

The Bulletin

OMFIF

January 2019
Vol.10 Ed.1



The 100th issue



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The Bulletin

January 2019. Vol.10 Ed.1



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Promoting gender balance in public-private finance

Gender Balance Index 2019 launch

The presence of women at the top of traditionally male-dominated public and private financial institutions is beneficial for both the organisations themselves and the global economy. Boards and executive teams benefit from the diversity of opinion offered by gender equality.

OMFIF is contributing to these trends by launching the sixth annual Gender Balance Index.

The launch includes a keynote presentation and panel discussion focusing on public sector initiatives and draws in private sector experience.

Venue: Embassy of Switzerland, London **Date:** 7 March 2019

For more information or to register your interest, please visit omfif.org/meetings

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About OMFIF

Dialogue on world finance and economic policy

THE Official Monetary and Financial Institutions Forum is an independent think tank for central banking, economic policy and public investment – a non-lobbying network for best practice in worldwide public-private sector exchanges. At its heart are Global Public Investors – central banks, sovereign funds and public pension funds – with investable assets of \$36tn, equivalent to 45% of world GDP.

With offices in London and Singapore, OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries. OMFIF promotes higher standards, performance-enhancing public-private sector exchanges and a better understanding of the world economy, in an atmosphere of mutual trust.



Membership

Membership offers insight through two complementary channels – Analysis and Meetings – where members play a prominent role in shaping the agenda. For more information about OMFIF membership, advertising or subscriptions contact membership@omfif.org



Analysis

OMFIF Analysis includes commentaries, charts, reports, summaries of meetings and The Bulletin. Contributors include in-house experts, advisers network members and representatives of member institutions and academic and official bodies. To submit an article for consideration contact the editorial team at analysis@omfif.org



Meetings

OMFIF Meetings take place within central banks and other official institutions and are held under OMFIF Rules. A full list of past and forthcoming meetings is available on www.omfif.org/meetings. For more information contact meetings@omfif.org



OMFIF Advisers Network

The 173-strong OMFIF advisers network, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors: monetary policy; political economy; capital markets; and industry and investment. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership changes annually owing to rotation.



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Bankers who fell to earth

OMFIF was born on a wave of reflection that the good times couldn't possibly last – because they only recently had come to an end. January 2010, the date of the first of what has now become 100 monthly Bulletins, marked the onset of a long, halting recovery from the financial crisis. The world gingerly edged forward, knowing that at each step it could fall down again.

Central banks have become more visible and more vulnerable. The 100th edition recognises the bittersweet realities of modern central banking. Summing up a view in both developed and emerging market economies, Daniel Mminele of the South African Reserve Bank writes, 'Given their expanded role and growing demands from society, central banks can expect to face more scrutiny and, in some circumstances, challenges to their independence.' This matches the findings of a series of OMFIF

seminars and research pieces over the years; the second decade of the 21st century was the time when central bankers fell to earth.

Jim Bullard of the St. Louis Federal Reserve writes on the Sisyphean quest to restore interest rates to 'normal' levels. Two central bankers bearing scars from the euro crisis – Yannis Stournaras from Greece and Carlos da Silva Costa from Portugal – dwell on the incomplete business of shoring up Europe's single currency. Nestor Espenilla from the Philippines, Mario Marcel from Chile and Turalay Kenç from Turkey summarise lengthy legacies of upheaval.

All our long-running themes are covered. We have articles on pensions from Andy Budden of Capital Group, on the rise of the renminbi from Gary Smith of Barings, on sustainable economics from Joaquim Levy, formerly of the World Bank, on central banks' gold-buying from Shaokai Fan of the World Gold Council. Karin Finkelston of the International Finance Corporation writes on impact investing, Hani Kablawi of BNY Mellon on custody services, the World Bank's Marcelo Giugale on insuring emerging market economies, and Frank Scheidig of DZ BANK on green bonds. For the 100th edition we have put on a display of economics pyrotechnics. Under the new quarterly format, the next Bulletin appears in April. We're sure it will be worth the wait.

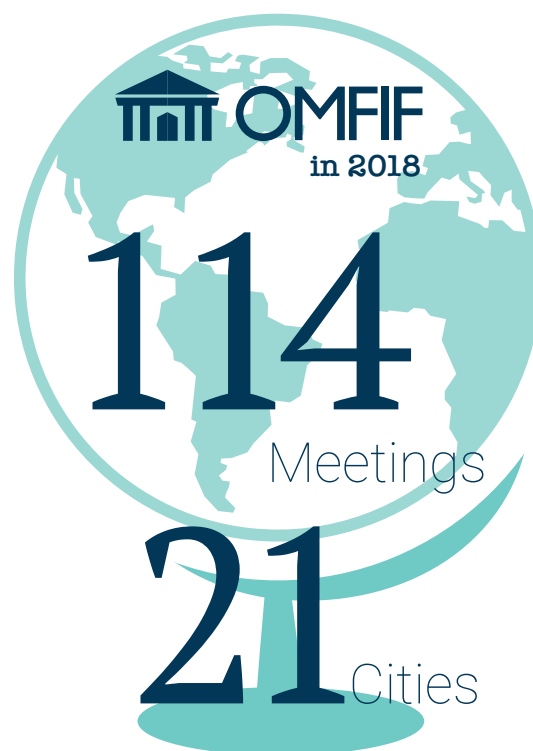


»12 November, Singapore

Demystifying digital currencies



AS PART of the 2018 FinTech Festival in Singapore, OMFIF, in collaboration with the Sim Kee Boon Institute for Financial Economics at Singapore Management University, held a high-level panel discussion on initial coin offerings, tokens and digital currencies. Speakers included Serey Chea, director general of central banking at the National Bank of Cambodia, Artur Granicki, director of the Polish Financial Supervision Authority, and Antony Lewis, director of research, cash and central bank digital currency strategy at R3.



Spencer joins advisory board

GRANT SPENCER, former governor of the Reserve Bank of New Zealand, has joined the OMFIF advisory board. He retires from the



Reserve Bank after a 40-year career in high-level banking, with roles that included head of strategy and business development ANZ Bank and special adviser to the International Monetary Fund.

»28 November, London

World real interest rate 'declining'

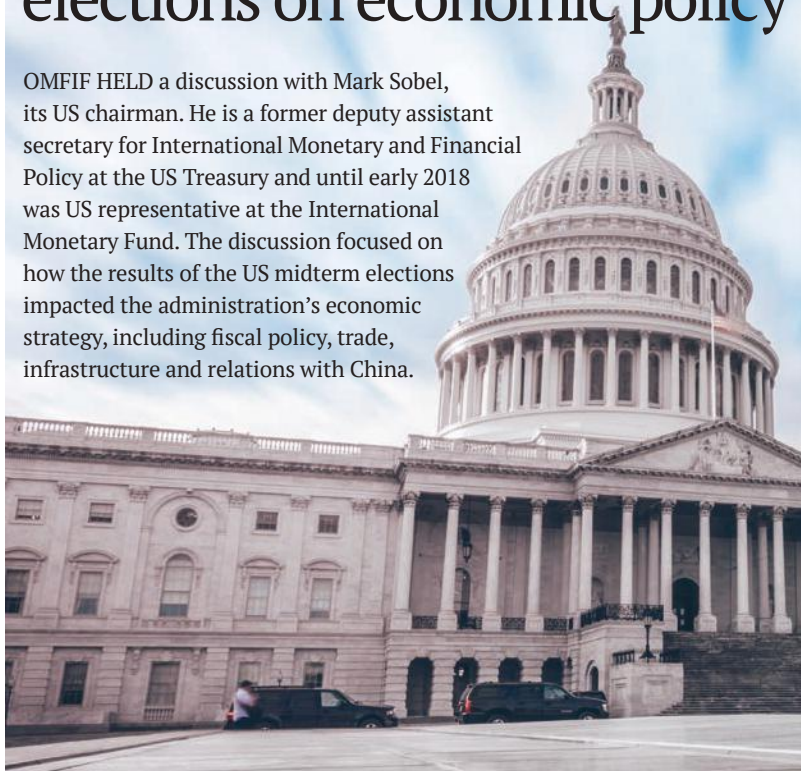
THE TREND in the world real interest rate has lowered by around two percentage points over the past 30-40 years, according to Domenico Giannone, assistant vice-president at the Federal Reserve Bank of New York, who presented his findings on global trends in interest rates at an OMFIF meeting in London. Topics for debate included inflation targeting in the US, reserves management and the unwinding of central bank balance sheets since quantitative easing. Presentation of Giannone's findings can be found at omfif.org/meetings.



»20 November, New York

Effects of the US mid-term elections on economic policy

OMFIF HELD a discussion with Mark Sobel, its US chairman. He is a former deputy assistant secretary for International Monetary and Financial Policy at the US Treasury and until early 2018 was US representative at the International Monetary Fund. The discussion focused on how the results of the US midterm elections impacted the administration's economic strategy, including fiscal policy, trade, infrastructure and relations with China.



»10 December, London

Balancing the roles of the ECB

OMFIF DISCUSSED the future of European banking with Ignazio Angeloni, member of the supervisory board of the European Central Bank. The meeting focused on how the ECB balances its roles of monitoring the euro area's banking sector while stimulating banks to lend more. Topics also included the reduction of the level of non-performing loans, improvements in banks' balance sheets and unwinding unconventional monetary policy.



FORTHCOMING MEETINGS

»Thursday 24 January, New York

Assessing global financial stability

Tobias Adrian, director of the IMF's monetary and capital markets department, outlines current and potential risks covered in an IMF global financial stability report that investigates whether we are any safer 10 years after the 2008 financial crisis.

»Thursday 31 January, London

Outlook for reserve asset management for 2019

A seminar on the outlook for public sector investment management in Europe for 2019, along with economic and financial developments in 2018. It brings together economic experts and asset managers from a public sector background.

»Thursday 7 March, London

Launch of the Gender Balance Index



Launch of OMFIF's sixth annual Gender Balance Index, which tracks the presence of men and women in senior positions at central banks and sovereign funds. The launch includes a panel discussion on the role of women in global public investment institutions.

»Monday 25 March, London

Developments in the US economy

A City Lecture with **Patrick Harker**, president of the Federal Reserve Bank of Philadelphia and member of the Federal Open Market Committee. The lecture covers macroeconomic developments in the US and the Fed's monetary policy outlook.

For details visit omfif.org/meetings

The Bulletin at 100: Preparing for a new era



David Marsh
OMFIF

The declared aim of the OMFIF Bulletin, set out in the first editorial in January 2010, was ‘to promote a dialogue on issues of particular interest for central banks and sovereign funds, and the community that follows them within the financial markets and beyond.’ Over 100 issues, with 11 editions a year, we have lived up to that pledge, extending range, detail and authorship, providing coverage in sectors ranging from green finance to digital currencies, including countries from Norway to New Zealand, from Brazil to Burundi.

The first issue presaged many future preoccupations. There were articles on US congressional attacks on the Federal Reserve, threats to central bank independence (John Nugée wrote: ‘Central banks are now no longer beyond the reach of politics’), reserve currency diversification and the renminbi. We carried an over-optimistic headline, ‘Arab monetary union plan inches closer’, over a piece claiming that the ‘mirage’ of Gulf monetary unity was becoming more distinct. Meghnad Desai called for a strengthened gold role in world money. Paul Volcker explained why he wished to separate ‘commercial banking activities essential to the functioning of our financial system from more speculative trading-oriented capital markets activities that are not.’ Harold James argued that financial ‘Balkanisation’ was impeding Europe’s monetary union – requiring continent-wide banking supervision and regulation.

Since the first issue – listing only 15 advisory board members (including stalwarts Darrell Delamaide, Oscar Lewisohn, Paola Subacchi, Niels Thygesen, Makoto Utsumi and Ernst Welteke) – The Bulletin

(as it became known in July/August 2014) has greatly developed. January 2011 saw a special issue on ‘The crisis of the euro’, featuring Michael Butler, a principal promoter of Britain’s ill-fated 1990 ‘hard euro’, advocating a parallel currency for the euro area. We have run editions on China, Japan, North America, Latin America. We have focused on former Fed Chair Janet Yellen, Nigerian President Muhammedu Buhari, Japanese Prime Minister Shinzo Abe, Xiaochuan Zhou, then governor of the People’s Bank of China, and Mauricio Macri, president of Argentina. We have adapted editions to OMFIF meetings taking place in individual countries or at specific fora. We marked the 50th edition and the first Main Meeting in the US with features on US energy. We devoted the July 2017 edition to green finance, coinciding with an OMFIF symposium at the Bundesbank. Africa was the theme in September 2018 and January 2014, while Asia was showcased in October 2018 when we launched two large reports at the International Monetary Fund–World Bank meetings in Bali.

We have made The Bulletin more digital, flexible, colourful and pictorial, particularly under layouts devised since 2017 by Simon Hadley and Will Coningsby-Brown. We have devised a longer-term schedule, aligning the publication with issues that OMFIF is highlighting over years rather than months: Danae Kyriakopoulou and Julian Frazer have played a big role in this. We have made The Bulletin home to an ever-expanding range of authors. We have greatly increased regular features ranging from the Monthly Review to the Advisers’ Poll. Mercifully, we have eschewed the dreaded phrase, ‘thought leadership’. All this prepares us for a new century-plus era, when OMFIF will publish The Bulletin quarterly, emphasising the longer-term edge to our work. ●

David Marsh is Chairman of OMFIF.



The Bulletin 100



Fed lessons from zero lower bound

Next financial crisis may come from outside banking sector



James Bullard
Federal Reserve
Bank of St. Louis

A decade ago, I took on the position of president and chief executive officer of the Federal Reserve Bank of St. Louis – one of 12 regional reserve banks that, together with the board of governors in Washington, make up the US Federal Reserve System. That was 1 April 2008, and it wasn't the time for jovial congratulations. The US was in the throes of a financial crisis, the mortgage crisis was already brewing, and major banks were failing. The Federal Reserve was cutting the target for the federal funds rate and debating unconventional stimulus measures.

These past 10 years have been anything but ordinary.

We've lived through the Great Recession, an era of near-zero interest rates, fears that the US would fall into a deflationary trap (it didn't) and implementation of unprecedented policies aimed at stopping an ever-deepening crisis. Through it all, we learned some important lessons.

This period underscored how challenging it is to encounter the zero lower bound for the Fed's policy rate. It turned out to be a more difficult issue than many of us appreciated. I had thought it was an issue of the 1930s Great Depression era, but ultimately the financial crisis changed how we think about central banking and how a central bank should conduct monetary policy at the zero lower bound.

Moreover, we experienced ultralow policy rates globally for much longer than anyone anticipated. Previously, it would have been surprising to stay at the zero lower bound for more than two quarters, much less a year. Yet the US remained at a near-zero policy rate for seven years – with Japan and

Europe even seeing negative interest rates. The idea that this would last for so long – far beyond ordinary business cycle time – was a shock to the global macroeconomic and central banking communities.

The 2007-09 crisis made people reconsider the intersection between the financial sector and real economy. We have learned to be more keenly attuned to the fact that financial crises can happen and that the modern economy is not protected against these shocks. While such crises are infrequent, they can be devastating to the economy as a whole when they do occur.

Getting back to normal

As any monetary policy-maker would be, I'm focused on where we're going in the years ahead, where the debate on monetary policy will lead us and what the right policy decisions will be in a new era.

In my view, there is not enough discussion about where the next financial crisis may originate. It has the potential to come from outside the traditional banking sector, as the 2007-09 crisis arguably did. As a central bank, we have an opportunity to reorient our thinking about risks to ensure we set the right policy and employ the right level of oversight to help mitigate or prevent the potential impacts of future crises.

If the last decade was focused

on unconventional monetary policy, the focus today is on 'getting back to normal' – that is, increasing the Fed's policy rate in line with better economic conditions and reducing the size of the Fed's balance sheet, which had grown under the quantitative easing programmes. Given the uncertainty about what 'normal' is, each of us on the Federal Open Market Committee brings his or her own views on what the appropriate policy rate path might be. That diversity of thought and discourse ultimately yields the best outcome.

We may not know with certainty what the future will hold, but being at the forefront of the ongoing, rigorous debate of optimal monetary policy is critical. We shouldn't shy away from discussing new approaches to control inflation, debunking old myths about how the economy works or discarding out-of-date macroeconomic theories in favour of new narratives with better explanatory power of the regimes in which we find ourselves.

It's an exciting time to be studying this dynamic global economy of the 21st century, the factors affecting it and what lies ahead. ●

James Bullard is President and Chief Executive Officer of the Federal Reserve Bank of St. Louis. [This article was adapted from the St. Louis Fed's annual report.](#)



'We shouldn't shy away from discussing new approaches to control inflation or discarding out-of-date macroeconomic theories.'

Scrutiny of central banks likely to increase

Greater transparency and accountability to match expanded responsibilities



Daniel Mminele
South African
Reserve Bank

A few months ago, we marked the 10-year anniversary of the collapse of Lehman Brothers and the start of a grave period for financial markets. For policy-makers, the past decade was characterised by strategies to deal with the aftermath of the 2008 financial crisis through a combination of ‘firefighting’ and trying to correct the defects that created the crisis.

Major central banks found themselves in unfamiliar territory. They relied increasingly on unconventional policies, the most prominent being quantitative easing, to boost inflation, support growth and reduce unemployment. Many commentators warned at the time that the longer central bankers went down that route, the more complex the exit would be.

Some countries are still implementing QE, while others are withdrawing such measures. As this ‘great exit’ unfolds and central banks pursue monetary policy normalisation and look to shrink their balance sheets, debates continue to rage about the success, or otherwise, of these unorthodox policies.

While the global economy emerged from recession in the fourth quarter of 2009, the pace of growth since has been

lacklustre. Many have argued that successive rounds of QE only encouraged risk taking in the financial economy rather than in the real economy. There does, however, seem to be consensus that QE played a crucial role in containing the crisis, and that central banks had little choice as ‘other policy-makers were paralysed by dysfunctional politics’, as Mohamed El-Erian says in his book *The Only Game in Town: Central Banks, Instability, and Avoiding the Next Collapse*.

In Africa, QE produced mixed results. The initial strong inflows of capital as part of search-for-yield strategies and favourable financial conditions allowed many sub-Saharan African countries to finance their deficits more easily, leading to a surge in eurodollar issuances. But the great exit is proving to be a challenge for many of these countries and those non-financial corporates that relied too heavily on a cash-flush system and cheap valuations to increase their leverage but paid too little attention to structural reform and improving their economic and financial resilience. Now they are finding it harder and more costly to meet their external financial obligations.

Another key feature of the financial market and policy-making landscape since 2010 has been the changing role of central banks. Leading up to the financial crisis, central banks focused primarily on achieving and maintaining low and stable

inflation, deemed necessary to create an environment conducive to sustainable economic growth. While the future primary role of central banks and monetary policy will remain medium-term price stability, lessons from 2008 clearly point to the need to give broader financial stability more prominence.

The rationale for the increased focus on financial stability is informed by the increasing interdependence of economies, the interconnectedness in the global financial system, and the systemic nature of risks brought about by this kind of integration. Policy-makers will continue to grapple with how best to manage the relationship between price and financial stability as well as macro- and microprudential policies.

Transparency and integrity

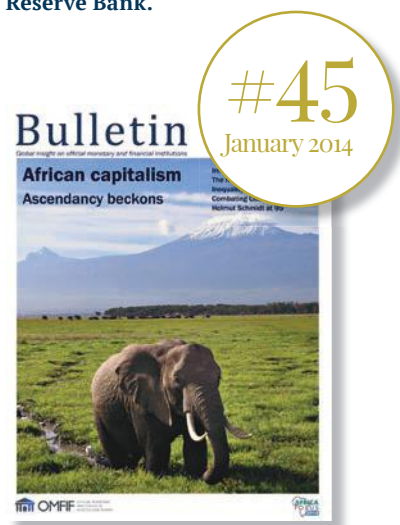
It is said that ‘prediction is very difficult, especially if it is about the future.’ The next decade is likely to see a rate of change not witnessed before, which will require financial markets and policy-making to be agile. The opportunities and threats in the wake of rapid technological advancement will become more difficult to distinguish.

One key theme that will shape the next decade will be the rise of financial technology. This will demand a careful balance between not stifling innovation while ensuring the safety and resilience of financial systems.

Institutions must continue to improve the resilience of the global financial system and guard against the erosion of hard-won international regulatory reforms while closely monitoring for any unintended consequences and adopting corrective measures. And as ever, appropriate governance and conduct standards must be enforced to strengthen the integrity and reputation of financial markets and participants.

Given their expanded role and growing demands from society, central banks can expect to face more scrutiny than was historically the case and, in some circumstances, challenges to their independence. This will require higher degrees of transparency to facilitate holding them accountable in view of their expanded responsibilities. ●

Daniel Mminele is Deputy Governor of the South African Reserve Bank.



An exercise in judgement and innovation

Pioneering monetary policy development in the emerging world



Mario Marcel
Banco Central
de Chile

After decades of high inflation, inflation targeting frameworks have proved their effectiveness in many emerging economies. This has been key in controlling price dynamics and anchoring expectations to target, delivering lower price and output volatility. Some countries have adopted fully-fledged forward-looking inflation targeting regimes together with floating exchange rates, helping them navigate a more turbulent global economy. This has been complemented with major improvements in communication, transparency and accountability.

Chile pioneered monetary policy innovation in the emerging world. Banco Central de Chile was granted independence and a price stability mandate nearly 30 years ago and exercised it swiftly, supported by an early version of inflation targets in the early 1990s. Over time, as the financial market has deepened the development of exchange rate hedging mechanisms, the central bank has overcome fears of floating.

As an open economy, Chile is not immune to external shocks, but the country's

ability to cushion them through the exchange rate and countercyclical policy responses has improved significantly. As a result, Chile's monetary policy framework has proved useful when facing subsequent challenges, including the 2008 financial crisis, the end of the commodity price boom in 2013-14, and in resisting pressures to tighten the monetary policy response to transitory pressures from short-term currency depreciations.

In each of the high-volatility episodes faced after the crisis, anchored inflation expectations, automatic fiscal stabilisers, foreign exchange hedging and a sound financial system have contributed to provide monetary policy with sufficient room for manoeuvre. But these factors are not exogenous to macroeconomic policy. They were nurtured by a consistent policy framework built and maintained over the last 20 years.

Ultimate responsibility

Inflation dynamics and the way they interact with economic variables are a central challenge for policy-makers who have price stability as their core mandate. We have observed persistently a puzzling behaviour of inflation in many developed countries, where standard approaches have done a poor job of predicting price pressures.

If inflation fails to respond to monetary impulses as predicted by models, financial imbalances may build up, fiscal discipline may erode and inflation risks may be underpriced by markets. This could expose them to reversals with data surprises going forward, transforming policy-making into a much more complex undertaking.

It has become more difficult to measure movements of prices, as standardised goods account for a smaller share of household consumption compared to services and fast-changing goods.

The advent of the digital economy also poses a major challenge to correctly measuring the value added throughout the wide range of complex and globalised economic activities. Structural changes especially relevant for emerging countries, like demographic transitions or lengthened international value chains, should also encourage central banks to develop appropriate tools to formulate and communicate policy paths that make forward-looking inflation targeting work.

As the economy evolves, the relevance of these tools must be kept constantly in check. The quantity and quality of data available to make policy decisions may also change substantially.

The dominance of regular economic surveys is challenged

by growing administrative datasets and 'big data'. One should never forget that data are only one instrument helping to capture economic behaviour. From a policy-making perspective, data collection, processing and statistical methods are a way to produce evidence for better decision-making.

Any central bank that operates in a forward-looking environment, dealing with many unobservable concepts, has the ultimate responsibility for using all the relevant information at hand and sharing such information with the public to ensure that decisions are easily understood. Monetary policy-making is not a bureaucratic procedure, but a powerful exercise in judgement. ●

Mario Marcel is Governor of the Banco Central de Chile.

#78
January 2017



Addressing reversal of financial integration

Delay in adjustments only magnifies Europe problem



Yannis Stournaras
Bank of Greece

Much has been done in recent years following the Greek debt crisis to improve the functioning of European economic and monetary union. Key initiatives included the provision of intergovernmental loans to Greece, establishment of the European Financial Stability Facility (and its successor, the European Stability Mechanism) and the creation of the (still incomplete) banking union.

There has been, too, the application of stricter rules on banking regulation and supervision, the establishment of the European Systemic Risk Board and the development of appropriate macroprudential instruments to identify and address system-wide risks. The European Central Bank developed new monetary policy instruments to deal with low inflation and growth, and the Single Supervisory Mechanism assumed responsibility for all systemic banks in the European Union, thus addressing the home-bias issue in supervision.

More recently the European Commission, in view of the Multiannual Financial Framework for the period 2021-2027, tabled proposals to establish a Reform Support Programme and a European Investment

Stabilisation Function. The new EU budgetary tools aim to bolster stability in times of stress through investment continuity and providing incentives for domestic structural reforms.

Nonetheless, the architecture of EMU is still, in many respects, incomplete. Euro area policy-makers cannot rely solely on ECB interventions. It is essential to ensure that the Commission's macroeconomic imbalances procedure operates more symmetrically both for member states with external deficits and for those with external surpluses. To date the burden of adjustment has fallen, to a large degree, on member states with current account and budget deficits, such as Greece on the eve of the crisis; member states with high current account surpluses could have responded more appropriately.

Since the crisis, policy-makers have observed a home bias in investment and a flow of euro area excess savings towards the rest of the world rather than within the EU. This has led to a reversal of the previously achieved financial integration and income convergence among euro area countries.

The priority, in these circumstances, must be to complete the banking union with a European deposit insurance scheme, as well as the capital markets union. This will restore intra-European financial flows, improve stability in the banking sector and promote private

risk-sharing in the EU. In this context, the role of the ESM could be enhanced to support banking union with a backstop facility.

EMU should enhance public sector risk-sharing by creating a centralised fiscal stabilisation tool. The Commission's proposed European investment stabilisation function could fill this role. Other suggestions involve a European unemployment insurance scheme and the issuance of European 'safe' bonds. These ideas deserve policy-makers' attention.

With regard to member states, national ownership and credible implementation of country-specific recommendations is crucial for promoting economic policy coordination and risk reduction. National policies should focus on structural reforms to improve the flexibility of domestic markets and reduce vulnerabilities in the financial sector. This should facilitate the adjustment of these economies to future shocks. They should also implement sound pro-growth fiscal policies that allow for stabilisation over the business cycle and ensure debt sustainability.

Solidarity in Europe

Policy-makers can draw several key policy messages from the Greek crisis. First, delaying necessary adjustments only magnifies the problem, which will then have to be addressed later on less favourable terms. Second, the proper sequencing of the reform

programme as well as ownership (mainly by the government but also the main opposition parties) is key to the adjustment's success.

Third, political solidarity and greater risk-sharing in the euro area to address large asymmetric shocks are of major importance. Pointing fingers at countries in difficulty only propagates populist voices on all sides.

Fourth, private and public risk-sharing should be enhanced by moving forward with the banking and capital markets unions and by creating a centralised fiscal stabilisation tool. To avoid moral hazard, risk-sharing should go together with risk reduction and close economic policy coordination. Moreover, countries need to improve income convergence and ensure that economic rebalancing operates symmetrically.

Last but not least, a final point on Greece: to bolster investors' confidence in the prospects of the Greek economy and to be able to refinance maturing debt on sustainable terms, the government must continue to implement reforms and avoid reneging on programme-related commitments.

The years since the debt crisis have been tremendously difficult for the euro area, but the European project endures. The firming up of EMU must be policy-makers' priority in the years to come. ●

Yannis Stournaras is Governor of the Bank of Greece.

Why we must complete banking union

Financial stability threats would hit citizens' trust



Carlos da Silva Costa
Banco de Portugal

Following the 2008 crisis, reforms were needed in Europe's financial sector. The establishment of the single rulebook and the launch of the European Union's banking union with its rules and institutions constitute a commendable success in this regard.

The banking union is currently based on two pillars: the Single Supervisory Mechanism and Single Resolution Mechanism. However, since these were put in place, the political will to complete the banking union has waned.

The banking union is missing critical elements – a fully-fledged European deposit insurance scheme, a backstop to the Single Resolution Fund and the

provision of liquidity in bank resolution – which jeopardises its fundamental benefits. As we progressed along the road, new and bigger hurdles emerged. Policy-makers focused excessively on 'risk reduction v. risk sharing' and lost sight of the banking union's overall objectives.

Incomplete setup

In this incomplete setup, banks are 'European in life but national in death'. Supervisory and resolution decisions are mostly taken at the European level, but the ensuing consequences still lie with taxpayers at the national level. This may have a potentially serious impact on national budgets, as the ultimate guarantor of financial stability remains national.

In view of the mismatch between European oversight and national liability, the different stakeholders' objectives and interests are unaligned. It is important to consider who is actually looking after financial stability.

Four years after the SSM became operational, much has been accomplished. Danièle Nouy, the former chair of the Supervisory Board (2014-18), must be praised for her decisive contribution to this success. Her perseverance was essential to establish the mechanism's credibility.

As Andrea Enria takes over Nouy's mandate, now is a good

opportunity to reflect on the many achievements of Europe's crisis management set-up and draw some preliminary lessons from the current (incomplete) architecture.

Looking ahead

With the benefit of hindsight, we should reflect on the need to strengthen the SSM's decision-making process, the need to draw a line clearly between regulatory powers and supervisory oversight, and ensuring the application of the principle of EU 'financial stability responsibility, regulatory responsibility and supervisory responsibility'.

Strengthening the decision-making process of the SSM would ensure shared ownership of problems and decisions, encouraging a broader vision on the implications of the SSM's decisions on financial stability. This could be achieved through the establishment of intermediate committees similar to those of the ECB's monetary policy function.

The separation of supervisory functions from regulatory ones is necessary for the political legitimisation of regulatory standards. The overlap of regulatory and supervisory territories guarantees

compliance with the principle of central responsibility for financial stability. In this context, it is necessary to find ways to ensure and safeguard this basic principle within banking union. It is also essential to determine which coordination and convergence mechanisms between territorial regulatory and supervisory authorities can be established between the banking union and the remaining EU member states.

One should not underestimate how much has been achieved in recent years. Nevertheless, the foundations of Europe's financial architecture are still not sufficiently robust to withstand the impact of a future crisis. This should be a priority for policy-makers and relevant institutions.

Decisive political will to move forward with the completion of the banking union is required. In the absence of this will, Europe must revisit its existing rules to safeguard financial stability. This is in the best interests of its people as few things can be more destructive to citizens' trust in European institutions than threats to financial stability. ●

Carlos da Silva Costa is Governor of the Banco de Portugal.

'One should not underestimate how much has been achieved in recent years. Nevertheless, the foundations of Europe's financial architecture are still not sufficiently robust to withstand the impact of a future crisis.'



Coping with challenges of complexity

Looking backward and forward to carve clear path for the future



**Nestor
Espenilla**
Bangko Sentral
ng Pilipinas

The start of a new year is a good time for reflection. People have different approaches to introspection. Some look back on the year that was, while others look forward to the possibilities of the year ahead. I tend to reflect by seeing both sides.

It is critical for decision-makers to look back and use lessons from the past to inform policy actions. At the same time, policies must be responsive and anticipate new challenges going forward.

The economic landscape has changed in the last 10 years. First, the markets do not always get it right. Before the 2008 financial crisis, policy-makers accepted the idea of an efficient and rational market. However, as Andrew Lo, director of the Laboratory for Financial Engineering at the Massachusetts Institute of Technology, pointed out, the crisis revealed painfully that sometimes the so-called ‘wisdom of the crowd’ can be overwhelmed by the ‘madness of the mob’. Markets, left unfettered, could lead to significant asset price misalignments, which could have destabilising effects on the economy.

Second, the global economy

has become increasingly interconnected. Such integration can facilitate greater incorporation of information, leading to more efficient pricing of assets. However, it can also amplify the transmission of negative shocks and lead to excess volatility across financial markets. Third, complexity is increasingly an economic and financial reality across the world. Two powerful forces are driving this. One is the fourth industrial revolution, which is transforming how people relate with one another. Take for instance advances in digital finance and fintech. While some solutions have great promise to unleash higher productivity and efficiency, the velocity at which these innovations are evolving could also be disruptive for the banking system. Another key factor is the prevalence of political issues shaking up the policy environment. Income inequality, which has fuelled the rise of populist sentiment, has led to a retreat from multilateralism. This adds further uncertainty and complicates the conduct of policy.

Looking forward

All of these changes require policy-makers to look forward and anticipate emerging challenges. At the Bangko Sentral ng Pilipinas (BSP), this approach is enshrined in the ‘Continuity Plus Plus’ agenda. The BSP is building

on its legacy of excellence by safeguarding price and financial stability with greater vigour. It has responded to inflation pressures with proactive policy actions to help temper inflation risks. The bank continues to fine-tune its execution of monetary and financial policies. It has implemented an interest rate corridor system, which is expected to aid development of domestic capital markets by fostering active liquidity management by banks and encouraging greater reliance on the use of market-friendly instruments.

Rethinking frameworks

The bank has been rethinking its frameworks to consider emerging trends and tipping points. The BSP has increased its focus on inclusive growth and integrated financial inclusion into its organisational objectives. The bank is committed to advancing its financial inclusion, financial education, and

consumer protection agenda to guarantee no one is left behind in terms of meaningful access to financial services. The BSP has set its sights on leveraging the digitalisation of the financial system as a primary platform for its financial inclusion agenda. It is collaborating closely with the banking industry to establish a safe, reliable and affordable retail payment system through the implementation of the Philippines’ National Retail Payment System. These measures should help provide everyone the opportunity to reap the benefits of the country’s economic growth.

In responding to the emerging challenges of our time we cannot afford to simply either look back or look forward. We must see both sides if we are to carve a clear path into the future. ●

Nestor Espenilla is Governor of the Bangko Sentral ng Pilipinas.

‘Income inequality, which has fuelled the rise of populist sentiment, has led to a retreat from multilateralism. This adds further uncertainty and complicates the conduct of policy.’



Building next-generation custody services

Full upgrade required if sector is to stand the test of time



Hani Kablawi
BNY Mellon

The first 100 issues of The Bulletin have covered a fascinating period for the financial services industry. The past decade has seen sweeping regulatory reforms and higher compliance burdens. Tougher capital and leverage rules were introduced. The sector grappled with persistently low yields and margins. Technological innovation led to new sources of competition. This was all underpinned by an uncertain geopolitical and macroeconomic outlook.

During this time, there have been significant developments

in the structure of the asset management industry and the products it offers. There is more concentration, and index-based passive investment vehicles have come to the fore. With the prospect of industry disruption from financial technology companies and internet giants, asset managers are working hard to offer the speed and personalisation their clients have come to expect in so many areas of their digital lives.

Full upgrade needed

Custody providers like BNY Mellon have evolved in response to the demand from investors and investment managers for new services and capabilities. But subtle changes may no longer be enough. The asset management industry requires a full upgrade to the next generation of custody services to remain relevant for the next 10 years.

The next generation of custody services will be deployed in four ways. The first is the provision of self-service tools to allow investors to consume information, intelligence and insight when and how it suits them. Investors require bespoke tools that provide greater visibility across the entire post-trade value chain on a timely and responsive basis, along with the ability to integrate those tools within their own systems.

The second is the enrichment and aggregation of data. By combining data on their own

platforms with the data and applications of partners and third parties, custodians can provide clients with deeper insights to result in operational efficiency and strategic advantage. The next generation of custody services involves sending information through application programming interfaces and widgets for both core and non-core custody services. Moreover, as financial institutions seek to leverage new sources of data, custodians will become aggregated data service providers.

The third way in which custody services will develop relates to asset classes. Custodians play a critical role in ensuring that investors can access a broad range of assets securely and cost-effectively. Investors adjust their asset mix to achieve higher returns, manage risks or comply with regulations. In doing so they seek new, often less-standardised assets, including new asset types such as cryptocurrencies.

The fourth area of enhancement is global access. A fundamental role of custodians is to supply infrastructure and local expertise to ensure clients can access markets and operate on a worldwide scale. Investors must be prepared to shift their focus at short notice. Custodians bridge the gap between local and global, and provide transparency within an enterprise-wide structure to support informed decision-

making. A comprehensive approach to servicing clients around the world relies on the seamless supply of custody-enabled services, such as collateral management, transfer agency and fund accounting.

Addressing risks

It will take time to roll out the next generation of custody services. Building an infrastructure fit for the next 10 years involves a significant investment in technology. But this is not simply about improving client services. It is also about ensuring the risks inherent in the global custody chain are addressed. These risks are not static; as last year's paper from the International Securities Services Association points out, custody has become significantly more complicated, as financial markets themselves have developed in both size and complexity. This trend is likely to continue.

To ensure a robust global investment infrastructure, custodians must be able to develop a reliable, adaptable and sustainable platform to meet the changing demands of the financial services industry over the next decade. ●

Hani Kablawi is CEO Global Asset Servicing and Chairman of EMEA, BNY Mellon. The views expressed herein are those of the author only and may not reflect the views of BNY Mellon.

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Past, present and future of central banking

Autonomy critical to overcoming financial repression and digital disruption



Turalay Kenç
University of
Cambridge

If the almost 400 years of central banking history reveals anything, it is that the functions of these institutions are fluid and will continue to evolve in the future.

Even over the last 10 years, the state of central banking has changed significantly. The view of a Chinese central banker quoted by Mervyn King, the former governor of the Bank of England (2003-13), in his book *The End of Alchemy* points out the real reason behind this development.

The Chinese policy-maker said to King in 2011, 'We in China

So what differentiates money and banking from economics?

The answer is related to the magic of fiat money, the money-multiplying alchemy of banking and associated paradoxical developments.

Power of optimism

Whenever an optimistic view of the future starts to take hold of society, a credit boom facilitated by easy money and credit policies often unfolds.

The power of optimism chiefly determines the extent of the episode. The expanded credit volume is likely to lower financial market volatility in the economy, leading to the so-called volatility paradox that 'low measured volatility is most risky'. In such cases, the central bank of the country either

deflationary and inflationary outcomes. This involves averting financial crises and designing corrective policies for the negative consequences of crises. Hence, the lesson to draw from the 2008 financial crisis is that financial stability should be central bankers' guiding principle.

Digital revolution

The digital age, characterised by artificial intelligence, distributed ledgers and big data, poses considerable challenges to central banks. These technological advances have the potential to change demand for cash (and even central bank money), credit intermediation, financial regulation and market volatility.

The emergence of anonymous digital currencies such as bitcoin may lead to currency substitution problems similar to deposit and liability dollarisation in some developing countries, where people prefer the currencies of foreign countries with lower inflation and interest rates to domestic money and credit as a unit of account, store of value and denominator in liabilities. Similarly, the rise of machine learning in finance may heighten risk and uncertainty in financial markets.

It remains to be seen whether the digital revolution will have a positive or negative impact on financial regulation, supervision

and surveillance. However, it is safe to say that digitalisation will probably facilitate the emergence of a cashless society. Policy-makers will welcome this, as it will remove the zero-lower bound on negative interest rates and hence make monetary policy more effective in the aftermath of financial crises.

The alchemy of fractional reserve banking and systemic risk associated with debt financing will continue to challenge central bankers as they look to implement an optimal mix of interest rate policy and macroprudential regulation.

In addition, when a central bank oversees both price and financial stability, monetary policy may be abused to reduce the government sector's real debt burden following a fiscal stimulus package. Such financial repression was observed in both the US and UK following the second world war until the early 1980s.

The emergence of private digital money and the need to avoid financial repressions mean central bank independence is of paramount importance if countries around the world are to overcome economic disruption in the years to come. ●

Turalay Kenç is Pembroke Visiting Professor of Finance at the University of Cambridge and former Deputy Governor of the Central Bank of the Republic of Turkey.

'It is safe to say that digitalisation will probably facilitate the emergence of a cashless society. Policy-makers will welcome this, as it will remove the zero-lower bound on negative interest rates and hence make monetary policy more effective in the aftermath of financial crises.'

have learned a good deal from the West about how competition and a market economy support industrialisation and create higher living standards... We want to emulate that... But I don't think you've quite got the hang of money and banking yet.'

does not have the mandate to intervene and hence prevent a possible crisis, or simply engages in crisis and aggregate demand management.

The goal of central banking is to protect the purchasing power of fiat money by allaying both

Green market passing milestones

Sustainable finance no longer just a virtue, but an absolutely necessity



Frank Scheidig
DZ BANK

Ten years ago, sustainable finance was in its infancy and specialised equity investors were responsible for driving socially responsible investments. With new issuances of around \$800m in 2009, sustainable bonds were a niche market. Around that time, only a few sovereign and supranational institutions were acting as pioneers. These included the European Investment Bank, which issued its first climate awareness bond in 2007, or the World Bank, which issued its first green bond in 2008.

The world has changed in the intervening years. There is a growing perception in developed economies that the current economic model, which rose out of the assumption of plentiful supply and measures success only in terms of economic growth, is no longer adequate. Economic growth is an incomplete indicator of

wellbeing. It does not value other essentials like security or environmental and social quality. People must realise that sustainable development and economic success are inseparably linked.

Countries need a new and sustainable growth model with different pillars: economic, environmental, social and governance. That is why, as early as eight years ago, DZ BANK developed a unique EESG analysis and rating methodology to facilitate sustainable stock and bond picking.

Building a sustainable economy cannot be achieved without the participation of capital markets. Two examples illustrate this. First, the Organisation for Economic Co-operation and Development estimates global infrastructure requires \$6.3tn per year in investment to be in line with the objectives set in the 2015 Paris climate change agreement. Second, achieving the United Nations' sustainable development goals by 2030 will require between \$5tn-\$7tn in annual investment across various sectors and industries.

Those financing needs are too vast to go through a 'central pot'. Public investment alone is not nearly enough. The sustainable funding gap can only be met by significantly increasing private sector participation with the help of the capital markets. Investors are beginning to recognise this, and sustainable investing is on the rise.

'Green goes rainbow'

With an estimated volume of more than \$100tn, the global fixed income market bears huge potential for facilitating the transition to a sustainable future. Sustainable bonds stand out as one of the most promising investment vehicles to support the transition towards a sustainable economy.

In 2017 the green bond market topped the \$100bn mark. According to DZ BANK's sustainable investment research, it has the potential to exceed \$200bn by end-2019. In addition, our researchers have observed that 'green is going rainbow', as issuers and investors move beyond the purely environmental perspective. Green bonds, which focus primarily on environment and climate-related matters, are being joined by 'blue' bonds for maritime and other social issues. All such ESG bond issuance is on the rise.

Sustainable finance is a rapidly developing market. In

addition to sustainable bonds, sustainable loans also have great potential for facilitating the transition to a sustainable future. The relatively nascent green loan market already passed a significant milestone when the Green Loan Principles, a framework for green lending, were introduced by the Loan Market Association in March 2018.

Over the last 10 years, capital markets have followed the right path to support the sustainable transformation of the world economy. But much is still to be done. It is important to find a common language in sustainable finance, and policy-makers must make progress on international standards and definitions. The arrival of the European Commission's action plan on financing sustainable growth arrived in March 2018 was warmly welcomed in this regard.

But legislators must not lose the balance between individual decisions and regulatory requirements. When it comes to regulation there is only on worthwhile formula: 'As much as necessary, as little as possible.'

All these examples demonstrate that sustainable development propelled by capital markets is no longer just a virtue, but an absolute necessity. ●

Frank Scheidig is Deputy Chairman of the OMFIF Advisory Board and Global Head of Senior Executive Banking at DZ BANK.

'There is a growing perception in developed economies that the current economic model, which rose out of the assumption of plentiful supply and measures success only in terms of economic growth, is no longer adequate.'

Looking past traditional market indicators

Social issues gaining influence on financial markets



Peter Zöllner
Bank for
International
Settlements

When reflecting on changes in financial markets over the last decade, it is tempting simply to look back on the events and policies unchained since the 2008 financial crisis. These include the introduction of unconventional monetary policy, macroprudential instruments and negative interest rates, the European sovereign debt crisis and, more recently, the beginning of monetary policy normalisation. An innumerable array of events has shaken up investors monitoring markets around the world.

However, in the current economic and political landscape, it is necessary to look beyond market indicators and intraday monitors. Analysts must focus on the big picture and on the long-term, non-financial issues that not only affect financial markets, but which will impact people's day-to-day activities for years to come.

The social pressure that led to events such as the UK's decision to withdraw from the European Union, as well as election outcomes in the US and Europe, accumulated over many years. Policy-makers should ask themselves what they can do to provide better living standards for the majority

of the population, and prevent the wealth inequality gap from widening.

This social inequality has fueled opposition to globalisation, free trade and human mobility, and renewed focus on austerity. This defies the long-standing global economic and political system, and with it, underlying policy. But such sentiment is also challenging the officials who work to preserve and foster economic growth and

'Social inequality has fueled opposition to globalisation, free trade and human mobility, and renewed focus on austerity. This defies the long-standing global economic and political system, and with it, underlying policy.'



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human development. Sovereign investors are being encouraged to turn to sustainable investing: for example, by incorporating environmental, social and governance criteria when choosing their assets. These themes, after all, are closely connected to the management of international reserve portfolios and sovereign funds.

In addition, technology's influence on the lives of financial market participants continues to expand markedly. Buying and selling are more automatised and convenient than ever before. Electronic and high frequency trading, rules-based funds, robo-advisers and crypto assets are among the many examples challenging incumbent banking business models. Policy-makers are starting to ponder if the macroeconomic indicators currently in place, like inflation rates, reflect these structural changes.

Those working in regulation, supervision and risk management must embrace innovation to pre-empt risks associated with new technologies while simultaneously reaping the benefits. Sovereign investors must prevent cybersecurity breaches, face financial market flash crashes and avoid falling prey to procyclical trading algorithms. Their financial market analysis will not only be about estimating risk premiums adequately and calculating the hedging costs of interest

rates, exchange rates and credit exposures. It will also be about gauging the consequences of model risk. Any mistakes in implementing or understanding new financial models and technology could lead to poor decision-making, financial and reputational damage and shocks to financial stability.

The years to come

Throughout the last decade, central banks have been instrumental in shaping financial markets, owing to the extraordinary efforts they put in place to mitigate the effects of the financial crisis.

In the years to come – and as monetary policy normalises – other long-term, non-financial concerns will probably be the focus of the world around us and, as a consequence, affect financial analysis and policy-making. It is worth paying close attention to how sovereign investors adapt to their changing environment. Enhanced knowledge of geopolitical themes, social goals, demographics and technology will be key in the fight to preserve the long-withstanding paradigms of political and economic integration. ●

Peter Zöllner is Head of the Banking Department at the Bank for International Settlements. The views expressed here are his own and not necessarily those of the Bank for International Settlements.

Towards united front in impact investing

Adopting IFC Principles will help define impact investment standards



Karin Finkelston
International
Finance
Corporation

Impact investment was still considered a niche market in 2010, when green bonds were in their infancy and the notion of incorporating environmental, social and governance themes in asset allocations was far from mainstream. Today, the market is at a critical inflection point. A growing number of investors – including a new generation of younger investors – are looking to align their investment strategies to the United Nations Sustainable Development Goals, to achieve positive outcomes for society alongside financial returns.

It is important to seize this momentum to scale up the market rapidly from its current \$228bn size. Institutional investors hold trillions in assets under management globally. If a fraction of this pool of money can be tapped, the market for impact investment could grow exponentially.

To realise that potential, it is essential to develop clear and agreed standards for the market. Many investments are labeled as ‘impact’, yet there is no agreed upon standard as to what constitutes an impact investment.

International Finance Corporation is spearheading an initiative to develop such

standards (‘Operational Principles for Impact Management’), in close partnership with the finance industry. With regard to impact and return, IFC is one of the original impact investors, with 62 years of experience. Furthermore, it is the largest impact investor, with \$57bn in its portfolio under management.

Industry partnership

IFC and other development finance institutions have been investing for impact for many years, and now a much wider range of private investors are interested in this dimension.

IFC has contributed to the Equator and Green Bond Principles. Using this experience, it worked with market players to create standards for impact investment. The IFC worked in partnership with a core group of asset managers, asset owners, and development finance institutions to work on a set of draft principles. These reflect emerging best practices by drawing on the accumulated experience of IFC, its peer development institutions, as well as a wide range of public and private institutions that have been investing for impact.

The principles describe essential features of managing investment funds with the intent to achieve positive social, economic or environmental impact alongside financial returns. They are designed to

integrate impact considerations into investment decisions throughout the investment life cycle: strategy, origination and structuring, portfolio management, exit, and independent verification. These principles will help avoid potential ‘impact washing’ – a key concern, which investors raised during the development of the Principles.

It is important before investing to define what impact is intended, set up targets, monitor performance, take corrective action if things go wrong and report the results at the end. It is critical to get the principles right, and thus IFC consulted widely to obtain additional input on the draft.

The final principles and the first set of signatories will be announced at the World Bank Group’s spring meetings in April 2019, where it will publish a report surveying the impact investing market. This

report will map out the size and potential of the impact investing market, identify the different players and investment strategies, and explain the analytical underpinnings of these principles. It will show how IFC applies the principles with its anticipated impact measurement and monitoring impact management system.

Investors must get behind the principles and sign on to them if we want to attract more funds for impact. Now is the time to show a unified front and work collectively towards meeting the SDGs.

A common and agreed approach to managing investments for impact will benefit all in the industry. ●

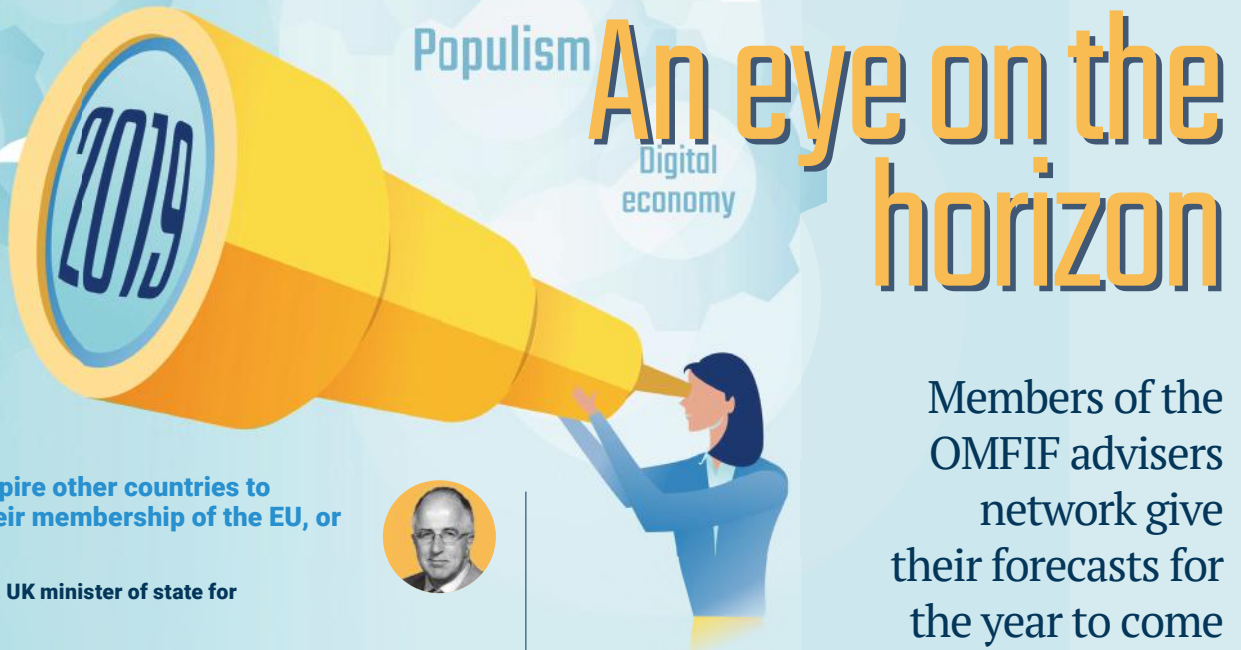
Karin Finkelston is International Finance Corporation Vice-President, Partnerships, Communication and Outreach.

‘A growing number of investors are looking to align their investment strategies to the United Nations Sustainable Development Goals, to achieve positive outcomes for society alongside financial returns.’

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2019 PREDICTIONS



Will Brexit inspire other countries to reconsider their membership of the EU, or deter them?

Denis MacShane, UK minister of state for Europe, 2002-05



The UK's withdrawal from the European Union has been a boost to the EU. Since the June 2016 UK membership referendum, most opinion polls in other EU states have shown an increase in support for membership of the bloc and the euro.

Before June 2016, anti-EU politicians like Marine Le Pen in France, the Alternative for Germany party, Matteo Salvini in Italy and the Swedish Democrats included in their speeches and party programmes Brexit-inspired references to quitting the euro and even the EU. But by December 2018, Brexit was seen as only a negative for the UK. There are no votes across the Channel for politicians who admire Brexit or argue it is a model to be copied.

Will the Indian government continue to put pressure on the Reserve Bank?

Meghnad Desai, emeritus professor of economics at the London School of Economics and Political Science



The government faces a difficult election in April and May this year, and the temptation to spend money to curry favour and 'buy votes' is extreme. The Reserve Bank of India is the only institution from which the government can secure enough money; doing so will do no good at all for the reputation of India as a responsible financial investment centre. But the politicians are likely to take a short-term view of such matters.

The government may instruct the RBI to breach its standards of risk assessments that have determined the size of its reserves. Following the resignation of Urjit Patel as governor in December 2018, citing 'personal reasons', pundits will have to wait and see whether his successor, Shaktikanta Das, will prostrate before the government or stand up against Delhi.

Members of the OMFIF advisers network give their forecasts for the year to come in economics, geopolitics and central banking.

What will be the impact of Fed tightening on the global economy?

Mark Sobel, OMFIF US Chairman



The outlook for Federal Reserve policy in 2019 is unsettled. The Fed has recently shifted its rhetoric, indicating the 2019 rate path will be data-dependent. Markets see limited prospects for 2019 rate increases, despite a strong labour market and solid outlook into the middle of next year.

In the past, when the Fed lowered interest rates to support the US economy, analysts viewed this as an attempt to depreciate the dollar and push capital to emerging markets, while quietly cheering the US effort, as this would improve export opportunities. When the Fed increases interest rates, some argue the US is absorbing capital from emerging markets, while cheering the higher growth causing the rate increases and the associated export opportunities.

The best thing the Fed can do for the global economy is focus on achieving its dual mandate of maximum employment and price stability, while ensuring financial stability is preserved and clearly communicating its monetary policy intentions. Other major economies with macroeconomic space should use it.

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Which country, if any, is most likely to adopt the euro next?

Miroslav Singer, Chief Economist, Generali CEE Holding



A country's decision to adopt the euro is based on political, rather than economic, merits. The government must identify clear benefits for its electorate and use these to 'sell' the idea of the single currency. Central and eastern European economies currently enjoy low inflation and a relatively stable exchange rate. They do not see any reason to adopt the euro, nor could they justify such a move to their constituents.

The country most likely to adopt the euro next is Bulgaria. In recent years, the country has weathered a series of banking crises, which served as a stark reminder of the disadvantage of fixed exchange rates. As a result, Bulgaria is willing to accept any new conditions to join the exchange rate mechanism and the euro area.

What would be the greatest risk to financial markets in 2019?

Colin Robertson, SW1 Consulting



The greatest risks to financial markets in 2019 will again be political, many with a populist theme. Old problems remain, such as North Korea and European politicians catering to popular revolt. Newer issues of government interference in central bank policy, US dismissal of global institutions, and the regulation of social media companies will gain in prominence. None of this will be readily resolved, certainly not by cutting interest rates, and a 'buy the dips' investment strategy (buying stocks after their price has dropped) is questionable. The good news is that markets are starting off 2019 on less demanding valuations after a poor year in 2018. A wide range of risks are being publicised daily in the media.

Who will succeed Mario Draghi as president of the European Central Bank and what will it mean for the euro area?

Caroline Butler, Walcot Partners



Interest rates are negative or flat and quantitative easing must be replaced by quantitative tightening. On the political front, French President Emmanuel Macron has hit a brick wall on his reforms, and Germany is in the midst of a change in leadership. Italy has never been keen on respecting EU-imposed budget deficit rules. And just in case no one has noticed, in 2019 Europe may be about to fracture over how to set future trade deals with the UK.

Mario Draghi must be replaced by a heavyweight central banker with a reputation for prudence. They should be someone who can persuade German politicians that the essential reforms of the euro area's institutions must be supported and will not be funded entirely by German taxpayers. Draghi's successor must have direct experience of economic policy. They should be in their early 60s at the start of their eight-year mandate. This rules out former National Bank of Belgium Governor Jan Smets (68 years old), former

Bank of Finland Governor Erkki Lukonen (69) and Oesterreichische Nationalbank Governor Ewald Nowotny (75). Christine Lagarde, managing director of the International Monetary Fund, is young enough but so far has ruled herself out, which suggests the ECB is unlikely to appoint its first female president. Moreover, Lagarde is French, and the bank's last three presidents have been Dutch, French and Italian. Spain's Luis de Guindos has just taken over as ECB vice-president. Therefore, the obvious direction is northwards to Germany. My candidate is Jens Weidmann, president of the Bundesbank. He has the steel needed to back reforms.

What can we expect in 2019 from Venezuela in the light of its hyperinflation crisis?

Steve Hanke, Johns Hopkins University



Hyperinflations are rare, strange beasts. There have only been 58 episodes of hyperinflation in history, and oddly enough, they are very easy to measure. This is done by converting changes in the local currency's exchange rate with the dollar on the black market into an implied inflation rate via purchasing power parity. I use PPP with high-frequency data to measure Venezuela's inflation rate. At this writing, Venezuela's annual inflation rate is 72,062%. However, while hyperinflation can be measured accurately, it is impossible to forecast. Surprisingly, this has not stopped the International Monetary Fund from dispensing with economic science. It has produced a steady stream of finger-in-the-wind forecasts. This culminated with the ridiculous 2018 year-end forecast of 2,500,000% annually.

After the year of #MeToo, what progress are we likely to see in the gender agenda in 2019? What key policies will be implemented to help women progress in financial institutions?

Vicky Pryce, Centre for Economics and Business Research



The pay gap and results of pay reviews enforced by the UK government have exposed not only discrepancies in pay and bonuses between men and women who perform 'equal work' but also crucially the lack of women in senior roles. The financial sector does badly in this area, not just in the UK but internationally. Women on

'Delivering stability in a world that is so financially interconnected will pose fresh challenges to central banks, with increased risks of politicisation.'

executive boards are a help, but a limited one. It is having enough female executives within firms that matters more, and this is what the Hampton-Alexander review, supported by the UK government, is now focusing on.

Some financial institutions are responding with their own internal targets. But policy-makers and heads of companies must speed up this process in 2019. That can only be done by introducing time-limited quotas for female senior representation in firms. That will force a change in incentives, pay and rewards to encourage investing in changing the macho working culture.

What will be the greatest source of macroeconomic instability in 2019?

Elliot Hentov, State Street Global Advisors



For the first time since the 2008 financial crisis, the balance sheets of global central banks will be shrinking. In other words, the net flow of liquidity provision will turn negative for the first time and a major tailwind of the past 10-year recovery is reversing. If the logic of quantitative easing was to use financial market dynamics (lower long-term rates, portfolio rotation, wealth effect) to boost real economic activity, then the opposite – quantitative tightening – should mirror this effect.

In 2018, the rapid reduction of liquidity raised volatility across financial markets. From the 2016 peak of roughly \$160bn per month, G10 central bank liquidity inflow dwindled to around \$23bn per month by late 2018. This is bound to become worse in 2019 as this figure crosses zero. The key question is whether turbulence in financial markets will remain contained or spill over into the real economy. Bearing in mind that this tightening is parallel to the rate cycle, even a pause in interest rate increases would not forestall this development.

What should central banks be most concerned about in 2019?

Hemraz Jankee, former Chief Economist, Central Bank of Mauritius



Central banks will be scanning a new and uncertain landscape in 2019. There are signs of a global economic slowdown, and some pundits are predicting a global recession.

The era of one policy objective (inflation targeting) and one tool (interest rates) appears to be over. Issues around crisis interventions have also incited questions about the operational independence of central banks. Addressing the 'new normal' is the immediate policy challenge facing central banks. They will need to balance the need to sustain growth and reduce the risks of instability that could result in the eventual unwinding of monetary stimulus. Delivering stability in a world that is so financially interconnected will pose fresh challenges to central banks, with increased risks of politicisation.

Downside risks such as the ripple effects of a trade war between the US and China, emerging market turbulence and the risk of a messy exit of the UK from the EU add further to uncertainty.

Issues relating to fintech and the advent of decentralised cryptocurrencies and their potential impact on monetary policy would also need to be addressed. Central banks must likewise be concerned with shoring up their defences against cyber attacks.

How will political developments change the economic outlook for Brazil?

Otaviano Canuto, former executive director, World Bank



In his inaugural speech Paulo Guedes, Brazil's economy minister, highlighted three main guidelines for the new government's economic policy. Two years ago, the senate approved a 20-year cap on public spending. To ensure this ceiling is feasible and sustainable, the government will introduce pension reforms and carry out a review of public spending. Second, Brazil will pursue a privatisation programme. This includes reinforcing the trend toward lower shares of public sector banks in credit provision. Third, a simplification of the tax system should improve the business environment and reduce its burden of resource waste on the private sector.

These three guidelines should help the Brazilian economy overcome the combination of fiscal obesity and anaemic productivity of the last decades. No wonder markets reacted so well when they were announced. If in the coming months the government and congress turn Guedes' speech into policy, private investments can be expected to surge. There lies the major hope for Brazil's growth recovery to speed up.

How will the confrontation between the European Commission and Italy over the latter's budget unfold?

Antonio Armellini, former Italian ambassador to Algeria, India and Nepal



Italy's running feud with the EU has been replaced by a provisional truce. Initial blustering has given way to careful negotiation by Prime Minister Giuseppe Conte under the silent aegis of President Sergio Mattarella. The European Commission has agreed not to initiate for now an excessive debt procedure following a cut in the projected budget deficit for 2019 to (a gimmicky) 2.04% from 2.4%. But the situation remains fraught and few believe that the budget numbers will ultimately hold up.

The populist League and Five Star Movement are in electioneering mode and will hold on to their flagship spending measures of universal citizens income, flat tax and pension reform in the run up to European elections that could reverse their present power relationship. An uneasy and occasionally confrontational stalemate with the EU will continue until then, after which the realities of a sagging economy will start kicking in. The government declares itself confident of living out the five years of the legislature, but early elections by the summer are on most people's minds. •

Ensuring a stable euro

John (Iannis) Mourmouras, senior deputy governor of the Bank of Greece, and **Danae Kyriakopoulou**, OMFIF's chief economist and head of research, discuss the future of the euro as it caps off a turbulent decade, and Greece's post-bail-out prospects.

Danae Kyriakopoulou: What will the euro's third decade be like and what role will Greece play? Are fears of a breakup of monetary union still justified and what needs to be done to strengthen the currency union's architecture?

John (Iannis) Mourmouras: The euro is the official currency of 19 countries and 340m citizens, and the second most important global reserve currency. Its introduction was a milestone in post-war Europe, comparable to the reunification of Germany and the breakup of the Soviet Union.

The first decade of a prolonged cycle of economic expansion and prosperity was followed by the 2010-12 sovereign debt crisis, resulting in high unemployment and poor growth performance. Despite continuing divergence between the North and the South with regard to real wages and productivity, overall the single currency has been a success. Nevertheless, it would be naïve to attribute the debt crisis solely to the failings of some European Union member states without recognising the shortcomings of monetary union's architecture.

To address the next global downturn and ensure a stable euro, economic and monetary union must be deepened. The agreement, at last December's euro summit,

on developing a budget instrument for the euro area and setting the terms of reference for the common backstop to the single resolution fund, was a welcome step. But progress is needed on the banking union's third pillar, the European deposit insurance scheme, and the capital markets union. Proposals such as a European safe bond and a European monetary fund will help mitigate the divergence between core and periphery countries and break the vicious cycle between banks and sovereigns.

DK: How do you see the European Central Bank's role evolving in the post-quantitative easing era and what would its role be in the next downturn?

JM: The ECB will continue reinvesting the principal payments from maturing securities purchased for an extended period of time, contributing to accommodative monetary policy and favourable liquidity conditions.

The main medium-term challenge for the ECB is the question of how long it will take to reduce the size of its balance sheet. There is no need to rush; it is important to take into account the uncertainty created among market participants and avoid any potential market disruptions. There are other – conventional

– tools to use if tightening is deemed necessary, including raising interest rates, increasing reserve requirements and using reverse repurchase operations to drain excess liquidity. No matter what the optimal size is, the central bank must communicate to markets what the new 'normal' balance sheet size will be.

DK: The Greek bail-out programme ended in August 2018. How confident are you in the economy's long-term prospects and what should be the reform priorities to ensure a successful return to market financing?

JM: There should be no complacency or slackening of effort on behalf of the national authorities, especially in 2019, an election year in Greece. The government must commit to the implementation of growth-enhancing reforms, particularly in the public sector (including administrative reform and speeding up of judicial procedures). This will enhance the country's credibility in the eyes of international capital markets and credit rating agencies.

Following a period of prolonged fiscal consolidation and private divestment, the country needs an investment shock. In 2014, I suggested reducing primary

surplus targets, along with slashing corporate tax rates drastically and gradually, in line with the fiercely competitive corporate tax rates applied by Greece's neighbours.

Some EU member states, such as Belgium, Denmark, Finland, Ireland, Sweden and Italy, have continuously recorded primary surpluses above 3.5% (on average) of their respective GDP. Their growth rate was more than 1.8%. However, economic activity is affected mainly by changes in fiscal policy. The composition of already-achieved primary surpluses determines growth impact, more so than their levels.

DK: What lessons do you draw on the relationship between central banks and national governments at times of crisis management, and did these put central bank independence to the test in the case of Greece?

JM: Central bank independence and its sister concept, accountability, were challenged during the 2008 financial crisis and the euro sovereign debt crisis. These challenges fall into two categories: first, the independence of central banks has been put into question by external parties. Second, even if independence is not formally challenged, it may be compromised as a result of altered conditions.

‘I strongly believe it is crucial to prevent populists from dictating the agenda in the forthcoming European elections. They lack the pragmatism of mainstream parties.’

External challenges to central bank independence stem mainly from political pressure. For instance, in the euro area, QE has been challenged both for being too expansive and too limited. On the other hand, the independence of central banks may be scrutinised due to concerns relating to whether a central bank with an extended mandate can operate transparently and have an appropriate degree of accountability in a democratic political and economic system.

All in all, an accountable, independent central bank needs broader support from the public. Clearly, with persistent negative rates, support for central banks is likely to drop. If a significant problem remains unsolved (for instance, a high stock of non-performing exposures), the public is bound to question the role of the supervisor. Fiscal and monetary authorities should have distinct roles in the economy and respect each other’s autonomy.

Given an increased role today for forward guidance in monetary policy and the management of expectations, the head of a central bank must be selected with the utmost care. It goes without saying the right candidate should have a spotless reputation and possess formidable technical expertise and communication skills. ●



Profile

Education: Holds a PhD from the University of London and is a graduate of the London School of Economics and Political Science.

Career: Mourmouras is senior deputy governor of the Bank of Greece and chair of its Financial Asset Management Committee. He was previously Greek deputy finance minister and chief economic adviser to the Greek prime minister, as well as head of the prime minister’s economic office. Mourmouras has held several academic positions at universities in Europe, Britain and the US, and currently is professor of macroeconomics at the University of Macedonia in Thessaloniki, Greece.

Below trend growth forecast for 2019

Troubling signs in euro area point to possibility of another recession

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

After the relative buoyancy of 2017, we have been raising concerns in 2018 that a slowdown in money growth in leading economies presaged a weakening in the global economy's pace of demand and output expansion. These have been justified by the now evident growth deceleration in major economies, notably the euro area and China.

Japan, as well as the UK, euro area and US, have an annual money supply growth rate of less than 4%. This is a meagre figure, consistent with (at most) trend growth in demand and output in early 2019. Prospective short-term developments in money growth are discouraging.

The US Federal Reserve's determination to run off the assets acquired in quantitative easing exercises from 2008-14 is likely to hinder significantly money growth in 2019. The European Central Bank has confirmed it will stop buying assets at the start of this

year. In the euro area, the tensions between Italy's populist government and European authorities are troubling. Moreover, Peter Praet, the ECB's chief economist, has warned that long-term refinancing operations (which for years have been financing for Europe's weakest banks) may not be renewed in 2020. Another euro area recession cannot be ruled out. In the UK, broad money growth (as measured by the M4x aggregate) has been weak in the last few months.

Money trends in the two largest developing countries seem more benign. China and India still enjoy positive money growth, with an annual rate almost in the double digits. However, in the last two decades, this number has often been well into the teens. The People's Bank of China is determined to maintain a steady rate of economic advance. It cut reserve requirements three times last year to encourage bank balance sheet expansion. However, money growth is at best moderate by Chinese standards.

Fortunately, with inflation very low almost everywhere, most central banks can reverse their current tightening posture if necessary. There is certainly no need to raise interest rates to contain inflation over the medium term. A recession is unnecessary and ought to be avoided. The most worrying potential exception is the euro area, where renewed money stagnation is possible. The ECB lacks the same freedom to relax policy as other central banks. Some of its actions favour certain member states over others and constraints arise from its multi-government membership. The end of the ECB's asset purchasing programme in 2019 may result in a fall in money growth towards zero, which could lead to another recession. ●

Juan Castañeda is Director and Tim Congdon is Chairman of the Institute of International Monetary Research. For a more detailed analysis of the latest money trends, see the IIMR monthly report at <https://www.mv-pt.org/monthly-monetary-update>.



The Economics of Monetary Unions. Past Experiences and the Eurozone.

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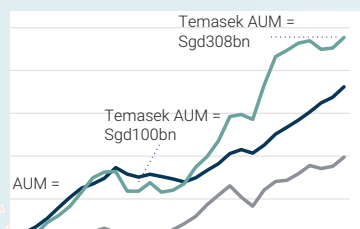
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Steering capital towards green finance

Fostering solidarity and accountability on climate risk in the banking sector



Joaquim Levy
World Bank

The corporate sector has become more conscious of how climate change can weigh on business operations and disrupt supply chains. Insurance premiums are moving in the wake of extreme weather events, and also because insurers have begun to internalise the potential impact of climate change. Investors are rewarding companies that integrate good environmental, social and governance practice into their activities.

Policies that foster greater disclosure will help markets to price climate-related risks better and identify sustainable investment's long-term benefits. Better data, together with new models that incorporate scenarios with feedback effects and non-linearities, can help policy-makers price and address the consequences of climate change. In this context, the contribution of financial regulators is unique, as they define the parameter of financial reporting and prudential requirements for safeguarding financial stability.

While there are empirical limits to the scope and reliability of forward-looking assessments of climate risk, regulators can use new models and data to understand better and address the linkages of climate change,

economic activity and financial risks.

The World Bank Group recognises the adverse impact that shocks to the environment present to ending extreme poverty and boosting shared prosperity. Estimates show that more than 90% of people facing extreme poverty are in countries that are politically fragile or vulnerable to climate risk. This underscores the importance of connecting growth-friendly policies with climate-smart investment to strengthen these countries' resilience.

Global co-operation

A consistent response from policy-makers will help the banking sector better manage climate-related risks on their balance sheets. It will also help the growing number of institutional investors and asset managers that are taking into account ESG considerations to shift their focus to long-term factors from short-term gains.

This co-operation between policy-makers and the finance sector can occur in several ways, starting with requiring asset owners to disclose their strategies on climate risk. Such disclosure can foster greater accountability and healthy competition in the industry. Reconciling fiduciary responsibility with long-term goals through clear metrics can provide a useful vocabulary for asset managers, institutional investors and service

providers, such as credit rating agencies and pension funds' investment consultants. This can be reinforced by longer-term mandates that shift the evaluation of investment performance towards sustainability and long-term goals.

The World Bank fosters co-operation across the investment value chain and between regulators to promote the integration of sustainability issues into financial decisions. The Bank has partnered with leading institutional investors to incorporate ESG principles into fixed-income strategies, and is building a global database on the ways companies disclose how their business activities comply with ESG principles.

In late 2018 the World Bank published guidelines on green bond proceeds management reporting. The Bank has also engaged in the development of a taxonomy for green finance and is collaborating with other members of the International Capital Markets Association in advancing the Green and Social Bond Principles and the role of sustainable development bonds. These bonds help fund policy reforms and actions that enable the expansion of green and social investment around the world.

The Bank is also working with regulators to explore how new evidence on the favourable risk profile of infrastructure could be better reflected in lower regulatory capital charges for

90%

Proportion of people in extreme poverty who live in countries that are vulnerable to climate risk

insurers and other financial institutions. Some studies using large samples of infrastructure debt suggest that if current regulations were calibrated to reflect the low default risk and higher recovery rates in infrastructure debt over the last 30 years, a significant amount of regulatory capital could be freed in both developed and emerging economies.

Availability of finance is a key component in facilitating systemic transitions and depends on the right price signals and economic incentives. This is not different in the case of funding mitigation and adaptation efforts to tackle climate change. Fostering the development of clear, rigorous frameworks to evaluate environmental risks can therefore bring extraordinary results. Market-funded mitigation and adaptation efforts can address real, existential threats and, as new technologies evolve and relative prices adjust, they can create many new jobs and increase productivity, if capital flows are adequately steered. ●

Joaquim Levy is former Managing Director and Chief Financial Officer of the World Bank Group.

Renminbi's global reserve share rising

China on the way to eventually contending with the dollar



Gary Smith
Barings

Asset class diversification continues to be a key theme for central bank foreign exchange reserves managers. A survey at a recent gathering of regional central bankers in Asia showed that more than half had amended their strategic asset allocation in the last two years, and more than two-thirds had expanded the permitted number of investible asset classes. Many had either invested in, or had considered, 'non-traditional' asset classes, including equities. Almost all expected the Chinese renminbi to become more important as a reserve currency over the next five years.

It is noteworthy that despite a weaker renminbi/dollar rate this year, the Chinese currency has increased its share in global reserves, according to International Monetary Fund data. An IMF report released at the end of September 2018 shows a jump in renminbi holdings of around \$50bn in the second quarter. Less than a decade after the launch of the renminbi internationalisation initiative, we estimate that more than 60 central banks have renminbi in their reserves. But allocations are still relatively small.

The IMF data suggest the global share of renminbi is around 2%, but we should

highlight the technical point that nations don't hold their own currency in foreign reserves. As the world's largest holder of foreign reserves, China effectively lowers the global reading for renminbi in global reserves. Feedback from central bankers in Asia supports the view that over the next five years a move to a 5% global share is probable. This would take the renminbi past the yen and sterling into third place in the reserve currency league table.

Contend with the dollar

There are three reasons why we at Barings believe allocations to the renminbi will continue to increase.

First, most nations have explained their decision to add renminbi to their reserves as a need to reflect growing trade flows with China.

However, these initial

allocations to the renminbi have reflected the existence, but not the magnitude, of trading relationships with China. A recent IMF paper suggests the international monetary system is becoming tripolar. Although still dominated by the dollar, the renminbi trading bloc has already surpassed that of the euro in terms of importance.

The renminbi bloc is centred on Asia, and Asian nations (even when excluding the Chinese total) are among the largest holders of foreign reserves in the world. These countries will be the key drivers if reserve currency weights are to change.

Second, in response to rhetoric about the US-China trade war and a rise in geopolitical tensions, Beijing may seek to deepen both trade and political relationships with Asian neighbours. In October 2018, Shinzo Abe made the first visit

to China by a Japanese prime minister since 2011, and used the occasion to announce that the People's Bank of China and Bank of Japan had signed a \$30bn currency swap agreement. This is five years after the previous agreement had expired during a period of frosty relations.

One consequence of current US trade and foreign policy action has been to help thaw relations between these East Asian neighbours. It may also help China extend its economic and political influence throughout Asia, encouraging the deepening of financial ties, including the building of renminbi-denominated foreign reserves.

Finally, the onshore Chinese bond market is the third largest in the world, according to Bloomberg data. As index providers continue to include Chinese markets, there will probably be rising pressure for global bond investors, including foreign reserves managers, to increase their allocations to the renminbi-denominated bond markets.

Given these factors, the renminbi is likely to continue climbing the reserve currency league table and will shortly become the third most widely held currency after the dollar and the euro. ●

Gary Smith is a Member of the OMFIF Advisory Council and Member of the Macroeconomic and Geopolitical Research team at Barings.

'Initial allocations to the renminbi have reflected the existence, but not the magnitude, of trading relationships with China. Although still dominated by the dollar, the renminbi trading bloc has already surpassed that of the euro in terms of importance.'



Fed's Powell equivocates on rate rises

Not wanting to play politics, policy-makers get played



Darrell Delamaide
OMFIF

There is little doubt President Donald Trump wanted the US Federal Reserve to forgo another rate increase in December. However, he knew the Fed could not be seen as bowing to his wishes. So he settled for the next best thing, with his barrage of tweets the day before the Federal Open Market Committee meeting. He trapped the committee's members into going through with the increase, and set them up as a scapegoat when, not if, the economy swoons.

Fed Chair Jerome Powell was at pains to deny politics played any role in the FOMC's unanimous decision. But the panel was certainly not free to stand pat, even if data suggested there was no compelling need to carry through with their fourth quarter-point increase of 2018.

This simple logic belied Powell's declaration of independence. 'Political considerations have played no role whatsoever in our discussion or decisions about monetary policy,' he said in response to a question at the press conference. 'Nothing will deter us from doing what we think is the right thing to do.' Except maybe if the president coincidentally tells you to do that. On 4 January, at a conference in Atlanta, responding to signs of fright on equity markets, Powell appeared to row back, saying markets had moved 'well ahead of the data' pricing in risks to the US economy, and emphasising the Fed would take a 'patient' approach to monetary policy tightening. 'US data seem to be on track to sustain good momentum into the new year.'

The Fed had set the trap itself. With its overconfident forward guidance and dot-plot graphs, it baked in the December rate increase and made itself a target of Trump criticism. At the press

conference, journalists peppered Powell with sceptical questions. Why, one inquired, if you are undershooting your inflation target and your own forecasts say you will continue to undershoot it next year, are you raising rates? Powell did not have an answer and virtually stammered his reply that a healthy economy justifies the rise. And yet Fed policy-makers scaled back their forecasts for growth this year and next amid signs the economy is losing momentum. 'The only way to achieve inflation symmetrically around 2% is to have inflation symmetrically around 2%,' Powell said, 'and we have been close to that. We are not there yet, and we have not declared victory. That remains to be accomplished.'

Economic turbulence

The other equivocation that stupefied investors was Powell's reference to economic modelling, even as the stock market was headed for disaster. 'There has been a sense of concern among business people and market people about global growth, and that may be partly about trade tensions, it may be partly about a variety of things,' Powell responded to a question about the Fed's assessment of risks. 'If you just mechanically drop into a model of the US economy tariffs, you do not see very large effects.'

Otherwise, it was a short month for speechifying by Fed policy-makers, who observe a quiet period the week before

an FOMC meeting and who went straight into the holiday period after the 19-20 December meeting.

Early that month, Atlanta Fed Chief Raphael Bostic suggested the Fed should proceed cautiously toward the 'neutral rate' regardless of economic turbulence. 'I am not seeing clear signs of overheating, nor am I seeing any indications of a material weakening in the macroeconomic data at the moment,' he said. A voting member in 2018, Bostic backed up his remarks by making the December rate increase unanimous.

St. Louis Fed Chief James Bullard continued to oppose the rate rises, urging policy-makers to delay the December increase as the yield curve inverted – that is, short-term rates topped long-term rates, which is often taken as heralding a recession.

'The current level of policy is about right,' he said two weeks before the FOMC went ahead with the rate rise anyway. Bullard did not get a vote in December, but rotates into a voting position this year.

Minneapolis Fed President Neel Kashkari also called for delay in further increase. 'Let's just step back and see what the economy presents us,' he said in early December. Kashkari was not a voter in 2018 and will not be again until next year. ●

Darrell Delamaide is US Editor at OMFIF.



Insurance: an answer to fiscal risk

Developing countries shielding finances from unexpected events



**Marcelo
Giugale**
World Bank

Finance ministers' fiscal plans can be blown off course by unexpected events over which they have no control. A government may incur massive relief expenses after a tsunami. A drought could ruin a country's main export crop. Higher oil prices may push up the value of gasoline subsidies. There could be a sudden rise in interest rates on a country's foreign debt, or an appreciation of the currency it borrows. The list goes on.

Public accounts are riddled with risks. They can derail austerity – or worsen profligacy – and diminish economic growth. This can have devastating consequences for a developing country, erasing years of progress in poverty reduction.

It is no surprise that policy-makers in emerging economies have started looking for ways to buy insurance against geological, climate, commodity and financial risks. Some have become quite proficient at it. Mexico has been using put options since the early 1990s to hedge its fiscal revenues from a sudden fall in the price of the oil it sells. Hurricane-prone Caribbean islands have been operating a catastrophe facility since 2007.

However, for an average developing country, the market

for this type of insurance is small, incomplete and imperfect. Politicians do not always trust that private insurers will charge a fair premium or pay up when crisis comes. Investors sometimes doubt the data that civil servants give them – or there may not be any data available. Sometimes neither side has the capacity to deal with the technicalities of modelling, monitoring and certifying an incident. It can be difficult to draft a billion-dollar contract based on the dozens of numerical parameters that make up an earthquake.

Multilateral institutions

Enter multilateral development banks. They can be a bridge between governments and investors, if that serves economic development. For decades, the bridge took the form of lending – those banks would borrow in the global market and on-lend to individual countries. Over time, public borrowers and private creditors grew comfortable dealing directly with each other. Now the latter supply the bulk of the former's financing needs.

A similar evolution is happening in the sovereign insurance market. In 2013, the World Bank helped Uruguay buy its first coverage against droughts. This broke the link between the weather and the country's financial health: when rains failed, hydropower production would come to a standstill. The state-owned

electricity company would then be forced to import diesel and absorb the loss. Passing it on to consumers was out of the question politically.

In 2017, the World Bank played the same intermediary role for municipalities in the Philippines, which bought an insurance policy against typhoons. Last year, the Bank arranged coverage against earthquakes for the Pacific Alliance nations of Chile, Colombia, Mexico and Peru. At \$1.4bn in total cover, it was the largest deal of its kind. The intermediation took many forms: advisory, capacity building, brokerage, insurance-and-reinsurance, trading of mirror 'catastrophe' bonds or of derivatives, and combinations of all these. Its value was always in connecting demand and supply.

Beyond budget stability

Hedging fiscal risks carries benefits beyond budget stability. First, it may reduce the cost of borrowing. Credit rating agencies will take into account that a country's fiscal horizon is less risky and may give its debt a better grade. That lowers the interest rates the country pays. Whether the saving on interest payments is enough to offset the cost of the insurance policy is an empirical question. I have found no evidence of such a 'free lunch'.

Second, this class of insurance is not indemnity – there is no compensation for the actual damage caused by an event.

Rather, it is parametric. If the event happens, countries get a fixed amount or a fixed price. This triggers a rapid pay out and eliminates problems of 'moral hazard'. There is neither time-consuming loss adjustment nor incentive to under-invest in prevention. If anything, the expense in the coverage signals to voters that their government is conscious of and serious about the risk in question.

Third, compared to total public expenditures, the cost of hedging fiscal risks is minimal. Annual premiums for a policy against earthquakes rarely exceed 5% of the value of the cover. Also, under most national legislations, insurance will not count as public debt, as there is no principal repayment involved.

Finance ministers in developing countries may not necessarily rush to insure their budgets, but it will form part of sound risk management strategies, together with emergency funds, reserves and contingent credit lines. There will be a learning process. Middle-income countries will lead, with poorer ones taking longer. Adoption will accelerate if natural disasters occur more frequently. The market will reward governments that buy insurance through better spreads on their debts. While it may take time, the direction is clear. ●

Marcelo Giugale is Director of financial advisory and banking at the World Bank.

Singapore model for Africa sovereign funds

Merit-based and outward-looking approach leads to efficient portfolio growth



Kelvin Tan
Core Advisory

Asian sovereign funds have played an important role as engines of development and economic growth over the past 50 years.

In 1965, Singapore's GDP per capita was just \$500, on par with that of Mexico and South Africa. In 2017, it was more than 100-fold higher, at \$56,000.

One of the factors contributing to the Singapore growth story is the savvy use of limited government resources. This was achieved through the creation of efficient investment vehicles geared towards the nation's industrial policy and economic development objectives. As Africa's own sovereign fund story unfolds, the examples set by Asian countries can serve as inspiration for reform.

Africa's sovereign funds have assets under management exceeding \$160bn. Apart from Botswana's Pula Fund, founded in 1994, all were formed in the 21st century. Pundits estimate that their numbers will reach 20 in the next three years, up from 12 today. The latest addition is Egypt's \$11bn sovereign fund.

Their mandate is clear: to safeguard today's wealth for future generations. But their relevance has been questioned. To create value, sovereign funds

must invest in transformative projects. Yet, of the 12 African funds, only seven have a clear mandate to do so: Nigeria, Rwanda, Ghana, Angola, Senegal, Gabon and Morocco.

Clear objectives

It is helpful to look back at Singapore's first steps into the world of sovereign funds. Following independence in 1965, the country faced an unemployment rate of around 10%, as well as a severe lack of capital and infrastructure. To stimulate industrialisation, the government took participative stakes with foreign investors. It also founded new companies in strategic sectors, such as trade, tourism, banking, defence and transportation.

As the scale and scope of state-led investments grew, the sovereign fund Temasek was founded in 1974 to manage the government's investments better. Its original Sgd354m (around \$250m) portfolio included 35 inherited government-linked companies, including Singapore Airlines and the Development Bank of Singapore.

Its initial goal was to free the ministry of finance from having to oversee government investments, allowing it to focus on its core policy-making activities. By the turn of the 1970s, Temasek took on a more commercial and entrepreneurial role as an engine of economic growth.

It started providing the companies in its portfolio with more capital, and gave them more management independence on a results-based reward system. Between 1974-83, the value of Temasek's investment portfolio increased to Sgd2.9bn, comprising 58 firms with more than 490 subsidiaries.

This focus on strategic investments and promotion of government-linked companies paid off. In 1999, 25 years after its inception, Temasek managed a portfolio worth Sgd100bn, almost 300 times its original value. In comparison, Botswana's Pula Fund, Africa's oldest sovereign fund, financed by revenues from diamond and mineral exports, does not have a clear investment objective. The fund has grown at a much slower pace than its Singaporean counterpart: its assets have reached \$5.7bn today from \$2.4bn in 1999 (the earliest available measure).

Investment in local projects and companies brought Temasek where it is today, with a domestic and global portfolio worth Sgd308bn. More importantly, it helped Singapore become more investable. For example, through Singapore Airlines, the country bolstered its national branding and tourism industry.

Stakes in the Port of Singapore Authority and national trading company Intraco allowed Singapore, as an export-orientated economy,

to strengthen its competitive advantage as a trade, maritime and shipping hub. Temasek's involvement with Singapore Telecommunications led to the company's successful initial public offering in 1993, when 1.69bn shares were sold for Sgd4.2bn. This catalysed the development of Singapore's capital markets. The IPO turned into an opportunity for Singaporeans to benefit from the country's economic growth when the government announced a 45% discount on shares for citizens.

Singapore is not the only Asian country where a sovereign fund made a corporate success story. In Malaysia, Khazanah's 10-year 'government-linked company transformation programme' led to the tripling of market capitalisation for the country's 20 largest companies, and 12.6% growth in shareholder returns.

Meritocracy and transparency

African governments traditionally have majority stakes in national assets in the mining, telecommunications, oil, gas and infrastructure sectors. This puts them in the best position to create future economic champions.

But Asia is proof that you do not need natural resources to create a successful sovereign fund. Those of China, Singapore, Hong Kong, South Korea and Malaysia are among the 20

‘Asia is proof that you do not need natural resources to create a successful sovereign fund. Those of China, Singapore, Hong Kong, South Korea and Malaysia are among the 20 largest sovereign funds in the world, and none are funded by commodities.’

largest sovereign funds in the world, and none is funded by commodities. In fact, according to the Peterson Institute for International Economics, around 20% of all countries with sovereign funds finance them from sources other than earnings from the export of natural resources or from foreign exchange reserves.

Whether or not commodities are part of the mix, pooling together state assets around a consolidated holding vehicle allows for more efficient capital raising and a stronger balance sheet base. Because of its ‘high degree of investment diversity and liquidity’ and its ‘above average consolidated financial profile’, Temasek was able to enjoy a triple-A rating for its maiden Sgd5bn 10-year bond issuance in September 2005.

This structure also brings several fiscal benefits. As a private company, Temasek pays taxes, and its sole shareholder is the ministry of finance, meaning that returns can be used as a fiscal cushion when Singapore faces budget deficits. The state investment holding company returned an average annual

dividend income of Sgd7bn over the last decade.

But what makes the biggest difference in how the funds work and are perceived is their relative independence from their governments. The increasing prominence of sovereign funds in Asia over the past 20 years led to concerns about their role and impact. Some feared that political agendas could drive their activities.

Singapore’s arm’s-length and meritocracy-based approach in

appointing external industry experts instead of government officials to grow portfolio companies into internationally competitive firms proved efficient. It also facilitated Temasek’s outward opening; today, only 27% of the fund’s portfolio is made of Singaporean investments.

Some African sovereign funds are already following this lead. The Nigeria Sovereign Investment Authority has won plaudits for prioritising its governance structure and transparency over financial performance. It is the top-ranked African country in the Linaburg-Maduell transparency index, and was hailed in the International Forum of Sovereign Wealth Funds’ most recent annual review. It was marked

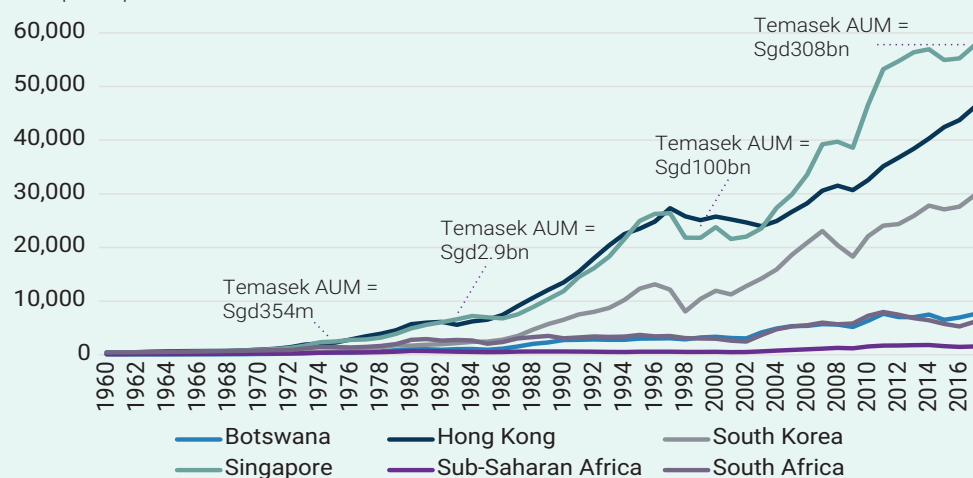
out as a leading example of an African fund with an ‘innovative sovereign wealth fund structure’ that ring-fences its operations and capital in accordance to different policy objectives, including savings, stabilisation and development.

Being new to the global sovereign fund scene has its challenges. It will take time for each African country to find what works and what doesn’t. But Africa can draw from Asia’s extensive experience in this field, so that it too can build sovereign funds to help create enduring growth on the continent. ●

Kelvin Tan is the Secretary-General of the Africa Southeast Asia Chamber of Commerce, and founder of Singapore-headquartered Core Advisory.

Singapore’s growth supported by the efficient use of government resources

GDP per capita, \$



Source: World bank data, OMFIF analysis

New architecture of payments systems

Distributed ledger technology warrants real-life application

**John Velissarios and
Ousmène Mandeng**
Accenture

Distributed ledger technology has made significant advances over recent years, affirming arguments that it is now beginning to challenge existing payments systems. DLT addresses inefficiencies and resiliency while allowing interoperability with existing and future payments systems. The case to implement this technology is among the strongest in cross-border payments, post-trade clearing and securities settlement.

Today, payments systems must address stricter regulation, liquidity and end-to-end risk management than ever before while preserving privacy, speed and scalability. Systems likewise have to accommodate an increasingly compressed securities life cycle, delivery v. payment and settlement in central bank money. They must also be able to adapt quickly to ensure new technologies can be integrated or allow interoperability to address a rapidly changing payments landscape.

Existing systems for large-value transactions are based on real-time gross settlement systems introduced in the 1990s. Many are in need of modernisation. But some critics doubt if DLT will be able to

future-proof payments systems. The question is whether DLT is superior to existing systems at reducing residual frictions, costs and risks and whether the technology can adapt to emerging requirements. Moreover, some pundits wonder whether DLT pilot projects have had enough success to warrant application to real-life situations. To all these, the answer is increasingly Yes.

Essential catalysts

DLT rests on the decentralisation of exchange, removes single points of failure and can streamline existing market structure by collapsing layers of interactions that impose undue risks, frictions and costs. Through these steps, the technology makes payments systems more efficient and resilient while making access more equitable and reducing operational and financial inefficiencies.

DLT relies on tokenisation of assets and currencies, by which all properties to allow an asset or currency to be transferred are recorded with the token. The combination of decentralisation and tokenisation offers the possibility to achieve true delivery v. payment in peer-to-peer transactions. These are the forebears of a faster, more efficient and more accessible payments infrastructure.

The tokenisation of currency plays a special role to allow

transactions to be conducted with finality. In the public sector, the adoption of central bank digital currencies is an essential catalyst to offer certainty in tokenised exchanges and a necessary condition to advance tokenisation of assets.

DLT addresses residual concerns about scalability and interoperability. In October 2018, the New York-headquartered Depository Trust and Clearing Corporation showed that DLT can support peak trading volumes in US equity markets. The third of phase of Project Jasper – an initiative run by Accenture, the Bank of Canada, Payments Canada, DLT company R3 and TMX, the parent company Toronto Stock Exchange – proved that DLT platforms can achieve settlement finality while addressing necessary scalability and privacy criteria.

Accenture was able to synchronise business processes across blockchain platforms from different technology providers, offering corporations the possibility to operate in a broader system not bound by a specific DLT platform.

Altered architecture

The superior data-sharing properties of DLT mean regulators can impose strict access and editing controls to safeguard privacy standards. Compared with current technologies, DLT enables more

efficient information sharing while preserving data integrity. It is designed to transfer and record ownership of tokens instantaneously, immutably and securely.

The existing institutional and legal arrangements are in large part endogenous to the technology of the market structure. Any significant change in technology may therefore require new institutional and legal arrangements. The adaptability and flexibility of DLT implies that such changes can be gradual.

DLT is set to alter the architecture of payments systems. Recent technological advances demonstrate that it is ready to be deployed in real-life scenarios. Concerns about the lack of maturity or scalability of the technology have been progressively assuaged and should no longer restrict DLT adoption.

The technology is part of a longer-term vision to promote increasing tokenisation of assets and currencies and offers the best technology to achieve that goal. More importantly, DLT can support broader objectives of improved financial integrity, equity, integration, resilience and transparency in payments. ●

John Velissarios is Accenture's Global Blockchain Technology & Security Lead, and Ousmène Mandeng is Senior Adviser to Accenture's Global Blockchain Technology.

Central bank gold buying soars

Trade wars, sanctions fears drive countries' purchases



Shaokai Fan
World Gold
Council

Central bank gold buying intensified in 2018, with more countries buying more gold, and for a greater variety of reasons. Net purchases totalled 351.5 tonnes in the first three quarters of 2018, up 17% from 2017 and the strongest showing since 2015. Momentum is growing, with net purchases of 148.4 tonnes in the third quarter alone, up 22% from the previous year.

As buying patterns change, so are the numbers of central banks entering the market. Historically, countries such as Russia, Kazakhstan and Turkey were among the most consistent buyers, making regular monthly purchases. In 2018, previously inactive central banks, including those of Poland, Hungary and India, have also been buying gold.

Traditionally, central bank reserve managers prioritise safety and liquidity when investing. This is why gold, the ultimate safe haven asset, has long been a mainstay for central bank reserve investment. However, as noted in a recent OMFIF report, the 'list of reasons to hold [foreign exchange] reserves has lengthened continually'. The same can be said for holding gold. Today, safety and liquidity remain the priority for reserve managers.

But the factors threatening to undermine these principles are intensifying, from specific issues such as macroeconomic conditions, financial sanctions, escalating trade wars and political uncertainty, to a potential structural shift in the international financial system.

Safety in diversity

For Russia, the largest and most consistent buyer of gold, the key issue is undoubtedly safety – specifically its desire for assets that are free from political risk. Russia's enormous accumulation of gold is in direct response to pressure from financial sanctions imposed by the West. Gold has become a strategically important asset because, as Dmitry Tulin, first deputy governor of the Central Bank of Russia, said in May 2018, it is a '100% guarantee from legal and political risks'. The substantial increase in Russian gold holdings has been accompanied by an equally substantial decrease in the country's holdings of US Treasuries, reflecting the Russian central bank's long-standing policy of de-dollarisation.

Market participants suggest that other central banks, such as Narodowy Bank Polski, have returned to gold after long periods of absence for diversification purposes, fuelled by worries over global political and economic uncertainty.

According to a reserve manager survey conducted by UBS in

2018, central bankers' greatest concerns about the global economy centre on trade wars and political developments in Europe and the US.

In early 2018 the Cboe volatility index jumped to its highest level since mid-2015, highlighting investor disquiet. Such concern may be specifically focused on the deteriorating long-term fiscal outlook in the US, Japan and Italy, coupled with the uncertainty around Britain's exit from the European Union. These factors could all make advanced economy sovereign debt less attractive.

At the same time, central banks may be evaluating the need for greater downside protection, as they explore riskier asset classes. According to the UBS survey and a global sovereign asset management study from Invesco, for example, reserve managers are moving into untapped markets, such as equities, corporate debt and real estate. Adding gold can act as a counterbalance against these investments, as it is almost completely uncorrelated to alternative assets.

Structural shifts

Against this backdrop, some central banks, such as Magyar Nemzeti Bank, are looking to gold for long-term 'stability objectives', noting that gold has 'a confidence-building feature'.

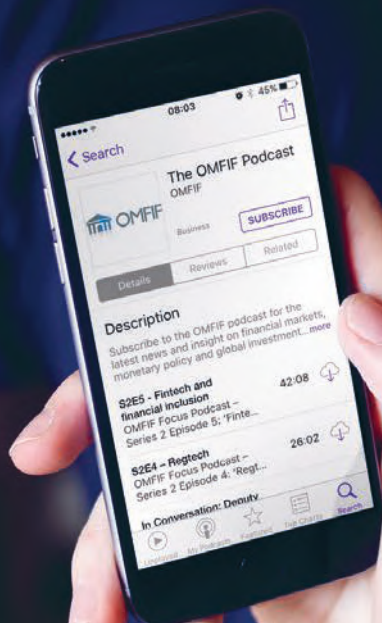
Hungary's recent gold purchase is notable, not just because the

central bank increased gold reserves tenfold after years of inactivity. It also said gold acts 'as a major line of defence under extreme market conditions or in times of structural changes in the international financial system or deep geopolitical crises'. While extreme market conditions and deep geopolitical crises are nothing new to financial markets, nascent structural changes are more unusual. Yet they are beginning to preoccupy investors, especially given the emergence of the Chinese renminbi on the international stage.

A report by the Reserve Bank of Australia noted that 'if China continues to gradually open the capital account and move towards a more flexible exchange rate, the next phase of internationalisation could see the renminbi emerge as a widely used regional currency in Asia.' As renminbi allocations grow over time, there is the potential for a longterm, structural shift towards a multicurrency system, rather than the current system revolving around the dollar.

Such a shift would undoubtedly be destabilising. According to World Gold Council research, it may lead some central banks to purchase gold as a hedge in anticipation of resultant market volatility. Perhaps Hungary's statement is evidence that such changes are closer than expected. ●

Shaokai Fan is a Director at the World Gold Council.



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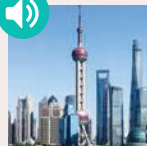
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Impact investment sector at critical stage

IFC Principles to help define impact investment standards



Andy Budden
Capital Group

Much of the pensions industry globally is set up to service the pre-retirement 'accumulation' phase. However, the need for advice and support continues well into the 'retirement income' phase.

Increased life expectancy and a rising older population mean financial planners must consider a longer time horizon compared with historical standards. Retirement provisions are changing due to shifting demographics and labour markets, which present obstacles to sustainability. These changes put greater impetus on the individual to fund more of their future retirement income and bear more risk in how those assets are managed.

Sustainable solutions

Today's generation of retirees view retirement differently than previous ones. Retirement is now viewed as another opportunity to pursue different life goals. Furthermore, retirement is no longer a single, discrete event. Instead, it is shifting more towards a continuum with moving parts. These differences mean individuals require greater flexibility to meet their needs.

Advice models must capture investor goals in a simple and flexible manner. In the

accumulation stage, most individuals' goal is to maximise returns. As they approach retirement, the focus tends to be on securing their retirement pot. Finally, when they are in retirement, the emphasis will be on receiving consistent, reliable sources of income with reduced market risk compared with the accumulation phase.

Given these major differences in goals and risks across the life stages, a different approach is required when it comes to advice for retirement income. Personalisation is key, particularly as advisers would be trusted with managing a much larger proportion of an individual's wealth over a longer timeframe.

Sustainable retirement solutions require more than income alone to be robust. Some of the biggest dangers in retirement are referred to as the unknown risks, such as the duration of one's retirement and major life events.

Managing downturns

While these risks appear unquantifiable, measures can be taken to manage them. Financial planners can apply several key principles to retirement income investing.

Growth is needed to reduce the likelihood of outliving your assets. Fixed income alone won't generate the income and growth that most investors need for the length of their retirement.

'Retirement provisions are changing due to shifting demographics and labour markets. This puts greater impetus on the individual to fund more of their future retirement income and bear more risk in how those assets are managed.'



Meaningful exposure to equities to achieve higher potential returns is key. As equities are more volatile than bonds, actively managing this exposure is crucial.

Investment mistakes are harder to rectify in retirement compared with when saving. The problem with market downturns when taking withdrawals from a portfolio in retirement is that it takes much more of an upswing to recover. If a strong upturn doesn't restore the portfolio, subsequent fixed-amount withdrawals will represent a greater percentage of the remaining portfolio. Often this is not sustainable, and the portfolio begins a downward and potentially irreversible trend.

The pattern of returns, known as sequencing risk, matters in retirement. It can dramatically alter the impact of market

downturns. As market returns are hard to predict and retirees need regular income, it is critical that proper portfolio structuring mitigates sequencing risk as far as possible.

A recommended approach to investing in retirement is one that reflects the different demands that retirement income presents – something that many investment solutions have not fully recognised.

It is crucial to understand investor needs from the outset and ensure advice is tailored to meet the different needs of the accumulation and retirement income phases. Actively managed, diversified and resilient portfolios are more likely to generate superior outcomes for investors over the long term. ●

Andy Budden is a Singapore-based Investment Director at Capital Group.

The numbers

CENTRAL BANKS IN THE SPOTLIGHT



US President Donald Trump attacked the **Federal Reserve** in December 2018, accusing it of having 'gone crazy' by raising interest rates by 2.25 points. He also expressed regret on his choice of Jay Powell as its chairman.

2.25

Urjit Patel resigned as governor of the **Reserve Bank of India** in December 2019, citing 'personal reasons'. The months prior included a battle with the government over central bank independence and who was to blame for a \$2bn bank fraud case at state-owned Punjab National Bank.

\$2BN

In December 2018 Mervyn King, former **Bank of England** governor, accused his successor, Mark Carney, of being 'unnecessarily' drawn into the politics of the UK's Brexit deal, and quoted a report that suggested the cost of leaving the European Union without a deal exceeds 10% of GDP.

10%

The chart

Each month we take a look at a chart from the world's central banks. This month, **The People's Bank of China**.



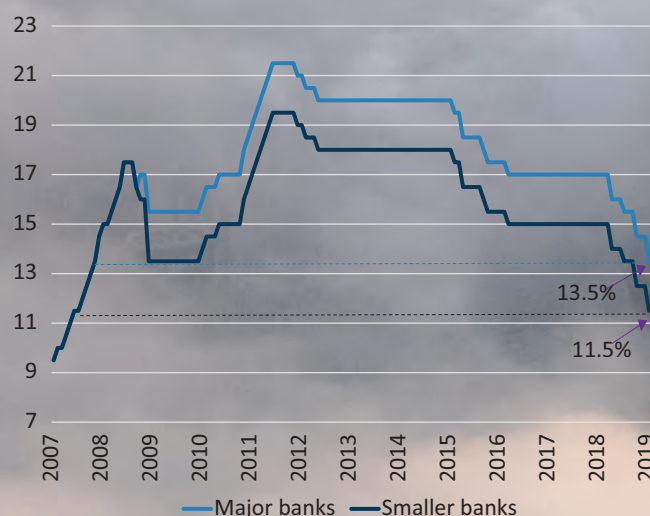
In response to a slowing economy in the light of falling consumer demand and poor manufacturing sector performance, the People's Bank of China plans to increase liquidity in the financial system through a second reduction in banks' reserve requirements.

By the end of January, the central bank is set to cut the reserve requirements by another half percentage point for both large and small lenders. The ratio for larger and smaller banks will fall to 13.5% and 11.5%, respectively, the lowest levels since 2007.

The central bank stated the cut will 'support the real economy and reduce financing costs'. It estimates that reducing the amount of cash banks are required to hold will release \$116.5bn of liquidity into the financial system, offsetting high demand ahead of the Chinese New Year.

As investor sentiment continues to deteriorate in the region, further easing by the PBoC is likely to occur through 2019.

China reduces required reserves of major banks to 11-year low
Reserve requirement ratio of banks in China, %



Source: People's Bank of China, OMFIF analysis

Euro enters decisive decade

Danae Kyriakopoulou

ON 1 January, the euro celebrated its 20th birthday. European Central Bank President

Mario Draghi once said the single currency is ‘like a bumblebee, a mystery of nature because it shouldn’t fly, but it does.’ Ashoka Mody, a former International Monetary Fund official and visiting professor at Princeton University, takes a different view in *Euro Tragedy: A Drama in Nine Acts*. For him, the answer is simple – the euro survives because it is a political project, supported artificially and unsustainably despite defying the principles of economics. The euro is not a mystery, but a tragedy creeping towards its final act.

‘Why did Europeans attempt such a venture that carried no obvious benefits but came with huge risks?’, Mody wonders. The first act of his thoroughly researched and detailed historical narrative unfolds in the early years of the European Coal and Steel Community and the Treaty of Rome. It looks at the origins of monetary union as a feeble-minded French vision to enable France to gain economic parity with West Germany, if only superficially. The much-hailed benefits of lowering transaction

costs and limiting uncertainty arising from exchange rate fluctuations were only secondary and emerged much later. From the start, the motivation for a European single currency was political.

Later came the argument that monetary union was necessary to safeguard peace in the previously war-torn continent, further strengthening the political incentives for an economically flawed project. Mody is particularly critical of German Chancellor Helmut Kohl, referring to the single currency as ‘Kohl’s euro’. In a particularly virulent passage, he accuses Kohl of having ‘legitimised the use of rhetoric and groupthink as a substitute for real economic and political analysis.’ This laid the foundations of an ill-designed currency union and paved the way for the flawed crisis-management and irresponsible idealism of later decades.

The book features several examples of continued hubris throughout the euro’s short life. He cites the ECB’s tightening policy amid the 2008 financial crisis. Mody mentions policy-makers ignoring the build-up of imbalances and credit bubbles in the euro area’s periphery. He also writes about the mismanagement by European institutions and the IMF of the Greek debt crisis. To improve the euro’s design, he proposes Greek debt forgiveness, making any new sovereign debt to private creditors subject to restructuring, and dismantling fiscal stability rules.

Mody’s criticisms of the

euro’s economic credentials are conventional and at times overstated. He dismisses the value of the euro as a ‘vincolo esterno’, an external constraint compelling leaders to pursue sound policies. He highlights the problems with a one-size-fits-all monetary policy for countries facing disparate economic realities, as well as the difficulties of a fixed exchange rate system in the face of divergent shocks.

Both these concerns are valid and important, but are becoming less so in an increasingly intertwined and globalised economy. This is demonstrated by the continued occurrence of crises even in countries with floating rates and the ability to conduct independent monetary

\$1.15 at the end of 2018, similar to when it launched in 1999. A recent Eurobarometer survey by the European Commission indicated the common currency remains popular. And while these achievements mask important regional divergences, they are not that different to those between the poorest and richer states in the US’ much longer-established currency union.

Still, even in this critical volume on the euro, Mody acknowledges many of the euro area’s weaknesses have little to do with the common currency and more to do with fiscal policies, productivity and underinvestment. He proposes shifting pro-European thinking away from ever closer integration.

‘For Mody, the euro survives because it is a political project, supported artificially and unsustainably despite defying the principles of economics.’

policy. Perhaps more importantly, the premise on which the book is based is not uncontroversial. While many countries have suffered economically, the euro’s record is not as bleak as Mody claims. As it enters its third decade, monetary union has grown in membership to include 19 countries from the original 11. The bloc’s economic clout has increased correspondingly, making the euro area the second-biggest economy in the world after the US. The euro’s value against the dollar stood at around

His alternative vision for more fragmentation through a new ‘Republic of Letters’ for Europe focused on education and innovation to drive prosperity is appealing, but not developed fully in the otherwise comprehensive tome. For the euro area to find continued success, policy-makers must address structural issues in the region’s economy, rather than blame the single currency for all of their problems. ●

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFIF.

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Trade war still likely to deepen, despite truce

Deeply rooted issues between China and US hard to repair

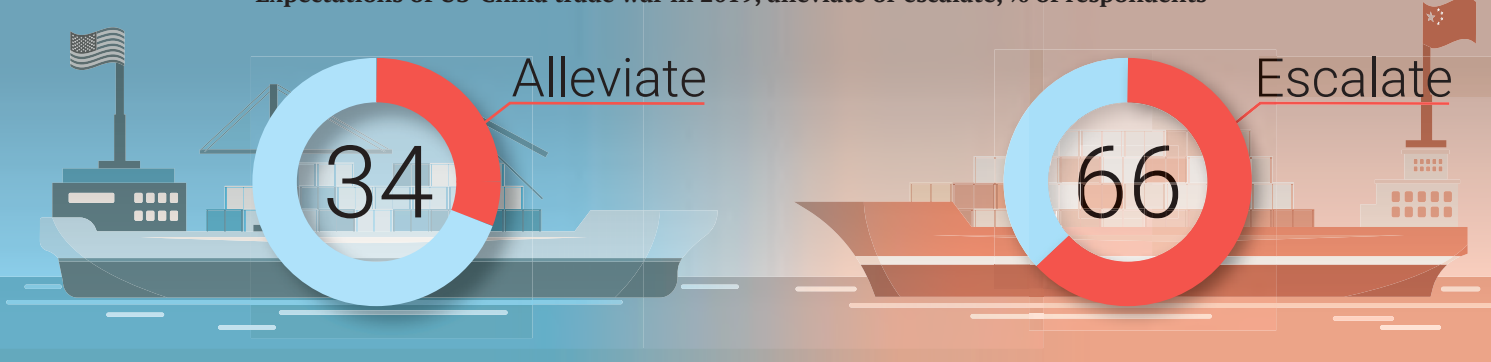
This month's poll focuses on the prospect of further trade antagonism between the US and China. Participants were asked: **'Will China and US trade tensions alleviate or escalate in 2019?'**

The majority saw the current trade stand-off as likely to continue well into the new year, with 66% agreeing escalation is inevitable. In particular, they agreed that neither the US nor China is prepared to back down on key issues like intellectual property and security. The G20 summit in Buenos Aires took

place during the running of the poll, in which Washington agreed not to impose higher tariffs on Chinese exports in exchange for a series of wide economic concessions from Beijing. Most answers came before the summit, but those who responded after saw this truce as flimsy, particularly with China indicating that it is in no rush to implement the changes.

However, 34% of respondents disagreed with this conclusion, suggesting that the political and economic pressure of waging a trade war, on both sides, would force any truce to endure.

Expectations of US-China trade war in 2019, alleviate or escalate, % of respondents



Trade tensions will ease in 2019, mainly due to the fact that an escalation does not serve any political interests at this time. In the US, Republicans' loss of the House of Representatives in the midterm elections and late-cycle rate tightening by the Federal Reserve combine to incentivise the White House to please equity markets – which suggests trade de-escalation. Similarly in China, the recent growth slowdown to address structural imbalances actually offers the opportunity for reform in areas that are equally conducive to improving trade ties.

Elliot Hentov, State Street Global Advisors

Trade tensions between China and the US will continue escalating into 2019.

Antonio Armellini, former Italian ambassador to Algeria, India and Nepal

Cyclical pressures should reduce as US growth slows while the Chinese economy stabilises. However, deeper issues such as intellectual property and security will prove more stubborn to resolve, even if Trump's tactics are less sensational.

Colin Robertson, SW1 Consulting



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