suggestions that the Fed's low interest rates are politically motivated. Judy Shelton, a member of Trump's economic advisory team, said, 'The Fed is independent and will remain independent.'

On whether Fed Chair Janet Yellen will serve out her full term, Shelton said, 'I can't imagine why she wouldn't.' The president cannot fire the Fed chair, and Yellen's two immediate predecessors, Alan Greenspan and Ben Bernanke, remained in office while a different party took over the White House. The chair rarely stays on the Fed board after their term expires even if the appointment as governor has more time to run.

Eric Rosengren, President, Boston Fed

Fischer's term as vice chair also expires in 2018. There are currently two vacancies on the board of governors, since the Republican Senate blocked Obama's two latest nominations. Trump will be able to fill those vacancies and then perhaps the two seats vacated by Yellen and Fischer, assuming they are not reappointed in their main positions and decide to leave the board. Daniel Tarullo, one of Obama's first appointments to the Fed board, is in his eighth year and may be ready to move on, although some argue he might want to stay to safeguard the independence of the central bank.

Trump may have less room to change Fed posts if Yellen and Fischer were to stay on the board after losing their current positions. Theoretically, Fischer could stay until 2020, Tarullo until 2022, and Yellen until 2024, leaving Trump with only the two current vacancies to fill. Governors can quit any time they want, and tenures have tended to be short given the financial sacrifice of serving in these government posts.

Obama appointed four new members to the board of governors in his first term. President Ronald Reagan appointed two. President Trump could end up appointing up to seven new governors in his first four years. ■

Darrell Delamaide is a writer and editor based in Washington.

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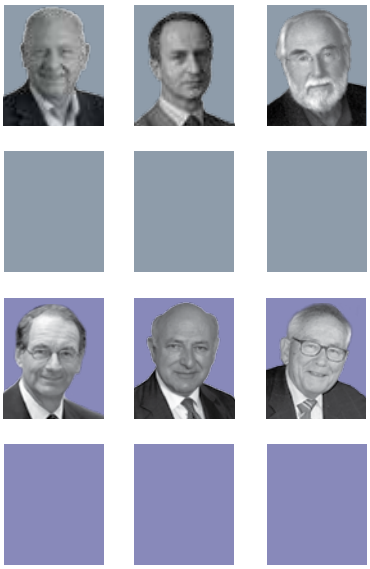

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Collapse in confidence

Refresher course on how Britain faced the IMF music

William Keegan, Advisory Board

***When Britain Went Bust: The 1976 IMF Crisis* comes with more ringing endorsements than your reviewer has lost euros since the onset of Britain's Brexit-induced latest currency crisis.**

Professor Richard Roberts, one of Britain's leading financial historians, will have spent years of research to produce this meticulously balanced study. It charts the run-up to, causes and immediate aftermath of the humiliating episode when the UK's Labour government of 1974-79 was forced 'to go cap in hand to the International Monetary Fund'.

The motivation for publication is that it is 40 years since the fatal year when Chancellor Denis Healey was forced to 'turn back at the airport', abandoning an official overseas visit to face the music of the country's economic crisis. But thanks to a classic quirk of economic history, the book could hardly have appeared at a more appropriate moment. International political and financial communities are looking in horror at the financial crisis which a Conservative government has brought upon this country. And Britain is by no means out of the woods yet.

'Never say "never"'

The 1976 crisis was precipitated by a collapse of confidence in British economic policy in the financial markets. Britain had a similar experience this year in the wake of the referendum of 23 June.

In a thoughtful foreword to Roberts' book, Lord Macpherson, recently retired permanent secretary to the Treasury, expresses the hope that, given low inflation and 'the increasing respectability of monetary financing of the deficit', the possibility of having to go again to the IMF appears remote. Although he emphasises that one thing he learned in the eye of the financial storm of 2007-09 was 'never to say "never"'.

The beauty of *When Britain Went Bust* is that it is succinct (140 pages) but comprehensive, and eschews jargon to be accessible to the general reader. This book is a refresher course for those of us who were there at the time, and a mine of interest for younger readers. Readers will learn, or be reminded, that this was by no means the only time that a British government had to resort to IMF borrowing.

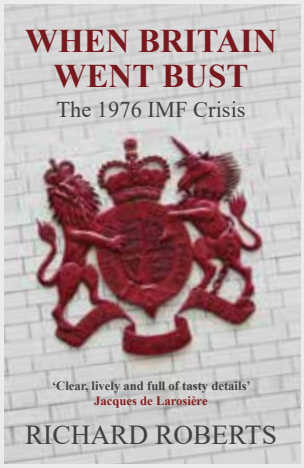
This is the episode that captured the public's interest, but the British were frequent fliers to Washington for IMF assistance, as well as to the central bankers in Basel, as successive governments struggled with Britain's relative economic decline and failure to 'pay our way' in the world.

> ***"The 1976 crisis captured the public's interest, but the British were frequent fliers to Washington for IMF assistance, as governments struggled with Britain's relative economic decline and failure to 'pay our way' in the world.***

It is a dramatic story: near fatal splits in the Labour cabinet over the terms of a deal that would satisfy the financial markets and a very hawkish US Treasury; Prime Minister Jim Callaghan emerging as the hero of the 1976 autumn as he kept that cabinet together with a magic touch for leadership, which certain successors have never learned; and a stunning performance by Chancellor Healey.

I kept in touch with Healey until his dying year. He always insisted that if the Treasury's forecasts had been better, the 1976 crisis could have been avoided. I doubt it, and so does Sir Douglas Wass, permanent secretary to the Treasury at the time, who wrote his classic account of 1976 in *Decline to Fall* and who is appropriately quoted by Roberts.

I myself covered the run up to the crisis for the Financial Times in 1975-76. I witnessed the Bank of England's concerns about inflation – 25% in 1975 – and public sector borrowing from the inside while on secondment there, and the aftermath when I joined The Observer in 1977.



Burial of Keynesian policies

Roberts is to be congratulated on a fine achievement. But one myth I should have liked him to scotch is that the speech made by Callaghan to the Labour conference signified the burial of Keynesian policies for good. He rightly concludes that Healey did not really adopt monetarism, as monetarists have claimed.

It is important to note that Callaghan's disavowal of the belief that 'you could spend your way out of recession' (in his 1976 conference speech), which was widely interpreted as 'an end to Keynesianism', was essentially tactical. It did the trick with Washington and the IMF. In Callaghan's memoirs he objected to the way it was being 'misused by Conservative spokesmen. They wanted to justify their malefactions in refusing to increase public expenditure at a time of recession, low investment and low inflation, and of record levels of jobless' during the early Thatcher period. ■

William Keegan is Senior Economics Commentator for The Observer. To buy When Britain Went Bust *please visit www.omfif.org/shop.*

Rate rise predicted for Fed in December

Advisory Board expects Yellen replacement in 2018, Renzi loss in Italy

This month's Advisory Board poll focused on the US and Italy, specifically the future of US monetary policy conduct under a new president and the outlook for Italy and Europe following the Italian constitutional referendum on 4 December. Advisory Board members were asked three questions. First, what changes the Federal Reserve will make to interest rates and when they will take place; second, how Donald Trump will affect the Fed chairmanship; and third, if Prime Minister Matteo Renzi will win the Italian referendum and whether this will have a positive or negative impact on the political and economic outlook for Italy and the wider euro area.

The majority of respondents – 95% – expect the Federal Reserve to raise rates, while 5% expect an interest rate cut. Of those expecting higher rates, 90% believe this will occur in December and the remainder foresee the rate rise in the first half of 2017. Accompanying tighter monetary policy, the majority of Advisory Board members – 70% – envisage that, when her term ends in February 2018, President Trump will replace Fed Chair Janet Yellen with a supporter to encourage growth and employment. Her reappointment is predicted by 20% of respondents, with 10% foreseeing Yellen being replaced by a hawkish governor or stepping down early.

On the Italian referendum, three quarters of Advisory Board members forecast Renzi to lose, 15% presume a win, and 10% are undecided. All responses classified the consequences as negative or unchanging to the current outlook, largely driven by 'political uncertainty and anxiety' transmitting through Italian and European markets.

'Globally, central banks are facing a crisis of confidence as their policies are increasingly thought to be ineffective. For the Federal Reserve post-election, this necessitates being seen as independent of politics which points to an early increase in interest rates if at all plausible.'
Colin Robertson, independent asset allocation consultant

'It is right for Trump's election to be analysed, but it should not be normalised. For better or worse, 2016 is an end of an era for the global order and the political economies of the West. Considering all areas of policy-making, we need to be cautious as the rejection of failure is not the same as the endorsement of a solution.'
Elliot Hentov, State Street Global Advisors

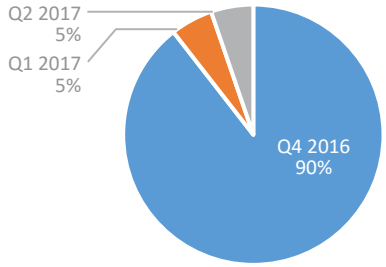
'I do not expect that Trump will pressure Yellen to step down before her term is up at the end of January 2018. Trump does have two open positions on the Board and he could have one or two more before January 2018. He could even appoint a chair-in-waiting. I expect that chair will be a moderate and not an ideologue.'
Ted Truman, Peterson Institute for International Economics

'The Italian referendum outcome will highlight the deep-rooted problems across parts of the euro area. It will reinforce the existing pressure on the European Central Bank to continue with an accommodative stance to help the economic adjustment already under way in a number of euro area economies.'
Gerard Lyons, Netwealth

These additional statements were received as part of the November poll, conducted between 14 and 25 November, with responses from 20 Advisory Board members.

High anticipation of a Fed rate rise in December 2016

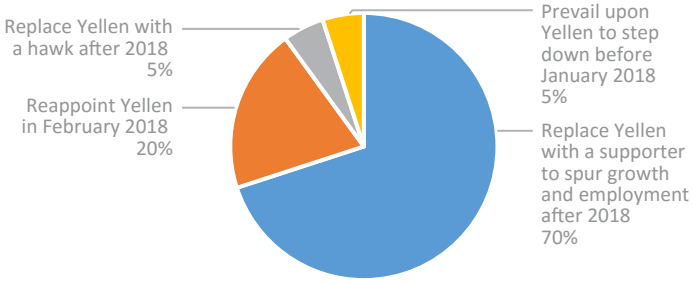
Percentage of responses



When will the Fed raise rates?

Trump to replace Yellen with a dove say 70%

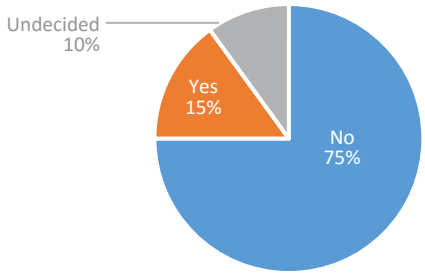
Percentage of responses



How will Trump deal with the chairmanship of the Fed?

Majority predicts Renzi to lose December referendum

Percentage of responses



Will Matteo Renzi win the 4 December referendum?

January's question

As Donald Trump enters office, how far will his policies veer away from his election promises on the following issues?

- **Trade**
- **Immigration**
- **Environment**
- **Healthcare**
- **Infrastructure investment**
- **Central Bank independence**
- **Taxation and social policy**