The Bulletin

October 2016
Vol. 7 Ed. 9

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

From monetary to fiscal
A point of inflection

FOCUS on Frankfurt's new path
Charles Goodhart, Geoffrey Wood on QE risks
Kingsley Chiedu Moghalu on African democracy
Vicky Pryce on Germany and the G20
Ignazio Visco on the euro policy mix
William White on zombie banks and companies

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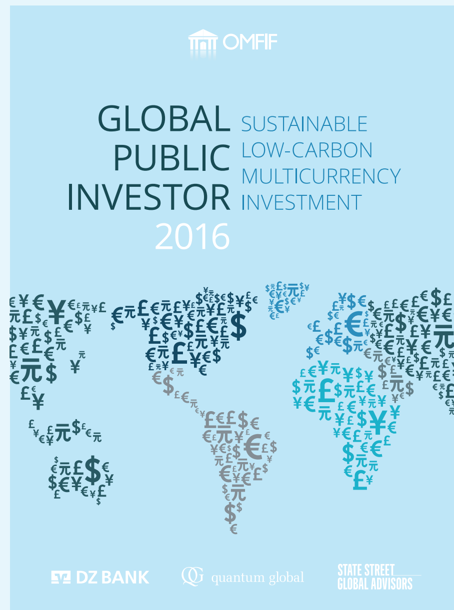
GLOBAL PUBLIC INVESTOR 2016



Global Public Investor 2016 **is the third annual report by OMFIF on public sector asset management and ownership. The increased detail and coverage builds on analysis in the 2015 and 2014 editions.**

GPI 2016 **is focused on two fundamental developments on the world investment scene: the use of a rising number of currencies in world asset management; and the growth of low-carbon investment, part of a general upgrading of the importance of sustainable investment.**

Selected media coverage

GPI 2014	GPI 2015	GPI 2016
The march of the sovereigns *The Economist* *17 June*	**Global state investors shift into property** *Financial Times* *20 May*	**China's central bank remains world's top public investor** *China Daily* *29 June*
Heimliche Strippenzieher der Finanzwelt *Die Welt* *27 June*	**Sovereign funds risk inflating global property bubble** *South China Morning Post* *21 May*	**Central banks lead fall in GPI's assets in 2015** *The Business Times* *29 June*

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Dialogue on world finance and economic policy

The Official Monetary and Financial Institutions Forum is an independent platform for dialogue and research. It serves as a non-lobbying network for worldwide public-private sector interaction in finance and economics. Members are private and public sector institutions globally. The aim is to promote exchanges of information and best practice in an atmosphere of mutual trust. OMFIF focuses on global policy and investment themes – particularly in asset management, capital markets and financial supervision/regulation – relating to central banks, sovereign funds, pension funds, regulators and treasuries.

Analysis

OMFIF Analysis includes research and commentary. Contributors include in-house experts, Advisory Board members, and representatives of member institutions and academic and official bodies. To submit an article for consideration contact the editorial team at **editorial@omfif.org**

Meetings

OMFIF Meetings take place within central banks and other official institutions and are held under the OMFIF Rules, where the source of information shared is not reported. A full list of past and forthcoming meetings is available on **www.omfif.org/meetings**. For more information contact **meetings@omfif.org**

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OMFIF membership is comprised of public and private institutions, ranging from central banks, sovereign funds, multilateral institutions and pension plans, to asset managers, banks and professional services firms. Members play a prominent role in shaping the thematic agenda and participate in OMFIF Analysis and Meetings. For more information about OMFIF membership, advertising or subscriptions contact **membership@omfif.org**

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The OMFIF 168-strong Advisory Board, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors, including banking, capital markets, public policy and economics and research. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership can change owing to rotation.

EDITORIAL

Monetary point of inflection getting closer

Central bankers responded to the global financial crisis with a mix of unconventional policies, including negative rates and asset purchases. Addressing September's OMFIF main meeting in Rome, Banca d'Italia Governor Ignazio Visco noted that such policies helped cushion the initial shock, and that both subsequent GDP growth and inflation would have been lower without them. But they have hardly provided a panacea. As Visco also noted, such policies have distorted markets and created risks for financial stability.

Extraordinarily loose policies have not only failed to boost growth substantially, but have also created dangerous debt overhangs in many economies. There have been some collateral effects too, examined in this month's Bulletin. Charles Goodhart and Geoffrey Wood argue that these measures have hurt bank profitability, while Stijn Claessens and Nicholas Coleman of the Federal Reserve Board of Governors, and Michael Donnelly of MIT, consider evidence on the effect on banks' net interest margins. Ben Robinson presents the findings of an OMFIF report, produced with BNY Mellon, showing that unconventional policies have reduced the supply of liquid assets for collateral. Panicos Demetriades, former governor of the Central Bank of Cyprus, highlights the negative consequences for central banks' credibility and the notion of their independence.

The good news is there are signs that monetary policy is reaching an important inflection point. This might not be apparent at first sight. The US Federal Reserve defied expectations that it would raise rates at its September meeting. But as Darrell Delamaide argues, this was driven more by politics than economics – a December rate rise is now a virtual certainty. Meanwhile, the Bank of Japan's decision to refrain from a rate cut and introduce yield curve controls in asset purchases confirms a shift to a more flexible approach. Some monetary alchemy will still be needed to help Japan exit its debt trap without pain – the subject of OMFIF's latest report, published in September, by John Plender. The case of the Bank of England is more worrying, maintains Peter Warburton, who argues that even a shock as big as Brexit did not warrant the Bank's August rate cut.

Yet escaping from this unconventional quicksand dragging down central bankers will not be easy. As Luiz Pereira da Silva of the Bank for International Settlements told an OMFIF City Lecture in September, central bankers face a 'singular dilemma': continuing with such policies carries dangers in the long run, but exiting also risks market panic. One way to exit is to use more fiscal policy to ease the pain of tightening the monetary screws. With borrowing rates at historical lows, it is now time for governments to invest and they are not doing enough of it. This is not just a feature of developed markets: Donald Mbaka of the Central Bank of Nigeria echoes Visco's warnings of a 'suboptimal policy mix'.

Despite these risks, the central bank that was the slowest to join the QE party may still find it hard to leave. Around half of respondents in our Advisory Board Poll expect the ECB to expand its QE programme into new asset classes instead of letting it expire in March 2017. This could bring the economics back into the spotlight, but for now Europe's biggest headache remains its politics. As Vicky Pryce highlights, divisions across the euro area have risen and anti-euro movements are gaining ground in many countries. Steve Hanke alerts us to a doomsday scenario for Italian banks – even though the well-publicised problems of Deutsche Bank may provide Italy with a welcome distraction. There may be some silver linings for the European economy however, as Brexit creates an opportunity for financial centres on the continent. This month's edition includes the second in OMFIF's series of Focus reports, examining the case for Frankfurt. We round off with William Keegan's review of an account of his time in politics by Ed Balls, the UK Labour party's shadow chancellor who lost his parliamentary seat in the 2015 election.

Perils of fiscal policy in disguise

Zombie banks, zombie companies: the reckoning

William White, Organisation for Economic Co-operation and Development

Unconventional monetary policies – as the bond-buying programmes by central banks in Japan, the US and continental Europe have been baptised – are really fiscal policy in disguise. As a result of central banks' transgression into the political sphere, the 40-year period of central banking independence is now effectively over. We will discover whether this puts the world on to a more or less stable footing.

Current policies foster financial instability. By squeezing credit and term spreads, the business models of banks, insurance companies and pension funds are put at risk, as is their lending. The functioning of financial markets has changed dramatically, with many asset prices bid up dangerously high, threatening future growth. Resources misallocated before 2008 have been locked in through zombie banks supporting zombie companies.

The insidious effects of persistently 'easy money' policies can be seen in the alarming slowdown in global growth. Two vicious circles are at work, with a wounded financial system contributing to both. On the demand side of the economy, accumulating debt creates headwinds that slow demand, leading to still more monetary expansion and yet more debt. On the supply side, misallocations slow growth, again leading to monetary easing, more misallocation and still less growth.

There is a route out of the impasse – reliant on government action rather than that of central banks. We need to adopt precepts from both Keynes and Hayek. To please Keynes, governments should use whatever room they have for fiscal expansion, with an emphasis on infrastructure investment in concert with the private sector. Into the Hayekian category fall measures to address excessive debt through careful debt write-offs and restructuring; this might require recapitalisation or closure of those financial firms that made the bad loans. Structural reforms to raise growth potential and the capacity to service debt will pay longer-term dividends.

A paradigm shift in thinking about how the economy and policy actually work is required – and then the political leadership to bring about well-balanced and judicious solutions. One way or another, the bill for accumulated debts will have to be met. If we do not marry the approaches of Keynes and Hayek, the bill will be paid by Greek taxi drivers and German taxpayers – in a fashion that would not only be profoundly unsatisfactory but also highly disorderly. I hope that this is not the path we end up taking.

William White is Chairman of the Economic and Development Review Committee at the OECD.

Advisory Board

OMFIF has appointed Jenny Corbett to the Advisory Board. For the full list of members, see p.24-25.

Professor Jenny Corbett is distinguished professor in the Crawford School of Public Policy at the Australia National University. She is reader in the Economy of Japan at the University of Oxford, a Research Fellow of the Centre for Economic Policy Research and a Research Associate of the Centre for Japanese Economy and Business at Columbia University. She was formerly the executive director of the Australia-Japan Research Centre. She has been a consultant to the Asian Development Bank, the Organisation for Economic Co-operation and Development, the World Bank and the European Commission.

'Clouded outlook' for Europe and euro

The clouded outlook for Europe and the euro following the UK vote to leave the European Union, and the need for flexible and innovative fiscal and monetary policies to lift growth and employment, topped the agenda at an OMFIF Economists Meeting at the National Bank of Hungary on 29 September.

There was a general discussion about the impact of the UK vote on faultlines in Europe, and agreement that this had caused great political uncertainty in all 28 member states, with UK doubts and questions about how to go forward compounding the problems. On a more optimistic view, the meeting heard, the UK would become associated with the EU through some form of 'satellite relationship' that would allow the City of London to maintain business through modified 'passporting' arrangements.

On a more pessimistic reading, delegates discussed how the EU was heading towards a painful period of transition, with heightened tensions both within and between members and non-members of the euro. The meeting also heard how the National Bank of Hungary was adjusting to increased vulnerability and pressure on GDP growth with a new monetary policy approach using a more flexible set of instruments. This policy balanced financial and monetary stability with the bank's inflation target and credit initiatives under 'funding for lending'.

Search for better policy mix in Rome

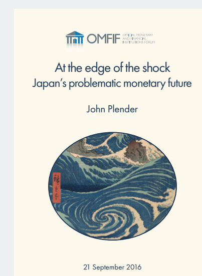
The ever more urgent search for a better mix of European fiscal and monetary policies was a guiding theme at OMFIF's Seventh Main Meeting in Europe at the Banca d'Italia on 22-23 September in Rome, against a background of slowing growth, high debt and political fragmentation in many countries.

The overall mood was sombre, with a widespread perception that political risk – from the US presidential election to an upsurge of anti-European political parties – had increased. One well-known political speaker said Europe's leaders were unable to resolve their difficulties because the continent's time-honoured recipe of dealing with crises through emergency action forged in the heat of upheaval was no longer working.

According to another top-line speaker, 'Not even in the global financial crisis have the problems been more difficult… There has been an erosion of the mutual trust on which 2008 co-operation was based,' he said, listing as the main European problems migration, Brexit, the rise of 'nationalist and populist' movements, financial and macroeconomic imbalances, and banking fragility.

Several speakers underlined the need for innovative thinking on Europe, including the possibility of co-operation between blocs of countries, placing different degrees of emphasis on political and economic integration. There was a broad discussion throughout the meeting on the support for 'populist' polices in the US and Europe, with opinion divided about the validity and longer-term effects of this development. *For Banca d'Italia Governor Ignazio Visco's speech see p.15.*

Japan's economy on 'the edge of a shock'



Japan's monetary and financial system is living on the edge of a shock, with the potential to rock a global financial system still worryingly fragile in the aftermath of the global financial crisis, according to an OMFIF report by John Plender, published in September.

Almost four years after the launch of 'Abenomics' – Prime Minister Shinzo Abe's three-pronged programme aimed at reviving Japan's economy – Japan remains stuck in an atypical debt trap. The country's aging demographic profile and history of excessive rates of corporate saving lie at the heart of an unsustainable build-up of debt that has necessitated increased public spending and caused the government to borrow as a substitute for tax receipts. Abenomics has failed to reverse this reality radically. Plender identifies three potential scenarios out of the debt trap, all of them problematic, and concludes that all encompass significant risks of financial stability that could spill over to the rest of the world. *For more details contact editorial@omfif.org*.

Canuto: Structural reforms key

Otaviano Canuto, executive director of the World Bank and member of the OMFIF Advisory Board, gave a City Lecture on 20 September in London on global imbalances.

These have recently re-emerged as an important topic for policy-makers, with current account positions across economies diverging again after a narrowing of imbalances following the global financial crisis. A rebalancing of internal and external objectives across countries would help support global growth, but it is not a panacea: country-specific agendas of structural reforms are key to help economies overcome 'income traps'. Canuto also touched on the economic outlook of his home country, Brazil. While he admitted that the economy is suffering from a double malaise of productivity anaemia and 'fiscal indigestion', he argued that a reduction in the risk premium for businesses, more competition in the private sector, and improved efficiency in the public sector should all contribute to a stronger economy.

Rules 'unevenly enforced'

Financial globalisation provided 'freedom' for advanced economies to run large current account deficits that amplified the effects of the crisis on emerging markets, Luiz Pereira da Silva, deputy general manager of the Bank for International Settlements, told an OMFIF City Lecture on 19 September in London.

Pereira da Silva drew attention to challenges facing emerging markets such as the uneven enforcement of rules in the international system. On advanced economies, he highlighted the 'singular dilemma' faced by international monetary policy-makers, between continuing with risky and decreasingly effective monetary policies and entering tightening that could cause market panic.

Asia meetings

OMFIF Singapore office opening reception

A reception to mark the opening of the OMFIF office in Singapore in the presence of Lord (Meghnad) Desai, chairman, OMFIF Advisory Board, Prof. Kishore Mahbubani, Dean, Lee Kuan Yew School of Public Policy and Mr Ravi Menon, managing director of the Monetary Authority of Singapore.
16 November, Singapore

Positioning Asia for growth in a challenging global economic environment

The gathering brings together senior representatives of official and private sector institutions from Singapore, the Asia Pacific region and beyond to discuss critical policy and investment issues facing the region. Co-hosted by the Monetary Authority of Singapore.
17 November, Singapore

Financial stability in an uncertain global environment

The goal of the seminar is to have candid, interactive discussions of the most significant current threats to financial stability, what needs to be done now to mitigate the most significant risks, what potential spillovers might occur, and whether crisis management arrangements are sufficient.
23 November, Kuala Lumpur

For details visit www.omfif.org/meetings.

Governments 'should move on stimulus'

Governments globally must place greater emphasis on fiscal stimulus and systemic reform to raise growth in view of low interest rates and diminishing effectiveness of monetary policy, Carolyn Wilkins, Bank of Canada first deputy governor, told an OMFIF City Lecture in London on 14 September.

Wilkins outlined the dangers of slow growth, caused by structural factors such as weak demographics and decelerating productivity. The effects include threats to financial stability, as lower neutral rates raise the risks for indebted households and impede the effectiveness of monetary policy. To address these concerns, Wilkins argued for promoting a sound global financial system through greater use of macroprudential tools, and stressed the importance of pro-growth policies, particularly on the fiscal side.

Greater coordination needed in Beijing

On 3 October, the first day for markets following the renminbi's inclusion in the special drawing right, OMFIF held a telephone briefing which discussed the need for greater coordination between economic and financial reforms in Beijing. Ben Shenglin, executive director, Renmin University International Monetary Research Institute, moderated the call between Alain Raes, chief executive, EMEA and Asia Pacific, SWIFT and Linda Yueh, fellow in Economics at St Edmund Hall, Oxford University.

US FOMC telephone briefing

Nick Verdi, senior foreign exchange strategist at Standard Chartered Bank, and Joseph Gagnon, senior fellow at the Peterson Institute for International Economics, told an OMFIF telephone briefing on 20 September that the US Federal Reserve was unlikely to raise rates the following day, reflecting the influence of the electoral cycle. The discussion also covered the Bank of Japan, with speakers agreeing that more monetary policy action was needed to support growth in the Japanese economy.

Limits of 'low-for-long' interest rates

How fluctuating economies affect bank margins and profits

Stijn Claessens, Nicholas Coleman, and Michael Donnelly

While overall bank profitability in advanced economies, measured by return on assets, has recovered from the worst of the global financial crisis, it remains low. Many banks are facing profitability challenges related to low net interest margins, typically measured as net interest income divided by interest earning assets, and weak loan and non-interest income growth.

While NIMs across many banks in advanced economies have been trending downwards over the longer term, they have fallen more sharply since the financial crisis – in part, it appears, because of lower interest rates.

In many ways, banks can benefit from low interest rates both directly (such as through valuation gains on securities they hold) and indirectly (for example, levels of non-performing loans will be lower as borrowers' debt service is less burdensome). On the narrower question of the effects of low interest rates on banks' NIMs, however, analytics and empirical findings suggest that NIMs are lower when interest rates are low.

Low short-term interest rates can depress bank margins. For many types of deposits, banks are reluctant to lower interest rates. As they must pass on lower rates on assets linked to contractual repricing terms (such as floating rate loans) to borrowers with other financing choices – and have an incentive to do so – bank margins compress as rates decline.

> *Net interest margins are lower when interest rates are low – banks must pass on lower rates on assets linked to contractual repricing terms.*

Analysing a sample of 108 relatively large international banks, many from Europe and Japan, and 16 from the US, Claudio Borio, Leonardo Gambacorta and Boris Hofmann, in their 2015 paper 'The influence of monetary policy on bank profitability' (BIS Working Paper 514, October 2015), documented the negative effects of low interest rates (and shallow yield curves) on banks' NIMs and profitability, concluding that effects were stronger at lower interest rates.

Evidence from the US supports this conclusion, though the direct effects of low rates are relatively small. Analysis for Germany suggests normally small long-run effects of interest rate changes on NIMs, but large effects in the recent, low-interest rate environment. Evidence for other countries has been more scarce.

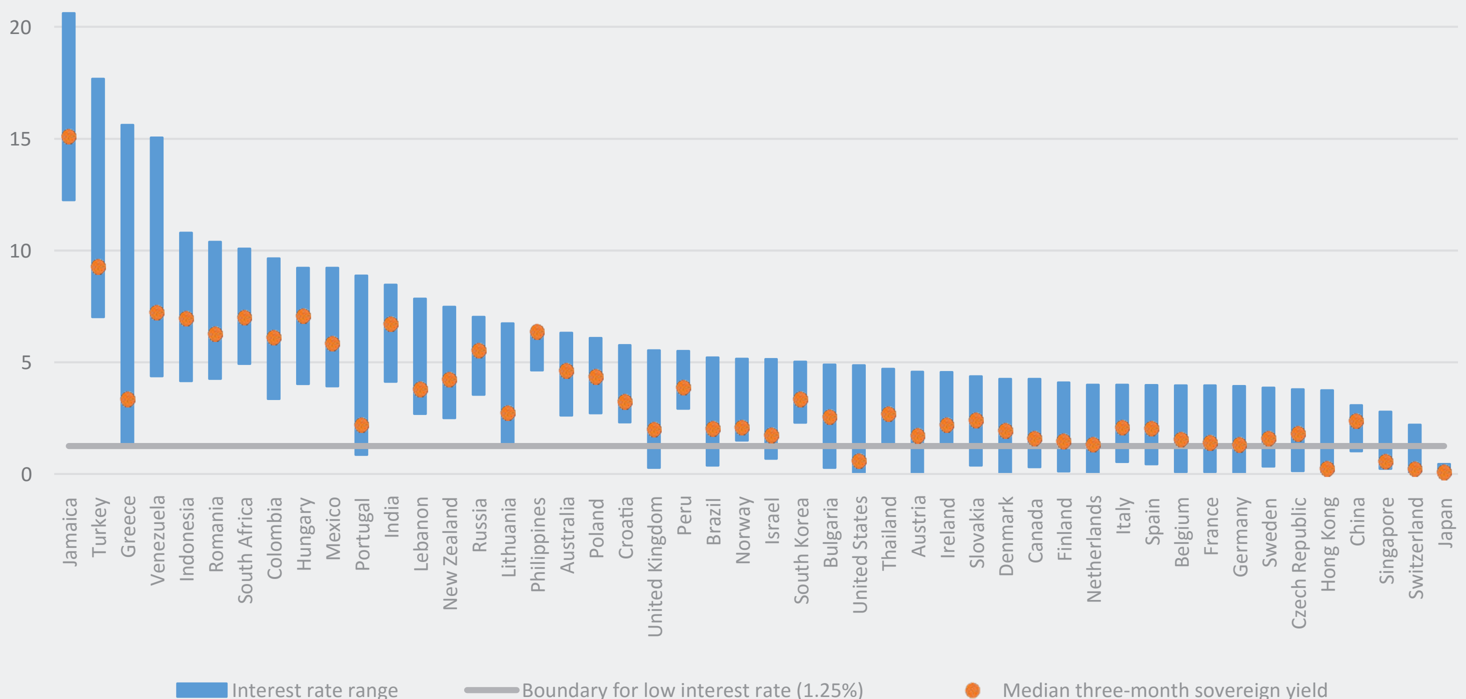
New analysis: data and methodology

Our new cross-country analysis confirms and expands on these findings. A database was assembled with 3,418 banks from 48 countries for the period 2005-13. Countries were classified each year as being in either a low- or high-rate environment, based on whether the interest rate on their three-month sovereign bond was below or above 1.25% (other cut-offs were also tested and yielded similar results).

Chart 1 shows the sample of countries covered and the range and median of the short-term yields in each country. The variations in rates are large for a number of countries, with many both in the high- and low-yield environment for some time (the

Chart 1: Advanced economies affected most by low yields

Range and median of short-term yields, %, and low interest rate boundary



Source: Bloomberg, FRB staff calculations. Values used are yearly averages of the implied three-month rate published by Bloomberg.

median provides a sense of how long each country has been in each environment).

Particularly advanced economies faced low yields after the global financial crisis – 19 such countries in 2009 as opposed to just two in 2005. These shifts help to estimate the differential impact of low rates on banks' NIMs.

Chart 2 shows that average NIMs are higher in the high-rate environment than in the low-rate environment. Profitability, measured by return on assets, is higher too in the high-rate environment. This is likely to reflect both higher NIMs and concurrent better overall economic and financial environments.

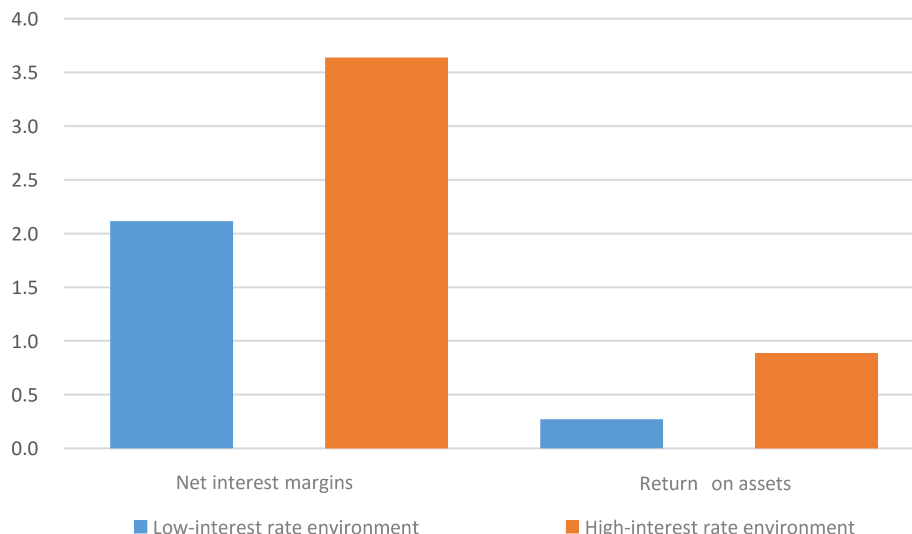
To isolate effects, we regressed the NIMs for all banks for each year on the average level of the three-month sovereign rate in that year (a common proxy for banks' marginal funding costs) – controlling for the bank's own lagged NIM, other time-varying bank characteristics, and a bank fixed effect, as well as GDP growth and the spread between the three-month and 10-year sovereign rates. The sample was then split into banks in low- and high-interest rate environments.

The results show that a decrease in the short-term interest rate lowers NIMs in both low- and high-rate rate environments, with effects symmetric for an interest rate increase. But, all other things being equal, effects are statistically greater in a low-rate environment.

Chart 3 summarises the regression results. For a representative bank, a one percentage point decrease in the short-term rate is associated with a 0.09 percentage point decrease in NIM in the high-rate environment versus a 0.17 percentage point decrease in the low-rate environment.

Chart 2: Negative impact when rates fall below 1.25%

Net interest margins and return on assets, %



Source: Bankscope, Federal Reserve staff analysis

We also analysed separately the effects of movement in interest rates on changes in interest expenses and interest income.

The more pronounced effects on NIMs in the low-rate environment are largely driven by the greater pass-through of low rates on interest income rather than on interest expenses.

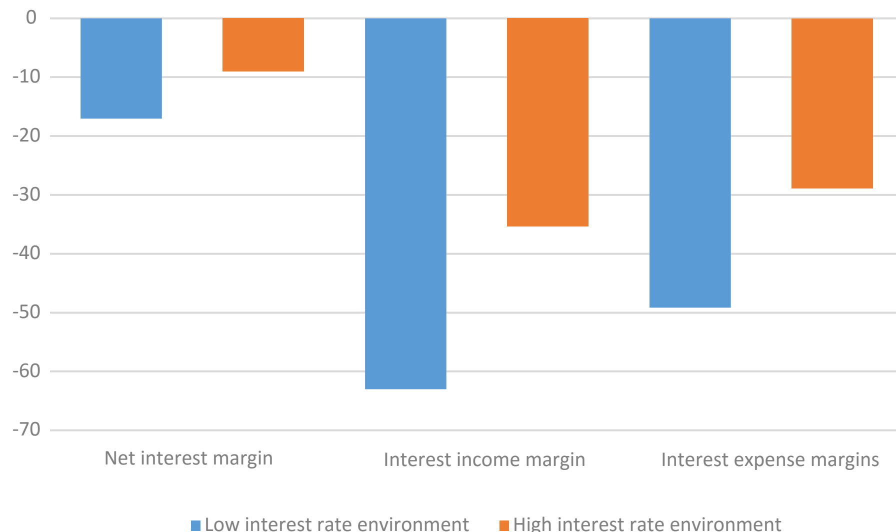
Specifically, a one percentage point decrease in the short-term rate is associated with a 0.63 percentage point decrease in the ratio of interest income to earning assets in the low-rate environment, and only a 0.35 percentage point decrease in the high-rate environment, a 0.28 percentage point difference. The equivalent difference is around 0.20 percentage points for the ratio of interest expense to liabilities.

In other words, at low rates, banks have greater difficulty reducing their funding rates. Moreover, they still largely have to pass the lower rates on to their borrowers.

This is likely to be due to greater competition, including from non-bank lenders, and lower demand for loans. Economic activity is lower in times of low interest rates, causing NIMs to decline more.

Chart 3: Short-term rates drive bank returns

Estimated impact on bank margins in low- and high-interest rate environments (bps)



Source: Federal Reserve staff analysis

Overall effects and conclusions

While there are caveats, our findings strongly suggest that NIMs are low when interest rates are low.

An important issue then is how banks can adjust their activities and cost structures to offset adverse effects on profitability and capital. Although institutions are making adjustments, such efforts take time, with limited immediate pay-offs when facing weak cyclical conditions and deleveraging pressures.

This poses a challenge for banking systems in many low-interest rate countries. Until lost income can be offset through other actions, lower profitability will reduce financial institutions' ability to build and attract capital.

This increases their vulnerability to shocks and declines in market confidence, undermines their ability to support the real economy, and potentially weakens the transmission channel of monetary policy. ■

Stijn Claessens and Nicholas Coleman are Economists at the Board of Governors of the Federal Reserve System. Michael Donnelly is a Masters student at MIT. The views expressed are those of the authors and should not be attributed to the Board of Governors of the Federal Reserve System.

Merkel's tasks for divided continent

Taking responsibility for unachievable G20 pledges

Vicky Pryce, Advisory Board

The G20 leaders' communiqué on 5 September following their summit in Hangzhou, China, was the last before Germany takes over the G20 leadership on 1 December. It was, as would be expected, a positive one, full of good intentions – geopolitical stability, solving the refugee crisis, containing environmental damage, fighting terrorism, and so on.

Angela Merkel, Chancellor of Germany

On the economic front, the leaders acknowledged that although the world recovery was 'progressing', this was not happening fast enough. Investment and trade remain sluggish, unemployment is still too high in many countries, and volatility in commodity and financial markets provides a threat to stability.

The threat of protectionism emerges when economies do less well. At times the threat is realised, backed by populist movements, before unravelling over time. But the damage can be significant.

The G20 leaders called for protectionist trends to be curtailed and restated their commitment to reducing trade barriers further, setting themselves firmly against competitive devaluations. The fear of protectionism and its negative impact on world trade were also highlighted by the International Monetary Fund in its latest World Economic Outlook published in early October.

A tide of nationalist fervour

But this is hard to achieve against a tide of increased nationalist fervour, in both economics and politics. Despite the rhetoric, a World Trade Organisation report on G20 trade restrictions, published in June, found that around 70% of restrictive measures were instigated by G20 economies.

The campaign slogan 'Taking back control' was instrumental in convincing the majority of British voters to support 'Brexit' on 23 June. Donald Trump's presidential campaign in the US has protectionism, even isolationism, as its core message.

Europe, severely shaken by the British vote to leave the European Union, has yet to decide in a cohesive way how to respond – something that the divisions evident at the conclusion of the EU's Bratislava summit on 16 September made very clear.

Meanwhile, nationalist parties are gaining ground in France, Italy, the Netherlands, Austria and Germany. Countries such as Poland, Hungary, and Slovakia protest that their voices are not being heard. Hungary's 2 October referendum overwhelmingly rejected European refugee-sharing proposals, although turnout was below the threshold for validity.

Southern Europeans are increasingly united and vocal about the unfairness, as well as the negative economic and social impact, of policies often perceived as being imposed by supranational European policy-makers. This creates the strong impression of a divided Europe.

One of the G20 leaders' main pledges clearly is not being met, namely the need for well-designed and coordinated monetary and fiscal policies to achieve 'strong, sustainable, balanced and inclusive growth'.

Rhetoric and reality

The European Central Bank is doing what it can on the monetary front, but this alone will not guarantee balanced growth. That requires other policy elements, including fiscal.

The G20 sets down a high standard: 'We are using fiscal policy flexibly and making tax policy and public expenditure more growth-friendly, including by prioritising high-quality investment, while enhancing resilience and ensuring debt as a share of GDP is on a sustainable path.'

The reality is somewhat different. Spain and Portugal narrowly escaped being fined for missing their deficit targets. Southern European countries' debt to GDP ratios remain unsustainable – not only Greece's 188% but Italy's 137%, Portugal's 130%, and Spain's now nearly 100%.

At the opposite extreme, Germany has ignored bodies including the Organisation for Economic Co-operation and Development, the European Commission and the International Monetary Fund by running a budget surplus and a current account surplus of some 7% of GDP. The current account surplus this year is expected to be even more, 9% of GDP

The popularity of Angela Merkel, the German chancellor, is falling following last year's significant influx of refugees. This led to her suffering setbacks in recent regional elections.

In Italy a constitutional referendum on 4 December could result in Prime Minister Matteo Renzi's downfall, though Renzi has stated that his government will remain in place irrespective of the result.

> *"The threat of protectionism emerges when economies do less well. At times the threat is realised, backed by populist movements, before unravelling over time. But the damage can be significant.*

There is still no firm government in Spain after two elections – a third is expected in December – and increasing talk of new elections in Greece.

Merkel must be wishing that another country could head the G20 from 1 December. Taking responsibility for unachievable G20 pledges adds one more task to her list of unenviable challenges. ■

Vicky Pryce is a Board Member at the Centre for Economics and Business Research and a former Joint Head of the UK Government Economic Service.

Global liquidity under pressure

OMFIF report highlights role of Global Public Investors

Ben Robinson

Global liquidity – a vital ingredient in the factors driving markets and growth worldwide – has been under severe strain in the eight years since the financial crisis. This is underlined by periodic disruption in even the most liquid market of sovereign bonds, as well as limits on some fund redemptions and less frequent trades and lower turnover for some assets. As an OMFIF report published on 11 October demonstrates, global public investment institutions have contributed to this situation, but sovereigns show a growing willingness to play a role in mitigating the challenges.

Low interest rates from central banks led to an expansion of high-yield and 'junk' bond issuance, while large public purchases of safe and liquid assets reduced yields for investors, pushing them towards these riskier assets.

A second cause of lower liquidity – the tightening of banking regulations which have raised the cost of balance sheet-intensive activities such as market-making – has meant banks have become less able and less willing to stabilise markets. In the past, banks and securities firms helped smooth the market when an immediate buyer or seller could not be found, by using their balance sheet to become the counterparty to trades. However since 2008 they have lowered their inventories by over 80%, reducing their ability to play a stabilising role.

Substantial dangers

The result is a large growth in primary market issuance despite a lack of secondary market depth, making assets vulnerable to rapid price corrections when monetary policy or market sentiment changes. The speed with which this may happen has increased as market participants have changed, including the growth of 'shadow banking' institutions, mutual funds and high-frequency traders, adding to complexity over counterparty risks and trade strategies.

The dangers are substantial. If liquidity in financial markets and the ability of corporate and sovereign bond issuers to raise funds at affordable prices are reduced, second round effects could emerge which set off a series of bankruptcies and insolvencies.

As seen after the financial crisis, when trust in financial markets evaporates, along with confidence in the quality of assets and the ready availability of funds on which liquidity depends, the reverberations can be deep and long-lasting.

The prospect of divergent monetary policy between different central banks brings these risks to the fore, as many emerging economies are highly leveraged, many mutual funds offer open-ended daily redemptions, and large amounts of post-crisis debt issuance remain outstanding. Future US rate hikes risk asset price deflation, a decline in new issuance and an increase in short positions.

In this context, compensating for the lack of liquidity-enhancing but balance sheet-intensive activities of banks, stabilising markets to prevent investor runs, and ensuring access to wholesale market funding are vital to avoiding a liquidity shock. As underlined by an OMFIF survey of sovereign institutions with $4.74tn in assets under management, sovereigns are willing to meet these challenges, particularly via increased capital markets activities such as securities lending and direct funding of less-liquid asset classes including private debt and equity.

> ***"Compensating for the lack of liquidity-enhancing but balance sheet-intensive activities of banks, stabilising markets to prevent investor runs, and ensuring access to wholesale market funding are vital to avoiding a liquidity shock.***

Among other palliatives, sovereign investors suggest widening collateral eligibility for repo transactions, increasing sovereign participation in wholesale funding markets, 'renting' their balance sheets, and directly funding some assets and projects to offset some of the issues of bank disintermediation.

Obstacles to overcome

Obstacles need to be overcome, however, including regulations on banks and dealers, a lack of coordination between regulators and sovereigns, and a lack of coordination among sovereigns themselves.

Some GPIs need to overcome internal rules that prevent them from pursuing a more active role in securities lending or repo markets. They need to manage the implied counterparty, credit, collateral and cash collateral reinvestment risk involved in these expanded activities.

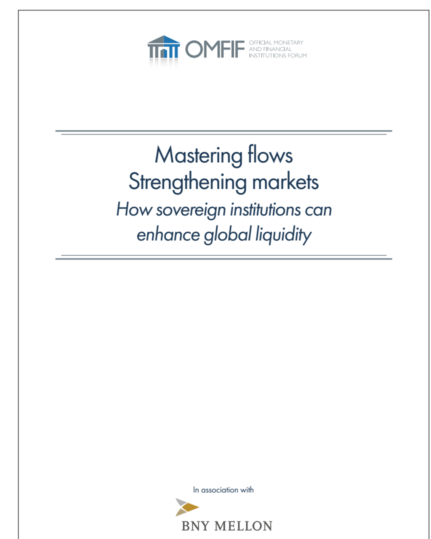
Reforms to market infrastructure and practices can offset some of these challenges, including via better collateral valuation rules and margining policies, as well as increased counterparty risk management. The tri-party repo reform in the US, and the European Markets Infrastructure Regulation which places a central clearing counterparty between traders, have helped to tackle some of these concerns. They have, however, raised costs and increased demand for high quality collateral. This raises the importance of collateral management and reuse facilities from custody banks.

Scope for sovereign involvement

The desirable level of sovereign institutions' involvement in capital markets is contested, with some survey respondents arguing that it is not the role of official institutions to price risk or make markets, and should instead act as asset managers with a long-term view. However more than 40% of institutions believe there is an increased capital markets role for sovereigns as a result of bank disintermediation.

The potential benefits are significant: not just an increase in market liquidity and resilience to destabilising shocks, but also the rewards of higher yields to offset the disbenefits of low or negative interest rates on high-quality liquid assets.

Ben Robinson is Economist at OMFIF. This is an edited version of 'Mastering flows, strengthening markets: how sovereign institutions can enhance global liquidity'. For a copy of the report, please contact editorial@omfif.org.



Fed holds off amid election campaign

December rate hike likely after 8 November vote

Darrell Delamaide, US editor

Despite the protests to the contrary, it was never likely that the US Federal Reserve would raise interest rates in September, just weeks before the presidential election. Even less so in November, just days before the vote.

Fed chair Janet Yellen sought to emphasise at the press conference following the late September meeting of the Federal Open Market Committee that the US central bank is not political in any way, shape or form.

'I can say, emphatically, that partisan politics plays no role in our decisions about the appropriate stance of monetary policy,' she said in response to a question. 'We do not discuss politics at our meetings and we do not take politics into account in our decisions.'

But that affirmation means it could not take any action with uncertain consequences so close to an election.

Raising rates could have a negative impact on stock prices. Making the move just as the last voters are making up their minds would bring a barrage of criticism from the staff of Hillary Clinton, who is campaigning on the steadiness of the economy under her fellow Democrat, Barack Obama.

'Fed doing political things'

Of course, not taking action can also be interpreted as political, and Donald Trump did not hesitate to level this charge in the first presidential debate.

'We are in a big, fat, ugly bubble,' Trump said, commenting on the US economy. 'And we better be awfully careful. And we have a Fed that's doing political things. This Janet Yellen of the Fed. The Fed is doing political – by keeping the interest rates at this level.'

The controversial candidate continued in his colourful, stream-of-consciousness way: 'And believe me: The day Obama goes off, and he leaves, and goes out to the golf course for the rest of his life to play golf, when they raise interest rates, you're going to see some very bad things happen, because the Fed is not doing their job. The Fed is being more political than secretary Clinton.'

Some Fed officials themselves have voiced concerns about asset bubbles forming after the long period of low interest rates, so Trump's critique is not outlandish.

But his personalising the criticism and directing it at Yellen puts her in an awkward position if Trump wins the election – which cannot be ruled out. Some analysts have gone so far as to suggest that Yellen would step down in the event of a Trump victory, even before the December FOMC meeting, if only to take the heat off the other Fed policy-makers.

That may sound somewhat far-fetched, but it indicates that the Fed cannot help but be drawn into the political quicksand of this bizarre election. It does not necessarily mean, however, that the Fed's explanation for leaving rates unchanged in September is just so much window-dressing.

'The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives,' the consensus statement read. 'The stance of monetary policy remains accommodative, thereby supporting further improvement in labour market conditions and a return to 2% inflation.'

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Dissent among the FOMC

However, there was an unusually high level of dissent. Three of the five regional bank heads who are voting members – Esther George of Kansas City, Loretta Mester of Philadelphia, and Eric Rosengren of Boston – said they would prefer to raise the target rate for federal funds a quarter point to 0.75% right now. Only James Bullard of St. Louis and William Dudley of New York supported Yellen and the other four in the Washington-based board of governors.

Could a decision come in November, she was asked at the press conference. 'Every meeting is live, and we will again assess as we always do incoming evidence in November and decide whether or not a move is warranted.' Don't hold your breath.

But Yellen also said that 'most participants do expect that one increase in the federal funds rate will be appropriate this year, and I would expect to see that if we continue on the current course of labour market improvement and there are no major new risks that develop and we simply stay on the current course.'

This seems to make a rate hike in December a virtual certainty, barring any unexpected bad news. (A Trump victory, for instance, could provoke a negative market reaction that would give the Fed pause.)

Esther George, President, Kansas City Fed

In a widely noted speech the week before the FOMC meeting, Fed governor Lael Brainard signalled decisively that the Fed would wait on action. She said in Chicago that 'the costs to the economy of greater than expected strength in demand are likely to be lower than the costs of significant unexpected weakness.'

Brainard, who many think could become Treasury secretary if Clinton wins, concluded: 'This asymmetry in risk management in today's new normal counsels prudence in the removal of policy accommodation.'

Restless regional bank chiefs

But the regional bank chiefs are restless. In an unusual move, Rosengren, usually a dove, issued a statement defending his dissenting vote: 'The economic progress since the last tightening in December might, by itself, be sufficient to justify a further increase in the rate target. However, it is in considering the implications of current policy for the sustainability of the expansion that the case for raising rates has now become even more compelling.'

Another dove, San Francisco Fed chief John Williams, indicated that the dissenting voters have support for their arguments from the seven regional bank heads who currently do not have a vote.

'It is getting harder and harder to justify interest rates being so incredibly low given where the US economy is and where it is going,' he told Reuters in an interview. 'I would support an interest rate increase. I think that the economy can handle that. I don't think that would stall, slow or derail the economic expansion. ■

Darrell Delamaide is a writer and editor based in Washington.

Quite erroneous policy

Little impact on real economy

Charles Goodhart and Geoffrey Wood

At a time when interest rates, throughout the yield curve, are at an all-time low, it could be argued that the public sector, the biggest debtor, should be trying to lock in such rates by shifting to ever longer maturities and duration.

However, if one adjusts for central bank swaps, under which central banks effectively buy longer-dated government debt in exchange for sight deposits, the overall maturity of public sector debt in most countries practising quantitative easing has been going down, not up.

We are told that such central bank deposits need not, indeed should not, ever get repaid. That they are, or should be, the equivalent of Consols (a type of British government bond redeemable at the option of the government) – quasi-permanent debt.

Jeremy C. Stein, professor of economics at Harvard University, argues that satisfying liquidity needs enhances financial stability and that monetary policy can continue by varying the interest paid on central bank deposits.

He adds that enlarged central bank balance sheets should remain a permanent feature. But as such reserve deposits are now interest-bearing, the huge volume of central bank deposits increases the public sector interest rate roll-over risk just as much as if the Treasury had issued a similar amount of Treasury bills.

If liquidity needs are satiated in this way – at a time when debt ratios have been climbing at a rate hitherto unparalleled in peacetime – why are there still claims that interest rates are being held down by excessive demand for 'safe' assets? Is this claim consistent with the narrowed risk premia now being observed?

> ***"Negative interest rates, a flat yield curve, and substantial fines on the banking institutions are hardly conducive to greater profitability.***

Furthermore, if the demand for liquidity, and reserves, by banks is to remain satisfied, what then constrains, and determines, the aggregate money stock, mostly consisting of commercial bank deposits, and bank lending to the private sector? The answer, we would presume, is the availability of bank (equity) capital. But capital will be made available only if the business is sufficiently profitable to earn a competitive return (unless the public sector injects the capital itself).

In the banking sector, negative interest rates, a flat yield curve, and substantial fines on the banking institutions (rather than the bankers who perpetrated, or failed to prevent, the misdeeds) are not conducive to greater profitability. Profitability is procyclical.

Has policy been actively damaging bank profitability and hence growth of money and credit? In most academic studies of the efficacy of monetary policy, all that appears to matter is the direct link between riskless official short-term rates, and future expectations thereof, and the real economy.

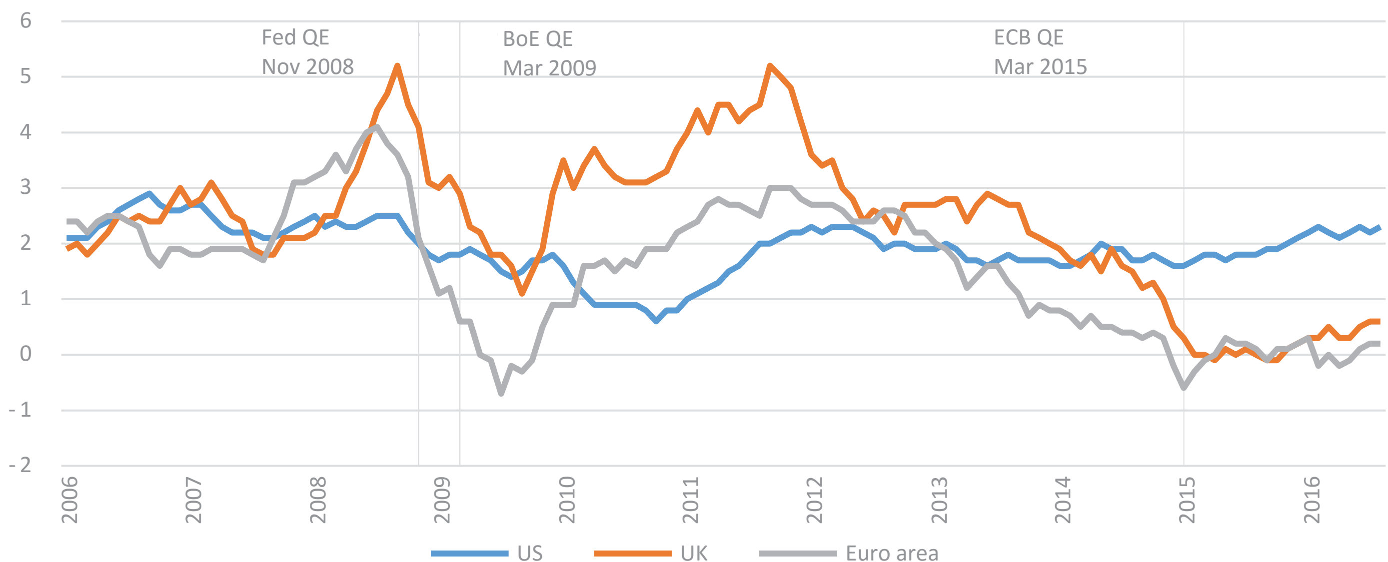
In David Reifschneider's 2016 Federal Reserve Board paper, 'Gauging the ability of the FOMC to respond to future recessions', the words 'bank', 'money supply' and 'credit' do not appear. The same official insouciance about the profitability of financial intermediation goes wider than just banks. Insurance companies and pension funds are pressured to hold matching assets against their liabilities. Policy then serves to reduce the availability and yield of such assets.

If the effect of monetary policy has been to weaken the profitability of financial intermediation, might this help to explain why the massive monetary expansion measures undertaken by central banks have had so little impact on the real economy? Perhaps QE has now become 'Quite Erroneous'. ■

Charles Goodhart is Professor Emeritus at the London School of Economics and Political Science. Geoffrey Wood is Professor Emeritus of Economics at the Cass Business School.

Despite QE, inflation remains subdued

Annual consumer price inflation, %



Source: US Bureau of Labor, ONS, Eurostat, OMFIF analysis

Market approach to climate change

Necessary transition to more sustainable economies

Flavia Micilotta, Eurosif

The 21st UN Climate Change 'Conference of the Parties', held in Paris in December 2015, ended with the milestone agreement for countries to reduce their greenhouse gas emissions sufficiently to keep the increase in global temperatures well below 2°C this century.

The agreement established a system for measuring individual countries' commitments and contribution every five years. A progress assessment is set for 2018.

Although it is too early to determine whether the agreement has been drafted sensibly or whether it will deliver on its commitments, it sets the tone for policies and businesses.

Investors now have a number of options to contribute to the transition to a more sustainable economy. In this context, the best-case scenario is a race to the top for both investors and companies to take part in the fight against climate change.

Policy push

The strongest policy push following the Paris conference came from France, where the government encouraged the financial community to adopt Article 173 of France's law on energy transition and green growth.

By asking investors to disclose how they factor environmental, social and governance criteria, as well as carbon-related aspects, into their investment policies, the law points the way towards more sustainable patterns of investment.

The Paris agreement also led a number of investors to reconsider their investments in oil. Mark Carney, the governor of the Bank of England, declared in September 2015 that investors faced potentially significant losses as a result of climate change action. Following this, even investors who did not think of themselves as particularly 'pro-environment' began to reconsider the viability of investing in oil companies. Now they are pondering the real costs of the carbon bubble.

> ***"Asking investors to disclose how they factor environmental, social and governance criteria, as well as carbon-related aspects, into their investment policies, points the way towards more sustainable patterns of investment.***

The European Commission demonstrated an understanding of the various issues of relevance to different stakeholders, as well as strong willingness to support this change.

In the last six months, it has launched two key consultations. These have examined how companies can increase their transparency, following up on the new directive on non-financial reporting, and how investors can improve their standards in respect of long-term and sustainable investments.

Both pieces of the same puzzle, the consultations have sent a strong message about the importance of those 'intangible' criteria, most often referred to as economic, social and governance criteria.

Looking to the long term

Embedding these criteria into investment analysis and portfolio construction across a range of asset classes is the underlying principle of sustainable and responsible investment. According to Eurosif's definition, socially responsible investment 'is a long-term orientated investment approach which integrates ESG factors in the research, analysis and selection process of securities within an investment portfolio. It combines fundamental analysis and engagement with an evaluation of ESG factors in order to better capture long-term returns for investors, and to benefit society by influencing the behaviour of companies.'

ESG incorporation

In ESG incorporation, investment institutions complement traditional quantitative analysis of financial risks and returns with qualitative and quantitative analyses of ESG policies, performance, practices and impacts.

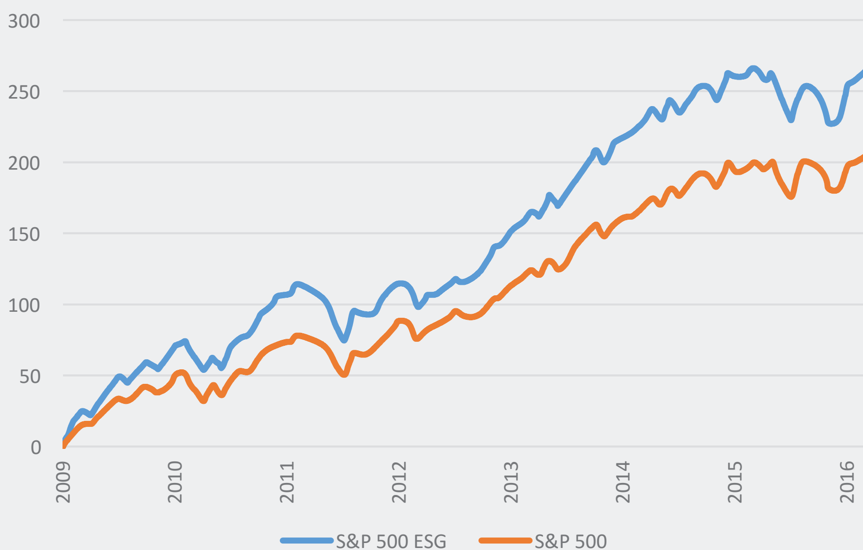
Asset managers and asset owners can incorporate ESG issues into the investment process in a variety of ways. Some may actively seek to include companies that have stronger ESG policies and practices in their portfolios, or to exclude or avoid companies with poor ESG track records.

Others may incorporate ESG factors to benchmark corporations to peers or to identify 'best in class' investment opportunities based on ESG issues. Still other responsible investors integrate ESG factors into the investment process as part of a wider evaluation of risk and return.

Regulators have come a long way in pushing the socially responsible investment industry forward. But much can still be done to help SRI become a significant factor in the transition to more sustainable economies. ■

ESG market indices outperform market counterparts

Growth of S&P 500 and ESG variant of index, %



Source: S&P 500 ESG Index

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