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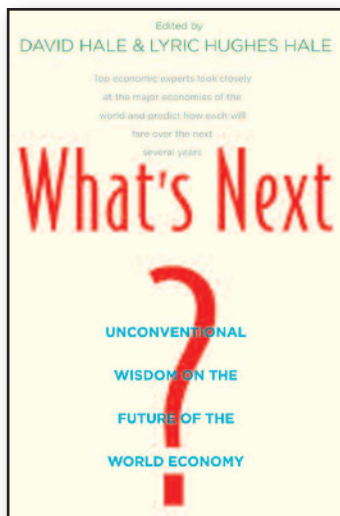
Unconventional Wisdom



In their new book, David and Lyric Hale cherrypick the best of the best of the world's economic seers.

Introduction

The newly published book, *What's Next? Unconventional Wisdom on the Future of the World Economy,* has contributions from twenty-three authors on six continents examining the outlook for the global economy. Some of the chapters focus on macro themes such as the prospects for economic growth in major countries, and often make arguments that run contrary to conventional wisdom, including why Africa's growth story, both in the recent past and over the next couple of decades, is much stronger than a perusal of major publications would lead you to believe. Other chapters have a micro focus on topics such as financial regulation and taxation, including an iconoclastic take on why U.S. commercial banks are, if anything, overcapitalized.

The sections presented here include highlights from five chapters in the book. Although the media's discussion of Mexico has primarily focused on the horrors of the drug war, Timothy Heyman asserts that Mexico has made tremendous strides toward becoming a developed country during the past two decades. John Greenwood argues in his chapter that the U.S. dollar will defy doomsday predictions and remain the preeminent international reserve currency for quite some time. In my chapter, I maintain that, despite many forecasters calling the gold market a bubble, the case for further price appreciation in gold is stronger today than it was even two years ago. Albert Bressand contends that oil prices are more likely to decline than appreciate over the near term. Finally, while many in the financial community have dismissed the Tobin Tax as an ineffectual method for correcting some of the system's excesses, Andrew Sheng makes the argument that a globally applied Tobin Tax, which has become regarded as a solution in the European Union since the book's publication, would produce a number of beneficial externalities for the global economy.

—David Hale

Mexico as Emerging Market

Mexican Stock Exchange

There are many ways to define "emerging market." One useful definition is "a country where the process of basic institution building is not complete." You can find institutional deficiencies in any emerging market, as we have in Mexico. But despite the absence of institutional reform, Mexico has not stood still over the last ten years, and it will not over the next two. Its stock market, a relevant indicator, has performed better than the emerging markets' average since the end of 2000, when the PAN came to power.

This performance reflects Mexico's basic strengths: its size, economic stability, and growing financial system. In population, land area, and US$ GDP, Mexico ranks between tenth and fifteenth in the world. The economic stability achieved by Salinas and Zedillo has been maintained by the PAN with strong finance ministers and stability at the Bank of Mexico. Owing to NAFTA and its geographic location, the Mexican manufacturing base has become even more closely integrated with the United States, especially in the automotive and electronics industries. Workers' remittances and tourism (first and third, respectively, among Mexican exports) are recovering with the U.S. economy and have helped to compensate for the decline in oil exports (now in second place).

Mexico's stock market, a relevant indicator, has performed better than the emerging markets' average since the end of 2000.

With an independent central bank that was established under Salinas, the financial system is dominated by global banks, including BBVA, Citi, HSBC, Santander, and Scotia, and was practically unaffected by the crisis. Over the last ten years the financial system has been greatly expanded by an obligatory pension system run by specialized fund managers, who at the end of June 2010 managed US$99 billion for 41 million accounts, with traditional mutual funds having grown to US$87 billion. This has led to a boom in mortgages and housing, with more than five million mortgages placed since 2000. The combination of economic stability and financial market deepening has led to a growth of the middle class, now estimated to include 60 million of Mexico's 110 million inhabitants.

Mexico's impressive stock market returns also reflect the performance of world-class listed companies, which have continued to grow inside and outside of Mexico. América Móvil is one of the world's largest cellular companies, and it operates in both Mexico and Latin America. Mexican mining groups include Peñoles, the largest silver company in the world, and Grupo Mexico, the largest copper company by reserves and the fifth largest producer. Televisa is the world's largest Spanish-language broadcaster, Cemex is the third-largest cement and concrete company, and Coca-Cola Femsa is the second-largest Coca-Cola bottler. Walmart de México, listed on the Mexican Stock Exchange, is one of Walmart's most successful subsidiaries.

—TIMOTHY HEYMAN
President of Heyman y Asociados, one of Mexico's leading independent institutional asset managers, and author of eight best-selling books on Mexican investments

DAVID LIFF, HTTP://CREATIVECOMMONS.ORG/LICENSES/BY/3.0/DEED.EN

The RMB as a Potential International Reserve Currency

The main test-bed for gradual liberalization of the RMB is Hong Kong.

Turning to consider future possible reserve currencies, what would have to happen for the Chinese RMB to emerge as an international reserve currency?

Viewed in terms of the nine criteria for an international reserve currency, China and the RMB currently only meet five (unit of account, medium of exchange, store of value, economic size, and creditor status), while the remaining four (availability beyond home borders, full convertibility, developed financial system, and network effects) have yet to be met. In terms of its government debt market, China's government and central bank bond market combined is still relatively small, with approximately $1.4 trillion outstanding in 2008, of which about half (mainly the central bank's sterilization issuance) was short term. Fiscal policy has generally been conservative, and the debt-to-GDP ratio is low, but the Chinese capital markets, including those for government securities, are still underdeveloped. Liquidity among domestic holders is limited as most purchasers hold until maturity. Foreign exchange controls mean that, other than for tourists' needs, the RMB is only available on a very limited basis to non-residents. Access to domestic, onshore RMB equity and debt markets by foreigners or by foreign entities is subject to qualified foreign institutional investors quotas, while onshore RMB deposit accounts at banks are simply not available to non-residents. Liberalization does not appear to be imminent for the onshore RMB markets. Thus, the RMB does not currently meet the criteria for becoming an international reserve currency.

However, in the offshore arena, the market for RMB has seen some significant developments, and there could be further substantial changes in the next decade. Numerous experiments are currently underway, including bilateral swaps between the Chinese central bank and foreign central banks (one side of which is RMB), and reciprocal invoicing of trade transactions between a number of partner economies and the People's Republic of China (again involving RMB).

But the main test-bed for gradual liberalization of the RMB is Hong Kong. For several years Hong Kong residents have been able to accumulate RMB deposits (at a limited rate), and since July 2010 several RMB investment products such as RMB-denominated bonds or money market funds have become available in the territory. Also since July 2010, Hong Kong banks have been allowed to offer settlement facilities for trade transactions (but not capital transactions) denominated in RMB, together with limited deposit and lending facilities. For example, loans to companies—whether resident in Hong Kong or not—are permitted if related to trade transactions, but not loans to individuals. These opportunities are important for Hong Kong's banks, but the overall market in offshore RMB will remain restricted in terms of size and type of transactions permitted. These transactions will not place the RMB in the same league as U.S. dollar transactions in London or Frankfurt where there are no such restrictions.

In the offshore arena, the market for RMB has seen some significant developments.

The gradual internationalization of the RMB must be understood in the broader context of the limited convertibility of the currency. The RMB is convertible only on current account (for trade and certain service transactions on production of the underlying documentation), while all capital transactions are subject to strict and detailed scrutiny and control. Consequently these tentative steps to create an offshore market in RMB are on a small scale and are far from allowing the RMB to become an internationally traded currency in the full sense of the term. Nevertheless, China's government is plainly intent on achieving both a more developed domestic capital market and a more internationalized currency. In summary, China's financial system will require many fundamental reforms and an extended period of development before the currency can become a serious contender for the role of international reserve currency. In order for the RMB to compete with—let alone replace—the U.S. dollar as the world's primary international reserve currency, it is clear that the Chinese authorities still have a long march ahead of them.

—JOHN GREENWOOD
Chief Economist, Invesco,
an international asset management company

Three Key Factors Will Influence the Price of Gold in the Medium Term

There will probably be three major factors influencing gold prices during the next five years. The first factor will be how long central banks pursue highly accommodative monetary policies in the G-7 countries. Gold is sensitive to the level of interest rates, so the highly accommodative monetary policies that have been in place since late 2008 have been positive for the metal. The slow pace of recovery in the U.S., European, and Japanese economies suggests that interest rates will remain low well into 2011, so monetary policy is unlikely to pose a challenge to gold in the short to intermediate term. In fact, the Federal Reserve has announced a program of quantitative easing to purchase $600 billion of government securities through June 2011 because of its impatience with the inability of low interest rates to revive the U.S. economy.

The second important factor will be the dollar. It rallied during the first half of 2010 because of Europe's financial problems, but the rally faltered when European conditions improved and there was evidence of sluggish growth in the U.S. economy. The great uncertainty about the dollar centers on when investors will demand higher bond yields to compensate for the inflation risk posed by America's large fiscal deficits. The fear of deflation has driven ten-year bond yields below 3.0 percent. There is no sign that investors will care about the fiscal deficit until the economy is much stronger and private credit demand revives. This factor could restrain bond yields through the early months of 2011. But when the economic recovery proceeds further and the Fed decides to raise interest rates, there will be greater concern about the deficit, and bond yields will rise. The foreign exchange market could also start to focus on the deficit and the fears that it will ultimately be inflationary. In such a scenario, gold could have a traditional rally as the dollar falls.

The most important new factor in the outlook for gold is the reemergence of central banks as gold buyers.

The third factor will be China. There is no way to predict when China's central bank will purchase more gold for its official reserves. As in 2009, it may not disclose any transactions until long after they have been completed. Private Chinese demand will increase, but it will be modest compared to potential central bank purchases. Chinese official purchases could easily give a significant boost to the confidence of the gold market in 2012 or 2013, but the market will not know what is happening until the central bank makes an announcement.

The price of gold has reached a new high in nominal terms, but it will not regain the inflation-adjusted peak it had in 1980 until the price rises to nearly $2,400 per ton. The price of gold began to rally in 2001 when the world economy was recovering from the collapse of the technology bubble. The price gains occurred against a backdrop of low U.S. interest rates, record current account imbalances, and the emergence of China as a major economic power. The current economic environment will be conducive to further price gains. Interest rates are at record lows. Central banks will have to maintain accommodative monetary policies in order to protect their banking systems. The dollar benefitted from problems in Europe, but the United States is also confronting unprecedented fiscal deficits. The most important new factor in the outlook for gold is the reemergence of central banks as gold buyers. After selling gold from the 1970s to the 2000s, central banks are once again adding gold to their reserves. During 2009 and 2010, China, India, Thailand, Russia, Sri Lanka, Bangladesh, and South Korea either purchased gold or announced plans to do so. The nations with the largest foreign exchange reserves in East Asia also have only modest gold holdings compared to the older industrial countries of Western Europe. They have traditionally pegged their currencies to the dollar and held dollar reserves because of their trade links to the U.S. economy, but the United States now represents a diminishing share of their trade, and there are many reasons to be concerned about the dollar's status as a secure asset.

If central banks want to diversify their reserves away from both the dollar and European currency, they will have to give serious consideration to gold as an alternative. China's reemergence as a great economic power is also likely to create a political dimension for the country's foreign exchange policies. China will want to hold more gold in order to demonstrate its new wealth and independence from the United States. These economic and political factors are creating potential new sources of gold demand that never existed before. They guarantee that the gold price will remain on an upward trajectory far into the future.

—DAVID HALE
Chairman, David Hale Global Economics

Paper Barrels

Forecasts by the International Energy Agency and other analysts assume that the speculative demand for oil will not get out of hand one way or another. Demand for "paper barrels" will continue to exercise an autonomous influence on oil prices. In the recent past, this took the form of massive investments in the futures markets in pursuit of large-scale gains as oil, and commodities more generally, turned into a major asset class for hedge fund and other investment fund portfolio managers. The sum of open interests on the NYMEX and ICE futures markets jumped from 950,000 contracts (equivalent to just under one billion barrels of oil) in 2004 to 2.7 million contracts (2.7 billion barrels of oil) in 2008. According to LCM Research, adding exchange-traded options and futures contracts to the latter figure represents no less than seven billion barrels of oil. The deleveraging that took place in the second half of 2008 reduced this amount to about 1.7 billion barrels. Over-the-counter crude oil contracts exacerbated this speculative spike, adding a full 120 percent to the peak figure as opposed to a fraction (on the order of 80 percent) before and after the spring 2008 episode. Similarly, passive investment into index funds also rose and fell spectacularly, from about $75 billion in 2006 to $280 billion by mid-summer 2008, and back to the 2006 level six months later. The Goldman Sachs-fed allure of $200-per-barrel oil has faded, and it is unlikely that the next couple of years will see an episode of exuberant investing comparable to the year 2008 that is still remembered for oil at $147 per barrel. Nevertheless, the fourth quarter of 2009 saw sustained investment in oil futures, and there may be other reasons why paper markets may not remain neutral for long. In particular, oil recently became a major instrument in efforts to hedge against a fall in the dollar. As observed by LCM, the spike in oil prices of late October 2009—during which time oil prices crossed what had been for five months a firm upper limit of $75—can only be explained by the weakening in what had been a negative relationship between gold and the dollar and by the role that oil played, at least for a few months, as "an asset class of choice for dollar refugees." If sustained for a long enough period, a significant weakening of the dollar could test not only this emerging coupling of currencies and oil markets, but possibly the manner in which Saudi Arabia defines what is presently an upper limit of $80 for the range of acceptable oil prices.

If sustained for a long enough period, a significant weakening of the dollar could test the manner in which Saudi Arabia defines what is presently an upper limit of $80 for the range of acceptable oil prices.

Altogether, many trends will converge to significantly change the parameters behind the "sweet spot" that oil markets found in late 2009 and that they still enjoyed in the summer of 2010. These trends include the rate of increase in demand, the date at which non-OPEC production peaks, the relative role of Saudi Arabia, Iran, and Iraq, and the time it takes for the share of alternatives to increase from minuscule to globally significant. These different variables will have major implications for policies and, to some extent, for prices. However, the bottom line remains that in 2030 (notwithstanding the thinking triggered by the Deepwater Horizon oil spill), ours will still be a hydrocarbon-powered economy, and enough oil and gas resources will be available to meet the huge energy demand that cannot be met by alternative energy sources, however rapid their development. Lessons learned in 2009 and 2010 highlight the importance of better governance of energy as well as climate issues.

—ALBERT BRESSAND
Aristotle Onassis Professor of Practice in International and Public Affairs at Columbia University's School of International and Public Affairs

An oil refinery in Mina-Al-Ahmadi, Kuwait.

The Turnover Tax Has Many Merits

A turnover tax has many merits. First, it is a user-pay tax that is less regressive than other forms of taxation. It is akin to a gambling tax on socially negative activities. Second, a turnover tax can be countercyclical, being increased or decreased depending on the level of speculative fever in the markets. When the risk of a bubble collapse rises, the tax rate can be increased to fund safety nets in the event of a crisis. It complements capital adequacy tools. Third, a turnover tax can finance global public goods that currently have no other forms of financing. Fourth, a turnover tax will reduce financial institutions' profits and hence their capacity to pay excessive bonuses that promote too much risk-taking at the expense of society. Fifth, the turnover tax collection system will generate data on financial transactions that will help regulators monitor excessive speculation, market manipulation, and insider trading, all of which currently prevent effective global financial market supervision.

Of course, the financial sector would object to any form of new tax. But those who prosper through public subsidy in the form of deposit guarantee and enjoy higher profits at public risk deserve to pay some tax. Those who argue for frictionless finance have created a windmill spinning at supersonic speed that has fractured the global financial structure. A minimal turnover tax will impede infinite financial derivative layering that creates complexity, opacity, and potential for systemic risks.

Those who argue for frictionless finance have created a windmill spinning at supersonic speed that has fractured the global financial structure.

Just how much can governments raise from a turnover tax? Based on the Bank for International Settlements' Triennial Survey data in 2007, the global annual value of foreign exchange turnover was roughly US$800 trillion. Adding another US$101 trillion of stock market trading based on the World Federation of Exchanges statistics would give total annual financial trading, excluding bonds and other over-the-counter transactions, of roughly US$900 trillion. Using a turnover tax of 0.005 percent would yield US$45 billion, roughly equivalent to the US$50 billion of annual aid pledged to Africa.

Global public goods are currently funded by equity (based on the Bretton Woods system which allocates weighted voting quotas to participating institutions) or by direct national grants. These mechanisms are not sustainable. We need a global tax to fund global public

goods. But for a turnover tax to work, it is vital that all of the G-20 countries agree to impose a single, uniform rate of, say, 0.005 percent to avoid a race to the bottom from the onset. This would put into place the module of fiscal standardization and tax mechanism that improves conditions for future coordination in monetary policy and financial regulation. The tax can be collected at the national level based on buyer-pay. The tax collected could be credited to a global fund, with a formula that would allow national governments to use part of the proceeds to resolve domestic crisis problems.

A global turnover tax can fund non-controversial global public goods, including international initiatives that promote education, before moving on to confront more controversial matters, such as funding to tackle climate change. Global problems are global tragedies of the commons. We cannot build a global fiscal system to tackle global problems overnight, but we must begin the debate.

—ANDREW SHENG
Author, From Asian to Global Financial Crisis *(2009) and former Chairman, Hong Kong Securities and Futures Commission*