The Bulletin

May 2017
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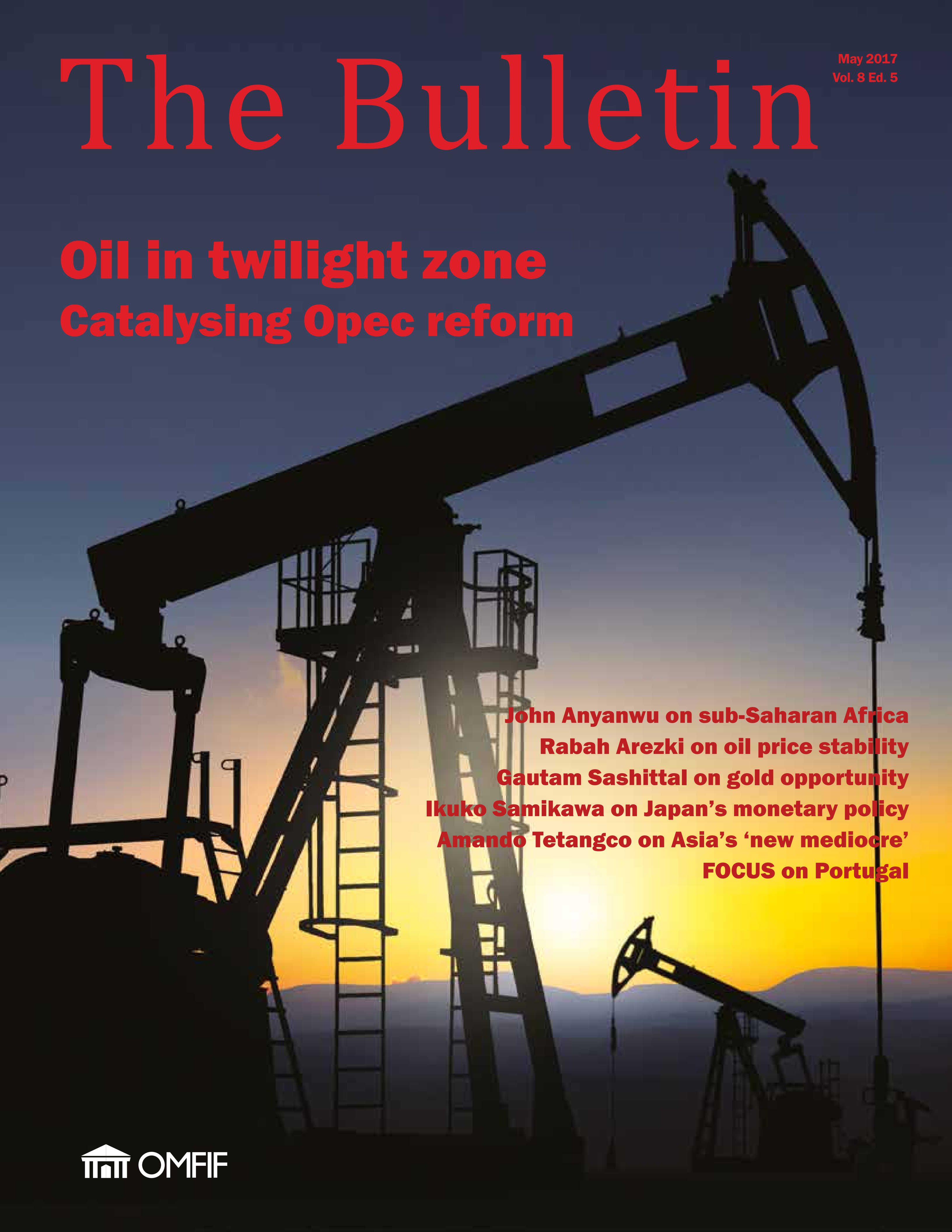

Oil in twilight zone
Catalysing Opec reform

John Anyanwu on sub-Saharan Africa
Rabah Arezki on oil price stability
Gautam Sashittal on gold opportunity
Ikuko Samikawa on Japan's monetary policy
Amando Tetangco on Asia's 'new mediocre'
FOCUS on Portugal

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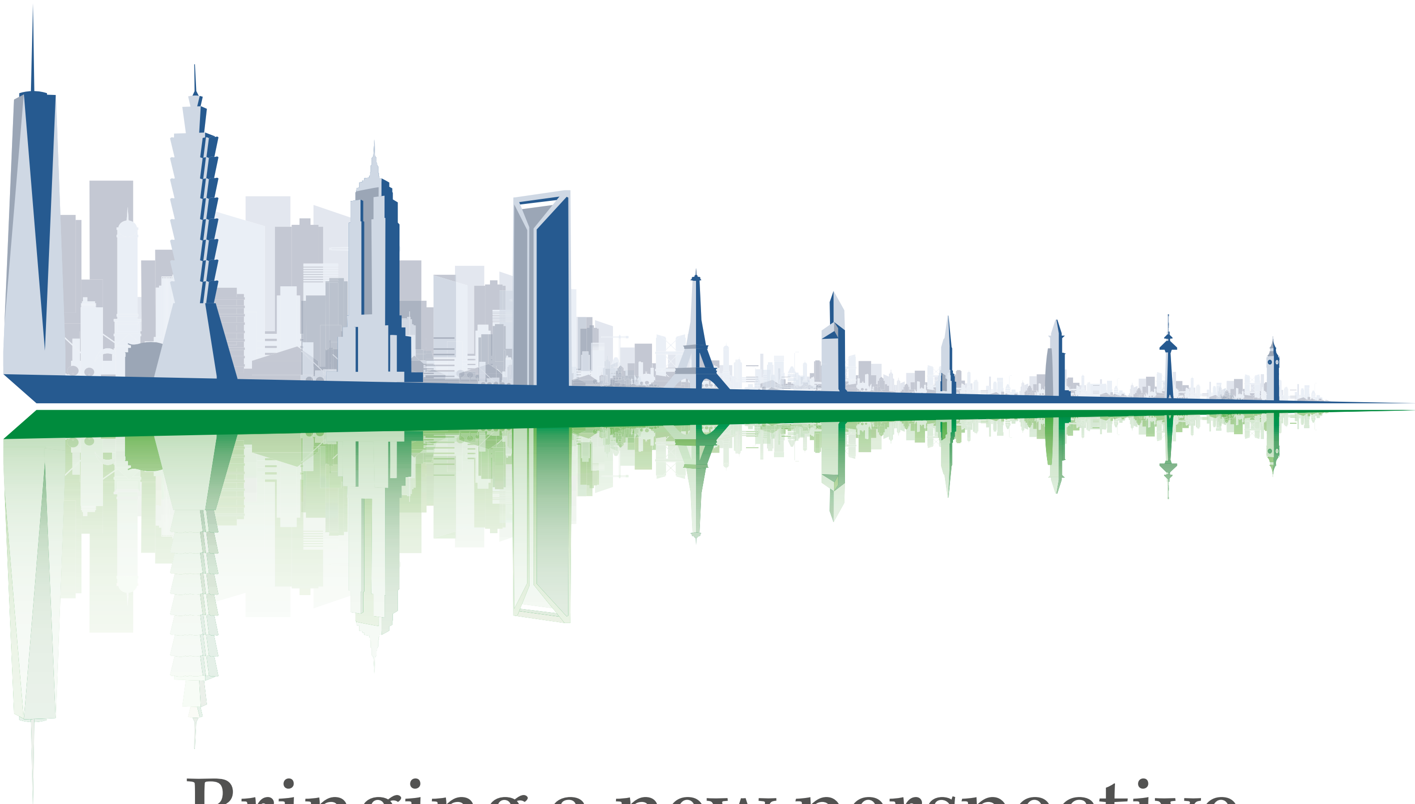

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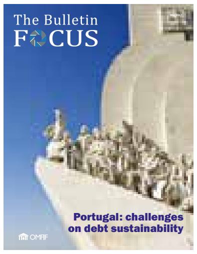

Portugal: new successes

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Dialogue on world finance and economic policy

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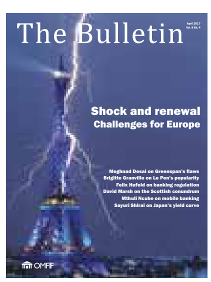
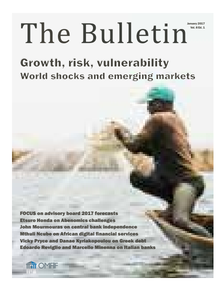
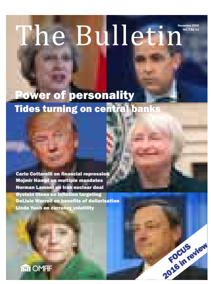
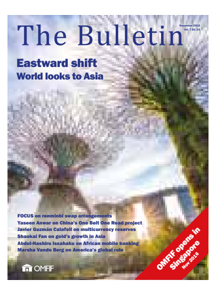








EDITORIAL

Oil in twilight zone: price uncertainty catalyst for reform

Oil prices are recovering this year from the 13-year lows seen in early 2016. But the upturn is unlikely to reassure producers because the fundamentals of demand, supply and exchange-rate dynamics point to price weakness continuing for some time. In January, the Organisation of the Petroleum Exporting Countries agreed to adjust production with the aim of stabilising prices. The oil market remains in the twilight zone – but this can be a powerful catalyst for reform among Opec states.

Rabah Arezki and Akito Matsumoto identify the threats to the agreement from non-compliance and rising shale oil output. The agreement may provide a short-term solution for exporters but to achieve sustainable development they need to adjust their growth models, argues Bhavin Patel, drawing attention to the fiscal responses of Gulf states. Other commodities are faring better than oil. Gautam Sashittal advocates the attractiveness of gold as a safe-haven asset during times of uncertainty.

Cedric Mbeng Mezui examines the links between commodity revenues and fiscal policy in Africa, warning against procyclical tendencies that expose external vulnerabilities. John Anyanwu advocates the need for greater state intervention to help lift Africa out of extreme poverty. The scandal associated with oil giant Petrobras risks delaying reform progress in Brazil, writes David Smith.

On Asia, Amando Tetangco, governor of Bangko Sentral ng Pilipinas, explores the reforms needed for the region to avoid the middle-income trap. One possibility is promoting financial infrastructure, where Asia still lags. As Adam Cotter writes, the latest International Monetary Fund reserve asset data show China punching significantly below its economic weight when it comes to the importance of the renminbi. Ikuko Samikawa argues that, under the framework of the fiscal theory of the price level, the Bank of Japan's adoption of yield curve control may lead to prices at last shifting to a rising trend.

The Federal Reserve appears to be adopting a more activist stance. Darrell Delamaide reflects on Fed officials' intentions regarding its balance sheet. As documented in the latest book by OMFIF Press, *Trump: The First One Hundred Days*, the US president may have changed his mind on monetary policy and the Fed. Having argued against the low-rate policy, he now defends it – and he appears to be warmer towards Janet Yellen, the Fed chair. Yet risks for his presidency remain. The Advisers Network was polled on the probability of impeachment. While 69% do not expect Donald Trump to be impeached, some suggested that he might resign.

The second in our series on central banks' balance sheets, prepared jointly by OMFIF and the National Bank of Poland, looks at the role of political uncertainty in boosting safe haven currencies in Denmark, Sweden and Switzerland. This has raised the foreign exchange component of their balance sheets, a possible threat to monetary stability. John Nugée explores the dilemmas facing central banks in exiting unconventional policies. Paweł Kowalewski and Mikołaj Szadkowski document the declining net financial assets of the European Central Bank, partly linked to lower emergency liquidity assistance to Greek banks. Jeroen Dijsselbloem, the Dutch finance minister, has raised eyebrows with his comments about southern euro area countries 'wasting money on wine and women'. Nick Malkoutzis takes issue with such talk, and argues that Europe will never understand and solve the euro area's problems unless creditors shoulder their share of the blame.

In our series of Focus reports on international financial centres we profile Portugal, a country in recovery mode that is steadily becoming a hub for European business services. The UK's decision to leave the EU may create opportunities for countries like Portugal. At the same time British Prime Minister Theresa May is doing her best to maintain jobs in the UK. David Marsh and Meghnad Desai admire May's decision to call a general election in June. This should give her the mandate needed to carry through Britain's exit from the European Union, a decision that she had not supported originally. Many civil servants find themselves in a similar position, experiencing a conflict between commitment to carrying out orders and doing what they believe is good for their country, as narrated in the memoir *With Respect, Minister*, by Brian Unwin, UK Treasury veteran and former European Investment Bank president, reviewed – with due respect – by William Keegan.

Internationalisation slow but stable

Obstacles cannot halt positive trend for renminbi

Song Ke, Renmin University of China

RENMINBI LIAISON NETWORK

The speed of renminbi internationalisation has fallen from fast to only stable. Renmin University's renminbi internationalisation index, reported by the school's International Monetary Institute, illustrates the share of renminbi in the denomination of international trade and finance and in official foreign reserves. The index scores from zero to 100. Were the renminbi to be the only international currency, the index would read 100; if it were not at all internationalised, it would be zero.

The index fell to 3.06 at end-2016 from 3.96 in the third quarter of 2015, reflecting some of the challenges facing the Chinese economy, such as the risk of large-scale capital flight. This year, though the score fell to 3.04 for the first quarter, several factors will positively influence renminbi internationalisation. Stable growth is returning, while Beijing's oft-extolled Belt and Road Initiative is committing many hundreds of billions of dollars to infrastructure projects in emerging markets.

The favourable impact of the renminbi's inclusion in the special drawing right (the International Monetary Fund's composite currency unit) should not be understated. The currency's stabilised exchange rate, in addition to a projected increase in cross-border trade and the opening of China's domestic bond market, are similarly encouraging.

Renminbi internationalisation still faces many obstacles – such as credit quality in the bond market and capital controls. The currency has embarked on a long journey, but nothing can halt its ultimately positive trend.

Song Ke is Deputy Director of the International Monetary Institute of the Renmin University of China in Beijing.

Asia will not follow ‘new mediocre’

Coinciding with the Asean+3 finance ministers and central bank governors meetings, the third OMFIF Asean Debate on 3 April in Cebu, the Phillipines, co-organised with the Bangko Sentral ng Pilipinas and attended by Governor Amando Tetangco, saw a strong consensus that Asia is not bound to follow the advanced economies’ ‘new mediocre’.

The panel of private and public sector industry practitioners discussed economic developments in Asean economies. The meeting focused on the future of growth, multicurrency reserve management, monetary policy, as well as macroeconomic trends for the Asia Pacific region and beyond.

Attendees were asked whether Asia is bound to follow advanced economies’ ‘new mediocre’. Before the debate 25% thought it would, 58% said no, and 17% were uncertain. After the debate the votes had changed to 8% saying yes, 83% voting no, and 8% being uncertain.

Capital flows ‘more focused on equity’

International capital flows are becoming more focused on equity and less on debt – a more stable position for the world economy as banks cut cross border lending, according to an analysis by McKinsey Global Institute presented by Susan Lund at an OMFIF-MGI seminar on 20 April in Washington.

A panel explored the effects of monetary policy and regulation on cross border capital flows in the era of President Donald Trump and the UK’s exit from the European Union. Speakers included Sebastian Mallaby, Council on Foreign Relations; Nathan Sheets, Peterson Institute for International Economics; Lord (Adair) Turner, Institute for New Economic Thinking; and Laura Tyson, Haas School of Business, University of California, Berkeley.

Lord (Meghnad) Desai, London School of Economics and Political Science and Chairman of the OMFIF Advisory Council, gave a keynote presentation.

Global renminbi opportunities

Prospects for further development of the renminbi as an international reserve currency were discussed at a meeting of the Renminbi Liaison Network, hosted by China Construction Bank of London on 25 April. Key themes were Sino-US relations and the US Treasury’s decision not to label Beijing a currency manipulator.

Attendees to the meeting discussed the impact of China-sponsored infrastructure projects, such as those managed under the pan-Asian Belt and Road initiative, on renminbi internalisation. The effect of Britain’s exit from the European Union on China’s opinion of the UK as a destination for investment was also debated.

Divergence on UK-EU trade deal

Contrasting views over the complexity of a UK-EU trade deal were displayed at an OMFIF debate on 27 March in London between John Redwood, Conservative MP, and Alexis Lautenberg, former Swiss EU trade negotiator. The discussion focussed on the advice the government is receiving on Brexit, including macroeconomic expectations and potential political ramifications.

Political union ‘explains UK exit’

Europe must forge political union to complete monetary union,’ Lord (Norman) Lamont, former UK chancellor of the exchequer, told an OMFIF lunch on 27 March in London. He added that Britain's incompatibility with this aim is a prime reason for leaving the EU, which should benefit from the exit of its ‘enfant terrible’.

Abenomics and the outlook for Japan

Akinari Horii, former assistant governor of the Bank of Japan up to 2010, spoke to OMFIF members on the perspectives for Japanese growth, Japanese monetary policy, Abenomics and Japan’s general position on world financial markets at a discussion on 3 April in London. Horii expressed confidence that Japan would eventually meet its inflation target.

Europe ‘should raise statue to Trump’

Europeans should raise a statue to President Donald Trump for promoting European unity, according to Dominique Moïsi, a founder of the French Institute for International Relations, at an OMFIF discussion on 6 April in London. He added that if Emmanuel Macron wins the May election, he would be France’s ‘most pro-European president’.

Proposal on EU citizen stance

The US Federal Reserve is heading towards further interest rate rises reflecting positive growth and unemployment news and a gradual rise in inflation towards 2%, said Charles Evans, president of the Federal Reserve Bank of Chicago, at an OMFIF-DZ BANK debate on 29 March in Frankfurt.

Meanwhile Lord (Jonathan) Hill, former European Commissioner, suggested that constructive dialogue between the UK and the EU27 on Britain's exit procedures would be boosted by greater generosity on dealing with EU citizens in the UK. He said that Europe still needs capital markets union after the UK's departure.

'Achilles heel' for Chinese growth

State-owned enterprise reform remains the 'Achilles heel' for Chinese growth, delegates were told at an OMFIF breakfast discussion on 18 April in Singapore.

Attendees heard that the Chinese leadership has long been aware that China has reached the limits of its old growth model and must now tackle land ownership, regulatory and productivity issues, whist maintaining market resilience and instilling greater levels of market discipline.

Regulators 'should adjust rules'

International regulators should consider recalibrating some elements of tighter financial rules to help safeguard growth, but should guard against undue unwinding, said Ravi Menon, managing director of the Monetary Authority of Singapore, in an OMFIF City Lecture on 20 April in Washington.

He added that the industry should aim for smart regulation, rather than choosing light or soft regulation.

Forthcoming meetings

Risk to financial stability in Asia
Hans Genberg, adviser for macroeconomic and monetary policy management at Seacen, presents his findings from a report entitled 'Global shocks and risk to financial stability in Asia'.
17 May, London

The dollar, the renminbi, and the evolution of the international monetary system
A joint policy dialogue convened by OMFIF and the South East Asian Central Banks Research and Training Centre on the future of the dollar and the renminbi in the international monetary system.
31 May, Kuala Lumpur

China and the world
Co-organised by OMFIF and the People's Bank of China School of Finance at Tsinghua University, the forum focuses on China's policies and practices for financial markets.
3-4 June, Beijing

Global trade, green finance and growth economies
An evening event to present the findings and review the issues covered in *Global Public Investor 2017*, devoted to public sector asset ownership and management across a range of official institutions around the world.
14 June, London

For details visit www.omfif.org/meetings.

Growth and investment in Europe

The slow growth, divergent monetary policy and political uncertainties in Europe were the focus points for OMFIF's seventh Economists Meeting held in Frankfurt on 29 March – the 27th Economists Meeting held in Europe since 2010. Also discussed were the politics and economics of the UK's withdrawal from the EU, and how to capitalise on Germany's economic growth.

Bank of Mexico 'pre-emptive' approach

Mexico uses monetary policy pre-emptively and sparingly as part of wider market stabilisation, Javier Guzmán Calafell, deputy governor of the Bank of Mexico, told an OMFIF briefing on 3 April in London. 'Our philosophy is to make interventions only in exceptional circumstances,' he said. The discussion focused on economic developments and prospects in Mexico.

Optimism for a UK-Canada trade deal

Canada wants to strike a trade deal rapidly with the UK, soon after Britain leaves the European Union, Bill Morneau, finance minister, said at an OMFIF City Lecture on 7 April in London. 'I just can't tell you what "rapidly" is,' he added, owing to the many uncertainties about the shape of the eventual UK-EU deal.

UK and Germany: a new relationship

The economic, financial and political implications of the UK's decision to leave the EU were discussed at an OMFIF discussion on 18 April in London with Joachim Wuermeling, who since November 2016 has been a member of the executive board of the German Bundesbank. He is responsible for Directorates General Markets and Information Technology.

Opec's rebalancing act

Shale oil threat to stability

Rabah Arezki and Akito Matsumoto, International Monetary Fund

In November 2014 the Organisation of the Petroleum Exporting Countries decided to maintain output despite a perceived global oil glut. The result was a steep decline in oil prices. Two years later Opec took a different tack and committed to a six-month, 1.2m b/d reduction in crude oil output, effective from January 2017. This led to a small price increase and some price stability that has persisted since November.

The resulting period of respite may be temporary. The price increase is likely to stimulate other oil production projects which can come on line quickly. A recent sharp decline in prices owing to higher than expected oil inventories in the US underscores the liminality of the Opec agreement.

An ineffective agreement

Saudi Arabia, Iraq, the United Arab Emirates and Kuwait are bearing the brunt of the Opec cuts, which could be extended another six months. Other member countries, such as Nigeria and Libya, have been exempted. Several non-Opec producers joined in and agreed to cut around 600,000 b/d. Russia committed to cut 300,000 b/d, and 10 other countries agreed to cut the remaining 300,000 b/d.

These agreements appear to have brought supply and demand into balance at a price just above $50 per barrel. This is largely because of the high degree of compliance by Opec members with the agreed level of production, which the organisation reported was close to 90% in January. This level stands in sharp contrast to the typically low adherence by Opec members to past production agreements. Some reports suggest that compliance is lower, but Saudi Arabia (by far the organisation's largest producer) has signalled it will do whatever it takes to enhance the credibility of the agreement and has cut its production more than required.

However, there are several threats to the effectiveness of the agreement. Some Opec members – Iran, Libya and Nigeria – have increased their production since October. Furthermore, not only did non-Opec producers make smaller reductions than member states, they also do not have to reach lower production targets as quickly. Russia has so far cut 120,000 of the 300,000 b/d it promised. Several analysts posit that some of the targeted reductions are phantom, reflecting a natural decline from historically high production levels, rather than active cuts.

> ***"Shale wells can begin production within a year of the initial investment. Conventional oil wells, in comparison, take several years to come to fruition***

Shale threat

But perhaps the biggest threat to the attempt to achieve price stability comes from shale oil producers. The $6 per barrel increase in spot oil prices that followed September's suggestion of an Opec agreement is expected to stimulate investment in oil production in 2017, after significant declines in the previous two years. An increase in shale oil output in the US could quickly offset much of the actual Opec and non-Opec production cuts, because shale wells can begin production within a year of the initial investment. Conventional oil investments, in comparison, take several years to come to fruition.

The shale effect has happened before. In early 2014, even though excess supply was developing, oil prices remained at around $100 per barrel because market participants expected Opec to cut production to support prices. This created a floor price that stimulated non-Opec production of not only shale oil, but oil from relatively high-cost sources as well. The floor price did not last long, owing to oversupply. As a result, oil prices began to fall, precipitously so after the Opec November 2014 meeting.

Despite Opec's ability to sustain its production agreement, a somewhat similar sequence of events is likely to occur because of shale oil's responsiveness to price changes. US shale oil investment declined sharply following the fall in oil prices that started in 2014 and, within a few months, production declined. The oil price rebound in 2016 helped boost investment, which was further enhanced by the announcement in September 2016 in Algeria that Opec intended to cut production levels. By February, US oil investment, as measured by the number of drilling rigs in operation, reached its highest level since November 2015.

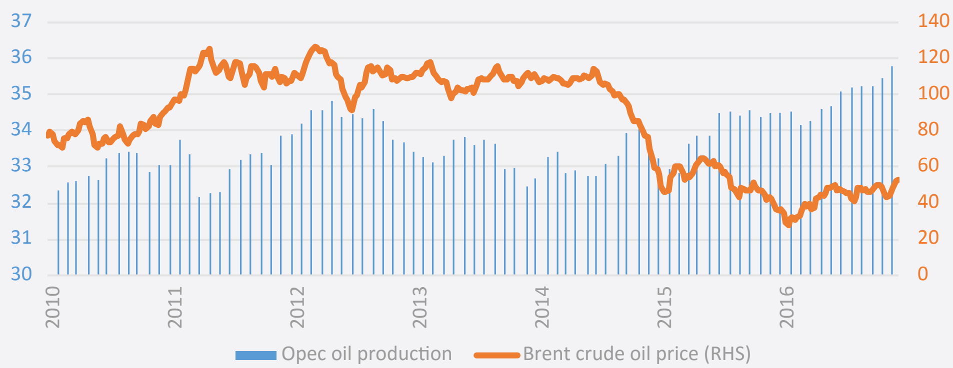
Rebalancing the market

Moreover, the shale oil threat is greater because producers in the US have become more efficient thanks to improved operations and increased selectivity in the wells they exploit. Although the ultimate capacity of shale oil production is uncertain, its behaviour is now a central feature of the new oil market and will help lead to less volatile production and price cycles.

The Opec agreement has hastened the rebalancing of the oil market, that is, when the supply of oil is in line with demand and accompanied by stable prices. The production agreement should reduce excess supply, at least temporarily. But the futures market in oil prices suggests that expectations are firmly anchored at around $50 per barrel. The forces unleashed by the Opec agreement will limit its effectiveness for the next few years. ■

Increased Opec production since 2015 contributes to falling oil price

Opec total oil production, million b/d, and Brent crude oil price, $bbl



Source: Energy Information Administration, OMFIF analysis

Rabah Arezki is Chief of the Commodities Unit, Research Department, and Akito Matsumoto is Economist in the Commodities Unit, Research Department, at the International Monetary Fund.

Oil exporters struggle to diversify

Market volatility underscores need for reform

Bhavin Patel

Sharp fluctuations in the oil price emphasise the significance of structural reform and economic diversification in the Middle East.

Since mid-2014 Brent crude prices have more than halved to around $50 per barrel from just over $110 per barrel. Prices have remained volatile while the market rebalances and as concerns about oversupply alternate with reports on production cuts. For oil exporters, the procyclicality of oil rents and current account balances as a share of GDP exacerbates risks of macroeconomic instability for these countries.

In 2013 oil export revenues exceeded $1.2tn for Gulf Co-operation Council economies (Saudi Arabia, Bahrain, Kuwait, the United Arab Emirates, Oman and Qatar). The International Monetary Fund projects these revenues will fall to $720bn by the end of 2017. Furthermore, as oil revenues make up on average more than 45% of tax revenues, the resulting budget deficits of over 9% in GCC countries are unlikely to recover in the near term (see Chart).

Short-term and short-sighted responses

Responding to the fall in oil revenues, GCC members have drawn down their fiscal buffers, including international reserves and sovereign fund savings. This has enabled fiscal authorities to withstand fluctuations in the oil price without sacrificing their exchange rate pegs.

Access to international capital markets has allowed GCC economies to raise $66bn in bond issuances in the last year, enabling them to meet short-term debt obligations. By the end of 2016 total dollar debt in the GCC reached a record $244bn – new highs are likely to be hit as budget deficits persist through to 2021.

A series of painful fiscal consolidation efforts further subdued some pressures. High levels of government spending have been key for regional economic development and are the chief mechanism for transferring the benefits of oil wealth to the population. Years of social spending have increased public employment and wages, as most of the population continues to be employed by the public sector.

"Access to international capital markets has allowed GCC economies to raise $66bn in bond issuances in the last year, enabling them to meet short-term debt obligations.

Traditionally, GCC countries have relied heavily on energy subsidies to maintain social stability. According to IMF estimates, GCC economies spent $175bn on post-tax subsidies in 2016, accounting for 10% of the region's overall GDP. Given the GCC's high government spending multiplier and reliance on oil wealth transfers, weaker spending and the planned introductions of VAT and excise duties in many member economies will inevitably weaken short-term growth prospects.

Arab oil exporters often respond to economic downturns by increasing current spending (wages and subsidies) and reducing investment spending. This means that while the population's welfare is maintained in the short term, investment contributions within GDP may suffer.

Between 2010-13, Bahrain increased spending on wages and social benefits to 24.6% of non-oil GDP from 20.4%, whereas spending on investment fell to 5.1% of non-oil GDP from 10.1%. Investing in quality infrastructure and human capital is crucial to boost economies' productive capacity and support economic diversification. Likewise, cuts to such spending are likely to impede growth of the non-oil sector, damping diversification efforts.

Economic diversification is the best way for the GCC to contend with protracted periods of low oil prices. Member states have presented a cache of long-term development plans, including the 'Saudi Vision 2030' and 'New Kuwait 2035' initiative, aimed at decreasing the region's dependence on oil wealth.

These strategies involve placing greater emphasis on private sector job creation, reforming overly bureaucratic processes, developing the small and medium-sized enterprise sector, and fostering private sector investment. The privatisation of state-owned enterprises or parts of these businesses, as in the case of oil giant Saudi Aramco, is intended to alleviate worsening deficits and reduce inefficiency.

Diversification hurdles

However, these programmes face high political hurdles. Kuwait and Oman have found it difficult to pass government reforms, new labour laws and legislation in the light of opposition from those who benefit from maintaining the status quo.

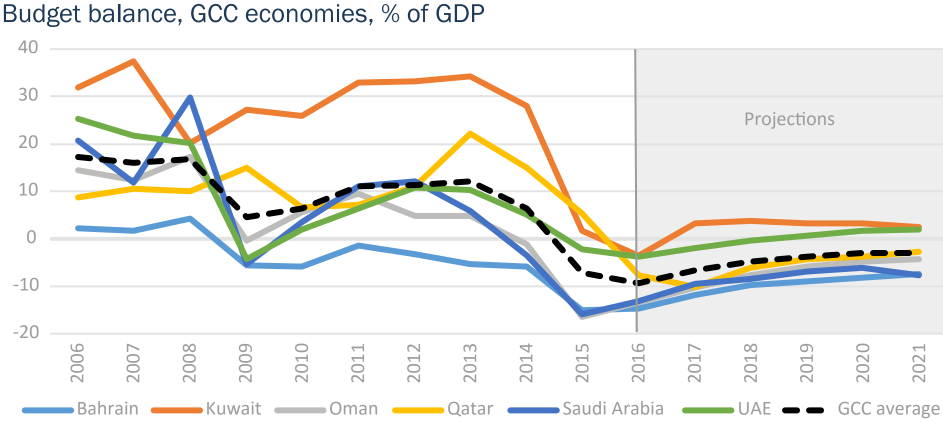
The most vocal political leader in the region so far is Mohammad bin Salman Al Saud, the deputy crown prince of Saudi Arabia. Aside from encouraging transparency in ministries and overseeing the Saudi Aramco initial public offering, the prince wants to increase female labour force participation in the historically conservative country to 30% from 22%.

Limited fiscal and monetary room for manoeuvre have tested GCC countries' ability to stabilise their economies. Plans of further fiscal consolidation are likely to contribute to weaker growth, and debt accumulation has so far been treated as the solution for maintaining welfare and subsidy programmes. Short-term access to capital has allowed the GCC to meet its spending needs, but failure to diversify the economy and the tax base threatens member states with unsustainable debt. ■

Bhavin Patel is Economist at OMFIF.

GCC fiscal deficits projected to recover slowly by 2021

Budget balance, GCC economies, % of GDP



Source: International Monetary Fund, OMFIF analysis

Bribe inquiries hamper Brazil progress

Temer 'has nothing to lose' on reforms

David Smith, Advisory Board

Brazil's Supreme Court is investigating more than 100 current and past politicians for taking bribes from oil major Petrobras via third party companies. The individuals involved include almost a third of the Brazilian cabinet, the chief of staff to President Michel Temer, and every head of state going back to 1985.

The scandal may paralyse the Temer government's much-needed reform programme. The administration wants to address everything from the huge fiscal deficit, to pensions, to the time it takes to open businesses in highly-regulated Brazil, where it takes 100 days to open a company.

Critical pension reforms

The fall-out from this investigation may also halt the remarkable trajectory of the Brazilian market in the past year. It is extraordinary to consider that, though the previous president was beset by impeachment proceedings and economic data from growth to unemployment worsened, Brazil's equity market has been by far the strongest among emerging economies. Markets have risen by nearly 40% in that period, with foreign investment flowing into the country as well.

'We cannot allow this to freeze our legislative agenda,' Temer declared, as investigators leaked the fact that he escaped being on the list only because a sitting head of state has, constitutionally, immunity from investigation for anything pre-dating his appointment. 'Our work to revive our country has to go on,' Temer said.

The crunch is likely to come over the next few weeks. With the economy having shrunk by 3.6% in 2016 and following eight consecutive negative quarters, representing the worst recession on record in Brazil, the Temer government has already acted on one critical front. The administration has pushed through a constitutional reform requiring a reduction in government spending, to 15% of GDP from 20%, over the next decade.

'But it is pension reform that lies at the heart of Temer's plan,' according to a leading banker and major supporter of the president in São Paulo. 'Can his government make our country accept that we have to live by the rules of the rest of the world, and put back retirement until 65? It's a hard sell for the average Brazilian, trust me.' That task has been made more difficult in the light of the bribery investigation: Temer's point man on pension reform, Chief of Staff Eliseu Padilha, is a prime suspect. Padilha has led the campaign to convince Brazilians that the country's pension deficit, $67bn in 2016, is unsustainable.

"The administration has pushed through a constitutional reform requiring a reduction in government spending, to 15% of GDP from 20%, over the next decade.

Michael Temer, President of Brazil

On 28 April millions of Brazilians participated in a general strike protesting Temer's pension proposals. It was the first such strike in more than 20 years.

If there's an unseen benefit in this crisis, it lies in Temer's personal position. With elections due next year and the president insistent that he will not run, his allies suggest he is uniquely placed to take risks on reform. As one supporter put it: 'Think about it: Temer has nothing to lose, he can go for broke, and dare to demand our country change its pension system, its tax code, and even allow entrepreneurs to set up a company in three days. That's his goal.'

Need to end corruption

Earlier in April Judge Sérgio Moro, the chief lawyer in the Brazil bribery investigation, visited Argentina, the other leading Latin American country committed to combatting government corruption. Moro's message was blunt: 'There's no reason Latin America has to live with such corruption, and there can be no stopping us now.'

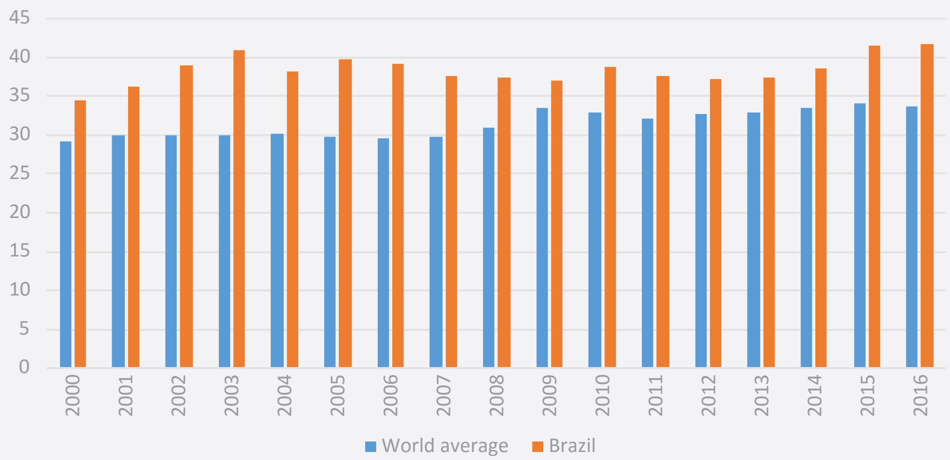
That significance of that decree to Argentina should not be underestimated. The government of Mauricio Macri in Buenos Aires insists that the Argentinian judiciary must be free to bring leaders of the previous government to justice for alleged corruption on a massive scale.

'Our institutions in Latin America are not yet acting as one when it comes to corruption,' Moro said. 'But justice is on the march in our major countries, getting stronger all the time, and Argentina is showing us too that confronting corruption is not an option: it's a must, for the benefit of all who live and work in a country's economy.' ■

David Smith represented the United Nations Secretary General in the Americas between 2004-14.

Brazil's government spending to GDP above world average

Total government expenditure, % of GDP



Source: International Monetary Fund, OMFIF analysis

Building a resilient Africa

Commodity exporters need strong financial systems

Cedric Mbeng Mezui, African Development Bank

Over the past two decades Africa's image has been transformed. A continent that used to be seen as a disaster area is now viewed as a land of promise.

This evolution has been captured by the headlines of The Economist newspaper: in 2000 Africa was 'The Hopeless Continent' but by 2013 it had been transformed into 'The Hopeful Continent'. In April last year it was 'The 1.2 billion opportunity' – a reference to Africa's population.

Africa's strengths are its young workforce and its enormous pool of natural resources. But, excluding the extractive industries, average economic growth across the continent remains anaemic. Africa's annual real GDP growth was on average 5.4% between 2000-10, and then 3.3% up to 2015.

Procyclical government spending

For most African countries that rely on exports of raw materials, the commodity boom is over. Structural weaknesses, which made their fiscal policies vulnerable, meant that they entered the current commodity slump with larger fiscal deficits than those they had at the onset of the financial crisis.

Africa is a net importer of agricultural products, with agricultural exports consisting mainly of a small number of primary commodities and reliant on preferential access to a few markets in developed countries.

In countries where governments are heavily dependent on commodity revenues, commodity price shifts tend to cause large fluctuations in the government's coffers. As a result, expenditure in these countries has been intensely procyclical.

Two basic indicators of fiscal vulnerability are the share of commodity revenues in total government revenues and the procyclical nature of government spending.

Reducing external vulnerabilities

In that context, the key challenge for commodity exporters is to deal with increasing levels of nominal debt, a high share of external to total public debt and depreciating currencies and increasing debt servicing costs, all of which trail fluctuations in the commodity markets (see Chart).

Factors for downside risks are the China slowdown, weak global growth, a change in global economic activity from manufacturing to services, the strong dollar, rising US interest rates and commodity supply growth.

If Africa is to make itself less vulnerable to fluctuations in international markets, it has to strengthen local financial systems and harness its assets to promote sustained and inclusive endogenous growth.

This requires a combination of factors, and the continent's positive demography is a good starting point.

With the median age in Africa around 18, pension funds and insurance companies have 40 years to accumulate savings before they need to start paying out. This would provide an immense reservoir of long-term capital for the financing of the real economy, as well as a consumer base.

Growth can be boosted further by the local processing of raw materials to increase the added value of products and meet domestic demand.

> *"Africa's strengths are its young workforce and its enormous pool of natural resources. But average economic growth across the continent remains anaemic.*

Encouraging domestic trade and domestic demand will help to make growth more endogenous. Commodity-exporting nations tend to have outward-orientated growth and this is an issue that needs to be addressed. From 2007-11 just 11% of merchandise exports from African countries stayed on the continent compared with 50% in developing Asia, 21% in Latin America and the Caribbean, and 70% in Europe.

Benefits of establishing exchanges

African governments need to promote the development of derivatives and commodity exchanges. These can help deliver improved market transparency; financing of commodity chain and financial market participants; hedging and risk management; and provide the financial resources for private sector participation in Africa's infrastructure development.

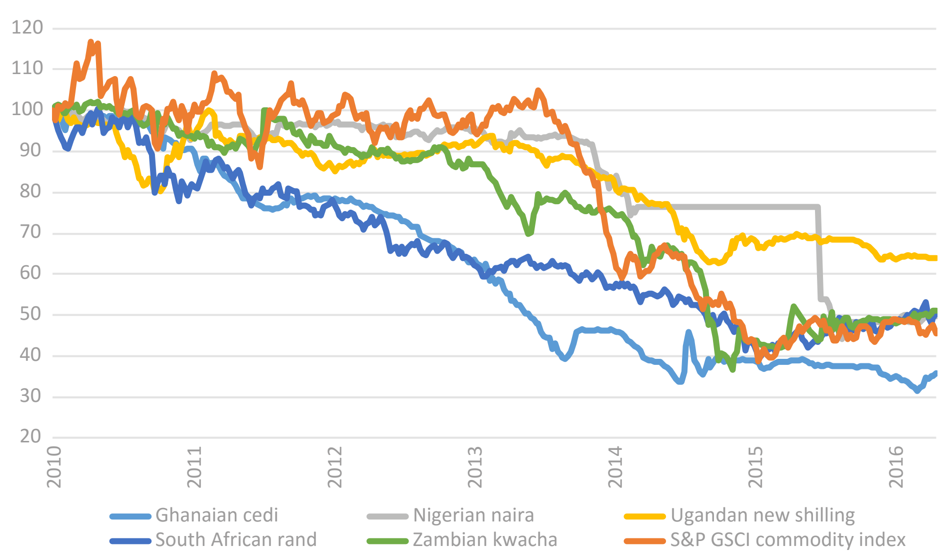
The secondary effects of establishing exchanges include job creation and enhanced cross-border economic integration as they offer venues for the mitigation of key financial and trade risks.

If the continent is to realise its promise, African countries need a long cycle of economic growth, mainly driven by innovation. To achieve this, these economies should give priority to deepening their financial systems. Unless they do this, fluctuations in the international landscape will always dictate the continent's economic and financial agenda. ■

Cedric Mbeng Mezui is coordinator of the African Financial Markets Initiative at the African Development Bank.

Commodity exporters' currencies depreciate as prices fall

Dollars per currency and S&P GSCI Commodity index, December 2010 = 100



Source: Thomson Reuters, OMFIF analysis

Reward as well as risk

Gold market opportunity cost is worth paying

Gautam Sashittal, Dubai Multi Commodities Centre

Two years ago some commentators predicted that the price of gold could fall below $1,000 an ounce and that the market was heading for a downward spiral. Today the precious metal costs around $1,250 an ounce, and its price has been on an upward trend since the start of the year.

This figure is a correction from the heights of 2011, when it hit $1,900 an ounce, but indicates that in times of geopolitical uncertainty investors still view gold as a safe haven.

Capital markets are seeing record inflows into gold-backed exchange-traded funds, continuing last year's trend when $64bn were invested. In Europe, investors are seeking protection from political risk linked to elections in key states, as well as from uncertainty around Britain's decision to leave the European Union.

Hedge against inflation

Another catalyst for the price rise is the persistence of low or negative real interest rates. Investors want yield, and they are not getting it. The US Federal reserve has indicated that interest rate rises will be gradual and moderate. Some market commentators believe that future rises have already been discounted by dollar investors.

The conservative approach of Federal Reserve Chair Janet Yellen is likely to keep the lid on dollar strength, which could be good for gold. The precious metal typically has an inverse relationship with the dollar.

Another factor in the strength of gold is its role as a hedge against inflation, which is rising in several developed countries, not least the US. High debt ratios in the US mean the central bank has limited scope for raising rates to try to stifle inflation. Radical monetary policy tightening might risk triggering a recession, or open the door to deflation, which policy-makers are trying to avoid.

Emerging market popularity

Gold provides neither a dividend nor an income, so there is an opportunity cost in holding it. However, many investors may take the view that this is a cost worth paying when interest rates are low and the gold price is forecast to remain stable, or strengthen.

Demand in India appears to have recovered after last year's crackdown on the informal economy by Prime Minister Narendra Modi. The World Gold Council says that the imminent goods and services tax will have a short-term impact on the Indian gold market but that this will be outweighed by the benefits of Modi's policies.

A stronger economy, a burgeoning middle class with plenty of disposable income and a more transparent gold industry are expected to underpin demand for precious metals for generations to come.

In China, gold has long been popular as a store of value. Developing countries are reluctant to rely too heavily on reserve holdings in dollars, and appear to be using gold as a counter to the weight of the US currency. In June 2016, China disclosed that it had gold holdings of 1,823 tonnes, up from 1,658 tonnes a year earlier. This is still a long way short of the US, the world's biggest official holder of gold with more than 8,100 tonnes.

In the developed world, central banks are conserving stocks or building them up after being net sellers before the financial crisis.

European central banks signed a five-year agreement in 1999, renewed in 2014, pledging a restrictive policy on gold sales until 2019. This is because many banks view gold as a hedge against potential losses in the weaker spots within the euro area. The market consensus is that central banks will buy more gold than they sell to try to diversify their reserves from their own currencies.

> ***"Developing countries are reluctant to rely too heavily on reserve holdings in dollars, and appear to be using gold as a counter to the weight of the US currency.***

For all the factors in gold's favour, there are also risks: from rising interest rates; a longer bull market in equities than anticipated; and a stronger performance from the dollar if the US economy continues to improve.

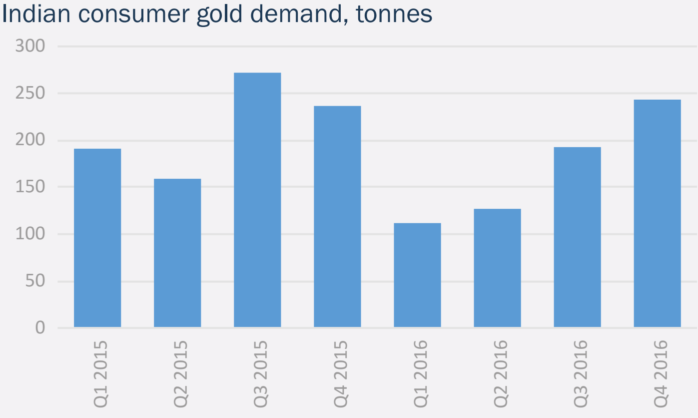
Taking these issues into account, the London Bullion Market Association's 2017 Forecast Survey estimates that the average gold price this year will be broadly in line with that of 2016.

Gold is unlike most commodities in that it is not just bought and sold for consumption, but is a store of value, a hedge, an investment. In a time of global uncertainty, gold is once again proving to be a beacon of stability. ■

Gautam Sashittal is Chief Executive of the Dubai Multi Commodities Centre.

Chart 1: Indian consumer demand set for recovery

Indian consumer gold demand, tonnes



Source: World Gold Council, OMFIF analysis

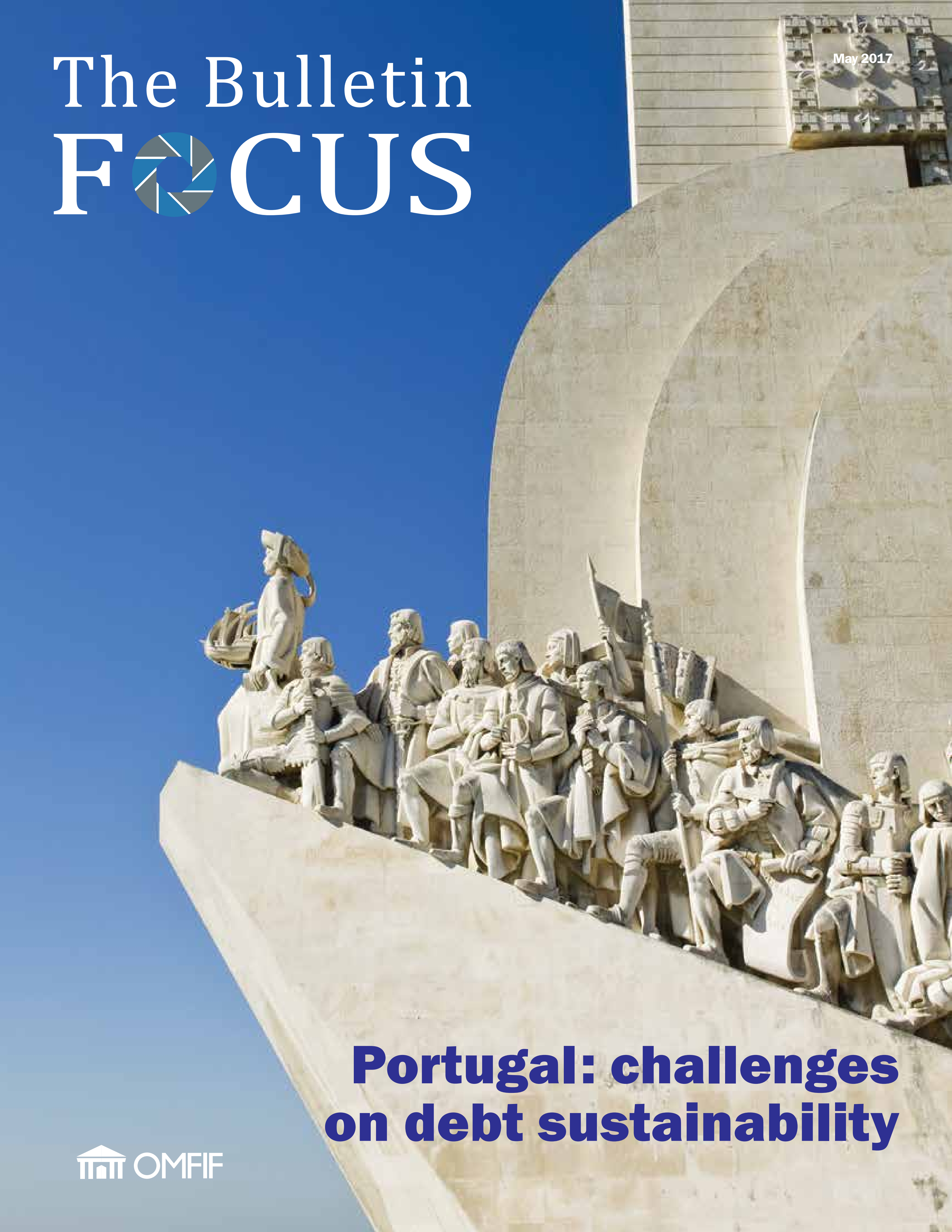
Chart 2: China accumulation slows after 2015 rise

China gold reserve holdings, % of world holdings

Source: World Gold Council, OMFIF analysis

May 2017

The Bulletin FOCUS



Portugal: challenges on debt sustainability

OMFIF

FOCUS: Portugal

Successes, surpluses and legacy problems

Portugal was one of the countries hit hardest by the euro area crisis, a result of historical weaknesses that were papered over when it joined the euro in 1999, causing large imbalances. The country had run high budget deficits since it emerged from dictatorship in 1974, reflecting low export competitiveness, productivity and investment, and a lack of fiscal discipline.

After euro introduction, the country's borrowing costs suddenly fell, and international credit flowed into the banking sector. Inflation fell, before rising beyond the euro area average. A boom in public and private sector borrowing led to the country over-reaching itself, with creditors withdrawing funding and the government turning to the International Monetary Fund and other official lenders – a crisis laying the foundations for the rapid correction of more recent years.

Given the scale of Portugal's legacy problems, its successes since 2010 have been substantial. In the immediate years after the financial crisis it experienced the greatest decline in investment of any EU country, at around 34% in real terms against an EU average of 10%. Investment rebounded strongly in 2012, with foreign direct investment inflows of almost €9bn, or over 4% of GDP, and has since stabilised.

"Portugal's strong links with Brazil and Angola provided it with an important source of demand during its recovery, and allowed it to diversify its trade and investment partners at a time when European economies were shrinking.

The country's budget deficit, once among the highest in Europe, is now down to 2.1% of GDP, while falling unit labour costs helped exports gain competitiveness and grow strongly from 2013, though these costs have since crept up. The current account is in surplus and is expected to improve further. Portugal exited its European Union-IMF bail-out in 2014 without need for follow-up measures.

The country's strong links with Brazil and Angola provided it with an important source of demand during its recovery, and allowed it to diversify its trade and investment partners at a time when European economies were contracting. Firms from these countries, along with Chinese and other investors, poured capital into Portugal's banking, communication, transport, energy, utility and other sectors. This helped the government reduce its share in state owned enterprises, as required by its bail-out conditions.

"As Portugal remains on the EU's fiscal watch list, given its history of large deficits, its borrowing costs are relatively higher than those of other European countries.

Structural reforms and improvements to labour markets, taxation and business conditions have put the country's fiscal position on to a more sustainable footing. As euro area growth improves and external demand picks up, these fundamentals could see the country leave its troubled past behind.

Substantial challenges remain. High indebtedness is weighing on investment, and interest payments take up a large part of the budget. As Portugal remains on the EU's fiscal watch list, given its history of large deficits, its borrowing costs are relatively higher than those of other European countries. This amounts to unfair treatment, according to Mário Centeno, the finance minister. He says international investors and ratings agencies should look to Portugal's big improvements since the crisis, and not its historical imbalances. The country's primary budget surplus (excluding interest payments) was an estimated 2.3% of GDP last year, the second highest in the euro area.

As this report makes clear, there are reasons for optimism, with the contribution by AICEP, the Portuguese Trade and Investment Promotion Agency, highlighting in particular the growing presence of foreign businesses and investors. Whether it can maintain this trajectory will depend crucially on how Portugal deals with its challenges of still sub-optimal growth and the debt overhang from the crisis years.

CONTENTS

New look Portugal is open for business

Ben Robinson

After nearly a decade of bad news since the start of the euro area's financial crisis, Portugal's financial sector is on its way to recovery. Its banks have been restructured, and foreign investors have taken over the government's share in many companies. The country has returned to international capital markets, with Caixa Geral de Depósitos, one of Portugal's largest banks, issuing a €500m subordinated bond in March 2017.

Improvements in Portugal's terms of trade have contributed to a recovery in the current account from a deficit of around 12% in 2008 to a surplus of 0.3% in 2016. However, a major problem is that the country's net international investment position remains weak, with a net debt figure of 110% of GDP in 2016.

The country's moderate growth last year of 1.4% marks a turnaround from the contraction of 4% in 2012. It also underlines the country's improved fortunes since the €78bn EU-IMF bail-out in 2011. After a series of structural reforms the government's budget deficit has fallen to 2.1% of GDP, the lowest in more than four decades and below the EU's 2.5% limit. In the light of these indications of fiscal sustainability, the country is seeking to restore its international credibility, improve its credit ratings and attract further investment.

> *"Recent improvements in Portugal's terms of trade have contributed to a recovery in the current account from a deficit of around 12% in 2008 to a surplus of 0.3% in 2016.*

Questions over debt sustainability

Despite its efforts, Portugal faces a number of difficulties. Corporate sector debt is around 140% of GDP and government debt is around 130% (see Chart 1a) – the highest in the euro area after Greece and Italy. With growth forecast to remain below 2% for the next few years, the debt is expected to be a still-high 123.5% by 2020. This has contributed to Portugal's low credit ratings – it has 'junk' status from three of the four main ratings agencies – and high borrowing costs. Interest payments on its debt amount to around 4.3% of GDP, almost double the euro area average.

These factors leave Portugal vulnerable to rising bond yields as the world moves towards monetary normalisation. The European Central Bank is adjusting its bond purchasing programme from €80bn a month to €60bn, and is expected to scale back further its quantitative easing in 2018, which could make borrowing more expensive. Political uncertainties in the euro area could send yields higher still. They have been trending upwards since last August and 10-year yields are around 3.9%.

> *"Portugal is highly vulnerable to rising bond yields as the European Central Bank adjusts its bond purchasing programme from €80bn a month to €60bn, which could make borrowing more expensive.*

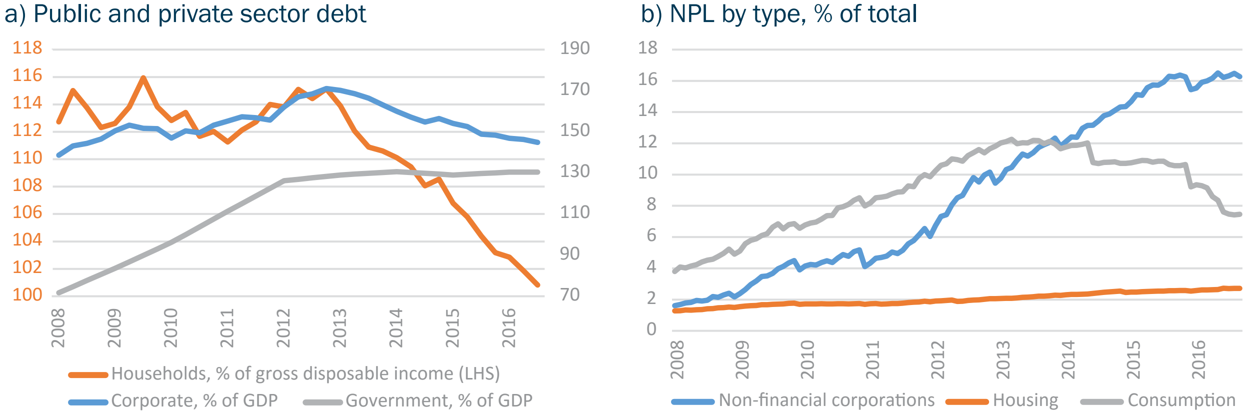
As long as questions remain over the country's debt sustainability and solvency, attracting further investment will be difficult. Creditors are worried that, should the country experience a shock that forced it to seek a second rescue, they would face large losses. The European Commission's 2017 country report for Portugal notes that it remains 'vulnerable to changing economic conditions and rising financing costs' given its incomplete structural reforms. Ominously, appetite for reform seems to have weakened under the present government.

The issue of debt sustainability is particularly troubling given the high level of non-performing loans on bank balance sheets (Chart 1b). Businesses, property development companies and others hit by Portugal's severe recession have struggled with repayments. The value of the assets of many of these companies, particularly in the property sector, declined dramatically.

Chart 1: Challenges to debt sustainability

a) Public and private sector debt

b) NPL by type, % of total



Source: OECD, OMFIF analysis

This asset devaluation resulted in a large number of foreclosed real estate assets on bank balance sheets and led to further risk pressures throughout the banking system. The NPL ratio, already high at 19.5% of all loans at the end of 2016, is still deteriorating in the corporate sector, with the ratios particularly high in the construction and real estate fields, although it has stabilised for household loans. The banks' high exposure to sovereign debt creates additional vulnerabilities.

“An important factor in the turnaround of Portugal's public finances has been the high level of inward capital flows from foreign investors into the financial, energy, transportation and communications sectors.

Improving access to finance

An important factor in the turnaround of Portugal's public finances and its GDP growth has been the high level of inward capital flows from foreign investors, particularly Angola, Brazil and China, into the financial, energy, transportation and communications sectors. At the end of March a further $1bn of capital was raised from the purchase by Lone Star, a US private equity fund, of a 75% stake in Novo Banco, a lender which was spun off after the collapse of Banco Espírito Santo in 2014. At the end of last year foreign investors owned 22.4% of total assets in the Portuguese banking system, while finance and insurance accounted for 72% of the country's inward foreign investment in 2016.

These purchases have reflected the large-scale sell-off of the government's stake in national companies as part of its bail-out agreement. Sales include a 70% share in the country's postal service, 45% of the national airline and large parts of the electricity and natural gas grid operator. In 2014 foreign buyers accounted for 80% of commercial property investment and 20% of residential property purchases. The inflows have been a key factor behind the improvement in the capital account and the increase in bank capital ratios.

The relative strengthening of the banking sector has improved access to finance for small and medium-sized enterprises, which make up the majority of Portuguese firms. Lack of access has been a major factor holding back the growth of these companies and has limited their ability to invest in productivity-enhancing equipment or new capacity. The 2016 European Central Bank survey on access to finance reported that 27% of Portuguese SMEs benefited from an increase in bank loan availability over the previous year. This is particularly important in Portugal, where companies are more dependent on bank loans as their main source of funding than the EU average (57% against 50%).

Access to non-bank funding is improving, too. The government's 'Capitalizar Programme', which seeks to create new credit lines for SMEs using money from the European structural and investment funds (ESIF) and other sources, was launched last summer. Changes to tax laws, including equal treatment of debt and equity financing to reduce the debt dependency of corporations, are boosting SME access to finance, along with the expansion of tax credits to cover a wider range of investment projects and tax relief for investors in start-ups.

“Changes to tax laws, including equal treatment of debt and equity financing to reduce the debt bias of corporations, are boosting SME access to finance.

Portugal has an allocation of €25.8bn from ESIF and other European sources for the 2014-20 period. It is using this to tackle the decline in investment seen over previous years. This is particularly important because the government has improved its deficit figure partly by reducing public investment spending. If this continues, the country's prospects would suffer significantly.

One of the goals of ESIF investments is to increase the tradable share of the economy. According to the central bank, by 2019 exports will be around 60% above their pre-crisis level and will amount to 46% of GDP, up from 31% in 2008. Greater economic openness is a key objective of the government. Combined imports and exports as a share of GDP are projected to be 91% by 2019, up from 79% currently and 72% before the crisis.

This improvement in export capacity has created a much healthier current account position. The central bank expects the current account surplus to increase slightly in 2018 and 2019, reflecting the 'shift of resources to corporations more exposed to international competition'.

Threat of rising bond yields

Despite the influx of capital from ESIF and the purchase of Portuguese assets by foreign investors, the country has had a difficult relationship with international investors. This could limit the extent of further inflows. Foreign creditors suffered a €2bn loss on their Novo Banco bonds after the government bailed them in to the 2015 rescue of the bank. This created concerns for risky debt elsewhere in the euro area, leading borrowing costs to rise significantly.

An additional strain was introduced when 14 international investors affected by losses, including BlackRock and Pimco, launched legal action against the central bank in April 2016. This is likely to have long-lasting repercussions for the investment climate. In April 2017 this group of investors sought an injunction to block the sale of Novo Banco's 75% stake to Lone Star. This type of investor uncertainty presents challenges to Portugal's recovery and to the strengthening of its financial system. BlackRock and Pimco both boycotted the Caixa Geral de Depósitos bond sale in March as a result of their dispute with the government. With two of the largest institutional investors refusing to participate in Portugal's debt markets the message for the wider investment community is less than encouraging.

These factors create additional risks for Portuguese taxpayers and for the country's public finances. Without sufficient investment and the continued purchase of private and public sector debt, bond yields will keep rising and the government might have to find ways of injecting more state funds into the banking system. This would set back the improvements in the budget deficit, possibly triggering a repetition of 2015, when the budget deficit was 4.4% of GDP, driven by the injection of 1.3% of GDP into the financial sector. That could, in turn, spark another rescue package, creating further losses for international investors in Portuguese debt, which own around 40% of the total and may be forced to accept write-downs.

Recovering macroeconomy

If this gloomy scenario was realised, a further rating downgrading would follow. If the only rating agency that currently considers Portuguese debt as 'investment grade' was to revise its views, the ECB would no longer be able to purchase Portuguese bonds as part of its asset purchase programme. This would increase bond yields and, in the absence of a central bank backstop, raise the spectre of default.

However, this pessimistic assessment must be set against general improvements. Unemployment has fallen from over 16% in early 2013 to around 11%, just above the euro area average, and is forecast to drop further to 8% by 2019 (Chart 2a). Youth unemployment remains high at 26%, though this is also decreasing. The fall in unemployment has been among the largest in the EU, according to European Commission data, driven by labour market reforms, wage adjustment and a strong growth in tourism. Wage adjustment has also been a factor behind the improved current account balance as growth in imports has been slower than growth in exports (Chart 2b). Emigration and an ageing population have lowered unemployment figures, though they have reduced the potential growth rate, which at 0.4% is less than half its pre-crisis average.

> *"The fall in unemployment has been among the largest in the EU, driven by labour market reforms, wage adjustment and a strong growth in tourism.*

Rising employment has in turn boosted consumption, one of the main reasons behind higher GDP growth in 2015 and 2016. Bank lending to consumers rose by 1% last year. The fall in unemployment continues to reduce the cost of unemployment benefits and services, helping with fiscal consolidation. Another bright spot is that income inequality is falling – an important political consideration given the many voters believing they have been left behind by recovery.

The government has implemented business reforms including improving the insolvency framework, adjusting taxation rules and simplifying administrative procedures, in order to improve its international attractiveness. The county's free trade zone of Madeira lowered the tax rate and provided tax exemptions on dividend payments for companies established there, in an attempt to boost competitiveness and attract new businesses. The country is 25th out of 190 in the World Bank's 2017 'ease of doing business' rankings, with high scores for trading across borders, enforcing contracts and resolving insolvencies. One result is the growing number of business services and back office functions moving to Portugal.

Portugal's next steps

These improving fundamentals provide a good basis for the next step in Portugal's recovery. Crucially the country needs to gain recognition from the EU and the ratings agencies of its improved fiscal position. This would allow Portugal to depart from its position as a country still subject to strong European fiscal constraints, and would bring about a sustained improvement in its credit rating. Portugal has undoubtedly scored considerable successes, but many positive trends are only temporary, including a significant terms of trade improvement resulting from low oil prices, low interest rates and asset purchases by the ECB.

The European Commission has highlighted the lack of progress on many of Portugal's country-specific targets. The skill level of the labour force is relatively low, particularly in sectors affected by digitalisation. Innovation remains constrained by the lack of co-operation between universities, research institutions and businesses, as well as problems over access to finance. The transition to a knowledge-based economy has shown little progress. A significant part of Portugal's recent growth has reflected better results in tourism and other service sectors where achieving productivity gains is difficult. Regulatory, legal and administrative barriers continue to hamper investment. The government's fiscal consolidation has come at the cost of long-term public investment, while appetite for further reforms has stalled. Public and private sector debt remain high and the banking system's improvements remain vulnerable to external shocks.

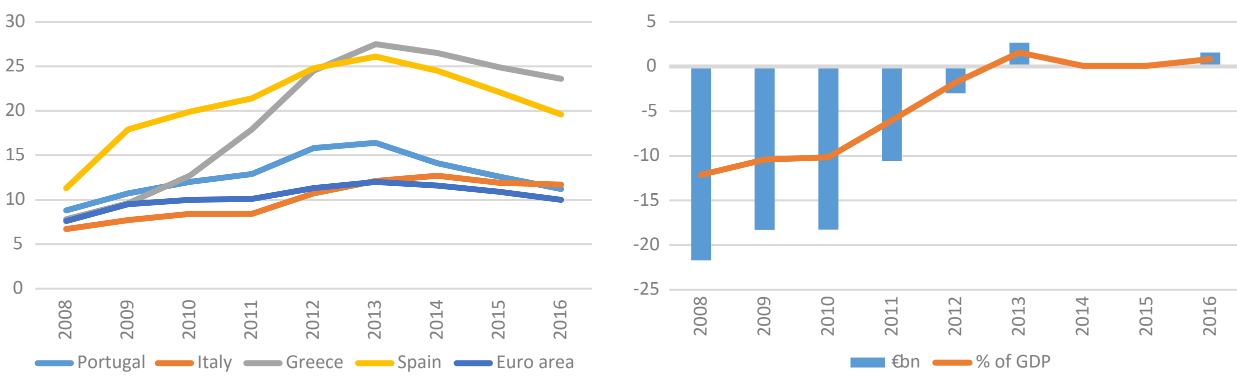
Portugal has come a long way since its post-crisis low. Its relative performance has been among the best in the euro area. If it is able to maintain its recent economic performance and does not backtrack on its reform agenda, Portugal could become a durable good news story in the euro area's recovery. ■

Ben Robinson is Economist at OMFIF.

Chart 2: Portugal's improving macroeconomy

a) Unemployment, % of active population

b) Current account balance



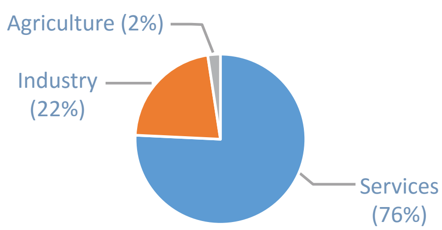
Source: Organisation for Economic Co-operation and Development, Banco de Portugal, OMFIF analysis

SNAPSHOT OF PORTUGUESE ECONOMY

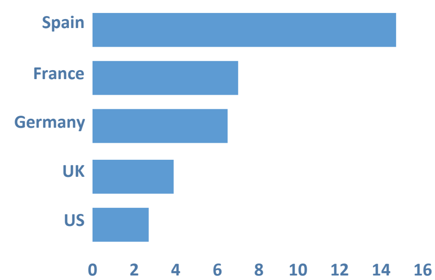
General information

Population	GDP (Current $)	GDP growth
10.3m	**$316bn**	**1.4%**
Inflation	Land area	Exchange rate ($/€)
1.4%	**92,212km²**	**1.09**

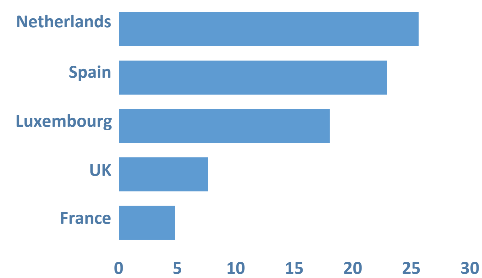
Economy composition
GDP by sector of origin, 2016



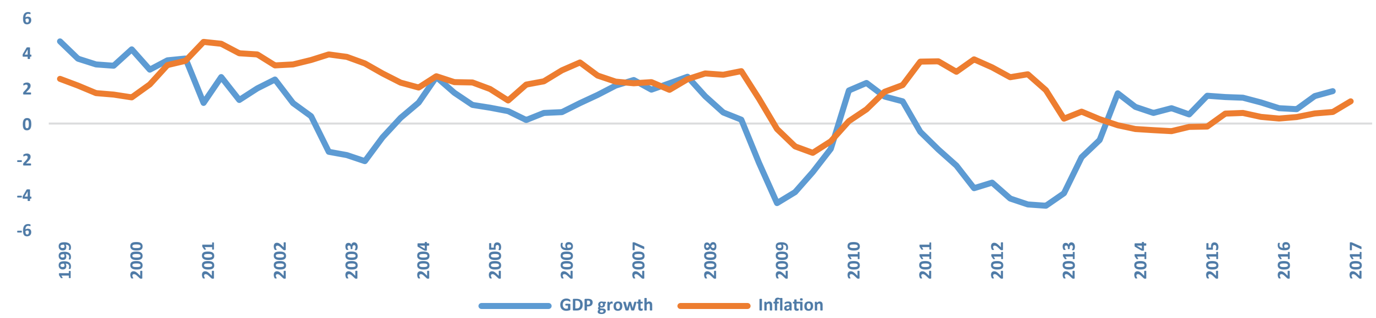
Top 5 trading partners
Exports, $bn, 2016



FDI inflows
Source country, % of total, 2016

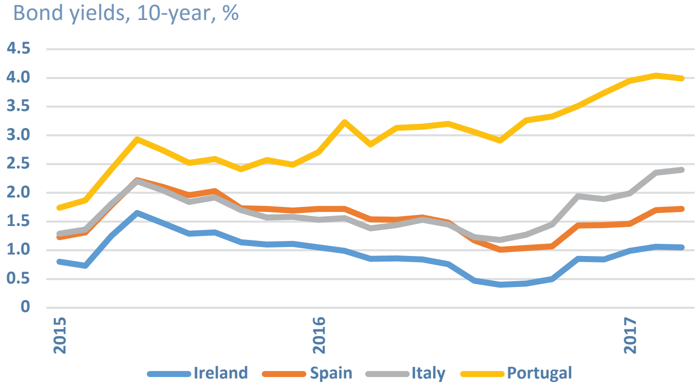


Growth and inflation struggle to recover from the crisis
Real GDP growth and HICP inflation, %



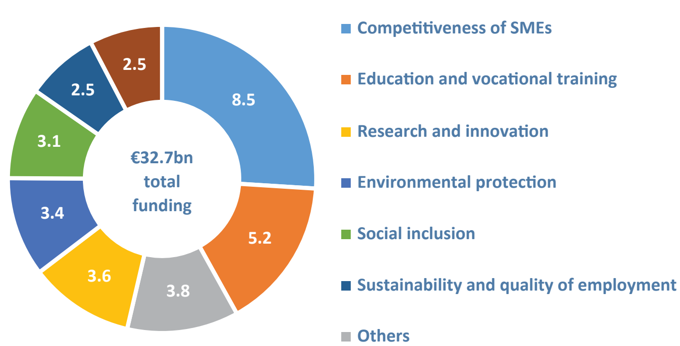
Source: Banco de Portugal, OMFIF analysis

Investors wary of Portuguese bonds
Bond yields, 10-year, %



Source: Thomson Reuters, OMFIF analysis

Portuguese investments from ESIF funds, €bn



Note: includes €6.9bn from Portuguese government. 'Others' includes climate change adaption, network infrastructure, technical assistance, information technology and efficient public administration

Thriving on talent and infrastructure

Luis Castro Henriques, Chief Executive, AICEP Portugal Global

How is Portugal positioning itself after a period of economic transition?

Portugal has positioned itself for a steady and strong return to the international financial markets, presenting itself as an attractive option for foreign investors seeking to diversify their portfolio. With GDP growth of 1.4 per cent in 2016, Portugal also registered one of its lowest budget deficits, and the government expects to reach a balanced budget by 2020. In 2016, household and corporate debt decreased, and this trend continued in the first quarter of 2017.

According to the Financial Times, ‘Portugal is the surprise hero of Eurozone growth as exports and tourism prosper’. In nearly all economic sectors, exports have grown since 2013. This trend is expected to continue, supported by the recovery of external demand. In 2016 exports represented 41% of GDP, compared with 29% in 2009.

Mirroring this recovery, interest in equity investments is on the rise. As well as acquiring traditional assets, investors have been focusing on dynamic, rapidly growing companies. The Portuguese Trade and Investment Promotion Agency (AICEP) has been working closely with overseas equity investors who are looking for an attractive and secure investment destination. Investors are particularly interested in stable Portuguese partners with an international presence. Successful alliances have already been made with business in Africa and America.

There is an interesting trend of business services moving to Portugal. What has caused this growing dynamic?

Portugal is welcoming business from around the world as a result of its competitive operational environment. From Portugal, multinationals are supplying business services worldwide, thanks to a combination of the country’s talent, infrastructure and operational costs. As outsourcing is evolving from being a service provider to acting as a source of innovation and added value, Portugal is increasing its relevance through one of its key factors: talent.

The sector has immense scope, offering financial services, customer support, software engineering, research and development centres, business process outsourcing and business process management. Renewed interest is coming from financial services companies, including banks. Offices are opening in Portugal for human resources, IT, risk analysis and compliance operations. More than 100 large-scale business services centres operate in Portugal, seven of which are Fortune 500 companies. The sector employs more than 40,000 people, expected to exceed 50,000 by 2020.

Is it something you see happening in the capital alone?

Most of the outsourcing services are based in Lisbon, but cities such as Porto and Braga are following its lead. Lisbon attracts diverse organisations, particularly financial services and IT, wanting to serve European and American markets. There are more than 60 businesses in Lisbon, including BNP Paribas, Siemens, Fujitsu, Solvay, Cap Gemini, Xerox, Microsoft, Cisco and Europcar. Vodafone and Panalpina are setting up competence centres to focus on research and development.

In the Porto Metropolitan area, companies are finding a vibrant environment in which to develop centres for accounting, payments, procurement, remote ticketing, cybersecurity and IT financial solutions. Adidas, Concentrix, Natixis, Euronext, Infineon, Linde, Sitel, Lufthansa and Paddy Power Betfair are among the 25 businesses already located in the region.

What are the main reasons for Portugal’s success?

Portugal’s well-educated workforce and growing productivity are major attractions for companies seeking to invest in the country. The availability of engineers, and people with financial expertise and languages skills, particularly English, offers scope for all types of business-services models as well as research and development activities. Job creation incentives and exemptions from social contributions are encouraging companies to be more ambitious in their business plans.

With a new generation of R&D activities (renewed partnerships between universities and the business sector), Portugal performs above the EU average in new doctorate graduates, international scientific co-publications and SMEs innovation.

Portugal sets itself apart with its business and labour environment. International employee surveys show that it has low turnover rates and absentee levels, along with low rates of nominal wages growth. Portugal is ahead in terms of licensing procedures, the environment for business start-ups, and e-government policies. State-of-the-art telecommunications and high-quality real estate are also identified by investors as among the country’s main advantages.

Entrepreneurs are finding their place in modern Portugal.

What is the role of AICEP?

AICEP offers a tailor-made service for new investors or for investors based in Portugal who want to expand their operations. It works as a single point of contact in all phases of the investment: pre-investment, incentives negotiation, settling in and aftercare. As a one-stop investment shop, it aims to make Portugal a magnet for business. ■

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UK leader's successful surprises

May with mandate: a bid for Europe

David Marsh

Theresa May has thrown caution to the wind and decided she wishes to lead Europe. The erstwhile careful campaigner to keep Britain in the European Union, who – since becoming prime minister last July – has fully espoused the 'UK out' cause, has undergone a second metamorphosis.

Her next step is to become a substantial election victor, crush the opposition Labour party, and gain a strong mandate to steer the UK to a reasonable economic and political exit deal with the remaining EU states.

The Conservative party was an unusual 20 percentage points ahead in the polls over luckless and semi-leaderless Labour when the election was called on 18 April. Unless something catastrophic happens, May in June will swap her present unelected status for the mantle of a European leader with sizeable popular backing.

By unexpectedly calling an early election for 8 June May has every chance of establishing Britain, from 9 June onwards, as an island of relative stability in an otherwise uncertain continent. Much may still go wrong. But May hopes her probable win will be translated into negotiating leverage that will give the UK clear benefits in a relatively smooth and 'soft' withdrawal agreement taking effect in 2019. She will plainly be hoping for maximum support from Angela Merkel in German and Emmanuel Macron in France.

> ***May has the chance of upstaging the Brexit hardliners in her party who, although at present quiescent, represent a potential threat.***

May and her advisers had argued against holding an early election. They pointed to her ability to govern effectively with a working majority in the House of Commons inherited from her predecessor, David Cameron, who resigned immediately after the UK voted to leave the EU on 23 June. In addition, the government had argued that an early poll would represent a distraction from Brexit talks. And May undeniably has enjoyed a series of easy victories against Jeremy Corbyn, the hapless Labour leader.

Against this, the prime minister has now clearly been swayed by a series of counter arguments calling for upending the status quo. Apart from the potential European benefits, she has the chance of upstaging the Brexit hardliners in her party who, although at present quiescent, represent a potential threat.

She can erase the continued irritant of the United Kingdom Independence Party, now seen to have outlived its purpose, and score some useful wins against the Scottish National Party north of the border.

This is not the first surprise in the Brexit saga. Cameron didn't expect to lose the June referendum and said he would stay on if he did. The Leave side in that campaign did not expect to win and had no leadership plan. May now has the chance to show that she can turn successive surprises to her advantage. ■

David Marsh is Managing Director of OMFIF.

Prime minister outwits rivals

Conservatives will enjoy a massive victory in election

Meghnad Desai, Advisory Council

Prime Minister Theresa May chose a very good moment to call a general election – the Conservatives are going to enjoy a massive victory.

Not only is the Labour party no longer a strong opposition, the United Kingdom Independence Party is also not as powerful as it used to be. UKIP, which ran on an anti-European Union platform in the 2015 general election, has been exposed as a one-item-agenda party and will not be rewarded further.

As far as the negotiations over Britain's exit from the European Union are concerned, calling the election as early as 8 June means May will have a stronger hand even before proceedings really get serious. The longer the EU27 delay starting negotiations in earnest, the more she can take advantage of that gap.

This is an astute move by May, and will give some clarity to British politics. The election will illustrate conclusively how good, or bad, Jeremy Corbyn has been as leader of the Labour party. It is not difficult to predict that Labour will suffer a massive defeat – since electing Corbyn as party chief in 2015, and reaffirming him in that role in a 2016 leadership contest, Labour's performance in polls has greatly deteriorated. It currently holds 229 of the 650 seats in the Commons, but will lose around 100 in the coming election.

> ***How many of the seats which Labour loses will go to the Liberal Democrats?***

The interesting question is whether the Scottish National Party will come back with as much strength as before. In Scotland the Conservatives are better off now than they have been for a long time. The SNP is likely to lose some of its Commons seats.

The June election will be an informal poll on the second Scottish independence referendum which Nicola Sturgeon, head of the SNP, proposed in March. Though it is the largest party in the devolved Scottish parliament, the SNP does not wield a majority. In both England and Scotland, it appears that May has outwitted all her rivals.

Another crucial concern is how many of the seats which Labour loses will go to the Liberal Democrats, the third party in English politics. If voters decide that Corbyn has been especially damaging, then the Labour party will lose its position as the primary opponent against the Conservatives to the Lib Dems.

There is no doubt that there will be a substantial Conservative majority after 8 June. What matters is how the remaining seats will be distributed between Labour and the Lib Dems, and how the SNP performs against the Scottish Conservatives. That is where the future will be decided. ■

Lord (Meghnad) Desai is Emeritus Professor of Economics at the London School of Economics and Political Science, and Chairman of the OMFIF Advisory Board. Between 1982-92, Desai was Labour party Chair for the constituency of Islington South and Finsbury.

Record low for net financial assets

ECB programmes contributing to excess liquidity

Paweł Kowalewski and Mikołaj Szadkowski, National Bank of Poland

The euro area's net financial assets fell in late February to a record low. The decrease is linked to the European Central Bank's extended asset purchase programme, which created excess liquidity in the euro area. Therefore, the fall in NFAs must be viewed as further evidence of the countercyclical effects of its liquidity management role.

In mid-2016 the ECB opted to disclose its disaggregated balance sheet data. This makes it easier to understand the processes affecting the euro area's balance sheet. The fall in NFAs is a combination of a decrease in assets and an increase in liabilities. Though the latter represents the higher share, it is the asset side that is more perplexing.

Asset purchase programme leads to NFA fall

Two positions on the asset side are responsible for the fall in NFAs. These are 'other claims on euro area credit institutions denominated in euro' and 'other securities', the latter being part of the largest group on the asset side, namely 'securities of euro area residents denominated in euro'.

The 'claims on euro area credit institutions denominated in euro' reached a record high in mid-2015, mainly because of an increase in ECB emergency liquidity assistance, related to yet another escalation of tensions in Greece. These claims (exceeding €130bn) helped to push the amount of financial assets at the time above the €1.5bn threshold. According to the Bank of Greece, in summer 2015 the ELA limit exceeded €89bn. Today, the same limit is set at €46.6bn, which should explain much of the fall in claims on euro area institutions (currently around €81.4bn).

The 'other securities' position is more difficult to explain, and national central banks are not offering many details. After reaching a new high in early 2015 (around €378bn), the amount of securities has fallen to €305bn. There are reasons to believe some central banks want to change the hierarchy of their securities following the ECB's public sector purchase programme. In particular, it was the activities of the Bank of Spain (in the period from the end of 2014 to the start of March 2017) which contributed to around 37% of the fall in the 'other securities' position.

> ***"Other European institutions are lodging assets at the Bundesbank since it represents a well-regarded safe-haven at a time of uncertainty.***

One liabilities position deserves particular attention, specifically 'other liabilities to euro area residents denominated in euros'. An examination of the performance of these liabilities from the end-2014 to the start of March 2017 illustrates that much of the increase (€86bn) is owing to a rise in deposits at the German Bundesbank (up around €75bn). This is largely related to the function of the European Stability Mechanism and the European Financial Stability Facility.

Other European institutions are lodging assets at the Bundesbank since it represents a well-regarded safe-haven at a time of uncertainty. Similarly, the increase in 'other liabilities' to 'non-euro area residents denominated in euros' (around €121bn from end-2014 to the start of March 2017) accounts for the largest fall of NFAs. The Bundesbank, where deposits have increased by €97.5bn, is again the principal agent responsible for the change.

Role in transmission mechanism

The relationship between the NFAs and the ECB's public sector purchase programme extends beyond liabilities to non-euro area residents. Rather, the NFAs seem to be directly related to overall liquidity management in the euro area.

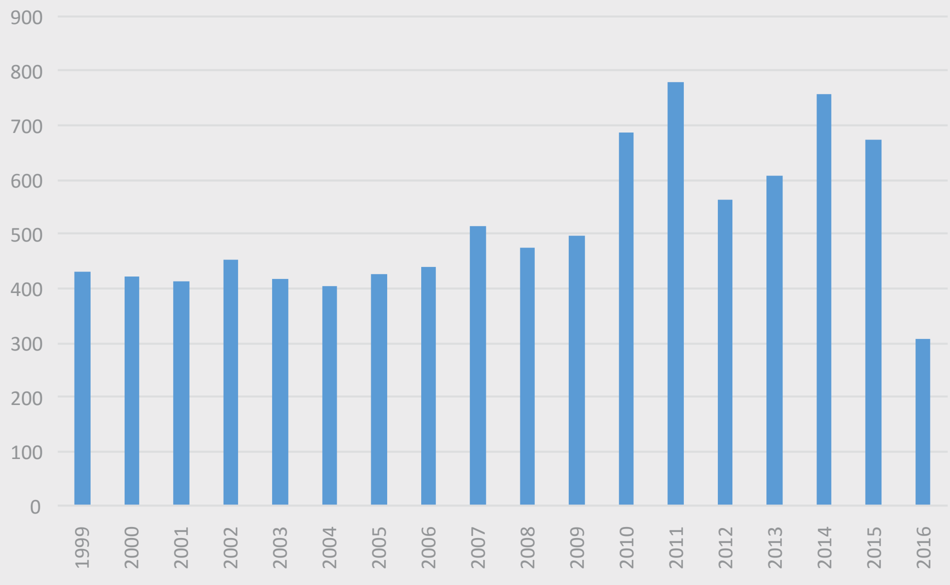
Prior to the 2008 financial crisis the agreement on NFAs was supposed to protect the liquidity deficit – today it is supposed to ensure that the size of the prevailing excess liquidity does not get out of control. This is why there are reasons to believe that NFAs play a role as a transmission mechanism.

Given that the amount of NFAs seems to be countercyclical to excess liquidity, their levels appear to exert an indirect influence on interest rates. Whenever the Euro OverNight Index Average (the weighted average of all overnight unsecured lending transactions in the interbank market) starts to increase, an increase in NFAs may limit further upward pressure on the market rate.

NFAs are positively correlated with the amount of cash in the euro area's monetary base. A rise in the share of cash – usually at the expense of excess liquidity in the banking system – in the monetary base precedes an increase in NFAs. With the volume of funds stemming from the ECB's extended asset purchase programme reaching a record high, the share of cash must move in the opposite direction. By doing so, it brings NFAs to an all-time low. ■

Net financial assets fall in 2016 following asset purchase programme

Eurosystem net financial assets, €bn



Source: European Central Bank, OMFIF analysis

Paweł Kowalewski is Economic Adviser in the Economic Analysis Department, and Mikołaj Szadkowski is an expert in the Accounting and Finance Department, at the National Bank of Poland.

Greece, Spain and the blame game

Reckless lenders must share responsibility for euro area crisis

Nick Malkoutzis, MacroPolis

When Jeroen Dijsselbloem, Dutch finance minister and president of the Eurogroup, implied that the euro area crisis was a result of the south wasting its wealth (on wine and women) he exposed a damaging side to discussions about the euro.

The idea of there being a higher and lower ground in the euro area has fuelled the moralistic approach to crisis management. This has driven a wedge between the core and the periphery, while compounding rather than solving many of the problems.

Solidarity is a myth

The definition of solidarity is when people act together for a common purpose. However, when European officials talk about solidarity in the context of the euro crisis, they present it as a one-way transaction: countries that were in danger of going under were rescued with loans from their partners.

This is a very limited interpretation of what happened. In fact members of a single currency that lacked fiscal unity and the tools to deal with a crisis ran into economic problems and were bailed out with loans that came with strict conditionality. Although this staved off disorderly defaults, meeting the conditions put a severe strain on the economies of the countries concerned. They put their public finances in order, they embarked on structural reforms and endured falls in their economic output as well as rises in unemployment levels.

As this adjustment was taking place, some of the euro area member states providing the loans were able to shore up their defences. This prevented a potentially devastating crisis dragging down their banks, which had lent freely to the bailed-out countries in previous years. The International Monetary Fund described in its 2013 evaluation of the first bail-out how the core insulated itself from Greek contagion.

It said, 'An upfront debt restructuring would have been better for Greece although this was not acceptable to the euro partners. A delayed debt restructuring also provided a window for private creditors to reduce exposures and shift debt into official hands. This happened on a significant scale and limited the bail-in of creditors when private sector involvement eventually took place, leaving taxpayers and the official sector on the hook.'

While the rest of the euro area put up the firewall, Spain, Cyprus, Portugal and Greece felt the heat of shuttered businesses, job losses and rising emigration, especially among their young people. The truth is that the bail-outs of southern euro area countries were partly designed to protect core euro area banks. Pretending they were selfless acts of solidarity is misleading. In the cases of Spain, Cyprus and Portugal, the terms of the programmes were met and the countries exited the bail-outs. Greece is yet to reach this point but each step it makes is defined by the terms its lenders set out.

Wasteful south

The other point to be made about Dijsselbloem's comment relates to the impression created (inadvertently, he says) that the crisis was a result of the south's profligacy. It is true that the onset of the crisis found Greece, Ireland, Spain, Portugal and Italy with a collective current account deficit of almost 7% of their GDP, suggesting that their economic priorities had gone awry.

> ***"The bail-outs of southern areas were partly designed to protect core area banks.***

But one cannot make a proper economic assessment by looking at just one side of the balance sheet. While the periphery was struggling, the core, including Germany and the Netherlands, recorded a surplus of around 6% of its GDP. A deficit in any country requires a surplus in another to finance it.

As economists Alexandr Hobza and Stefan Zeugner point out in a 2014 European Commission paper, the euro area's overall current account 'stayed moderately positive', never exceeding 1% of GDP. 'The euro area current account position during its first decade thus could be called an "imbalanced balance",' they write. 'This implies that the deficits were almost exclusively financed from the surpluses in other euro area countries.'

What the euro area witnessed in the build-up to the crisis was a capital flow from the core, which was capital-rich thanks to excessive savings, to the periphery, which was in a hurry to catch up with its partners in the newly created euro. The crisis brought these flows to a sudden stop.

In many cases the periphery did not invest its new-found (borrowed) wealth wisely, as perhaps it should have. Some of it was spent on imports from the north, from consumer goods to military hardware, rather than on domestic production. Spain produced a property bubble, Greece inflated its public spending, Portugal increased consumption, and Cyprus lost control of its banks.

Jeroen Dijsselbloem, President, Eurogroup

However, where there is bad borrowing, there is also bad lending. We cannot speak of unacceptable actions on the part of the borrowers and ignore the lenders. They benefited greatly from the financial integration the single currency provided but were absolved of any responsibility when their practices failed.

In Greece's case, the discussion centres almost exclusively on wasteful public spending and hardly ever on the equally reckless lending. German and French banks had an exposure of $150bn to Greece in 2010, when it signed its first Memorandum of Understanding.

To ignore the failings of the lenders means that euro area policy-makers are not genuinely interested in strengthening the single currency as a whole and each of its members individually. They are simply looking for a scapegoat to blame because short-term national politics outweigh the long-term interests of educating voters about what actually happened.

Seven years on, Cyprus has exited its bail-out and is returning to growth, Spain is gradually overcoming the damage inflicted by its property boom, Portugal has posted its lowest budget deficit (2.1% of GDP) since 1974, and Greece stands on the verge of a deal with its lenders that may put it on a path towards genuine recovery.

This of all years, when the European Union is celebrating its 60th anniversary, is not the time to sow the seeds of division. We should, instead, be looking at how the euro area can move towards genuine convergence. ■

Nick Malkoutzis is Editor of MacroPolis. This is an edited version of an article originally published at www.macropolis.gr.

Political tensions push up ‘safe’ currencies

Rise in value of reserves boosts central banks’ balance sheets

OMFIF and National Bank of Poland analysis

The central banks of advanced economies responded to the financial crisis by expanding their balance sheets at an extraordinary pace. Nine years on, some are assessing the risks and benefits of exiting such policies and reversing this balance sheet expansion. In the latest part of this Bulletin series, prepared jointly by OMFIF and the National Bank of Poland, we examine further the development of the balance sheets of key central banks, the Swiss National Bank, Swedish Riksbank and Danish National Bank.

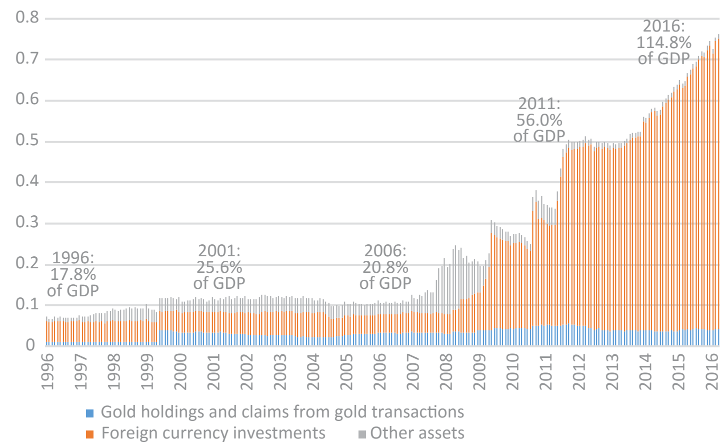
Switzerland’s foreign reserves rise to record levels

After falling in January, the Swiss National Bank’s foreign exchange reserves have risen sharply, pointing to its increased presence in the foreign exchange market. The foreign reserves (excluding gold) reached Chf688.9bn ($693bn) in March, up from Chf674.0bn in February. This will push the SNB balance sheet ever higher. The data for March point to it reaching an unprecedented Chf763.2bn, well above GDP, which was Chf650.1bn in 2016.

The funds held on the SNB sight deposit soared too, surpassing Chf480.0bn on 21 April, possibly in response to increased political tensions ahead of the first round of the French presidential elections. In 2016 the SNB’s negative rate policy earned it profits of Chf1.6bn on its Swiss franc positions, of which Chf1.5bn originated from negative rates on sight deposits (originally imposed in January 2015).

Valuation changes on gold holdings enabled the SNB to register a gain of Chf3.9bn. However, the greatest contribution to SNB profits for 2016 came from gains on foreign currency positions (Chf19.4bn). All in all, the SNB registered a profit of Chf24.5bn, a turnaround from 2015 when it experienced its biggest loss ever of Chf23.3bn.

Swiss National Bank balance sheet, assets Chf tn



Source: Swiss National Bank, National Bank of Poland, OMFIF analysis

Like the rest of the world, Switzerland is experiencing a rise in inflation. However, at 0.6% in March there is still a lot for the SNB to do to reach its target of around 2%. In contrast to other central banks which have resorted to unconventional policies, the SNB appears to have plenty of room for manoeuvre and relies on the purchase of foreign assets. Foreign currency investments increased to Chf710.5bn in the first quarter of 2017 from Chf595.4bn in the previous year, with 42.2% held in euros, 34.4% in dollars, 7.6% in yen, 6.4% in sterling, 2.7% in Canadian dollars and 6.8% in other currencies.

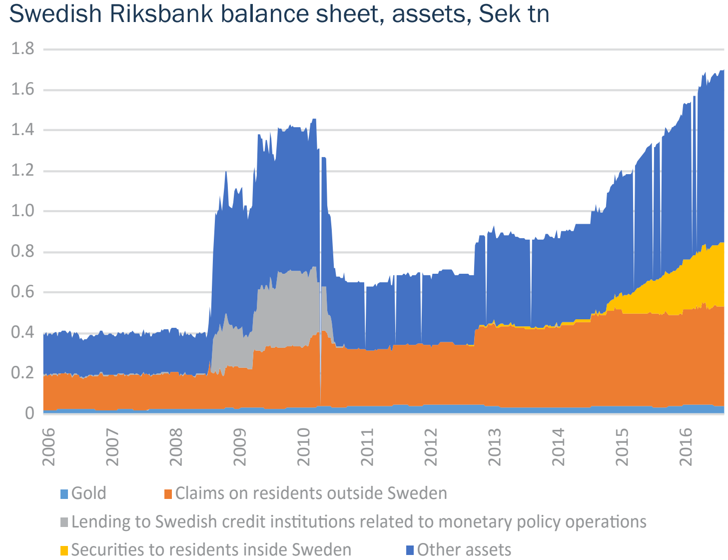
Riksbank leaves rates unchanged despite rising inflation

After a long period of deflation, Sweden’s inflation rate seems to be heading towards the Riksbank’s target of 2%. However, having reached 1.8% in February, the consumer price index slipped to 1.3% the following month. The other measure of inflation in Sweden, the CPIF (CPI with a fixed interest rate, which is not directly affected by changes in mortgage rates) fell to 1.5% in March after hitting 2% a month earlier.

The Riksbank’s reference rate remains at all-time low (minus 0.5%) and the bank does not expect to raise it until 2018. Positive territory is unlikely to be reached before early 2019. In the light of this expansionary policy, government purchases will continue for the first six months of this year, bringing total bond purchases to Sek290bn ($32.6bn), without reinvestment. Little wonder the Riksbank is keen to bring inflation levels up.

After a sharp appreciation of the krona at the start of 2017, it reversed some of its gains, stabilising against the euro at around SEK9.50. But it then weakened to Sek9.60 after March’s lower than expected inflation figures. The proportion of cash on the Riksbank balance sheet has fallen continuously, dropping from 54% 10 years ago to 7% now.

Swedish Riksbank balance sheet, assets, Sek tn



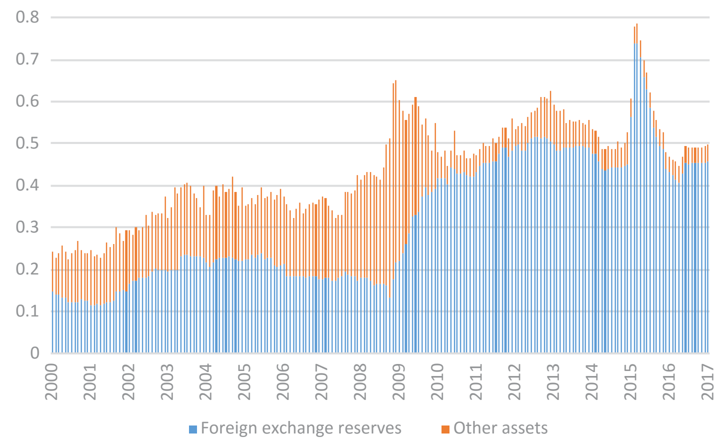
Source: Swedish Riksbank, National Bank of Poland, OMFIF analysis

Strong krone prompts national bank intervention

In February and March the Danish National Bank resumed its foreign exchange intervention aimed at weakening the krone. The Danish currency is not supposed to deviate by more than +/-0.5% within the narrow ERM II corridor against the euro, but has been close to the upper limit since November. This reflects the way political uncertainty in some European countries is prompting investors to look for safe havens. Having hardly intervened in the second half of 2016, the DNB purchased Dkk4.7bn ($0.7bn) of foreign currency in February, and Dkk5.6bn in March.

The krone was at a higher level at the start of this year than in early 2015, when Denmark became a safe haven for many investors ahead of asset purchases by the European Central Bank. This is particularly striking because the spread between the deposit rate in the euro area and in Denmark is much smaller. At the height of the 2015 tensions, the spread reached 55bp. Since then, the ECB has cut its deposit rate twice while Denmark has increased its rate from minus 0.75% to minus 0.65%, reducing the spread to 25bp.

Danish National Bank balance sheet, assets, Dkk tn



Source: Danish National Bank, National Bank of Poland, OMFIF analysis

April brought important changes in the government securities market, where issuances are conducted by the central bank on behalf of the government. From now on, each primary dealer will be measured relative to those who provide the best price quote. To further improve the quality of a quotation, the banks offering best quotations will receive annual payments of up to DKK25m from the government.

This analysis was led by Paweł Kowalewski, Economic Adviser in the Bureau of Monetary Policy Strategy at the National Bank of Poland, with contributions from Bhavin Patel, Economist at OMFIF.

Central banks without a rule book

Route from unorthodoxy: gradual, painstaking, nervous

John Nugée

Reinvigorated economies are in evidence across much of the developed world. Growth is becoming more firmly established. Inflation is trending upwards in the US, euro area and UK.

After seven years of unorthodox operations, primarily quantitative easing, central banks are beginning to consider when and how to normalise monetary policy. In March Mario Draghi, president of the European Central Bank, said that while the ECB's interest rates would stay unchanged, there was 'no longer a sense of urgency for taking further actions' on monetary stimulus. On 15 March the US Federal Reserve fulfilled expectations by raising interest rates by 25 basis points. Commentators are forecasting another two Fed increases in 2017.

But, if rate rises are back on the agenda in much of the G7, another consequence of unorthodox policies is still very much with us. Central bank balance sheets (investigated in the April Bulletin and further on p.16-17 of this edition) remain substantial – 20% or higher for the Fed, ECB and Bank of England, and 80% for the Bank of Japan. There are few signs that these circumstances will change soon.

Misleading market signals

This subject has been hotly debated within central banking circles. Central bankers have been discussing what constitutes the optimal long-term size and composition of central bank balance sheets almost since unorthodox policies were introduced. For every central banker who argued that there was no alternative to QE, there was another who asked, 'Where will this lead, and how do we end it?'

> ***"There are fundamental questions, such as what the role of the central bank is and what its optimal involvement in a free market should be.***

The counter argument of 'We must do something, this is something, so we must do it' prevailed. And despite concerns that these policies had dubious grounding in monetary theory, the results have, in many ways, been successful. Developed economies avoided a repeat of the great depression, and growth has returned to most of them.

But there are other more fundamental questions, such as what the role of the central bank is and what its optimal involvement in a free market should be.

At various times in the past seven years, central banks' direct involvement has been so extensive that markets have been in danger of ceasing to act as a window into the true workings of an economy. There is a risk that markets now show central bankers only the impact of their own policies.

The desire to end the experiment of QE is, therefore, felt keenly. But to bring that debate into the public domain, central banks will need to address three issues.

Gradual route out

First, they must rebut the beguiling argument that a small balance sheet will lead to prosperity simply because this is how things seemed in the past. This argument mistakes correlation for causality, and ignores all the other changes since QE was brought in – not least the effect that very low interest rates have had on the interaction between bank reserves and interest rate policy.

Second, they will need a coherent theory of whether the impact of the central bank balance sheet on an economy is predominantly a stock or flow matter – is it the fact of having a large balance sheet that matters, or the act of increasing it? And, after QE, central banks will need to determine whether 'normality' refers to the point when a balance sheet stops growing, or when it shrinks back to some predetermined size.

Third, if central bankers decide that their balance sheets should shrink, they will need to articulate to the public a clear proposal for how to accomplish this and what the economy's response is likely to be. It would be reckless to start the process in any other way. Central banks could cause real damage to the economy, markets and their own reputation if the process goes wrong.

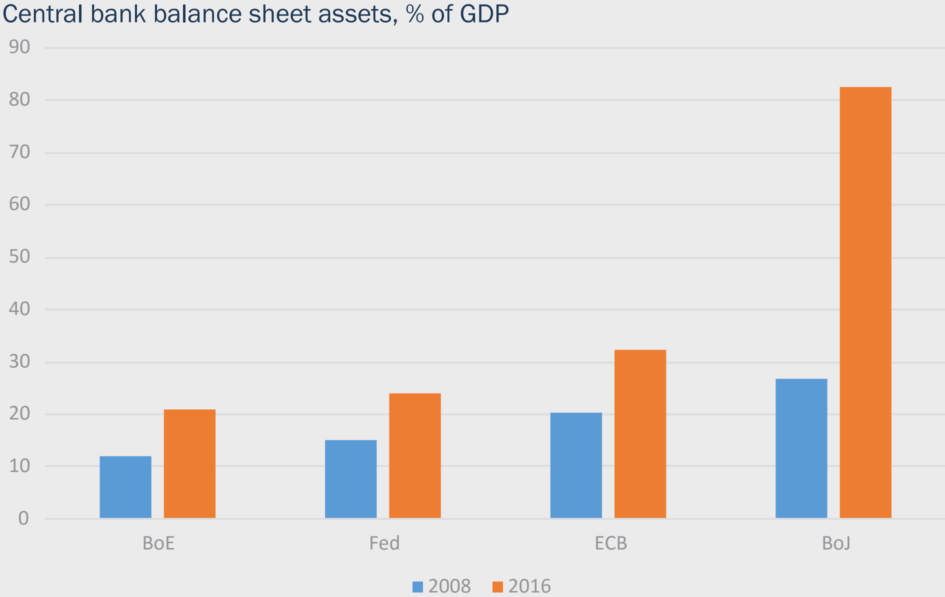
The unorthodox nature of much recent monetary policy means that, just as there was no rulebook for how to conduct it, there is no rulebook for how to end it. But whereas the scale and urgency of the crisis seven years ago meant that central bankers had to be brave and unorthodox, there is no such urgency now, and no need to gamble the economy's future on an untried policy change.

The route out of unorthodoxy is likely to be gradual, painstaking and nervous – with central bankers aware that mistakes could cause setbacks that could lead them back to another bout of unorthodoxy with still less chance of reversal. ■

John Nugée is a Director of OMFIF and a former Chief Manager of Reserves at the Bank of England.

QE programmes have increased central bank balance sheet sizes

Central bank balance sheet assets, % of GDP



Source: Bank of England, Federal Reserve, European Central Bank, Bank of Japan, International Monetary Fund WEO, OMFIF analysis

Fed seeks consensus on balance sheet

Markets kept guessing about rate rises

Darrell Delamaide, US editor

Janet Yellen, the Federal Reserve chair, says that the US central bank is ready for a shift in policy now that unemployment has dropped to 4.5%, and inflation, at 1.8%, is 'reasonably close' to the Fed's 2% target. She told an audience at the University of Michigan that the Fed was aiming to give the economy some stimulus but not too much: 'We want to be ahead of the curve.'

Market participants are now trying to predict what combination of interest rate policy and balance-sheet management the Fed will adopt to keep the economy 'on an even keel', to quote Yellen.

A consensus seems to be emerging among members of the Federal Open Market Committee that the Fed should begin to reduce its balance sheet later this year. This would involve ending or tapering its policy of reinvesting proceeds and rolling over expiring bonds.

Pause in interest rate rises

New York Fed President William Dudley, a permanent voter on the panel, is one of those who suggest that such a change is possible. He believes it could be accompanied by a pause in interest rate rises to help 'make sure that the balance sheet doesn't turn out to be a bigger decision' than expected.

Market watchers have been predicting two more rate rises this year, but St Louis Fed President James Bullard says that only one would be desirable if reinvestment were ended, as that would represent sufficient tightening of monetary policy.

He is at odds with Robert Kaplan, Dallas Fed chief, a voting member of the FOMC for the first time this year. Kaplan agrees that the Fed could start shrinking its balance sheet but does not believe it will affect the case for two more rate increases.

Esther George, head of the Kansas City Fed, is another FOMC member who believes the Fed should start shrinking its balance sheet later this year. She suggests that the process should then continue automatically and not be adjusted to short-term data.

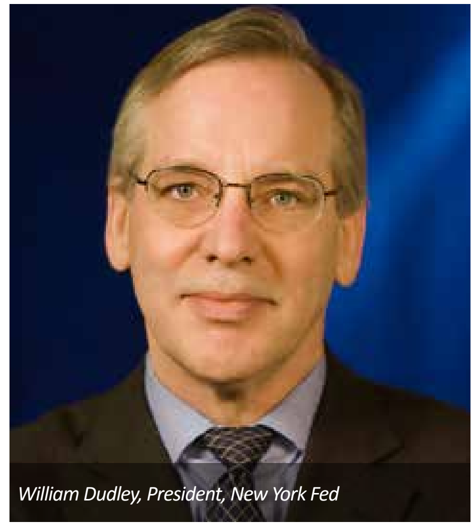
Eric Rosengren, Boston Fed chief, says that the Fed should shed its bond holdings only very gradually so as not to interfere with planned rate increases. 'By initially retiring only a small percentage of maturing securities,

> ***"Market watchers have been predicting two more rate rises this year, but St Louis Fed President James Bullard says that only one would be desirable if reinvestment were ended.***

and then very gradually shrinking the volume of the securities being reinvested,' Rosengren said at the Levy Economics Institute at Bard College, 'the tightening of short-term interest rates should not need to be much different than it would be in the absence of shrinking the balance sheet.'

US economic growth declined in the first quarter but Fed Vice Chair Stanley Fischer says that Fed policy-makers see this as temporary. They expect growth to rebound in the second quarter so the slowdown should not affect plans for rate rises, he says.

He is cautious, however, about the timing of a reduction in the balance sheet. 'Minutes of the March meeting said that people expected we'd make the decision by the end of the year,' he said in a television interview.



William Dudley, President, New York Fed

'Whether we'll also start by the end of the year wasn't discussed.'

Speculation over Yellen's future

Meanwhile, speculation about Yellen's future as Fed chair continues. President Donald Trump, having previously said he would replace her when her term expires next year, told the Wall Street Journal that he might renominate her after all. 'I like her, I respect her,' Trump said, adding that the two had met in the Oval Office. The president, who has complained that the dollar is getting too strong, also said, 'I do like a low-interest rate policy, I must be honest with you.'

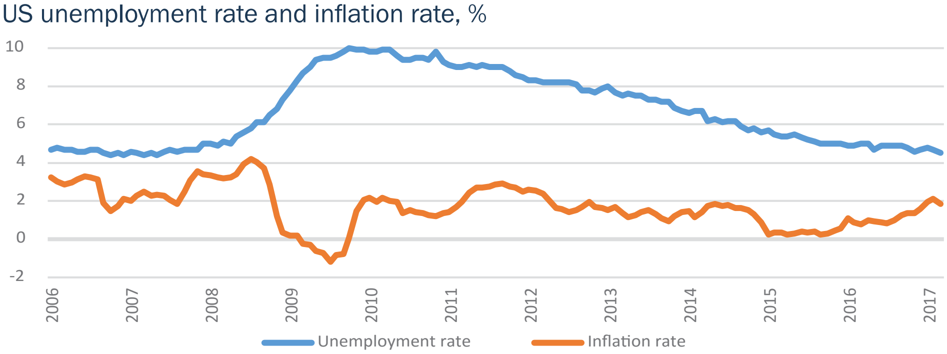
Meanwhile, Treasury Secretary Steve Mnuchin said the administration was 'very close' to naming its appointees for two of the three empty positions on the board of governors – the one reserved by tradition for a community banker and the position of vice chair for regulation, which was created by the Dodd-Frank post-crisis legislation but has never been filled.

In the interim, Fed Governor Jerome Powell will take on bank oversight duties after Daniel Tarullo, who had been in charge of them, stepped down in early April. Though his tenure may be brief, Powell, a Republican appointee in the senior George Bush administration, indicated he was willing to review some of the rules imposed by Tarullo. Many of the regulations were 'novel,' he said at the Global Finance Forum in Washington. 'It is not likely we would have gotten everything exactly right on the first attempt.' ■

Darrell Delamaide is a writer and editor based in Washington.

Unemployment and inflation close to Fed target prompts policy shift

US unemployment rate and inflation rate, %



Source: US Bureau of Economic Analysis, OMFIF analysis

Narrowing Japan's monetary policy paths

Escaping deflation through fiscal dominance

Ikuko Samikawa, Japan Center for Economic Research

The fiscal theory of the price level (FTPL), an especially unorthodox economic idea, is attracting increased public attention in Tokyo as an alternative to the Bank of Japan's bold monetary policy. Fundamentally, the FTPL proposes that fiscal policy, rather than monetary policy, has the greatest impact in determining the price of goods and services.

Since April 2013 the BoJ has conducted large-scale 'quantitative and qualitative monetary easing' (QQE) to overcome deflation. When QQE was first introduced, the BoJ announced it would 'achieve the price stability target of 2% [in terms of the annual inflation rate] at the earliest possible time, with a time horizon of about two years'. Governor Haruhiko Kuroda's aggressive monetary policy has entered its fifth year, but the price stability target of 2% inflation has not been achieved (see Chart 1).

Monetary policy at the zero bound

Japan has been in secular stagnation since the end of the 1990s, with a decline in the natural rate of interest (the real interest rate that brings savings and investment into balance). The declining trend in natural rates can also be observed in Europe and the US. Larry Summers, former US Treasury secretary, has said 'the kind of Japan-style stagnation that has plagued the industrial world in recent years may be with us for quite some time'.

Escaping deflation would require central banks to guide the real interest rate lower than the natural rate to produce an accommodative atmosphere. However, when the natural rate of interest turns negative and there is little margin to cut the nominal rate it becomes difficult for monetary policy alone to guide the real interest rate below the negative natural rate.

To address persistent deflation, the BoJ has been purchasing unprecedented amounts of Japanese government bonds every month – around ¥9tn ($82bn) (see Chart 2). This measure may, however, be reaching its limits. The BoJ already holds nearly 40% of the total JGBs issued. In addition, although the Bank introduced its negative interest rate policy in January 2016, further cuts may be difficult.

Fiscal dominance and yield curve control

In August, Nobel Prize-winning economist Christopher Sims stated, with regard to Japan's stagnant economy, that, 'What is required is that fiscal policy be seen as aimed at increasing the inflation rate, with monetary and fiscal policy coordinated on this objective.' Since then, the FTPL has won increased popularity in Japan as the 'Sims theory'.

> *"It is possible that a transition from monetary dominance to fiscal dominance took place in September 2016.*

A government trying to maintain fiscal discipline attempts to secure financial resources by raising taxes and reducing expenditure. Meanwhile, the actions of the central bank responsible for carrying out monetary policy are categorised by 'whether sufficient policy rate changes are made relative to its inflation targeting'.

Given these considerations, Japan may have moved to the phase of fiscal dominance proposed by Sims. It is a combination of fiscal policy which does not try to observe fiscal discipline, and monetary policy that does not change the policy rate that is needed to reach the inflation target.

The Japanese government has announced its aim to achieve a primary surplus by 2020. However, the Cabinet office's January 2017 'medium-to-long-term economic and fiscal outlook and revitalisation' shows that this goal is probably unattainable. Even if the consumption tax is increased in October 2019 as scheduled, the primary deficit is projected to be around ¥8.3tn, far from the government's surplus target.

When applying the framework of the FTPL, it is possible that a transition from monetary dominance to fiscal dominance took place in September 2016, with the adoption of yield curve control.

Yield curve control aims to influence the long end as well as the short end of the yield curve. It sets the interest rate on the policy-rate balance of the BoJ's current account to minus 0.1%, and the 10-year Japanese government bond yield to around 0%. The introduction of yield curve control, in the FTPL framework, means prices may at last be on an upward trend.

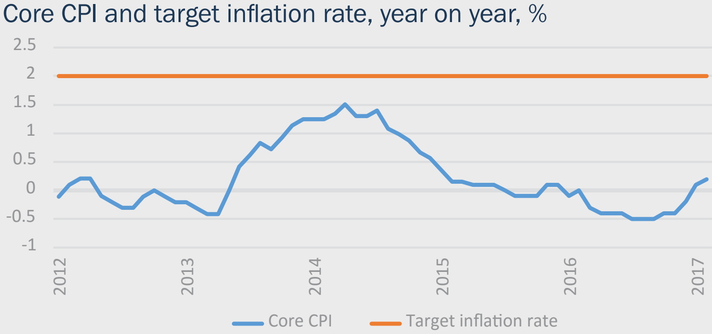
If an FTPL strategy for escaping deflation can be worked out under the leadership of the government, either the maturity structure of government liabilities would be shortened or new policies would be promoted to reduce the future fiscal surplus.

Changing the expectations of the private sector is important. Consumers tend to respond to falling prices by spending more, which in turn boosts the economy and raises employment and wealth. This has not been the case in Japan. If people do not believe in the government or central bank, consumption will remain weak, and prices will not rise. ■

Ikuko Samikawa is Director of Financial Research and Principal Economist of the Economic Research Department at the Japan Center for Economic Research.

Chart 1: Japan's inflation far from target

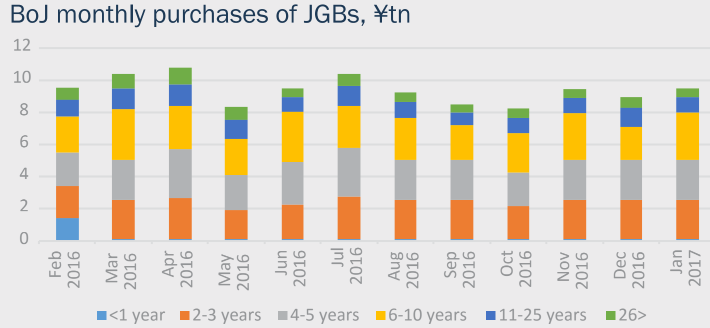
Core CPI and target inflation rate, year on year, %



Source: Bank of Japan

Chart 2: BoJ monthly bond purchases around ¥9tn

BoJ monthly purchases of JGBs, ¥tn



Source: Iwata, Fueda-Samikawa and Takahashi (2017)

Asia looks to sidestep 'new mediocre'

Crunch of 1997 prompted reforms and resilience

Amando Tetangco, Bangko Sentral ng Pilipinas

In 2014 Christine Lagarde, managing director of the International Monetary Fund, described the global economy as being at an 'inflection point'. She said it could either 'muddle along with subpar growth', what she then called the 'new mediocre', or it could aim for a better path 'where bold policies would accelerate growth'.

At the time of her speech, the IMF was about to release its revised global growth forecast, and prospects were bleak. It had been six years since the global financial crisis, and the recovery was proceeding slowly.

Output growth and employment in advanced economies remained below pre-crisis levels. Inflation was generally low and stable, but in some countries laboured below policy targets. Moreover, deflationary pressures were mounting in countries like Japan and in the euro area.

> ***"In the six years after the financial crisis, emerging Asia contributed the most towards global growth. Between 2009-14, emerging Asian economies grew at an average rate of 7.5% annually.***

Among the views put forward to explain the 'new mediocre' were secular stagnation and the failure of advanced economies to undertake the necessary balance sheet repairs and structural reforms to address supply-side weaknesses. Unconventional monetary policies through massive liquidity injections and testing the zero bound of policy rates had not translated into sustained growth.

In contrast, in the six years after the financial crisis, emerging Asia contributed the most towards global growth. Between 2009-14, emerging Asian economies grew at an average rate of 7.5% annually.

Global economic transition

The global economy is transitioning from a deep recession to relatively stable growth. The IMF's central projection, based on its January World Economic Outlook update, is that global growth will rise to 3.4% in 2017 and 3.6% in 2018, from 3.1% in 2016. Although this represents an improvement for the global economy, the average growth rate over the post-financial crisis period (2010-16) of 3.8% remains below the pre-crisis (2002-08) level of 4.5%.

Growth among advanced economies is being led by the US, which is expected to return to a sustainable path based on the latest IMF projections. The Fund projects 2.3% and 2.5% US growth for 2017 and 2018 respectively.

Meanwhile, many emerging markets continue to enjoy robust growth, though some are experiencing a slowdown driven by near-term cyclical and long-term structural factors. The IMF forecasts growth of 6.4% for emerging and developing Asia in 2017, declining to 6.3% in 2018.

Record of Asian structural reform

Asia demonstrated its resilience after the global financial crisis. Data show that, relative to the rest of the world, the depth of the output decline in Asia was smaller by almost three percentage points. This durability is based on the region's response to the 1997 Asian financial crisis, which led to the key reforms that defined Asian economies in the 2000s.

With a mindset that macroeconomic policies, including strong financial and external positions, are equally important to sustain economic resilience, policy-makers in Asia adopted a more proactive and rigorous approach to banking supervision. Macroprudential policies became staples of Asian central banks in addressing emerging systemic risks in the financial sector. In the light of more flexible exchange rates, many Asian central banks accumulated foreign reserves as buffers against a sudden reversal of capital flows.

These reforms have profited Asia, though more may be needed if the region is to deliver consistently robust growth and cope with external risks. Countries are preparing for these challenges, such as increasing US protectionism and the UK's exit from the European Union, in different ways, and levels of openness in the region vary.

For some, like the Philippines, domestic aggregate demand has been the main driver of growth. Others, like China, have moved from export-led growth towards developing service-led economies. In the meantime, trade among members of the Association of Southeast Asian Nations has been increasing. In the case of the Philippines, the Asean bloc has become the country's primary trading partner.

Avoiding the new mediocre

A disorderly reaction to projected US interest rate increases and broader uncertainty about asynchrony of monetary policies in advanced economies could lead to capital flow reversals and increased asset price volatility in emerging Asian markets. This could contribute to significant currency depreciation and inflationary pressures.

> ***"To avoid the middle income trap, countries must implement policies that effectively counter boom-bust cycles, create opportunities to take advantage of demographic trends, promote education and infrastructure, and foster greater trade integration.***

Domestic vulnerabilities or slow progress on reforms could trigger a switch in investor sentiment, leading to a tightening of domestic financial conditions. Additionally, many Asian economies are at a stage of development at which, historically, sustained rapid growth becomes difficult, otherwise known as the middle income trap.

After almost a decade of being above historical trends, the Asian Development Bank estimates potential growth in emerging Asian economies has declined by about two percentage points.

To avoid the middle income trap, countries must implement policies that effectively counter boom-bust cycles, create opportunities to take advantage of demographic trends, promote education and infrastructure, build strong governance, and foster greater trade integration.

Uncertainty in the global economy will test Asia's resilience. The region's ability to withstand shocks depends on the structural reforms and proactive policies that its leading countries effect. A misstep in this direction, and Asia may follow the path of the 'new mediocre'. ■

Amando Tetangco is Governor of the Bangko Sentral ng Pilipinas. This is an abridged version of a speech given at the OMFIF Third Annual Asean Seminar on 3 April in Cebu, the Philippines.

Renminbi seventh of reserve currencies

Central banks cautious in building China holdings

Adam Cotter

At the end of March the International Monetary Fund reported holdings of $85bn of renminbi claims in the foreign exchange reserves of the world's central banks. This statement, covering the last quarter of 2016, was the first official IMF analysis since China's currency was included in the special drawing right, the Fund's composite currency unit.

Of the eight currencies included in the IMF's 'composition of official foreign exchange reserves', the renminbi is the seventh most widely held. The Chinese currency trails the dollar, euro, sterling, yen, the Canadian dollar, and the Australian dollar. US reserve asset supremacy remains, with the dollar accounting for 64% of reported reserves, adding up to $5.1tn. The renminbi accounts for just over 1% of the $7.9tn disclosed in a total of 146 reporting central banks and other reserves-holding entities.

The latest IMF data match the findings of an earlier, less comprehensive survey in August 2015, showing that 38 monetary authorities held renminbi assets in 2014, making up 1.1% of global holdings of 'official assets' (a wider definition than 'reserve assets'), against 27 holders (0.7% of the total) in 2013.

Renminbi's status will mature

When the IMF included the renminbi in the SDR basket from October 2016, it gave the currency a weight of 11%, or one-third the share of the euro and one-quarter of the dollar. This indicates that the Fund expects the renminbi's status as a major reserve currency to grow significantly.

Beijing promotes the international use of its currency through swap arrangements and by supporting trade settlement in renminbi. The authorities are improving foreign investors' access to Chinese capital markets. However, Chinese policy-makers must do more to allay concerns over currency manipulation, financial market transparency and rising debt levels. One problem is that there are too few renminbi-denominated liquid assets for reserve managers to own.

Asian monetary authorities hold most global foreign reserves. Capital preservation and liquidity are the priority. China's size implies reserve managers should hold around 20% of their liquidity in renminbi in due course. Such an allocation implies that central banks should own a similar share of China's $9tn bond market. While Chinese policy-makers have tried to attract foreign reserve managers, central banks have yet to invest meaningfully in Chinese bonds.

Internationalisation remains an aspiration

The use of the renminbi in global trade has diminished. In December, it accounted for 1.7% of payments, down from 2.3% a year earlier, according to the Society for Worldwide Interbank Financial Telecommunication. Over the whole of 2016, the value of payments made in renminbi fell by almost one-third.

Both Yi Gang, deputy governor of the People's Bank of China, and Pan Gongsheng, director of the State Administration of Foreign Exchange, have indicated that keeping the renminbi stable is a priority.

Internationalisation of the currency remains a long-term aspiration. But in the short term, demand for Chinese assets will not be able to offset the pressure for capital outflows. A continuing government clampdown on corruption by politicians and other public officials, in addition to renminbi uncertainty, is discouraging investment into China.

> ***"Chinese policy-makers must do more to allay concerns over currency manipulation, financial market transparency, and rising debt levels.***

The $7tn equity market may provide additional depth, but central banks will continue to act cautiously. In March the MSCI opted against wider inclusion of Chinese A shares into its emerging market benchmark. In the long term, full inclusion in the MSCI and FTSE benchmarks could lead to more than $600bn in equity inflows.

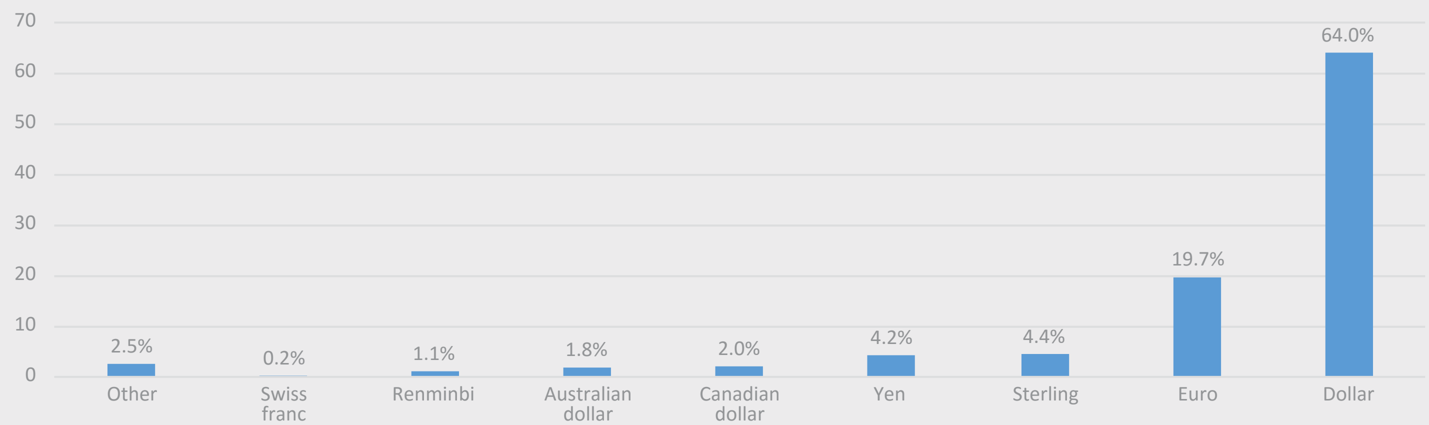
Though China faces several tests on its path towards market liberalisation, the renminbi's global status as an international reserve currency can only improve from this humble start. ■

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

RENMINBI LIAISON NETWORK

Renminbi's place in global currency reserves disproportionate to China's economic clout

Currency composition of world foreign exchange reserves, %, end-December 2016



Source: International Monetary Fund COFER, OMFIF analysis

Pulling sub-Saharan Africa out of poverty

World's poorest region needs more government intervention

John Anyanwu, African Development Bank

The first of the United Nations' Sustainable Development Goals aims to end poverty everywhere by 2030. This builds on the ambition of the Millennium Development Goals in cutting extreme poverty to half its 1990 level by 2015. The only region in which the 50% reduction was not achieved was sub-Saharan Africa.

Based on the updated poverty line of $1.90 a day (revised in 2015 from $1.25 by the World Bank), sub-Saharan Africa continues to lag behind. It is the only region where the number of people living under the poverty line has been rising steadily since 1990.

By contrast, estimates indicate that 71m people in the Asia Pacific region, or 3.5% of the region's population, were living on less than $1.90 a day in 2013, down from 966m (60.2%) in 1990. In sub-Saharan Africa, although the percentage living in poverty declined to 41% in 2013 from 54.3% in 1990, the overall number of affected people increased to 389m from 276m. In 2013, the extreme poor in sub-Saharan Africa accounted for more than half of the world's 767m total living in that state. In 1990, sub-Saharan Africa accounted for only 15% of the total.

The sub-Saharan poverty gap, a measure of how far, on average, the poor are below the poverty line, has been the highest of any region every year since 1990. The gap peaked at 27% in 1993 before declining to 16% in 2013. This compares with 3.4% for the Asia Pacific region.

High and persistent poverty

Sub-Saharan Africa's poverty is the most severe in the world. This is defined by the proportion of families that are the 'poorest of the poor' of all the global regions. This peaked at 16% in 1993 before declining to 8.4% in 2013. Further analysis shows that poverty was high and persistent in all the sub-regions over that period. In central Africa an average of 54.3% of the population was living below the poverty line; in southern Africa the figure was around 50%; in east Africa 49.5%; and in west Africa 45%.

However, regional and sub-regional averages mask country differences. The Democratic Republic of Congo tops the list of the poorest countries in sub-Saharan Africa with 84.2% of its people living in extreme poverty. The DRC is followed by Burundi (81%), Mozambique (78.2%), the Central African Republic (71.8%), and Niger (71.4%).

The main causes of the region's persistent poverty are high income inequality, countries' dependence on oil revenue, the high prevalence of HIV among young women, and seemingly interminable civil wars.

Poverty reduction is brought about by higher levels of economic development, increased government expenditure, greater development assistance and aid, urbanisation, and access to clean water. In understanding this, policy-makers should implement poverty reduction measures such as welfare programmes based on conditional cash transfers, guaranteed employment schemes, and labour market training.

Poverty can also be alleviated by investing in health, nutrition and education, and through land and property rights reforms that benefit rural dwellers, particularly women.

> ***"Policy-makers should implement poverty reduction measures such as welfare programmes based on conditional cash transfers, guaranteed employment schemes, and labour market training.***

Countries in sub-Saharan Africa must increase their national incomes. This can be achieved through macroeconomic and structural reforms that improve their competitiveness and create more and better jobs. This would increase participation in economic activity, remove blocks to private and public investment, boost funding for infrastructure, and give rise to better productivity.

Agricultural productivity could be improved by creating incentives and opportunities for the private sector, and giving smallholders more government support in terms of finance, formalisation of land ownership, and technical advice.

More government action is necessary

The solution to poverty is not less government intervention but more. Governments could reduce poverty by spending on public services, conditional cash transfer programmes, safety nets, targeted subsidies and public works. In this way, incomes, goods and services can be transferred to vulnerable citizens.

Since oil rents increase inequality, and therefore exacerbate poverty, international financial institutions such as the African Development Bank have to help countries acquire the capacity for the effective management of oil rents and other related revenues. Encouraging diversification from dependence on oil and other natural resources is vital.

As part of their poverty reduction strategies, sub-Saharan countries need to increase urban investment. They must clarify property rights and strengthen urban planning, as well as invest in building and infrastructure. Such measures will help to build dense, connected, and efficient cities, and further reduce poverty.

HIV should be another target of policy-makers. Research shows that high HIV prevalence increases poverty, and more should be spent on antiretroviral therapy programmes, which, although expensive, are cost effective.

Sub-Saharan countries must also implement policies to promote peace and stability, and reduce the incidence of civil wars. At the same time, they need to strengthen democratic governance, and root out corruption.

These measures are essential to achieve countries' sustainable development goals for eliminating poverty. Encouraging democratic political involvement helps to ensure the implementation of policies that lead to productive economies and healthy societies. ■

John Anyanwu is Lead Research Economist in the Macroeconomic Policy, Forecasting & Research Department at the African Development Bank.

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Loyalty and scepticism in Whitehall

A vivid memoir on the minutiae of British government

William Keegan, Advisory Council

The title of Sir Brian Unwin's fascinating memoir, *With Respect, Minister: A View from Inside Whitehall*, is a play on the famous BBC television series *Yes, Minister*. The show's theme was the way that, while nominally in charge, the minister, Jim Hacker, was continually outwitted by his senior civil service official Sir Humphrey Appleby.

Most British prime ministers and chancellors publish memoirs, but books by former Treasury officials are rare. The most memorable in recent years is *Decline to Fall* by the late Sir Douglas Wass, on the 1976 sterling crisis when Britain was forced, in humiliating circumstances, to borrow from the International Monetary Fund.

Denis Healey, chancellor at the time, complained in his memoirs that if only the Treasury's economic forecasts had not been so bad, recourse to the IMF could have been avoided. Wass, then senior Treasury civil servant, took issue with Healey's view. Unwin, one of the officials attempting to control soaring public expenditure at the time, endorses Wass' opinion.

When Wass died earlier this year, some obituarists maintained that he had been a model for the fictional Appleby. But junior officials who worked for Wass at the time disputed this, arguing that he was not at all manipulative, but the model of a civil servant: one who gives the best advice but accepts that ministers decide, and who understands the duty of the civil service to implement these decisions to the best of their ability, whatever they personally believe.

Unwin makes clear in these illuminating memoirs that he backs the Wass school of thought. Yet the phrase 'with respect, minister' is a neat way of capturing the scepticism sometimes felt by civil servants.

The peaks of Whitehall

Unwin's route to the Treasury and Cabinet Office was via the old Commonwealth Relations Office. During his colonial phase Unwin was close to the scene when Dag Hammarskjöld, United Nations secretary-general, was killed in a plane crash in 1961. Hammarskjöld was due to attend secret peace talks with Moise Tshombe, president of the province of Katanga, which had broken away from the Belgian Congo. Conspiracy theories about the crash have raged ever since, but Unwin is convinced the crash was due to pilot error, not foul play.

> ***"Unwin saw it as the ultimate compliment when Jacques Delors, European Commission president, criticised him for being* trop dynamique.**

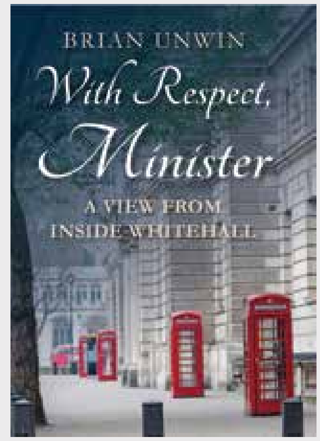
On a lighter note, he tells another story from his days in west Africa about presenting a gift of books to the Ghana Gliding School and how the director – 'an attractive, blue-eyed, silver-blonde female in her 50s' – offered to take him on a flight.

'It was only later that I learned (I had inexplicably not been briefed beforehand) that she was Hanna Reitsch, the celebrated Luftwaffe ace and test pilot and Hitler's personal pilot,' writes Unwin.

From there on Unwin's gliding is confined to the government departmental peaks of Whitehall, and finally to the presidency of the European Investment Bank. The EIB finances Europe's infrastructure projects, including many in Britain, but receives precious little recognition in the UK.

'If the prime minister says…'

While in Whitehall Unwin was closely involved in one of the most prominent skirmishes Prime Minister Margaret Thatcher had with Europe over the vexed 1980s budget rebate. Here again, while himself being a passionate European, he did his civil service job in arguing for Thatcher, and pushing a hard bargain. He was hardly a 'Thatcherite', but seems to have had a good relationship with the prime minister.



He admits, however, to having pushed the 'with respect, minister' approach to the limit when insisting, as a serious bird watcher, that Thatcher was wrong to claim she had heard a nightingale singing early in the year. Overhearing Unwin's alternative view of nightingales in January, the cabinet secretary took him aside and said: 'A word of advice, Brian. If the prime minister says she heard a nightingale outside No.10 [Downing Street] last night, she heard a nightingale.'

Unwin's natural enthusiasm rings through. He saw it as the ultimate compliment when Jacques Delors, European Commission president, criticised him for being *trop dynamique*. Apart from some great stories, this memoir gives a vivid insider account of how the minutiae of British government work.

Loyal civil servants must sometimes bite their tongues. They may believe in the concept of public service, but Unwin and colleagues were understandably shocked when Sir Geoffrey Howe, chancellor between 1979-83, asked: 'Why some of us were still working in the Treasury and not out there in the City earning much higher salaries.' With respect, minister… ■

William Keegan is Senior Economics Commentator for The Observer.

Trump expected to avoid impeachment

Two thirds of advisers believe US president will serve full term

This month's advisers network poll focuses on Donald Trump's future as US president after his first 100 days in office. Members of the advisers network were asked, 'Will Donald Trump be impeached before his presidential term ends?' The options included impeachment in the first half of his term, in the second half, or no impeachment.

The Trump-Russia scandal has already cast a shadow over the new administration. Some commentators believe that Trump now faces the more viable threat of impeachment through his failures to divest his businesses and alleged violations of rules governing emoluments and gifts.

Of those polled, 69% believe he will not be impeached, 26% expect an impeachment in the second half of his presidency, while only 5% forecast an impeachment in the first half of his presidency. A popular alternative among advisers is for a Richard Nixon-style resignation before any formal charges are brought against the president.

Trump's adversarial nature when dealing with Congress, proclivity for overriding legislated regulations, and habit of challenging judges are expected to slow any possible impeachment process.

'The unhappy memory of the last impeachment, that of Bill Clinton in 1998, will temper the political establishment into seeking other ways to hold Trump to account.'
David Smith, formerly United Nations

'I do not think he will be impeached, but I do think that he will resign sometime in the second term for 'medical reasons'. Pressures will build up for impeachment, but he will not stay on until formal hearings start.'
Hans Genberg, The Seacen Centre

'He is a one-term president already, so why bother with such a time-consuming, complex and politically divisive initiative unless something really criminal emerges, in which case he would rather quit than be humiliated.'
Stewart Fleming, St Antony's College, University of Oxford

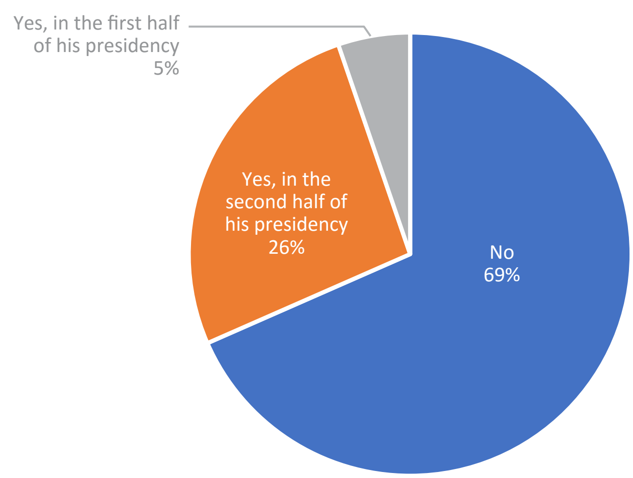
'The system of checks and balances in the US works so well that Trump's policies will change quickly and no impeachment will be necessary.'
José Roberto Novaes de Almeida, University of Brasilia

'If ever the term "low crimes and misdemeanours" was invented for a man, it is surely for Trump. Like Richard Nixon, he will give an order and do something without realising it is an impeachable offence. It may have to wait until after the mid-term elections when more people who are not so beholden to Trump or frightened of his political machine will be elected to Congress.'
Denis MacShane, Avisa Partners

'I would say that Trump will not be impeached before his presidential term ends because, despite his impetuous one-liners, he has a full Republican Congress and very sound advisers, including the top military. He is quite cautious in his actual policy decisions because of the above and is learning quickly the complexities faced by a US president.'
Jack Wigglesworth, formerly LIFFE

These statements were received as part of the April poll, conducted between 5-25 April, with responses from 38 advisory network members.

Majority expects Trump to escape impeachment
Percentage of responses



Will Donald Trump be impeached before his presidential term ends?

Source: OMFIF analysis

'It is wishful thinking by political commentators to believe impeachment is probable. Both the House of Representatives and Senate are in Republican party hands and will remain so, absent a huge unexpected swing in 2018. Republicans will not abandon their president. Rather than becoming more extreme, and thus more prone to turmoil, the Trump administration is moving in a more mainstream direction as reality bites and political constraints take effect. This increases the likelihood he will serve a full term and run for a second.'
Stuart Mackintosh, Group of Thirty

June's question

- **What is your judgement on Theresa May's call for elections?**
- **What are your expectations for the UK election outcome?**
- **What will be the outcome of the French parliamentary elections?**
- **Will France manage to make up the economic lag with Germany in the next five years?**