The Bulletin

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All eyes on Asia

The diverse prospects facing emerging economies

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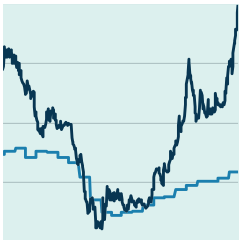

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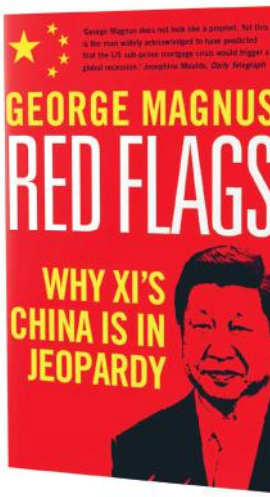

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Dialogue on world finance and economic policy

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.

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

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Emerging diversities

Ever since the 'taper tantrum' of 2013 when Ben Bernanke, then chair of the Federal Reserve, announced the scaling down of the Fed's asset purchase programme, which prompted sudden capital outflows from emerging markets, policy-makers across Asia have become acutely aware of their exposure to the vagaries of international markets. In response, central banks and finance ministries across emerging markets have largely followed prudent policies to safeguard their economies. Asia has been at the centre of these efforts: OMFIF's emerging markets vulnerability index, which examines levels of foreign reserves, credit growth, external debt and current account balances, highlights Asian economies as being among the most resilient.

But rising oil prices, a strengthening dollar and hawkish Fed have introduced new challenges. Starting with countries marked by idiosyncratic vulnerabilities stemming from shaky economic fundamentals and political uncertainty, last month's sell-off has since spread to countries with stronger fundamentals. From Argentina to South Africa and from Turkey to the Philippines, the turmoil is truly global.

This month's Bulletin highlights the diverse prospects facing emerging economies, aiming to add nuance to what has generally been a crudely defined asset class. Contributors assess economic policy initiatives such as the development of financial instruments to help emerging markets adapt to climate change; developing ESG-related data and disclosures in China; and innovative funding tools for the development of transport infrastructure in the Philippines.

OMFIF's meetings programme has complemented these efforts through roundtables hosted last month in London with the central bank governors of Indonesia and the Philippines. Through our office in Singapore – which celebrates its second anniversary in November – we continue to promote such dialogue across Asia, and look forward to hosting a meeting in collaboration with the Bank of Thailand on the future of central banks later this month as part of a series of OMFIF events during the week of the International Monetary Fund-World Bank Group meetings in Bali.

Danae Kyriakopoulou
Chief Economist and Head of Research

»4 September, Singapore

Emerging misconduct risk in the financial sector

SOUTH East Asian Central Banks and OMFIF convened a forum to evaluate the appropriate supervisory approach and governance frameworks to mitigate emerging misconduct risk in the finance. Speakers included William Black, associate professor of economics and law at the University of Missouri-Kansas City, and Hans Tjio, deputy chairman of the advisory committee at SGX Listing.

»10 September, London

Political and economic outlook for the UK

OMFIF organised a discussion with Nicky Morgan, member of parliament for Loughborough and chair of the Treasury select committee. The meeting focused on the UK's political and economic position in the run up to withdrawal from the European Union.

»22 August, London

Future relationship between UK and European Union

OMFIF organised a discussion with Philip Rycroft, permanent secretary at the UK Department for Exiting the European Union. Topics included the negotiation process for the UK's withdrawal from the EU, the nature of a possible transition agreement, and UK economic growth post-Brexit.

»11 September, London

Enhancing the innovator-regulator conversation

OMFIF organised a discussion with Martin Moloney, special adviser on policy and risk at the Central Bank of Ireland. The meeting focused on how regulators and innovators applying advanced technologies in financial services can collaborate better. Following the launch of the Central Bank of Ireland's Innovation Hub, debate centred on how value can be added by engagement with regulators and how these authorities can achieve equitable treatment of and learn from innovators.

»11 September, London

Expansionary monetary policy

A ROUNDTABLE discussion with Stefan Ingves, governor of Sveriges Riksbank, the central bank of Sweden, and chairman of the Basel Committee on Banking Supervision. The discussion focused on monetary policy, shrinking balances sheets, the outlook for the krona, central bank independence and euro area integration.

»24 August, Singapore

Managing financial globalisation

THE multilateralised financial safety net built up by the Asean+3 countries over the last two decades will play an increasingly important role in the multilayered global financial system, according to Masatsugu Asakawa, Japanese vice-minister of finance for international affairs. Asakawa was speaking at an OMFIF roundtable, which included discussions on managing financial globalisation and the strengthening of regional financial safety nets.

»5-7 September, Berlin

New market order

OMFIF participated in the DZ BANK International Capital Markets Conference. It brought together leading policy-makers, financial experts and industry representatives to discuss political and macroeconomic developments in Europe and beyond. The panel, moderated by OMFIF Chairman David Marsh, included Marek Belka, former prime minister of Poland, Jeffrey Franks, director of the International Monetary Fund's Europe office, and Tianling Wang, counsellor at the the embassy of the Chinese Embassy in Berlin.

FORTHCOMING MEETINGS

»Monday 5 November, London

Central banks and digital currencies

A roundtable discussion with **Jon Nicolaisen**, deputy governor of Norges Bank. The meeting will focus on the development of central bank digital currencies and their effects on financial stability, along with private cryptocurrencies and distributed ledger technology.

»Wednesday 14 November, Tokyo

OMFIF-Japan Center for Economic Research meeting

The third joint policy meeting by OMFIF and the Japan Center for Economic Research. The meeting will cover global monetary policy, geo-political dynamics, global debt and cyber resilience.

»Monday 10 December, London

Balancing the roles of the European Central Bank

A lunch discussion with **Ignazio Angeloni**, member of the supervisory board at the European Central Bank. The meeting will focus on how the ECB balances its roles of monitoring the euro area's banking sector whilst stimulating banks to lend more.

»Thursday 31 January, London

Outlook for reserve asset management for 2019

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

For details visit omfif.org/meetings

All eyes on Asia

As the IMF meetings head to Indonesia, we highlight some of the issues economies throughout the region are facing.

Beijing will not 'weaponise' the renminbi

Aggressive depreciation of currency would hurt China's world role

Robert Dohner
Atlantic Council

As US-China trade tensions veer towards a trade war, most of the actions have been on tariffs and goods trade. China has countered US tariffs on solar panels, steel, aluminium, industrial equipment and medical devices with increased duties on soya beans and other foods, agricultural products, and automobiles. The US in turn has threatened to impose tariffs on essentially all imports from China.

The escalating trade conflict has taken place in an environment of strong US economic performance, while Chinese growth has been slowing. It has also coincided with a depreciating renminbi exchange rate. After strengthening in the first three months of the year, the Chinese currency became the worst-performing in Asia, falling by 7.7% against the dollar, and 6.6.% from early June to the end of August.

From a market perspective, renminbi weakness is easy to explain. US interest rates are rising, the dollar has strengthened, and there are concerns about slowing growth and rising defaults in China. But renminbi depreciation has led to accusations that this is taking place with People's Bank of China encouragement and that China may 'weaponise' its exchange rate, opening a new front in the trade conflict.

The renminbi continued to weaken over the summer, but forebodings of a weaponised renminbi are misplaced. Markets may edge the renminbi exchange rate lower, possibly with PBoC acquiescence. For three reasons, however, China is unlikely to actively weaken its exchange rate as an aggressive measure in a trade conflict with the US.

More effective measures

The first reason is that intentional renminbi depreciation has significant risks for domestic financial stability. Despite the PBoC's efforts to introduce greater flexibility and market determination, the foreign exchange market remains acutely sensitive to perceptions of what the PBoC wants the exchange rate to be.

This was illustrated by the central bank's disastrous attempt to recalibrate exchange rate policy in August 2015, which led to a sharp depreciation and surge of capital flight from China. Even if China's large foreign exchange reserves and capital controls could stem the tide, the authorities' strong aversion to market turmoil and fear of loss of control over capital flight remain a strong discouragement to shifts in exchange rate policy. If the US-China trade conflict intensifies, this aversion would certainly grow. There would be a high premium on assuring the public and the markets that the Chinese economy is stable and the authorities are in control.

The second reason is that renminbi depreciation is a blunt instrument. It affects all China's trade partners, not just the US. In fact, China tends to target carefully its use of trade and investment policy for sanctions purposes. Examples are restrictions on Philippine bananas (related to a dispute over the South China Sea) or on Chinese operations of South Korea's Lotte confectionary company (over deployment of the US anti-missile defence system in South Korea). Not simply targeting the US, this year China has applied its retaliatory tariffs to products like soya beans from districts with Republican congressmen.

China's cuts in its global tariffs on automobiles and automobile parts, along with an increase in tariffs on these products from the US, are another illustration of the government's targeted approach. The country faces a much larger direct trade exposure in the US market than the US does in China. However, this should give little comfort to Washington, since Beijing has ways to impose costs on the much larger operations of US firms in China. The measures include adverse or withheld administrative approvals, such as the one that scuttled chipmaker Qualcomm's bid for Dutch chipmaker NXP.

China's global standing

The third reason China is likely to forgo currency as a trade weapon is that it would undercut China's larger ambitions to exert global leadership and diminish US standing. Starting with President Xi Jinping's speech at the Davos World Economic Forum in 2017, the country has tried to establish China's narrative as the preserver of open markets and the global architecture. Beijing has sought to cast the US as aggressor and China's responses as measured. It has tried to court other countries impacted by US actions, particularly the European Union.

Adoption of a 'China first' exchange rate depreciation would revive suspicions of China's willingness to 'game' the international system. Still more important, it would risk squandering what China sees as its moment to claim international leadership. ●

Robert Dohner is a Senior Fellow at the Atlantic Council in Washington. He was previously Deputy Assistant Secretary for International Economic Analysis and Deputy Assistant Secretary for Asia at the US Treasury.

Making infrastructure pay for itself

Governments consider land value capture to reduce tax burden

Cesar Purisima and Haraya Buensuceso
Milken Institute

Discussions on transport infrastructure in the Philippines tend to focus on the boons and banes of different financing models. But the sustainability of a transport service hinges on the ability to pay for it. Whether publicly or privately financed, adequate and reliable funding underlies every project's long-term success.

Rodrigo Duterte, the Philippine president, has made infrastructure a large part of his economic development strategy. Under the Php8tn-Php9tn (around $150bn-$170bn) 'Build, Build, Build' programme, the government has committed to increasing public spending on infrastructure to 7.4% of GDP by 2022 from 5.4% in 2017. Almost 4,900 projects are scheduled for completion over the next three years.

Historically, the Philippines relied on general taxation and, where applicable, user fees to sustain its borrowing and spending. One promising option for the transportation sector is the use of land value capture. This class of funding tools leverages the benefits of higher land values around transport facilities such as urban transit stations and toll road exits and has been applied in many of the world's largest cities. In the case of the extension of Line 7 of the New York metro system, LVC funded up to 88% of total project costs.

Land value capture refers to the act of collecting a share of the benefits generated by public actions that enhance the value of land. Transport infrastructure investments and associated regulatory decisions, such as changes in land use, typically lead to improvements in accessibility or productivity. Land and properties become more desirable as people and businesses are willing to pay a premium to be near new infrastructure.

The user-pays approach suggests that the costs of a transport system should be borne primarily by the users of that system. However, the majority of the world's transit systems struggle to cover their operations and maintenance costs using fare revenues, let alone construction or debt service costs. Governments usually shoulder a sizeable fraction of the costs through general taxation.

Citizens residing outside a metropolis often take issue with paying for expensive transit services from which their benefits are indirect and difficult to measure. At the same time, raising fares is politically contentious. Even when fares are increased successfully, the extra revenue may still not cover costs.

Advantages of LVC

The greatest merit of land value capture is its ability to address this two-pronged problem of a substantial taxpayer burden and limited revenues. LVC extends the definition of beneficiaries to include landowners near new infrastructure whose land has been made more valuable by its existence. Extracting funds from those areas that directly benefit from public transport infrastructure not only ensures that the profits this infrastructure generates are mobilised for the benefit of the greater community, but also frees up tax revenue for competing priorities. In the absence of LVC, pent-up land values are pocketed by existing landowners or even speculators who make investments in anticipation of the demand for land new projects typically induce.

Engaging the public, aligning business and government interests, and encouraging carefully planned and coordinated land use around transport infrastructure are just some of the additional benefits LVC can bring. However, in isolation they do not constitute sufficient basis for the pursuit of LVC.

LVC cannot alter the economic viability of infrastructure projects. It may enable a government to deliver projects and their associated economic benefits sooner, by front-loading funding, but LVC ought to remain a secondary consideration to these projects' inherent economic value. It is only warranted if projects already make strategic or economic sense, and if it can make infrastructure funding fairer, more efficient and sustainable. ●

Cesar Purisima is Asia Fellow, and former Finance Minister of the Phillipines, and Haraya Buensuceso is Princeton in Asia Fellow at the Milken Institute. This piece is an abridged version of a paper that was originally published on the Milken Institute website in July 2018.

Executing ESG strategies in China

Refocus on sustainable investing coincides with the change in market dynamics

Richard Pan
China Asset Management

China's growing focus on sustainable investments has emerged as quality of life improved, mirroring the social, industrial, and economic development trend of the West.

The country's onshore equity market is the second largest in the world by market capitalisation, and its green bond market became the largest in the world in 2016.

Sustainable investing was sidelined during China's double-digit growth era owing to the economy's competitive dynamics. Significant external demand propelled the economy, and companies were focused on rapid growth and establishing their market position.

The refocus on sustainable investing coincides with the change in market dynamics and consumption upgrades in the economy. In 2017, green finance emerged as one of the key strategic initiatives of China's 13th five-year plan. However, the adoption and implementation of sustainable investing is a lengthy process. It takes research, education and trial and error before achieving the right balance. Dialogue and idea sharing with China's more experienced global counterparts must take place.

Until now, the implementation of environmental, social and governance strategies in China has been limited. In August 2017 the total market size of Chinese funds focused on ESG themes was just Rmb22bn (around $3.2bn), against a global total of more than $20tn of assets managed under responsible investment strategies.

Effective engagement

Poor data quality and frequently inaccessible information make it difficult to analyse Chinese companies' ESG performance. Data points on public companies may be hard to acquire as they are often disclosed on a voluntary basis. In cases where data points are available, they must be further scrutinised and verified. Proprietarily-managed ESG coverage is often subject to standardisation and cost efficiency concerns. An investor would have had to expend substantial resources to ensure adequate coverage, both in breadth and depth, of the thousands of companies within the A-share investable universe. Furthermore, ESG coverage in the onshore Chinese market by global firms had been limited until 2017, when index provider MSCI announced the inclusion of Chinese A-shares in its emerging market indices. This provided momentum for asset managers and rating agencies to begin to rate Chinese A-share companies.

In the China offshore equity market where higher quality data are available, ESG factors were shown to provide excess returns. In the onshore market, where fewer data points were available, ESG factors delivered around 6.5% annualised excess returns, according to research by China Asset Management. Companies with high ESG scores outperformed those with low ones.

In addition to discovering value through research and portfolio management, ESG engagement may be another source of value creation for invested companies. This involves communicating with company management on corporate strategy and governance. In China and most of Asia, 'soft' engagement with investors is done for a few reasons. First, there is higher concentration of shares in major shareholders than in other regions. Second, investors prefer to maintain a friendly market reputation. And third, legal structures and frameworks in parts of Asia may still present ambiguities in the event of board room escalations; a soft approach can save stakeholders from expensive and lengthy proxy fights.

Taking root

A company's ability to attain long-term sustainable performance is a function of its corporate strategy and the management's ability to implement it. This is especially important in the current Chinese market, where companies flourished on strong economic development, but their long-term prosperity may be compromised if management is too focused on short-term performance. Companies without proper investment in environmental protection are more likely to incur additional expenses in the future in reclamation, fines, or capital investments.

Only in the last couple of years has ESG investing begun to take root in China, and Chinese companies still have much to learn from their global peers. As direct beneficiaries, the Chinese market, its investors and participants will be more open to sustainable and responsible investing.

Regulators are likely to require ESG-related data to be disclosed regularly. And international investors and institutions will play a constructive role in shaping the next stage of Chinese financial markets. China Asset Management will continue to explore ways to improve our research processes, invest responsibly and fulfil our fiduciary duty. ●

Richard Pan is Head PM, Head of QFII Investments and International Business at China Asset Management.

Partners for the common climate good

Advanced economies must support emerging markets to develop sustainably

Joachim Nagel
KfW

This summer brought record-breaking heatwaves to many regions around the globe. In countries that usually enjoy more moderate weather, such as Germany, people have become aware that climate change is not a possible future scenario – it is happening now. Climate change is a global phenomenon, which means it can be tackled only through international co-operation.

While the advanced economies have been the major emitters of carbon dioxide for decades, emerging markets have caught up quickly in recent years. Relative to the size of their populations, the greenhouse gases emitted by emerging markets still trail leading economies such as the US, Japan or Germany. However, China has become the largest source of carbon dioxide emissions in absolute terms. Rising emissions from emerging economies are the other side of strong economic development.

These countries often argue that their emissions are unavoidable in the light of their economic progress. They compare this developmental phase to the period of industrialisation most advanced economies experienced during the 19th and 20th centuries. Reducing emissions comes at a cost developing countries do not want to shoulder alone. They feel disadvantaged when advanced economies ask them to curb emissions in a way the industrialised world never had to.

Global public good

It is in our common interest to counter climate change, as well as air pollution, deforestation and environmental degradation, no matter where they occur, because they affect us all. This is similar to the common interest we have in securing other global public benefits like financial stability or trade rules. On behalf of the German government, KfW co-operates with more advanced emerging market economies, such as India and China. It supports these countries in adapting to and mitigating climate change.

One of our shared endeavours is reaching the 1.5 degrees Celsius objective of the Paris climate agreement. The aim of this international accord is to keep global warming under two degrees Celsius above pre-industrial levels, preferably 1.5 degrees. A range of financing instruments is available, from grants to promotional loans. Moreover, KfW is in the process of developing instruments specifically adapted to the climate change threat. One example is the refinement of climate risk insurance; another is green bonds, where KfW is engaged as an investor and issuer.

> 'Four of the 10 largest cities in the world are in India and China. This growth poses a particular challenge with regard to climate change – but also a chance to curb emissions.'

Apart from choosing the appropriate instrument, it is important to aim support at sectors that are most relevant and vulnerable to climate change. The energy sector comes to mind immediately. Almost 50% of KfW's commitments in Asia have been made in the energy, environment and climate field.

Rapid urbanisation

But there are other areas that have grown in importance recently. Urbanisation is a significant trend in emerging markets. Half of the 100 fastest-growing cities can be found in Asia. Four of the 10 largest cities in the world are in India and China. This growth poses a particular challenge with regard to climate change – but also a chance to curb emissions. Right now, in most countries, one-quarter of national emissions are generated by the three largest metropolitan areas.

The probability of successfully tackling these problems will increase significantly if advanced economies support emerging markets to develop sustainably. This kind of co-operation will gain in importance in a world where old alliances have recently been called into question. Global problems such as climate change will punish a failure to co-operate across borders, regions and levels of economic development. This is why KfW maintains its commitment to emerging markets. Working with countries such as China, India and Indonesia as global development partners is not an option, but a necessity. ●

Joachim Nagel is Member of the Executive Board at KfW, the German state-owned development bank.

Cash fights back against obsolescence

Electronic transactions are public, susceptible to power cuts and can be hacked

Taimur Baig
DBS Bank

Neither electronic payments nor electronic money are new phenomena. More than a century ago, traders in London and New York communicated with each other in real time through telegram – exchanging news, trading instructions and payment orders. Western Union began using its telegraph network to wire money in 1872. Central banks have been managing the issuance of reserves to banks electronically for many decades. Mobile payments and digital wallets have been around for nearly 20 years.

What has changed over the past decade is that mobile computing power and connection speeds have improved tremendously, bringing instant digital payments and settlements to consumers. During the same period, entrepreneurs created systems of digital currency issuance and settlement that take place privately and globally.

Starting in 2009, but gaining worldwide attention in the last five years, bitcoin epitomises the keen interest in digital currencies. The cryptocurrency universe has expanded rapidly; there are more than 1,600 types of tradeable cryptocurrencies. Call it speculative, precautionary or portfolio diversification, but digital currencies have captured investors' attention.

The advent of credit and debit cards ushered in an era of cashless payments several decades ago, and their use continues to rise. It is estimated that card payments as a share of GDP have doubled in both advanced and emerging economies since 2000 (to around 25% of GDP). People have more cards per head and they use them more frequently, but they spend less per transaction. As payment infrastructures have deepened, day-to-day transactions can now be settled with a card. Online payments have soared.

India conducted the most interesting recent experiment regarding cash. In late 2016, the government made a surprise demonetisation announcement, requiring the deposit of all high-value notes, followed by a gradual introduction of new notes. The process was complemented by a push for e-payments. By the end of 2017, e-payments had increased, as expected, but cash in circulation had also returned to previous levels (and, in 2018, has climbed above previous peaks).

Rise in demand for cash

Demand for cash is up by around 2 percentage points of GDP globally since 2000, although this varies considerably between countries. The variation does not depend on the level of development; Japan has a high cash demand (20% of GDP) while cash demand in China has fallen by 5 percentage points of GDP (to 9%). Sweden has also experienced a marked decline.

The 2008 financial crisis pushed up cash demand in some developed countries. Iceland is the starkest example, with cash in circulation doubling since then.

In Singapore, both cash and non-cash use has been rising steadily over the past decade. The reasons for the demand for cash are shown by the distribution of currencies by denomination. Large-denomination banknotes, due to their portability, are suited for storing value, whereas small-denomination banknotes and coins are more likely to be used for payments.

Cash seems to be mounting a strong resistance against obsolescence, even in a highly connected and advanced economy like Singapore. It may be susceptible to counterfeiting, but no one can hack into cash and power cuts cannot disrupt these transactions. For small and medium-sized enterprises in Singapore that do a large amount of business with vendors across the border in Indonesia and Malaysia, cash remains a key source of settlement.

There may also be genuine demand for cash from those who carry out legal but private transactions. People may not wish to have a record of certain transactions, such as helping a struggling relative or paying for an embarrassing habit or guilty pleasure, but that does not make these activities illegal. When both parties want to remain out of the public eye, cash is the only way to guarantee privacy. ●

Taimur Baig is Managing Director and Chief Economist at DBS Bank. A longer version of this article can be read on the DBS website.

Normalisation risks dip in money growth

No signs of higher inflation from central bank policies

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

In an ideal world, broad money growth should mirror the rate of growth of real output, in order to maintain price stability. In the short term, inflation is affected by many factors, such as energy prices, but over the medium and long term it is explained by changes in the quantity of money in excess of rises in national output. A persistent rate of money growth much above the trend rate of growth of the economy will lead to inflation.

What does that imply for the conduct of monetary policy in the leading economies at present?

The trend rate of growth in the euro area, Japan and the UK is not much more than 1% per year. Money growth should run at most at around 4% a year to be consistent with stability objectives. For the US, with its somewhat more dynamic economy, a slightly higher figure may be appropriate.

Happily, these are the sort of numbers that have been recorded in the current decade.

Since the start of 2011 the typical annual rate of increase in the M3 broad money measure in the US has been 3.8%. The US has enjoyed a long expansion with negligible inflation. In the euro area over the same period the average rate of growth of M3, according to the European Central Bank, has been 3.5%. Here the pace of money growth has been higher since the start of the ECB's asset purchases in early 2015, and so too has been the advance of demand and output.

Shrinking balance sheets

Central banks seem intent on policy normalisation, where they mean a reduction in the size of their balance sheets. The Federal Reserve plans soon to run off $150bn of assets per quarter.

Suppose that the non-bank private sector repays at redemption bonds held by the Fed from its bank deposits. Then those deposits fall and money balances are destroyed.

The Fed's asset run-off might lower the quantity of money by, say, $300bn in 2019, taking money growth back towards negligible levels. One can raise the same concerns about the euro area, where the ECB's asset purchases are due to end at the start of 2019.

The latest numbers argue against undue alarm. In both the US and the euro area they show money growth running at an annualised rate (in the last three months) of around 4%. Nevertheless, the euro area has suffered a slower pace of improvement in demand and output in 2018 than in 2017, perhaps partly because the ECB's asset purchases are more modest than in 2016 and 2017.

Central banks will need to ensure that policy normalisation is compatible with steady growth in the quantity of money at the sort of figure (4% at an annual rate) consistent with both low inflation and wider macroeconomic stability. ●

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

Worldview

This month's expert analysis

Promise of digital fiat currency

Token-based system preserves roles of central and commercial banks

Bejoy Das Gupta
eCurrency

Central banks are considering issuing digital fiat currencies to maximise economic gains, remain relevant in a digital world and respond to the rise in popularity of cryptocurrencies. DFCs hold the promise of being legal tender, electronic and fully convertible one-for-one into sovereign-backed notes. They would be universal, always available, and usable across all payment networks. They provide instant and final settlement, are included in base money and have cash-like properties.

In recent years, mobile providers have begun to offer inexpensive and readily available digital payment services, while cryptocurrencies have sought to position themselves as an alternative to state-backed money. However, mobile operators essentially provide private money, which carries credit, technology and stability risks. Cryptocurrencies are unstable, and bring investor and consumer protection concerns.

There are numerous benefits to replacing a portion of a country's cash with DFCs. First, they would provide a credit risk-free payments system, backed by the state. This would avoid concentration and technology risk associated with privately-operated systems. It helps maintain control over money supply. It would ensure central banks remain relevant where cash use has dramatically declined, as in Sweden, and continue to earn seigniorage income.

Second, adopting DFCs can sharply reduce physical currency printing and distributing expenses, as well as other transaction costs. The total annual cost of cash could be 1%-2% of GDP, or 3%-5% of the value of a transaction; DFCs can drive down recurring costs to fractions of that.

DFCs are not limited by the denomination structure of banknotes and, unlike cash, can be used for long-distance and cross-border transactions, the cost of which could drop significantly. This is beneficial for small businesses and individuals, and can foster financial inclusion in developing countries.

Battle of the banks

Analysts are debating DFCs' design and monetary policy considerations. On design, there has been discussion about token- v. account-based frameworks: DFCs can be designed as a token-based system, where storage and processing are decentralised in a payments instrument, or as an accounts-based system, where storage and transactions are processed by the central bank. A token-based model most closely resembles cash, where the DFC is distributed across payments systems.

In contrast, an accounts-based approach, where the central bank offers digital accounts to retail consumers, runs the risk of being a competitor to commercial banks and could contribute to financial instability during flights to safety. Some central banks argue that interest-bearing DFC accounts could raise funding costs for banks, contribute to volatility, with outcomes dependent on regulation, deposit insurance and perceptions. Many central banks contend that token-based DFCs are the preferred option. In that case, monetary policy transmission and financial stability consequences would be limited, with controlled anonymity for small transactions. A token-based approach also helps preserve the two-tiered financial system, with key roles for central and commercial banks.

The use of a consensus network approach for DFCs based on the digital ledger technology underpinning blockchain, where the transactions register is replicated among all network participants, is falling out of favour. This method is constrained by slow processing speeds and limited transaction volumes, and is not under the sole control of central banks. The energy and computing costs are also high. It is exposed to counterfeiting risks and the finality of transaction settlements is not assured.

While central banks are evaluating DFCs, eCurrency solutions have begun to be deployed in card-based and mobile-based e-money payment systems. Earlier this year in Asia, the Rizal Commercial Banking Corporation used eCurrency technology to launch the ePiso in the Philippines in accord with the central bank's sandbox regulations. eCurrency's digital secured stored-value product was launched in West Africa last year with Banque Régionale de Marchés and approved by the Central Bank of West African States.

Over time, we expect central banks to use the eCurrency architecture to issue DFCs, enhancing e-money networks and private sector innovations. The solution supports both token- and accounts-based DFC systems, does not rely on distributed ledger technology, works well for both retail and wholesale transactions, is fully interoperable and is cryptographically secured. ●

1%-2%

The average annual cost of printing and distributing cash, as a percentage of GDP

Bejoy Das Gupta is Chief Economist at eCurrency, a technology company that enables central banks to issue digital fiat currency.

Transforming the investor experience

Digitalisation and standardisation revolutionise investment management

Ileana Sodani
BNY Mellon

Investment management has long embraced technology. However, it is only recently, as computational power increased and software became easier to deploy, that the industry has been able to interrogate data more effectively to find greater efficiencies, add value and improve performance.

Digitalisation and standardisation are helping institutional investors, asset managers and asset servicing companies overcome the limitations of legacy systems and get more value out of their extensive holdings of data.

Innovations in artificial intelligence, such as machine learning and process automation, are accelerating this trend.

Value of digitalisation

The benefits stemming from these developments are manifold. First, the investor experience can be enhanced through a more tailored and responsive service. Asset-servicing providers are leveraging application programming interfaces and other new technologies to deliver data to institutional investors and asset managers more quickly and more flexibly to support process efficiency and investment insight. Wealth managers are turning to a new suite of tools, such as 'robo advisers', data analytics and real-time services, to offer a more personal service for individual investors.

Second, data analytics highlight opportunities to control costs through automation and standardising processes. This also improves supply chain management.

The third advantage concerns better risk management. The continued systematic analysis of data can lead to better quality control and enable the early identification of negative trends. 'Regtech' also has the potential to transform regulatory compliance.

Fourth, ever more sophisticated and powerful analytical tools help to generate new investment ideas, enhance performance and support research, product development and testing.

As the digital economy generates an array of new sources of unstructured but potentially valuable data, existing information flows are being streamlined and customised. Asset managers are using new technology and data analytics to create a more client-centric experience than previously possible, whether those clients are major institutions or private investors.

Non-traditional competition

This brings dangers as well as opportunities. The impetus to explore data-driven opportunities for differentiation in the investment industry is fuelled, at least in part, by the threat of non-traditional competition. Many other sectors of the economy have been disrupted in this way in recent years.

It is possible that digital technology, with its power to connect suppliers directly to consumers, could bring about disintermediation. This could affect the structure of the investment management industry.

Asset management may be given away 'free' in future, paid for through the value of customer data. In the digital economy, consumers have become used to not paying for services directly, and the number of passive funds charging no or very low fees is increasing.

The other side of the coin concerns the higher expectations of the investment industry's customers, driven largely by their experiences of other sectors of the economy. Both individual investors and people making asset allocation decisions on behalf of institutional investors have come to expect instant access to accurate information at any time of the day, in user-friendly and mobile formats. The investment industry is working hard to catch up with those expectations.

As new technologies are adopted, it is worth remembering that they can change the competitive landscape in unexpected ways. The investment management industry cannot lose sight of investors' needs and must be alert and agile in this evolving market. The most successful companies will be those that can best exploit digital technology in a way that truly transforms the investor experience. ●

> 'Asset management may be given away "free" in future. In the digital economy, consumers have become used to not paying for services directly.'

Ileana Sodani is Head of Business Development for Asset Servicing in Europe, the Middle East and Africa at BNY Mellon. The views expressed here are those of the author only and may not reflect the bank's views.

Reserves management objectives

Some liquidity should be sacrificed in exchange for greater returns

Gary Smith and John Nugée
Barings and OMFIF

The orthodox view that foreign exchange reserves should be available for immediate use in the currency markets is deep seated. But there is evidence to suggest that spending reserves to defend an exchange rate can not only be unsuccessful but also, sometimes, counterproductive.

Rather than being viewed primarily as a tool for intervention, managers should treat reserves as one of several contributors to the generation of confidence in a nation's currency. They should not be viewed in isolation; there is no level of reserves that can compensate for a wider deterioration of macroeconomic conditions. Moreover, rapid spending of reserves can create a feedback loop and undermine confidence in an economy and currency.

Acceptance of this point should lead to a review of the list of reasons for holding reserves and debate on why they are predominantly held in highly liquid instruments. This, in turn, should precipitate a discussion on appropriate asset allocation.

Vicious circles

It is worth recalling the Chinese programme of intervention between mid-2014 and the end of 2016. Over this period, China spent around $1tn of reserves (one-quarter of its holdings), but the renminbi nonetheless declined in value against the dollar by almost 15%. The outcome confounded conventional theory.

The relationship between reserves deployment and currency value did not work as expected because the wider story was not supportive. Policy announcements were clumsy, capital outflows were strong and US rates were being hiked. In practice, China's use of foreign exchange reserves actually created a sense of unease that undermined the currency.

Similar effects have been observed in Argentina recently, Russia in 2014, South Korea in 2008 and across Asia in 1997.

In these cases, the size and rate of depletion of reserves became the focus of market attention. Ample reserves began to be viewed less as a policy tool and more as a policy objective that monetary authorities were failing to achieve. The perception of reserves adequacy swung rapidly from 'sufficient' to 'insufficient'.

A key issue is that calculating reserves adequacy is an imprecise science, with a poor track record. The International Monetary Fund has in recent years attempted to bring rigour to this analysis with the publication of a methodology called 'assessing reserve adequacy'. However, a statement that a nation's reserves are 95% adequate can mean either that they are only 5% short of being entirely adequate, or that they are adequate to cover 95% of possible eventualities. These are not the same, and neither address the real issue. Crises are binary, and a nation either has enough reserves or it does not.

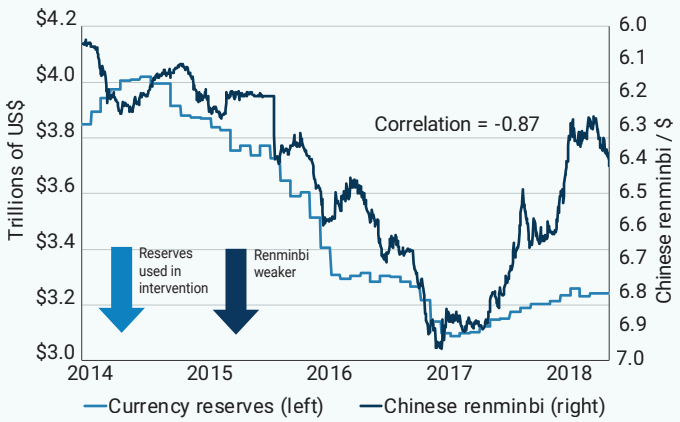
The spring 2018 crisis in Argentina highlighted this point. IMF metrics suggested that on the eve of the crisis, Argentina had a 95% adequacy ratio. When it tried to defend the peso with a combination of intervention and rate increases in May 2018, the market was unimpressed. Raising rates to 40% was not a sign of strength; it was interpreted as a sign of desperation, prompting the currency to fall further against the dollar. Seeking help from the IMF had become the only option.

Sound macroeconomic policies are more important than the liquidity of foreign exchange reserves in securing market confi dence in a currency. Acceptance of this point should encourage central bankers to reconsider their adherence to the classic reserves management objectives of 'security, liquidity and (only then) return'. The outcome should be that foreign exchange reserve managers place less emphasis on liquidity, and are more able to focus on return. ●

Gary Smith is Member of the OMFIF Advisory Council and Member of the Strategic Relationship Management Team at Barings. John Nugée is Senior Adviser at OMFIF and former Chief Manager of Reserves at the Bank of England. This article is based on a report from Smith and Nugée entitled 'The changing importance of foreign exchange reserves', which can be downloaded on the OMFIF website.

Reserves sell-off failed to halt renminbi depreciation

PBoC reserves and renminbi, $ exchange rate



Source: Bloomberg, International Monetary Fund

Emerging markets attract multinationals

Digitalisation and disruption building global companies in developing world

Andy Budden
Capital Group

It is not only globalisation that is creating opportunities for multinational companies in emerging markets. Since the turn of the century, digitalisation – the integration of digital technologies into everyday life – has been a key source of growth as well as disruption for many industries.

Multinationals in developed markets, particularly those in the US, have led the way in capturing growth in the digitally connected world. Google acquired YouTube a decade ago and now accounts for 40% of all music consumed in the US. Artificial intelligence and machine learning will help improve YouTube's services, which could boost Google's ability to monetise content with relevant advertising internationally – 26% of the search giant's revenue is generated in emerging markets.

The rise of digitalisation enables idea-driven multinationals to grow faster because they have easier access to a larger pool of end-users. Facebook has more than 2bn average monthly users, which makes it the largest virtual country in the world, and half of all internet users are on the social network. Facebook already generates 26% of its revenues from emerging markets.

Knowledge-intensive companies with an understanding of data and information can increase in scale in emerging markets while also delivering societal value. In developed markets, disruptors often displace existing competitors, but in emerging markets they tend to fill gaps in product or service provision.

> 'China has six companies with a market capitalisation of more than $50bn – around as many as Canada.'

Selective investments in leading global companies can enable investors to gain broader, more holistic access to opportunities in emerging markets.

By focusing on the economic exposure and revenue streams of a company instead of analysing it based on the traditional domicile approach, investors can gain a clearer picture of business risks and rewards. A revenue approach is impossible with index investing, and typical large-cap funds often ignore the risks of domicile-based investing. Asset allocation to emerging markets through an index can narrow the scope of investment exposure significantly.

Innovative emerging markets

The large multinational companies that dominate world commerce have traditionally been concentrated in developed markets. However, innovation in emerging markets looks set to change this. The dynamics that have kept emerging markets from producing leading global companies are shifting. There is a general trend towards less state ownership and intervention, better corporate governance and increasing globalisation in developing economies.

China is leading the charge. It has six companies with a market capitalisation of more than $50bn – around as many as Canada. India and Russia have three, while Brazil and South Africa each have one. The potential for these countries to catch up is enormous, given the concentration of global companies in some advanced economies.

The UK, with an economy around the same size as India's, has more than four times as many companies with a market capitalisation of $50bn.

Historically, the largest companies in emerging markets have been capital-intensive, mainly domestic financial services, telecommunications and utilities – and mining companies in resource-rich nations. Often these were state- or local-family owned, which placed constraints on management vision and strategy.

Developed market companies evolved faster because they were quicker to adopt new technologies and search for growth. These multinationals have long known that tapping into the growth and increasing sophistication of emerging markets is one of the most important ways to sustain their long-term success.

Innovation and scale now flow both ways between emerging and developed markets and 'new economy' sectors that are focused on technology play an even bigger role in developing economies than they do in advanced ones.

China and India's rapid development over the past decade, coupled with abundant access to capital and the emergence of data-driven corporations, is enabling accelerated globalisation of emerging market innovators. While emerging market-domiciled global players comprise less than 20% of the total Fortune Global 500, this is predicted to more than double by 2025. ●

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

Profit in fixing social ills

Institutional investors should explore impact investment

Bertrand Beghin
ChangeSquare

With the advent of any new market or industry, it takes time for definitions to settle down. A case in point is the difference between environmental, social and governance or socially responsible investing, and impact investing.

Blackrock, the world's largest asset manager, announced this year that it will require its funds to consider ESG criteria in their investment decision-making. While this is a positive step for the investment community, it is not necessarily an impact-investing agenda.

The financial market has around $77tn of assets under management. The ESG/SRI share of this is around $25tn. Growing public awareness of and demand for more ethically and responsibly produced goods and services has driven this expansion. However, the impact investing market was valued at just $228bn in 2017, less than 0.3% of the total.

ESG/SRI v. impact investing

ESG/SRI investments focus on publicly traded companies and are vetted using two filters. The first is a negative screening methodology. For example, from an ESG/SRI standpoint, companies listed on the FTSE 100 and S&P 500 engaged in 'controversial activity', such as arms manufacturing, pornography, tobacco or oil and gas, would be omitted.

Second, the remaining companies would be screened based on how they operate, using a best-in-class methodology. This would consider whether a business is environmentally friendly, whether it has fair and equal governance policies and is gender inclusive, or if it runs a strong corporate social responsibility programme. This methodology looks at how the company operates, not at the nature of the company, its products or services.

By comparison, impact investing primarily uses positive screening. This methodology considers the nature of a company and its products or services to see if its expected impact is embedded in its founding documents, culture, design principles or articles of governance to try and alleviate a social or environmental ill.

Examples include a financial technology company aimed at providing access to capital for rural farmers or a health technology company that provides chronic-disease diagnostic tools to the poorest members of society.

Typical impact investing sectors include agriculture, education, healthcare, inclusive finance, renewable energy and women's empowerment. In recent years these fields have been expanded to include green infrastructure and technology implementations such as blockchain.

A common misconception is that impact ventures sacrifice scale and growth for social good. Several ventures prove that seeking a social impact can deliver a financial return. Standout examples include M-Pesa, the Kenyan mobile money service that promotes inclusive finance; Jibu, a company seeking to deliver affordable clean drinking water in East Africa; d.light, a solar-energy provider; and Patagonia, which makes sustainable outdoor clothing.

$25tn

The size of the ESG/SRI market

'Some argue impact ventures sacrifice growth for social good. But several ventures prove that seeking a social impact can deliver a financial return.'

Institutional investors

Institutional investors are not active in this area because the majority of impact investment companies are early-stage ventures and privately held.

They are mostly funded by venture capital or private equity firms, as well as family offices and high net worth individuals, which represent a small segment of institutional allocations. Some institutional investor impact-themed funds have targeted small to mid-cap companies generating social value, such as WHEB Groups' FP WHEB Sustainability Fund or Hermes' Impact Opportunities. Not all ESG/SRI funds are equal; some have greater social or environmental impact than others.

Investing in the private market is not on every asset manager's agenda, but ESG/SRI investments are a good introduction to sustainability and ethical investment, given the amount of information, key performance indicators and liquidity in public markets.

Institutional investors should explore opportunities in the impact investment market to help build a generation of companies dedicated to tackling the most pressing issues facing humanity, while delivering strong financial returns. ●

Bertrand Beghin is Chief Executive Officer of ChangeSquare.

STATE STREET GLOBAL ADVISORS

Index Funds Must be Activists to Serve Investors

Cyrus Taraporvela
President & CEO, *State Street Global Advisors*

State Street Global Advisors serves governments, institutions and financial advisors with a rigorous approach, breadth of capabilities and belief that good stewardship is good investing for the long term. Pioneers in index, ETF, and ESG investing and the world's third largest asset manager, we are always inventing new ways to invest

State Street Global Advisors seeks long-term value for millions of ordinary investors in a world that has become increasingly obsessed with short-term results. This goal is why we have developed a rigorous, research-based shareholder engagement programme. We raise all kinds of issues with boards that might materially impact their company's ability to generate sustainable returns over the long haul.

While our active funds can sell a company if we disagree with its executives, our index funds cannot choose the shares in which they invest. We are essentially permanent capital and cannot turn the S&P 500 into the S&P 499. That means we need to take a long-term perspective on behalf of our clients. At a time when some activist shareholders are keen on extracting short-term profits from companies, we provide a healthy and necessary counterweight.

Our primary fiduciary obligation to our investors is to maximise the probability of attractive long term returns. Flows into index-based strategies have increased so dramatically over the past few years that we must take this responsibility more seriously than ever. Millions of individual investors count on the low-cost access to markets around the world provided by exchange traded funds and other trackers. This has democratised access to markets that were once available and affordable only to larger institutional investors.

We carefully select the issues we focus on with companies, based on rigorous research into their impact on investment performance. For example, numerous studies show that diversity at the board level leads to better decision making, fewer reputational crises and ultimately better returns.

This is the reason why we placed the Fearless Girl statue on Wall Street and issued specific guidance to boards to take steps to improve diversity. Performance was our motivation. This is just one example of how we seek to maximise transparency around our views, the research underpinning them, and our voting intentions. Others can be found in our new 2017 Asset Stewardship Report (https://www.ssga.com/investment-topics/environmental-social-governance/2018/07/annual-stewardship-report-2017.pdf) that provides details on our proxy voting and engagement on thousands of management and shareholder proposals in 82 different countries across the globe. Increasingly, our clients are pushing for more clarity on non-traditional investment issues. They want to know how companies are incorporating climate risk into their long-term strategy; whether they are adopting best practices around corporate governance, board quality and pay policies; how they are adapting to technology disruptions that could threaten their industries.

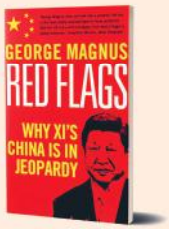
We need only look to recent corporate scandals around poor internal controls to remind us of the importance of active shareholder engagement. Our focus on active stewardship in a rapidly changing and complex world is more important than ever for ensuring healthy public markets, resilient economic growth and shared prosperity. We are creating long-term value; not imposing values.

ssga.com/fearlessgirl

Book review

China's Xi: omnipotence and brittleness

David Marsh



GEORGE Magnus's book on China will meet scepticism in Beijing, but will be widely read there – and in many other places where the world's No. 2 economy is a subject of mystification, veneration or concern. *Red Flags – Why Xi's China is in Jeopardy* focuses on the inescapable signs that China can no longer ratchet up seemingly never-ending economic growth. In a sense, Magnus's book tells us what we know already. He highlights China's anonymous 'authoritative source', who stirred debate in May 2016 with an interview in the People's Daily. A person widely believed to be Liu He, a close adviser to President Xi Jinping, fulminated against a dangerous debt-fuelled economic model. At a time when China was battling capital flight, renminbi weakness and a 40% fall in the Shanghai stock market, the article raised widespread attention – and provides a framework for Magnus.

As befits a celebrated financial analyst, the former chief economist of UBS applies a pitiless lens to China's development and perspectives. The country's sense of historical purpose and quest for achievement appears in many ways to be on a collision course with reality. Magnus rails against western China-watchers whom he accuses of naivety or sycophancy in neglecting less positive aspects of China's rise. 'Fawning and awe', as he calls it, play along with China's own carefully constructed self-enhancing narrative. Consciously or not, Magnus aligns himself with the relentlessly questioning spirit guiding President Donald Trump's pursuit of a more equitable balance in the Sino-US trade, investment and technology relationship. US unilateralism appears to buttress China's opportunities to enhance geopolitical power in a leaderless world. Yet Trump's eagerness to open a trade war exacerbates further what Magnus terms China's 'four traps': over debt, the renminbi, demography and its move to middle-income status.

Magnus well depicts the conflicts behind the renminbi's rise to intentional reserve status. China's emphasis on currency stability will come unstuck unless Beijing implements compatible monetary and credit policies. It will not have a truly global currency unless it relaxes capital controls and allows foreigners greater access to the renminbi capital market. The renminbi's inclusion in the International Monetary Fund's special drawing right was part of a quid pro quo with the US under which China stood to gain prestige while enhancing financial liberalisation. By running current account surpluses and restricting renminbi flows, Magnus believes Chinese polices will solidify US monetary hegemony. Yet his recommendation that China should run trade deficits to allow foreigners to accumulate its currency is unconvincing. That would surely exacerbate China's exposure to the international monetary pressures that Beijing wishes to keep in check.

Xi's potential pitfalls result from a juxtaposition of circumstances hardly foreseeable in 2012 when he embarked on his path to the presidency. By cancelling constitutional term limits, Xi has strengthened his domestic grip but exposed himself further to the inherent contradictions of authoritarian rule. He is trying to reap the benefits of a liberal world trading order just at the time when the US president is doing his best to dismantle it. A Chinese autocrat backed by the all-encompassing Communist party faces an American autocrat supported by US geopolitical and monetary might. Instruments such as the Belt and Road initiative and a burgeoning renminbi zone among clientele countries designed to buttress China's world power may end up undermining it. Xi's apparent omnipotence hides brittleness. ●

David Marsh is Chairman of OMFIF.

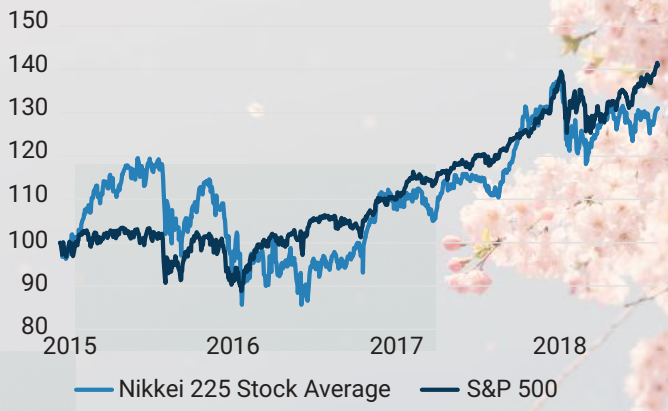
The chart

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

Global growth pushed stock prices up over the last few years, but both Japanese and US markets fell in February amid rising long-term bond yields and heightened inflation expectations. The S&P 500 has since bounced back, enjoying its longest-ever bull market run, while the Nikkei 225 is recovering more sluggishly.

Tokyo stock market slow but steady

Stock market indices, 2015 = 100



Source: OMFIF analysis, Bank of Japan, Thomson Reuter

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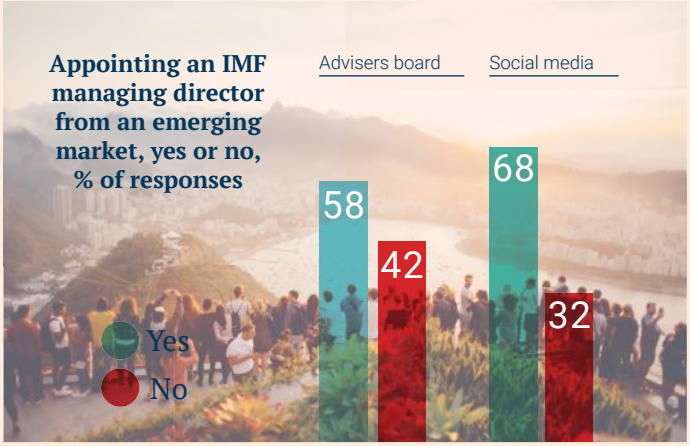
Advisers network poll

Next IMF chief should 'break from the norm'

Alternative factors should be considered for the candidate



This month's poll focuses on the choice for the next head of the International Monetary Fund. Participants were asked: **'When Christine Lagarde's term ends as managing director of the International Monetary Fund, should her successor be someone from an emerging market?'**

Of those who responded to the advisers network poll, 58% believe the candidate should be from an emerging economy. Some also explained that a non-European candidate, due to their dominance of the role in recent years, would send the message that the IMF executive is more representative. It was also suggested that the push for better diversity in finance would expedite this. However, 42% argued that picking someone from an emerging markets was less important than other factors, citing merit and experience ahead of geography.

The social media poll dovetailed with the advisers' responses, with 68% of respondents feeling that the appointment should be from an emerging market.

It is not a case of the next leader not being from Europe. We need our international institutions to be truly international, and to function as fully independent.

Mark Crosby, Monash Business School

No, I believe that the 'old gentlemen agreement' to appoint an American at the World Bank and a European at the International Monetary Fund will hold.

Fabio Scacciavillani, Oman Investment Fund

The question will be whether Lagarde wants a third term. If she does, she will receive it. If not, it should be a merit-based choice to succeed her.

Ted Truman, Peterson Institute for International Economics

For the sake of discipline over lending, her successor should come from a creditor country, whether developed or emerging.

Akinari Horii, The Canon Institute for Global Studies

Yes, this would send the right signal that the IMF is not only for the European Union and US.

Brigitte Granville, Queen Mary, University of London

Not necessarily. Country of origin is less important than the ability to lead staff and rally members to respond to global crises.

Irena Asmundson, California Department of Finance

November's question:

Saudi Arabia has shelved the proposed initial public offering of state-owned oil company Saudi Aramco. Is this a sign of the kingdom's waning commitment to its ambitious Vision 2030 reform programme?