The Bulletin

OMFIF

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# ADVENTURES IN BREXITLAND

UK's search for way out of European maze


OMFIF, the South African Reserve Bank and the World Bank Treasury's Reserves Advisory and Management Program (RAMP), convene public sector asset managers, as well as select private market participants, over two days.

The Forum focuses on governance, macroeconomic and financial developments, as well as the challenges and opportunities for public sector investment managers. The aim is to discuss best practices and offer an avenue for an interactive dialogue.

**Venue:** South Africa Reserve Bank, Pretoria **Date:** 14-15 June 2018

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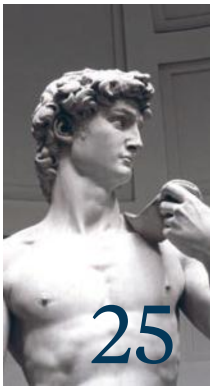
## Money Matters




*Cover illustration: Ellie Foreman-Peck*

## Worldview





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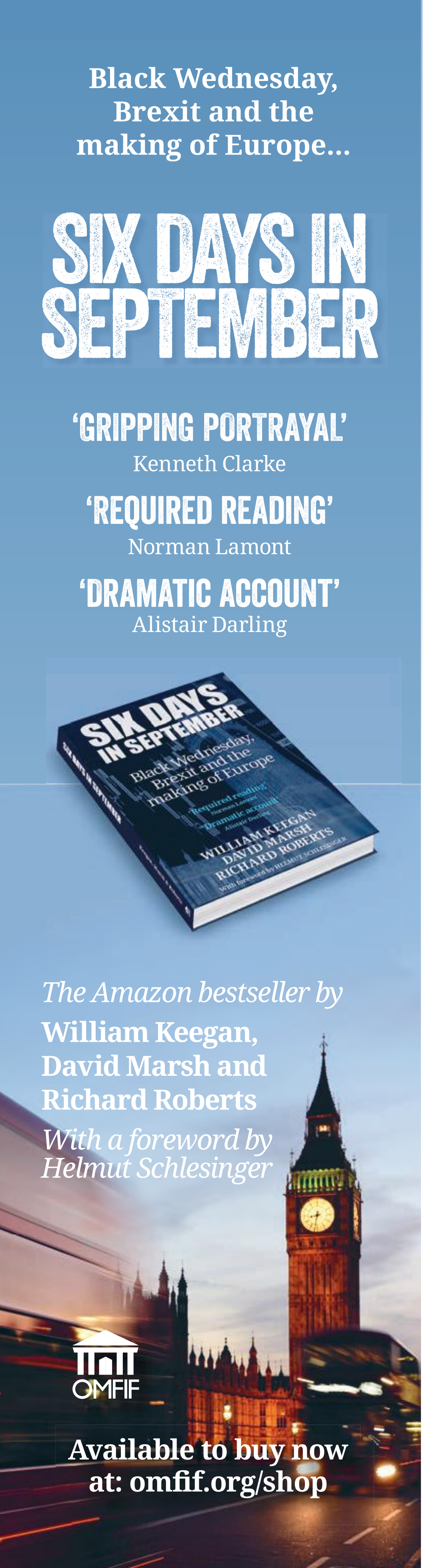




# Dialogue on world finance and economic policy

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 $33.8tn, 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 exchanges between public and private sectors and a better understanding of the world economy, in an atmosphere of mutual trust.

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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 178-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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# Adventures in Brexitland

The agreement between Britain and the European Union for a 21-month Brexit transition period was welcome news to many concerned about the time required to prepare the parameters for the future relationship among the two partners. But while it provides temporary relief, the agreement does not eliminate the longer-term uncertainty around what the UK is transitioning to.

Many questions remain open. These include the Northern Ireland/Republic of Ireland border, the rights of European and UK nationals in each other's territories, and the competitiveness of the City of London. And they extend to the rights to fish in British waters and the colour of UK passports (which as we note on p.26 will cost £490m and will be made in France).

This broad canvas provides room for diverse visions on what Britain's future relationship with the EU should and could be. In this month's Bulletin, we feature competing views from, among others, Liam Fox, the UK's international trade minister, who champions new trade opportunities, and Andrew Adonis, Labour peer in the House of Lords, who is campaigning to reverse Brexit and has introduced proposals for a second referendum.

This reflects OMFIF's position as an independent platform for dialogue and research. In the run-up to the referendum itself, we ran 100 commentaries in 100 days: a third arguing for Brexit, a third for Remain, and a third a neutral. Over the past year or so we have organised roundtables with figures on all sides of the debate, including politicians such as John McDonnell, Ken Clarke, Chuka Umunna, Nigel Lawson, Norman Lamont and Vince Cable, as well as regulators like Andrew Bailey and Jon Cunliffe.

An uncertain global policy environment further complicates Brexit. The transition agreement requires critical decisions to be made during a period when the EU will be facing changes at the top. European Parliament elections take place in May 2019, while Commission President Jean-Claude Juncker's term runs out in the autumn of that year.

On the economic front, this will coincide with the normalisation of monetary policy in developed markets, which could cause asset prices to reverse after an unusually long bull cycle. Additional challenges from increased protectionism in global trade, cyber scandals and threats to central bank independence make the outlook for Britain's adventures in Brexitland (with apologies to Lewis Carroll) 'curiouser and curiouser'.

**Danae Kyriakopoulou**
*Chief Economist and Head of Research*

»7 March, London and Singapore

# G20 'fair poorly' on gender balance




'GENDER equality is smart business and smart economics,' said Yvonne Tsikata, vice-president of the World Bank, at the London launch of OMFIF's 2018 Gender Balance Index, which tracks the presence of men and women in senior positions of public investment institutions around the world. The report was also launched in Singapore and speakers included Jan Bellens, global emerging markets leader at EY, and Flora Chao, head of funding at the International Finance Corporation.

This year's results reveal that there is still significant gender imbalance, particularly in G20 countries, with only two of their central banks in the top 20 ranking. In response, Anna Trzecińska, vice-president of Narodowy Bank Polski, summarised that 'countries that want to remain competitive will need to make gender equality a part of their human capital investment'. To achieve this, Marc-Olivier Strauss-Kahn, director general, Banque de France, suggested 'both high-level sponsorship and bottom-up approach'.


*Visit **omfif.org/analysis** to download the full report*

»12 March, London

## The state of the Conservative party

OMFIF held a discussion with Dominic Grieve, Conservative member of parliament for Beaconsfield and a rebel against the 'Brexit whip'. Attendees discussed his party and its position on the UK's exit from the European Union, the role of parliament in the withdrawal process, and the future of the UK-EU trading relationship.

»13 March, Frankfurt

## Realigning interests in Europe

OMFIF convened the eight Economists Meeting, which focused on macroeconomic and political developments in Germany and Europe and the implications of monetary policy for the banking sector, and Basel III and Mifid II. Speakers included Otmar Issing, president, Center for Financial Studies.

»15 March, London

# From Brexit to financial innovations

'THE European Union should stand strong, remain attractive and open to the rest of the world – the City of London could help us to achieve that aim,' said Robert Ophèle, chair of the Autorité des marchés financiers, France's stock market regulator, at an OMFIF City Lecture on challenges for financial regulation. Along with discussing Britain's future outside the EU, Ophèle covered how to improve the way financial regulation is designed and institutionally set up, and how to organise balanced relationships with 'third' countries. He explained that overall, 'there is an urgent need to rethink the EU regulatory framework, improve it and ensure it is appropriate for the EU27 before accepting to largely open our financial markets.'

»20 March, Prague

# The future of money

OMFIF and the Czech National Bank organised a seminar on private cryptocurrencies, central bank digital currencies, distributed ledger technology and the wider digital economy. Representatives from the public and private sectors agreed that the current wave of distributed ledger or blockchain technology is only the first generation and that further developments are unstoppable. With this comes new challenges for central bank policy-makers and regulators, including the proliferation of private cryptocurrencies as well as the need to create a common taxonomy and regulatory standards for these new digital assets.

## FORTHCOMING MEETINGS

»Monday 2 April, Singapore

### Balancing opportunities and risk for finance

OMFIF organises the fourth **OMFIF Asean debate**, co-organised with the Monetary Authority of Singapore and held to coincide with the Asean+3 meetings in Singapore. The debate focuses on technology, cryptocurrencies and disaster mitigation.

»Monday 16 April, Paris

### Future of the euro

OMFIF organises a symposium on the institutional reinforcement of monetary union in the light of political changes in France and Germany. The discussion focuses on the reasons for these adjustments and how to achieve them.

»Tuesday 17 April, New York

### Inflation targeting and economic recovery in Brazil

**Ilan Goldfajn**, governor of the Banco Central do Brasil, gives a City Lecture on the future of the Brazilian economy, which include prospects for continued growth and recovery, fiscal reforms, and overhauling the public pension system.

»Tuesday 24 April, London

### European monetary and financial framework

**François Villeroy de Galhau**, governor of the Banque de France, gives a City Lecture on developments in the euro area. Topics include the outlook for the ECB's asset purchase programme, the impact of negative interest rates, and boosting competitiveness.

For details visit omfif.org/meetings


# ADVENTURES IN BREXITLAND

Uncertainty around Brexit weighs heavily on the UK and distracts from other domestic issues. But London is likely to remain a global hub as Britain explores new trade opportunities.

*Illustrations by Ellie Foreman-Peck*

# London will remain a global hub

## Concentrated pool of talent is key to the City's competitiveness

**Catherine McGuinness**
City of London Corporation

London is one of most sophisticated financial centres in the world. Despite the uncertainties the city faces as a result of the UK having voted to leave the European Union in 2016, fundamentals remain strong and London will continue to lead the way as a global business hub. Companies including Bloomberg, BNP Paribas, Sumitomo Mitsui Banking Corporation and Bank of America remain committed to the City in a post-referendum economy.

As policy chair at the City of London Corporation, I am focused on the future competitiveness of the City. Global growth relies on the effective and efficient functioning of international centres of finance, which allocate capital to productive uses. London's global reach allows companies that come to the City to access a wide range of financial services at competitive prices and raise finance from international investors and banks while drawing on a concentrated pool of expertise and innovation.

If international financial centres were no longer able to function in the way that they should, markets would fragment, leading to higher costs, higher risks and reduced choice for households, governments and companies. This would adversely affect global, regional and domestic market growth and competitiveness.

Brexit represents a risk to free trade with the EU, and an opportunity for free trade with the rest of the world. The best approach on both would be to push for free trade across all sectors of the economy, goods and services alike. The City of London Corporation is advocating for continued mutual market access with the EU, underpinned by mutual recognition, alongside an increasing focus on trade with the rest of the world.

But whatever happens, London will remain a hub. It is no accident that London maintains a dominant position. It commands several comparative advantages: time zone (the City's business day overlaps with other financial centres); the widespread use of English; the fair and efficient UK legal system; internationally-rated universities; and, at the very centre of the City's competitiveness, access to talent. While competition for highly skilled and mobile talent is becoming more intense, London leads the way as a location for companies seeking to access its unrivalled talent and amenities.

### International talent

The City of London Corporation's research report, 'The City as a Place for People', found that London is the world's leader in terms of deal-making, business and attracting international talent. London is the primary European city for businesses according to 58% of institutional investors. In addition, 89% of global institutional investors saw London as the best European city for financial services talent.

These findings were supported by a separate survey of corporate decision-makers, showing London far outstripped its continental rivals. Businesses listed the City's proximity to innovative and creative clients and tech hubs, the breadth and depth of expertise across financial and professional services, transport infrastructure, cultural offering, smart-enabled office buildings and access to world-leading specialists, services and clients. Put simply, in today's global and technologically driven economy, place is an important asset because it helps to attract vital talent.

The City is one of the densest business districts in the world, attracting almost 500,000 people to work each day, seven out of 10 in highly skilled jobs. This cluster of talent creates a sense of dynamism, allowing businesses to network and tap into specialist expertise and knowledge.

Global cities are strategic sites that manage and guide the global economy and that have both the scale and history to support businesses to capitalise on the comparative advantages offered by urban locations.

The future attractiveness and competitiveness of the City depends not only on its ability to evolve, but, increasingly, on place, people and talent.

**Catherine McGuinness is Policy Chair of the City of London Corporation.**

# Britain's post-Brexit trade opportunities

## Promoting the UK's investment management industry

**Liam Fox**
UK Department for International Trade

Leaving the European Union presents the UK with an unprecedented opportunity. It will allow the country to shape trade policy that benefits the economy, businesses and consumers. The Department for International Trade's ambition is for Britain to be a champion of free trade and take advantage of growing global trade and economic prospects.

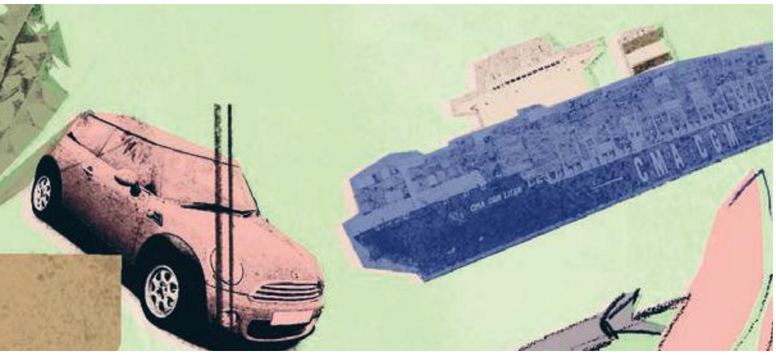
The International Monetary Fund predicts that 90% of global growth in the next decade will occur outside Europe. Yet the EU does not have trade agreements in place with many of the major nations in Africa, Asia and the Indian subcontinent that will propel this growth. Continued growth in emerging markets will create considerable commercial opportunities for UK service suppliers, especially when the government is able to take advantage of new freedoms to determine an independent trade policy.

On current trends, the global middle class is expected to include more than 5.4bn people by 2030, with most growth taking place in Asia. China alone will soon pass the 600m mark. With increasing life expectancy and disposable income, there will be a greater need to save for retirement and healthcare. There will be rising demand to manage and grow savings and retirement funds, which will create huge growth potential for the UK investment management industry.

### Promoting UK services

The UK is the largest centre for asset management in Europe and second largest globally, with around £8.1tn of assets under management. The asset management industry is a major source of jobs across the country, directly employing around 38,000 people. A further 56,000 people are employed in outsourced and other related services.

Collaboration between government and industry will be vital to help the UK expand its global footprint. DIT will promote industry through its overseas network and regular trade missions, helping develop innovative investment strategies and laying the foundations for long-term growth.




This will involve coordinated international engagement to attract overseas firms to locate in the UK and promote UK firms overseas. DIT already does this through its 'one stop shop' concierge service for asset managers looking to invest and operate in the UK. The idea is simple – DIT will provide advice and support from market opportunities, as well as access to a UK-wide network of asset managers, services and advisers, ensuring that operating in the UK is as easy as possible.

While the UK asset management industry has a global reach, some barriers to market access remain. In many emerging economies, UK funds are not permitted to be distributed without the presence of 'passporting' arrangements. In China for example, foreign funds cannot be distributed in the local market without obtaining relevant quotas.

Alongside the UK Financial Conduct Authority, the British government will explore the possibility of mutual recognition agreements. These would allow UK asset managers in target markets to distribute their funds in each other's jurisdiction, seeking to deliver tangible benefits to UK-based firms and the wider UK economy.

The white paper entitled 'Preparing for our future UK trade policy' highlights the government's aim to ensure continuity of existing agreements as well as pursue ambitious new trade relationships. Free trade agreements will help facilitate trade flows and provide legal certainty to businesses. Several countries have already shown interest in deepening their trading relationships with the UK through such arrangements. These agreements, however, are just one of the many mechanisms available to UK trade negotiators.

In recognition of the asset management sector's importance to the UK economy and the industry's global reach, the government will guarantee that future free trade agreements complement the country's international regulatory co-operation and reflect the priorities and concerns of UK asset managers.

With a stable, responsive and innovative business environment, the sector will continue to thrive, delivering the best outcomes for consumers and business. The strengths of the financial services industry will provide a firm foundation for future growth in a world of growing opportunity. ●

**Liam Fox is the UK Secretary of State for International Trade, President of the Board of Trade and Conservative Member of Parliament for North Somerset.**

# Stop Brexit, boost infrastructure

## UK uncertainty hurts investment and much else

**Andrew Adonis**
Advisory Board

Uncertainty around Britain's exit from the European Union has a major bearing on the UK's long-term infrastructure requirements. Serious infrastructure investment demands long-term thinking, optimism, stability and governmental capacity. Brexit will engender short-termism, pessimism, instability and will incapacitate the British government.

Large-scale projects take time to develop and build. The Channel tunnel took six years to construct, the extension of the London underground network's Jubilee line the same, while initiatives to roll out 4G mobile signal across Britain began in 2012 and are still far from completion.

Today's British politicians in the UK lack the ability to plan and deliver. It remains unclear what will happen next March, when the two-year Brexit negotiating period prescribed by Article 50 of the Lisbon treaty is set to end. The negotiating period may be extended, giving politicians more time to try to secure the benefits of EU membership before leaving, (an impossible task). There may be a transition period, though what it may comprise is uncertain. Airlines flying from the UK to EU countries do not know what terms they will operate under. More fundamentally, it is unclear what Britain's borders will look like or how the labour market will be affected.

### Political instability

The inability as yet of ministers to give any credible responses to this small selection of quandaries prevents developers from being able to commit to long-term plans. There is a real danger that pessimism will prevent new, important projects from being conceived. It takes bravery, creativity and an immense amount of will power to push through major infrastructure projects.

As Britain retreats from the global stage and turns its attention towards solving the dilemmas raised by Brexit, it is unclear if developers will be resolute enough to build the 1m homes that the UK desperately needs.

Political stability is vital to create an environment that encourages investment. Ministers who hold their posts for extended periods develop a better understanding of their department and thus are much better able to guide difficult projects to completion. Civil servants and other public officials are hesitant to recommend committing to major undertakings when the political landscape is so uncertain.

The economic uncertainty that accompanies the government's ill-defined Brexit plans is having a devastating effect on infrastructure investment. The Treasury cannot commit to spending money it does not know will exist, and for private investors the risks of devoting funds to the UK may soon outweigh the opportunities.

### Shortage of capacity

With all minds focused on disentangling the UK from Europe there is an acute shortage of capacity to deal with other issues. The Department for Exiting the EU is poaching civil servants from other departments, a symbol of Brexit's stranglehold on the government.

On every level – from local councils to national assemblies in Wales and Scotland – sorting out the complications of Brexit is taking up everyone's time and energy. As with the National Health Service, education and many other important areas of government, infrastructure policy is being woefully neglected as the government pursues a damaging policy with which ever fewer people agree.

Infrastructure investment is desperately needed – digital infrastructure and an expansion of airport capacity being two of the most pressing priorities – but Brexit makes solving this less probable. Fortunately, there is a simple solution to all these problems. Stop Brexit. This outcome is possible, and the campaign for a referendum on the government's Brexit deal suggests it might happen early next year. ●

**Lord (Andrew) Adonis is former Secretary of State for Transport and former Chair of the National Infrastructure Commission. He is a member of the OMFIF Advisory Board.**

# Global focus key to UK success

## Britain will have greater influence in international organisations

**Gerard Lyons**
Advisory Board

Outside the EU, the UK economy will emerge stronger and Britain will have a prominent global presence. But this could take time. Leaving the EU is an economic shock, as it is not easy to leave an organisation one has been in for over 45 years. Those who fear Brexit will be a stepping stone to an insular, inward-looking Britain will be proved wrong.

A successful Brexit requires the UK to focus on three inter-related areas: its domestic economy, its future relationship with the EU and its relationship with the rest of the world. The global focus will be a key part of the UK's future success.

A large and growing part of the law that governs international commerce is made by global institutions. This ranges from safety standards in cars to climate change, while financial services are overseen at a global level via the Basel Committee on Banking Supervision and the Financial Stability Board. The UK will play a leading role in these, independent of the EU. Moreover, it will regain its own seat at the World Trade Organisation, instead of being represented as just one of 28 EU members.

'To succeed, countries need to embrace change, adapt, be flexible and control their own destiny. We can only do that with Brexit.'

Outside the EU, Britain will remain a key member of global economic bodies like the G7, G20, Organisation for Economic Co-operation and Development, International Monetary Fund and World Bank.

Beyond economics and commerce, the UK is central to global defence and intelligence networks and is a leading member of the North Atlantic Treaty Organisation. In fact, the UK is the only EU country that both continues to meet its commitment to spend 2% of GDP on defence and contribute 0.7% of GDP to international aid.

The UK will retain permanent membership of the United Nations Security Council. Of course, the UN, like the IMF and World Bank, still needs to reform to reflect the growing importance of emerging economies. Then there is the potential of the Commonwealth too.

When one considers this list, it is hard to argue that the UK would suddenly lose influence outside the EU. It is certainly not as if the EU has been able to cut trade deals better than nations acting alone.

The UK should have moved sooner on granting EU citizens rights following the referendum but this has now been addressed. After Brexit, the UK will determine its own migration policy, as befits an open country with a multicultural society and a global reach. It will still be an attractive place where people will want to work and study. The UK's university sector is a global leader. The government has made it clear the UK will contribute to global exchange and science programmes.

The City will remain the major financial centre of Europe. Many of its features are Brexit-proof: the English language, the time zone, which overlaps with the business day in other financial markets, and the common law legal system, which is preferred in commercial and financial contracts. The combination of skills, knowledge and financial infrastructure found in London is also very attractive. Since the referendum, investment by leading tech companies has strengthened London's aim to become the global leader in financial technology.

Globalisation, the internet and technology have removed economic borders. To succeed, countries need to embrace change, adapt, be flexible and control their own destiny. We can only do that with Brexit.

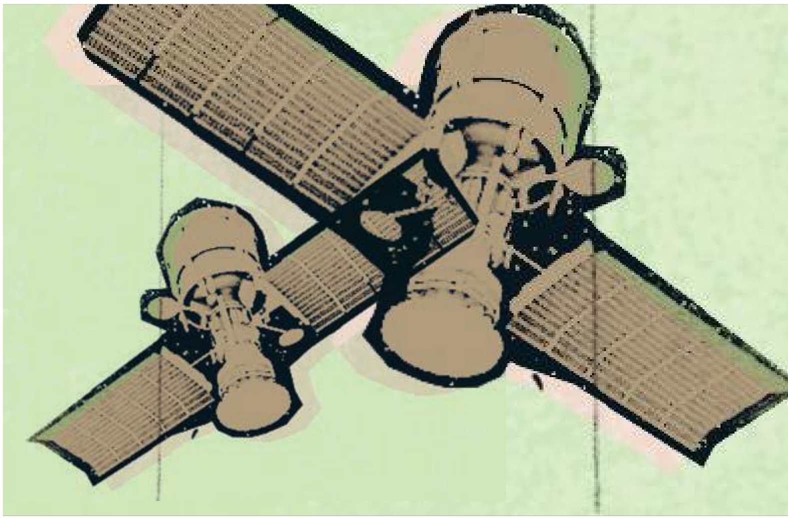
The EU is becoming more centralising, regulating and controlling. The UK needs to ensure its global message is made clear and that London and the UK will be seen as even more attractive places to do business in, as well as from. ●

**Gerard Lyons is an international economist and a Member of the OMFIF Advisory Board.**

# Lowering barriers to UK-GCC trade

## Bilateral deals between UK and Gulf states may arise

**Bhavin Patel**
OMFIF



The potential cost to the UK's economic performance and influence from leaving the European Union has made Britain's relations with Gulf countries more important. Prospects for a free trade agreement, a rise in defence spending in Gulf Co-operation Council states and reaffirmed bilateral ties with many GCC countries all underscore the UK's renewed interest in the region.

The UK's total trade volume with the GCC in 2016 was $44.5bn, a marked jump from the $19.1bn in 2010 and $13.2bn in 2005. Improving diversity of industry in the GCC is likely to strengthen further these trade opportunities for the UK.

Machinery and mechanical appliances, as well as aerospace products, dominate UK exports to the GCC. Only 32% of GCC imports from the UK are in services, largely dominated by the health and education sectors. In the longer term, the burgeoning consumer market in the region will provide worthwhile investment opportunities. The GCC has a young and growing population with high income per capita.

However, enhancing trade will require the GCC to lower the barriers that British firms face. The UK-GCC joint working group on trade, which held its inaugural meeting in October 2017, intends to address these restrictions. However, since its inception, no explicit trade strategy has been discussed. This is because the group is bound by the UK-EU common commercial policy, meaning the parties are unable to action any deals until Britain formally leaves the union, though they continue to develop strategies to enhance UK firms' access to GCC markets.

Despite the removal of some larger barriers to entry, the group argues that the plethora of byzantine barriers are of greater concern for British firms. These include a lack of clarity and transparency in the legal environment in Gulf states, GCC-wide labelling requirements and stipulations that a segment of the workforce comes from the local population. There is the risk, too, of not receiving payments, as there is no explicit framework in place that protects against delayed payment or non-payment of contracts.

### Free trade talks

The GCC made 103 reforms – one-third of all reforms made in the Middle East and North Africa, according to research from the World Bank – between 2016-17 in an effort to improve the business environment in the region. Saudi Arabia has been the most active, implementing a significant reform plan to improve the ease of doing business in the country, with the underlying principle of involving the private sector in its decision-making. Last month's Saudi delegation to the UK included the Saudi Arabian General Investment Authority, whose representatives led educational briefings and discussions with British firms affected by these reforms.

Under the terms of the Brexit negotiations, the UK has the opportunity to establish new free trade agreements with countries not presently involved in any with the EU. Moreover, the UK's trade links to the Gulf are not subject to any current agreement between the GCC and the EU and will not lapse when Britain leaves the union.

The GCC tends to negotiate collectively, as it did when finalising agreements with Singapore in 2008 and the European Free Trade Association – namely Iceland, Liechtenstein, Norway and Switzerland – in 2009. The UK would probably have to follow the same path. However, establishing any such multilateral agreement may prove problematic, given the collapse of diplomatic relations between Qatar and other Middle Eastern and North African countries last year. This began in June 2017, following allegations that Qatar was financing terrorist activities.

The case for the conclusion of a free trade agreement is strong, and may encourage the UK and individual GCC states to pursue bilateral agreements if the political troubles with Qatar are unresolved.

Such agreements are expected to reduce tariffs and duties, extend existing trade frameworks, and lead to more intensive economic engagement between the UK and the Gulf.

**Bhavin Patel is Economist at OMFIF.**

# Banking on Basel

**William Coen**, secretary general of the Basel Committee on Banking Supervision, speaks with OMFIF's Chief Economist **Danae Kyriakopoulou** about transposing banking regulations to national rules, crypto-assets and the importance of institutional transparency.

**Danae Kyriakopoulou: The banking industry has undergone intense reform since the 2008 financial crisis. The Basel Committee on Banking Supervision published rules on bank capital requirements in December. What are you hoping to achieve?**

**William Coen:** The final Basel III reforms represent a major milestone in the Basel Committee's response to the crisis. Together with previous standards, they address shortcomings with the regulatory framework.

The latest revisions aim to reduce excessive variability of risk-weighted assets. At the peak of the crisis, many stakeholders lost faith in banks' internal model-based estimates of risk-weighted assets. The reforms focus on enhancing the robustness, comparability and risk sensitivity of regulatory capital ratios, and include three key elements. First, an aggregate output floor, which sets a limait on how much capital benefit a bank can get using its internal models. Second, the standardised approaches have been significantly improved. And third, the option for using models or modelled parameters has in certain cases been restricted or removed.

The other important aspect is that these reforms largely conclude the Committee's policy-making work. We are now increasingly focusing on ensuring that the standards are implemented consistently and in a timely way.

**DK: You also published a consultative document on market risk. How does that fit within other types of risk?**

**WC:** The paper provides targeted revisions to the standard published in January 2016. It proposes ways to better operationalise some parts of the framework, clarify some other aspects and modify the calibration of some elements of the framework.

The main source of risk for most banks is credit risk, followed by operational risk. Market risk is usually less than 10% of total risk-weighted assets, though for large trading banks that are heavily involved in hedging and market-making activities, the figure can be significantly greater. It's important that the market risk framework is not overly-engineered and finalised in time for implementation.

**DK: The Financial Stability Board discussed cryptocurrencies and crypto-assets at the G20 meeting in Buenos Aires in March. What regulatory and prudential issues do you see there?**

**WC:** We're taking a targeted, sequential approach on crypto-assets. At present, the financial stability risks from such assets are relatively low. But it is important to set out the regulatory treatment of banks' holdings, and to consider the potential risks of crypto-assets to the banking system. What should the capital rules say? What about the liquidity standards? What about risk concentrations?

In the first instance, we are looking at how our 28 member jurisdictions treat these assets. We'll then discuss whether any further work should be done at the Committee level.

**DK: I also wanted to ask you about the issue of capital weightings on banks' holdings of sovereign bonds.**

**WC:** A few years ago, the Committee reviewed the regulatory treatment of sovereign exposures. The review was gradual, holistic and careful, and included an assessment of the sources and channels of sovereign risk in the banking system, the roles of sovereign exposures in financial markets and the broader macroeconomy.

The resulting discussion paper was published in December and provided a set of potential ideas on how to treat sovereigns from a banking perspective. It covers fundamental issues, such as how to define a sovereign exposure. It also includes potential ideas related to the capital treatment of banks' sovereign exposures. So far the Committee has not reached a consensus to make any changes to the treatment of sovereign exposures. But the responses we receive on the paper will help inform our longer-term thinking on this issue.

**DK: You announced at your**

‘I think transparency around what the Basel Committee is doing is essential. The decision to publish a summary of the discussions is another step in the right direction.’

**last meeting that you will be publishing a summary of discussions from committee meetings. How does that fit with the overall shift towards greater transparency from institutions and committees like yours?**

**WC:** From a public policy perspective, I think transparency is very important. The Committee has taken steps to enhance its transparency over the past few years, which ultimately lends further legitimacy and accountability to our policy decisions. The decision to publish a summary of the discussions is another step in this direction. The summaries complement existing transparency initiatives. We publish our work programme on our website, which sets out the Committee’s strategic priorities. Both the chair of the Committee and I deliver speeches around the world to further explain and discuss our work. And, time permitting, we are always willing to meet with interested stakeholders to discuss the Committee’s work.

## Profile

**Education:** Coen received his MBA from Fordham University and his BSc from Manhattan College.

**Career:** Before being appointed head of the Basel Committee on Banking Supervision in 2014, Coen served as deputy secretary general from 2007. He joined the committee’s secretariat in 1999, having previously worked for the Board of Governors of the Federal Reserve System in Washington as well as for the US Office of the Comptroller of the Currency.

# Money deceleration weakens economy

## Fed balance sheet unwinding may impede rate rises

**Juan Castañeda and Tim Congdon**
Institute of International Monetary Research

The latest figures from the US and euro area go some way to confirming forecasts of slowing money growth in 2018. This is occurring ahead of the projected acceleration of Federal Resereve balance sheet unwinding and the European Central Bank's reduction in its pace of asset purchases.

This means broad money growth in the US and euro area may fall to between 0%-3% at an annualised rate by mid-2018. This would be a definite negative for asset markets and economic activity in 2018, and justifies a view that increases in demand and output will run at a lower rate this year than in 2017.

Fed policy-makers pay almost no attention to the broad money supply, or indeed any monetary aggregate. In 2006 the Fed officially announced it would stop calculating and publishing the M3 measure since, according to a press release from the time, is 'does not appear to convey any additional information about economic activity that is not already embodied in M2 and has not played a role in the monetary policy process for many years'.

The impact of changes in broad money growth on asset markets, business confidence and demand is felt with a short lag, while the impact on inflation registers over the longer term and is more variable. At any rate, the Fed will adjust policy not to the evidence that broad money growth is slowing, but only to signs of a weaker economy.

For the moment analysts are predicting gradual rises in the fed funds rate in anticipation of the inflationary effects of allegedly tight labour markets. But if money growth is slowing and restrains the US economy by this autumn, or even this summer, then the prospect of higher rates may evaporate. Fed officials may not fully appreciate the deflationary consequences of the reduction in the money supply caused by the unwinding of their balance sheet.

The ECB, conversely, does look at broad money. The exact thinking behind its QE programme is far from clear, but it is uncanny that the annual growth rate of M3 has been so close to 5% since early 2015, a rate compatible with inflation below the 2% target and above the 2% expected GDP growth in the euro area for 2018.

A plausible claim is that the ECB has been informally targeting roughly 5% growth of M3 for the last three years, which have undoubtedly been much more positive for the euro area than the three preceding years. A significant reduction in the pace of the ECB's asset purchases could lead to slower money growth, and a weakening of demand and output. The cut in asset purchases – to €30bn per month from €60bn per month – might cause M3 growth to be around 2% lower annually than would otherwise be the case.

Peter Praet, the ECB's chief economist, is said to be nervous that the complete ending of the asset purchases in September this year might be a mistake. This may put a halt to the ECB's plans to raise rates in the second half of 2019. ●

**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.**

# Worldview

## This month's expert analysis







# Development through gender equality

## Emerging markets show benefits for productivity and income

**Otaviano Canuto**
Advisory Council

Brazilian conditional cash transfers are small amounts of money the government distributes directly to poor households on condition that their children attend school and are vaccinated. The money goes to the women of the household, because research undertaken in the 1990s – and later confirmed in other countries – showed an increase in babies' height and weight when women have more control over household income. Greater control over household resources by women can strengthen an economy where many people are poor, as spending patterns tend to be shaped in ways that benefit children.

Reducing gender inequality can boost economic growth in surprising ways. Most analyses of infrastructure investment focus on the ways it can lift growth by reducing the time and resources wasted in production and transportation. Its gender-asymmetric effects in poor countries are less well-known. More and better access to rural roads, water and power grids reduce the time mothers allocate to household chores and raise the time allocated to work outside the home, human capital accumulation and/or child-rearing. The latter leads to improved health in both childhood and adulthood.

Crucially, the increase in time devoted to human capital accumulation raises women's bargaining power, which translates into a stronger family preference for girls' education and children's health, an increase in the average share of family income spent on children, and a weaker preference for current consumption.

There is also the productivity effect of reducing gender inequality of opportunity. In 2012, the World Bank estimated that labour productivity could rise by up to 25% in some developing countries if barriers to women working in certain sectors or occupations were scrapped. It pointed out that maize yields would rise by almost one-sixth in Malawi and Ghana if women farmers were to have the same access as men to fertilisers and other inputs.

'Labour productivity could rise by up to 25% in some developing countries if barriers to women working in certain sectors were scrapped.'

### Equal work, equal pay

In the same report, the World Bank cited an example from India. Giving power to women at the local level led to increases in the provision of public goods, such as water and sanitation, which mattered more to women.

Some dimensions of gender inequality in developing economies have diminished over the last few decades. However, there is still much scope to boost economic growth via policies orientated to reducing inequality.

In Brazil, progress has been made in reducing gender inequality. Women's literacy rates have increased and the share of the female labour force with tertiary education is even higher than for men. Government policies have been addressing the needs of mothers, providing healthcare before and during pregnancy and at birth, and childcare and education.

A lot needs to be done. Even though there has been an increase in the share of women employed in the non-agricultural sector, their comparative advantage in terms of their share of tertiary education has not been reflected in wages.

Pierre-Richard Agénor, a professor of economics at the University of Manchester, and I have illustrated the impact of lowering gender inequality on raising Brazil's economic growth. Suppose a government successfully implements anti-discrimination laws that lead to the elimination of gender bias against women in the workplace. Using Brazil's data, our model-based calculations suggest an 'equal work, equal pay' policy could add up to 0.2 percentage points to a country's annual GDP growth rate. This is just the direct effect of increases in women's take-home pay, not considering other effects on the allocation of talent and the production of human capital.

We simulated the effects of a budget-neutral increase in government spending on infrastructure. Calculations suggest a rise of one percentage point of GDP could add 0.5-0.9 percentage points to Brazil's annual rate of output growth.

Gender inequality is a strong deterrent to prosperity. Policy-makers globally must show they understand this fundamental point and act accordingly. ●

**Otaviano Canuto is an Executive Director of the World Bank and a Member of the OMFIF Advisory Council. The opinions expressed in this article are his own.**

# Diversity through fintech education

## Lifelong learning empowers financial professionals

**Tram Anh Nguyen**
Centre for Finance, Technology and Entrepreneurship

Developments in financial technology offer enormous opportunities to those willing to embrace technological advancement. Moreover, these are opening doors to those who would have never considered pursuing a career in finance.

Fintech can only thrive if a specialised workforce supports it. But the industry suffers from a lack of qualified talent, with some fintech companies considering relocation to access much-needed expertise more easily. According to the UK government's Digital Strategy, it is probable that in the next two decades 90% of jobs 'will require some element of digital skills'.

Technological phenomena such as mobile devices, cloud computing and artificial intelligence have already had a considerable impact on finance services. Apart from disrupting long-standing processes, these advances are creating new opportunities for financial institutions to benefit from digitalisation.

Technological literacy is crucial, but it is equally important to understand that, to have a successful career, professionals must become lifelong learners. They must regularly update their skills and adapt to the fast-changing world of fintech.

This is what the Centre for Finance, Technology, and Entrepreneurship, an education platform aiming to train the next generation of highly-skilled finance professionals, was set up to achieve.

On launching CFTE's online platform, it was surprising to learn that 60% of the learners came from a non-financial services background. Contrary to initial assumptions, most are technologists, entrepreneurs, marketers, consultants, lawyers, professors and students, rather than finance professionals. This is important, because for the benefits of fintech to be realised fully, as diverse a group of people as possible must help draw them out.

Students on the platform come from more than 35 countries, including South Africa, the United Arab Emirates, Malaysia, Vietnam, Taiwan and Australia. Most of the intake comes from the UK, followed by Asia and then the US, where fintech is most strongly established. A large proportion of learners are based in large financial centres, but a significant share comes from developing regions.

### Gender parity

Studies from last year, such as professional service firm EY's 'fintech census', highlight continued gender disparity in the sector – only 29% of employees are women. It was encouraging, against this backdrop and considering the general skills shortage in fintech, to see that 40% of the learners on CFTE's platform are women.

This form of learning and continued education can greatly help women to infiltrate male-dominated financial services. Having access to a pool of well-trained and highly-skilled female professionals can help the finance industry to flourish, quite apart from addressing the sector's conspicuous gender disparity.

Putting more emphasis on imparting knowledge to individuals from varied backgrounds and ensuring equal opportunity for both men and women is essential if the financial sector hopes to promote greater diversity.

Fintech companies and banking institutions are beginning to collaborate and form partnerships. This will help traditional firms embrace a more diverse workforce empowered by lifelong learning and the democratisation of fintech knowledge. Employing professionals with a solid foundation in this disruptive field will catalyse change in the financial industry. ●

**Tram Anh Nguyen is Co-Founder of the Centre for Finance, Technology and Entrepreneurship, headquartered in London.**

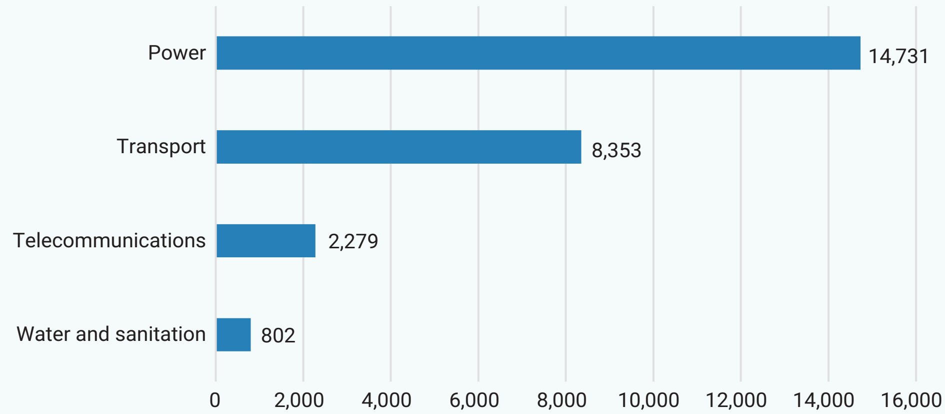
'Fintech companies and banking institutions are beginning to collaborate and form partnerships. This will help traditional firms embrace a more diverse workforce empowered by lifelong learning.'

# Matching partners to projects

## Collaboration as the best way to resolve bottlenecks

**Clara Chan**
Hong Kong
Monetary Authority

**Power needs bulk of infrastructure investment in Asia**
Infrastructure needs by sector, 2016-2030, $bn




*Source: International Monetary Fund, OMFIF analysis*

Infrastructure is one of the hottest trends in the investment world. As someone with a long career in this field, including being involved in cross-border initiatives such as the Shenzhen Bay Port and Hong Kong-Zhuhai-Macau Bridge in my previous roles in the Hong Kong Special Administrative Region government and legal profession, I firmly believe that infrastructure lays the foundation for a society to thrive by enabling the flow of people, capital and resources. It is as powerful as technology in making the world flatter, smaller and more liveable.

As the chief investment officer for private markets at the Hong Kong Monetary Authority, infrastructure investing is one of my key mandates. There is no doubt that a good infrastructure investment should deliver its social functions and generate an attractive risk-adjusted return. The latter, particularly for projects in emerging markets, is the subject of much debate.

A simple yet effective way to articulate the key issues in this regard is to focus on the four Cs: capital, collaboration, creativity and caution. In infrastructure investing, the nature and duration of capital is important. Long-term, patient capital seems to match this asset class better. The right mix of equity and debt capital is essential to incentivising timely project delivery and sustainable operation.

Collaboration is generally preferred in infrastructure projects. This does not just refer to collaboration between investors and developers, investors and operators, or investors and local governments, but also among different investors. Pooling wisdom and expertise is the most efficient way to incubate actionable ideas. Matching capital to appropriate projects and partners is never easy, and collaboration is often the best way to resolve bottlenecks.

Against this backdrop, the Hong Kong Monetary Authority established the Infrastructure Financing Facilitation Office in 2016 to bring together stakeholders for potential collaboration, an initiative that has been well received.

Creativity is another important part of the tool kit. It is crucial to solving unexpected problems in situations ranging from deal and partnership structuring to risk mitigation.

Lastly, caution is also important. Risks need to be considered seriously and mitigated effectively, because upsides will take care of themselves but downsides won't.

Applying the four Cs in practice is never easy. This is particularly true for infrastructure in emerging markets, which many investors consider to be relatively uncharted waters. The Hong Kong Monetary Authority is cognisant of potential challenges and unknown in the uncharted waters, and is responding to them by actions – actions to know our markets, understand our partners, learn our lessons and pick our deals. Experience shows that we can only unveil opportunities from challenges, and turn unknowns to knowns, by well-planned and dedicated actions.

> 'Infrastructure is as powerful as technology in making the world more liveable.'

Based on the Hong Kong Monetary Authority's first-hand experience, the good news is that the breadth and depth of infrastructure opportunities in emerging markets are tremendous. More projects are unfolding, and the best is yet to come. ●

**Clara Chan is Chief Investment Officer for Private Markets at the Hong Kong Monetary Authority.**

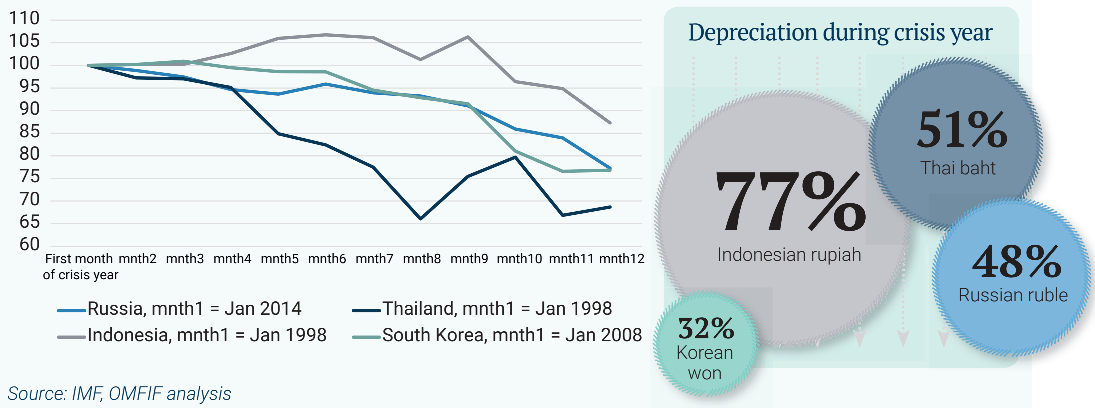
# An echo of Goodhart's law

## Dynamic management and foreign exchange reserves

**Gary Smith**
Advisory Council

**Reserves deplete as central banks fail to defend domestic currencies**

International reserve assets, indexed to first month of respective crisis year = 100




*Source: IMF, OMFIF analysis*

It can be argued that China's deployment of foreign exchange reserves between mid-2014 and the end of 2016 was the most unsuccessful use of such reserves in history. Around $1tn was spent and, despite this, the renminbi declined in value against the dollar by almost 15%. The outcome confounded conventional theory. The relationship between reserves deployment and currency value did not work as expected.

In defence of Beijing, it is impossible to say where the currency might have moved if the reserves had not been deployed. Capital controls played an important part, to halt and then reverse currency weakness in 2017. However, these factors should not deflect from recognising that intervention to support the currency not only appeared to be unsuccessful, but counterproductive. When the intervention ended, the renminbi rose in value. This adds to the mystery.

The Chinese experience was not unique. There is plenty of evidence to suggest this outcome is probable.

A vicious circle can develop, where the use of reserves creates a sense of unease that undermines the currency, as happened in Russia in 2014, South Korea in 2008, and across Asia in 1997.

In these cases the size and rate of depletion became the focus of market attention. Instead of simply being a tool to help achieve currency stability, the reserves became a policy objective in themselves. This is a variation on Goodhart's law, which can be summarised as stating that when a measure becomes a target, it ceases to be a good measure.

A nation without foreign exchange reserves will be viewed as vulnerable on multiple levels. But a nation with reserves may also look vulnerable the moment they are utilised. As the head of reserves at a central bank with more than $100bn in reserves noted at a recent OMFIF seminar, it's not how much you have, but whether you have had any need to spend. The concept of reserves adequacy can be rendered redundant by the act of usage.

These circumstances have led to some questions about whether the use and, in turn, accumulation of reserves is pointless. The answer to these questions hinges on the purpose of foreign exchange reserves.

### Dynamic reserves management

The list of uses for foreign exchange reserves has grown over the last 30 years. In 2018 they are much more than a tool for currency intervention.

Although managing the value of domestic currencies might have been the original reason to hold and accumulate reserves, this use has a poor record of success. In terms of the list of reasons to hold reserves, this should be a candidate for relegation.

To have value as a threat to the foreign exchange markets, reserves (and the assets of related sovereign funds) may need to be more than 100% of GDP, as in Hong Kong and Singapore, rather than the 40% of GDP in China in 2014.

There are two conclusions, with overlapping implications. First, any argument that suggests a need for greater foreign exchange reserves should also demand a more dynamic approach to their management. Second, a relegation of the currency intervention motivation for holding reserves in turn argues for a promotion of the case for the conservation of reserves.

This implies a diminished need for liquidity, and hence greater justifi cation for pursuing yield-enhancing strategies.

**Gary Smith is Member of the Strategic Relationship Management Team at Barings and Member of the OMFIF Advisory Council.**

# Gold beats untested cryptocurrencies

## Blockchain may facilitate digital gold assets

**John Reade**
World Gold Council

In 2017 the price of gold rose 13%, a creditable performance. In the same period, bitcoin delivered a 13-fold increase in value, prompting some to claim that cryptocurrencies could replace gold as an asset class.

However, though these digital assets may develop into an established part of the financial system, they are no replacement for gold, a dependable investment tool.

Gold is a highly liquid asset, and trades in an established regulatory framework. Its supply and demand dynamics are unique. These characteristics underpin gold's status as a mainstream financial asset.

Gold has appreciated by an average of 10% per year for more than 30 years, with relatively little volatility. Bitcoin is markedly different. Last December it soared to almost $20,000 per unit, though it never exceeded $1,000 before 2017, and has fallen back to around $10,000 this year. Such volatility potentially limits bitcoin's use as a transaction token and is hardly characteristic of a mainstream currency, let alone a store of value.

The cryptocurrency market is said to be worth more than $800bn. But there is no clear two-way market, sales are said to be costly and time-consuming, and trading volumes are low. Bitcoin trades $2bn, on average, each day. The gold market trades roughly $250bn per day.

With a 7,000-year history as an asset and a long-standing role as money, gold is owned by central banks as well as institutional and retail investors. As a tangible asset, gold has varied technical applications, including in the computer chips that 'mine' bitcoin.

Cryptocurrencies are designed to be used as tokens in electronic payment systems, but limited spending opportunities hamper their widespread use. Furthermore, genuine cryptocurrency transactions are usually quickly converted into fiat currencies.

The volume of bitcoins increases by around 4% per year and is engineered to decline to zero growth around the year 2140. This diminishing growth rate and finite quantity are attractive attributes, but bitcoin is not alone as a blockchain application. Given the many cryptocurrency alternatives, new and better blockchain-based coin applications may be seen as equivalent to increasing supply, not unlike fiat currency.

### Gold blockchains

Trade in gold is widely authorised and regulated in many markets, while most countries have yet to approve cryptocurrencies, even if they have stopped short of banning them outright. Bitcoin and other cryptocurrencies may be subject to sudden restrictions, particularly if governments become concerned about their impact on economic policy. South Korea, for instance, in January announced increased regulatory measures, while in the UK investors face hurdles to convert cryptocurrencies.

Some commentators claim that gold prices and demand are suffering at the expense of cryptocurrencies. However, there is no quantifiable evidence to suggest this is true, and the factors that propelled the gold price in 2017 appeared little changed from previous year's, however there are some positives aspects to cryptocurrencies.

Blockchain, the distributed ledger technology that underpins cryptocurrencies, is genuinely innovative.

Various players in the gold market are exploring how blockchain might transform gold into a 'digital asset', tracking provenance across the supply chain and introducing efficiencies into post-trade settlement processes. Such applications are typically built on private blockchains rather than using bitcoin or other 'public blockchains'.

> 'Various players in the gold market are exploring how blockchain might transform gold into a "digital asset", tracking provenance across the supply chain and introducing efficiencies into post-trade settlement processes.'

Unlike gold, cryptocurrencies are yet to be tested across economic cycles. The market is young and liquidity is scarce. How prices, returns and sentiment may respond if stock markets become more volatile is open to debate. Gold, however, sees demand in good times and in bad.

**John Reade is Chief Strategist at the World Gold Council.**

# Technology trumps tariffs

## Ecommerce platforms offer low-cost boost to global trade

**Ben Robinson**
OMFIF

The Trump administration's imposition of tariffs on steel and aluminium imports, announced in March, raises the spectre of an escalating trade war. The European Union, China and Canada have all threatened retaliation, while the justification for the tariffs, on grounds of national security, risks undermining the rule-based trade dispute mechanism of the World Trade Organisation. The threat to the synchronised global recovery and to investment, innovation and jobs, is substantial.

But while tariffs are the most visible form of trade costs, and the ones most easily controlled by governments, they are not the most important. Differing regulations and product standards, uneven access to trade finance, lengthy customs procedures and taxes, as well as infrastructure and transportation costs, can have a much greater effect.

These factors are behind the relatively low participation rate in global trade. Only 10%-20% of companies export their products, and this trade is dominated by large firms that can afford the complex processes, customs and payments involved. Much of this trade happens within the supply chains of large companies, on which smaller firms depend for demand. The average exporter sells to just three or four countries.

> 'Only 10%-20% of companies export their products, and this trade is dominated by large businesses. The average exporter only sells to three or four countries.'

Developments in logistics, electronic payments, data processing and global product listings, aided by online commerce platforms, are changing this rapidly. Such platforms are tackling high costs and complexity by combining a range of services that trade depends on, such as customs facilitation, shipping, warehousing, and data and payments handling, and performing them as part of the sales process. Using data generated by online transactions, they also offer targeted marketing and search tools and global product listings, significantly reducing information barriers.

Data from eBay suggest these factors have lowered trade costs on ecommerce platforms sixfold relative to traditional exports. As a result, up to 98% of companies listed on platforms like eBay, Amazon and Alibaba trade internationally. They also export to more countries, at between 20 and 40 on average.

This combination of processes distinguishes the ecommerce model from companies that simply have an online presence. These companies must pay for advertising, shipping, website design and other factors separately, both reducing their reach and raising their costs.

### Improving logistics

The World Bank estimates that improving the efficiency of national logistics services would have a greater impact on boosting trade than the elimination of all tariffs. Ecommerce is providing the catalyst for this improvement.

Over the past six years, institutional investors have spent almost $100bn on logistics centres, warehousing, data storage and other infrastructure related to ecommerce. This has increased export efficiency and lowered transportation costs at a time when governments have generally been underspending on infrastructure.

Yet despite its rapid growth, ecommerce's share of world trade remains low and is uneven between regions. Ecommerce platforms face a number of hurdles. Overcoming them will require government support.

Inefficient ports, bad roads, monopolies on infrastructure ownership and lack of domestic competition are among the challenges. The low threshold at which consumers in some countries must pay customs duties on imported items, which disproportionately affect the high-volume, low-value goods that dominate small and medium-sized enterprises' exports, must be raised. These taxes are highly disruptive to ecommerce models that depend on rapid, low cost exports and which allow international refunds and returns as part of the service.

The prospect of achieving economic growth and development by utilising online marketplaces may persuade governments to adapt their policies. The potential is particularly high in emerging economies, where internet penetration is growing rapidly from a low base.

Malaysia opened the first free-trade 'e-hub' with China's Alibaba in November 2017, offering simplified regulations, customs clearance, payments and logistics to facilitate trade between SMEs from the two countries. The WTO made ecommerce a focus of its ministerial meeting in December.

This trend could be transformational. Global trade growth has slowed to half its pre-crisis average and export participation remains uneven. At a time when governments are contemplating trade barriers, ecommerce platforms and their associated digital, logistics and financial services could help drive a new and more balanced wave of trade expansion. ●

**Ben Robinson is Senior Economist at OMFIF.**

# Bank of Japan losses from QQE exit

## Need for government injection may threaten independence

**Ikuko Fueda-Samikawa**
Japan Center for Economic Research

Haruhiko Kuroda, governor of the Bank of Japan, begins his second term on 9 April. When he took up position in 2013 the bank introduced its quantitative and qualitative monetary easing (QQE), and said that its 2% price stability target would be fully achieved in around two years.

However, Japan's inflation rate has been sluggish, and the bank is carrying over the 2% target to Kuroda's second term. In the light of the prolonging of the QQE programme, the size of the bank's balance sheet now exceeds that of the US Federal Reserve.

The bloating of the balance sheet means the bank is likely to incur losses when it winds down QQE. This is because the difference between the investment yield of long-term government bonds held by the bank and the rate the bank pays on excess reserves to private financial institutions is only around 0.3%.

If the bank raises its policy rate to 0.5%, the difference would become negative. If, for example, the core consumer price index inflation rate reaches 2% by financial year 2022, ending March 2023, and the bank gradually raises its policy rate to 2%, it will incur financial losses of around ¥19tn ($177bn). As it will not be able to offset this with its own capital, it will consider raising the reserve requirement rate for private banks and/or changing accounting rules to post losses by the central bank as negative deferred assets.

Raising the reserve requirement rate is, in effect, a tax on private banks. Even if the Bank of Japan changes its accounting rules to introduce deferred assets, the losses will not dissipate, and these will have to be covered by future profits. Neither raising the reserve requirement nor changing the accounting rules is realistic.

**$177bn**

**Bank of Japan's potential losses if core CPI inflation rate reaches 2% by 2022**

### Threat to independence

An alternative path for the bank might be to seek a capital injection from the government.

The bank expanded the monetary base to realise its price stability target, which helped the government to issue bonds at lower interest rates. However, when the bank begins to tighten monetary policy, the government will have to raise debt at a higher rate. Moreover, if losses occur in the bank, payments to the national treasury will decrease.

In a worst case scenario, a public capital injection may be needed to fill the loss, though the existing legislation does not stipulate how compensation should occur.

At that point, the matter of central bank independence will arise. Under normal circumstances, many central banks transfer their seigniorage to their governments. But it is unclear what should happen if a central bank falls into negative equity.

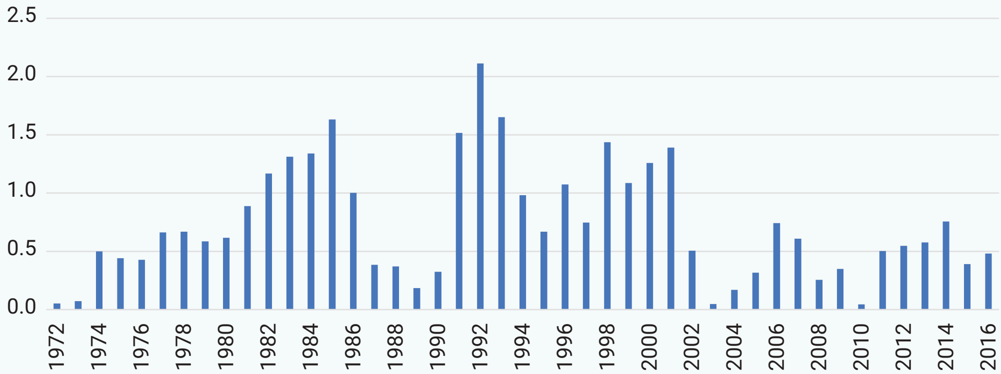
In the process of financial normalisation, the conflict between monetary policy and government debt management policy comes to the fore. It may be necessary to establish arrangements for the distribution of profits and losses between them. If the Bank of Japan cannot maintain its independence, the credibility of the yen will decline. Not only will inflation occur, but the bank will face government intervention in monetary policy.

Unlike the Fed, the Bank of Japan will incur losses in the process of monetary normalisation. Central bank independence will soon become an issue in Japan. ●

**Ikuko Fueda-Samikawa is Principal Economist and Director of Financial Research department at the Japan Center for Economic Research.**

**Japan's government receiving $500bn in central bank seigniorage**

Bank of Japan seigniorage remitted to Japanese government, ¥tn




*Source: Japan's Ministry of Finance.*
*Note: 2016 financial year*

# Italian limbo obscures economic risk

## Problem that euro area could find too great to manage

**Elliot Hentov**
Advisory Board

The Italian electorate has split parliament into three incompatible blocs, none of which have a majority. Turnout for the 4 March election, at 73%, was an all-time low by Italian standards since mandatory voting was abolished in 1994. Polling data indicate that those who did not participate were typically mainstream voters disillusioned with the political process. This helps explain the success of populist parties such as the League and the Five Star Movement (M5S). In areas where turnout did increase – mainly in the impoverished south – voters were motivated by protest and largely supported M5S.

The only stable coalitions, in terms of the numbers of seats, would involve M5S and the League, or M5S and the Democratic party. Many observers believe the allure of power could lead to an M5S-League coalition sharing a policy programme of fiscal expansion, immigration pushback and EU obstruction. But M5S takes pride in not striking coalition deals and competes directly with the League for a similar voter base. Coalition negotiations are likely to last months, and the durability of any government is questionable. Italy is likely to be in political limbo until at least the summer, heavily influencing efforts by France and Germany to push through long-overdue reforms in Europe, such as on banking union.

Markets responded relatively calmly. Italian government bond yields added just five basis points to reach 2% the morning after the election, and the Italian stock market dropped just 1.3%. This suggests investors have become more tolerant of political uncertainty against a backdrop of better European growth. In the short term, the outcome of the election is immaterial, as there will probably be no policy developments of any kind for many months. A short-lived coalition or new elections could extend the life of an ineffectual government into 2019.

### Long-term breakdown

However, this benign view ignores the medium- and long-term risks of an Italian economic breakdown. The government of Italy remains the world's fourth largest borrower, raising around €240bn in 2018 alone. The Italian debt management office has skilfully taken advantage of the low yield environment to extend the average maturity of government debt to nearly seven years. This has reduced the pressure of managing the country's €2tn of debt stock, yet Italy still needs to roll over sovereign debt worth around 16% of GDP every year – the highest rate in the euro area.

Such debt-servicing capacity demands a prudent policy framework. Fortunately, Italy has been fiscally responsible in recent years. The debt overhang is a legacy issue from the 20th century, while Italy has run the largest primary surplus in the euro area since 2008 at an annual average just below 1.5% of GDP.

The League and M5S believe this creates room for fiscal stimulus to help poor Italians. Apart from Greece, Italy is the only country in the euro area which, adjusting for inflation, recorded a lower GDP per capita in 2017 compared to 1999, when the euro was created. If the government introduces stimulus policies, it is likely to come into greater conflict with the European Union's fiscal rules.

While the populists have ruled out a referendum on euro membership, they have little in common at an EU level on other issues central to their campaign, namely the migration crisis and forming a banking union – weak Italian banks have been a major reason for the country's disappointing economic recovery. However, to be effective at obstruction in intergovernmental negotiations in Brussels, one needs to have a steady government at home.

A politically uncertain, economically weak and increasingly anti-EU Italy could eventually become too great a problem for the euro area to manage. ●

**Elliot Hentov is Head of Policy & Research, Official Institutions Group, at State Street Global Advisors, and a Member of the OMFIF Advisory Board.**

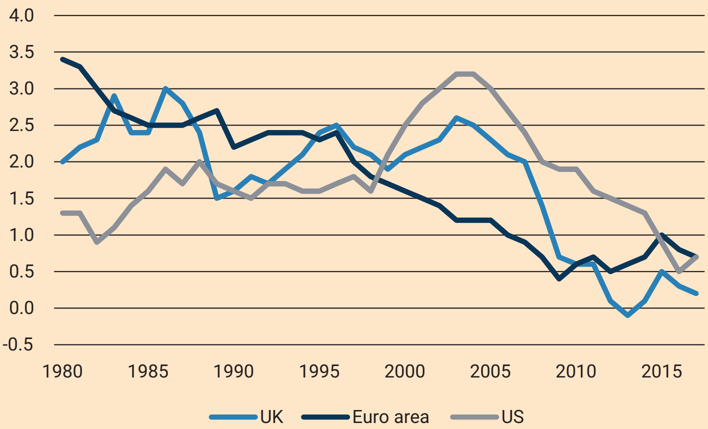

*Source: IMF*

## The chart

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

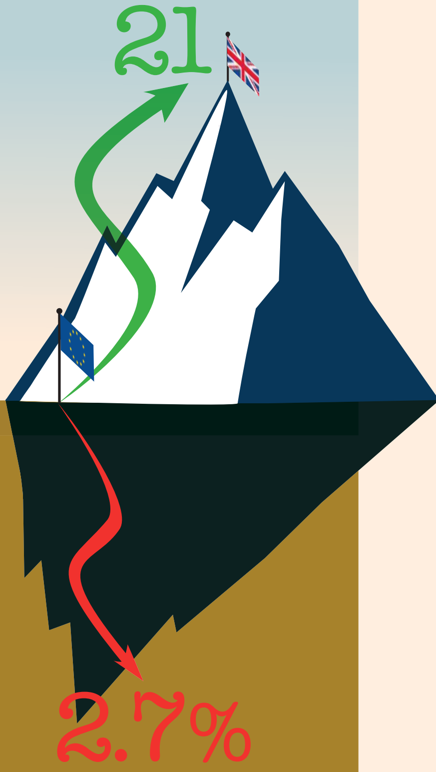
Productivity growth rates in advanced economies have been falling since before the 2008 financial crisis, with the euro area decline beginning almost a decade earlier. It rebounded marginally from a low of 0.4% in 2009 but remains under 1%. UK and US growth rates have been stuck below 2% since 2008. The Bank of England expects productivity growth in these economies to recover in the coming years, although a return to pre-crisis rates over that time is improbable.

**Low productivity haunts advanced economies**
Year-on-year change, %




*Source: Bank of England*

## The Brexit numbers




The number of months secured as a transition period for Britain during Brexit negotiations. This provides extra time for the UK government to plan for Brexit-related changes to Britain's customs, immigration and regulatory systems.

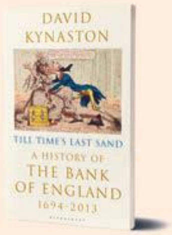
UK inflation slowed to 2.7%, more than expected during February, as the post-Brexit fall in the pound's effect on consumer prices began to ease out of the figures. 2.8% was predicted by analysts. This was down from 3% in January.

**£490m**

The value of the contract that Gemalto, a security company based in Paris, has won to produce Britain's new dark blue passports. With the change of colour from burgundy seen as a symbol of the UK taking back sovereignty from the European Union, the move has been criticised and is facing a review in the House of Lords.

## From slavery to supervision

*William Keegan*




DAVID Kynaston has always displayed a healthy scepticism about the City of London, whose history and ability to adapt he has chronicled so well. It was therefore adventurous of the Bank of England to commission him to write *Till Time's Last Sand*, aimed more at the general reader than some of the more technical tomes published over the years. When I worked at the bank in the mid-1970s the most popular history was the three-volume opus by economist Richard Sayers, which was so substantial and detailed that an extra volume was added solely to cover the index.

Much has changed since then. Kynaston navigates us through the failures of regulation in the 1980s and 1990s – including the collapse of Johnson Matthey Bankers, Bank of Credit and Commerce International and Barings Bank – as well as the punishment meted out by Gordon Brown, the UK chancellor of the exchequer and later Labour prime minister, for supervisory failures. The good news for the bank was the award in 1997 of operational independence in monetary policy. This was less a favour than a way of freeing the chancellor to get on with his economic and social policies, with less suspicion in the financial markets, of which the Labour party had good historical reasons to worry. However, in a further desire to please the markets, Labour at the turn of the century indulged them in 'light touch regulation', which Brown subsequently regretted.

Kynaston takes us to 2013 and the end of Mervyn King's governorship (2003-13), and is scrupulously fair in covering the 2008 financial crisis. Though some reviewers have been concerned that Kynaston did not have full access to the bank's archives for 2007-08 and after, he has done his research. King emerges as having been far too closely associated with the UK coalition government's fiscal policies in 2010. In the words of Sushil Wadhwani, former member of the bank's monetary policy committee: 'No central bank governor should allow this to occur. It is a great pity that the perception of independence has been put at risk.'

### Rogues and miscreants

While the more recent history will be of interest to financial practitioners, the earlier centuries make for riveting reading. The bank was founded in 1694 to finance Britain's efforts in the Nine Years War against France. It played a vital role in helping to finance many other conflicts, including the Napoleonic wars from 1793, when Prime Minister William Pitt the Younger raided the bank's coffers. The cartoonist James Gillray gave it an appropriate and enduring nickname – The Old Lady of Threadneedle Street, politically ravished by Pitt's demands for finance.

The infant bank employed rogues and forgers, with miscreants being hanged or transported to the other side of the world for the most trivial-sounding crimes. Governors and directors were involved in the slave trade, and one, William Robinson, had to resign when his company became insolvent.

Given the bank's importance, not only to the UK but to many parts of the world, Kynaston's book cannot be recommended highly enough. Quite apart from its interest to the general reader, it deserves a place on the bookshelves of everybody in the OMFIF world. •

**William Keegan is Senior Economics Commentator for The Observer and a Member of the OMFIF Advisory Council.**

'The good news for the bank was the award in 1997 of operational independence. This was less a favour than a way of freeing the chancellor to get on with his economic and social policies.'


*James Gillray's The Old Lady of Threadneedle Street in Danger (1797)*

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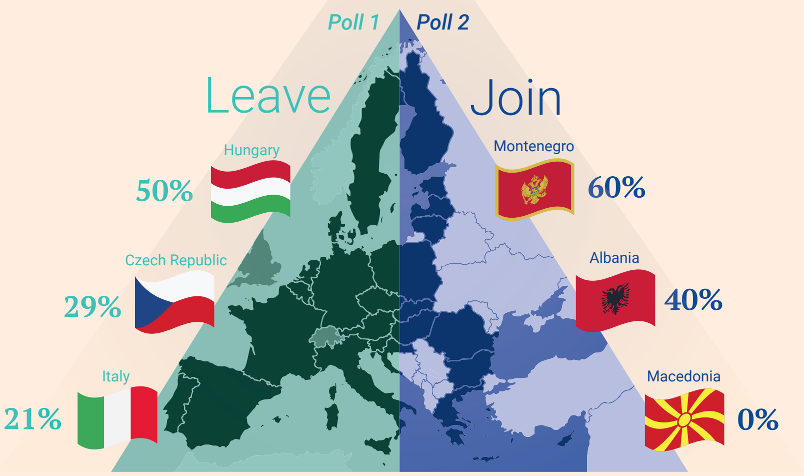
Advisers network poll

# Brexit 'not likely' to deter EU members

## Network expects the union to expand rather than reduce

**Countries likely to leave and join the European Union after Britain's proposed exit, % of votes in Twitter polls.**




The poll for this month focuses on the future composition of the European Union after Britain finalises its proposed exit. Participants were asked: **'With Britain scheduled to exit the European Union in one year's time, which countries are most likely to: (a) leave next and (b) join next?'**

Of those who responded to the advisers network poll, many suggested that all remaining 27 members would stay in the EU into the near future. Reasons for this included the uncertainty surrounding the global financial and political landscape, forcing European countries together. Some proposed that the EU would expand further, with the most probable next members coming from the Balkan states. As part of two polls, OMFIF's Twitter network were given three options on who might leave and stay (see chart). Hungary came top on who would leave next, while respondents echoed the advisers in supporting Montenegro to join next.

Iceland will be first to join. It is hard for an EU member state to contemplate seriously an exit under current global political and economic conditions.

**Korkmaz Ilkorur, Credit Europe**

I don't expect any joiners before 2028, but a reformed EU could be able to digest the expansion of ex-Yugoslav republics and Albania.

**Elliot Hentov, State Street Global Advisors**

It is highly improbable that current members want to leave, irrespective of criticism of its institutions and some EU policies.

**Laurens Jan Brinkhorst, Leiden University**

Italy would face a devastating financial crisis if it dared even to discuss 'Italexit' seriously.

**Kohout Pavel (@KohoutPavel)**

Serbia is led by a pro-EU party which appears likely to stay in power. They are an obvious candidate to join.

**Miroslav Singer, Generali CEE Holding**

Italy is most likely to leave next, although I think it highly improbable.

**Jeffry Frieden, Harvard University**

These statements were received as part of the March poll, conducted between 5-19 March.

## May's question:

**With Facebook's recent data leak, is the EU's promise of greater external and internal regulation enough to maintain consumer faith in the company?**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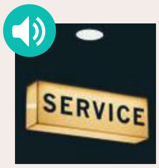
Boon Chye Loh, chair of Singapore's Diversity Action Committee and chief executive of the Singapore Exchange, joins Adam Cotter to discuss the issues surrounding OMFIF's 2018 Gender Balance Index report. Topics include the current state of gender diversity in Singaporean industry and how men can play a role in encouraging diversity in the workplace.

### Derisking in the Pacific

Steven Beck, head of trade and supply chain finance at the Asian Development Bank, joins Anton Varga. They examine solutions for addressing the negative impact of derisking and the effectiveness of existing regulation. They also discuss the impact of correspondent banking, trade finance in Asia Pacific, and the effect of derisking on the financial sector.




### The role of services in global trade

Lucian Cernat, chief trade economist at the European Commission, joins Ben Robinson. They discuss changing patterns of trade and investment resulting from the growing importance of services to production and employment. They address the role of foreign direct investment in delivering services, as well as its effect on current account balances and modern trade policy design.

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