The Bulletin

OMFIF

June 2018
Vol.9 Ed.6

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'There is no planet B'

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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 $36tn, equivalent to 45% of world GDP.

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Evaluating ESG strategies

June marks the anniversary of President Donald Trump's decision to withdraw the US from the 2015 Paris climate agreement. Perhaps paradoxically, the US retreat has provided impetus for others to advance the climate change agenda. Emmanuel Macron has stood out among world leaders in this respect since being elected to the French presidency a year ago. His answer to Trump's 'make America great again' motto is to 'make our planet great again'.

Rhetoric has been matched with action, not only by politicians but also investors. The value of green bonds issued grew over the past year to $155.5bn, the highest level of annual issuance on record. While this is still a small fraction of the overall fixed income market, green bonds are gaining prominence in investors' portfolios. In March, Amundi and the International Finance Corporation closed the largest green bond ever raised, at $1.4bn. Public investors – central banks, sovereign funds and public pension funds – are also playing an increasingly important role in this market's development, as explored in detail in OMFIF's latest *Global Public Investor* report, launched in London last month.

We continue to ensure that our research into public investors' environmental, social and governance strategies sparks debate and informs policy. Next month OMFIF will be hosting the second annual Global Public Investor Green Finance Symposium, in association with the Bank for International Settlements, Monetary Authority of Singapore and IFC. There is still a long way to go to a fully developed market for green investments. Our second ESG podcast series explores the obstacles to advancement and focuses on what is needed to move the agenda forward. As Macron told the US Congress during his visit to Washington in April, 'There is no planet B.'

Danae Kyriakopoulou
Chief Economist and Head of Research

»23 May, London

GPI 2018 launch: Chile governor warns on US tightening

'US monetary tightening will disrupt some emerging market economies,' Mario Marcel, governor of the Banco Central de Chile, warned. 'We've never had this fiscal expansion [in the US] at this stage of the cycle and with this level of debt in the world's largest economy.' He was speaking at the launch of *Global Public Investor 2018*, OMFIF's annual report focusing on public sector asset ownership and management across 750 official institutions around the world. Speakers included Joaquim Levy, managing director and chief financial officer of the World Bank Group, Frank Scheidig, global head of senior executive banking at DZ BANK, Sergei Guriev, chief economist of the European Bank for Reconstruction and Development, and Louis de Montpellier, senior managing director and global head of the official institutions group at State Street Global Advisors.

For the first time, OMFIF is offering a comprehensive interactive online databank for the GPI 2018*, available as a practical resource for the reserves management and research departments of all Global Public Investors. For more information, visit* ***omfif.org/shop****.*

»22 May, Bucharest

The state of the euro area

OMFIF held its first Economists Meeting with the National Bank of Romania. The discussion focused on the outlook for growth across the euro area, an analysis of the benefits and costs of joining Europe's economic and monetary union, and the economic and political risks facing Europe.

»3 May, Manila

Investing for a sustainable future

OMFIF held a seminar at the Asian Development Bank's annual meetings, focusing on the search for sustainable long-term investment returns in Asia. Speakers included Jingdong Hua, vice-president and treasurer of the IFC, and Ingrid van Wees and Zhang Wencai, vice presidents of the ADB.

»3 May, London

Monetary outlook for Poland

OMFIF organised a discussion with Łukasz Hardt, member of the monetary policy council of Narodowy Bank Polski. Topics included Poland's economic and monetary outlook, prospects for deeper European integration, the implications of Brexit and developments in global and financial markets.

»3 May, London

Brazil's economic vision

OMFIF organised a briefing with Tiago Berriel, deputy governor for international affairs and corporate risks at the Banco Central do Brasil. The meeting covered the economic climate in Brazil, projected growth in the country and expected fiscal and monetary reforms.

»2 May, London

UK dilemma for customs union

THE dilemmas facing Britain over a customs partnership with the European Union and the effect of EU withdrawal on the UK economy were examined in an OMFIF breakfast meeting with Nicky Morgan, Conservative MP for Loughborough and chair of the Treasury select committee.

FORTHCOMING MEETINGS

»Monday 11 June, London

Political economy roundtable

A roundtable briefing with **Sir Simon McDonald**, permanent under-secretary and head of the diplomatic service at the UK Foreign and Commonwealth Office. The discussion focuses on economic relations between the UK and Japan after Brexit.

»Wednesday 13 June, London

Maintaining financial stability in the UK

A City Lecture with **Anil Kashyap**, external member of the Financial Policy Committee at the Bank of England. The lecture examines how macroprudential policy-making does and should work in practice, and challenges in making it fully operational.

»Thursday 14 June, Pretoria

Asset and risk management forum

A seminar in partnership with the South African Reserve Bank and the World Bank Treasury's Reserve Advisory Management Program. The discussion focuses on financial developments as well as opportunities for public sector investment management.

»Monday 18 June, London

Future of the European Central Bank

A panel discussion to analyse the role of the European Central Bank and the future of the euro area. The meeting focuses on the ECB'S loose and expansionary monetary policy, the timing of policy normalisation and structural reform in the euro area.

For details visit omfif.org/meetings

esg

'There is no planet B'

Rhetoric on climate change is being matched with action by politicians and public investors. Central banks, sovereign funds and public pension funds are critical to the development of the green finance market.

Asia at the frontline for ESG investing

Japan's GPIF leads way with exacting criteria for management

Marsha Vande Berg
Advisory Council

Warren Buffett, the US business magnate and world's third-richest man, is famously known for a business philosophy that centres on securing returns by investing in 'wonderful companies at fair prices'. But investors, including those at institutional levels in Europe, the US and increasingly in Asia, are declaring they want something in addition to returns.

Increasingly they are taking into account the social and environmental impact of the actitivities of the companies in which they invest. They are less inclined to question why they should make investments that favour the environment, counter climate change, favour social conditions and improve corporate governance. They are simply doing it – in multiples.

The US Forum for Sustainable and Responsible Investment reported that $8.7tn in US-domiciled assets under management were in socially responsible investments at the start of 2016, a 33% increase from 2014. These trillions were deployed by 477 institutional investors, 300 money managers and 1,043 community investing financial institutions. One-third of the assets were held by institutional investors or money managers who filed or co-filed shareholder resolutions on environmental, social and governance issues between 2014-16.

The forum surmised that the 33% growth reflected heightened market penetration of ESG products, increasing levels of investor advocacy and a wider awareness among investors, especially asset owners and the public beneficiaries they represent.

Asia policy takes lead

Circumstances are different in Asia, where support through policy has been an important factor behind the increased emphasis on SRI and ESG investment. The CFA Institute, a global association of investment professionals, puts Asia's ESG AUM at $500bn, 2.2% of the estimated $23tn of global ESG assets. Japan accounts for most of Asia's ESG investments. Assets outside the country are in the range of $52bn, reflecting in large part the activity of investors in Hong Kong, Taiwan, South Korea and Malaysia.

Some stock exchanges are mandating sustainability reporting by listed companies as they strengthen governance standards and pay closer attention to transparency for traded equities. Singapore's bourse requires listed companies to conduct and disclose analysis of material economic, environmental and social issues that impact business performance or substantively affect key stakeholders. The exchange also requires disclosure of performance indicators as well as affirmation by the board of directors.

In Japan the massive Government Pension Investment Fund, with $1.45tn AUM, is putting nearly $9bn into three ESG indices. This more than triples its ESG allocation to 10% of its equity holdings. In doing so, the GPIF is moving to the frontline of ESG-focused pension and sovereign fund investment.

The fund has tied its investment philosophy to its responsibilities as a signatory to the London-based Principles for Responsible Investment network. The GPIF now requires its asset managers to meet exacting ESG-related criteria or be fired. Overall, the world's largest single pool of pension money has positioned itself to make a marked difference to the world of ESG-managed assets.

> 'The GPIF has positioned itself to make a marked difference to the world of ESG-managed assets.'

South Korea's National Pension Service is also a PRI signatory and, as a result, has made significant allocations to ESG strategies. The Chinese government has rolled out several initiatives that include increased collaboration with European counterparts in the wake of the Donald Trump administration's retreat from the Paris climate accord.

Beijing has set up five green finance pilot zones and committed to increasing China's reliance on hydro, wind, solar and nuclear energy. These accounted for 20% of the country's total consumption in 2016, up from 14.5% in 2012. Beijing intends for 20% of vehicles in China to be powered by alternative fuels by 2025. China is also the world's largest issuer of green bonds, having increased its issuance to $36bn in 2016 from almost zero in 2015. It now accounts for 39% of global green bond issuance.

In contrast to the US, where Trump has set out to unwind Obama-era climate regulations, China is adopting stringent environment protection rules and increasing its mandatory energy efficient targets. The expectation is that regulatory and government-led initiatives will propel growth in green investment. The Shanghai-Hong Kong Stock Connect, for example, provides a direct channel for foreign investment into Chinese green bonds.

Like China, India is home to some of the world's worst air pollution. It is the third largest emitter of greenhouse gases, after China and the US. Since becoming a signatory to the Paris accords, Delhi has pledged that by 2030 at

least 40% of its electricity capacity will come from sources that do not use fossil fuels. The significance of Delhi's commitment is underscored by the fact that India must rapidly expand its energy infrastructure if it is to maintain 5% annual growth, the minimum to sustain job creation and meet the needs of the world's second largest population and one of its youngest workforces.

Institutionally, SRI investing in India is at its earliest stages of development, with estimated total investment of around $31bn, according to Oxfam India. Most ($25bn) is in equities held by global investors that evaluate their investments against SRI strategies, plus green bonds ($5.5bn).

Some 95 socially responsible funds from around the world are invested in India and allocate 18.5% of their funds to Indian companies. Aside from general macroeconomic trends favouring these products, growing interest in ESG among Indian asset managers and a budding green bond market are sparking the development of this sector.

US retreat

Younger investors are another strong influence on ESG interest across Asia. Many will inherit massive family wealth – the number of people in China, for instance, with investable assets of at least $30m is expected to double in the next five years. Unlike their parents, many younger investors are eager to demonstrate a commitment to green energy, sustainable infrastructure and ethical companies.

The world of investment and finance is changing in ways that are sure to impinge on older generations' priorities when making investments. Government policy, through its absence or otherwise, will have a substantial impact, especially as the divide between the US and the rest of the world widens in this area.

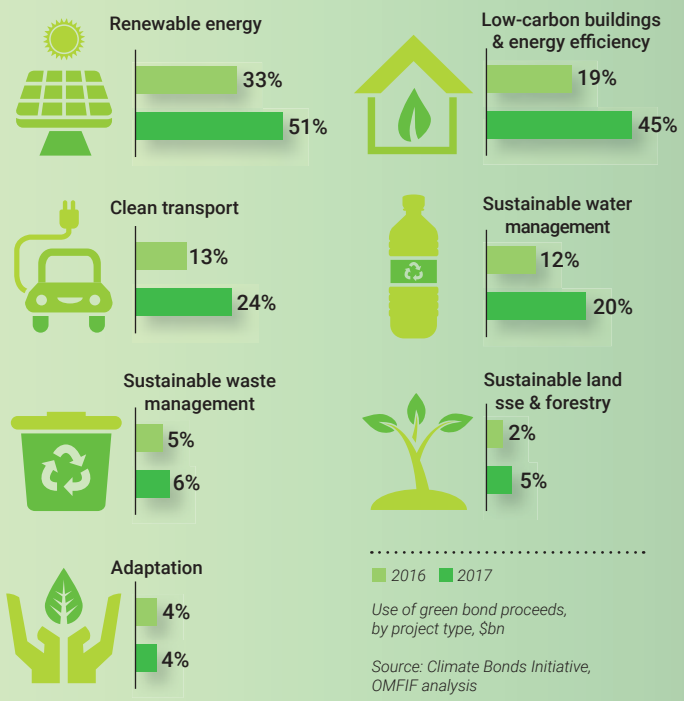
While the US retreats from the global stage on climate-related issues, Asia's embrace at the policy, regulatory and institutional investment levels is sure to exert a demonstrable, perhaps outsized, influence on the market. More than half of the world's population lives in Asia, and the region contributes one-third of global GDP, and an even greater share of global GDP growth.

In the US the chief executives of the world's two largest passive investors, BlackRock and Vanguard, are calling on corporations to demonstrate their social purpose even when doing so may not be good for returns. Such notions are likely to be fuzzy for Warren Buffett and his flagship Berkshire Hathaway. Despite being right about markets more times than not, Buffett and Berkshire Hathaway may end up changing their definition of what constitutes a 'wonderful company' at a 'fair price'. ●

Marsha Vande Berg is a 2016-17 Stanford University Distinguished Career Fellow.

ESG products on the **rise**

Renewables and real estate dominate use of green bond proceeds



Use of green bond proceeds, by project type, $bn

Source: Climate Bonds Initiative, OMFIF analysis

Europe leads sovereign green bond issuance

Poland	(Dec 2016)	$791m
France	(Jan 2017)	$7.6bn
Fiji	(Oct 2017)	$50m
Nigeria	(Dec 2017)	$29.7m
Poland	(Feb 2018)	$1.2bn
Indonesia	(Feb 2018)	$1.25bn
Belgium	(Feb 2018)	$4.5bn

Source: OMFIF analysis

Smarter finance for low-carbon transition

Transition to carbon neutral represents a significant economic challenge

Jean Boissinot
French Treasury

In the 2015 Paris agreement, the shared realisation that climate change is having increasingly significant effects led the international community to affirm its long-term objective: to keep the rise in global average temperature below two degrees Celsius. If the transition to a carbon neutral world seems achievable from a technological perspective, its scale should not be underestimated.

The low carbon transition represents a significant economic challenge, requiring the complementary actions of public authorities, economic actors and financial institutions.

On the public side, policies are needed to put a price on carbon, such as cap and trade or a carbon tax, as well as an overall framework that fosters long-term decisions. Public authorities have an imperative to align their policies with the Paris agreement, from phasing out implicit fossil fuel subsidies to prioritising transition-related issues in research and development programmes.

Transition-conscious companies must develop or seek out technologies and deploy new solutions and products. They must adapt productive capital to economy-wide carbon neutrality. This is only marginally about more investment; it is fundamentally about different investment. Every company needs to embed a climate change perspective into its decision-making, or risk contributing to the build-up of 'stranded' assets that will become uneconomical as more countries pursue low-carbon policies.

While it cannot achieve much on its own, a financial system that takes account of climate change-related issues not only could contribute directly to financing the low carbon transition and to managing risks; it would also amplify the policy signal. Developing smarter finance matters for the transition beyond mere financing.

'Green' or 'sustainable finance' agendas are being designed and implemented in a growing number of jurisdictions. France has been at the forefront by introducing policies that promote better integration of sustainability throughout the economy. To enable the financial sector to price climate change-related risks and grasp opportunities, corporate disclosure has been strengthened.

To nudge appropriation, accelerate innovation and disseminate best practice, institutional investors and asset managers are required to report on how they integrate environmental, social and governance issues into their investment strategies. To improve climate change-related risk management, the prudential supervisor is engaging with supervisees.

To contribute to deepening the green bond market, France's debt management office is issuing green bonds. To ensure that retail investors can find robust 'green' or 'sustainable' products, dedicated labels have been developed.

Integrated regulation

These policies are proving effective. The reporting requirements have contributed to the management of more than 90% of the domestic insurance sector assets to incorporate climate change concerns.

The integration of climate change issues in the dialogue between regulators and companies has been one of the factors behind French banks' leadership in this field among their European peers. The involvement of the debt management office in the green bond market contributed to a renewed interest for these bonds among issuers and enabled them to formalise their commitment to this market.

The key to such developments may be to foster the adoption of climate change policies and emphasise each economic participant's personal responsibility in devising the right course of action. Smart regulation can help the advent of smarter finance, and policy can contribute to developing markets and strengthening their integrity. But eventually, ensuring that finance is contributing to a 'good society' rests on a culture of doing what's right. This requires everyone in the financial sector, whether in private firms or public authorities, understanding the role they are expected to fulfil. ●

Jean Boissinot is Director, Financial Stability at the French Treasury.

> 'The key is to foster the adoption of climate change policies and emphasise personal responsibility in devising the right course of action. Smart regulation can help the advent of smarter finance.'

Public investors shift to ESG

Building up minuscule global green finance market

Danae Kyriakopoulou
OMFIF

As long-term investors, public pension funds and sovereign funds pay close attention to environmental, social and governance issues. Climate-related risks will intensify over time, and public investors are adapting their strategies to reflect their commitment to responsible asset ownership.

Public investors' commitment to responsible ownership often takes the form of divestments from companies that contradict ESG principles, such as tobacco or carbon-exposed businesses. European and North American pension funds are leading the way. In December 2017 the European Parliament passed a resolution calling on all public and private institutions to divest from fossil fuels. In January 2018, New York City announced it would divest the $5bn fossil fuel investments held by its five public pension funds over the next five years.

Bans on tobacco investments have existed for much longer. Two of the US's largest pension funds, the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS), banned them in 2000. Norway's Norges Bank Investment Management pulled out of tobacco in 2010, and Dutch ABP announced it would divest from such companies in January 2018.

Such strategies have proved financially costly. A study commissioned by CalPERS in 2015 found that it had forfeited as much as $3bn in returns because of its divestments, exposing contradictions as public investors strive to be ethical and profitable at the same time.

Active investing

As large investors, sovereign funds and pension funds can exert considerable influence over investee companies by exercising shareholder rights to encourage them to take ESG issues more seriously.

The rise of proxy advisory services, which help institutional investors decide how to vote in shareholder meetings, has bolstered activist ownership to improve reporting and transparency standards and enhance the sustainability of investors' portfolio companies. In March 2018, Sweden's AP7 pension fund and the Church of England Pensions Board joined Australia's Local Government Super in preparing a shareholder resolution calling on mining giant Rio Tinto to review its membership of coal lobby groups.

Of the subset of asset owners whose portfolios are partially managed externally, 76% of respondents to an OMFIF asset allocation survey in 2018 said they require external managers to consider environmental and sustainable issues in their investments. NBIM, for example, has five mandates for environment-related investments.

A third channel through which public investors can address ESG considerations is actively investing in sustainable assets. Several public pension funds have committed to increasing their green investments. These include Japan's Government Pension Investment Fund, CalSTRS, ABP, Sweden's AP funds and France's Ircantec, among many others.

Sovereign funds, many of which derive their revenue from oil, have come under pressure to diversify into green finance because of the weak oil market since 2014. African sovereign funds from Senegal, Nigeria and Morocco support green infrastructure initiatives such as solar farms and water projects. In the Middle East, Mubadala and the Abu Dhabi Investment Authority are among the world's largest sovereign investors in renewable energy and green infrastructure. In Europe, NBIM has a mandate to devote Nkr30bn-Nkr60bn ($3.7bn-$7.4bn) to 'environment-related investments'. Asian public investors such as China's State Administration of Foreign Exchange and the Hong Kong Monetary Authority's Exchange Fund are leaders in green debt funding.

While NBIM is an exception in that few institutions have formal targets, OMFIF's survey findings show that ESG is an important consideration for many. Most respondents (73%) said they invest in green or sustainable assets, the most common being green bonds. Since the European Investment Bank first issued such a bond in 2007, the market has evolved rapidly. The value of green bonds issued doubled for two consecutive years, reaching a record $155.5bn in 2017.

Obstacles to green growth

However, there are major obstacles to the expansion of sustainable finance initiatives. Although progress is being made, there is no international standard for what constitutes a green bond, nor is there a global monitoring mechanism to ensure compliance with existing frameworks.

The green finance market remains a minuscule part of overall assets. Total outstanding global green bond issuance was $221bn at the end of 2017, compared to more than $100tn for the total fixed income sector. Despite public investors' best intentions, much must be achieved at the policy level before green finance experiences meaningful growth. ●

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFIF. The themes in this article are explored further in *Global Public Investor 2018* and the OMFIF report 'Real Momentum: Global Public Investors and the Real Assets Market', in association with BNY Mellon, published on 20 June.

Overcoming 'tragedy of the horizon'

Capital markets play a leading role in fighting climate change

Louise Dudley
Hermes Investment Management

In 2015, Mark Carney, governor of the Bank of England, called climate change 'the tragedy of the horizon'. He was referring to how the impact of climate change will be felt beyond the traditional horizons of most actors, imposing costs on future generations that the current one has no direct incentive to fix.

Research shows that global temperatures will rise by more than two degrees by the end of the century unless serious action is taken. In this context, it is impossible to overestimate the importance of the 2015 Paris agreement. It unites the world in a single deal to tackle climate change by committing signatory countries to keeping the global temperature rise this century below two degrees, limiting emissions of greenhouse gases and transitioning to a low-carbon economy.

The Principles for Responsible Investment, the United Nations-supported investor network, has found that 74% of asset owners see climate change as one of the most important long-term investment trends, up 8% from 2016. Hermes Investment Management has first-hand experience of this. Clients are increasingly citing climate-related risk as one of the most prominent elements in the environmental, social and governance sphere.

Climate-related financial risk can broadly be divided into two categories – carbon risk, which relates to the transition to a low-carbon economy, and climate impact risk, which relates to the physical consequences of climate change. Climate-related financial risk may arise for myriad reasons, including changing demand for carbon-intensive exports, incentivising individuals or institutions to ignore risks, and changing investor appetite for carbon-intensive assets.

Transparency in business

Evaluating the impact of climate change and assessing carbon risk is an enormous task for investors. Capital markets must play a leading role in turning ambition into action. Several investor frameworks and initiatives have been established to accelerate the transition to a low-carbon economy.

Hermes is a member of, among other initiatives, the Portfolio Decarbonisation Coalition, Montreal Pledge, Transition Pathway Initiative and Climate Action 100+. The firm is committed to supporting the Task Force on Climate-related Financial Disclosures, which has published guidelines on how companies can report climate impacts in mainstream financial filings. This could help investors make more informed decisions that take into account climate risks and opportunities.

Transparency is key. Company disclosures on climate change have improved significantly overtime, but there are plenty of gaps. Hermes has improved its data procurement in this area, collaborated with climate change experts and held talks on climate risk.

Stewardship is another core element of Hermes' investment approach. The firm advocates for change in individual companies, as well as at a broader market level, to promote robust governance structures and ensure that proper principles are applied.

The wave of initiatives launched by the investment industry and other capital market participants shows that progress is being made. Monitoring the efficacy of these initiatives will be crucial to successfully addressing the climate challenge before it becomes a tragedy. ●

Louise Dudley is Global Equities Portfolio Manager at Hermes Investment Management. The views and opinions contained herein are those of the author and may not necessarily represent views expressed or reflected in other Hermes communications, strategies or products.

'Transparency is key. Company disclosures on climate change have improved significantly overtime, but there are plenty of gaps.'

Sustainability bonds a game-changer

Public investments and private capital can transform society

Frank Scheidig
Advisory Council

The path towards a sustainable economy is inconceivable without the involvement of capital markets. According to the International Energy Agency, $53tn will be needed between now and 2035 to limit global warming to two degrees Celsius above pre-industrial levels. This figure increases the longer it takes to implement the necessary steps. The investment needed to restrict global warming to less than two degrees, which should prevent catastrophic climate change, is accordingly higher. $90tn, or $6tn per year, will be necessary to finance the United Nations' sustainable development goals in the next 15 years.

'Those financing needs are too vast to go through a "central pot". The climate financing and the SDG funding gap can only be met by significantly increasing private sector participation with the help of capital markets,' says Marcus Pratsch, head of sustainable investment research at DZ BANK.

Sustainability bonds are a game-changer. With an estimated volume of more than $100tn, the global fixed income market has huge potential for facilitating the transition to a sustainable future.

In 2017 the green bond market celebrated its 10th birthday. The European Investment Bank issued a bond in 2007 that enabled investors to participate in the financing of projects that contribute to climate action. KfW, the German state financing agency, alone accounts for around 68% of the country's green bond market.

The market experienced a record year in 2017, with global issuance reaching $155.5bn according to the Climate Bond Initiative. In 2018, Pratsch expects the market to surpass the $250bn mark. The CBI's aim is to keep doubling labelled issuance volume to top $1tn by the end of 2020.

Market development

Sustainability is about more than just the green perspective, says Pratsch. The International Capital Market Association has published the social bond principles and the sustainability bond guidelines. DZ BANK has taken account of four dimensions of sustainability in its EESG analysis methodology since 2009: economy, environment, social and governance. Bond issuances can be used to finance projects with social objectives, mixed objectives (environmental and social) or a special theme, such as sustainable real estate. The market for social bonds officially kicked off in late 2014/early 2015 when the Spanish Instituto de Crédito Oficial issued the world's first product of this kind.

While the market for social bonds is a fraction of the size of the green bond market, it is expected to grow quickly. According to the International Capital Market Association, annual issuance of social bonds has grown more than 17 times since 2014, with the majority based on the social bonds principles.

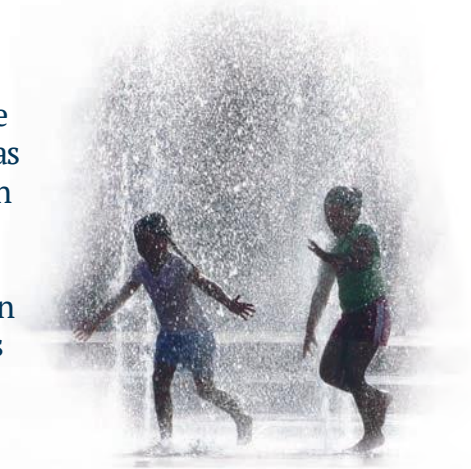
In March the Council of Europe Development Bank (CEB), the oldest such bank in Europe with an exclusively social mandate, issued its second euro-denominated social inclusion bond. The CEB contributes to the implementation of socially orientated investment projects in three ways. These are sustainable and inclusive growth, integration of refugees, displaced persons and migrants, and developing adaptation and mitigation measures against climate change. The proceeds of the recent issue will be used to finance social housing, education and to support micro-, small and medium-sized enterprises.

In April Caja Rural de Navarra, a regional co-operative bank that operates mainly in the Basque region, Navarre and Rioja, issued its second euro-denominated sustainability covered bond, using the proceeds to refinance loans granted for sustainable agriculture, renewable energy, energy efficiency, sustainable forest management, waste management, affordable housing, social inclusion, education and economic inclusion. As a co-operative bank that lends to traditionally underserved rural regions, Caja Rural de Navarra has a record of contributing to economic and social development, says Pratsch.

The positive momentum of successful issuances beyond a purely green agenda is expected to continue. Public investments alone are not nearly enough. Private capital must be mobilised to transform society. ●

Frank Scheidig is Global Head of Senior Executive Banking at DZ BANK.

'Annual issuance of social bonds has grown more than 17 times since 2014, with the majority based on the social bonds principles.'



Mobilising forward-looking finance

Urgency and opportunity in fighting climate change

Antoni Ballabriga
BBVA

The world today is characterised by a sense of urgency, but also of opportunity. We are in an age marked by major environmental, social and technological challenges, in which the private sector plays a crucial role.

These issues have become much more important in financial institutions' business models. Four forces have radically changed the thinking on sustainability in the last two years.

First, sustainability has become part of global political discourse through the United Nations' 2030 Agenda for Sustainable Development, its sustainable development goals and the Paris climate accord. Second is market opportunity. The sustainable development goals will account for a market of $12tn per year and expected annual investments between $5tn-$7tn by 2030. Third is the growing pressure on institutional investors to integrate environmental and social criteria into their investment policies. Fourth, regulation in the financial industry, both mandatory and recommended, has become more intense and strict.

Banks must reimagine what their purpose is in this environment. Their new goals must aim at having as positive an impact as possible on people's lives.

Pledge to change

Banks play a critical role in boosting sustainable development by channelling funds to projects on renewable energy, energy efficiency, waste management, water treatment and access to essential goods and services such as inclusive finance. They must help their clients to transition towards a low-carbon economy.

BBVA has ample experience in this field. Over the last few years the bank has offered clients innovative solutions for sustainable finance. In 2017, BBVA was the leading issuer of green bonds in Spain, with issuances amounting to €10.6bn. With the help of clients, it has grown into a pioneer in green loans and closed 2017 as the world's most active institution.

BBVA aspires to be a catalyst for change and will take even more ambitious steps, as illustrated by Pledge 2025, the bank's strategy around climate change and sustainable development published in February. This is an eight-year pledge built on three pillars: finance, management and engagement.

BBVA will mobilise €100bn in green and social finance, sustainable infrastructure, agribusiness, social entrepreneurship and financial inclusion. The bank has pledged that by 2025, 70% of the energy it contracts will come from renewable sources, while its direct carbon emissions will fall by around 68% compared to 2015. BBVA is also the first global bank to report its exposure to fossil fuels, which stands at 3.4% of total assets.

BBVA has agreed to involve all its stakeholders in boosting the financial industry's contribution to sustainable development. Given their scope, the sustainable development goals can only be met if we all commit to fight climate change. This requires awareness, shared knowledge, calls to action, dialogue and partnerships with all stakeholders, as well as international and sectoral collaboration.

These are the first steps on a long and necessary journey. BBVA believes there must a systemic change in the financial world. The future of banks is forward-looking finance. ●

Antoni Ballabriga is Global Head of Responsible Business at BBVA.

$12tn

Annual size of market from UN sustainable development goals

'Banks play a critical role in boosting sustainable development by channelling funds to projects on renewable energy, energy efficiency and waste management.'

Bridging Latin America's infrastructure gap

Lack of standardisation deters sustainable investment

Maria Tapia
Inter-American Development Bank

Infrastructure is probably the single most important factor for growth in Latin America and the Caribbean. Experts predict energy demand in the region will double by 2030 and that 90% of the population will live in cities by 2050.

Filling the region's infrastructure gap will require $300bn in investment per year, around twice the amount being spent today. In the light of countries' limited fiscal space, mobilising private finance is essential to meet this goal. Institutional investors have so far invested sparingly in infrastructure. Global assets under management stand at $84.9tn, of which $2.7tn are in Latin America and the Caribbean. Less than 1% of these assets are invested in infrastructure projects.

Speaking at the Climate Bond Initiative conference in March, Christiana Figueres, executive secretary of the United Nations Framework Convention on Climate Change, highlighted the huge opportunity to invest in infrastructure. This is especially the case in emerging markets; 60% of the urban space these economies will need during the next century does not exist. Figueres urged investors to direct resources towards low-carbon and climate-resilient infrastructure.

Defining sustainability

In 2016 the Inter-American Development Bank (IDB) partnered with Mercer Consulting to strengthen their relationships with investors and bridge the sustainable infrastructure gap in Latin America and the Caribbean. Despite growing attention among investors to environmental, social and governance issues, research conducted by the IDB and Mercer found that many are only now developing a formal approach to sustainable infrastructure.

Sustainability is an intricate concept and there is no consensus on what investing in sustainable infrastructure entails. Therefore, the IDB has developed a working definition of sustainable infrastructure that presents four main principles of sustainability covering economic and financial, environmental, social and institutional dimensions. The proposed framework suggests that each of these principles must be considered across the entire project cycle, including in the planning, design, construction and management of infrastructure.

To bolster sustainable infrastructure in Latin America and the Caribbean, the IDB is following a three-part strategy. First, promoting the definition of sustainable infrastructure among governments and the private sector. Second, stimulating markets through incentives such as tax credits and public-private partnerships. And third, mobilising private sector financing.

> 'Despite growing attention among investors to environmental, social and governance issues, IDB research finds that many are only now developing a formal approach to sustainable infrastructure.'

Innovative finance

To mobilise private sector resources, the IDB has created the UK Sustainable Infrastructure Programme in partnership with the UK department of business, energy and industrial strategy. The UK government is contributing £177m through a single donor trust fund, managed by the IDB. The fund's objective is to promote strategic private sector investments in sustainable, low-carbon infrastructure to help Latin American and Caribbean countries deliver their nationally determined contributions under the Paris climate accord.

Operations will focus on Brazil, Colombia, Mexico and Peru and target investments in transport, energy, water and waste management. The programme will draw on innovative finance, including blending non-traditional public and private finance, developing performance-based incentives, de-risking financial mechanisms, promoting new models of PPPs, and bundling smaller low-carbon projects to access capital markets.

Standardising sustainable infrastructure will simplify due diligence and make it easier to involve private investors. It will also improve transparency in the sector, which will minimise the credit risk of infrastructure projects and attract a larger spectrum of institutional investors.

The IDB will continue to encourage sustainable infrastructure investment at all levels, particularly from the private sector, as the best way to ensure that Latin American and Caribbean countries pursue low-carbon and climate-resilient growth. ●

Maria Tapia is the Lead Climate Change Specialist at the Inter-American Development Bank.

Asset management evolution

Hani Kablawi, CEO of Global Asset Servicing and EMEA chairman at BNY Mellon, and **Ben Robinson**, deputy head of research at OMFIF, discuss the evolution of the asset management industry over the past 20 years, monetary policy developments and the impact of fintech.

Ben Robinson: You have worked in the global asset management industry for more than 20 years. How has it changed and what are your clients' biggest concerns?

Hani Kablawi: There have been significant developments in both the structure of the asset management industry and the products it offers. Twenty years ago, the industry was still dominated by small and medium-sized managers who primarily offered active portfolio management services. Now there is far more concentration and index-based passive investment vehicles have come to the fore. Competitive pressures have propelled this change, stemming in part from technological innovation. In a digital world, those pressures continue to intensify and the competition has become more diverse. With the prospect of industry disruption from fintech firms and internet giants, asset managers are working hard to provide the immediacy, intimacy and seamless interface that their clients and customers have come to expect.

BR: Markets have experienced several shocks over the last 20 years, from the dot.com bubble to the 2008 financial crisis. How have these experiences shaped the approach to risk and collateral management?

HK: Over the years, global custodians have augmented safekeeping, settlement and corporate actions with additional services, such as regulatory monitoring and analytics. These are designed to support asset owners and asset management clients with risk mitigation. Our collateral management business has grown significantly since the financial crisis. This reflects various regulations that require an increasing number of transactions to be collateralised. This in turn presents our clients with opportunities. For example, high-quality liquid assets are in demand by market participants to post as collateral. The holders of these assets tend to be institutional asset owners, and can benefit from enhanced returns by lending HQLA. In a low interest rate environment, such incremental returns can help clients achieve their portfolio objectives.

BR: Central bank actions since 2008 have lowered bond yields while providing large volumes of global liquidity and boosting asset valuations. What will be the consequences of policy normalisation in the US and a gradual reduction in the Federal Reserve's balance sheet?

HK: The scale of quantitative easing after 2008 was unprecedented and the normalisation of policy – even if via gradual and predictable steps – could be as significant. The QE cushion not only boosted risk asset prices; it distorted capital markets while suppressing volatility. This is because any bad news was tempered by the possibility that central banks would ease again. Greater volatility will create more risk but also opportunities. Tightening will have different impacts on different market sectors and could create a richer environment for active investors.

BR: Infrastructure and real estate have been among the fastest-growing asset classes for institutional investors. How are they adapting to these assets?

HK: Institutional investors have been seeking a wider range of investment opportunities to provide stable, inflation-adjusted sources of income. This has been fundamental to the shift to real assets, as demonstrated in the BNY Mellon/OMFIF survey published this month on real asset investment by public investors. Asset managers and asset owners are creating separate real estate and infrastructure portfolios, increasing their exposure to overseas real assets, getting involved in unlisted and greenfield projects and targeting larger deals. As central banks scale back QE, thereby increasing bond yields, we might expect an increase in the number of real asset investors looking for exits. However, many investors remain committed to real assets and view a potential market downturn as a chance to increase their holdings.

BR: New technologies, such as blockchain, are upending business models. What are the biggest changes you anticipate in the asset servicing industry over the next five years?

HK: Technological innovation is setting the pace of change for asset servicing. Digital technology can improve efficiency, reduce settlement cycles, enable real-time information sharing and analysis, increase system resiliency and enhance client service. We can expect further competition, including from established technology providers, while the safekeeping of new asset types such as digital keys and cryptocurrencies will create interesting challenges. For instance, BNY Mellon plays a significant role in the US government securities clearing and repo markets. Our recent platform upgrade includes the immutability feature of blockchain to safeguard data. Providers who embrace innovation will continue to play a vital role in financial services.

'The scale of QE after 2008 was unprecedented and the normalisation of policy – albeit via gradual and predictable steps – could be as significant. The QE cushion not only boosted risk asset prices; it distorted capital markets while suppressing volatility.'

Profile

Education: Kablawi earned his bachelor's and master's degrees in finance at the University of Iowa.

Career: Kablawi is a member of BNY Mellon's executive committee, the organisation's most senior management body. Since joining BNY in 1997, he has held several client, regional and business management roles in New York, Abu Dhabi, Dubai and London. Kablawi previously worked for HSBC and Mashreq Bank in New York.

Worldview

This month's expert analysis

European Commission boosts blockchain

Embracing cross-border collaboration and harmonisation

Pēteris Zilgalvis
European Commission

On 8 March 2018 the European Commission published its 'FinTech action plan: For a more competitive and innovative European financial sector'. Among the innovations that it addresses are blockchain and distributed ledger technologies. While being technology neutral in its approach to regulation, the commission is using its research, innovation programmes and 'digital single market' policy frameworks to promote the uptake of promising technologies in the European Union.

There have been many blockchain pilot projects in areas such as payments, securities, deposits, lending, raising capital, investment management, trading and post-trade, as well as trade finance and reporting. The successful application of this technology will require deep collaboration between incumbent financial institutions, innovators and regulators.

In February the commission launched the EU blockchain observatory and forum, which will run for two years. These will monitor trends and developments in financial technology, pooling expertise to address sectoral and cross-sectoral issues and exploring cross-border cases of blockchain use. The forum and observatory will also examine the feasibility of a public EU blockchain infrastructure to develop cross-border services.

With the support of the EU observatory and forum and the European standardisation organisations, the commission will continue to assess legal, governance and scalability issues and support harmonisation efforts. The commission has connected with the International Standards Organisation's committee on blockchain and distributed ledger technologies, and European standardisation organisations have been invited to take on a leadership role in identifying specific EU features for blockchain.

Digital single market

The commission has already taken steps to set up a cross-sectoral EU blockchain initiative. This will enable early adoption of blockchain technology in the financial sector and increase Europe's competitiveness and technological leadership. The initiative will complement other elements of the commission's action plan, notably the suitability check of EU financial legislation. It will rely also on pilot actions supported through Horizon 2020, the largest EU research and innovation programme that makes €77bn in funding available between 2014-20.

The European Blockchain Partnership, which was signed by 22 countries in April 2018, is a key part of these initiatives. The partnership will facilitate information sharing between member states and help them prepare for the launch of EU-wide blockchain applications across the digital single market.

The partnership aims to identify, by September 2018, a set of public sector services that would benefit from a blockchain services infrastructure. By the end of 2018, technical specifications will be prepared and essential framework conditions, including compliance with regulatory requirements, will be identified. Whether blockchain can be deployed and funded as a digital services infrastructure through the Connecting Europe Facility will also be assessed.

Blockchain and distributed ledger technologies will transform the way information and assets are exchanged, validated, shared and accessed. Europe, a hotbed for digital expertise and cross-border collaboration, will play a leading role in the development and application of these technologies. ●

Pēteris Zilgalvis is Head of the Start-ups and Innovation Unit in the European Commission's digital single market directorate.

Hazards of initial coin offerings

Regulatory coordination needed to attract institutional investors

Bhavin Patel
OMFIF

The access to distributed ledger technology that underpins ripple, ethereum, bitcoin and other cryptocurrency platforms has allowed companies to create their own digital tokens that can be offered to the public to generate funds.

These 'initial coin offerings' provide an alternative source of venture capital for start-ups and encourage innovation in how these digital tokens can be used. Between January 2017-February 2018, ICOs raised $4.5bn, outweighing venture capital investment in blockchain-related start-ups more than threefold.

In contrast to initial public offerings on stock exchanges, ICO issuers do not sacrifice equity for financing. ICOs also allow for borderless online sales with fewer points of friction. They typically bypass legal, jurisdictional and business hurdles, and investment is promoted directly to a global investor base. However, investors face major risks.

There is a lack of market security; 81% of ICOs are fraudulent, according to ICO advisory firm Satis Group. Investors buy into the promise of a digital infrastructure's utility and significant returns without having access to the underlying product. They usually can't consult business plans or accurate financial information about the issuer. These hazards are exemplified by the fact that only 8% of all cryptocurrencies make it on to exchanges.

Issuers are often anonymous and difficult to trace, making it easier for fraudsters to exit the market with investors' capital. In addition, the method of investing adds a layer of 'currency risk', as investors must buy into ICOs through existing cryptocurrencies with high price volatility. This could make cashing out into a fiat currency especially costly.

As most digital tokens are issued without being registered as securities, investors are denied a number of legal rights. There are no shareholders rights, and a lack of liquidity preference in the event that the company defaults or becomes insolvent. This means ICO holders are unlikely to reclaim their initial investment. Furthermore, the absence of antidilution protection allows issuers to release additional tokens to generate more funding, diluting the value of initial investors' holdings.

One way in which investors can find protection is to sell their tokens very soon after an ICO. This is a strategy that many venture capitalists follow to insure against devaluation. However, this only increases market volatility.

Regulatory arbitrage

Determining what legal and supervisory framework a cryptocurrency falls under depends on how regulators classify it among asset classes. International coordination on this is lacking, and the various jurisdictions that do regulate cryptocurrencies categorise them in different ways. Others use a case-by-case approach to determine a cryptocurrency's asset class.

These inconsistencies create the risk of regulatory arbitrage. Competition between regulatory regimes, as countries try to attract innovative companies, exacerbates this divergence between markets.

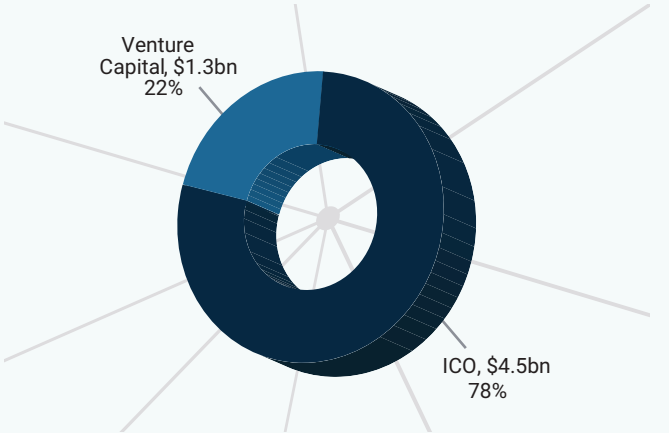
In the US and Canada cryptocurrencies fall into legal grey areas. The European Union is yet to formalise its approach, as the European Securities and Markets Authority is assessing how to apply Mifid II rules to digital assets. The Swiss Financial Market Supervisory Authority, Bermuda Monetary Authority and Gibraltar Financial Services Commission define cryptocurrencies as a separate asset class to which new regulations should apply.

Greater regulation will have a positive effect on ICOs and the cryptocurrency market only if it provides certainty about how markets will operate globally. Strengthening investor protection by providing assurances and improving transparency during ICOs could attract institutional investors, which would generate liquidity and support market stability. ●

Bhavin Patel is Economist at OMFIF.

ICOs critical for funding blockchain innovation

Blockchain-related start-up funding, % and $bn, Jan 2017-Feb 2018



Source: Crunchbase, OMFIF analysis

Inflation was not dead but just resting

Wider corporate credit spreads point to difficult times

Bob Baur
Principal Global Investors

Despite three decades of economic lull, inflation is again drawing breath. Many point to wage growth and a robust economy as the reasons for its revival. While that is true, there is a deeper, long-term structural trend at work – globalisation's downward pressure on inflation is fading.

Globalisation's narcotic effect on inflation began in the 1980s. As obstacles to global trade dispersed, hundreds of millions of low-wage, underemployed workers in developing countries became part of the global workforce. These lower labour inputs kept prices low for consumers in developed countries. Meanwhile, the massive infrastructure investment in developing countries led to an oversupply of goods. Then, beginning in 2007, a series of financial crises arose to stifle inflation and fill the world with a pervasive fear of low growth and a dread of deflation.

But inflation wasn't dead, just resting. Access to underemployed, low-cost labour is dwindling, pushing production costs and consumer prices higher. For globalisation to keep inflation under pressure, the world would need another 1bn underemployed, low-wage workers. In the short term, it's difficult to see where they would come from. Wages in China have surged at double-digit rates for almost two decades. Manufacturing costs in the US are nearly the same as in China.

Weakened global forces

With the 2008 financial crisis over and a global economic expansion underway, people are spending again, and demand is rising. Developed markets are using their excess capacity, which had been a drag on inflation. And while inflation isn't expected to spike, most central banks are likely to reach their 2% targets this year.

With the weakening of global forces that bridled interest rates and inflation, businesses, economies and investors alike should prepare accordingly. Businesses should begin to see more pricing power, pushing wage growth higher. For investors, solid long-term financial returns will be harder to find as the long subsidy from monetary largesse ends. Central banks should find it easier to hit their inflation targets. That could push up the neutral rate of interest, so it may take an extra rate increase or so to normalise monetary policy.

Yields on corporate credit will rise from their current low levels, which should widen the spread between corporate and treasury yields somewhat. Wider spreads between higher- and lower-rated credits can be expected as well. As such, central banks may need to watch for widening corporate credit spreads as a harbinger of difficult economic times. Governments and sovereign funds may find it easier to fund their long-term liabilities with somewhat higher long-term yields.

As the pallid complexion of inflation grows pink with life once again, pundits will need a new paradigm. 'Lower for longer' will be shorter than they expected. Maybe they can replace it with 'languish no longer'? ●

Bob Baur is Chief Global Economist at Principal Global Investors.

'With the weakening of global forces that bridled interest rates and inflation, businesses, economies and investors alike should prepare accordingly.'

Making returns on knowledge

How innovation can flow from globalisation

Otaviano Canuto
Advisory Council

The April issue of the International Monetary Fund's World Economic Outlook included a chapter on how globalisation has helped technology leaders' knowledge spread faster. Cross-border technological diffusion has not only contributed to rising domestic productivity levels in advanced and emerging economies, but also facilitated a partial reshaping of the innovation landscape. Some recipient countries have become significant new sources of research and development as well as patents.

More trade, foreign direct investment and international use of patents have disseminated knowledge and technology across borders. This diffusion can lead to increases in average outputs at relatively low costs. Knowledge flows from abroad can have an impact both on productivity, through the adoption of foreign technologies in the production process, and on innovation, when combined with domestic R&D. The WEO estimates that in emerging market economies, 'from 2004 to 2014, foreign knowledge accounted for about 0.7 percentage point of labour productivity growth a year, or 40% of observed sectoral productivity growth, compared with 0.4 percentage point annual growth during 1995–2003'. According to the report, these results remain robust even when China is excluded, indicating that productivity effects were broad-based among emerging market economies.

International sources of technological innovation are changing, as R&D expenditures skyrocket in China and stocks of international patents pile up in South Korea. These countries have joined traditional leaders in sectors such as electrical and optical equipment and, especially South Korea, machinery.

> 'International sources of technological innovation are changing, as R&D expenditures skyrocket in China and stocks of international patents pile up in South Korea.'

This has happened even as, since the early 2000s, frontier economies have gone through a slowdown in the increase of labour and total factor productivity, a measure of how efficiently inputs are being used in the production process. These economies have also experienced slower growth in patenting and, to some extent, lower R&D investment.

The WEO highlights the positive effects of heightened international competition on innovation and technological diffusion. This could be considered an additional channel through which globalisation is reinforcing incentives to innovate and adopt technologies from abroad.

Local prerequisites

Simple interconnectedness does not automatically spark productivity increases and local innovation. Any application of technology needs locally specific content that cannot be acquired or transferred by means of textbooks or other codifiable forms of knowledge transmission. This knowledge cannot be made explicit, such as through the use of blueprints, and thus cannot be perfectly diffused as either public information or private property. It must be developed locally.

Production, technology adoption and invention requires a relatively high level of such idiosyncratic knowledge and local capabilities. It is typical for latecomers to start from production and technological adoption and only then move on to invention. That has been the case in South Korea and China. These countries are developing their innovation capabilities after intense learning through using and adapting existing technologies.

Success depends on access to finance, infrastructure, skilled labour, and good managerial and organisational practices. In the absence of these factors, returns from investing in the development of capabilities are likely to be low. Solutions must be found to market failures that generate disincentives to the accumulation of knowledge. The transaction costs associated with doing business, such as trading across borders, hiring and enforcing contracts, also cannot be too high.

> **40%**
> Observed sectoral productivity growth in emerging markets between 2004 and 2014

This beneficial environment is not widespread, which is why there have not been large changes in the international innovation landscape. It also explains what Xavier Cirera and William Maloney, economists at the World Bank, have called the innovation paradox. Low levels of innovation-related investment in developing economies do not correlate with the high returns thought to accompany technological adoption and catch-up. Globalisation may spread knowledge. Profiting fully from that knowledge requires a further effort. ●

Otaviano Canuto is an Executive Director of the World Bank. The opinions expressed in this article are his own.

Brexit uncertainty dominates UK economy

Slowdown while country is still a member of the EU is worrying

Vicky Pryce
Advisory Board

First, the good news. A mini-boom in global trade in the last couple of years has been favourable for UK exports of goods and services, especially to the euro area. The fall in the pound since the referendum on leaving the European Union in June 2016 has helped. Employment is at record levels. The current government budget shows a surplus for 2017-18. Despite the trebling of the UK's debt since the financial crisis, markets are still prepared to lend at very favourable rates and the cost of servicing the debt is similar to what it was in 2008. That is important, as the government had to borrow an extra £42.6bn in the financial year that just ended and the debt to GDP ratio has risen to just over 86%.

And now for the bad news. In normal circumstances this happy combination would have led to strong growth in the UK economy. Instead, last year the UK moved to the bottom of the league table of G7 major economies in terms of economic growth.

In May, the Bank of England postponed its widely anticipated increase in interest rates from the 0.5% level it had raised it to in November 2017 after first quarter GDP growth of just 0.1%. It also revised its own growth forecast for this year down to 1.4%, slightly below the IMF's April forecast of 1.6%.

The independent Office for Budget Responsibility expects the UK will find it difficult to achieve economic expansion of more than 1.5% in any year between now and 2022, the end of the current parliamentary period.

The uncertainty caused by Brexit and the squeeze of real disposable incomes as a result of the pick-up in inflation since the referendum are already evident. Mark Carney, governor of the BoE, has stated that, unless sentiment improves, the UK will have lost about 2% of GDP by the end of this year compared to where it would have been had there not been a referendum.

But at his press conference after the rate decision, Carney still talked about likely increases in interest rates later in the year. The bank believes the economy's output gap has pretty much disappeared. It may be right. Business investment remains weak and productivity growth has been well below the rates achieved in the 10 years before the 2008 financial crisis. In that environment, rising demand would tend to have a stronger impact on inflation and this would need to be tackled by higher rates.

Impact of inflation

Most of the rise in inflation to above the 2% target has been due to the weaker pound since the referendum. But even that impact is now lessening as sterling's depreciation is working itself out of the year-on-year comparison.

UK households, which were encouraged to borrow heavily when rates were cut to record lows after the referendum and by a massive injection of liquidity by the BoE, are now more cautious with their borrowing and spending.

At the same time credit conditions, particularly for small and medium-sized enterprises, are tightening. Manufacturing production growth seems to have ground to a halt in the last few months while service growth is slowing down. Margins are being squeezed in many sectors and cash flow problems down the supply chain are magnified by late payments.

The UK may be experiencing just a momentary pause reflecting global worries about a new trade war. If uncertainty about Brexit and world trade lifts, the result will be faster growth. But the slowdown in the UK has occurred while it is still a member of the EU and a transition deal to at least the end of 2020 seems likely.

In view of persistent worries about future trade arrangements with the EU, it would be a brave person who could claim to predict UK's economic path. ●

Vicky Pryce is Board Member at the Centre for Economics and Business Research.

'The independent Office for Budget Responsibility expects the UK will find it difficult to achieve growth of more than 1.5% in any year between now and 2022.'

Picture: Land Rover MENA

Women face pension poverty

Gender pay gap, cultural factors and longevity lead to lower savings

Suzanne Bishopric
Global Sovereign Advisors

While there has been intense focus on general pension underfunding throughout the developed world, many have overlooked how much worse the problem is for women.

When greater numbers of women entered the workforce in the 1970s, they typically earned only 60% of a man's income, so it should not come as a surprise that their retirement savings are lower. At the time, authorities assumed women would achieve income equality in short order, but their income has remained lower than men's, and pension systems have made no adjustment for women's different career paths. The World Economic Forum's 2017 report projected that it would take 217 years before women would be making as much money as men.

Because retirement funds are built up from gradual savings from income, it is obvious that those who earn less money will accumulate smaller pension pots. Unfortunately, a number of other factors have stacked the equation against women.

Unpaid gaps in employment are one of the biggest reasons for the reduced retirement savings of women. The average woman in the US absent is from the paid workforce for about 5.5 years to tend to children. Another, less noticeable, gap occurs because women tend to marry older men. When the husband retires, the wife tends to leave the workforce before her statutory retirement age.

It gets worse when one considers who looks after for elderly relatives, because women are not paid for the care they provide to family members. However, when women reach the age when they need care themselves, they have often been widowed, and so must pay for the services they once provided for free to others. Compounding this problem is the fact that women are disproportionately afflicted by the chronic disabling diseases of old age.

Longevity creates the risk of outliving one's savings. At present, a woman will live about five to seven years longer than her husband, yet will have to support herself with pension savings estimated to be 30%-40% lower than his.

Retirement solutions

Urgent remedies are needed. Some solutions would require a cultural revolution, such as encouraging women to marry men who are younger, so wives won't be tempted to drop out of the workforce to accompany their husbands into retirement.

First, to correct salary injustices of the past, any social security scheme or pension fund that was based on income should be grossed up to adjust for women's lower pay, until women are shown to earn the same amount as men. Thus any pension payment based on a woman's work when women were earning 60% of a man's salary should be divided by 0.6, or increased by the fraction that makes it equal with that of her male peers. Without this kind of adjustment, pension systems would effectively perpetuate gender wage gaps of the past.

Second, support mechanisms such as paid maternity leave or affordable childcare should be provided to families with young children, to avoid forcing mothers to choose between jeopardising their careers and neglecting their children. Enabling mothers to stay on the payroll, even if only part time, not merely generates income but also keeps women's skills and professional connections current.

Third, some allowance for unpaid childcare or eldercare services should be incorporated into retirement schemes, such as minimum contributions to pension plans for persons caring for infants and elders.

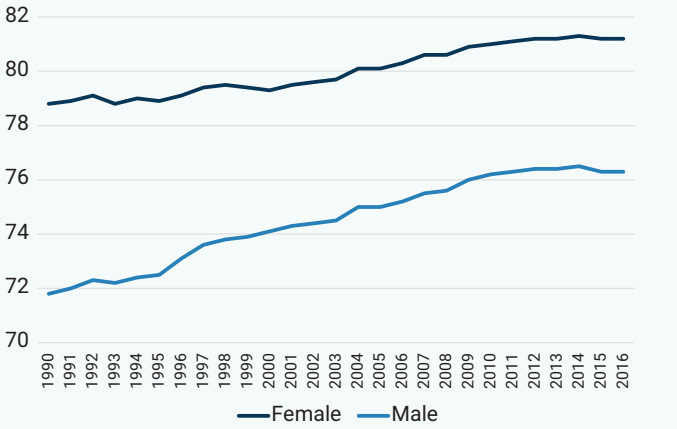
The old saying 'a woman's work is never done' left unspoken that a woman's work was never paid. Now that women have joined the workforce, it is time to rebalance the workload.

Once women attain paycheck parity and men share equally in the joys and tribulations of the home front, it will be far easier to balance the pension equation. ●

Suzanne Bishopric is Managing Partner at Global Sovereign Advisors and was formerly Treasurer at the United Nations and Director of its Joint Staff Pension Fund.

Women on average live five years longer than men

Life expectancy at birth in the US, number of years, by gender



Source: World Bank, OMFIF analysis

Williams positioned for Fed leadership

Incoming New York Fed chief rethinks policy approach

Darrell Delamaide
US editor

With US monetary policy on a path towards at least two more quarter-point rate increases this year, the Federal Reserve is rethinking how it formulates policy. Much of this emanates from John Williams, the San Francisco Fed chief who takes over the powerful New York Fed on 18 June.

Williams seems to be positioning himself to take on a leadership role. There is something of a vacuum at the Fed, with the Washington-based board of governors reduced to just three members. Jay Powell, who took over as chair in February, is the first non-economist in charge for nearly four decades.

Whatever market savvy Powell brings, he simply does not have the intellectual clout of his immediate predecessors, Janet Yellen and Ben Bernanke. This is what Williams, with a doctorate from Stanford University and a 24-year Fed career, can offer.

The New York Fed, which executes all the market transactions to implement monetary policy, has always enjoyed a privileged position. Before Congress revised the Federal Reserve Act in 1933 to strengthen the board, the New York bank *was* the Fed.

Today the New York Fed chief is the only regional bank president who is a permanent voting member of the policy-making Federal Open Market Committee. In fact, the New York chief is ex officio the vice-chair of the FOMC, and effectively the second most powerful person at the Fed.

Flexible targets

The Fed's fundamental rethinking includes Williams' idea of replacing the 2% inflation target with a 'price-level target'. The Fed would commit to a certain level of prices rather than a steady rate of inflation, allowing it to intervene sooner if it is consistently missing its target, as has been the case not only in recent months, but in recent years.

Raphael Bostic, head of the Atlanta Fed, seems to agree with the concept. He has noted that a flexible price-level target is consistent with a long-range inflation target of 2%. In his view, the Fed would intervene if there was a 5% deviation from the price-level path in either direction. 'Price stability is in my view achieved if people can have confidence that the purchasing power of the dollars they hold today will fall within a certain range at any date in the future,' he wrote in his blog in April.

Williams' real obsession, however, is the natural rate of interest, or 'r-star'. He believes this natural rate is much lower now than it has been in the past, at around 0.5%. If inflation is running at 2%, then optimum interest rates would be 2.5%. In short, after the increase in rates to 1.5%-1.75% in March, the Fed is near that optimum rate and should stop raising rates when it reaches it.

'In a world of low r-star, policy-makers, banks, businesses, and households all need to plan for lower interest rates than they've experienced in decades past,' Williams said in May at a meeting of the Economic Club of Minnesota in Minneapolis.

Also in Minneapolis, Williams predicted the end of forward guidance. 'We can't keep talking about policy normalisation once we're around what we think of as a neutral interest rate,' Williams said, referring to the level of interest rates that neither slows nor speeds up the economy. 'So, I think this forward guidance, at some point, will be past its shelf life.'

This didn't stop him from giving his own forecast about inflation. Wage growth has been slow to ramp up, he said, despite tightening in the labour market. 'It is a reason, a serious reason, that I'm not that worried about inflation, or wage inflation, or price inflation, being on the cusp of an outburst,' Williams said.

Richard Clarida, Columbia University economist and Trump's nominee for Fed vice-chair, told senators at his confirmation hearing that he had reservations about the Fed's quantitative easing. While it made sense when introduced at the outset of the 2008 financial crisis, subsequent extensions were more questionable, he said.

Clarida's confirmation would bring another academic economist to the FOMC. But he would lack Williams' familiarity with the Fed. At 55, Williams could well look forward to one or two terms of a Powell chairmanship, and then a shot at the top job himself. ●

Darrell Delamaide is a writer and editor based in Washington.

> 'Whatever market savvy Powell brings, he simply does not have the intellectual clout of his immediate predecessors, Janet Yellen and Ben Bernanke. This is what Williams, with a doctorate from Stanford University and a 24-year Fed career, can offer.'

> **2.5%**
> Optimum interest rate if inflation runs at 2%, according to Williams

US risks alienation in China deal

Washington's allies suffer from deficit reduction plan

Ben Robinson
OMFIF

President Donald Trump has been more consistent on trade policy than any other area. Yet it is increasingly difficult to discern what 'success' would look like in his attempted redrawing of China-US trade relations.

On 19 May Washington and Beijing issued a statement detailing measures to reduce the $337bn US bilateral deficit, Trump's greatest single grievance. China agreed to 'significantly increase' its purchases of US exports, especially from the agriculture and energy sectors, supplementing a previous commitment to purchase more US semiconductors. The announcement was enough for Washington to postpone the imposition of tariffs on $150bn of Chinese exports.

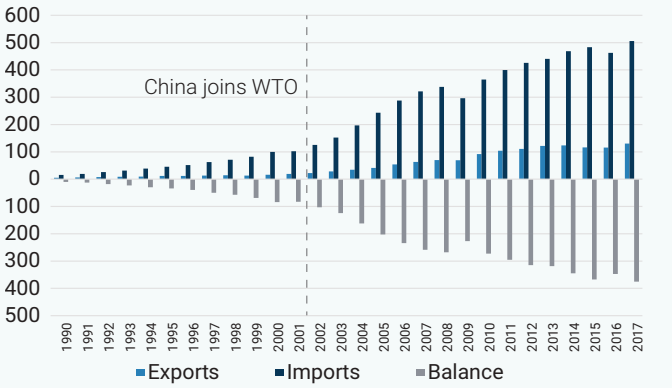
Beijing had threatened to retaliate to the tariffs, raising the possibility of a trade war. The latest announcement has therefore been met with relief. But it raises more questions than it answers.

The agreement hardly touches China's large industrial subsidy programme, which contributed to the high volume of low cost steel and other goods finding their way to US markets that sparked trade squabbles last year. Nor does it address the protection of intellectual property, the main concern for US businesses. Indeed, Trump's plan to lift a ban on sales of US parts to ZTE, a Chinese telecommunications group, was seen by many as capitulation to Beijing.

Fundamentally, the agreement does not solve the cause of the US deficit (leaving aside the issue of whether deficits actually are a bad thing or not). A country's trade balance is primarily determined by its level of domestic savings and investment. Nothing in the US-China agreement, nor other parts of Trump's policies, tackles the US's low savings to investment rate. In fact, Trump's tax cuts and spending plans are likely to widen the deficit further. The administration seems to be pursuing two contradictory policies. It is Washington's allies who have the most to lose.

US deficit reaches historic high in 2017

Bilateral goods trade balance with China, $bn



Source: US Census Bureau, OMFIF analysis

Unhappy allies, bold rivals

To accommodate the increase in US imports, Beijing will have to reduce its imports from elsewhere. Many of Washington's Asian allies are key suppliers of semiconductors to China, including Japan, South Korea and Taiwan. Chinese imports from these countries may fall, creating difficulties for their governments that stem directly from Trump's 'America first' agenda.

The agreement with the US has bolstered China's strategy of playing countries off against each other. By pursuing its goal of deficit reduction, Washington has jeopardised its allies' exports to China. This may encourage those countries to prioritise their national interests in future dealings with Beijing, at the expense of regional cohesion.

After the US, China's largest agricultural import suppliers are Brazil, Australia, Canada, New Zealand and Argentina. All but the latter are historical US allies that have suffered since the end of the commodity super-cycle in 2014 and placed their hopes on boosting exports to China. If these countries feel the US is negatively affecting their ability to do so, they may seek to strengthen their relationship with China in other ways. Beijing is likely to benefit as traditional allies compete for China's beneficence.

The move could also embolden US rivals. The agreement to increase energy imports from the US directly challenges Russia's goal of supplying more gas to China, as Moscow looks to diversify its export base away from an increasingly unfriendly Europe.

Russia is building a system of pipelines to supply gas to eastern China. Increased competition from US exports means it may face significant pricing pressures, forcing it to look elsewhere. Moscow may focus more on strategic projects with select European countries through the proposed Nord Stream 2 and South Stream pipelines – both of which the US opposes. Russia could likewise seek to increase co-operation with Iran's energy industry, against which the US plans to reimpose sanctions.

Although Trump may declare victory over the deficit, his actions create a wider range of issues that are likely to strengthen Beijing and weaken Washington. ●

Ben Robinson is Deputy Head at OMFIF.

The chart

Each month we take a look at a chart from the world's central banks. This month, the South African Reserve Bank.

The composite leading business cycle indicator dipped slightly in March from a six-year high of 108.3 the previous month, breaking an upward trend that began in mid-2017. This is in line with real GDP growth in the final three quarters of last year, which was consistently above 2% following a contraction in the first quarter. The South African Reserve Bank publishes the indicator, updated monthly and adjusted seasonally, as a projection of economic growth based on a varied set of 11 contributory indicators, including interest rate spreads and changes in the real economy.

South Africa's economic outlook improving

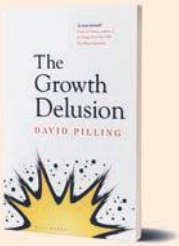
Composite leading business cycle indicator, Indexed: 2015=100

Source: South African Reserve Bank, OMFIF analysis

The World Cup numbers

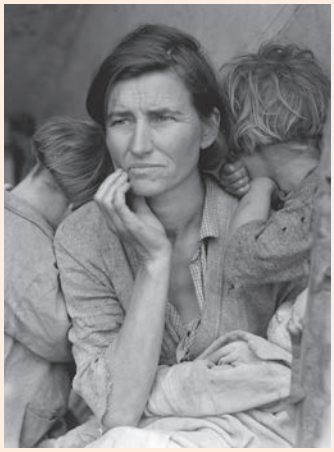
Humbling reminder of economics' shortcomings

Ben Robinson



FOR two centuries the world's finest physicists struggled to devise ways to measure 'luminiferous aether' – the invisible, nonreactive and in all other ways undetectable medium through which light waves were thought to travel. Then in 1905 Albert Einstein showed that it doesn't exist. If distinguished scientists, whose discipline is founded on empirical observation and objectivity, can be misled by a concept for so long, other disciplines must be equally vulnerable to error.

Gross domestic product, a single statistic used as the fundamental measure of growth, policy success and national wellbeing, is one of economics' most problematic concepts. Yet, as David Pilling explains in *The Growth Delusion*, GDP remains 'the denominator in many of public policy's most important ratios'. The result is occasionally contradictory and, in some cases, damaging policy choices.



GDP was devised in the 1930s to measure the economic impact of the great depression. ***Picture:*** *Florence Owens Thompson, the 'Migrant Mother', photographer Dorothea Lange's famous depiction of the era.*

The issues with GDP fall into three main categories. First, it was devised in the 1930s to measure the economic impact of the great depression. It was based on production and output statistics collected through surveys of factories, farms and mines. The methodology has changed little over the decades, but the nature of economic activity has shifted profoundly.

It is much more difficult to measure the intangible, technology-enabled, service-based economy by these methods than an economy based on 'things you can drop on your foot'. In fact, internet-enabled services destroy growth according to conventional GDP figures. This is because many things that were previously paid for, including entertainment, news and communication, are now essentially free, and the marginal cost of production has fallen to zero. There have been substantial advances in quality, and we are able to do much more with less, which improves welfare. GDP fails to capture this.

Second, informal and unpaid work is not counted in GDP. But in many economies, particularly across the developing world, this is the basis of economic activity. As Africa editor for the Financial Times, Pilling has seen this absurdity first hand. He contrasts official figures for Kenya, which suggest national income per capita is less than $1 per day for half the population, with the fact that more than 80% of the adult population owns a mobile phone. The official data fail to capture the 'kiosk economy', where 'transactions are made beneath the radar of the taxman or the statistician'.

Third, GDP says nothing about wellbeing, happiness or sustainability. It measures the flow of what is produced but ignores the stock of what may be depleted in the process or the benefits of putting off consumption to a later date. Inefficient production that uses more inputs adds more to GDP. The cost of cleaning up environmental damage resulting from these inefficient practices also adds to GDP. An efficient country, by contrast, may be penalised with a smaller GDP.

Measuring 'wealth' (the net stock of assets) rather than income derived from drawing down those assets would force policy-makers to reassess the primacy of GDP. However, difficulties in valuing natural resources or measuring quality of life make this impractical; we are stuck with an imperfect measure.

Pilling does not argue for GDP to be scrapped. There is no obvious replacement and it serves a valuable purpose. The problem lies in making it '*the* number we use to define success'. As Robert Kennedy lamented, it measures everything 'except that which makes life worthwhile'.

Pilling's solution is simple. Look at per capita growth, median income and measures of inequality and well-being alongside GDP for a better idea of what is happening. It is not a novel idea, but by highlighting GDP's many flaws and detailing the absurdities that its pursuit can lead to, *The Growth Delusion* serves as a humbling reminder of economics' shortcomings.

> 'Inefficient production that uses more inputs adds more to GDP. The cost of cleaning up environmental damage resulting from these inefficient practices also adds to GDP. An efficient country, by contrast, may be penalised with a smaller GDP.'

For a discipline that often claims to be a science, the inability to accurately measure growth is a serious deficiency. By focusing more on 'what actually matters' and less on GDP for its own sake, we may all become richer – though not, perhaps, in ways that conventional economics has much to say about. ●

Ben Robinson is Deputy Head of Research at OMFIF.

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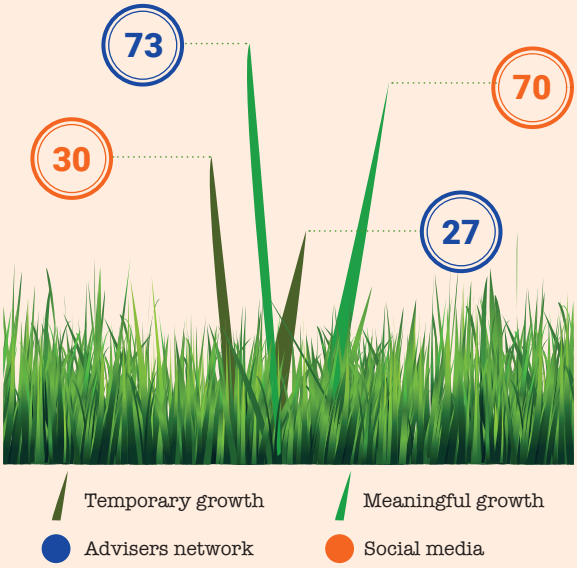
Advisers network poll

Positive view of green bonds' future prospects

Institutional support crucial for accelerating drive on sustainability

Likelihood of growth in green bonds, % of responses



The poll for this month focuses on the rise of green bonds in 2018. Participants were asked **'Green bond issuance is hitting record levels this year. Is this a sign of meaningful future growth, or is it just temporary?'**

Of those who responded to the advisers network poll, 73% believe the issuance levels recorded this year are not a fad. Commitment to green projects through recent United Nations directives and the 2015 Paris agreement were popular explanations for the pick up in sustainable investment. Even so, some expressed caution that full institutional support in areas such as carbon pricing is needed before high levels of growth can occur.

On the other side, 27% of advisers suggested there would be only temporary growth. Investors' need to gain the highest possible yields was given as a strong reason for why green bonds, which generally offer lower returns compared to other assets, may struggle to become more popular. OMFIF's online poll echoed the result of the advisers network, with 70% of voters predicting meaningful growth in green bond issuance.

Increased issuance is a sign of meaningful future growth. The same will be seen for social bonds.

Olivier Rousseau, Fonds de réserve pour les retraites

The success of green bonds will depend on their return. Even the strongest supporters will not buy investments that have low returns.

John Kornblum, former US diplomat

Growth will be temporary unless carbon pricing is given teeth globally to support demand.

Irena Asmundson, California Department of Finance

Green bonds are just an allocation of total investment in bonds. As a percentage of total bond investment I only see a gradual increase.

Paul Newton, London & Oxford Capital Markets

This year's increase in issuance is a sign of substantive and durable future growth.

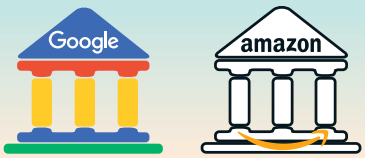
Hans Blommestein, Vivid Economics

With the G20, central banks and regulators continuing to support the green sector, this is the start of a long run shift towards sustainable finance.

Stuart Mackintosh, Group of Thirty

July's question:

With companies like Amazon and Google beginning to offer similar services as banks, should 'big tech' be brought under the same regulations?



Chief Operating Officer of OMFIF Ltd

City of London, Competitive + Benefits

OMFIF is seeking to employ an experienced Chief Operating Officer to help reinforce Company effectiveness and performance as the No.1 independent think tank for central banking, economic policy and public investment. This position calls for a person of authority and energy with operational management acumen and ability to forge a cohesive team spirit in a dynamic, commercial environment involving worldwide interactions with many public and private sector institutions.

The successful candidate will report to the Managing Director and work closely with other directors and members of OMFIF's close-knit management group, with significant potential for personal development and commercial reward. The relationship with the Managing Director - who is focusing on business development, marketing, sales, commercial relationships with Member companies and institutions, and external representation/communication - will be particularly important.

The COO will concentrate on internal functions and coordination geared to assuring and building OMFIF's programme of meetings and discussions backed up by appropriately digitalised client-targeted research and publishing. The COO will take overall responsibility for all internal operational functions.

This is a substantial opportunity for a motivated candidate likely to be in mid-career who will become a key part of OMFIF's senior management team helping to fulfil its remit of developing business in the UK and across the world.

The Chief Operating Officer will:

• take overall responsibility for the smooth running of all internal functions to meet the Company's financial, operational and strategic targets
• influence and support the Company's annual and multi-year strategic targets, and ensure all internal processes and activities lead to successfully meeting these targets
• help provide the organisational, budgetary and personnel conditions for realising an optimal combination of meetings and publications fulfilling the needs of member firms and partner institutions globally
• develop existing relationships and build new ones with suppliers and service providers for all internal functions
• encourage and cultivate strong connectivity between OMFIF offices in Europe and Asia, and particularly, ensure excellent internal information flows between departments
• assist other members of the management team in guiding, developing and inspiring all team members globally

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• ability to think, plan and communicate in a disciplined yet creative fashion in a fast-paced environment
• digital experience of using technology to improve business performance across operations, communications and other functional areas
• flawless attention to detail in all administrative operational functions, and related to economics, finance and public-private sector interactions with the Company's members and partners globally
• experience of motivating staff in a fast-moving, deadline-orientated environment attuned to the needs of an increasingly digitalised world where teamwork is at a premium

About OMFIF:

OMFIF is a dynamic and independent think tank. Through offices in London and Singapore, the twin channels of research and meetings promote dialogue on world finance and economic policy worldwide at the highest levels. An annual programme of meetings and research brings together a comprehensive global network of public and private sector experts and gives staff the opportunity to work directly with economic, political and investment decision-makers and specialists.

OMFIF is embarking on a period of further international expansion. We strive to maintain a fast-moving and dynamic atmosphere where creative ideas are encouraged, with no two days the same. We are looking for people from diverse backgrounds who are keen to develop their skills, gain responsibility and share our vision of realising full potential, embodying the Company values of independence, innovation and integrity.

Application:

Applicants who meet the application criteria and have the right to live and work in the UK are invited to send their CV and cover letter to: jobs@omfif.org, with 'Application for Chief Operating Officer' in the email subject line. Only those applicants under consideration will be contacted.

OMFIF strictly adheres to the Equality Act (2010) and provides equal opportunities to applicants and employees from all demographic backgrounds.

By applying for this role, you agree to OMFIF retaining your CV/Cover Letter for six months, until our recruitment and onboarding process is complete.

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