



The Bulletin

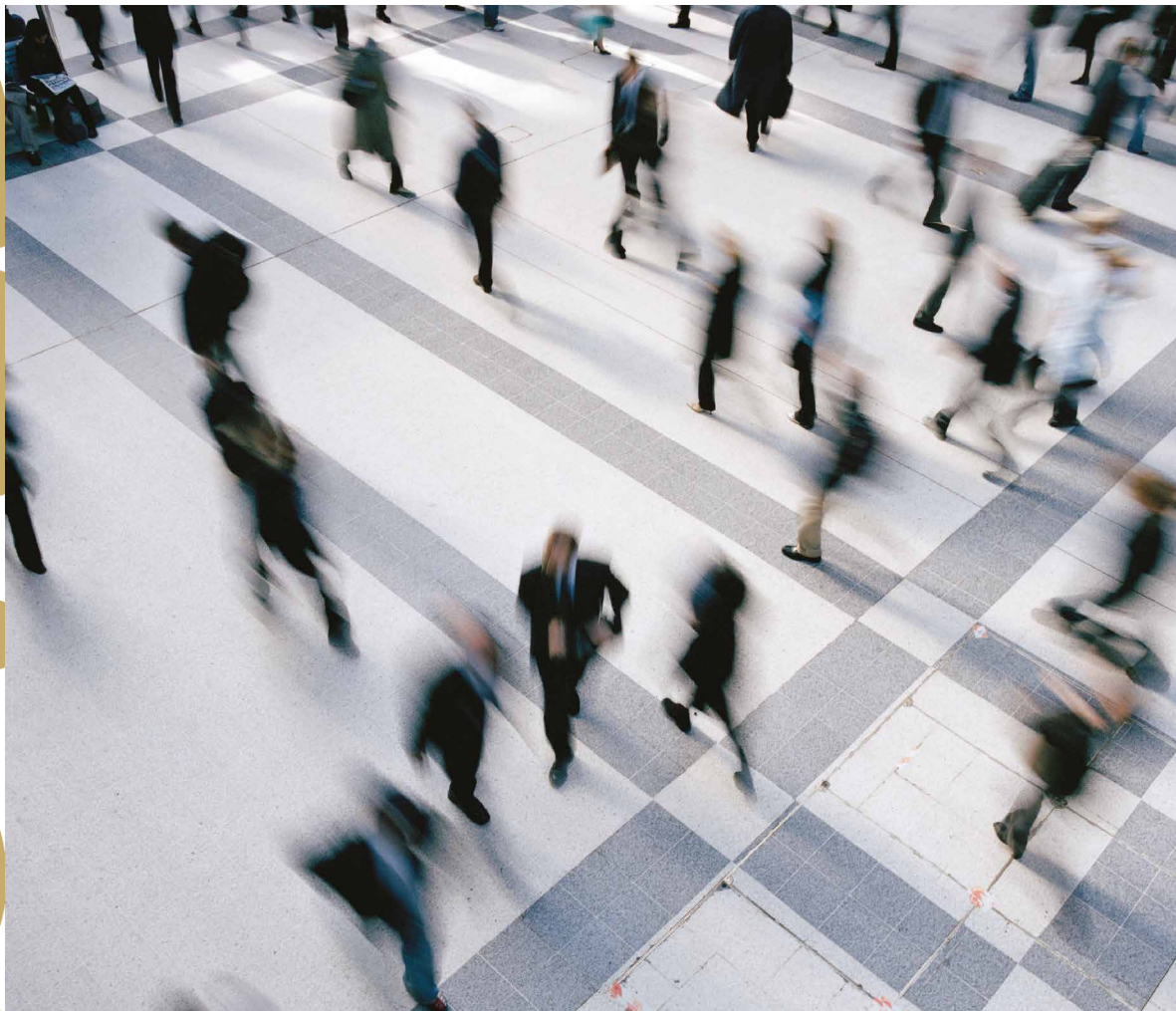
January 2016
Vol. 7 Ed. 1

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

Going their own way Multicurrency journeys

Nick Butler on stranded assets
Otmar Issing on euro impasse
Kingsley Moghalu on central banks
John Mourmouras on Europe's future
Athanasios Orphanides on Greece's non-rescue

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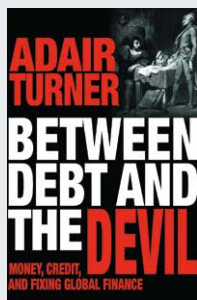
Going their own way

The world is en route towards a multicurrency system in which the dollar will share its central role with other currencies, including the euro, yen, sterling and the up-and-coming, volatile yet potentially pivotal renminbi. As the monetary authorities behind these currencies prepare to go their own way in interest rate policies, historical precedent, and the overshooting often associated with asset diversification, indicate that flux and uncertainty lie ahead. ■



Book review

In the review section, William Keegan enjoys Adair Turner's 'eminently readable' assessment of the 2008 financial crisis, *Between Debt and the Devil*. Turner headed the UK's Financial Services Authority at the height of the crisis, working closely with Chancellor of the Exchequer Alistair Darling and Bank of England Governor Mervyn King to address a systemic banking failure none of them foresaw. His concerns are with historically high levels of public and private sector debt, and the need to restore sense and utility to the banking system.



The year ahead

Mixed views for 2016

Europe

Europe must resolve the euro trilemma

Flawed rescue threatens integration

Fate of the euro and the UK referendum

Improving EMU's incomplete architecture

No closer to political union

International monetary policy

Fed panel turns more hawkish

Biggest danger is bank bashing

Emerging markets

Independence: important, not absolute

Beware Russian weakness

Insecurity in 'a time out of joint'

Sustainable investment

Action plan needed following accord

Climate change and stranded assets

Book review

A man who 'didn't see it coming'

Advisory Board

David Owen

Athanasios Orphanides

Gus O'Donnell

John Mourmouras

Otmar Issing

Darrell Delamaide

Steve Hanke

Kingsley Moghalu

Ben Robinson

Michael Stürmer

Ruud Lubbers and Paul van Seters

Nick Butler

William Keegan

Spotting when the bubble will burst

Analysing how divergent monetary policies will affect global economic growth and asset prices in 2016 is a difficult task, writes Brian Reading.

Computer screens have replaced crystal balls, silicon chips are the substitute for tea leaves. Still nobody sees the future.

Zero interest rate policies and quantitative easing have divorced markets from fundamentals. Divergence entails convergence, either economic fundamentals up or asset prices down. Ultimately the latter.

The dollar's the key. An increasing US trade deficit drives global growth while capital inflows push up the dollar. Normalising is dollar bubble-building then bubble-busting. Debt-trap arithmetic spawned early 2000s dollar crisis fears. Instead domestic debt did the damage.



We should remember the Triffin dilemma – the conflict between the tendency for a reserve currency to run a current account deficit, and creditor countries' increasing reluctance to hold that currency as the deficit widens.

Upward convergence ends when America can no longer afford to export growth. This bubble will burst, maybe in 2016, more likely 2017. ■

Brian Reading is an independent economist.

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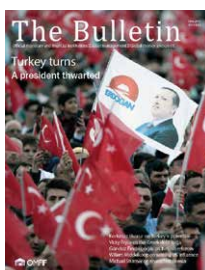
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EDITORIAL

Lessons of history for a chaotic monetary world

OMFIF has declared 2016 'The Year of the Multicurrency System'. Diverse currencies are competing for status and clout in a crowded and chaotic monetary world. All the monetary units that from 1 October will make up the International Monetary Fund's special drawing right – the dollar, euro, sterling, yen and renminbi – are subject to their own set of inherent strains and tribulations.

This is particularly the case for the No. 2 reserve currency, the euro, a money that has not yet reached maturity, to the extent that it combines 19 countries that do not (and may never) form a unitary state. The January 2016 issue analyses the trials besetting the European single currency, with articles by David Owen, Athanasios Orphanides, Gus O'Donnell, John Mourmouras and Otmar Issing. The renminbi, under pressure against the dollar in the early days of January, will be the subject of the February edition.

We include our 2016 predictions, from 20 members of the advisory board and other OMFIF associates – ranging over the US presidential election, myriad risks for financial markets, the dollar, renminbi and euro, Abenomics, the oil price and leading emerging market economies including Argentina, Brazil, China and South Africa. Darrell Delamaide, Marsha Vande Berg and Steve Hanke dissect the Fed's December interest rate rise and the prospects for more to come. Michael Stürmer and Ben Robinson place under the microscope Russia and its effects on Europe and the US. Janusz Reiter reports on the nationalist backlash in central and eastern Europe. Kingsley Moghalu, a former deputy governor of the Central Bank of Nigeria, outlines pressures facing central banks across the world, including in his own country, concluding that independence, although necessary, must never be absolute. William Keegan reviews Adair Turner's book *Between Debt and the Devil*.

In terms of the dollar-renminbi fluctuations, we have, in some ways, been here before. The twin centrepieces of the Bretton Woods system, the dollar and sterling, were both under strain as a result of economic weaknesses in the 1960s and 1970s. This led to colossal upheavals in the fixed exchange rate system which, in those comparatively sheltered days, encompassed mainly the industrialised world in an arrangement protected from overly disruptive capital movements by exchange and financial controls.

Curiously, the main beneficiary at the time was the German D-mark, the currency that has bequeathed the euro. A prime motivation behind the fusing of European money was the judgement by Chancellor Helmut Schmidt in the 1970s that the then West Germany was too vulnerable to take on the burden of running the world's second most important reserve currency. His premonition proved fatally correct. The D-mark plummeted against a rampant dollar in the early 1980s – a decline that indirectly led to Schmidt's political demise in 1982.

Currency history demonstrates important lessons for China. Reserve asset status confers power, but this goes hand in hand with considerable responsibilities, and can expose countries to major setbacks. The interplay of political and monetary influence is another lesson. Ever since money was first introduced there have, from time to time, been dominant currencies. Their dominance has depended on the power of the issuer or on the reputation of the currency and its metal content. The dollar will remain the No. 1 currency for years to come, but we will see periodic assaults on its pre-eminence as other currencies wax and wane. The new-old multicurrency world beckons. It may be a bumpy ride. ■



Danger of the super-dollar

Emerging market debt bubble worse than 2007-08

Marcello Minenna and Edoardo Reviglio



The dollar has reached its highest level since the early 2000s on a trade-weighted basis. This reflects higher US interest rates, expansive monetary policies elsewhere, and rising international tensions. The 'super-dollar' cheapens exports to America's still world-beating economy, helping the world recovery. But there is a considerable downside: the rising value of \$7.6tn of dollar-denominated debt issued by international borrowers, mainly concentrated on emerging countries.

Strong economic growth and cheap credit in countries such as China, Brazil and Indonesia have driven governments, banks and large companies into massive dollar borrowing over the past decade. As the credit tide turns, the volume of bad loans is likely to grow to dangerous proportions. For example, China's non-performing loans are estimated at \$630bn.

If the dollar rises further, many private debtors in emerging economies could be forced over the limit of sustainability, triggering runs on government finance and more global financial chaos.

Emerging market issuers have gained advantages by following their dollar borrowing strategy. After the Federal Reserve's quantitative

easing started in 2009, they benefited from low US interest rates and a low dollar. The industrialised countries' financial system encouraged a 'race to debt' through the 'hunt for yield', pushing a slice of the funds freed up by QE towards emerging market economies.

As a result, a large proportion of dollar debt in these countries is owed by the private rather than the public sector. Total corporate debt exceeds 100% of GDP in leading emerging economies such as China and Russia. This represents a higher debt overhang than in industrialised countries in 2007-08, just before the subprime crisis.

China's economic slowdown and the decline in commodity prices since early 2013 have seen the dollar's 10-year devaluation cycle go into reverse. Banks and large companies in emerging economies face increasing costs to repay their dollar debts, just when their economies are in trouble. All this creates the risk of a vicious circle in many emerging market economies, just one of the uncertainties besetting investors at the beginning of a volatile new year. ■

Marcello Minenna is Ph.D. Lecturer, London Graduate School of Mathematical Finance. Edoardo Reviglio is Chief Economist, CDP Group, Rome.

ADVISORY BOARD

OMFIF has appointed Graham Hacche and Edoardo Reviglio to the Advisory Board. For the full list of members, please see p. 28-29.



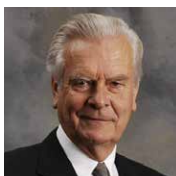
Graham Hacche is a visiting fellow of the National Institute of Economic and Social Research in London and editor of the chapter on the world economy in its quarterly National Institute Economic Review. Between 1982 and 2009 he worked at the IMF, including as the head of the division responsible for the Fund's biannual World Economic Outlook report (1995-99) and deputy director of the external relations department (1999-2009). From 1972 to 1982 he was an economist at the Bank of England. He holds degrees in economics from the universities of Cambridge and Oxford.



Edoardo Reviglio is chief economist, CDP Group, Rome. He is professor of economics at LUISS Guido Carli in Rome and at International University College of Turin and the general secretary of the commission to reform the public property section of the Italian civil code. He has covered various positions in the public sector, including chief economist and head of the research department at Istituto per la Ricostruzione Industriale and member of the Council of Economic Advisers of the Italian ministry of economy and finance. He also acted as economic advisor to the Italian minister of economy and finance.

BRIEFINGS

Owen urges Cameron to slow UK EU poll plans to ease Brexit threat



Britain should postpone to 2017 its planned referendum on European Union membership to increase the chances that the UK will remain in the Union, according to David Owen, former British foreign secretary and member of the OMFIF advisory board. At a conference in Berlin on 14 January co-organised by OMFIF, Owen said the European Commission's plans for a possible new treaty for further integration, with proposals to be published in early 2017, created an opening for a British referendum in November or early December 2017, a year later than currently planned.

Desai praises Fed rate hike as gesture of US economic confidence



In a telephone briefing on 15 December on the US Federal Reserve's forthcoming interest rate rise (announced on 16 December), Meghnad Desai, chairman of the OMFIF advisory board, said the expected hike in the fed funds rate would be a gesture of confidence in the US economy and a sign that the Fed was able to act ahead of the start of the 2016 election year. Other participants in the briefing, moderated by John Plender, were Stefan Bielmeyer of DZ BANK, Robert Minikin of Standard Chartered Bank and George Hoguet of State Street Global Advisors.

BOOK LAUNCH

Tide of returning Africans 'spearheading economic dynamism'

A growing tide of Africans is returning to the continent from Europe and North America to spearhead economic and business dynamism and speed political reforms, according to Jean-Claude Bastos de Morais, principal author of *The Convergence of Nations – Why Africa's time is Now*, published by OMFIF Press.

Bastos de Morais, founder of Quantum Global Group, was speaking at the book's launch on 10 December in London to a 150-strong audience drawn from politics, business, finance, research, and the media. He said 'returnees' form part of a 'new wave of economic development that is changing the face of Africa.'

Among other contributors, Abena Annan, founder of Ghana's Obaasema magazine, calls on investors 'to wake up to the vibrant and growing cultural scene in Africa'. Kevin Chika Urama, managing director of Quantum Global Research Lab, highlights Africa's growing young population as a source of opportunity. Sneha Shah, Thomson Reuters managing director for Sub-Saharan Africa, says increased intra-African trade and higher financial and communication flows are a 'necessary condition for transforming the continent's business services'.

The book, which includes contributions from 31 authors from 15 countries, emphasises Africa's need to embrace globalisation. While it also ranges across challenges including corruption, disease and terrorism, it highlights the 'demographic dividend' from Africa's young, dynamic and increasingly well-educated population, and sets down new precepts for 'African capitalism'.

In the foreword, President of the African Development Bank Akinwumi Adesina writes: 'As always, Africa must aim high. This time we can and we will achieve our aims. This expertly written book will heighten international understanding of and interest in our continent.'

The Convergence of Nations can be purchased from www.omfif.org/shop.



Launch of *The Convergence of Nations*: left to right – Kevin Chika Urama, Abena Annan, Jean-Claude Bastos de Morais and Sneha Shah.

Turbulent transition

OMFIF sets year of multicurrency system

The world is headed towards the uncharted waters of a durable multicurrency reserve system in which the dollar will share its pivotal role with a range of other currencies, including the renminbi.

Over the next 12 months, OMFIF will be attempting to shed light on whether the multicurrency system will be more or less stable than the de facto duopoly that has occupied the world monetary centre stage for the past 80 years – first, sterling and the dollar (up to 1945); then the dollar and sterling (1945-76); the dollar and the D-mark (1976-99); and, since 1999, the dollar and the euro. It seems we are heading for a turbulent transition.

The evolution of the multicurrency system has been on OMFIF's agenda since it was established in January 2010. One of the first analyses of this topic was by David Marsh, OMFIF managing director and co-founder, in the Financial Times in August 1979 (see below). There is good cause for thinking that the European Union may soon be officially recognised as a 'multicurrency bloc'. For all these reasons, OMFIF has declared 2016 'the Year of the Multicurrency System'.

All the currencies that from 1 October will make up the International Monetary Fund's special drawing right – the dollar, euro, sterling, yen and renminbi – are subject to their own inherent strains and tribulations. This is particularly the case for the number two reserve currency, the euro, a still-experimental money combining 19 countries.

China will rise as the US wanes, but this rebalancing will occur gradually rather than abruptly, and setbacks and perturbations are likely along the way. China's ascent will inevitably be riddled with political and economic challenges that lead to occasional severe disruption.

As part of China's catch-up, the authorities behind the renminbi are still learning the rudiments of running an international currency. But the West needs to guard against hubris or arrogance. Pivotal moments in the history of significant reserve currencies backed by centuries of capitalist development – Britain's departure from the gold standard in 1931, the US break with gold in 1971, or Germany's disruptive policies on the D-mark in the European currency upheavals after reunification in 1990 – are hardly models of smooth financial management.

In previous transitions gold – without a formal role in the system, and yet important for many countries' reserves – has come into its own. This was seen in the changeover between sterling and the dollar in the 1960s and the 1970s – and may be the case in the next 10 years as the renminbi rises. In the past 30 years, the world has seen sizeable increase in reserve holdings, far-reaching trade and investment globalisation, the ascent of emerging market economies, and the spread of financial markets linked by instant communications. A far greater weight of global capital is jostling to find a home across more time zones in a much broader variety of instruments.

Reaching a steady equilibrium will take time. The shift is highly unlikely to be orderly.

MULTICURRENCY MEETINGS



2016 YEAR OF THE MULTICURRENCY SYSTEM

The political economy of exchange rates

Prof. Jeffry Frieden, Harvard University
Department of Government
20 January, London

Global economic and currency challenges

Prof. Maurice Obstfeld, chief economist,
International Monetary Fund
20 January, London

At the heart of Europe

Prof. Ewald Nowotny, president, Austrian
National Bank
25 January, Vienna

Asia and the world financial architecture

Takehiko Nakao, president, Asian
Development Bank
26 January, London

The euro and the world economy

Joachim Nagel, Bundesbank; Prof. Otmar
Issing, formerly European Central Bank;
Lord (Norman) Lamont, former UK
chancellor of the exchequer
4 February, Frankfurt

The multicurrency reserve system

Jaime Caruana, general manager, Bank for
International Settlements
4 February, London

Spain and the European economy

Luis M. Linde, governor, Banco de España
9 February, London

Monetary influences from Brexit

Wolfgang Schäuble, German finance
minister; Peter Mandelson, former
European commissioner
3 March, London

Europe's deadlock – the euro crisis

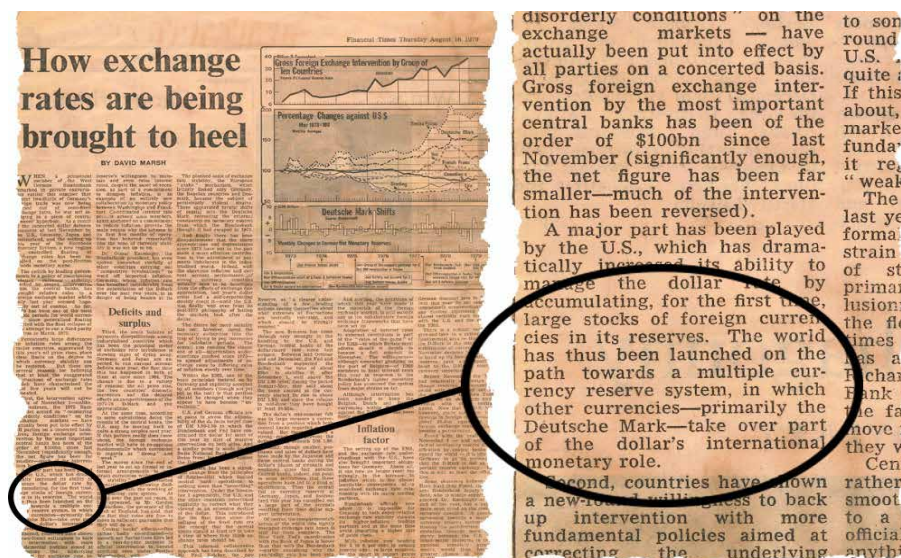
Nigel Lawson, former UK chancellor of the
exchequer; David Owen, former UK foreign
secretary
22 March, London

Risk and yield management for official asset managers in a multicurrency system

James Bullard, president, Federal Reserve
Bank of St. Louis
23 May, Beijing

The US economy in 2016

Robert Kaplan, president, Federal Reserve
Bank of Dallas
29 May, London



by David Marsh, Financial Times, 16 August 1979

Clinton ahead, Lagarde and Merkel to stay

Risks for China, euro, yen, junk bonds – oil at \$45-\$50

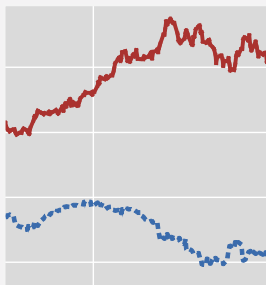
Hillary Clinton has the edge in the US election – but nothing is assured. Chancellor Angela Merkel will remain in power despite refugee alarms. Christine Lagarde will stay at the IMF. The oil price will recover to \$45-\$50 a barrel. India will outpace China. The euro area faces a fresh crisis. US-Russian rapprochement on Syria is unlikely. Junk bonds will be hit. The renminbi will fall further. The markets are not pricing in risks for the yen if Japanese inflation rises. OMFIF's advisory board predictions make mixed reading. Welcome to 2016.



What is the greatest source of macroeconomic instability in 2016?

The scope for China's structural slowdown to create macroeconomic instability is large. This was demonstrated by the badly managed devaluation of the renminbi last year and the botched attempt by the authorities to prop up the stock market. The start of the New Year confirmed my view. China could precipitate a new round of currency wars, as its overvalued currency creates strong temptation for Beijing to devalue. This would come on top of a real depreciation that is already under way thanks to producer price deflation, leading to global financial instability and a protectionist backlash in the US.

John Plender, Chairman, OMFIF



What is the greatest danger facing financial markets?

During the prolonged period of near zero interest rates I had frequent premonitions that, while the Federal Reserve and other central banks were concerned about the trade-off between employment and inflation, another portfolio crisis was the real danger. Market fragility since the start of 2016 has shown that many equity prices were unsustainably high. China is not sufficiently important for western markets to justify the decline. Rather, markets are realising they have been overvaluing assets in recent years. Financial volatility is very likely this year.

Meghnad Desai, Emeritus Professor of Economics, London School of Economics and Political Science



Which risks are least recognised by financial markets?

Higher than expected inflation in Japan is an under-recognised risk. There is continuing pressure on the Bank of Japan to expand quantitative easing to try to reach its inflation target. In due course, the potential supply of Japanese government bonds in the banking system will be exhausted, with important consequences for money growth. When inflation finally takes off the BoJ will be hard pressed to manage a safe exit from QE because it will have difficulty holding down nominal yields on JGBs, and the yen could suffer an uncontrolled plunge. The scope for financial chaos is not negligible.

John Plender, Chairman, OMFIF



Who will be the US presidential candidates and who will win the November election?

Hillary Clinton may win the Democratic nomination for president, but no one knows who will get the nod from the Republican party. If Donald Trump fails to win the nomination on the first ballot of the Republican convention in July, delegates will be free to vote for whomever they wish. Paul Ryan, the 2012 vice presidential candidate and newly installed Speaker of the House, could emerge as the nominee in the event of a stalemate. This uncertainty gives Clinton an edge in the general election in November but, in a campaign full of surprises, a Clinton victory is anything but assured.

Darrell Delamaide, US Editor



What will be the pace of US interest rate rises, and where will the Fed fund rate be in December?

A key reason for the Fed tightening in December was strong US job creation, with unemployment down to 5%. The tightening labour market is reflected in 3.1% wage growth, up from 2-2.5% in 2014, contributing to core inflation (minus food and energy) of 1.3%. It's only a matter of time before prices and costs move closer to the Fed's 2% target, but declining energy costs, the drag from weak exports and an apparent disconnect between wage growth and unemployment are countervailing forces. As a result, interest rates are unlikely to reach the Fed's predicted target of 1.25% and 1.5% this year. I believe they will not climb above 1%.

Marsha Vande Berg, Senior Fellow, Harvard University



How significant is the danger of a junk bond upset affecting market stability?

When safe assets yield peanuts, demand for enhanced returns becomes insatiable. Wrongly calibrated risk is inevitable. Junk bonds' nemesis has come. QE is the 'sorcerer's apprentice' in Disney's *Fantasia*. Losses pass around and multiply until reaching deep pockets – taxpayers'. Regulatory requirements don't prevent losses multiplying. Unforeseen oil and hard commodity price collapses have undermined banks' adequacy tests. Capital must be replenished not used, imperilling loans and liquidity. Mutual funds and ETFs have no last-resort lender. Shale and emerging market corporate borrowers are stuffed. Witches' brooms are at work.

Brian Reading, independent economist



Where will the oil price be at the end of 2016?

Prices will be volatile. The risks of more conflict in the Middle East, including ISIS activity in Northern Iraq and Libya, could jeopardise supply. Sub-\$40 prices don't look sustainable for producing countries. Saudi Arabia faces intense pressure to cut production. Yet the ceiling for limited price rises is quite low. Iran and others want to increase output, Russia and the North Sea have already raised theirs. More tight oil from shale rocks will come on stream if prices rise. Demand is growing modestly, but remains outstripped by supply – \$45 to \$50 a barrel is a reasonable bet for end-2016. Only a Saudi revolution could push prices through the ceiling.

Nick Butler, Chair, King's Policy Institute, King's College London



Will there be a US-Russian rapprochement to bring an end to the civil war in Syria?

In an American election year, there will be no rapprochement with Putin's criminal regime or his disdain for the principles of democracy. Nor should there be. But there can be a concerted effort at crisis diplomacy based on the few shared interests which continue to exist, in particular the concerns of both the West and Russia over the spread of Islamic radicalism. To succeed, this must be a common effort of the Atlantic Alliance and not just an American project. Will this work? Recent behaviour of both sides leaves little room for optimism. But we should hope that they try.

John Kornblum, former US Ambassador to Germany



Are economic buffers of high foreign exchange reserves sufficient for stability in emerging markets?

The key question is the outlook for emerging market currencies. The consensus view is that they face another difficult year in 2016. Perhaps we should challenge this view. I would argue that there is a lot of bad news already priced into many emerging market currencies and that, at some stage, this point will be recognised. If emerging market currencies are stable or, whisper it, actually rally in 2016, then buffers such as foreign exchange reserves will not be tested, and indeed may be rebuilt in those nations that saw declines in 2015.

Gary Smith, Head of Sovereign Wealth Funds and Official Institutions, Barings Asset Management



Will the IMF's position as 'policeman' of the world economy be strengthened by quota changes?

The December 2015 reform of the IMF's governance structure was a welcome move, but more needs to be done to catch up with the changing realities of the global economy's emerging power structure. For the IMF to retain its credibility, effectiveness and relevance in preserving global financial stability, it is vital that it embarks immediately on the 15th Review of its quota distribution, a task that should have been completed by December 2015. This would indicate to the world that the IMF is committed to continuing its mandated tradition of the regular five-yearly quota review exercise on a continuous basis.

Rakesh Mohan, former Executive Director for India, International Monetary Fund



Who is likely to be the next IMF managing director?

Enjoying the advantage of being the incumbent, with strong backing from the IMF's major shareholders, Christine Lagarde's prospects for a second term as IMF managing director are bright. Three actions have solidified her broadly based support. First, she has proved highly useful to the US and Europe in the IMF's handling of Ukraine's economic crisis. Second, she has pleased China by getting its currency included in the SDR basket. Third, she has succeeded in convincing the US Congress to agree to IMF reform, which has increased the relative voice of the emerging market countries in the IMF's governance.

Desmond Lachman, Resident Scholar, American Enterprise Institute



What is the biggest crisis facing the euro area?

As recent elections in Spain and Portugal make clear, economic reforms remain highly unpopular. This is increasing the divergence between debtor and creditor countries in Europe. Weaker economies insist that further reforms are politically damaging, while Germany maintains these changes are necessary to strengthen the euro system. This could lead to the economically stronger countries questioning whether it makes long-term political and economic sense to remain a member of the euro area in its current guise. The lack of common ideals could lead to a fresh crisis for the euro area in 2016.

Stefan Bielmeier, Global Head of Research and Economics, DZ Bank



Will Angela Merkel survive 2016 as German chancellor?

Yes. She will, if only by default and because there is no one in the parliamentary party – or, for that matter, in Munich's state chancellery – to wield the dagger. It would be preferable if she resigned, but there are no successors. She has an impressive army to protect her from media criticism: most of the left-wing liberal media have supported her through thick and thin, including through the refugee crisis, which threatens to be the defining issue for the rest of her tenure. She will stick to her guns – whatever happens. There is unlikely to be any combination of political forces to displace her after the 2017 elections.

Michael Stürmer, Chief Correspondent, Die Welt and former adviser to Chancellor Helmut Kohl



What will be the result of the referendum in the UK?

I question if Britain's referendum on EU membership will happen as early as many assume. The prime minister dare not lose the vote, for if he does he will enter the hall of shame of disastrous British prime ministers alongside Lord North and Neville Chamberlain. Every referendum in Europe this century with the word 'Europe' on the ballot paper has been lost. The British press remains anti-European. Business won't get involved. Now senior cabinet ministers can campaign for Brexit. I hope I am wrong, but my euros are still on a narrow 'out' vote.

Denis MacShane, former Minister for Europe



Will 2016 be a successful year for Abenomics?

Although growth won't be scintillating, it will be hard to find a much better prospect than Japan around the globe. The Abe administration's popularity is solid following the virtual elimination of unemployment, while Japan's dire fiscal position has improved with the reappearance of limited inflation. The situation will improve further this year. The market accorded belated safe haven recognition to Japan in December 2015 as the yen rose against the dollar, despite the decision to raise US interest rates. Bank of Japan Governor Haruhiko Kuroda has been remarkably successful in his monetary policy based on exchange rate targeting.

Shumpei Takemori, Professor of Economics, Keio University



What will this year hold for China and India?

China is experiencing a difficult transition from an export-driven economy to one relying on its domestic market. Chinese policy-makers have shown they lack the ability to manage the transition smoothly, so bumps are likely along the way as they ascend the learning curve. India has always relied on its domestic market and, with a decisive government attracting significant foreign investment, GDP growth in 2016 may be around 7.5%-8.5%. Inflation has been brought below 5% and there is a tough anti-inflation policy in place. Narendra Modi's government has faced irrational obstacles in parliament, but this year may prove less disappointing.

Meghnad Desai, Emeritus Professor of Economics, London School of Economics and Political Science



Will the renminbi weaken significantly against the dollar?

Yes. By 2013 the renminbi had strengthened to 6 to the dollar, but is presently on a weakening trend at 6.5. How strongly and how long this continues will depend on the divergence of the US and Chinese economies and their interest rates. China has tried to avert US criticism by moving its currency peg from the dollar to a basket of currencies. Timing will be important: China will not want to arouse US passions late in an election year. The currency could have two bouts of depreciation – one around March (once it gains EU WTO market economy status on tariffs) and another in late 2016.

John Adams, Chief Executive, China Financial Services



Will the new Chinese demographic policies start to exert a positive influence on population dynamics?

China's decision to end its one-child policy came at a time of slower growth and rising concern about an ageing population. To meet future economic growth targets the government must focus on supply-side issues, including labour input. The new policy may come too late and do too little however, unless more supportive policies, such as financial subsidies for subsequent children, are implemented in the near future. Neither can the new demographic policy alter the lag effect of China's past demographic controls, which will see a growing bulge in those aged over 60 in the years up to 2050.

Haihong Gao, Director, Research Center for International Finance, Chinese Academy of Social Sciences



How will Latin American central banks deal with rising US interest rates?

Many Latin American countries have seen a sharp depreciation of their currencies caused by the fall in commodity prices. The resulting inflationary pressures have led to a tightening of monetary policy across the region. Lower growth in China and the gradual normalisation of US monetary policy will raise borrowing costs and constrain Latin American central banks' room to adapt to the new environment. While most central banks will continue to tighten monetary conditions, the effects of the Fed rate increases will generally be manageable, especially in those countries with flexible exchange rates.

José Manuel González-Páramo, Member, Executive Board, BBVA Group



Will Brazilian president Dilma Rousseff survive the impeachment process?

Chances are that Rousseff will survive attempts at impeachment in the short term. But whether she survives or not matters less, perhaps, than the fall-out from the impeachment process, weakening, as it does, her ability to reshape the Brazilian economy and return the country to growth. The departure of Finance Minister Joaquim Levy at the end of 2015 was a serious blow to the prospects of reform. Her choice of his replacement suggests battening down the hatches in the ruling Workers' party in the face of rising inflation, unemployment and fiscal deficits. Such a strategy indicates a fight for survival.

David Smith, former UN Director, Southern Cone



Will the real's decline against the dollar come to an end in 2016?

Having devalued by 67.5% in nominal terms over the past two years, Brazil's real effective exchange rate has reached a stable level. International reserves are at an historically high \$370bn, and the massive fall in imports generated by Brazil's recession has produced a record trade surplus. However, although the trend for a stable real exchange rate seems clearly established, I expect frequent oscillations in nominal rates as markets test the levels managed by the Brazilian central bank. Short-term arbitrage movements are likely to occur every time economic policy announcements create doubt, which should be a common occurrence.

Luiz Eduardo Mellin, Senior Managing Partner, International Economic Synergies



Will President Mauricio Macri succeed in stabilising the Argentine economy?

President Macri believes he has no time to lose if he is to rebuild the Argentine economy, and his year-end moves showed brave policy-making, laced with careful preparation and market savvy. The peso has been devalued, the country's vast agribusiness sector is exporting furiously, and his new government is assiduously courting foreign investment. Watch out for strikes and protests, as he seeks to keep wage rises below inflation, and keep an eye on an opposition that seeks instability. But the early signs are positive – a new government that believes in returning Argentina to the real world.

David Smith, former UN Director, Southern Cone



Will President Jacob Zuma survive in power in 2016?

South African President Zuma may just survive the year following a crude attempt in December 2015 to replace a competent finance minister with an inexperienced backbencher. He wanted to make the Treasury less hostile to provincial political allies, business cronies and friends in state-owned companies in need of funds. His moves hurt both the rand and government bonds, while his own political muscle has been weakened. There is no obvious replacement should the party opt to oust him, but he may face a challenge should the party perform poorly in local elections this year.

Peter Bruce, Editor in Chief, Business Day, Financial Mail and BusinessDayTV



Europe needs to resolve euro trilemma

Britain must delay vote to 2017 to lower Brexit chances

David Owen, Advisory Board

In April 1978, I attended the European summit in Copenhagen as British foreign secretary. There, I first heard Helmut Schmidt and Valéry Giscard d'Estaing, the German and French leaders, spell out their ideas for European monetary union. Little did I realise they were outlining a project that was doomed to destroy Europe's then slowly evolving unity.

In retrospect, this was the first outward sign of the 'vice of pretension' that is doing so much to erode today's European Union. Britain concluded that the exchange rate mechanism launched by Schmidt and Giscard was at best premature for the UK, and declared it would not join. But it did join the overall framework, the European Monetary System, and signed up to its share of European currency units.

Now we know the ERM was flawed. The UK eventually joined in 1990 but was forced to leave in 1992, albeit with no significant consequences. The British government since 2010 has made clear that it is more than content to support an 'efficiently designed' euro area, as its continued failure harms the British economy. But virtually every necessary reform puts the euro system on the path to greater political integration, a direction of travel neither I, nor many British people, want to embark on.

A paper by Maurice Obstfeld, now chief economist of the International Monetary Fund, published by the European Commission in April 2013 when he was an academic at the University of California, is relevant here. 'The euro area must confront a financial-fiscal trilemma: countries in the euro area can no longer enjoy all three [desired characteristics] – financial integration with other member states, financial stability, and fiscal independence – because the cost of banking rescues may now go beyond national fiscal capacities.'

Unless the British people see this euro area 'trilemma' resolved very soon, as well as recognition of the need to safeguard the interests of non-euro countries within the EU, Britain is likely to vote to leave when it holds a referendum on EU membership, most likely in June or September this year.

Since 2009, the US Treasury has been making determined representations to the

euro area to act to disentangle the euro crisis. The message from Europe has been that the time is not yet right for substantive action. But when will it be right?

As Obstfeld reminded us in 2013, 'Most of EMU's first decade was passed in a singularly benign global environment. That allowed EMU to skirt the biggest potential challenges identified before its 1999 launch.'

According to Obstfeld, 'The EU imposed the euro on a linked system of national economies with well-known structural rigidities in labour and product markets. Within each country, powerful national

“ It is absurd to go on with the myth that Britain is negotiating only over the UK's interests. Most of Cameron's proposed changes can, and should, be presented as of value to Europe as a whole – not just the EU, but the wider membership of the EEA and indeed, eventually, all European countries. ”

vested interests protected existing distortions.'

This EU unilateralism is now spreading to the EU 'five presidents', headed by European Commission chief Jean-Claude Juncker, who – we are told in leaks from Brussels – is discussing plans for a substantial new treaty, with a proposed timetable due to be published in early 2017. This has a significant bearing on British Prime Minister David Cameron's negotiating plans.

This creates an opening for a British referendum in November or early December 2017, a year later than currently planned. This would take into account possible treaty changes involving the European Economic Area, something I have long championed.

But the UK is instead preparing for a referendum in 2016. Juncker and Cameron

would be better served by bringing together their separate negotiations, and extending them to the end of 2017. It is not too late to negotiate for an expanded non-integrated European Economic Area to continue alongside an integrated euro area.

It is absurd to go on with the myth that Britain is negotiating only over the UK's interests. Most of Cameron's proposed changes can, and should, be presented as of value to Europe as a whole – not just the EU, but the wider membership of the EEA and indeed, eventually, all European countries.



We need to wake up. We are all being fooled in the EU, not just the UK: by Cameron over this short-term fix, and by Juncker and the five presidents.

It is time to call both Juncker's and Cameron's bluff and restore some confidence to financial markets that Europe and the UK are getting their act together.

If Cameron and Juncker fail to bring their negotiations together, and Britain is asked to vote in 2016, then the chances of Brexit will markedly increase. ■

Lord (David) Owen is a former UK Foreign Secretary. This is an abridged version of a speech given in Berlin on 14 January to the 12th annual Berlin conference of the British Chamber of Commerce in Germany and the German-British Forum. The full speech can be found at www.omfif.org/news/2016/



Flawed rescue threatens integration

How 2010 Greek package served French, German interests

Athanasios Orphanides, Advisory Board

The mismanagement of the euro crisis has its roots in the euro area's flawed political structure. A study of the European Union and International Monetary Fund programme imposed on Greece in May 2010 highlights both the nature of the problem and the difficulty in resolving it.

Governments of some member states – particularly Germany – were able to exploit problems in others to support their own interests. Furthermore, key governments were able to exert undue influence on the IMF, compromising its role to the detriment of other member states and the euro area as a whole.

The May 2010 programme was the original sin of the euro area crisis. Rather than help Greece, it was designed to protect specific political and financial interests in other member states, above all France and Germany.

The ease with which the euro was exploited to shift losses from one member state to another, and the absence of a corrective mechanism, render the current framework unsustainable. In its current form, the euro poses a threat to the overall project of European integration.

Given its accumulated experience, the IMF could have helped contain the crisis and resolve it effectively. By applying its established lending framework, it could have guided a successful programme.

“The IMF questioned the sustainability of Greek government debt. But the May 2010 programme was implemented without any debt restructuring, largely reflecting the preference of France and Germany.

However, its role was counterproductive. The IMF circumvented its own established rules by introducing a flawed ‘systemic exemption’ to its lending framework. Using a legitimate concern – the risk of contagion – as a pretext, it underwrote a programme that shifted crisis losses to Greece that other euro members could have borne. This precipitated the country's economic collapse and created a poor precedent for subsequent crisis mismanagement in the euro area.



Greek anti-IMF protest in 2010

At the end of 2009, Greece faced questions about the sustainability of its government debt, becoming the first euro area member state to require IMF assistance. It faced many of the macroeconomic problems commonly encountered in countries turning to the IMF.

Accumulated populist spending had led to sustained budget deficits and current account deficits, a loss of competitiveness, and an overvalued real exchange rate.

Greece's euro membership created additional challenges – the government had relinquished control of its own monetary and exchange rate policy, tools it could have used to defuse the crisis.

The design and implementation of an IMF programme for Greece required coordination with other euro area governments and institutions. The resulting complications led to decisions that transformed the problem. What could have been handled as an ordinary IMF programme became a systemic euro area crisis.

The Greek programme effectively became subject to the approval of each of the other euro governments, making decision-making dependent on other states' competing and conflicting financial and political interests.

The need for proper crisis management

Every crisis generates losses. Proper crisis management should minimise the total economic cost and manage a fair distribution of losses across time and across stakeholders. However, no institution or government in the euro area has the responsibility or authority to take such decisions.

Political survival of elected governments demands that leaders focus on voters and public opinion in their own state, regardless of whether this leads to decisions that are harmful to other states and the euro area as a whole. This creates incentives for diverting losses among different groups of stakeholders and different euro members.

The result was unfortunate but predictable – massive economic destruction in some member states, and a considerably higher total cost for Europe as a whole.

Chart 1 (p. 14) suggests the consequences of the mismanagement for the euro area as a whole. The economic performance of the euro area and the US developed in >>

>> parallel during the first decade of the euro. Yet since the euro crisis began, performance has diverged significantly.

Using the US as a benchmark of what could be achieved in the euro area with reasonable macroeconomic policy and crisis management, the data suggest that crisis mismanagement has generated a sustained annual loss of about 10% of GDP per person.

Winners and losers

The crisis has created winners and losers among euro area member states. Germany has been by far the biggest, and perhaps the only, winner.

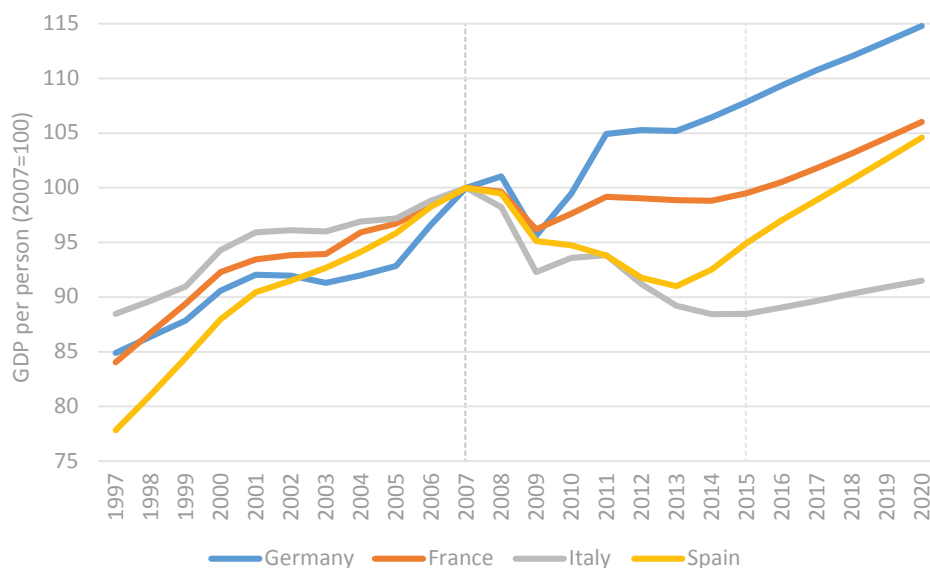
Chart 2, which compares data and projections for the four largest euro member states, together representing around 80% of euro area GDP, reveals large and sustained differences between these economies. Among these, Germany is the only one that appears to have satisfactorily recovered from the global financial crisis. France has fallen behind and only recently recovered to pre-crisis per capita GDP levels. Spain and Italy have performed considerably worse.

Chart 3 (p. 15) presents another comparison with the US, and suggests the extent to which euro mismanagement has benefited Germany to the detriment of the rest of the euro area.

Taking the US performance as a benchmark, the euro crisis has created a persistent 15% gap in GDP per person between Germany and the rest of the 12 countries that originally formed the euro area. The Greek picture is still more dramatic.

Chart 2: Large differences between four largest member states

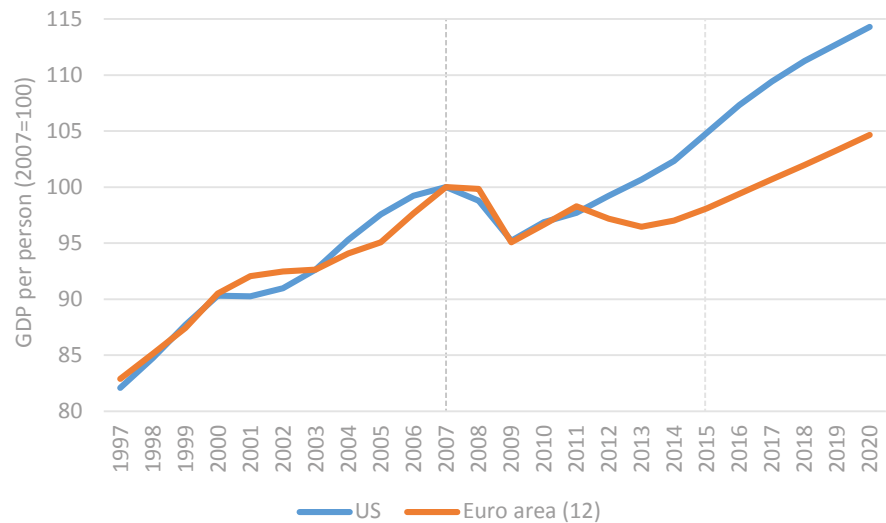
Real GDP per person – largest euro area member states, 1997-2020



Source: Annual data and projections from April 2015 IMF World Economic Outlook

Chart 1: Economic performance divergence of US and euro area

Real GDP per person – US vs euro area, 1997-2020



Source: Annual data and projections from April 2015 IMF World Economic Outlook

Chart 4 (p. 15), which compares quarterly real GDP data for Germany, Greece and the euro area as a whole, indexed to 100 at end-2007, underlines the catastrophic consequences of the May 2010 programme. Real GDP in Greece has declined by more than a quarter, a destruction of Great Depression proportions.

Common weaknesses

To be sure, Greece had serious problems in 2009. But Greek weaknesses then were similar to problems commonly encountered among IMF lending applicants and successfully tackled by the IMF. The IMF

provides loans subject to conditionality, which is usually unpopular.

With a properly designed programme, the hardship imposed is normally smaller than that which would emerge without the Fund's involvement. IMF programmes invariably prescribe fiscal austerity. But it is recognised that austerity beyond a democracy's breaking point becomes counterproductive.

In view of Greece's euro membership, the intra-euro area nominal exchange rate had to remain fixed. As a result, more of the adjustment burden had to occur via internal devaluation – a relative decline in domestic prices and wages. This is a slower process than an adjustment through nominal devaluation, suggesting that a successful IMF programme might have required a more gradual fiscal adjustment to avoid an austerity-induced economic collapse.

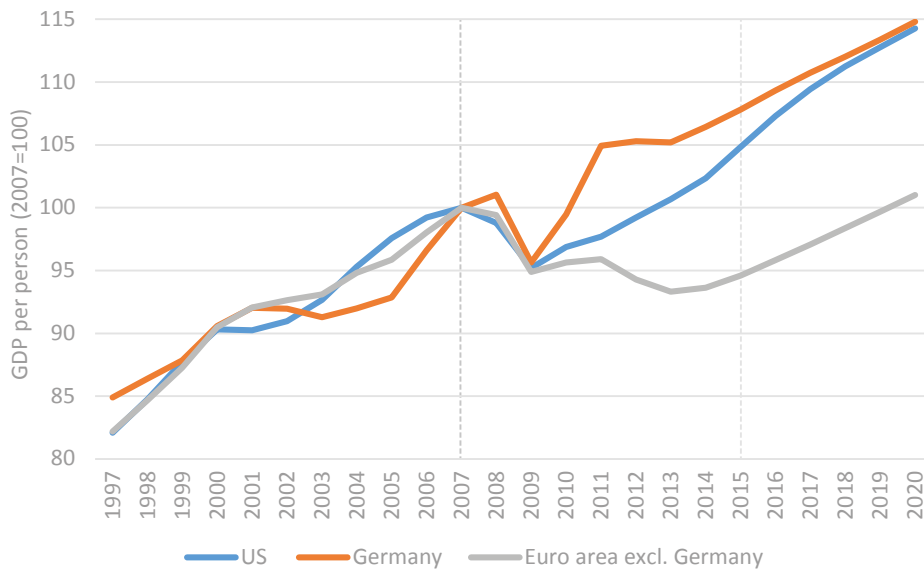
Greece's relatively high initial level of debt was another vexing issue. By the time Greece turned to the IMF for assistance its debt had risen to 115% of GDP, partly because euro area government bond yield convergence, lowering debt financing costs, helped to encourage deficit financing..

The IMF questioned the sustainability of Greek government debt. But the May 2010 programme was implemented without any debt restructuring, largely reflecting the preference of France and Germany, which took a leading role in the programme's design.

The programme called for an unprecedented fiscal adjustment of around 15% of GDP. The fiscal consolidation in the baseline scenario envisaged the primary

Chart 3: How euro mismanagement has benefited Germany

Real GDP per person – Germany vs euro area excluding Germany, 1997-2020



Source: Annual data and projections from April 2015 IMF World Economic Outlook

balance improving from a deficit of 8.6% of GDP in 2009 to a surplus of 6% by 2014 and beyond. Although the absence of exchange rate flexibility would have called for a more gradual fiscal correction, public opinion in Germany demanded the opposite – harsher measures to facilitate parliamentary approval without discomfort for Chancellor Angela Merkel.

From Germany's perspective, as long as IMF staff could maintain that the programme

would succeed, the harsher the austerity measures the better. The IMF deemed that the associated decline in economic activity would be relatively benign and short-lived.

According to the baseline scenario, while output was expected to contract in 2010-11, growth was expected to recover to 2.75% in 2015. Overall, the IMF staff appraisal of the programme, and of the level of backing by the Greek government, was very positive: 'The new Greek authorities have risen to the

challenge by embarking on a bold multi-year programme that is extraordinary in terms of the scale of planned adjustment and the comprehensiveness of reforms.' In the event, the Greek economy collapsed and the EU/IMF programme failed.

Charts 5-9 (p.15-17) compare the baseline scenario of the May 2010 programme with subsequent outcomes. Data and forecasts for the baseline scenario are taken from the May 2010 IMF staff report. Outcomes are taken from the IMF's April 2015 World Economic Outlook.

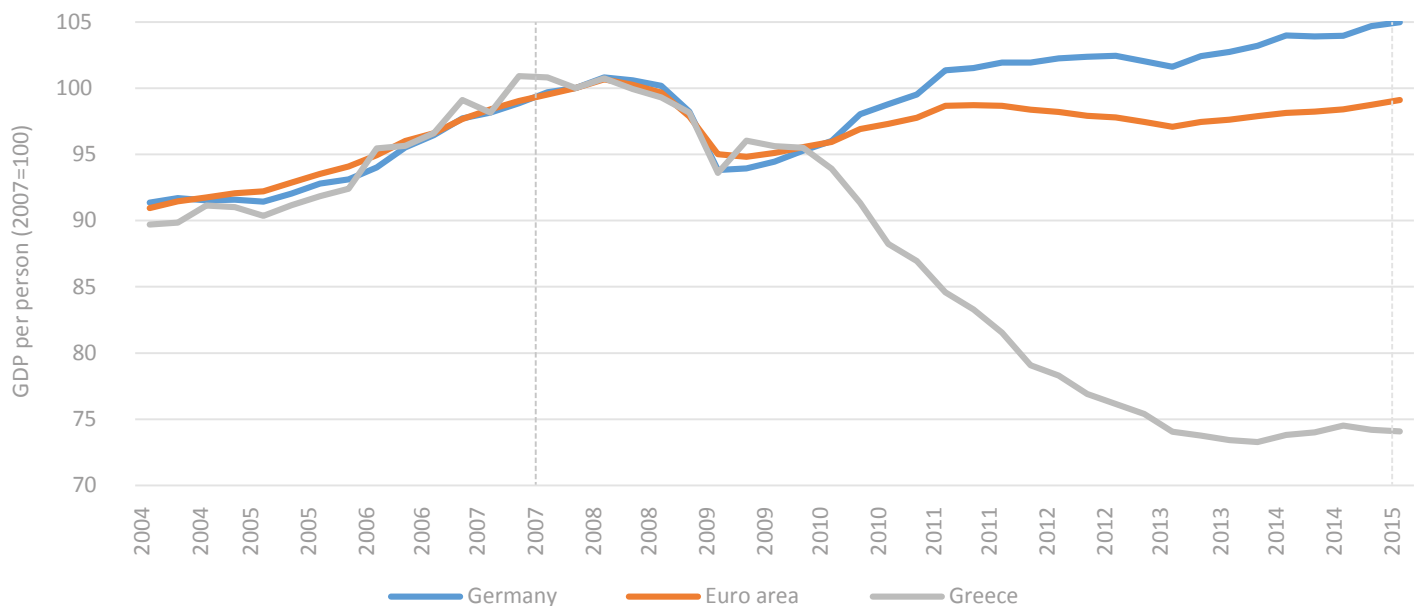
Chart 5, which compares the projected and actual paths of the Greek government deficit, suggests that Athens generally implemented austerity as planned. But as Charts 6 and 7 underline, this fiscal austerity was not accompanied by the envisaged relatively benign recession. Rather than peaking at around 15%, as assumed, unemployment jumped to over 25%. Rather than return to growth in 2012, real GDP continued to decline.

Measured in 2010 euros, the path of actual real GDP has remained at around €50bn per year below the 2010 projections, resulting in a cumulative output loss to date approximately equivalent to a full year's GDP.

Chart 8 shows a corresponding deviation in projected and actual nominal GDP. As a result of the output collapse, Chart 9 shows that debt-to-GDP projections proved wide of the mark. >>

Chart 4: Winner and losers of the euro crisis

Real GDP person – Germany, Greece and euro area (quarterly data), 2004-2015



Source: Eurostat quarterly data of real GDP

>> The saga has been marked by attempts by euro area politicians to shape public opinion in a manner favourable to their own interests and aspirations.

In democracies, crises offer fertile ground for demagoguery. Politicians in different member states have attempted to avoid blame and, if possible, shift it to others, generating considerable animosity and mistrust. Supporters of the Berlin and Athens governments have developed markedly different narratives of events.

The Berlin narrative lays down that German taxpayer money has been financing Greek profligacy since 2010. According to this account, Greek governments since 2010 have consistently failed despite generous support from Germany. Athens has no choice but to engineer further austerity measures to honour its commitments – otherwise, Greece should no longer be part of the euro.

The Athens narrative runs differently: Germany exploited its power to block an ordinary IMF programme, and instead supported a plan that imposed excessive debt on the Greek people while protecting German interests. According to this account, austerity policies have pushed Greece into a debt trap. As a result, the German government should accept its responsibility and agree a compromise that eases Greece's debt burden.

Which version is closer to reality? Arguably, both narratives contain elements of truth as well as distortions. However, one telling comment on the circumstances of the Greek programme provides an important indication of the motivations behind what happened.

On 18 May 2010, just one week after the EU-IMF programme was decided, former Bundesbank President Karl Otto Pöhl expressed serious doubts about the programme's wisdom, questioned whether Greek debt was sustainable, and backed debt restructuring to lighten the burden.

Other observers and analysts expressed similar views. Pöhl disputed official explanations as to the programme's rationale, and observed that it was guided largely by the need to protect French and German banks, 'especially the French banks', from debt write-offs.

Why did the May 2010 programme rule out a restructuring of Greek debt if this, or a

Chart 5: Projected and actual paths of Greek government deficit
Greece's deficit-to-GDP ratio, 1999-2015



Source: Annual data and projections. 2010 series reflects May 2010 programme, as published at the time. 2015 series reflects data from April 2015 IMF World Economic Outlook

similar measure, was required for its success? A restructuring presented an economic cost to French and German interests, as well as significant political risks for Merkel's government.

As an example, consider the case of Hypo Real Estate (HRE), a bank the German government had bailed out and subsequently nationalised in 2009. At the time, HRE had exposures of around €10bn in Greece and €58bn in Spain, Portugal and Italy combined. A restructuring of Greek debt would have probably caused HRE to collapse.

influence of protecting other interests.

Critical technical errors included overly optimistic assumptions. The report noted that IMF staff had made clear from the outset that risks were such that debt was 'not judged to be sustainable with high probability'. But debt restructuring was 'ruled out by the euro area'; a 'systemic exemption' was introduced to the lending framework as a justification for ruling out debt restructuring.

Among possible lessons, the report noted that 'earlier debt restructuring could have eased the burden of adjustment on Greece and contributed to a less dramatic contraction in output. The delay provided a window for private creditors to reduce exposures and shift debt into official hands. This shift occurred on a significant scale and left the official sector on the hook.'

Available information suggests that IMF management was fully aware that the Greek programme that its board approved on 9 May 2010 was doomed to fail; it was

already planning subsequent modifications, including a restructuring of the debt for a later time. It has also emerged that numerous IMF board members expressed misgivings about the programme before it was approved.

To ease concerns, the German government publicly announced that German financial institutions would maintain their exposures to Greece once the programme had been approved.

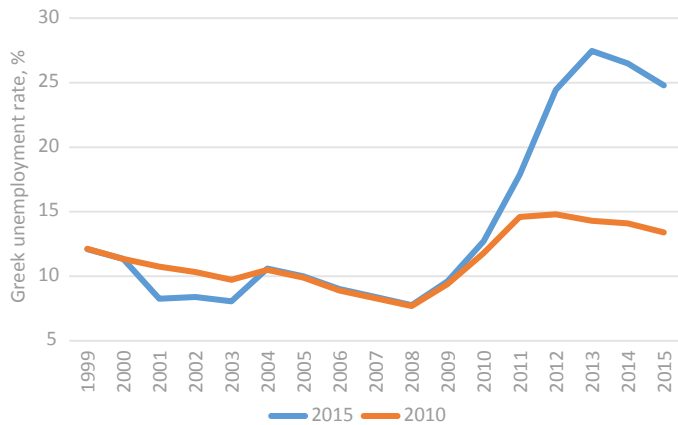
“ In democracies, crises offer fertile ground for demagoguery. Politicians in different member states have attempted to avoid blame and, if possible, shift it to others, generating considerable animosity and mistrust. Supporters of the Berlin and Athens governments have developed markedly different narratives of events. ”

A second bailout of the bank, while it was already under government management, could have generated such a public outcry as to amount to political suicide for Merkel.

Lessons to learn

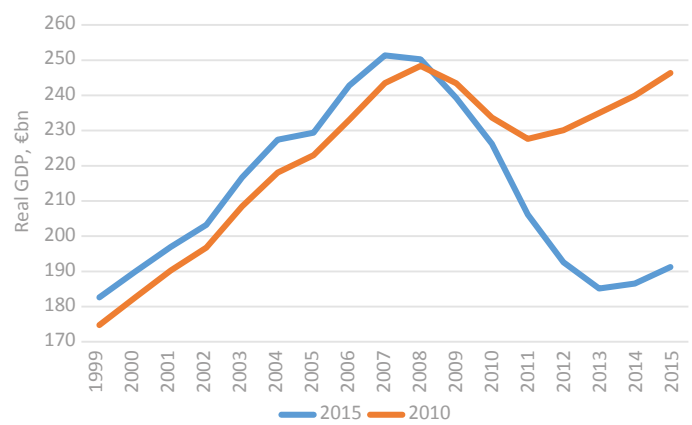
In June 2013, the IMF published an evaluation of the failed May 2010 programme that identified numerous flaws and all but confirmed the outsized

Chart 6: Unemployment jumped to more than 25%
Greece's unemployment rate, 1999-2015



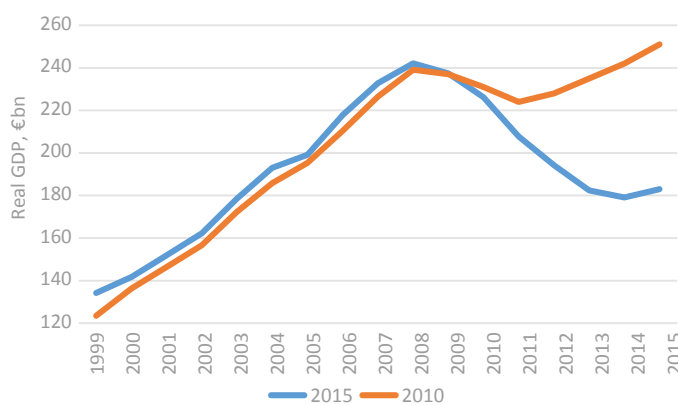
Source: Annual data and projections. 2010 series reflects May 2010 programme, as published at the time. 2015 series reflects data from April 2015 IMF World Economic Outlook.

Chart 7: Continued decline in real GDP
Greece, real GDP, 1999-2015



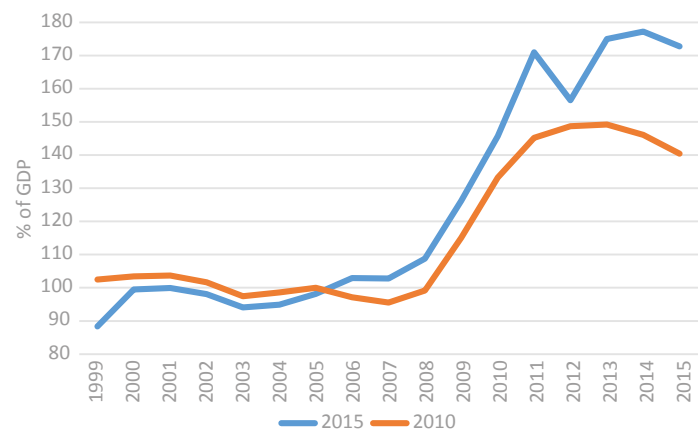
Source: Annual data and projections. 2010 series reflects May 2010 programme, as published at the time. 2015 series reflects data from April 2015 IMF World Economic Outlook.

Chart 8: Deviation in projected and actual nominal GDP
Greece, nominal GDP, 1999-2015



Source: Annual data and projections. 2010 series reflects May 2010 programme, as published at the time. 2015 series reflects data from April 2015 IMF World Economic Outlook.

Chart 9: Wide variation in debt-to-GDP projections
Greece's debt-to-GDP ratio, 1999-2015



Source: Annual data and projections. 2010 series reflects May 2010 programme, as published at the time. 2015 series reflects data from April 2015 IMF World Economic Outlook, including effect of 2012 debt restructuring.

The French government communicated a similar position to the IMF. Had France and Germany honoured these commitments, the programme's odds of success would have been materially higher.

In the event, once the programme was approved and the restructuring of their holdings of Greek debt avoided, German and French financial institutions reduced their exposures.

This included German financial institutions that the German finance ministry had specifically named as having agreed to 'positively help Greece's adjustment process'.

In principle, avoiding a restructuring in May 2010 could have represented a desirable outcome for the euro area as a whole. But since most of the benefit of avoiding a restructuring would accrue to French and German interests, France and Germany should have contributed to the resources required to make the Greek programme successful without a restructuring.

For its part, if this reduced the overall losses from contagion, the IMF could have deviated from its normal guidelines and avoided the restructuring to protect stakeholders in other member states, but only if these states' governments were willing to contribute to an equivalent reduction in Greece's debt burden.

There is no denying that Greek government policies started the problem in Greece. However, had key governments not interfered with the process, and had the IMF designed a programme that respected its own rules, the Greek crisis would almost certainly have been resolved long ago, without the destruction of the past five years.

Instead, the EU and IMF imposed a programme that was known to be doomed to fail. Prevailing rules were not respected. New rules were devised and implemented to protect specific interests outside Greece.

The May 2010 programme protected German and French financial institutions

from financial losses, and Merkel's government from political costs. But it also led to a catastrophe in Greece and set a precedent for subsequent mismanagement of the euro area crisis.

The euro's political and economic framework has encouraged conflict over co-operation. This has proven disastrous for the euro area as a whole and ultimately for Europe. ■

Athanasios Orphanides is Professor of the Practice of Global Economics and Management in the Sloan School of Management at the Massachusetts Institute of Technology and a member of the OMFIF Advisory Board. Between May 2007 and May 2012, he served as governor of the Central Bank of Cyprus and was a member of the ECB Governing Council. This essay draws on 'The Euro Area Crisis Five Years After the Original Sin,' the author's Credit and Capital Markets Lecture presented at the 14th Annual Conference of the European Economics and Finance Society in Brussels on 13 June 2015. The complete lecture can be found at: ssrn.com/abstract=2676103



UK referendum could move markets

Why the euro is condemned to intermittent crises

Gus O'Donnell, former UK Cabinet Secretary

Over the last few years, as the Greek crisis has unfolded, I have lost count of the number of times I have thanked God that the UK is not a member of the euro. I was heavily involved in the UK Treasury's 'five tests analysis' of 2003. This assessed the case for the UK joining the euro, based particularly on whether monetary union as set up in 1998-99 embodied sufficient adjustment mechanisms to deal with imbalances and asymmetric shocks.

The 2003 exercise concluded that the UK could not live with a single interest rate set by the European Central Bank and without its own exchange rate. Other countries have found that living with one interest rate, no exchange rate flexibility and the fiscal requirements of the euro area necessitate policies that are politically very difficult. As Jean-Claude Juncker, president of the European Commission, has put it: 'We all know what to do, but we don't know how to get re-elected once we have done it.'

This raises the question of the euro's future. The most likely scenario is 'muddle through', along the lines we have seen for many years now. In other words, we will have intermittent crises, but the political desire to keep the euro dream intact will win out eventually over all other considerations. One extreme scenario is the complete breakdown of the euro area, with a return to single currencies for most countries, possibly with some kind of link to a rump euro.

At the other extreme would be a move towards 'ever closer union', marked by real shifts towards political union. My own guess is that the probabilities of these three outcomes are roughly 60-20-20.

The euro has problems because it is such a heterogeneous area. Oil price shocks have different effects in different countries; exposures to commodity prices more generally are different. Public debt levels vary enormously, so the impact on debt repayments of eventual increases will vary considerably.

These structural problems are unlikely to end soon. But the European project of 'ever closer union', as spelt out in the Maastricht Treaty, means that governments and central banks will do everything they can to keep the euro from collapsing.

The main legacy of the Greek experience will be to delay the euro's expansion to ever more EU member states. I hope more of them will do the detailed economic analysis needed before committing to adopting the euro. And I hope existing members will think hard about when to admit future applicants.

For some years we will have a group of 'outs' who will want to preserve their position relative to the 'ins'. This is important for the UK. Britain will have allies when pushing for stronger rights for the 'out' group relative to the euro area in the renegotiation prior to the EU referendum. This will be particularly important for the British government's wish to maintain the supremacy of London as a global financial centre.

Narrow inflation-targeting

European governments face many challenges. But in the economic sphere they increasingly need to answer the question: what they are trying to achieve? Central banks have simple inflation targets, but do we really care only about inflation? What about growth, unemployment, and productivity? Are we seeing the end of narrow inflation-targeting?

The US Federal Reserve has a more complex mandate: achieving maximum sustainable employment and price stability, interpreted as low and stable inflation. The Maastricht Treaty opted to give the ECB a simple inflation target, reflecting the view in 1992 that achieving low and stable inflation was the best that could be done to support growth and employment.

In 1997, the UK set up an independent monetary policy committee at the Bank of England, with the objective of price stability, defined by an inflation target but subject to the condition that it should support the government's economic policy. In this era of very low inflation, the MPC has very sensibly interpreted its mandate in a flexible manner.

The uncertainties over monetary union, the relationship between the 'ins' and the 'outs', and the question of what kind of policies national central banks should follow all feed into the debate about Britain's EU membership. Uncertainty ahead of the referendum will be damaging to the UK economy. This level of uncertainty is likely to reduce, or delay, UK investment, particularly from foreign investors hoping to locate inside the EU. It might have an impact on the whole EU: an EU without the UK would be less business-friendly and less keen to control its budget and subsidies in areas like agriculture.

“The European project of ‘ever closer union’ means that governments and central banks will do everything they can to keep the euro from collapsing.”

Unknown referendum outcome

Ahead of the referendum the betting odds, which outperformed opinion polls in Britain's last referendum (over Scottish membership of the UK), still back the 'remain in' camp, while the polls suggest it is too close to call.

Prospects for the referendum may move markets in coming months. More broadly, the outlook for the euro area and the UK look likely to remain very different. In the run-up to the referendum, the economic news will continually confirm that the UK is outperforming the euro area. This is slightly misleading, as the UK economy was hit much more by the financial crisis, but it will influence perceptions, both within and outside Britain. ■

Lord Gus O'Donnell is a former UK Cabinet Secretary and Permanent Secretary at the Treasury, now strategic adviser at Toronto-Dominion Bank. This is an edited extract of his speech at a London Bullion Market Association conference in Vienna on 19 October 2015. The full speech is available in the January 2016 edition of Alchemist, the publication of the LBMA.

Different mandates



Federal Reserve System

Achieving maximum sustainable employment and price stability, defined as low and stable inflation.

European Central Bank

Price stability, defined by an inflation target set by the ECB.



Bank of England

Price stability, defined by an inflation target, supporting government's economic policy.



Improving EMU's incomplete architecture

Why Europe needs more than ECB asset purchases

John Mourmouras, Bank of Greece

Economic and monetary union, long dogged by failure to complete its initial architecture and design, faces both shorter- and longer-term problems. Among measures to help resolve issues in the first category, on 3 December the European Central Bank extended its asset purchase programme by six months until the end of March 2017, taking total asset purchases to €1.5tn and broadening asset eligibility to include local and regional debt.

Inflation has been persistently below the ECB's 2% objective since January 2013, below 1% for almost two years, and below 0.5% for 16 consecutive months. Inflation isn't the European Union's only concern; there are many more, including Europe's anaemic growth record, its 22m unemployed and the escalating refugee crisis.

The euro area's macroeconomic framework contains the following elements: internal devaluation in some distressed peripheral countries (cuts in real wages with little productivity gains); fiscal devaluation in other countries (shifts in taxes away from labour towards indirect taxes); and fiscal



macroeconomic policies to boost aggregate demand.

Take, for instance, the excessive macroeconomic imbalance procedures, established during the debt crisis to improve national policy coordination. So one would tend to ask whether these procedures have so far been a failure, proving ineffective, for example, in addressing excessive current account surpluses in the euro area – 8% of GDP last year in Germany.

The European Union has put forward various measures to promote more harmonised policies, including technical assistance to help

members implement growth-enhancing administrative and structural reforms, national competitiveness boards, and a European deposit guarantee scheme. These are all welcome ideas and proposals, some of which are yet to be implemented and tested in practice.

Foundations for a banking union

On the standard question of whether there should be a wider or deeper Europe, we have witnessed new thinking.

Last year's 'five presidents' report' set out an ambitious agenda, laying down the foundations and a timeline for a banking union, as well as steps towards fiscal union and a capital markets union. This reflects a welcome shift towards more burden-sharing.

The question remains how quickly Europe will complete EMU and move towards a common deposit guarantee scheme or some form of sovereign debt mutualisation. Or indeed put in place the initiative of Jonathan Hill, the EU Commissioner responsible for financial services, for a capital markets union to improve the financing of the EU economy by bolstering market-based finance for small and medium-sized enterprises.

Personally, I would like to see the European Stability Mechanism, the bail-out fund set up at the height of the crisis to rescue indebted peripheral nations, mutate into a truly European Monetary Fund in charge, among other things, of future debt restructuring in euro members.

Most of Europe's tribulations can be attributed to its failure to resolve crises through mutual agreement and collective action, violating the EU's fundamental values of cooperation and solidarity.

Ultimately, we see the demands of avoiding moral hazard and strengthening national responsibility competing against the need for European solidarity and risk-sharing.

Europe has to achieve the right balance between these principles. This will be the ultimate test for the effectiveness of institutional design improvements and for the overall goal of better economic governance.

Jobs, growth and social cohesion are what matters to the average European, not a better institutional design for monetary union. The dramatic rise in unemployment and lack of job creation, drastic cuts in living standards and persistent recession have led to rising euroscepticism, and unleashed the dark forces of neofascism in some member states.

There is a real risk of a two-speed Europe across all policy fields. As the day approaches for the British referendum on EU membership, a discussion on where Europe is heading becomes ever more necessary, not just for the UK, but for the rest of Europe. ■

Prof. John (Iannis) Mourmouras is Senior Deputy Governor, Bank of Greece and a former Deputy Greek Finance Minister. This is an abridged version of his OMFIF City Lecture in London on 9 December 2015.

“ The question is whether QE is enough on its own to avert the negative spiral of low inflation, or whether we need other macroeconomic policies to boost aggregate demand.

consolidation accompanied by private-debt deleveraging. Unsurprisingly, the result is poor growth and low nominal demand.

The ECB's quantitative easing makes sense: inflation has been and always will be a monetary phenomenon, so combatting low inflation requires monetary policy. However, euro area nominal demand has been persistently weak.

Nominal GDP has cumulatively increased by 7.7% over the past seven years, compared with 27% in the seven years before the crisis (2002-08). So one would tend to ask whether low inflation is a symptom or a cause of weak euro area demand.

The question is whether QE is enough on its own to avert the negative spiral of low inflation, or whether we need other



No closer to political union

Fiscal responsibility must remain with national governments

Otmar Issing, Center for Financial Studies

On its establishment in 1999, economic and monetary union was intended to propel Europe towards political union. In fact, no progress toward political unification has been made – or even really attempted.

The euro is no longer a strong common currency reinforcing a shared European identity. Rather, it is now a source of deep resentment among European peoples – resentment that, 70 years after the end of the second world war, was meant to have been eliminated.

Many observers have suggested that the EMU crisis represents a vital opportunity to overcome these tensions and forge an ever closer union. Supporters of deeper integration often quote Jean Monnet, one of the European Union's main architects, who stated that crises are critical to spurring progress towards European integration.

But this approach appears unlikely to work when there is so little trust among member states, and at a time when political parties opposed to further integration have gained ground in elections all over Europe.

A landmark referendum

Britain's forthcoming referendum on EU membership, which seems likely to take place this summer, will be a landmark event. One reason for holding the referendum is that the British government believes the euro area needs further integration to survive and prosper, a move in which the UK itself does not want to take part.

Whatever the outcome, for such an important member of the EU to consider departing is hardly a ringing signal of confidence in the Union's future. If European governments or the European Commission push forward on the path towards political

union under such circumstances, this would be likely to create even more resistance, not just from outside but from inside the euro area itself.

'Deep, genuine, and fair' EMU

Last year's report from the 'five presidents' – the European Commission, the European Council, the Eurogroup of finance ministers, the European Central Bank, and the European Parliament – called for progress towards a 'deep, genuine, and fair' EMU. This would include economic, financial, and fiscal union, and a political union that provided 'genuine democratic accountability, legitimacy, and institutional strengthening'.

The report recommended launching an agenda for greater integration only after 2017, following elections in France and Germany. The timing appears to reflect the fear that voters in the biggest countries would respond negatively to the proposal – again, not a sign of great confidence.

In my view, the report, like the proposal to establish a European finance minister, is fundamentally flawed. Its underlying assumption – that steps toward all its goals should be taken in parallel, with a genuine political union emerging at the end of the process – is problematic.

Establishing a political union would require amendments to national constitutions and, in most countries, referendums. But voters are far from enthusiastic about the prospect of ceding more authority to Europe.

The reality is that a European political union is unlikely to be established anytime soon. And without true political unification, efforts to pursue the rest of the presidents' plan, including transferring fiscal powers to

the European level, collective fiscal decision-making and the possible setting up of a euro area treasury, would carry serious risks.

Within the existing institutional framework, political responsibility for higher transfer payments among countries must remain with the national governments, controlled by national parliaments and electorates.

Political union through the back door

Political union may be possible in the distant future. But it cannot be achieved through the back door by eroding members' fiscal sovereignty. Attempting to compel transfer payments would generate moral hazard on the part of recipients and resistance from donors, while the resulting increase in tensions could jeopardise the integration that has been achieved to date.

Given this, Europe's monetary union will have to exist without political union for a considerable period – in other words, the EMU will remain an institutional arrangement among individual countries that retain their fiscal sovereignty.

The key to making such a system work is to ensure that national governments are held accountable for their economic policies.

European governments must respect all treaties and commitments without exception – including, crucially, the Maastricht Treaty's 'no bail-out' clause. The German government must stick firmly to the principle that EMU should not degenerate into a system for the transfer of wealth and income from more solvent to less solvent euro members. ■

Otmar Issing is President of the Center for Financial Studies, Frankfurt, and a former member of the European Central Bank's Executive Board.





Fed panel turns more hawkish

Yellen has forged consensus on gradual tightening

Darrell Delamaide, US editor

Everyone agrees that the Federal Open Market Committee will be somewhat more hawkish in 2016 as four new regional bank presidents rotate into voting positions. However, following the skill shown by Federal Reserve Chair Janet Yellen in December in reaching a consensus on the Fed's first rate hike in more than nine years, it may not really matter.

All 17 of the FOMC members take part in the debate. The shift in voting members is only significant to the extent that one or other dissents from the consensus statement issued at the end of the eight meetings.

For the moment, there appears to be a fair consensus that a gradual increase, with three or four hikes of 25 basis points over the year, strikes the right balance between accommodation and normalisation.

If the economy stays on its forecast trajectory of steady, if slow, growth, and inflation gradually picks up as expected, it is hard to see any voting members feeling strongly enough to dissent.

For example, Kansas City Fed chief Esther George rotates back into a voting position for the second time since taking over from long-time president Thomas Hoenig in 2011. As a voting member in 2013, she followed Hoenig in routinely dissenting from the consensus view. But that was during the quantitative easing phase of the current cycle as the Fed continued its asset purchases.

Even if George would have liked to start sooner and go a little faster with monetary tightening, she is unlikely to dissent as long as the Fed gradually raises rates. At an OMFIF briefing in London in November, she emphasised her preference for steady moves towards interest rate normalisation.

Meanwhile, Cleveland Fed president Loretta Mester is back as a voting member, having had a turn in the second half of 2014, when she succeeded Sandra Pianalto. (While nine of the regional bank chiefs get to vote only every third year, the heads of the Chicago and Cleveland Fed banks vote in alternate years.)

Mester, who was chief economist for former Philadelphia Fed chief Charles Plosser, is viewed as a hawk, but perhaps not as fervent a one as George. In any case,

she dutifully signed up to the consensus in 2014. It would be surprising if she bucked the consensus this year in the absence of a sharp divergence of opinion.

In a speech at a National Association of Business Economics meeting in San Francisco in early January, Mester said she had supported the panel's December action. 'Based on the economic outlook, I thought it was prudent to take the first step on the path of gradual normalisation of interest rates.'

In separate remarks to Reuters, she acknowledged she would probably prefer 'a little steeper' path of increases than the four

“ If the economy stays on its trajectory of steady, if slow, growth, and inflation gradually picks up as expected, it is hard to see any voting members feeling strongly enough to dissent.

quarter-point rises suggested by the 'dot plot' projections of FOMC members. But she added that she was 'pretty comfortable with the median path'.

St. Louis Fed chief James Bullard, a seven-year FOMC veteran, wanted to start the normalisation process much earlier last year. As long as the economic data allow gradual tightening, there would be little reason for him to dissent either. On the other hand, Bullard sounded a more cautious note on 14 January by saying in a speech in Memphis, Tennessee, the latest decline in oil prices may delay the return of inflation to the central bank's 2% target.

The dovish Eric Rosengren, the head of the Boston Fed, is unlikely to upset the apple cart. 'I prefer a path that involves only gradual increases in interest rates,' he said in a November speech in Portsmouth, Rhode Island, '...and that essentially probes how tight labour markets can be, consistent with our 2% inflation target'.

Last year, only the hawkish Jeffrey Lacker, the head of the Richmond Fed, dissented from the consensus statement. Having run

out of patience with the panel's reluctance to finally raise rates, he registered his dissent in the September and October meetings. But he fell into line with the consensus to raise rates in December.

Others who rotated out of voting positions were middle-of-the-roader Dennis Lockhart in Atlanta and the decidedly doveish heads of the Chicago and San Francisco regional banks, Charles Evans and John Williams.

The four other members of the truncated Board of Governors are unlikely to buck the strong tradition of siding with the chair,



though Governor Lael Brainard late last year expressed doubt about moving ahead with rate increases as long as inflation remains so stubbornly low.

Similarly, head of the New York Fed William Dudley, who is the FOMC's vice-chair and a permanent voting member, is very unlikely to split with Yellen. Given his ambivalent statements in late 2015, he is more likely to be a doveish brake on tightening than a driver for higher rates.

The two pending nominations to bring the Fed board up to full strength are unlikely to get a confirmation hearing anytime soon. The chairman of the Senate Banking Committee, Alabama Republican Richard Shelby, has dug in his heels over the White House's failure to name a Fed vice-chair for regulation, as provided for in the Dodd-Frank financial reform act. He has repeatedly said that he will take no action on the nominations until President Barack Obama names a vice-chair – it remains to be seen who will blink first. ■

Darrell Delamaide is a writer and editor based in Washington, DC.



Biggest danger is bank bashing

Solid money growth shows US can withstand Fed tightening

Steve Hanke, Advisory Board

For over a year, newspapers were filled with speculation about when and by how much the Federal Reserve would raise the federal funds interest rate. Well, the Fed finally raised the rate in December. Now, everyone is wringing their hands over what the tightening cycle will look like.

This obsession with the course of the fed funds rate is curious to say the least. Indeed, since the early 1980s there have been five episodes in which the Fed raised rates. And, in each of these cases, economic growth remained steady or accelerated.

So, why all the hand-wringing? This is probably a Keynesian hangover. Yes, the Keynesians focus on interest rates. The mainstream macro model that is widely used today is referred to as a 'New Keynesian' model. The thrust of monetary policy in this model is entirely captured by changes in current and expected interest rates. Money is nowhere to be found.

This is amazing, particularly since Keynes dedicates quite a few pages in *A Tract on Monetary Reform* (1923) to money and its role in national income determination. Then, in his two-volume 1930 work, *A Treatise on Money* – a work of which the dean of monetarism, Milton Friedman, wrote approvingly – Keynes devotes a great deal of space to banks and their important role in creating money.

In particular, Keynes separates money into two classes: state money and bank money. State money is the high-powered money that is produced by central banks. Bank money is produced by commercial banks through deposit creation.

Keynes spends many pages in *A Treatise on Money* dealing with bank money. This isn't surprising because, as Keynes makes

“The link between growth in money supply and nominal GDP is unambiguous and overwhelming. There are centuries of clear evidence for this – even though plenty of deniers of basic principles remain in evidence.

clear, bank money was much larger than state money in 1930. Well, not much has changed since then. Today, for example, bank money accounts for almost 82% of total M4 money supply in the UK.

We should keep our eyes on money broadly measured (state, plus bank money), and money properly measured (Divisia, not simple sum measures). A monetary approach to national income determination is what counts over the medium term. The link between growth in money supply and nominal GDP is unambiguous and

overwhelming. There are centuries of clear evidence for this – even though plenty of deniers of basic principles remain in evidence.

Let's look at the world's largest economy, the US. The chart shows the growth rate for nominal final sales to domestic purchasers, which is a good proxy for nominal aggregate demand, and the growth rate for broad money (M4 as reported by the Center for Financial Stability in New York).

Since the 2008 financial crisis, the money-nominal aggregate demand linkage has been rather tight. We can also observe that the US remains in a growth recession. The economy is growing, but at less than its post-1987 average rate.

After three rounds of quantitative easing, how could this anaemic growth picture prevail? Well, when it comes to broad money, bank money is what counts. And the policies that have affected the growth in US bank money (read: Basel III and the Dodd-Frank legislation) have been massively contractionary and procyclical.

To mitigate this tightness, the Fed has engaged in quantitative easing. But the squeeze on bank money has thrown cold water on much of the QE. In consequence, broad money has grown slowly since 2008, and so has nominal aggregate demand.

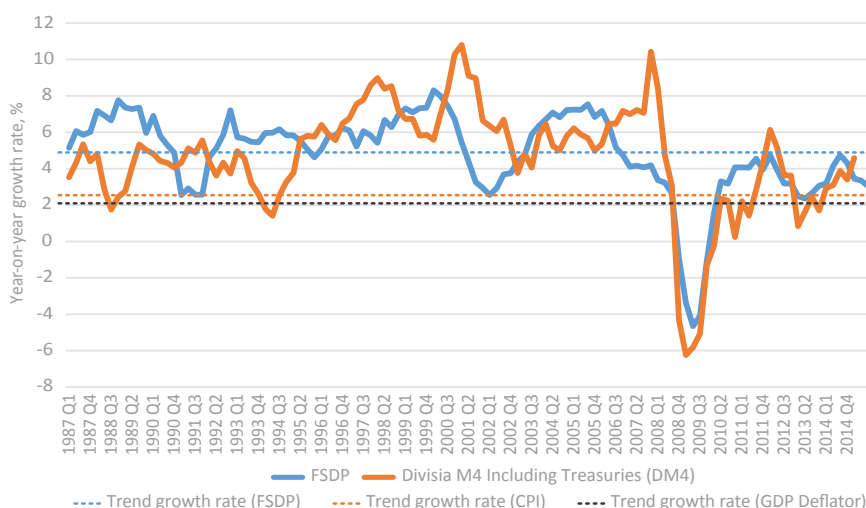
However, since early 2013 the growth rate of broad money has accelerated. It is now growing at a 4.6% annual rate – the highest reading since May 2013. If this continues, nominal aggregate demand should reach its annual trend rate of 4.8% in the near future.

So the US economy looks in a healthy enough state to withstand a modest further increase in interest rates.

The biggest risk to the US economy is not Fed interest rate tightening, but another round of bank bashing through misplaced regulations. ■

Tight link between money growth and aggregate demand

US final sales to domestic purchasers (FSDP) and Divisia M4



Source: Federal Reserve Economic Database

Notes: FSDP = GDP + Import - Export - ΔInventory; FSDP data measured quarterly; Divisia M4 data lagged 3 quarters.

Steve Hanke is a Professor of Applied Economics and Co-director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise at The Johns Hopkins University in Baltimore.



Independence: important, not absolute

In Nigeria, and elsewhere, central banks matter

Kingsley Moghalu, Advisory Board

Since the financial crisis of 2007-08, when central banks saved the global economy through strong, concerted (though belated) action, they have gained ever higher profiles as guardians of economic policy, both nationally and internationally.

Controversies in the past few months surrounding central banks in India and in my own country, Nigeria, have sharpened the debate on the independence of reserve banks. There have been tensions over central banking stewardship in other countries, including Argentina, Hungary, Malawi, Mauritius, Venezuela and Zambia.

In India, the independence of the Reserve Bank of India and its governor, Raghuram Rajan, was perceived as under threat when the Indian government proposed that its nominees form the majority on a new monetary policy committee. The matter was resolved with an agreement to establish a committee with equal representation from the RBI and the Indian government, but with the governor holding the casting vote in the event of deadlock.

Unlike India, for many years the Central Bank of Nigeria has had a formal 12-member MPC consisting of the governor, four deputy governors, and seven other outside members, including the permanent secretary of the finance ministry. I was one of these deputy governors between 2009 and 2014.

The reason for this balance of internal and external members is to ensure the CBN remains independent in monetary policy while involving other knowledgeable outside experts. All MPC members vote individually on decisions based on their own assessment of economic data and the macroeconomic situation.

National economic interest

Central banks should think and act rationally in the longer-term national economic interest, even if their decisions may be politically unpopular in the shorter term. They should not be influenced by politicians eyeing the election cycle.

Where institutions are weak, vested political or commercial interests can easily bend them to the service of sub-optimal agendas or misguided notions of 'national interest'.

'External interference' is usually understood to stem from governments. But central bank independence must also mean independence from other forces. These include economic agents with vested interests such as commercial or investment banks, and even foreign portfolio investors.

Independence makes central banks more effective in performing their functions, particularly managing inflation and maintaining price stability. This is in the best interests of both governments and their citizens.

Nowhere is this more evident than in Africa, where inflation in the 1980s averaged 25%, but independent central banks have since helped improve macroeconomic stability. Central bank independence is a significant factor in sovereign ratings and assessments of a country's broader governance and institutions, as is the independence of the judiciary.

In Nigeria, the CBN's independence – stipulated in the central banking act of 2007 – enabled it wrestle inflation down to single digits and undertake far-reaching post-crisis banking reforms. The prior absence of this

“Where institutions are weak, vested political or commercial interests can easily bend them to the service of sub-optimal agendas or misguided notions of 'national interest'.

independence contributed to the country's lacklustre economic performance in the 1990s.

Requiring external political approval for necessary measures, the bank frequently acted inadequately and too late. It failed to rein in politically connected fraudsters in the banking industry, resulting in failed banks that wiped out the savings of many Nigerians.

There are some contradictions between central bank independence and elected governments' political legitimacy. A state institution, and the officials appointed to work in it, cannot be completely decoupled from the larger apparatus and activities of the state.



Central bank accountability

An enlightened political leadership must recognise the national interest of respecting the central bank's operational and administrative independence, but this can never be absolute. Egregious malfeasance or spectacular incompetence can create exceptions. Moreover, there are strong mechanisms for accountability in Nigeria, as in most other democracies.

Central banks must defend their independence when required, but they must remain above the political fray to maintain

their legitimacy. They have to avoid the twin extremes of becoming, on the one hand, an 'errand boy' for politicians, and on the other a noisy 'opposition party' to a democratically

elected government. A central bank that assumes either of these roles has lost its way.

Instead, whether in a crisis or in calmer times, central banks must show a balanced sense of responsibility, combined with intellectual depth, long-term thinking, and political and economic sure-footedness.

That is the way forward, for Nigeria and all other democracies. ■

Prof. Kingsley Moghalu is a former Deputy Governor of the Central Bank of Nigeria. He teaches international business and public policy and is a senior fellow in the Council on Emerging Market Enterprises at The Fletcher School of Law and Diplomacy at Tufts University, Boston.



Beware Russian weakness

The security implications of economic decline

Ben Robinson, OMFIF Economist

The coming 12 months will be dominated by falling oil and commodity prices, declining foreign exchange reserves, economic slowdown in developing countries, conflict in the Middle East and the global rise of militant Islam. Nowhere do these pressing issues coalesce in a more potentially destabilising way than in Russia. Greater consideration must be given to the consequences of these issues in the year ahead.

Russia plays an important but underappreciated role in maintaining global stability, by helping to suppress the many sources of potential conflict in the post-Soviet space. It has deep social, economic and historical links to central Asia, the south Caucasus and the Balkans. This means – for better or worse – that Moscow is indispensable when it comes to engaging with these regions and managing tensions within them.

To serve its own purposes, Russia has acted as a status quo power in these areas, seeking to maintain a balance among competing regional interests and rival external powers. But as economic challenges threaten its ability to maintain this role, a wide range of political and security risks emerge.

Central Asia is deeply divided – a result of borders drawn by Moscow during Soviet times that deliberately divided ethnic groups and prevented any one state from gaining sufficient domestic natural resources.

“To serve its own purposes, Russia has acted as a status quo power in the post-Soviet space, seeking to maintain a balance among competing regional interests and rival external powers.”

This has resulted in a firm Russian economic, political or security presence in each of the countries, making Moscow key to managing the resulting tensions. Were Russia no longer able to play this role, conflicts could escalate quickly.

In the south Caucasus, Russia has intervened in the rivalry between Armenia and Azerbaijan to achieve a fragile stalemate



in the territorial dispute over Nagorno-Karabakh. If Moscow's influence weakened, these regional hostilities could escalate into open conflict that would impinge rapidly on Europe's fragile and overwhelmed southern borders.

In the Balkans, Slavic ties to Serbia and sections of the Croatian and Bosnian populations make Russia the main external ally in the regional rivalry between the Serb and Muslim populations, as well as a counterpoint to Iran and Turkey's growing influence. Upsetting this fragile balance of power could quickly escalate into a new Balkan conflict.

Making these issues more difficult to resolve is instability in the Middle East, where Russian involvement is aimed in part at limiting the spread of Turkish and Iranian influence in central Asia and the northern and southern Caucasus. Losing its ability to influence events in the Middle East would reduce Russia's ability to maintain the balance in these regions.

Limiting the spread of Saudi Arabian-sponsored Sunni religious groups in the Balkans and in the northern Caucasus regions of Dagestan and Chechnya is a further priority for Russia. Moscow has suppressed nationalism and Islamic militancy in the northern Caucasus, albeit bloodily.

But a weakened Russia unable to contain these insurgencies could create a haven for terrorists on Europe's border.

Finally, Russia has successfully maintained the territorial integrity of its vast eastern expanse, preventing regional breakaway movements and tying resource-rich eastern Siberia firmly into its orbit – and not losing that influence to Beijing, at least so far.

Should it become unable to maintain this strategic balancing act, territorial expansion and a potential land-grab by space- and resource-hungry neighbours in Asia (including Japan, with which Russia has unresolved territorial disputes dating from the second world war) are not inconceivable.

The dangers of a weak Russia for the rest of the Eurasian continent are therefore palpable. Some combination of state collapse, civil war, secession, ethnic conflict, a mass movement of refugees and the spread of radical Islam along Russia's long and porous border, as well as the intensification of regional conflicts in the Middle East and elsewhere, are real possibilities.

The West has to think carefully about whether a stronger or a weaker Russia is most damaging to international security. Falling oil prices, currency depreciation, depleted foreign exchange reserves, the expense of supporting foreign wars and the cost of western sanctions all point in the direction of weakness.

The next 12 months will demonstrate the security consequences of Russia's economic decline. ■



Insecurity in 'a time out of joint'

High time to force compromises with Moscow

Michael Stürmer, Advisory Board

The cold war is over, but the world is an ever more dangerous place. During a recent conference between Russia and western governments, a seasoned US diplomat said he had never felt so close to disaster in 50 years of professional life. None of the participants questioned the validity of his statement. The new mood of confrontation requires an agonising reappraisal and a return to Realpolitik.

'The time is out of joint' – the quote from Shakespeare's Prince of Denmark is apposite because the crises and conflicts of our time are non-linear, creating their own often uncontrollable dynamics.

We need to cast our minds back to October 2014, to a luxury hotel more than 1,000 metres above the city of Sochi, a health resort on the Black Sea. There, members of the Valdai Club, an informal gathering of Russia experts, were greeted by a slogan that captured the new mood in Russia: 'New order or no order'.

The Kremlin wanted to show that Russia was back in the Great Game, that it wished to be respected as a global power, and that Russian elites were unwilling to live by values other than their own – whatever the cost. The past 10 years have seen a progressive exercise by President Vladimir Putin warning the West not to move too closely to the bear's den.

Russia has wanted to remind the US of its near-unlimited escalation power – above all in mobilising patriotic sentiment at home and turning Russian dreams away from western style democracy towards intimidating Russia's neighbourhood – menacingly termed the 'near abroad'.

Historians of the 19th century would be reminded of the Czar's perennial ambition to be recognised as the gendarme of Europe and guardian of the Holy Alliance.

A major shift in the global 'correlation of forces' – to borrow a concept from Soviet-speak – took place under Putin's watch, built on a steady rise in the price of oil, and resulting in a military modernisation that the West ignored – at its peril.

The good days are over. Western enthusiasm has all but evaporated, due to Russia's takeover of Crimea and the hybrid war in the Donbas region. Russia is, again, 'a riddle inside an enigma shrouded in mystery', as Winston Churchill famously stated.

“ A major shift in the global 'correlation of forces' took place under Putin's watch, built on a steady rise in the price of oil, and resulting in a military modernisation that the West ignored – at its peril.

'Punish Putin' was the US administration's knee-jerk reaction to the formal annexation of Crimea – something the Russians maintain was secession, confirmed by a hasty referendum. While history is on the Russian side, international law backs US and EU sanctions.

But the West, under the gloss of righteousness and massive pressure from the US Treasury, is deeply divided over sanctions. Germany is following the US lead, but grumbling ever more loudly, and even signing up to a second 'North Stream' gas pipeline, much to the dismay of eastern and southern European allies.

Sanctions are neither peace nor war, but something in between. To make the global strategic balance dependent on a player like Ukraine amounts to insouciance, and invites not only misunderstanding, but disaster.

It is high time to forge compromises, find face-saving solutions such as a non-aligned status for Ukraine, hold a referendum and see what happens. The whole of the Balkans, Bismarck once said in a similar context, is not worth the healthy bones of a Pomeranian grenadier.

Confrontation is on the cards, but so is co-operation. Russia was an active member of the 'five plus one' group that secured Iran's containment. In Syria,

Russia is defending its interest on the Mediterranean coast. It does so 'by invitation', as the Russians keep saying. Once again, the motive is Russia's national interest.

Any German government will need to perform a delicate balancing act between a resurgent Russia and the US' tendency to attempt to run Europe and the Middle East by remote control. While the US is still indispensable to maintaining a semblance of international balance, the Europeans will have to be much more serious in global affairs.

More trouble is in the making, including between Washington and Berlin. A difficult and dangerous year lies ahead. ■

Michael Stürmer is Chief Correspondent at Die Welt and former adviser to Chancellor Helmut Kohl

Economic uncertainty could temper central and eastern Europe nationalism

The nationalist stance adopted by central European governments reflects economic success and a relatively stable security environment, writes Janusz Reiter in Warsaw.

Following the fall of the Berlin Wall, the former Communist countries looked to Brussels for security, money, and to set a good example, but Brussels is now first and foremost a source of funds. Should that change, however, Europe may be needed again.

Domestic wrangling in Poland is unlikely to be resolved this year, creating tensions with the EU. The new government watching the German refugee crisis is ever more convinced that history is on its side. But two sources of uncertainty persist – the economy and Russia. Depending on Russia's path, Poland could soften its European stance.

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Action plan needed following accord

Paris breakthrough is only a first step

Ruud Lubbers and Paul van Seters, Advisory Board



The international climate accord in Paris was the best possible agreement between participating countries. But it is only a first step. There was no text in the draft concerning shipping and aviation – partly reflecting the strength of these sectors' lobbying organisations.

New intergovernmental agreements on these matters representing a follow-up to Paris are of utmost importance. Attempting to achieve such agreements in December would have produced a toothless text. So an action plan is needed to realise these goals in the period to 2030.

The transition to a low-carbon economy

Similarly, the accord does not contain any information on how governments should promote the transition to a low-carbon economy. Three instruments are generally used – rules and regulations, fossil energy taxes, and trading systems such as the European ETS.

In the accord, individual countries are free to make their own choices. For the time being, this is the right way. But the corporate world, particularly the World Business Council for Sustainable Development – bearing in mind the enormous consequences for international trade and employment

policy – is lobbying governments hard to make more selective choices.

Here, too, an action plan is needed, requiring periodic evaluation and new commitments to achieve concrete results by 2030 at the latest.

Paul Polman, Unilever chief executive and a member of the sustainable development commission established by UN Secretary-General Ban Ki-moon, has set a good example. Polman has declared that, by 2030, Unilever will switch to renewable resources for all energy use. For electricity, the company has pledged to meet this goal by 2020.

Helping achieve such targets, solar energy has become significantly cheaper year on year since 2000. This trend is bound to continue for some time, allowing profitable storage for optimal use, and cross-border networks through improved grids.

Phasing out fossil fuels is essential, not only for the sake of the climate, but to put economies on to a sounder footing. This requires difficult decisions on the pace of the transition and dealing with the financial consequences of 'stranded assets'.

Conference breakthrough

The breakthrough achieved at the COP21 conference had been some time in the

making. One significant milestone came in autumn 2014, when G2 (the US and China) leaders declared they wanted to make a success of the Paris meetings. Ban played a big role by setting post-2015 sustainability goals as part of a drive to combat climate change.

Pope Francis then surprised the world in spring 2015 with his encyclical on climate change and inequality, *Laudato Si* (Care for our Common Home), showing significant common ground with the 1987 Brundtland Report, Our Common Future.

This close co-operation between the pope and Ban became visible at the UN General Assembly in September, when Pope Francis was a special guest.

Parallel to this alliance between the UN and the pope, the Paris conference showed the effectiveness of an alliance with the corporate sector to deal effectively with climate change.

In this way, the international business community is making a notable commitment to achieving low-carbon economies worldwide – but much more needs to be done. ■

Ruud Lubbers is a former Netherlands Prime Minister.

Paul van Seters is Professor at Tilburg University.

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Climate change and stranded assets

Attaining low-carbon economy will be a protracted process

Nick Butler, Advisory Board

The risk that significant volumes of energy assets worldwide could become 'stranded' because of policies aimed at countering climate change has preoccupied industry and academic experts for years.

The conclusion of the Paris climate conference in December highlighted the breadth of concern about the issue, with 189 countries agreeing to take steps to 'decarbonise' their economies. The accord is not legally binding and not all the commitments will be met, but the direction of change is clear.

The conference reinforced issues that Bank of England Governor Mark Carney raised in a controversial speech in September. Carney tacitly endorsed the view that significant amounts of coal, oil and natural gas – while identified and in some cases valued on the extractive industry's books – can never be used and are valueless.

Exaggerating transitional risks

Carney's speech attracted attention because he touched on themes seldom the preserve of practising central bankers. But there are considerable grounds for thinking he has done investors a disservice by unnecessarily exaggerating transitional risks associated with new international energy policy regimes aimed at a lower carbon economy.

Carney stated that 'changes in policy, technology and physical risks could prompt a reassessment of the value of a wide range of assets as costs and opportunities become apparent'. This is much less provable than the view he developed in the bulk of his speech – that risks associated with climate change will have to be incorporated into future insurance contracts.

This question begins with physical risks: the impact of climate and weather-related events that could cause floods and storms, and damage property or trade. It includes the issue of liability risks. Both are already beginning to be taken seriously. The Bank of England and the London insurance market are establishing standards that were the principal subject of Carney's speech.

Where Carney appears to have exaggerated was in the area of transition risks. On the one hand, he was saying nothing dramatically new – the energy business is

familiar with the concept of stranded assets.

The new concept to which Carney referred was that the world would have to adopt a 'carbon budget', setting a maximum amount of usable carbon. If that concept is correct, all the coal, oil and natural gas that can be safely used has already been discovered. Over time, hydrocarbons will be

“The point may well come when the impacts of climate change force a radical change in policy, but we are not there yet.

priced out of the market. On this analysis, exploration is valueless, as are some of the resources already identified. The rest should stay buried, and cannot be valued as corporate assets.

This logic rests on three assumptions, and the likelihood that they will all hold is extremely low. The assumptions are, first, that public policy action will curb hydrocarbon use to keep total emissions within a prescribed limit. Second, that alternative energy supplies will be available in time and at a low enough cost to enable consumers to switch away from hydrocarbons. Third, that attempts to reduce emissions using techniques such as carbon capture and storage (CCS) will not be viable on the scale required to allow continued hydrocarbon use.

Carbon capture unlikely to be the answer

Most observers would agree that the third assumption is correct. Current CCS projects are minimal and there is no clear financial model to encourage companies to invest. Most current CCS projects are economic only because they support enhanced oil recovery. Matters may change but, on current trends, CCS will not make a major difference.

The second assumption has yet to be proved, but remains open. Low carbon costs are falling, other than for new nuclear developments. Solar costs have fallen dramatically. There are serious advances in storage technology that could transform the economics of intermittently producing renewables. But the big breakthroughs that would allow global deployment are still hope rather than reality.

That brings us to the assumption that policy measures will limit hydrocarbon use to keep the world within the carbon budget. This seems completely unrealistic.

The reality is evident from the debates at the Paris conference. The commitments made and the resource transfers promised to change the trajectory of hydrocarbon consumption are not sufficient to prevent continued growth in the use of oil, coal and natural gas. The US may limit hydrocarbon use, but that judgement crucially depends on the development of a consensus in the US that does not yet exist.

Greater consensus needed

European policy carries a degree of consensus, but the level of agreement is not yet strong enough to implement the one policy measure that would make a difference – a carbon price.

China and India will take steps to encourage renewables, but it is hard to see coal not being the main source of energy supply for either country for the foreseeable future. Until a low-cost and low-carbon source of energy emerges, they will stick with the energy mix they have.

This means that the period of adjustment to a low-carbon economy on which the stranded assets theory is based will take a very long time. The carbon budget will be broken and climate change will begin to take effect. This is why Carney's comments on the insurance impacts are correct and important.

The point may well come when the impacts of climate change force a radical change in policy, but we are not there yet. The issue for long-term investors is whether individual companies can explain their strategies for dealing with a very different world.

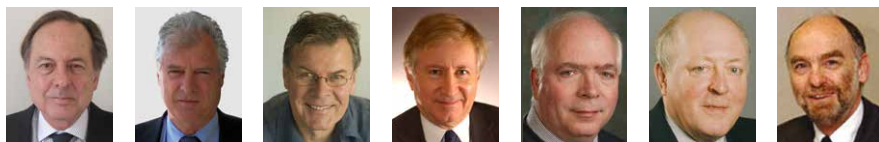
The winners will be those who can adjust, adapt their business models and use their economic strength and reach as decarbonisation develops. The losers will be those who are unable to change. ■

Prof. Nick Butler is a Visiting Fellow and Chair of the King's Policy Institute at King's College London.

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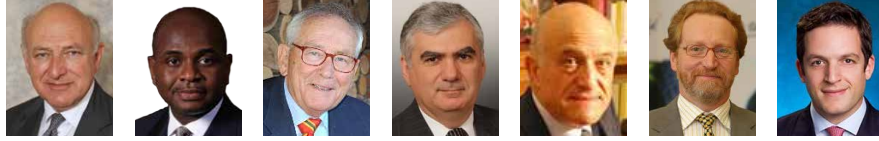


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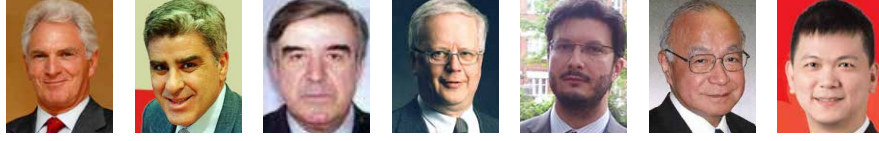
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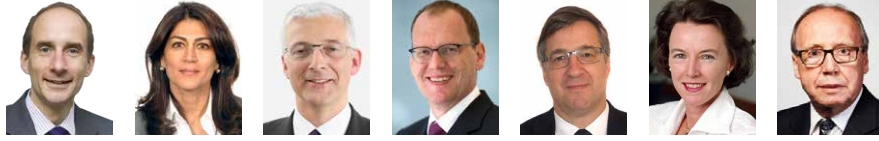


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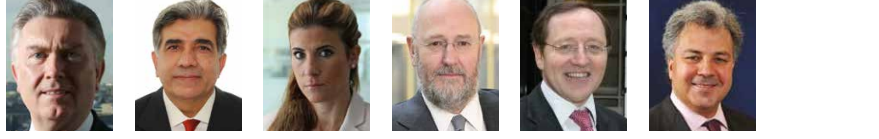
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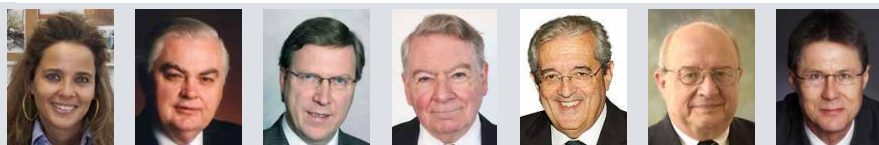
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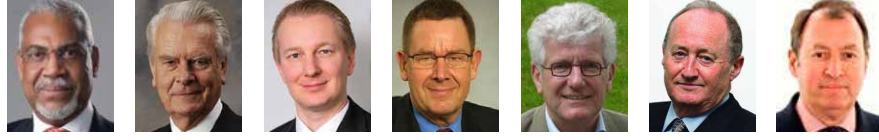
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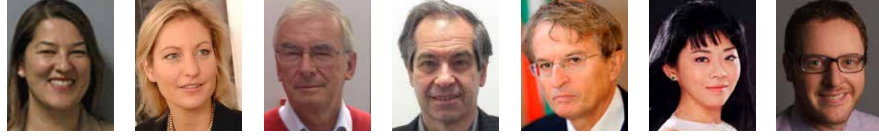
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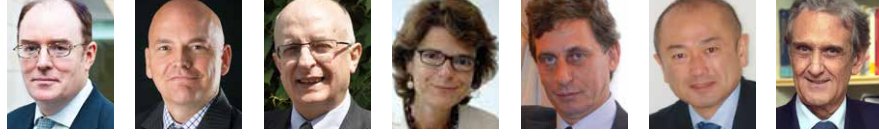
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A man who 'didn't see it coming'

Belief in conventional wisdom led to economic failure

William Keegan, Advisory Board

Adair Turner headed the UK's Financial Services Authority at the height – or perhaps one should say the depth – of the 2008 financial crisis. As such, he worked closely with Chancellor of the Exchequer Alistair Darling and Bank of England Governor Mervyn King to cope with the ramifications of a systemic banking failure that none of them foresaw. As the Queen famously asked on a visit to the London School of Economics in early 2009: 'Why did no one see it coming?'

Some had an inkling that something was wrong – William White, then at the Bank for International Settlements, and Raguram Rajan at the IMF spring to mind. But Turner freely admits that he was not among them.

Rather, he belonged to the conventional wisdom brigade that trusted in the excessively mathematical economists who had won Nobel Prizes for their work on the now discredited efficient markets hypothesis and rational expectations hypothesis.

Fatal conceit

In this eminently readable book, which derives from hard-won experience, impressive scholarship and what comes across as agonised reflection, Turner neatly points to one of the staging posts on the way to these intellectual failures: 'Friedrich Hayek argued that there was a "fatal conceit" in socialist planning that made it not only undesirable but also quite impossible.

'It assumed that it was possible for planning authorities to gain such comprehensive knowledge of both present conditions and future developments as to allow mathematically precise optimisation.' But such knowledge 'is not given to anyone in its totality'.

We all know that following the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union in 1991, belief in the wonders of

excessively free markets, nurtured during the Reagan-Thatcher years, was given free rein. Turner argues that the economic orthodoxy that preceded the financial crisis 'suffered from not just a similar but in some senses the very same conceit' that Hayek attributed to socialist planning.

According to those now discredited hypotheses, free markets would always deliver optimal results. All those weird financial products would reduce risk rather than increase it, central banks could control inflation, and financial stability would take care of itself.

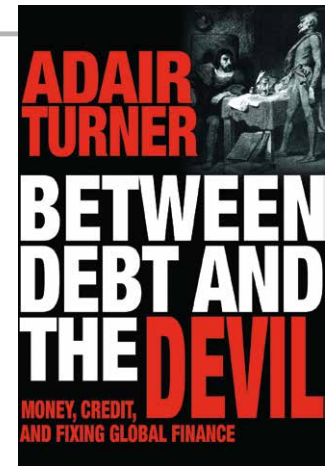
In a world where the attenuation of the power of organised labour and the price competition unleashed by globalisation helped, central banks were credited with controlling inflation. But unfortunately this applied to inflation of goods and services rather than assets. There was a free for all in the growth of debt and credit, with the consequent financial instability.

Public and private debt

Turner's concerns are with the historically high levels of public and private sector debt, and the need to restore sense and utility to the banking system. He is well known for describing most of the activities of the financial 'industry' as 'socially useless'.

He goes into great detail about how the banking sector's systemic risk taking might be brought under better control. Perhaps I have become an 'old fogey', but much of what he and others preach reminds me of the cautious approach of government and the Bank of England in those post-war decades before the era of financial liberalisation.

Turner is not alone in worrying about excessive levels of public as well as private sector debt. But I don't think he makes enough allowance for the fact that public sector debt simply had to rise in the face of



private sector deleveraging and the collapse of demand.

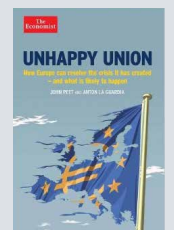
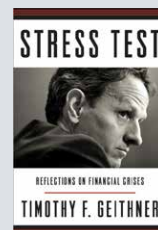
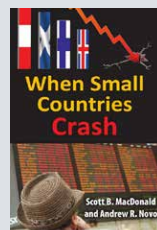
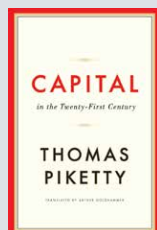
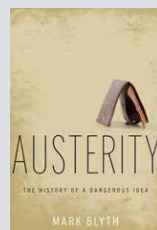
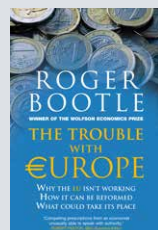
He is certainly – and rightly – concerned about the depressed level of aggregate demand, and the fact that output is so far below what it would have been had pre-crisis trends continued. Although historically low interest rates and quantitative easing have helped, the recovery has been exiguous by past standards.

Boosting demand

How to boost demand? Turner is very interested in so called 'helicopter money', a concept pioneered by Milton Friedman and popularised by Ben Bernanke – basically, printing money and handing it out, as a more direct way of stimulation than QE.

As policy-makers become more and more desperate, its time may come. For myself, I stick to the view that using old-fashioned fiscal policy is the way to stimulate a depressed economy when monetary policy has reached its limits, in the hope of producing the growth that will let the level of public sector debt look after itself. What has proved disastrous is a policy of austerity. ■

William Keegan is Senior Economics Commentator at The Observer.



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