



Abe relies on BoJ arm-twisting

Growth plans aimed at securing power in upper house

Shumpei Takemori, Advisory Board

Shinzo Abe, the new Japanese prime minister, is relying on Bank of Japan (BoJ) arm-twisting and big public spending measures amounting to ¥11tn to provide sufficient momentum to win crucial elections in the upper house of the Japanese parliament this summer.

Following victory for his Liberal Democratic Party (LDP) in December's lower house elections, Abe needs to secure a majority in the upper house, too, to prevent politics becoming utterly dysfunctional – the painful experience he had as prime minister in 2006. Victory in the upper house election, which

would be the last major poll for three years, would enable the prime minister to pursue pet projects like rewriting the Japanese constitution.

Abe has little substance to offer. His growth strategy was patched together at the last minute before the December election. He appears confident of the success of his magic formula: pressure on the Bank of Japan governor to raise its inflation target and print more money. These short-term measures will have long-term effects, notably by determining whether or not the government can increase the consumption tax rate from 5% to 8%

as planned in December. Enacting the measure depends on Japan's economic condition in the second quarter of 2013. In the event of a major slump, the Government would probably decide to withdraw the tax increase.

Since 2005, the life expectancy of a Japanese prime minister has been less than a year. The 'pro-growth' LDP in fact has a miserable record. For 18 years when it was in power, from 1990 to 2007, Japan's average nominal growth was a mere 0.8%. (In real terms, growth was slightly over 1%, because Japan has been plagued by deflation.)

(continued on page 12 ...)

OMFIF launches Year of the Luso-Economy and Focus on Renminbi in 2013

OMFIF is launching the Year of the Luso-Economy in 2013 to recognise the importance of the nine Portuguese-speaking nations in Europe, Latin America, Africa and Asia for world development and finance. One of the highlights will be a large roundtable meeting in Brasilia jointly hosted by Banco Central do Brasil and OMFIF on 17-18 June. OMFIF is also intensifying its focus on the internationalisation of the renminbi.

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Euro misery

Brilliant ECB proposal

Meghnad Desai, Advisory Board

The euro area came near to breaking up in 2012 or at least ejecting Greece. Various dire threats were issued; elections were held which threatened the worst. In the end misery was given renewed support. It is likely to be endless.

Greece will take the poisoned chalice and drink it. A whole generation of Greek youth will have their lives blighted. Among a large number of largely toothless institutions, the European Central Bank (ECB) is the only one showing decisiveness. Its proposal of bailing out countries if they asked for help was a brilliant confidence trick.

No country would be likely to ask for such help as it would indicate to the markets that bankruptcy was imminent. Markets would act faster than the ECB and hence no country has made an application. Yet the expectation that they may do so has buoyed markets.

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Letter from the chairman



At different speeds Western qualms, eastern confidence

David Marsh, Chairman

As OMFIF enters its fourth year, the world seems to be moving at different speeds, in different directions. In the west, partly because of the First World War, the superstitious see a '13' in a year as denoting ill-fortune. No such qualms are felt in relatively confident Asia or the Islamic world. The US and Europe remain beset by clouds of anxiety, whether contemplating (although temporarily rescued from) the fiscal cliff or weighed down by the contradictions of the euro.

OMFIF is using this period of world transition to launch two initiatives for 2013: the Year of the Luso-Economy, highlighting links between nine Portuguese-speaking nations, and Focus on Renminbi, pinpointing the way in which the Chinese currency is gradually attaining international status.

Japan is a half-way house. In its long efforts to shake off the yoke of deflation, the country is a negative role model for east and west. Shumpei Takemori caustically describes the political and economic challenges facing new/old prime minister Shinzo Abe, saying the growth plan hastily assembled by his Liberal Democratic Party possesses little substance. Meghnad Desai surveys a year in which the euro has survived, damaged but intact, and declares that the European Central Bank, a 'class central bank', has pulled off 'a brilliant confidence trick' with its proposal to buy unlimited quantities of weak countries' bonds.

Europe takes up a lot of space. The Bundesbank's Kirsten Lommatsch looks at undoubted progress in rebalancing the European economy by the peripheral euro members. She says there are strong reasons to believe, because of structural changes (and income losses), current account deficit reductions in these countries may be sustainable.

Showing OMFIF's diversity of view, three advisory board members, Ruud Lubbers and Paul van Seters from the Netherlands and Christopher Tugendhat from the UK, draw opposite conclusions from the results of the December EU summit. Our latest trawl through financial archives uncovers some remarkable joint traits displayed by Bundesbank president Jens Weidmann and his predecessor-but-two Hans Tietmeyer.

On the renminbi front, Kelvin Lau and Stephen Green explain Standard Chartered's new index for measuring the Chinese currency's internationalisation. Gary Smith of BNP Paribas outlines the historic nature of the reserve currency diversification that seems likely in coming years. Again with an eye on Asia, advisory board member Moorad Choudhry describes how Asian banks have few difficulties with the Basel III restrictions and opines how the real banking problem is becoming not deficient but excess liquidity.

Gabriel Stein takes a contrarian look at the unforeseen consequences of the ultra-low interest rates seen in most of the western world and forecasts trouble ahead when easing comes to an end. In this vein, Darrell Delamaide surveys the US Federal Reserve's position after announcement of an unemployment target for interest rates – and describes how, despite the increasingly dovish nature of the FOMC, Ben Bernanke is not taking support for monetary easing for granted.

Michael Lafferty comments on latest UK proposals for an 'electrified' ring-fence for banks. Michael Kaimakliotis sets down his 10 predictions for 2013. Brian Quinn examines the tricky monetary and financial problems facing any future independent Scottish government. Frederick Hopson recounts an exchange on economics and banking in a slick London club. William Keegan looks at who will be living dangerously in 2013, ranging from George Osborne to Mario Draghi. You may need my best wishes for a Happy New Year. ☐

David Marsh



Euro adjustment progress

Permanent income decline in crisis countries

Kirsten Lommatzsch, Deutsche Bundesbank

Across the so-called 'peripheral' countries of the euro area, external rebalancing, measured by reduction of current account deficits, has made substantial progress in the past two years. The improvements in current accounts reflect strong adjustments in the balance of goods and services. In the first half of 2012, the current account was nearly balanced in Spain (an improvement of nearly 7 percentage points from the first half of 2008), and declined to only 1% of GDP (an improvement of 9 percentage points) in Portugal.

The surplus in the Irish balance of goods and services exceeded that of the corresponding period in 2008 by about 15 percentage points. The Greek current account deficit declined by about 10 percentage points. Greece was the sole country in the periphery – the above-named countries plus Italy – where changes in the income balance (related to debt restructuring in early 2012) made a substantial contribution to reducing the deficit.

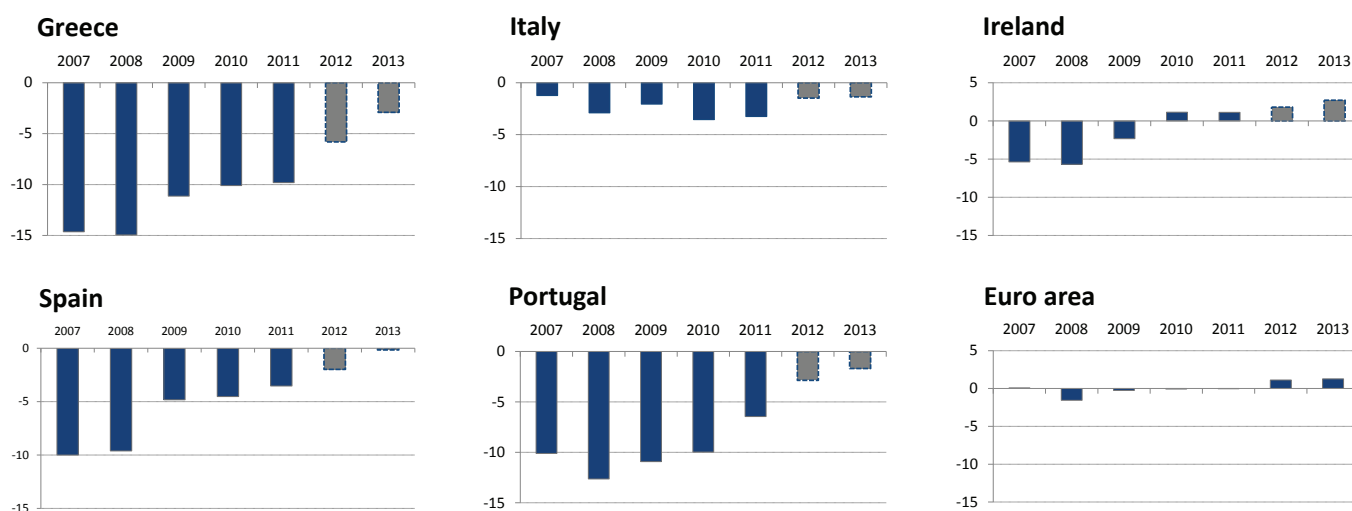
It is frequently questioned whether these developments can be considered sustainable, i.e. whether they reflect durable corrections of supply and demand. Indeed, the reductions in current account imbalances have been accompanied by strong declines in domestic demand and imports. As a result, fears have been expressed that adjustments may have been driven mainly by cyclical weakness. This would imply that imbalances would resume once the recovery is underway. For the correction to be lasting, price competitiveness has to improve and trend growth has to rise through sectoral rebalancing towards sectors with higher productivity growth.

Indeed, domestic demand has shrunk massively in euro area peripheral countries (by nearly 26% in Greece, 22% in Ireland, 14% in Portugal, 13% in Spain and 9% in Italy between 2008 Q2 and 2012 Q2). However, this decline can only partly be regarded as cyclical. First, pre-crisis demand growth was often driven by vigorous bank lending and loose financing conditions, which are unlikely to reappear in the medium term.

Second, government transfers have been cut as part of the reforms of social welfare systems, including pension systems or unemployment benefit schemes. Increases in direct and indirect taxes, charges and administered prices will damp domestic demand over the medium to long term.

Greece was the sole country in the periphery where changes in the income balance (related to debt restructuring in early 2012) made a substantial contribution to reducing the deficit.

Current account balances as percentage of GDP



Source: IMF 2012 and 2013 forecast figures from the World Economic Outlook, October 2012.
Deutsche Bundesbank

Labour income growth has been subdued in recent quarters, while structural unemployment rates have risen. As a result, the decline in real disposable incomes in all crisis countries has to a large extent been permanent. At the same time, there have been undoubted structural improvements on the supply side. One indicator of this is the robust export performance in some of the crisis countries. In the second quarter of 2012, real exports of goods and services exceeded their pre-crisis levels by nearly 10% in Ireland, 7% in Spain and around 6% in Portugal. Admittedly, the depreciation of the euro has helped improve price competitiveness and may have stimulated exports.

However, firms have also increased efforts to expand their export activities and to tap new markets. Real exchange rates based on unit labour costs signal sizeable gains in cost competitiveness. Compared with the second quarter of 2008, the unit labour cost-deflated real exchange rate has depreciated by 21% in Ireland, 11% in Spain, 6% in Portugal, and 11% in Greece. In all these countries, real exchange rates, computed in this way, are close to or even below the level of the first quarter of 1999. (Real exchange rates based on consumer prices or GDP deflators are distorted by numerous increases in indirect taxes and administered prices, which affect only domestic sales prices. That explains why these indicators often do not show any improvement in price competitiveness relative to the euro area partners.)

To some extent, these improvements in labour cost competitiveness stem from declines in average compensation per employee. Equally important (in some countries even more important) are productivity gains, often related to labour shedding. These gains can be attributed to the fact that, in a cyclical slump, less profitable (and most probably less productive) firms across the economy are forced to withdraw from the market.

In addition, employment has been cut in industries that benefited most from vigorous, credit-driven demand, which made even the employment of rather unproductive workers profitable in the short term. The contraction of some sectors, and the corresponding increase in average labour productivity, thus represent part of the sectoral rebalancing process. In the future it can be expected that this will lead to employment growth in other, more productive sectors. Recent wage moderation can be helpful, as it will not only allow growth to be more labour-intensive but also make new investment in fixed and human capital profitable, which is indispensable for a return to higher trend growth rates.

Rebalancing can be observed, too, in Germany. Admittedly, the current account surplus in 2012 will have risen again on the year. In the first half of 2012, Germany's current account surplus stood at 6% of GDP (nearly 1 percentage point above the corresponding period last year). However, this increase is entirely due to trade outside the euro area. The current account surplus with the rest of the euro area was 2.25% of German GDP, 2.5 percentage points lower than in 2008. Germany's surplus on the balance of goods and services vis-à-vis the five peripheral countries dropped to 0.25% of GDP. At the same time, the surplus in transactions outside the euro area rose by 1.5 percentage points of GDP since the first half of 2008, owing in particular to trade with North America and China.

To some extent, this reflects the effect of the weaker euro. However, it is also due to the composition of German exports. A comparison of the range of Chinese imports with exports supplied by Germany, France, Italy and Spain shows that German exports match Chinese demand better than those of the other countries.* However, other euro members, including Spain and Portugal, have also seen their exports to China grow quite vigorously in the past few years, albeit from a rather low level.

As a result, although Germany's current account surplus has widened recently, external rebalancing vis-à-vis its euro area partners is underway. This is reflected in recent employment growth in Germany, which has occurred mainly in the non-tradable sectors. Compared with the pre-crisis level, overall employment rose by 3% until the summer of 2012.

Whereas employment in industry was still 2% below its pre-crisis level, in both construction and public services (mainly due to healthcare) it was up by 5%, and in professional, technical and scientific services by 10%. These employment data provide further evidence that, in the substantial economic rebalancing across the euro area, Germany is playing its part. ☐

*Deutsche Bundesbank Monthly Report, July 2011.

Recent wage moderation can be helpful, as it will not only allow growth to be more labour-intensive but also make new investment in fixed and human capital profitable.



Support for bank separation When the ring-fence needs electrifying

Michael Lafferty, Deputy Chairman

Anyone hoping the Vickers proposals to ring-fence retail banking within the big UK universal banks would get watered down will be shocked by the first report of the country's Parliamentary Commission on Banking Standards.

Far from scaling back the recommendations of the Independent Commission on Banking under Sir John Vickers, the Parliamentary Commission – made up of members of both houses of parliament – calls for the Vickers proposals to be strengthened in several powerful respects. This includes so-called 'electrification' of the ring-fence by giving the regulator the reserve power to force the complete break-up of banks.

A possible 'Volcker Rule' banning proprietary trading is still under consideration at the Commission and will be dealt with in a further report in 2013 which will also look at banking standards and culture.

Andrew Tyrie, the Conservative MP who chairs the parliamentary commission, said: 'The proposals, as they stand, fall well short of what is required. Over time, the ring-fence will be tested and challenged by the banks. Politicians, too, could succumb to lobbying from banks and others, adding to pressure to put holes in the ring-fence.'

'For the ring-fence to succeed, banks need to be discouraged from gaming the rules. All history tells us they will do this unless incentivised not to. That's why we recommend electrification. The legislation needs to set out a reserve power for separation; the regulator needs to know he can use it.'

Tyrie's Commission is frequently scathing about what has been going on in British banking over the past two decades – even going so far as to talk about 'banks performing alchemy'.

The opening paragraph of the report goes to the heart of the matter. 'Public confidence in bankers and banking has been shaken to its roots. Certain conduct in wholesale markets, for example in relation to the London Interbank Offered Rate (LIBOR), has exposed a culture of culpable greed far removed from the interests of bank customers, at least among some market participants. The systematic mis-selling of a range of retail products, over a number of years, on a scale which is only now becoming apparent, has reinforced the impression of a culture across the banking sector which viewed the customer as a short-term source of revenue rather than a long-term client.'

The report adds: 'The bank failures and weaknesses in 2007 and 2008 required a massive injection of taxpayers' money, yet the bankers and bank creditors who had benefited the most in the years leading up to that crisis were seen to have suffered little, if at all, from the consequences.'

The Commission says it has received convincing evidence on the benefits for financial stability of some form of separation of universal banks. 'There is evidence to suggest that, as well as supporting financial stability and reducing the risk to the taxpayer, separation has the potential to change the culture of banks for the better and to make banks simpler and easier to monitor.' These are propositions to which the Commission says it will return in the New Year.

The report goes into considerable detail about how ring-fencing should work in practice – and begins by pointing out that while ring-fenced banks will carry out the majority of essential economic functions which need protecting, it is important to be clear that it is these functions that enjoy protection and not the bank itself or its shareholders or creditors. 'There should be no government guarantee of ring-fenced banks, nor perception of one. Neither does ring-fencing mean that risks from non-ring-fenced banks can be ignored, as such institutions will remain systemic and difficult to resolve,' it adds. ☐

'For the ring-fence to succeed, banks need to be discouraged from gaming the rules. All history tells us they will do this unless incentivised not to. That's why we recommend electrification.'



Tracking renminbi expansion

Demand for trade settlement holds key

Kelvin Lau and Stephen Green, Standard Chartered Bank



China's re-entry into the global economy was arguably the most important economic development of the past 30 years. One of the next major steps for China as it redefines its position in the world economy will be the emergence of the renminbi as a dominant currency in international trade and as a reserve currency.

Rapidly increasing use of the renminbi for trade settlement and exponential growth in the offshore renminbi market are important milestones. Standard Chartered has developed the Renminbi Globalisation Index (RGI) to measure the extent of renminbi internationalisation, helping track the ups and downs of the process. We have also introduced a comprehensive survey of local and global corporates that will help track the motives for, and next steps in, using the renminbi offshore. There is a strong appetite among survey respondents to use the renminbi market for China-related business. Ultimately, renminbi use is expected to reach a level to rival other reserve currencies.

The renminbi's move towards reserve currency status could eventually lead to a multipolar world of reserve currencies, away from the current dollar-dominated system. This would fundamentally alter the global financial system in a way not seen since the start of the Bretton Woods era in 1945. China began to accelerate its push for renminbi internationalisation in 2010. Over time, as the renminbi becomes an attractive alternative to the dollar, China will share in the benefits of reserve currency status. These include being considered a safe haven in times of global risk aversion. Additionally, a reserve currency can benefit from the famous 'exorbitant privilege', which means a currency is widely accepted as a store of value in itself because other countries use it to facilitate trade.

Historically, the country with the world's main reserve currency was usually the largest economy at the time, as well as usually the largest exporter and net creditor. China is already the world's largest trading nation and a major global creditor. However, renminbi assets may not match the depth and liquidity of the dollar capital markets for a long time. Costs and ease of transactions have historically been a major determinant of reserve currency status. However, China still has capital controls in place, even as policy-makers push for the currency's greater international use. Many would argue that full capital account convertibility is needed before the renminbi can be taken seriously as a reserve currency.

Complementing the RGI is the quarterly Offshore Renminbi Corporate Survey. The aim is to gauge the change in offshore renminbi usage over the past six months, and to measure expectations for the next six months. While the RGI tells us where things stand now, the survey gives us a forward-looking view. The more qualitative questions provide added flavour and texture, including details on the factors that would motivate respondents to increase their offshore renminbi use.

Corporates in various locations are asked whether they are (or plan to be) involved in six main areas of offshore renminbi activity: Offshore renminbi deposits; mainland renminbi trade settlement; Hong Kong renminbi foreign exchange transactions; Dim Sum bond issuance; Hong Kong renminbi loans and portfolio investments in renminbi. Top managers of companies in 16 locations were interviewed for our first survey, conducted between mid-October and early November. Respondents comprise a mix of multinationals and companies with a more local/regional focus.

The survey shows that 76% of respondents are either conducting business in at least one of the six areas of offshore renminbi activity we asked about, or may consider doing so over the next six months. Existing offshore renminbi users are more willing to expand their usage, with 48% saying they may start to use one or more of the offshore renminbi products they are not currently using in the next six months. This contrasts with only 39% for current non-users. ☐

China began to accelerate its internationalisation push in 2010. As the renminbi becomes an attractive alternative to the dollar, China will share in the benefits of reserve currency status.

Standard Chartered Renminbi Globalisation Index (RGI)

The RGI aims to measure overall growth in offshore renminbi usage. The index measures the currency's use as a store of wealth, a trade settlement currency and a means of capital raising, as well as its foreign exchange market trading volume. The RGI also helps to identify inevitable setbacks on a promising long-term uptrend.

The RGI is computed on a monthly basis, based on four market components with weights inversely proportional to their variance – (1) renminbi deposits in Hong Kong, (2) trade settlement and other international payments, (3) offshore renminbi (Dim Sum) bonds and certificates of deposit (CDs) issued, and (4) foreign exchange turnover, all from an offshore perspective and denominated in renminbi. These components are seen as representing the major areas of offshore renminbi activity by corporates, and also taken into account the availability, reliability and trackability of the data.

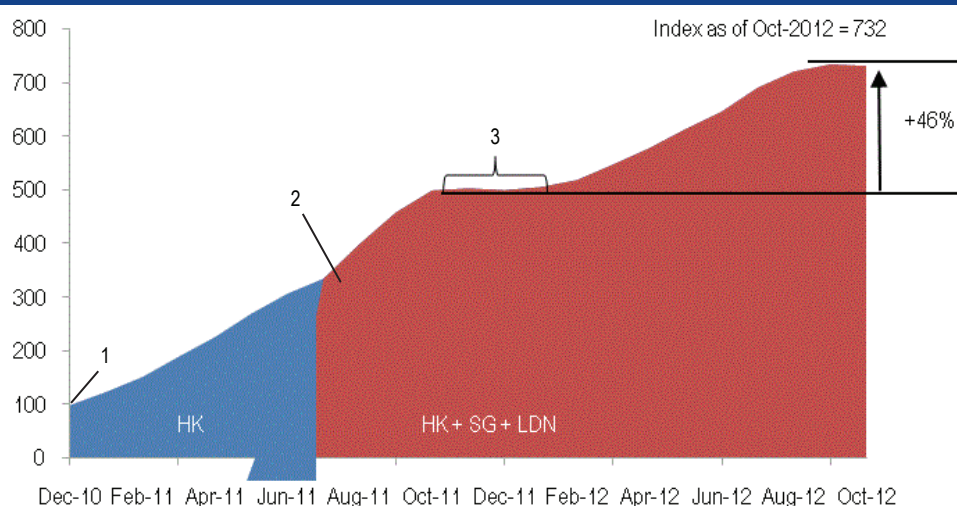
Both quantitative and qualitative thresholds are in place to determine an offshore market's eligibility for index inclusion. This adds scalability to our index as the renminbi continues to extend its global reach. Location-specific data for each component are re-used to compute a corresponding global aggregate. The index initially covered only Hong Kong; Singapore and London were added in August 2011. As other centres, such as Taipei or New York, become more significant, they will be added to the index.

The chart shows the RGI going back to December 2010, at which point a base of 100 was set. In H2-2010 the renminbi was first allowed to trade freely on a strictly offshore basis for non-trade-related purposes (which led to different onshore and offshore pricing). Offshore renminbi business could be developed freely as long as it did not involve the flow of renminbi back into mainland China (non-trade cross-border renminbi remittances are subject to quotas or case-by-case approval). The birth of Hong Kong renminbi trading incentivised corporates to switch to renminbi trade settlement, which boosted renminbi deposits and, in turn, supported Dim Sum bond issuance.

It is therefore unsurprising that, in less than two years since December 2010, the RGI has grown more than sevenfold. The pause in the uptrend in the fourth quarter of 2011 and the first quarter of 2012 reflected the setback in the Hong Kong renminbi market then. This sell-off took place in September 2011, when the global financial markets were still reeling from the escalating European sovereign debt crisis. While renminbi deposits in Hong Kong have yet to return to pre-shock levels, the recovery in the RGI has been impressive, driven by a swift rebound in all three of the other index components. As of October 2012, the index was 45% higher than its previous peak in the fourth quarter of 2011. Looking beyond deposit accumulation, there is plenty of momentum behind further Hong Kong renminbi growth.

As of October 2012, the RGI was 45% higher than its previous peak in the fourth quarter of 2011. There is plenty of momentum behind further Hong Kong renminbi growth.

Standard Chartered RGI to October 2012: up more than sevenfold since 2010



Source: Standard Chartered Research

Note 1: An index base of 100 was set for Dec-2010, initially covering Hong Kong only.

Note 2: Singapore and London became eligible markets and were added to the RGI in Aug-2010.

Note 3: Brief pauses in the RGI uptrend in Q4-2011 and Q1-2012 reflect a period of caution and market consolidation following late Q3-2011 market turbulence triggered by global risk aversion.



China share set to rise Why renminbi will become No. 3 reserve currency

Gary Smith, BNP Paribas Investment Partners

Central banks' move into the renminbi, which is likely to become the third most important reserve currency (after the dollar and the euro) within five years, is a central element of currency diversification by asset managers around the world.

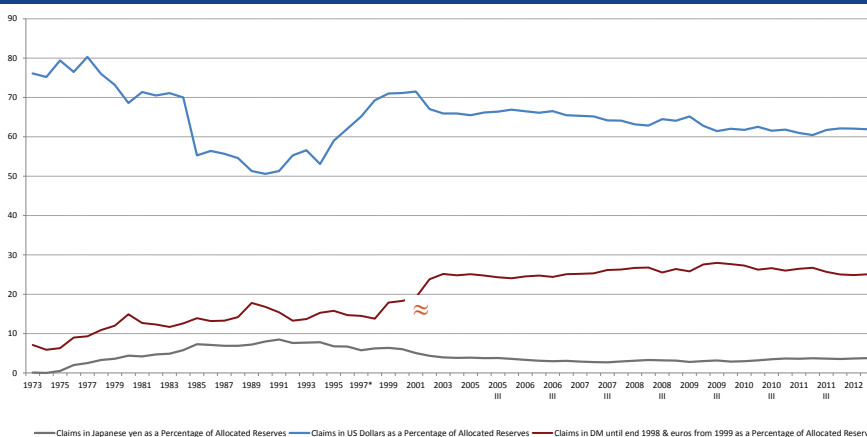
Allocations to the renminbi are currently extremely small, partly because it is not yet fully convertible, but the number of central banks interested in gaining access to the Chinese currency is large – an important factor behind the gradual emergence of a multi-currency reserve system. The diversification trend is being driven both by very low interest rates in traditional government bond markets, and, more positively, by higher interest rates and better fundamentals elsewhere.

An analysis of how central bank reserve managers have allocated their exposure among the wider reserve currencies since the collapse of the Bretton Woods system in the early 1970s might provide some guidance to the future. Although the world has never had a stable multi-reserve currency system (see OMFIF Monthly Bulletin, November 2012, p.10-13), a move towards such a system appears inevitable over the next decade. New currencies such as the renminbi will pull the world in this direction, continuing a trend under way since 1973. The current average dollar weighting in reserve portfolios is around 60%. This is not a magic number that is impervious to change, and it is also a relatively large number, which will therefore make the dollar vulnerable to changing preferences.

As Chart 1 shows, according to figures from the International Monetary Fund, the dollar's share in international reserves in 1973 (when the total was much lower than today) was almost 80%. (Some diversification out of the dollar took place with the establishment of the Special Drawing Right in the late 1960s.) The dollar's share of reserves has been quite volatile. The period of sharpest decline came in the late 1970s, a period of high US inflation and macroeconomic uncertainty. From a starting point close to zero in 1973, the yen's weight reached about 9% at the peak of the Japanese economic success story in the late 1980s, but has since fallen back to around 4%. The decline since the 1990s has reflected low interest rates on yen assets, and Japan's continuing economic and financial difficulties – relevant considerations for today.

These examples underline how economic and financial concerns, coupled with low interest rates, have been key influences on central banks' reserve asset choices. Weak growth, very low interest rates, and a possible trend towards currency devaluation may weaken demand for the dollar, euro, yen, Swiss franc, and sterling, the five standard reserve currencies listed by the IMF in its Currency Composition of Official Foreign Exchange Reserves (COFER) series.

Chart 1: Claims in dollars, yen & euros as a % of allocated central bank reserves



Source: IMF Statistics Department COFER database and International Financial Statistics, IMF, annual reports, various years; IMF, Currency Composition of Foreign Exchange Reserves Database.

Allocations to the renminbi are currently extremely small, partly because it is not yet fully convertible, but the number of central banks interested in gaining access to the Chinese currency is large.

In addition to prospects for interest rates and currency values, reserve asset allocations will be crucially influenced by private sector usage. The dollar starts with a figure of over 60%, so the US currency looks most vulnerable to a fall. The more private sector agents use a currency, the greater the need for the central banking community to hold it in foreign exchange reserves. The rapid acceleration in private sector usage of the renminbi is an important factor likely to drive future renminbi allocations. China currently settles around 10% of its trade in renminbi, compared with around 2% as recently as 2010. Use of the renminbi still has significant upside potential, and as a guide, one should note that 30% of Japanese trade is denominated in yen. Growing trade and settlement in the Chinese currency will be a potent factor influencing central bank choice of reserve currency allocation.

Arvind Subramanian, now at the Peterson Institute for International Economics, has used an economic dominance index (in his 2011 book, *Eclipse*) which can help explain past reserve currency allocations and forecast the future. His economic dominance calculation (see Chart 2) is based on three key variables – global trade, global GDP weightings, and exports of capital.

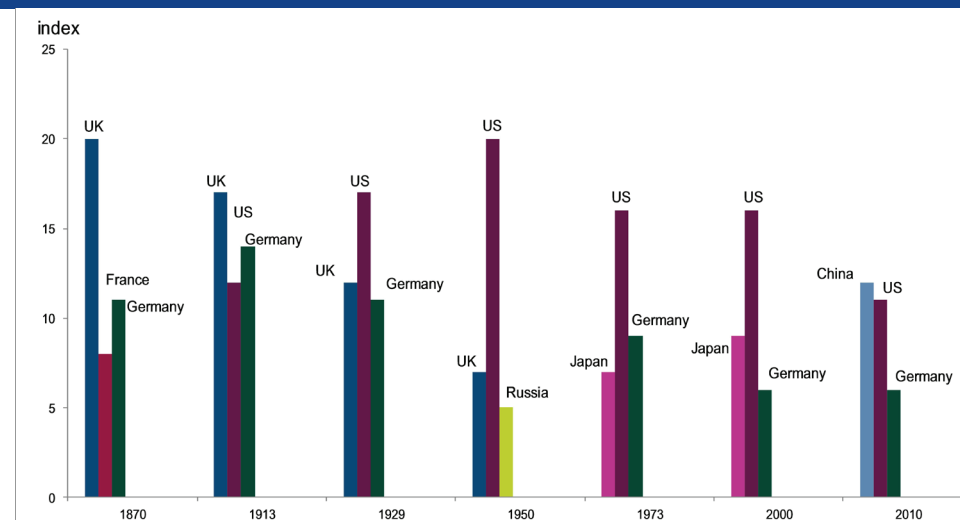
The calculation can be used to provide snapshots of relative economic dominance. In 1870, the dominance of the UK is relatively clear. By 1929 the US was the dominant economy, and by 1950 that position had been greatly extended. In 1950, Russia made an appearance. The 1973 snapshot coincided with the collapse of Bretton Woods, and the launch of a new world monetary order; at that time the dollar was the undisputed primary reserve currency. In 2000 not much had changed. But by 2010, using the Subramanian calculation, China was already the most economically dominant nation in the world.

Other factors, not simply measures of economic dominance, play a role in influencing reserve currency status. Sterling maintained its world currency role long after the UK ceased to be the world's dominant economy. How far might diversification into the renminbi extend? Despite recent moves into renminbi assets, the global allocation has probably not yet passed the 0.5% level. Reserve currency preferences are driven by many factors, but preferences change, and economic forces play a key role in this process. Other factors, such as inertia, also play a role in influencing reserve currency status, and will ensure that the dollar maintains a primary role.

Nevertheless, the world is on the verge of a significant change in preferences for reserve currency holdings. This has particular implications for the renminbi. A reserve allocation to the renminbi of close to zero, with the US dollar weight at 60% or so, does not look appropriate for today, let alone for 2015 or 2020. These relative weights may not change rapidly, but a total allocation to the renminbi of only around 5% would be sufficient to make it the world's third most important reserve currency. This looks likely to be reached in the next five years. ☐

There are reasons to believe that the world is on the verge of a significant change in preferences for reserve currency holdings. This has implications for many new currencies, but particularly for the renminbi.

Chart 2: Economic dominance index 1870-2010 for the top three countries



Source: Arvind Subramanian.

Notes: This index is a weighted average of the share of a country in world GDP, trade, and world net exports of capital. The index ranges from 0 to 100% (for creditors) but could assume negative values for net debtors. The weights for this figure are 0.6 for trade; 0.35 for GDP (split equally between GDP measured at market and purchasing power parity exchange rates, respectively); and 0.05 for net exports of capital.



Top 10 forecasts for 2013

Investors can expect further balm of easy money

Michael Kaimakliotis, Quantum Global Investment Management

Major crises have good times and bad times interspersed. 2012 was mostly good times: Until the end of February, the European Central Bank's Long Term Refinancing Operations (LTRO) saved the day. After July it was the 'Draghi put' in the form of the ECB president's promise (not yet enacted) to protect euro members bonds with ECB firepower through 'Outright Monetary Transactions'.

Everything in between now seems forgettable as investors bask in the glow of healthy returns across most asset classes.

What can we expect in 2013? I think investors will generally continue to experience benign outcomes as central banks apply the balm of easy money more forcefully. The acute phase of the euro crisis is in remission as the ECB stands ready to administer the OMT and the Chinese economy shows welcome buoyancy.

But the crisis is far from over. It is important to remember that massive debt crises can only be cured in one (or a combination) of the following ways: default, inflation, a technological boom or one or more lost decades of economic growth. Until now the acute phase of the crisis has been managed.

So we seem to be proceeding on the path towards the lost decade. But the debt overhang has worsened since 2008 with the accumulation of debt on government balance sheets outstripping declines in the private sector. That leaves the global economy highly susceptible to shocks it could otherwise withstand. So all predictions for 2013 and beyond should be seen in a context where the world has a tendency to quickly end up in bad places without the helping hands of policy-makers. Here's my top 10 list for 2013.

1. The fiscal cliff debate in the US will spark many reactions

In some ways, the last minute deal with Congress has not averted fiscal confrontation, simply postponed it. This will result in a) massive tensions within the Republican party as it tries (and eventually manages) to shift leftwards in an effort to claim the middle ground in the US political spectrum b) relief when a deal gets done c) disappointment when the US economy slows anyway.

2. Currency wars will flare up again

The Bank of Japan will emerge as a force to be reckoned with. The yen will weaken significantly. Japanese government bond futures will fall as long term interest rates rise sharply. These have been a favourite trading strategy for the past two months – and this is not likely to change.

3. It's time for 'risk on' strategies – alpha and beta

Investors realise that returns will be harder to come by in 2013 following the strong performance – in particular the massive rally in credit – in 2012. At the same derivatives markets show us that volatility levels are now low and correlations are falling. This will lead investors to a) increase portfolio risk levels and b) increase emphasis on generating alpha.

This means money will flow again to the underperforming hedge fund sector – which may finally perform since relative value and especially carry trades have a chance to flourish in such an environment. The general increase in portfolio risk levels, together with the build-up in leverage associated with the aforementioned trading strategies, will carry markets upward. But, unhappily, this will sow the seeds for an eventual decline. So investors should enjoy the going while they can.

Investors will generally continue to experience benign outcomes as central banks apply the balm of easy money more forcefully.

4. Argentina is likely to default on its debts in spring 2013

A US court may decide Argentina must choose between paying creditors that refused to accept Argentina's debt exchange offers in 2005 and 2010, and all its bondholders – or paying none of them. The ramifications are unlikely to shake financial markets. But this would weigh on fixed income investors' sentiment as they contemplate the ways in which some of their holdings are now riskier than a few years before (subordinated by the public sector and covered bonds, *pari passu* with outstanding creditors, affected by coming bail-in requirements).

With Basel III approaching and profitability lagging, banks will finally be forced to bring costs sustainably lower.

5. Central banks will reduce real interest rates

They will do this by allowing inflation to rise while keeping the lid on nominal interest rates. Central banks from the Fed to the Bank of England and the Bank of Japan are set to get more aggressive in 2013. This follows a year when balance sheets at the Fed and BoJ barely increased – while those at the ECB didn't budge after the second LTRO at the end of February. The central banks will be trying hard in 2013 to crank up the printing presses while at the same time convincing investors that there is no threat of inflation. That is the best way for them to reduce the real value of outstanding (government) debts. They may then boost the prices of risky assets and gold while preventing the appearance of the bond market vigilantes.

6. The Swiss National Bank will raise the euro/ Swiss franc floor to 1.25

An important part of the reason for the SNB's plan, announced just before Christmas, to open a new Singapore office in mid-2013 is to reinforce its operations to stop the franc from rising against the euro. Heavy purchases of foreign currency bonds, with a new emphasis now on Asian currencies, form an important part of the arsenal. With its new Singapore base the SNB will be spoiling for a fight. People may ask why it spends money opening in the Far East. But the investment will be well spent if the bank raises the floor to 1.25, boosts economic growth by 0.3 percentage points and saves jobs. SNB president Thomas Jordan will earn his praise.

7. First signs of a re-awakening of European securitisation markets

Banks have been slow to adopt the measures recommended by banking regulators to standardise contracts and improve transparency in order to relaunch the European securitisation markets which have been moribund since 2007. Why should they rush to finance themselves through securitisation when the LTRO funds are so cheap? Securitisation also would force banks to recognise losses on assets which remain marked up. So don't expect a big rebound but 2013 may see the first signs of thawing.

8. Five more global banks are likely to close major business lines

With Basel III approaching and profitability lagging, banks will finally be forced to bring costs sustainably lower. UBS was the first underperforming bank to take concrete action in 2012. There are many more underperformers which should follow UBS's lead in 2013. This will reduce overcapacity and help restore profitability at both the banks which make cuts and those which do not.

9. Corporate interest expenses will reach a turning point

Interest expenses will edge upwards as companies continue to take on extra leverage and corporate bond yields reach bottom. This will mark the beginning of a long-term trend that will weigh on corporate profit margins (and profits more generally) for the coming decade.

10. China will see further liberalisation of deposit rates

This is bad news for banks in the short term but very good news for China's depositors. China is easing the financial repression of depositors, allowing banks to compete for deposits by offering higher interest rates. This should reduce the incentive for clients to invest in the so-called 'wealth management products' offered by many banks, which direct clients' money to potentially risky investment projects. Deposit rate liberalisation will bring risks for the banks, which will see their net interest margins decline, and for the projects which have been dependent on cheap financing. But Chinese consumers, for once, should benefit. ☐

Abe relies on BoJ arm-twisting (... continued from page 1)

Abe's previous performance as prime minister, for barely one year from September 2006, was lacklustre, and he suffered a big loss in an upper house election in the middle of the LDP's term. His public spending measures may appear questionable in the face of a public debt mountain amounting to over 200% of GDP.

However, unlike other countries, Japan never experienced a capital flight even in

the middle of the crisis. Countries facing such a situation experience currency depreciation and higher interest rates caused by lack of funds. In Japan's case, the opposite has happened up to now.

Corporations have coped with the financial squeeze resulting from collapse of the previous asset bubble by withdrawing foreign assets, converting dollars into yen and causing the currency to appreciate. Japan was thus the only

country experiencing appreciation in the middle of the financial crisis.

Can things go on this way forever? Low Japanese interest rates will persist as long as the country holds sufficient foreign assets. The situation will change once foreign assets start to decline. If Japan moves into current account deficit in coming years, after already starting to run trade deficits, low Japanese interest rates will no longer be assured. ☒

OMFIF launches Year of the Luso-Economy and Focus on Renminbi in 2013 (... continued from page 1)

The growth of Asia symbolised by the rise of China, and a new solidarity between Portugal and its former colonies, are two signs of global economic transition.

In January 2013 OMFIF launches a major research report 'Gold, the renminbi and the multi-currency reserve system' commissioned by the World Gold Council, exploring the place of the Chinese currency and gold in a new worldwide monetary constellation.

The future of the renminbi will be one of the issues discussed at a joint OMFIF-CF40 China-Europe Economists' Symposium on 12 January in Beijing for a group of policy-makers and financial representatives from China, Europe and beyond.

Underlined by the articles in this Bulletin by Kelvin Lau, Stephen Green and Gary Smith, the renminbi will emerge gradually as an international currency as Beijing eases restrictions on its use in transactions and investments abroad.

The OMFIF report explores the consequences for official asset management of greater dispersion of economic power around the world. It states: 'The world is headed towards the uncharted waters of a durable multi-currency reserve system, where the dollar will share its pivotal role with a range of other currencies, including the renminbi.' The report analyses the reasons behind China's desire to see greater internationalisation of the renminbi. 'Questions over the role and

scope of the renminbi go to the heart of world politics and the international trading economy.'

OMFIF believes the rebalancing of the world economy through China's economic rise will occur gradually rather than abruptly and that setbacks and perturbations are likely along the way. 'The coming time of flux and uncertainty will be a period when reserve holders spread their investments into a relatively wide range of assets and sectors.' At a time of worldwide doubt over the riskiness of bonds issued by sovereign governments, OMFIF believes that official reserve holders will value gold's attractiveness as an asset that is independent of governments and their excessive borrowing. ☒

Euro misery (... continued from page 1)

The ECB is a 'class act' and knows a trick or two. But how long can the conjuring trick last?

In the longer run prospects are dim for the euro area. None of its structural problems is resolved. A tighter fiscal union would suit the northern countries if it did not bind them to rescue the weaker southern members. What is needed is a euro-wide tax which could be used for transfer payments. But there is no such proposal on the table.

The euro is a long-running experiment to test the validity of Hayek's proposal of a 'Denationalised Money'. Euro members have a lot of learning to do as to how to live in a renewed Gold Standard without discoveries of gold deposits in California or Australia to ease the burden of deflation. What we have instead is a

banking union which gives the ECB the right to supervise 6,000 banks in the euro area. We will see if it works.

The UK has a plan to eliminate its budget deficit over five years and it is quite clear that the recession in its neighbouring countries is delaying the recovery. Even so the UK can print its own money and has been doing so. As in the US, quantitative easing has had dubious success.

The only argument for it is the counterfactual one that without QE things would have been worse still. Emerging economies such as Brazil see this as a dumping strategy which exports the woes of the Anglo-American economies. And there is another drawback: QE delays deleveraging by giving 'zombie' firms and households

which are technically bankrupt a false hope that they will survive.

The US had a slow time for most of the year and unemployment has fallen only with the greatest reluctance. But Obama's re-election has reduced uncertainty ahead. I have always held that falling over the fiscal cliff would be a wake-up call to the smug American political establishment. It will have to get to grips with its debt burden seriously and come up with a credible long term plan.

But, with the next congressional elections only two years away, short-termism is more likely to win than statesmanship. This bolsters the narrative of America slipping down the world economic league table – unless fracking comes to the rescue. ☒



Why we must heed monetary threat

The risks of ultra-low low interest rates

Gabriel Stein, Chief Economic Adviser

In December the Reserve Bank of Australia (RBA) cut its policy interest rate, and the European Central Bank discussed following suit. Other central banks, notably the Swedish Riksbank, may cut interest rates again as well. The Fed has announced that its policy interest rate will remain low until mid-2015.

A number of questions spring to mind. Is it right to cut? Will such measures help the respective economies? And, most important, what are the risks of extending current ultra-low interest rates for a further long period? Overall, there is one all-encompassing message. Ultra-low interest rates were a necessary part of policy to combat the financial crisis. But the longer they remain in force, the less effect they have and the greater the risks they bring.

These questions are given further point by the two-way nature of the debate. The Bank of Canada has hinted strongly and repeatedly in recent months that the time is approaching for interest rates to rise. There have even been similar indications from the Bank of England.

Continued euro area weakness – in the midst of another recession from which it is unlikely to emerge until mid-2013, with the sovereign debt crisis unresolved – points to the need for further European monetary easing. Less clearly, the slowdown in the Australian economy – where policy interest rates remain high by global standards – presents arguments in the same direction. Similar arguments can be made elsewhere.

Whether lower interest rates would have a material effect is a different story. Whether the ECB's repo rate is 0.75% or 0.5% probably matters little. Whether the RBA cash rate is 3% or 2% arguably has a greater effect – highlighting the diminishing impact of policy interest rates near the zero-bound.

As well as these shorter-term issues, we must consider the longer term. The current monetary policy debate seems to be dominated by two propositions. First, we can and must return to the growth rates of the mid-2000s. Secondly, the (only) means to achieve this is to keep monetary policy loose, since fiscal policy has to be tight. (This is, of course, a generalisation. There is no dearth of people arguing for looser fiscal policies; but very few seem to be arguing in favour of tighter monetary policy anywhere.)

Leaving aside the issue of whether the growth rates of the mid-2000s are attainable, only relatively few policy-makers seem to consider the effect of keeping interest rates low – possibly too low – for too long. Yet it is clear that there are effects and that these can be quite serious.

Standard economic theory on this goes back at least to Knut Wicksell, a leading economist of the Stockholm school. If (to use Wicksell's terminology) the 'market' rate of interest (the rate at which banks lend to non-banks) is lower than the 'natural' rate of interest (the rate at which savings and investment equalise), there is a misallocation of resources. The artificially low threshold for investments will ultimately lead to a money and credit boom and then to inflation.

However, this stance may need to be modified in view of current circumstances. We are still in the midst or – at best – the aftermath of a money- and credit-induced boom and bust. While politicians are eager for banks to lend, banks are generally unwilling to comply; and while companies may be happy to take advantage of low interest rates, households are still trying to deleverage in most advanced economies. Hence an inflationary credit boom is, for the time being, highly unlikely.

In looking at the effects of ultra-low interest rates, it is initially helpful to distinguish between three sectors: government, corporate and household.

Whether the ECB's repo rate is 0.75% or 0.5% probably matters little.

Whether the RBA cash rate is 3% or 2% arguably has a greater effect – highlighting the diminishing impact of policy interest rates near the zero-bound.

In terms of government, while low interest rates make it easier to finance today's deficits – and therefore make the future debt burden easier to carry – the risk is that governments feel that they can relax structural reforms. Low interest rates are supposed to buy governments time; but there is an inherent temptation to use the time to postpone unpopular spending cuts and/or tax hikes. (All spending cuts and tax hikes can safely be assumed to be unpopular with someone, certainly with most politicians.) A further attraction is for governments to issue debt at the shorter end of the yield curve, where interest rates are likely to be the lowest.

The lure of this option increased in the euro area when the ECB announced in September that its so-called Outright Monetary Transactions programme (if implemented) would be concentrated on short-term bonds. Shortening debt duration brings its own problems if and when interest rates eventually rise, above all, through a rapid acceleration in interest rate costs and a sharp drop in the market value of bonds held on banks' (and asset managers') books.

For the corporate sector, the situation is somewhat more complex. Low interest rates lower the threshold for necessary returns on investment, and so in theory boost corporate capital expenditure. However, if the interest rate is artificially low, the danger of malinvestment – misallocation of resources – rises. In the longer term, this can reduce the economy's long-term trend growth rate.

A report from the Federal Reserve Bank of Dallas* notes that low rates further impede the reallocation from less to more productive use of capital as banks – unwilling to acknowledge losses on loans – extend further credit to 'zombie' companies. Low interest rates therefore have the effect of encouraging not only imprudent borrowing – but also imprudent lending. This trend was particularly noticeable in Japan in the 1990s and early 2000s.

The current world combination of low market interest rates and banks unwilling to lend introduces a further issue. Companies are making greater use of markets, and less of banks, when it comes to raising money. That is not necessarily bad. But it means that corporate borrowing has no effect in boosting money supply growth at a time when its weakness is of substantial concern. This is heightened by the pressure on banks to increase their capital/asset ratios, which has a direct contractionary effect on the stock of broad money.

The worries about the effect of ultra-low interest rates on governments and companies are serious. But it is in the third area, the household sector, where the repercussions are likely to be the most paradoxical and harmful. Certainly, low interest rates help households deleverage, at least where their borrowing is at variable interest rates. But, once again, this encourages excessive borrowing, the more so if it is felt that current interest rate levels will remain for the foreseeable future. This is particularly acute in countries such as Sweden and the UK where no-amortisation loans are fairly common.

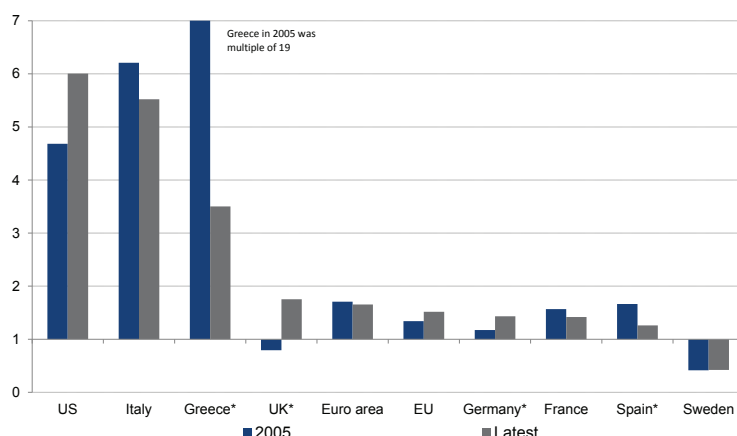
But this is only part of the risk. Another is that low interest rates, rather than stimulating greater household consumption, may have the opposite effect, namely leading to higher savings. This could happen for one of three reasons: First, if households take advantage of low interest rates to accelerate their deleveraging process, not least if they do not believe that interest rates will remain low for ever. Second, if repeated government and central bank action to ensure continued ultra-low interest rates gives the impression of panic and that the economy is in fact in a worse state than is generally perceived ('What do they know that we do not?'), causing households to increase their savings as a precautionary measure.

Third and possibly most likely, if households, rather than aiming to save a certain percentage of their income, aim at achieving either a certain amount of savings, or an amount of savings that – presumably in retirement – will provide a certain annual revenue. In spite of the rise in household debt before the crisis and low interest rates, households in most countries still have higher interest revenues than expenditures, Sweden being a significant exception. In spite of interest rates having fallen sharply since the Great Recession began, interest income has remained stable relative to interest expenditure or even risen in some European countries, e.g. the UK and Germany, indicating an increase in savings. (See chart on p.15).

While low interest rates make it easier to finance today's deficits – and therefore make the future debt burden easier to carry – the risk is that governments feel that they can relax structural reforms.

*William R White, *Ultra-Easy Monetary Policy and the Law of Unintended Consequences*, Federal Reserve Bank of Dallas Working Paper No 126, August 2012, <http://www.dallasfed.org/assets/documents/institute/wpapers/2012/0126.pdf>

Household interest income relative to household interest expenditure ('Latest' is 2011, unless marked * in which case it is 2010)



Sources: Eurostat (EU members); Bureau of Economic Analysis NIPA tables (US)

The risk that lower interest rates spur increased household saving rather than spending is compounded by another factor. This is that it will be more difficult for any entity with long-term fixed liabilities – such as insurance companies, pension funds or companies with commitments to paying defined benefit pensions – to achieve the returns necessary to fulfil their commitments.

Low interest rates reduce their revenues and increase the net present value of future liabilities. If households become aware of this threat to their pensions, there is a possibility that they will respond by ramping up their own savings even more.

There are other possible serious repercussions. One risk is that insurance companies, pension funds et al will be driven to riskier investments to compensate for the low returns on safer investments, a danger highlighted by the UK Financial Services Authority in late October 2012 – the same day that the Financial Times reported a resurgence in the issuance of CLOs (collateralised lending obligations) in the US market with the same background.

A further question is whether low interest rates really do boost asset values. The evidence from the repeated quantitative easing announcements in the US and the UK, or from the ECB's various measures in the euro area, implies that the euphoria period gets shorter and shorter, and US mortgage rates have begun to rise again.

Even if asset prices stay higher, do higher asset prices really have the intended effect on spurring household spending? Economic theory assumes they do; but once again, the experience of the last few years means that the wealth effect may be lower than in the past. Unfortunately, this is only conjecture. We will not be able to truly measure this for some years.

As well as the problems highlighted by these sectoral issues, there are also considerations for the economy as a whole. The current policy, however justified as a temporary measure, clearly favours debtors over creditors. Bearing in mind that the crisis was caused by excess debt – although this in turn was induced by excess savings elsewhere – it is doubtful if this is the ideal message to send. Furthermore, the longer present circumstances persist, the stronger the constituency in favour of maintaining interest rates at ultra-low levels is likely to become, making an exit more difficult.

All this assumes that current interest rate levels are indeed abnormally low. If so, interest rates will at some stage return to 'normal' (whatever that means) – and we will see the mother of all bond bear markets. However, this is what many people believed for years would happen in Japan. In the process, they lost a lot of money shorting Japanese government bonds. If current interest rate levels are instead the 'new normal' – in other words, if Europe and the US are the new Japan, with trend growth around 1% and deflation threatening – then we could be stuck with these rates for many years to come. This is unlikely, and will be covered in a future article. But, if it were so, we would face a further string of challenges that would further add to the unhealthy distortions and hidden pitfalls building up in our economies. ☒

If current interest rate levels are indeed abnormally low, interest rates will at some stage return to 'normal' (whatever that means) – and we will see the mother of all bond bear markets.



Paradoxical consequences of Basel III

When too much liquidity can harm economies

Moorad Choudhry, Advisory Board

The transatlantic financial crisis, and the almost universal focus in its wake for banks to hold excess liquidity, has led to a number of paradoxical results.

More conservative liquidity and funding principles being followed by banks worldwide, partly but not solely because of Basel III, coupled with leading central banks' extreme monetary easing, are leading to surplus liabilities becoming a major preoccupation for internationally operating banks.

Dealing with issues arising from excess liquidity, far more than coping with funding bottlenecks, will be a great challenge for banks over the medium-term. This is at present an area of concern above all for Asia-Pacific banks, but it will extend to US and European banks in due course.

The banking industry should be thinking in greater depth about what the new liquidity regime implies for clients and markets in general. The overall message is that too much bank liquidity may end up not only restricting banks' operations in a way that damages customers, but also harming the economy as a whole – the opposite of what was intended

The financial crisis was concentrated among US and European banks, although the economic impact was transmitted worldwide. The Basel III liquidity principles, represented by the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) metrics, have presented very few problems for Asia-Pacific financial institutions. Asia-Pacific banks already had their liquidity crisis in 1997, and learnt from it. The new requirements were already being met in most cases. Indeed, they were more or less already enshrined in Asian banking culture by the time of the 2008 Lehman Bros default.

Not just in Asia, but around the world, the debate has shifted from the risks of over-reliance on short-term wholesale funds to one about where to deploy funds for anything other than a zero or negligible return at the central bank.

Banks are now funding themselves less in wholesale markets and moving to a greater share of customer and more stable 'Type B' deposits, as indicated by the chart below on US banks' wholesale funding. A similar trend can be observed for European banks. This is universally accepted as positive.

The overall message is that too much bank liquidity may end up not only restricting banks' operations in a way that damages customers, but also harming the economy as a whole – the opposite of what was intended.

US banks' wholesale funding as share of balance sheet liabilities 2006-2012



Source: US Federal Reserve

But interbank funding is not all bad per se; over-reliance on it to fund illiquid assets was the market's undoing in 2007-08. Interbank funding enabled banks to benefit from greater trading liquidity as an outlet for liabilities and as a source of temporary but still revenue-positive assets. This benefited the economy as a whole because a healthy banking sector is vital to societal development.

It is worth considering the medium-term impact of the Basel III regime and the change in funding model for banks' customers and the global economy. On one level, bank funding models will be more stable and less at risk from a funding freeze. But banks are like oil tankers; they take a long time to change direction. In due course European banks, like many Asia-Pacific banks today, will face difficult questions on where to deploy surplus liabilities, and if necessary how to remove them from the balance sheet altogether.

The impact on customers especially affects larger corporations that have more than one banker and look to place funds across a number of suppliers. We witnessed falling deposit rates during 2012. This is not beneficial to customers, but can only be expected when banking markets are awash with funding at the macro level. Within the euro area, this may even manifest itself ultimately in negative interest rates, as we have observed in Japanese yen over the years.

Japanese-style scenario not conducive to output growth

Over time, finding a home for one's cash could become increasingly problematic. This is not a good place for the economy to be. It may incentivise some corporates to start investing their cash in capital projects rather than banking it. Yet we can all agree that a Japanese-style money market scenario is not conducive to output growth.

The global consequences need to be reviewed carefully. Excess cash can be expensive. But that doesn't necessarily mean extending the risk-reward profile, especially when the economic environment remains uncertain. There would be little point in securing a best-practice risk culture on the liability side of the balance sheet only to negate this by taking substantially more risks on the asset side.

The debate over deploying surplus liabilities appears to be one of seeing at what point, beyond AAA sovereign bonds, banks remain comfortable, starting with investment-grade corporate bonds and ending up with (say) equities and commodity finance.

The latter is certainly viable, but may be too rich for some appetites, depending on the individual bank's risk aversion. Where, in applying surplus funds, banks restrict themselves to investing in sovereign bonds, they may be tempted to hold long-dated assets, which in turn creates greater market risk.

Another approach is to review banks' business models. An excess of liabilities can end up being too much of a good thing. Is the solution to revamp the operating model so that these funds disappear? For example, banks could refocus their deposit-raising strategy to concentrate on fewer sectors, or different sectors, so that the surplus slowly unwinds itself.

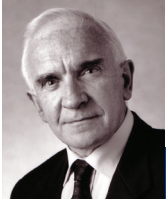
This can result from the application of Basel III, under which certain types of liabilities bring a higher liquidity buffer requirement.

The answer may well lie, over time, in engineering the surplus away. But that will have a negative effect on certain clients, and will suggest the banking sector is no longer in a position to service its entire current customer base.

There are no easy answers. The lessons of 2008 have been well learnt, one hopes. But we must keep a close eye on the medium-term impact of the new bank funding model that it demands. This applies not just to customers and markets but also to overall economic development. ☒

This is Part 1 in a series of articles on bank liquidity. Prof. Choudhry is a member of the OMFIF Advisory Board. He writes in a personal capacity.

Where, in applying surplus funds, banks restrict themselves to investing in sovereign bonds, they may be tempted to hold long-dated assets, which in turn creates greater market risk.



Constraints on Scotland

Lessons of euro for an independent Edinburgh

Brian Quinn, Brian Quinn Consulting

An independent Scottish sovereign state would have to address a number of issues in the areas of economic and financial policy, including the appropriate institutions necessary to support and execute these policies. This raises difficult questions, given the degree of integration of the current UK economy, the shared institutions, and the geographic adjacency of Scotland and the other members of the current UK.

The issues potentially facing an independent Edinburgh government encompass many defining elements of a sovereign state, extending from the currency and monetary policy through to public finances and debt management, regulation and supervision of financial services, and management of foreign exchange reserves. The connected issues of choice of currency and monetary policy are fundamental. Deciding to adopt an exchange rate for a currency that is fixed in relation to another currency has very different implications for domestic monetary policy than following a floating exchange rate.

The euro crisis has, in a way, come at an opportune time for the debate on Scottish independence. The broad vision of moving to an integrated European economy in a series of steps has been shown to be flawed. The formation of the single European market, removing barriers to competition and freedom of resource movements, was seen as the first step. The adoption of a single currency represented the next stage. But deciding to take this step before including and coordinating the other areas of policy, most notably but not only fiscal policy, is now recognised to have been a profound mistake.

One of the reasons the euro area has been encountering such difficulties is because the rates of productivity and the degrees of integration among its 17 members are so different; hence the poor fit of ECB interest policy for some countries in the past and the serious strains at present in agreeing the necessary changes in national fiscal policies. By contrast, the economies of Scotland and the rest of the UK are well integrated and there is no evidence that monetary or fiscal policies have been particularly detrimental to Scotland, in terms of inflation and growth. Interest rate policy has taken into account conditions in all regions of the UK without discrimination, and differences in the effects of public finance policies have been dealt with by agreed transfer of resources.

An independent Scotland may be able to find a separation model that retains many of the economic and financial benefits available from membership of the current UK. But, as the euro crisis demonstrates, failing to get the preconditions clear in terms of the policy mix and institutional framework could be costly and risky.

One of the largest questions for an independent Scotland would focus on the currency. Choosing to adopt a different, new currency from sterling would involve establishing a central bank to pursue a policy of price stability and financial stability.

Adopting the euro from the outset of independence is almost certainly unavailable as an option, since there would have to be a qualifying period for any prospective new entrant. Another route would be to choose a separate national currency linked in a fixed relationship with another currency. A further option would be to retain sterling as the Scottish currency, already defined as the preferred choice by the Scottish National Party, which forms the present devolved Scottish government.

In view of the experience with the euro, the UK government and parliament would be likely to set conditions for Scotland's participation in a revised sterling zone. These conditions would include fiscal and budgetary policies, public debt management, financial regulation and supervision and crisis management: all areas that the euro crisis has shown as closely interconnected.

The issues potentially facing an independent Edinburgh encompass many defining elements, extending from the currency and monetary policy through to public finances and debt management.

A prospective independent Scottish government could contest such conditions in the negotiations for a treaty governing the proposed currency union, but only up to a point. The market reaction to a refusal, or serious differences over terms, is not difficult to imagine.

By choosing to announce its preference to retain sterling as the currency of an independent Scotland, the current Scottish government has effectively surrendered its freedom to determine monetary policy and severely circumscribed its freedom of action in the area of public finances. As part of the agreement with London on sterling, an independent Scotland would be unlikely to be allowed to run budget deficits or public debt ratios materially higher than those in the rest of the UK.

There would still be some room for differences in public finance. Rates of income tax, both company and personal, could presumably differ from the remaining UK, as well as the scope and rates of expenditure taxes. Even here, however, there could be limits arising from EU single market legislation and from any deal struck as part of a separation treaty.

Debt management would be a tricky issue. At present there are no Scottish state obligations in issue in financial markets. It is not self-evident that Scottish sovereign debt, whether amounts transferred from the UK government or newly issued debt, would enjoy an AAA rating from the outset. It seems likely that the rating agencies would wish to observe the performance of a newly independent Scottish government before awarding a rating enjoyed by only a very few sovereign states.

How an independent Scotland would deal with the regulation and supervision of its financial sector institutions is another difficult matter. There is uncertainty about its freedom of choice under current EU laws.

A senior member of the SNP government has stated recently that regulation and financial supervision of Scottish financial institutions would continue to be carried out by the Bank of England, under its enlarged responsibilities for supervision. This has been challenged by a senior former Scottish Executive official, and by a former chairman and chief executive of the UK Financial Services Authority, on the grounds that each member state of the EU must have its own regulator, referred to as the 'competent authority' under the EU regulatory framework.

The structure and institutional arrangements for the proposed European banking union are not yet very clear. However it appears that an independent Scotland would not be able to join this banking union from the outset of independence. In view of the UK government's statement that it does not intend to participate, Scotland would not have the option of having its banks supervised by the ECB under the new EU framework.

On a strict interpretation of EU statutes, an independent Scotland would have to establish its own regulatory, supervisory and crisis management systems de novo. That would take much time and would create uncertainties for both the European and UK financial systems that would be unwelcome. There is always the possibility in the context of the negotiations about the structure of the banking union, that the European Commission could be persuaded that the arrangements for authorisation, regulation and supervision of Scottish banks, and for crisis management, should rest with the London government and the Bank of England.

Such an outcome would avoid the uncertainty and expense entailed in setting up a new and untested institution within the EU, but would not remove all other issues, such as the prudential requirements and deposit insurance system for Scottish banks. However it is difficult to envisage the government of the rest of the UK agreeing to significant differences between the requirements applying to Scottish and the remaining UK banks. Thus, even assuming it is available, the most attractive solution in this crucial area would also limit the freedom of choice for an independent Scotland. ☐

This is an abridged version of a paper prepared for the David Hume Institute and Edinburgh University, one of a series of contributions for their ESRC-funded 'conversation' on the economic implications of constitutional change in Scotland. For the full version, see www.davidhumeinstitute.com.

It is not self-evident that Scottish sovereign debt, whether amounts transferred from the UK government or newly issued debt, would enjoy an AAA rating from the outset.



Preparing for the worst High price of maintaining the euro

Christopher Tugendhat, Advisory Board

The euro has survived in one piece but at a very heavy price. Not so long ago, the European Union was admired as a model for post-modern interstate relationships from which Asians and Latin Americans could learn. That is no longer the case.

Indeed, it is the reverse. Asians compare the way the EU has been dealing with its problems with the way they handled theirs a few years ago. The episode has also damaged very considerably the EU's relationships with its main trading partners in the US and elsewhere.

Worse still is the price being paid by the euro area. The deficit countries have made more progress that they are often given credit for in improving their competitiveness and trade balances. Yet the burden of austerity grows ever heavier. This embitters relations among the populations of member states, with anti-German feeling now strong in the Mediterranean and resentment and bail-out fatigue growing in Germany and elsewhere in northern Europe. Such a situation cannot continue.

To many in leadership positions, the response is to transform the euro area from a currency union into a fully-fledged fiscal and economic union. The presidents of the European Commission and the European Council have produced blueprints that would, in effect, place ultimate economic and budgetary control with the European institutions.

Not very much progress has been made down the road. The EU summit in December achieved consensus on a banking union agreement, but a very partial one. Some euro members, too, balk at the consequences of what is being proposed. However, it is the route map that has been set and it is one that Britain cannot go down.

Some other EU members outside the euro cannot do so either. Yet it would be contrary to Britain's national interest to leave the EU and contrary to the national interest of all members, whether within the euro or not, for the EU to break up.

The challenge facing all EU governments is to find a way to maintain the EU in such a way that it can embrace both those wishing closer integration and those who, within an overarching framework, want looser and more flexible arrangements. British ministers should direct their energies to maintaining the single market, the common external trade policy and their supporting structures, from which Britain derives great benefit, so that they work as effectively as possible in the interests of both the euro-ins and the euro-outs.

As the largest non-euro country, Britain is well placed to rally all those outside the euro behind proposals to reconstruct the EU along these lines in the interests of both groups. Within the euro area there will be those ready to respond to such an approach.

In November Mark Rutte, the Dutch Prime Minister, called for the EU to carry out a review of its powers and consider returning some to the member states, saying, 'What we want to do is have a debate at the level of the 27, on whether Europe is not involved in too many areas which could be addressed at the national level.' While calling for 'more Europe' on budget discipline and in handling Europe-wide financial issues, he said he is 'not in favour of a federalist European state'.

A British plan for the reconstruction of the EU is required not only to enable the euro area and those who want a looser involvement to work together in constructive harmony. We must also bear in mind that there is no guarantee that the euro will hold together.

Everyone, including the UK, needs to make preparations to ensure that the EU and its core structures can be maintained in the event that not all current euro members can live within its disciplines or, perhaps, within its aspirations. ☐

The deficit countries have made more progress that they are often given credit for in improving their competitiveness and trade balances. Yet the burden of austerity grows ever heavier. This embitters relations among the populations of the member states.



Great step forward for euro

Towards enactment of subsidiarity principle

Ruud Lubbers and Paul van Seters, Advisory Board



Herman Van Rompuy, president of the European Council, termed it a 'good week' for the European Union. Within a couple of days in mid-December the EU picked up the Nobel peace prize in Oslo, finance ministers agreed on a Single Supervisory Mechanism (SSM) for banks, the Eurogroup provided major new support for Greece, and the European Council decided a number of measures to strengthen economic and monetary union (EMU).

The package of proposals (the so-called Plan Van Rompuy) before the European Council on 13-14 December in Brussels aimed to produce a 'specific and time-bound roadmap for the completion of EMU'. The European Council made history by accepting the spirit and some of the essentials of the Plan Van Rompuy. EMU has not been completed, but it has made great strides forward. Because of this, EMU and the EU will be generally better equipped to deal with the immense problems they face.

The plan contains four closely connected building blocks: a banking union, a budgetary union, an economic union, and a political union. The European Council has now de facto adopted the banking union; proposals for the other three unions have to be further developed and will be back on the agenda of the European Council in June 2013.

Why do we think this glass is half full? When the various instruments of a banking union (next to SSM, a European resolution mechanism and a European deposit guarantee scheme) become operational – and that will be the case in the course of 2013 and 2014 – that will exercise a strong positive force on realising the other parts of the Van Rompuy plan.

The European Council may have postponed decisions on certain important issues, but it clearly endorsed Van Rompuy's basic perspective. Whatever changes are made to the plan, the idea of a budgetary union and the idea of an economic union will not be reversed. The European Council has accepted Van Rompuy's roadmap as its own.

As to the political union, the Van Rompuy plan refers to the need for more democratic legitimacy and accountability, and to strengthening the role of the national parliaments as well as of the European Parliament. This hardly very creative approach has now been embraced by the European Council.

In the last sentence of its statement at the end of the summit, the Council says: 'The European Parliament and national parliaments will determine together the organisation and promotion of a conference of their representatives to discuss EMU-related issues.'

Still, this conference may be important because it offers a platform to speak fundamentally about how EMU and the subsidiarity principle are connected, or should be connected. The central question is: What stays with the national member states and the national parliaments and what belongs to the European Commission and the European Parliament? The 'contracts' between member states and the EU that have now been proposed may indicate where this is going.

Thinking seriously about a political union – differently from that of a banking union, budgetary union, or economic union – has clearly only just started. But we draw an optimistic conclusion from all this. It seems as if, in the next few years, EMU will be completed, or at least strengthened, by a banking union, budgetary union, and economic union.

We can confidently expect that, from the practice of an enlarged and stronger EMU, all kinds of ideas will flow about how to build a genuine and viable political union. We can then expect that the subsidiarity principle in the domain of the euro will at last be given shape and substance. ☐

We can confidently expect that, from the practice of an enlarged and stronger EMU, all kinds of ideas will flow about how to build a genuine and viable political union.

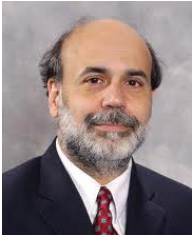


Nuanced view of unemployment target

Bernanke, with secure majority, seeks to disarm hawks

Darrell Delamaide, Board of Contributing Editors

While the Federal Open Market Committee (FOMC) at its December meeting set a specific target for the unemployment rate, 6.5%, as guidance for when it might reverse its stance on interest rates, Federal Reserve Chairman Ben Bernanke (voter) was somewhat vaguer in his press conference about possible changes in asset purchases.



Ben Bernanke

Bernanke's stance indicates a nuanced view on interest rates, apparently in a bid to keep faith with more hawkish members of the FOMC who may be opposed to the Fed's ultra-monetary easing policy. Bernanke's comments came shortly before the beginning of a year where it appears – as a result of changes in the voting status of FOMC members – that the panel will tilt even more towards 'dovish.' Precisely because Fed watchers are well aware of this arithmetic, Bernanke seems to be trying to show that he does not take further FOMC dovishness as a natural state of affairs, but is willing to defend decisions every step of the way.

Now that the fiscal cliff has, at least for the time being, been averted, with presumably bullish consequences for US growth, the delicate trade-off between unemployment, growth and inflation will become even more sensitive for Bernanke and his followers. Although high unemployment means the bond purchases will continue, Bernanke emphasised that the criteria used for decisions on the pace and amount of purchases will be 'qualitative' rather than 'quantitative.'

In a concession to FOMC members who don't think it's wise to tie monetary policy to any single specific indicator, Bernanke listed a number of criteria the committee will consider: 'The Committee will be evaluating a range of labour market indicators,' he said, 'including the unemployment rate, payroll employment, hours worked, and labour force participation, among others. Because increases in demand and production are normally precursors to improvements in labour market conditions, we will also be looking carefully at the pace of economic activity more broadly.'

In addition, Bernanke went on, the panel will be constantly assessing the efficacy of the bond purchase programme and whether it is leading to any unintended consequences. This is a further sop to FOMC hawks who are not convinced the central bank liquidity is of any help in the current economic situation and may create the potential for a sudden spike in inflation. As to the unemployment target itself, Bernanke made clear that picking this number did not alter the panel's expectation that it will be well into 2015 before interest rates need to be raised. He emphasised that 6.5% is not what the Fed considers to be a satisfactory level of unemployment – that would be somewhere between 5.2% and 6%, he said – but given the lag in the impact of monetary policy, it seems like a good point to consider a possible reversal in policy.

Monetary policy up close and personal

When asked during the press conference how people in his hometown in South Carolina might feel about the impact of a fiscal cliff, Bernanke offered a personal note that explains some of his thinking about economics and monetary policy. 'I come from a part of South Carolina which has been economically challenged for quite a long time and remains so,' Bernanke said, describing it as a region that is mostly agricultural with just a little bit of manufacturing. As such, it remains plagued with a very high unemployment rate, a high foreclosure rate, and other ill-effects of the recession.

'So, part of the reason that we are engaging in these policies is to try and create a stronger economy – more jobs,' Bernanke said, 'so that folks across the country, including places like the one where I grew up, will have more opportunity to have better lives for themselves.'

Fisher dissents in colourful terms



Richard Fisher

Dallas Fed President **Richard Fisher (non-voter)** remained unrepentantly opposed to the FOMC line and told a television interviewer two days later that, as it became increasingly difficult to exit the Fed's accommodative monetary policy, it reminded him of a hit song from the 1970s. 'We are at risk of what I call a "Hotel California" monetary policy,' he said on CNBC, referring to a song by the rock group the Eagles, 'where we can check out any time we want from this programme, but we can never leave.'

In a speech the following week, Fisher went on to reiterate a constant theme of his – that the reason for a sluggish economy is not insufficient liquidity but an uncertain economic environment that keeps business from investing.

'Quantitative easing is a necessary but insufficient tool to spark job creation,' he told an audience in Gainesville, Texas. 'Employers will not deploy the cheap and abundant capital on hand towards job creation while there is so much uncertainty surrounding final demand for the goods and services they sell.'

As he is wont to do, Fisher embarked on an extended metaphor, this time a colourful example from animal husbandry about a big 2,200-pound breeding bull called 'Too Big to Fail' who is kept from performing his duty with 'pretty cows' by a fence raised as an obstacle.

'Think of the uncertainty...surrounding the resolution of the fiscal cliff as a fence,' Fisher said, driving home his point. 'Businesses, just like 'Too Big,' have plenty of liquidity; they have the resources they need to do what we want them to do, in this case, invest in job creation. But as long as that fence of uncertainty is in place, they will not be able to perform.'

Lacker dissents with a final vote



Jeffrey Lacker

Richmond Fed President **Jeffrey Lacker**, who finished his year as a voting member by registering yet another dissent to the December statement, told an audience in Charlotte, North Carolina, that setting a specific unemployment target could create problems for the Fed's dual mandate.

'I believe that tying the federal funds rate to a specific numerical threshold for unemployment is inconsistent with a balanced approach to the FOMC's price stability and maximum employment mandates,' Lacker said.

He would have preferred that interest rate policy, like the asset purchase programme, would be determined by a qualitative assessment. Even though the 6.5% unemployment rate was set as a target only as long as inflation remained below 2.5%, Lacker saw the potential for a 'problematic tension' between the two goals.

'These two commitments could well conflict because inflationary pressures can arise without triggering the inflation safety clause,' Lacker said. 'In the past, we've had to act preemptively to head off incipient inflation pressures because re-establishing credibility after it has eroded is costly and economically damaging.'

Bernanke view cited on monetary aims of new Japanese premier

Fed officials are not likely to comment directly on the declared intentions of newly-elected Japanese prime minister Shinzo Abe to promote a more aggressive monetary policy to combat deflation, but Fed watchers were quick to comment on the mid-December election using Bernanke's own analysis.

New York Times columnist Floyd Norris quoted a Bernanke statement from 2002 in connection with Abe's plans: 'Under a paper-money system, a determined government can always generate higher spending and, hence, positive inflation.'

In this speech, then-Fed governor Bernanke borrowed Milton Friedman's phrase about a 'helicopter drop' of money that gave him the 'Helicopter Ben' nickname he has yet to shake off.

Abe has spoken of raising the Bank of Japan inflation target to stimulate the perennially sluggish Japanese economy. Norris quotes Harvard economist Kenneth Rogoff to the effect that no one knows how much monetary stimulus would be needed to achieve that.

But University of Oregon professor Tim Duy, an influential Fed watcher, cautions that people often overlook that Bernanke in that speech was referring not to monetary policy alone, but to its interaction with fiscal policy. After all, he speaks of a 'determined government,' not a 'determined monetary authority.'

In Duy's view, the real endgame in the Japanese case would be explicit monetisation of Japanese government deficit to create inflation, though he speculates that Abe may not be interested enough in economics to follow through on such a plan. ☐

'In the past, we've had to act preemptively to head off incipient inflation pressures because re-establishing credibility after it has eroded is costly and economically damaging.'

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OMFIF welcomes new members to the Advisory Board

OMFIF is pleased to welcome Paola Subacchi, Research Director for International Economics at the Royal Institute for International Affairs, as a new vice chairman of the OMFIF Advisory Board. Subacchi has extensive experience in macroeconomic analysis, forecasting and strategic advice and is a contributor to leading journals and a regular media commentator. We also welcome Robert Bischof, Economic Adviser to German Industry UK, and Jukka Pihlman, Global Head, Central Banks and Sovereign Wealth Funds at Standard Chartered Bank. This takes the total number of Advisory Board members to 119. The OMFIF Advisory Board, covering the global economic system, includes people who contribute to OMFIF's output in many ways, who are also available to carry out advisory work and other services for OMFIF members.

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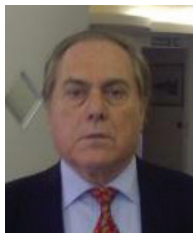


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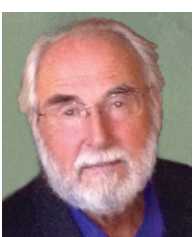
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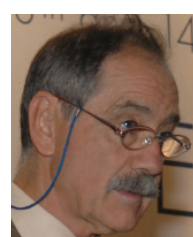
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Gary Smith is Global Head of Official Institutions at BNP Paribas Investment Partners.

Christopher Tugendhat is a former European Commissioner.

An occasional look at the great characters of world finance



The End is Nigh, or is it?

Big problem for 2013: The price of claret

Frederick Hopson, Advisory Board

Bertram called me as usual at the last minute. 'Rod you have to come to my Christmas party at 5 Hertford Street, you will love it.' For those who don't know, this is the new club of Robin Birley, the son of the famous founder of Annabel's.

As I had been rather impressed, if not enchanted, by Bert's views over the last few years, I felt it opportune to take a look at the latest hangout of the rich and famous.

Bert had been terribly right. I stress the word 'terribly'.

His cynical views on the banking crisis and bonuses had been spot on. As he predicted, banks had continued to make obscene amounts of money for their employees, if not for their shareholders.

His view that austerity was only for the poor proved correct. The venue in Shepherd's Market confirmed the point.

The subdued elegance of the decor and glittery outfits of the numerous 6 foot beauties (surely not all Russian) were in stark contrast to the decor and apparel of the population at large.

Looking at those entering I wondered if the BBC shouldn't create a new programme: 'I'm a celebrity, please get me into here...'

So luckily for me, testimony to my ex-schoolmate's excellent connections, I was once again offered a glimpse of that other world. I spied the loutish figure of a loud-mouthed BBC TV star in the smoking room – yes, the clubs for the wealthy have smoking rooms...and knew that the evening was warming up promisingly.

'Well Rod,' he started, with trademark enthusiasm. 'What do you think? As you can see in here, the real economy is recovering,' he ventured, his gaze wandering to a shapely pair of legs.

'Not quite sure what you mean by real,' I replied. 'I am just about able to make ends meet on my scribbler's salary and hardly get any interest on my savings. My bank charges me exorbitant amounts for a mortgage that they refinance at zero percent; where is this so called recovery?'

He paused to order some Dom Perignon and looked at me with that greedily boyish look of his.

'Rod, once again you miss the point: the transfer of debt from the private sector to the public sector is now almost over. The taxpayer has an enormous bill but the new policy of higher inflation targeting will take care of that. Look what it's already done for the salary of the new Governor of the Bank of England! Soon everyone will be clamouring for more money, it's just a question of time...

'The governments of the world know no shame; they just want to get re-elected. The day of reckoning has been postponed. We're entering a new era of debased money!'

'So you think our government is on the right track, allowing massive payoffs and systematic tax avoidance, not to mention the way they allow the BBC to be managed.'

'Rod, you have to realise, it's like a very exclusive club.' Betram looked around, savouring the atmosphere. 'If the government wanted people to pay tax they could easily legislate, but then our status as a tax haven would be jeopardised. Most of these guys went to the same schools.'

'They look after their own, no different at all to the previous government! There are a few sacrificial lambs, slapped wrists and then quick rehabilitation...Just because someone has no integrity doesn't mean they can't be good managers.'

'Bert that's all very well, but look what corruption and bureaucracy did to the EU. We have Commissioners flying around in private jets and drawing salaries that dwarf those of the heads of government. Then they get to manage banks and bankrupt them and draw pensions that the taxpayer has to fund.'

'Rod, you need to read up on Roman history. As things become gradually more unstable, there's a lot of turbulence and volatility. With all those Chinese working so hard for almost nothing it is obvious that the monied classes want to cash in before it all comes to an abrupt end. In any case in Europe. There's a big country called Germany that is already starting to foot the bill, at least for the time being. The only way they can pay it is to have higher inflation. That's why I bought Spanish bonds at 7%, Who can say one doesn't do one's bit to save Europe!'

'And do you intend to keep them 'til they mature, I was under the impression you believed the Spanish to be incompetent at managing their economy?'

'Well the Spanish government may well be a catastrophe, but some of their people are not: look at Inditex! Of course, I have already sold the bonds and with the profit bought a new house in Zagaleta in Marbella, got it at an amazing discount, €5m – it would have cost €10m four years ago!'

'So you think Spain will now recover?'

'Well Rod, this has been a crisis for the underclass, not for the rich! You probably noticed that, while the rest of the UK housing market has been on the decline, in the last few years prime property in London has doubled and tripled. The same goes for Courchevel and St Tropez!'

Bertrand was warming up: 'The hot spots are only available to a chosen few, so you need to get in when there is a bit of a sell-off! When the big inflation takes place, you want to have hard assets and they must be prime and preferably gated. You don't want the population at your door now, do you?'

Looking at the discreet entrance to the club, I got a very clear impression of what he meant. No queues here...

'So you think the world economy and Europe have been saved by cheap money?'

'No Rod, please don't be naive, we have pushed the problem out a few years; the politicians can keep their seats on boards, massive payouts can continue to the incompetent. All we have done is avert an immediate collapse. In five years time a new version of Paul Volcker will be needed to sort out the massive inflation, but in the meantime let's have some Clos du Marquis. 85 was really a good year.'

Rod's brow furrowed. It was clear there was one big problem on his mind for 2013. The Chinese keep driving up the price of claret! ☒

Looking ahead – 2013 diary dates

Gold and the Renminbi – OMFIF Report launch

11 January, Renmin University, Beijing

Lecture with James Bullard

President, Federal Reserve Bank of St. Louis
22 May, London

China-Europe Economists Symposium

China-Europe Economy: Challenges and Opportunities
12 January, Shangri-La Hotel, Beijing

Lecture with Jaime Caruana

General Manager, Bank for International Settlements
16 May, London

Lecture with Álvaro Santos Pereira

Minister of Economy and Labour, Portugal
25 February, London

Lecture with Stanley Fischer

Governor, Central Bank of Israel
13 June, London

Small steps for Europe

Italy and France will determine course of euro crisis

DZ Bank Economic Forecast Table

GDP growth

	2011	2012	2013	2014
US	1.8	2.2	2.0	3.0
Japan	-0.7	1.7	0.6	1.4
China	9.3	7.8	8.5	8.7
Euro area	1.5	-0.4	-0.3	1.3
Germany	3.0	0.9	0.4	2.2
France	1.7	0.1	0.2	1.0
Italy	0.5	-2.5	-0.9	0.7
Spain	0.4	-1.4	-1.9	0.9
UK	0.9	-0.2	0.4	1.5

Addendum

Asia excl. Japan	7.4	6.2	6.9	7.3
World	3.6	3.0	3.2	3.9

Consumer prices (% y/y)

US	3.2	2.2	2.7	3.0
Japan	-0.3	0.0	0.1	1.5
China	5.4	2.6	3.0	4.1
Euro area	2.7	2.5	2.5	2.5
Germany	2.5	2.1	2.1	2.6
France	2.3	2.2	2.3	2.4
Italy	2.9	3.3	2.4	2.4
Spain	3.1	2.5	3.5	2.5
UK	4.5	2.8	2.4	2.7

Current account balance (% of GDP)

US	-3.1	-3.2	-3.1	-3.2
Japan	2.0	1.0	1.2	1.7
China	2.8	2.5	2.6	2.1
Euro area	0.0	0.2	0.2	0.5
Germany	5.7	5.9	4.3	3.9
France	-2.0	-2.3	-2.2	-2.0
Italy	-3.3	-1.5	-0.8	-0.5
Spain	-3.5	-2.7	-1.6	-0.2
UK	-1.9	-3.0	-2.5	-1.8

Produced in association with DZ Bank group,
a partner and supporter of OMFIF

At their latest summit meeting in Brussels in December, euro area leaders approved Greece's desperately-needed financial aid programme and agreed on a road map for establishing a common banking supervisor. There does not appear to be a consensus for further reform of the currency union's institutions.

Talks on the subject have been put off to 2013. The markets have been largely calm and quiet over the last weeks. The phase of peak uncertainty over the euro crisis appears to be behind us for now.

The same 'small steps' approach to combating the crisis can be expected to predominate again in 2013. The individual euro countries have widely differing interests.

Negotiations will remain difficult. In advance of the autumn parliamentary elections in Germany, the Berlin government can hardly be expected to countenance major concessions.

The French government is trying to define a distinct economic policy course in the face of a deteriorating economy. In the third biggest euro member country, Italy, parliamentary elections will come in February. The country needs further reforms that only a stable government can deliver. Whether we will see such an outcome is difficult to predict.

Economic and political developments in France and Italy will essentially determine the course of the euro crisis in 2013. In view of their size, neither country could envisage using present bail-out mechanisms as a safety net if a crisis developed.

Should Italy return to an effective government in the spring and economic policy pragmatism triumphs over ideology in France, then the chances of a euro area economic recovery in 2013 would be very favourable. However, the crisis is not over yet. The risks are considerable and should not be overlooked.

In the US, the last-minute agreement in the fiscal talks brought some relief, but did not solve the problems. The pace of aggregate economic growth is likely to have slowed in the closing quarter of 2012 and will probably remain weak in the first quarter of 2013 too. This conclusion is implied not only by the downturn of the confidence indicators but also 'hard data'.

In China, the scale of the economic upturn is becoming clearer. Most reported indicators suggest recovery is gaining increasing traction. Growth will again accelerate to above 8% in the first quarter of 2013.

However, China's GDP growth will still remain below levels in recent years. Growth will approach 9% again during 2014 only if there is a general acceleration of global expansion. It would be difficult to predict today that this will be the case. ☐



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 *An occasional foray into monetary secrets hidden in archives*

Why no one heeded Bundesbank warnings

Tietmeyer's 1997 predictions on 'limits of adaptability' and possible employment cuts echo Weidmann's strictures now

Jens Weidmann, the Bundesbank president, publicly and pointedly sets his hard line on euro rescue efforts in the mainstream of the German central bank's steely monetary traditions. Probably more than any leading central bank chief in living memory, he peppers speeches and statements with the lore of his predecessors.

In a New Year interview with the Sunday edition of the Frankfurter Allgemeine Zeitung (FAZ), he quoted two previous Bundesbank presidents, Karl Blessing and Otmar Emminger. Weidmann recalls in particular the celebrated statement of the former, 50 years ago in January 1963, that economic and monetary union (EMU) required 'a common trade policy, a common finance and budget policy, a common economic policy, a common social and wage policy – a common policy all round'.

The past president with whom Weidmann appears to have most empathy is Helmut Schlesinger, the redoubtable Bundesbank chief between 1991 and 1993, precisely double Weidmann's age. Schlesinger previously presided over the Bundesbank's economics department and formed a fearsome tandem as deputy president under Karl Otto Pöhl between 1980 and 1991. However, there is also a remarkable overlap with the views of Hans Tietmeyer, Schlesinger's successor, who headed the Bundesbank between 1993 and 1999 and warned on many occasions of the risks faced by a monetary union composed of unequal or non-convergent members.

Schlesinger himself candidly remarked last year that even the Bundesbank 'lacked the imagination' to predict the extent of the euro pitfalls that sub-optimal economic rigour could bring. Germany itself is vulnerable to criticism that it led the move to indiscipline by neglecting the strictures of the Stability and Growth Pact in the early 2000s. Budgetary overshooting by Chancellor Gerhard Schröder was relatively minor, particular compared with the scale of later misdemeanours. But Germany's European partners regularly bring up alleged Teutonic fiscal malfeasance whenever they wish to blunt Berlin's opposition to euro bail-out proposals. Italian premier Mario Monti did this at the December 2012 Brussels summit and no doubt we will see this again in 2013.

The similarity between the Weidmann and Tietmeyer approaches is underlined by the uncanny parallels between two statements separated by 15 years. Weidmann in the FAZ on 30 December 2012 echoes Tietmeyer in a speech to the German Taxpayers Institute in Aachen on 3 November 1997. Tietmeyer's predictions were prescient. Countries which entered monetary union with false hopes and, sometimes, with false credential, cannot say they were not warned.

One of the problems was that speeches such as the one made by Tietmeyer (in German) in 1997 were largely for domestic consumption. Unlike today at the Bundesbank, which pays great attention to the need to bring Weidmann's views to very wide international attention, no one was regularly translating the Bundesbank president's speeches into English.

Weidmann 2012: Back in 1963, Karl Blessing, one of my predecessors, pointed out that monetary union should be embedded in a political union. When monetary union was introduced at the beginning of the 1990s, the Bundesbank cautioned that, at the very least, a set of clear rules to be observed by all members was necessary.

Tietmeyer 1997: Political and social partners in all participating countries must show they have the will, in a strong and stable way, to bear permanently the political and economic consequences of the common currency.

Weidmann 2012: I have the feeling that nobody is ready at present to take the great leap towards a political union. To me, that means that we have to remain grounded in the current legal framework defined by the Maastricht Treaty and that, within this framework, we have to restore the balance between liability and control.

Tietmeyer 1997: The euro area will still be made up of largely sovereign nation states with different regulatory and social systems. In all probability we will live for a long time without the kind of checks and balances and common systems applying with a nation-state, such as a common legal and tax system, common fiscal and social security systems and redistributive tax measures. That's not to mention completely different structures and traditions.

Weidmann 2012: The crisis seems to have calmed down somewhat. Reforms are making progress. However, the root causes are far from being entirely eradicated.

Tietmeyer 1997: The potential for disruptive forces in a monetary union joining together several states will be fundamentally greater than in a nation state.

Weidmann 2012: The core of the crisis is located in the periphery countries: burgeoning household debt, excessive government debt and insufficient competitiveness creates doubts that those countries will be able to manage their debt burden.

Tietmeyer 1997: With the [ending of the] exchange rate the countries definitively abandon the hinge with which they have been able to absorb large differences in inflation, competitiveness and the policy mix with [other European] countries. Those who in early 1998 have not reached the necessary convergence for a stable euro would be advised initially, in their own economic interest, rather to make further progress outside the monetary union.

Weidmann 2012: I am convinced that Spain will service its debt and will be able to reform its economy. However, at the heart of the Maastricht Treaty is that euro area countries are responsible for their own fiscal policy and are subject to market discipline. If we generally rule out insolvency, that will undermine the incentive for countries to keep their fiscal house in order.

Tietmeyer 1997: Certainly the monetary union might offer [a country that enters monetary union] a lower interest rate on the capital market than if it went its own separate way. But the country must note that [in future] all national monetary policy adjustments will have a direct effect on the real economy. This demands especially high internal flexibility.

Weidmann 2012: Now it is a question of improving the framework of rules and the will to comply with agreements. [Crisis fatigue] is precisely what can become a threat. Namely, when policy-makers want no part of the crisis any longer, and expect the central bank to come and put out the fire.

Tietmeyer 1997: A country with insufficient convergence could quickly reach the limits of its adaptability. Necessary severe cuts in the labour market or in the area of public finances would weigh heavily on the acceptance of the euro in this country, not to mention the burdens for other members in capital market interest rates and potential conflicts between [member] countries.

Weidmann 2012: A clean dividing line between monetary and fiscal policy is important. In addition, the announcement [of possible ECB bond purchases] is a sort of insurance policy backed by the central bank – but the insurance is not making the system any more stable. I fear that eagerness to reform will flag if monetary policy-makers come to the rescue time and again.

Tietmeyer 1997: We are not seeing in any way the end of national political decision-making. Rather what we need is a political orientation that consciously accepts the challenges of a common currency. This requires not simply sustainable discipline in fiscal and social policy. Also necessary is resolution of structural problems and a competitive development of employment costs.

Weidmann 2012: I am afraid of stability policy risks and the hazard of blurring the boundaries between monetary and fiscal policy. The Eurosystem should not lead to an extensively communalisation of sovereign solvency risks, which would be too close to monetary financing of governments.

Tietmeyer 1997: Reinforced cooperation between euro states will be useful in economic, financial and social policy areas. But this must not lead to limitations on monetary policy and not to an attack on the independence of the European Central Bank.

Weidmann 2012: Once people begin to fear that we are printing money to fund budget deficits, our credibility as a guardian of monetary stability will quickly go out the window.

Tietmeyer 1997: Complete and sustainable stability is the main requirement for the success of this ambitious project [monetary union]. Inflation does not support economic development, but damages it.

Weidmann 2012: Throughout the entire debate, my greatest concern has been about protecting the central bank's credibility. I don't think [the euro would have suffered any damage if the ECB had done nothing]. Policy-makers would have then had to take action. I am well aware that these are difficult decisions for policy-makers. But it is the job of policy-makers, and not the central bank, to decide on redistributing solvency risks.

Tietmeyer 1997: Entry into monetary union does not open the door to paradise. The euro does not dissolve the economic and structural problems of participating countries. Unemployment, too, will not be automatically reduced.

Weidmann 2012: Central banks must not allow any doubts to emerge about their stability orientation. I never said that the inflation rate would be the problem this year or next. Rather, the issue is confidence in the ability and the will of the central bank to ensure price stability in the medium and long term.

Tietmeyer 1997: The Bundesbank's responsibility ... grew with the confidence acquired by the D-Mark as a result of many years of sustained stability on the financial markets. We want to, and must, transfer this confidence to the euro. That's why the Bundesbank, especially before the start of monetary union, will do everything to prevent the build-up of inflation potential.

Weidmann 2012: [Whether countries will be compliant with the Maastricht targets] would be trying to predict the very distant future. That question has to be answered by policy-makers.

Tietmeyer 1997: Even before entry into the monetary union, countries need to display an extensive stability-orientated political synchronisation and a corresponding basic orientation in society and politics. The selection of participants may therefore only be based on a sustainable fulfilment of all the criteria agreed in the treaty. ☐



Introducing Year of the Luso-Economy

Strength through diversity for wide group of nations

Edward Longhurst-Pierce, Chief Operating Officer, OMFIF

Luso, from the Roman province of Lusitania that is now modern day Portugal, refers to the widespread and richly-varied Portuguese-speaking world. From the Old World to the New, throughout Africa and across to Asia, a shared historical, cultural and linguistic heritage is now reemerging as a catalyst to strengthen old trade ties as the global financial crisis promotes greater diversity.

Recognising the importance of one of the world's most dynamic economic groupings linking some 240m people, OMFIF has declared 2013 to be the Year of the Luso-Economy, with a programme of meetings and discussions looking at the nine countries that make up this group.

Having spoken in recent months to a wide range of official sector representatives from Brazil, Portugal, Angola and Mozambique, I had the impression that there now appears to be a heightened sense of economic solidarity and trade and investment diversification as former Portuguese colonies seek further mutual cooperation. Recent developments in Brazil and Portugal, as well as Angola and Mozambique, have been well-documented, but what of the other members of this 'Club of Nine'?

Below is a snapshot of each country to summarise their recent economic performance and prospects. In coming months, in a series of Luso-economy meetings, OMFIF aims to highlight the positive interactions between these diverse economies and the rest of the world. It would not be surprising if, by the end of 2013, these countries collectively provided some of the brighter spots in the overall world economic picture. ☐



Angola: confidence remains as challenges lie ahead

Oil exports and foreign loans have prompted economic growth and fuelled a reconstruction boom in one of Africa's major oil producers as Angola rebuilds its infrastructure following years of civil war. It has undergone a period of transformation to become the fastest-growing economy in Africa and one of the fastest in the world. One of the consequences of this is an increase in Angolan private investments abroad, notably in Portugal. Oil-backed credit from China is financing infrastructure but it will take a generation to feel the impact. The new \$5bn Fundo Soberano de Angola (FSDEA) sovereign wealth fund should help the country's growth if properly managed.

★ **3.9% growth in 2011 picked up to 6.8% in 2012 but is set to slow from 5.5% to 5.2% over the next 3 to 4 years.**



Brazil: modest expansion better than boom times

Brazil is the world's seventh largest economy. In recent years, the country has followed sensible policies to stabilise debt, trade and banking and can now act as a world powerhouse both politically and economically. There is a growing perception of Brazil as a standalone investment location, beyond the distractive BRIC acronym and after a growth downturn, Brazil is set to return to growth in 2013. Major challenges include lowering dependence on the dollar and harnessing stable long-term investment inflows. Internationalisation is another watchword, with public and private enterprises looking to invest further afield but also looking to raise funds from abroad.

★ **2.7% growth in 2011, 1.5% in 2012 picking up to 4% projected in 2013.**



Cape Verde: tourism hot spot joins island economy club

Cape Verde is recognised as having achieved political and economic stability and is often praised as an example of stability and growth in Africa. The government has adopted market-oriented economic policies, an open approach to foreign investment and extensive privatisation programme. It has close economic ties with Portugal as well as the US and EU, and its currency is linked to the euro. In recent years, real GDP has increased on average by over 7% a year, bolstered by one of the fastest growing tourism industries in the world, as well as by substantial capital inflows. It is now considered a member of the same island economy club as Mauritius and Seychelles.

★ **Real GDP growth is set to rise marginally from 4.3% in 2012 to 4.4% in 2013.**



Guinea-Bissau: political instability leads to arrested development

Guinea-Bissau is one of the poorest countries in the world, with massive foreign debt and a heavy reliance on foreign aid and primary crops. A long period of political instability has resulted in a depressed economy and increased macroeconomic imbalances. Attempts to stabilise the economy through increased fiscal discipline and spending controls were thwarted by a military coup in April 2012. Due to high costs, the exploitation of oil and mineral resources is not a near-term prospect, with 400,000 barrels per day of petrol currently produced. Angola has shown interest in investing in Guinea-Bissau, but along with main multilateral institutions, has retreated from any financing in the country.

★ After a 2.8% drop in 2012, real GDP is set to increase by 5.7% in 2013, with potential double-digit growth beyond.



Macao: gaming dominant despite diversification

Macao, a Special Administrative Region (SAR) of China, has seen massive commercial and tourist development. It shares many of Hong Kong's business characteristics as an open economy and free port with a stable political environment and positive economic outlook. Macao is governed under the 'one country, two systems' principle, and has a large degree of autonomy. The economy is heavily dependent on gambling and tourism, but includes other chief economic activities such as manufacturing, textiles and financial services. As a free-trade area and independent tariff zone, Macao has numerous economic and trade relations, especially with the EU and Lusophone nations.

★ 21% real GDP growth in 2011 is dropping to 10% in 2012 and 2013.



Mozambique: macroeconomic stability pays dividends

Once one of the world's poorest countries, Mozambique is now one of the fastest growing economies and is expected to become a global energy power as the world leader in coal and gas exports. Future rapid GDP growth hinges on several major foreign investment projects, continued economic reform, and the revival of agriculture, transportation, and tourism. Strategic foreign investment, privatisation, financial sector strengthening, the introduction of a value-added tax, comprehensive judicial, customs, civil service, government budget, audit, and inspection capability reforms are all part of a major economic reform package currently being rolled out.

★ From 7.3% growth in 2011, Mozambique continues to shine with an estimated 7.5% in 2012 and 8.4% in 2013.



Portugal: reforms working but biggest test still to come

As part of a deep-seated economic restructuring, Portugal is now moving towards an export-orientated industry. The country has forged closer ties with former colonies and benefited from faster trade with China, although exports to the US and Germany have dropped. No European economy has done more in the way of reform, with structural changes to speed up licensing procedures, amend business law, encourage innovation, cut down bureaucracy and liberalise employment markets. Reserves of oil, gas and minerals are also being actively exploited, leading to billions of dollars of new investment. Mining exports could make up 3-4% of GDP in coming years.

★ Declines are expected in real GDP of 1.7% in 2011, 3% in 2012 and 1% in 2013.



São Tomé and Príncipe: reforms and diversification precede oil profits

The smallest African nation in terms of population, São Tomé is set to profit from large offshore oil reserves over the next few years, reducing dependence on foreign aid and cocoa exports. Due in part to the anticipated exploitation of oil, the government has encouraged a programme of economic diversification and has made significant progress in reforming public finance management. Real GDP growth has been driven mainly by the construction, consumer, retail, tourism and mining sectors. Continued prudential fiscal policy, an increase in oil revenues and investments in agriculture and infrastructure will contribute to this increase.

★ 4.5% growth in 2012, 5.5% in 2013 with double-digit growth beyond 2015 if oil projects go to plan.



Timor-Leste: rapid growth as economy is rebuilt

The first new nation of the 21st Century and one of Asia's poorest, Timor-Leste is set to profit from huge offshore oil and gas fields in the Timor Sea, defined in a Joint Petroleum Development Area (JPDA) agreement with Australia, stating 50:50 shares of revenues (estimated at about \$20bn). In 2005 the Timor-Leste Petroleum Fund was set up and fiscal policy since then has been expansionary, with the government increasing spending on public transfers and infrastructure. The economy continues to grow rapidly on the back of government spending, with investment focusing on major infrastructure projects, hoping to generate further private sector investment.

★ 10.6% real GDP growth in 2011, 10% in 2012 and 10% in 2013.

A regular round-up on international monetary affairs



Year for living dangerously

Far too much expected of Draghi and Carney

William Keegan, Chairman, Board of Contributing Editors

So Britain's prime minister David Cameron wants his chairmanship of the Group of Eight this year to be marked by progress on trade negotiations, both transatlantic – the US and Europe – and that subject which already seems to have been around for an eternity, namely the Doha Round.

When announcing his aim, Cameron was gratuitously contemptuous of the kind of concerted policy action announced by his predecessor Gordon Brown at the beginning of April 2009. I fear such contempt is all too characteristic of Cameron, who presides over an oxymoronic economic strategy of 'expansionary fiscal contraction' which has palpably failed.

It is not often that one experiences anything quite so close to a laboratory experiment in economic policy as the comparison between the policies pursued on either side of the Atlantic since Cameron and his Chancellor of the Exchequer George Osborne came to power in May 2010.

The 2009 G20 economic summit in London saw a massive commitment to fiscal, monetary and trade credit stimulus at a time when world trade had been plunging at an annual rate of almost 20%.

As the then President of the World Bank, Robert Zoellick, declared at the time, the G20 action, initiated and driven through thanks to the determination of UK prime minister Gordon Brown, 'stopped the rot.' The underlying financial crisis was still with us, but seemingly under some sort of control.

A year or so later, thanks to the stimulus,

there were tangible signs of economic recovery in the US and UK. Although slow by post-Second World War standards, and inhibited by budget cuts at state level, the US recovery persisted, while the UK recovery was stopped in its tracks by the austerity programme unveiled with threats of Armageddon by Chancellor Osborne in summer 2010.

Meanwhile, the obsession with programmes of austerity permeated the euro area, with an all too predictable impact on output and employment. By the turn of 2012/13 even Germany was suffering from the repercussions

The Republicans, Messrs Cameron and Osborne, and most of those involved in the economic policies of the euro are likely to continue living dangerously in 2013, with Mario Draghi, and possibly Mark Carney, behaving like the legendary English King Canute – powerless to control the tide. A rescue operation from China or Japan looks unlikely.

of the cuts in domestic demand it had effectively foisted on its allegedly delinquent euro neighbours.

As we enter 2013, the common factor in economic policy around the world is that all the main countries and their leaders appear to be living dangerously. In the US we have been going through all the nonsense of the so called fiscal cliff.

The magnitude of the folly of the Republican right can be illustrated by the following anecdote. When John Llewellyn, now of Llewellyn Consultants, was chief forecaster at the OECD, he used to regard a proposed change in a country's fiscal stance of 0.25% as hardly worthy of consideration; a change of 0.5% was 'interesting'; and a 1% change was 'THE story.'

Well, until challenged by the benign forces of President Obama and the preponderance of the Democratic party, the prospect was for a tightening in US fiscal policy of over 3%!

The austerity programmes continue in the UK and euro area. Far too much is expected of Mario Draghi, President of the European Central Bank, who, let's face it, doesn't have the power to live up to his famous 'whatever it takes' soundbite.

The same is true of Mark Carney, who openly speculates about a more ambitious monetary policy when he arrives at the Bank of England in July, but who will have no influence over the deflationary fiscal policy which keeps the UK economy depressed.

The Republicans, Messrs Cameron and Osborne, and most of those involved in the economic policies of

the euro are likely to continue living dangerously in 2013, with Mario Draghi, and possibly Mark Carney, behaving like the legendary English King Canute – powerless to control the tide.

A rescue operation from China or Japan? The Chinese authorities are trying to deflate a bubble, and their large export sector is already being hit by developments, or non-developments, in Europe.

And Japan is embarking, after a long period of a painfully uncompetitive exchange rate, on a currency war of its own.

Boy, are we all going to live dangerously in 2013. ☒