The Bulletin

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Up in the air

Interpreting global flows and trade regionalisation

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Dialogue on world finance and economic policy

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

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The state of globalisation

From the UK's Brexit challenge and US unilateralism, to trade wars and European immigration concerns, the unifying theme that preoccupied liberal policy-makers in 2018 was the political threat to economic globalisation and how best to share the benefits of an interconnected world.

For the last Bulletin of 2018, we invited contributors to review the state of globalisation. They address the increased importance of the regulatory component in regional trade agreements, and how competition from local firms may be a greater threat to multinationals than trade wars. On global finance, contributors argue that the change in composition of capital flows does not imply more stability, and that the Basel Committee should ensure implementation of its rules for supervision are adequately tailored to developing countries.

International co-operation is essential to many of OMFIF's core themes, and our meetings and research aim to bring together perspectives reflecting our diverse and global membership. In April and November, we held meetings in Paris and Berlin respectively on how to reform the architecture of the euro area. In October, we were hosted by the United Nations to discuss how the world's central banks can work together to address the consequences of climate change for our economies. Over the summer months, we collaborated with 21 central banks to research integrating blockchain technology in their interbank payments systems. Much more is on the agenda for 2019, covering the intersections of finance with technology, the environment, trade and politics.

Danae Kyriakopoulou
Chief Economist and Head of Research

»25 October, London

Monetary policy in Canada

A ROUNDTABLE discussion with Lawrence Schembri, deputy governor of the Bank of Canada. Schembri discussed Canadian monetary policy, economic developments in the country and its outlook as presented in the Bank's Monetary Policy Report.

»17 October, Johannesburg

Emerging capital markets

REGIONAL integration should be a key priority in the process of developing capital markets across the African continent, but countries should also look to benchmark their policies to those of other emerging markets, according to panellists at the launch of the Absa Africa Financial Markets Index at the Gordon Institute of Business Science in Johannesburg.

»1 November, Berlin

Future of the euro

OMFIF'S newly established Chief Economists Network had its first meeting in Berlin, hosted by Jörg Zeuner, chief economist at KfW. The CEN brought together chief economists and research directors from the public and private sectors for dialogue and analysis. The meeting focused on the prospects for reform of the architecture of Europe's economic and monetary union, drawing attention to the need to reduce imbalances across the euro area. Speakers included former ECB President Jean-Claude Trichet and German Finance Ministry State Secretary Jörg Kukies.

»12 November, London

Progress of Brexit

OMFIF organised a roundtable with Lord (Norman) Lamont, chancellor of the exchequer (1990-93) and Lord (Christopher) Tugendhat, vice-president of the European Commission (1981-85), on the state of the UK's withdrawal from the European Union. Topics of discussion included the UK's negotiation process, the economic and political impact of the different Brexit scenarios, and the future relationship between the EU and the UK.

»5 November, London

Central bank digital currencies

OMFIF held a discussion with Jon Nicolaisen, deputy governor of Norges Bank, on developments in central bank digital currencies and the practical implications on the financial system. Discussion focused on the use of cash, the models for CBDCs, new technology transforming payment systems, cryptocurrencies, and how central banks should shape appropriate policy responses.

»20 November, London

Crypto market regulation

'TWO-THIRDS of institutional investors (surveyed) expressed willingness to invest in the crypto-asset market if regulation improves,' according to OMFIF's Kat Usita at the launch of the OMFIF and London & Oxford 'Global crypto-asset regulatory landscape' report.

»31 October, Geneva

Central banks and green finance

RECOGNISING climate-related changes as financial risk ensures these issues do not require expansion of central bank mandates. This was a key message at a panel hosted by OMFIF and the United Nations Conference on Trade and Development at Geneva's World Investment Forum.

»8 November, Singapore

Singapore fintech growth

LIMITS on talent, unified regulatory approaches and interoperability are barriers to Singapore becoming a global leader in fintech. This was a key message at an OMFIF roundtable discussion on the global fintech landscape attended by Mark Field, the UK's minister of state for Asia.

»10 October, Singapore

Cities of the future

THE 2018 OMFIF-Barings panel explored the future of world cities. Discussion focused on how urban populations incorporate new technology in their work, home and leisure time, and how these advances disrupt current patterns and create opportunities for innovative business models. Speakers included Heenam Choi, chief executive officer of the Korea Investment Corporation, and Christopher Smart, head of macroeconomic research, Barings.

FORTHCOMING MEETINGS

»Monday 10 December, London

Balancing the roles of the European Central Bank

A lunch discussion with **Ignazio Angeloni**, member of the supervisory board of the European Central Bank. The meeting focuses on how the ECB balances its roles of monitoring the euro area's banking sector while 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 brings together a group of economic experts and asset managers from a public sector background.

»Thursday 7 March, London

Launch of the Gender Balance Index

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

»Monday 25 March, London

Developments in the US economy

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

For details visit omfif.org/meetings

Illustration: Mike Kelley AWNS

Up in the air

From Brexit to trade wars, the unifying theme that preoccupied policy-makers in 2018 was the political threat to economic globalisation and how best to share the benefits of an interconnected world.

The new rules of international trade

Regional agreements pose challenge to global non-discriminatory framework

Rohini Acharya
World Trade Organisation

Countries have notified 290 regional trade agreements to the World Trade Organisation, and are negotiating many more. At the turn of the century, fewer than 100 such agreements were in force.

In the past, RTAs focused on liberalising tariffs on trade in goods. Today, they increasingly include commitments on trade in services, investment and other provisions not usually associated with border protection. These extend in some circumstances to questions on intellectual property, government procurement, competition, electronic commerce, environment and labour. But their expansion poses challenges to the non-discriminatory framework on which global trade rules are based.

Most RTAs use existing WTO rules as building blocks for further trade liberalisation and rule-making. The question is how much further they go and what can be said about any resulting divergence between WTO rules and provisions found in RTAs.

One area where one would expect such divergence is trade liberalisation commitments, with RTA partners agreeing to eliminate tariffs between themselves while maintaining tariffs against all other WTO members. The growth of RTAs has meant countries are likely to be increasingly trading with each other preferentially rather than under their 'most favoured nation' tariffs.

The WTO enforces rules on the use of trade defence measures, trade in services and intellectual property rights. For some provisions such as anti-dumping, there appears to be practically no divergence between the commitments espoused in RTAs and the WTO rules. In most cases, WTO members opt to maintain their rights and obligations under WTO rules in the RTAs they sign. In some other areas, such as sanitary and phytosanitary provisions, there is some divergence, but mostly on procedures rather than the rules themselves.

WTO rulebook

RTAs increasingly include regulatory provisions in areas that are only partially or not yet covered by WTO rules. These include government procurement and investment, which are partially subject to WTO disciplines, and others such as competition, environment and labour, which are not. Here there tends to be greater divergence between WTO and RTA rules.

RTAs that include provisions on competition, trade and environment, labour and gender are creating new guidelines that are not yet in the WTO's rulebook. In other areas like government procurement, a growing number of non-members of the WTO's plurilateral Agreement on Government Procurement are making significant commitments on this issue through their RTAs. However, while WTO members are creating new rules through their RTAs that other WTO members are not subject to, these behind-the-border provisions tend to be applied in a non-discriminatory manner. This means they are of some benefit to non-RTA parties as well.

Even when there are divergences, WTO members have tended to use common approaches or templates in their RTAs. In services, while several members have followed the 'positive list' approach (where countries list the products for which tariffs will be lowered) taken in the WTO's General Agreement on Trade and Services, the 'negative list' developed by the North American Free Trade Agreement (where countries list the products against which barriers will be maintained) is increasingly popular. In dispute settlement, similarly, most members tend to use common approaches in the relevant chapters of their RTAs.

As tariffs and other trade barriers have declined over time, market access is no longer the only reason to negotiate RTAs. Instead, modern regional agreements include a range of other rules to regulate behind-the-border provisions that have implications for international trade. Such provisions, while negotiated between RTA partners, are usually extended to all economic operators regardless of nationality.

In several cases, it does not make practical sense for such regulatory changes to be restricted only to operators from RTA partners. In others, exceptions allowing discrimination, such as under the General Agreements on Tariffs and Trade and on Trade and Services, are not permitted by the WTO's Trade-Related Aspects of Intellectual Property Rights Agreement. This confluence of factors requires RTA commitments to be extended to all other WTO members.

Thus, while market access and related issues, such as rules of origin, are designed to deflect trade from third parties, rules and regulations on several subjects are implemented by RTA parties non-discriminatorily and could be beneficial for all trading partners. Policy-makers must bear in mind all of these complexities as regional and bilateral trading arrangements become increasingly popular around the world. ●

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Regionalisation among Asian powerhouses

Major regional advanced and emerging economies rely on one another

Joergen Oerstroem Moeller
ISEAS Yusof Ishak Institute

The US is no longer the sole custodian of economic globalisation, nor does it want to be. Its share of global GDP has fallen to 22% in 2018 from 38% in 1970. President Donald Trump is realigning Washington's commitments to global rules, cutting costs, disregarding international institutions and neglecting key partners. With the US adopting unilateralism, globalisation is left without an enforcer. In response, countries around the world are opting for an alternative through regionalisation.

Nowhere is this more pronounced than in Asia. According to the Asian Development Bank, intraregional trade in 2017 stood at 57.3% up from an average of 55.9% between 2010-15. Even more revealing are global value chains, which show how much of a country's imports and exports is being channelled back into the global economy instead of used for domestic consumption or investment. The higher the share, the more value-added a country delivers to the global economy. The share for the US is 46.5%, with China just behind at 44.4%.

The share of intraregional Asian foreign direct investment is growing, and currently stands at 55%. Ten years ago, China's savings surplus was almost 10% of its GDP. For 2018, it is forecast at 0.6%. China may have harboured plans to grow into a global investor, but such a role is beyond its reach at this time. Instead, Beijing has chosen to underpin its strong position in intraregional trade through investment, as the extent of the cross-border Belt & Road infrastructure initiative indicates.

Four Asian blocks

Regional development in Asia will revolve around four blocks: China, India, Japan and Southeast Asia. As globalisation slackens, Asia will compensate through regionalisation.

China imports high-tech goods from Japan to facilitate the expansion of its own high-tech manufacturing sector. With the US and Europe becoming increasingly vigilant about the transfer of technology and intellectual property from western businesses to China, Japan will grow in importance to Beijing. India will replace China as the primary supplier of labour intensive, low-cost manufacturing in Asia. Beijing can benefit from this migration of manufacturing by investing in India, which is already on the upturn.

India needs China's help to grow into a manufacturing hub. Beijing can provide training, infrastructure and logistics, which would be welcome from an economic perspective, but may incite political backlash. Japan has invested more than $25bn in India over the last 17 years and is likely to continue investing heavily in the country. At the same time, Japan needs China as a market for its investment goods and expects India to be a good outlet for its exports, with a high share of finished products going directly into consumption or investment.

Southeast Asia is home to a wide variety of countries and enjoys both a diversified economy and proximity to large and wealthy markets in Japan, China and India. This part of the world offers many opportunities that should not to be missed as the US and European share of global GDP falls. Southeast Asia can deliver resources, commodities, intermediate goods, finished products and services across a broad range of industries including tourism and finance.

All four blocks stand to lose out if political or economic relations sour. Japan would retreat into its shell. India's integration into global value chains would slow. The Arab world, Africa and perhaps Russia are potential alternative partners for New Delhi, but none of them can match China, Japan or Southeast Asia. China would have to contend with lower economic growth and slower progress in its high-tech industry. This is something the leadership in Beijing dreads. Southeast Asia depends on China and Japan, its No. 1 and No. 2 trading partners, respectively. China accounts for 17% of Southeast Asian trade and Japan just below 10%, while India is No. 8 at around 2%-3%.

Forecasts say that by 2050 Asia will account for more than half of global GDP and more than half of the world's population. By then, its status as the world's economic powerhouse is likely to be firmly cemented. Much will depend on how well the major players in the region are able to co-operate as international sympathy for globalisation wanes. The response will be a stronger Asia decoupled from the global economy. ●

Joergen Oerstroem Moeller is Senior Research Fellow, ISEAS Yusof Ishak Institute, and a former State Secretary at the Danish foreign ministry.

Trump's moral victory on Nafta

Democrats may still scupper revised trade agreement

Darrell Delamaide
OMFIF

Replacing the North American Free Trade Agreement was a core issue for Donald Trump during his presidental campaign. But the Democratic takeover of the House of Representatives after the midterm elections in early November could complicate US legislative approval for the US-Mexico-Canada Agreement, Nafta's proposed successor.

The new USMCA includes important measures to achieve Trump's stated goals. Chief among them is to have higher local content requirements for automobiles and higher wages for auto workers in order to qualify for tariff-free trade.

The measures are aimed at German and Japanese car manufacturers as well as domestic companies to keep jobs from migrating to Mexico and to expand investment in the US. Daimler and BMW, for instance, have large assembly plants in the US, but import most engines. Consequently, their cars would not meet the new local content requirements. Volkswagen has large production facilities in Mexico, where average wages are far below the $16 per hour required for a portion of workers.

The opening of Canadian dairy markets to US producers is a further boon for Washington. This was a major concession by Ottawa to join the bilateral accord reached by Mexico and the US, even if it is only for 3.6% of the Canadian market.

Often forgotten in discussions about the Northern American car industry is the important role played by Canadian parts suppliers, who can now maintain their place in automakers' supply chains. Also, like US workers, they benefit from the requirement that 40%-45% of the parts have the higher wage threshold. Mexican autoworkers could benefit, since the requirement is likely to trickle through to them as well.

In addition, there are some environmental and labour protections. Mexico will give workers the right to unionise, extend labour protection to migrant workers and protect women from discrimination. That will benefit Mexican workers and/or keep jobs in the US.

Some marginal provisions such as the extension of copyrights and pharmaceutical patents and prohibiting duties on music and e-books will benefit online companies, as well as raising thresholds for duty-free shipments. The revised treaty also phases out investor-state arbitration, which critics thought gave too much leverage to corporations.

The agreement doesn't include Trump's tariffs on steel and aluminium. That being said, these were applied to Mexico and Canada to give the US further leverage in talks, and may be removed when or if the new agreement is ratified.

> 'Replacing Nafta was a core issue for President Trump. The new USMCA includes important measures to achieve what he wanted.'

Congressional bickering

The USMCA is, in short, somewhat more than a repackaged Nafta, if not a revolutionary change. Moreover, it is a moral victory for Trump's trade policy.

Democrats don't have much against the USMCA, but are reluctant to hand over a political victory to Trump. The House majority they will enjoy in the new Congress from January will give Democrats the ability to block it.

The administration could try to push through the agreement during December's lame duck session with the old Congress and the Republican majority in both houses, though that could lead to a backlash. Democrats may insist on changes in 2019, but Mexico and Canada will be in no mood to make them.

> **16 years**
> Expiration clause inserted into new Nafta deal

The new treaty has a sunset clause that means it will expire in 16 years, but first there must be a sunrise. It will be an early test for the new Congress whether Democrats and Republicans are willing to work together for the good of the country or continue their inveterate bickering. If Democrats' main complaint is that the revised treaty does not go far enough, that is hardly a reason to scupper the deal.

There are questions about whether Trump would be able to withdraw from Nafta if the new treaty fails without approval from Congress, since the former was implemented through congressional ratification.

Trump could try anyway, which might push the deal to the courts. Given his vehemence in condemning Nafta during the 2016 campaign, it seems improbable that he would simply walk away from a defeat. ●

Darrell Delamaide is US editor at OMFIF.

Metamorphosis of global finance

Flows of financial assets demand heightened regulatory vigilance

Otaviano Canuto
OMFIF

The wave of financial globalisation – as measured by the ratio of the stock of foreign assets to world GDP – began to rise in the mid-1990s, and has peaked since the 2008 financial crisis. This period saw external financial assets and liabilities soar. Financial openness (the sum of foreign assets and liabilities as a proportion of GDP) reached levels three times higher than those recorded before the second world war.

There have also been changes in the composition of flows. While total cross-border lending decreased as a proportion of GDP, global ratios of foreign liabilities to GDP have remained stable in the light of increasing flows of foreign direct investment, equity portfolios and debt securities. Such aggregate figures, however, gloss over some relevant details.

In advanced economies, cross-border movements of financial assets have risen greatly since the mid-90s. Levels of financial openness relative to trade openness (the sum of exports and imports as a proportion of GDP) were similar for both advanced and emerging economies until the mid-1980s, but rose rapidly in the former's case after the mid-90s. According to the Bank for International Settlements, cross-border financial assets and liabilities rose to 570% of GDP from 135% between the mid-90s and 2016 for advanced economies. For emerging economies, they rose to 180% of GDP from 100%.

Several factors have contributed to mounting cross-border financial transactions. Rising production and foreign trade correspond not simply to the movement of goods, but stimulate cross-border payments and the growth of trade finance. In advanced economies, financial liberalisation and the expansion of increasingly sophisticated financial markets created conditions for a surge in foreign transactions of assets. Financial openness also rose faster than trade openness in emerging countries, albeit at a slower pace than advanced economies.

> 'The metamorphosis of global finance has not suppressed the need for policies to monitor and cope with risk.'

Sources of flows

In Europe, the inauguration of the single currency in 1999 boosted cross-border transactions. As markets revised down their assessments of risk premiums across the euro area towards German levels, cross-border transactions were further exacerbated.

European banks contributed to the inflation of the US financial system's asset bubble in the early 2000s. These institutions used US wholesale funding markets to sustain exposures to US borrowers through shadow banking. Despite their small presence in the US commercial banking sector, their effect on overall credit conditions was magnified through the shadow banking system.

The 2008 financial crisis and euro area crisis led to the retrenchment of European banks' foreign claims as companies moved to mitigate losses and deleverage balance sheets. Tighter banking regulation and the tilt towards domestic assets under unconventional monetary policies also played a key role. These factors have also led to deleveraging, balance-sheet shrinking and domestic reorientation by banks in other crisis-affected advanced economies outside of Europe.

Although banks in other economies have increased their foreign lending, levels of global financial openness have been maintained in large part because of growing flows of non-lending instruments.

Some of these new features of financial globalisation may engender greater stability. Higher capital buffers and set minimums for liquid assets have reduced the weight of bank lending and allayed balance sheet volatility. The higher share of equity and FDI may carry longer-term return horizons and closer alignment of risks between asset purchasers and originators.

Some likewise argue that the unwinding of debt-financed current account imbalances is making global finance more stable. However, flows of FDI correspond in part to disguised debt flows and/or transfers motivated by tax arbitrage or regulatory evasion. Cross-border debt flows, in turn, are sensitive to global factors and are highly procyclical with respect to monetary-financial conditions in either source and/or destination countries.

The metamorphosis of global finance has not suppressed the need for policies to monitor and cope with risk. Recipients of net capital inflows must continue to strengthen their institutions and reinforce the alignment of risk between investors and countries. Regulatory vigilance against excess financial euphoria or depression remain necessary. ●

Otaviano Canuto is a Member of the OMFIF Advisory Council and a former Vice-President and former Executive Director of the World Bank.

No-deal Brexit would mean transport chaos

Consequences would extend far beyond the sector

Kat Usita
OMFIF

One of the pillars of the European Union – the free movement of goods and services between member states – is facilitated by transport connectivity. As such, transport will be one of the sectors most affected by the UK's departure from the bloc.

Major disruptions to transport are never contained within the sector. They have a tangible domino effect that reaches any industry relying on movement, from products to the workers who come in to create them.

Unlike tariffs or immigration policy, the consequences of transport restrictions are immediate. There is no waiting for the price of goods to go up, or for the flow of EU migrant workers to taper. Without adequate transport arrangements leading up to March 2019, the result will be visible: grounded flights, coaches stuck at borders and traffic jams resulting from port congestion.

UK Transport Secretary Chris Grayling insists that this is not cause for panic. He says the UK has coped with aviation disasters in the past, including the collapse of British airline Monarch last year, that left 110,000 passengers stranded overseas.

The UK and the EU say they are working to ensure all forms of cross-border travel remain uninterrupted after March 2019. However, earlier this year, the UK wrote to EU27 governments to request side negotiations on transport. Michel Barnier, the European Commission's chief Brexit negotiator, criticised then UK Brexit Secretary Dominic Raab for preparing for worst-case scenarios, implying that the minister had undermined trust in the negotiating process.

Worst-case scenarios

Brussels may have been bruised by the attempt at side deals, but there is pragmatism in pursuing such arrangements on transport. A no-deal Brexit would result in the loss of unrestricted entry and exit rights for all modes of transport.

Because the UK is part of the European common aviation area, its registered airlines can fly to and from EU member states (along with Norway, Iceland, the Balkans and Liechtenstein). The single aviation market has liberalised air travel between and within member states, boosting the airline industry's growth and supporting tourism.

When the UK leaves the EU, it will cease to be a member of the ECAA, and will lose its rights under the single market. In the absence of a deal, UK airlines would need to seek permission from individual EU member states to fly in, out and within. For both sides, it makes sense for the UK to maintain some form of agreement with the bloc, including the possibility of re-entering the ECAA as a new member, since it is one of the EU's largest aviation markets. However, without clarity on the issue, the UK may end up forming reciprocal arrangements with each market.

In the meantime, the lack of overall certainty has its costs. Advance planning – critical in determining flight schedules and demand for seats – would be more challenging. Popular low-cost Irish carrier Ryanair claims there has been no reduction in bookings for travel dates post-Brexit. While this indicates consumer confidence that air travel will be unaffected, it also confirms that any potential chaos would happen on a large scale.

Ultimately, the cost of disruption will be borne by passengers. Airlines like Ryanair have been selling tickets for travel beyond March 2019 with a warning clause on Brexit, indicating that passengers will not be able to claim compensation should flights be grounded. While this may not affect the long-term attractiveness of the UK as a destination, it shows the trouble with uncertainty.

Moreover, there is the question of the planned development of London's Heathrow airport. The decision to build a third runway was made this year, following a lengthy debate over whether Gatwick airport should be expanded instead. Failure to reach an agreement on flights could jeopardise the expansion project's financial viability. Heathrow Airport Holdings reportedly raised £1bn in debt this year specifically to cushion any difficulty stemming from Brexit.

The UK transports 90% of its trade by sea, with the EU its largest trading partner. Brexit – and leaving the customs union – entails tariffs on European goods, along with customs checks on imports. Implementing them is costly: the additional processing time would create congestion in ports and the roads around them.

Businesses will take a hit, but so will consumers. The price of goods will rise in the light of tariffs and supply chain delays. UK exporters will face similar difficulties as their goods enter ports in mainland Europe.

In the long-term, Brexit

> 'A no-deal Brexit would result in the loss of unrestricted entry and exit rights for all modes of transport.'

may benefit the UK. It has the second largest ports industry in Europe, and withdrawal from the customs union will enable further growth as Britain gains freedom to trade with countries outside the EU. Congestion in Dover, currently handling 17% of trade goods in the UK, could mean business for quieter ports in the north.

Expanding port capacity requires time and significant investment, as ports that receive diverted traffic will need to be prepared to handle the influx of cargo efficiently. Waiting for a deal to come through is holding back the necessary port development. In the worst case, ships may be forced to unload containers in alternative ports that are ill-equipped to process them, creating bottlenecks and increasing costs.

As many as 38,000 UK-registered hauling vehicles entering Europe will be affected in the absence of a deal on road transport. As with shipping, lorries are an important element in enabling trade, and the EU single market allowing vehicles to move freely has kept logistical costs low. Additional border checks would delay journeys and impact supply chain costs for UK companies.

The UK government's back-up plan is to rely on permits issued by the European Conference of Ministers of Transport. Only 3,816 permits are available for 2019, covering just 10% of UK haulers. The quota may be increased in coming years, but only if the 43 ECMT countries unanimously agree.

There is also the issue of driving licences. UK professional drivers will no longer have the automatic right to drive within the EU, unless they are fortunate enough to secure one of the limited ECMTs available. The problem also affects tourists and ordinary drivers, who will need to apply for international driving permits if they want to drive in Europe.

Network peril

London's status as a financial and economic powerhouse was achieved partly because of its developed transport network. England's strategic location – a middle ground between Asian and American time zones – makes it an optimal base for many multinational companies. It shaped Heathrow into an ideal transatlantic flight hub, making London easily accessible for business travel, and turned Dover into one of the world's busiest ports for passengers and freight.

The wave of migration to the UK, which has helped channel both skilled and unskilled labour into the country's economy, was made possible partly by transport connectivity, and not just because of employment opportunities within the transport sector. Affordable flights within Europe's common aviation area, along with several rail and coach options, make it easier for migrants to decide to move to work or study in another country, knowing that it is reasonably cheap to visit home.

Securing a deal, as with everything related with Brexit, provides certainty for transport. It should not be treated as a disaster to cope with, but rather one to prevent by all means. ●

Kat Usita is Economist at OMFIF

38,000

UK-registered hauling vehicles entering Europe will be affected in the absence of a deal on road transport

Nimble multinationals endure trade conflicts

Smaller, disruptive competitors pose greater threat to incumbent companies

Joanna Jonsson
Capital Group

The most common question I am asked these days as a portfolio manager is whether I am worried about the impact of global trade restrictions on trade-dependent multinational companies. While investors ought to follow these political conflicts closely, one should not be overly concerned about the impact on well-managed multinationals; they are the companies best-positioned to navigate an uncertain environment and devise effective solutions.

Some multinationals are starting to employ nimble, 'multi-local' business strategies that bring them closer to consumers and local buying trends. Others have been doing so for years, reaping the benefits of a tailored approach to local markets.

For investors, it is crucial to avoid focusing too much on the noise surrounding trade and protectionism. It is easy to get lost in new data points every day, so much so that investors may decide to shy away from multinational companies. This can be detrimental to successful, long-term investing.

Smart companies decipher how best to address these problems. Invest in strong, global companies with seasoned management teams, and they will usually prosper regardless of the environment. The best-run multinationals find ways to win even when governments engage in disquieting activity.

Multi-local success

The multi-local approach is gaining traction. Investors should be searching for companies establishing successful operations in their local markets, rather than retreating in the face of global trade barriers. It is becoming increasingly important for multinational companies to produce where they sell. They must be able to move quickly and respond effectively to local competition.

Sportswear giant Nike epitomises this approach. This summer, the company unveiled a new data-driven retail store in Los Angeles that stocks shoes according to online buying trends in surrounding areas. In Europe, Nike has launched a speedy supply-chain initiative that allows it to tailor colours and materials based on individual customer preferences in each city where it operates.

In the financial sector, Visa and Mastercard are following a similar approach by taking into account local considerations for electronic payment processing. This method meets not just the preferences of local customers but also the strict financial regulations of myriad governments. As a result, both companies are growing at a healthy rate while fending off competition from other financial technology businesses.

Another example is Temenos, the Swiss technology company that is rapidly growing its highly-local business of providing and upgrading banks' enterprise software programmes. Many of its customers use outmoded technology and require 'ultra-local' solutions to comply with state and federal banking regulations in their domestic markets. This European company is in the midst of an ambitious expansion into the US.

Emerging competition

This multi-local approach is crucial for multinational companies based in the US, Europe and Japan that are looking to stay relevant or expand into faster growing emerging markets. Many of those economies – China, India, Brazil, among others – are nurturing their own multinational giants, as well as smaller single-country-focused competitors.

Aside from the trade worries, some multinationals are lagging behind smaller competitors who are more in touch with local markets. That is a bigger threat to multinational companies than any political issues. Emerging market consumers are looking for brands they can trust and companies that know the local marketplace. Large multinationals that can think locally, act nimbly and launch products more quickly – in essence, behaving like an emerging company – are better positioned for long-term success. Ultimately, today's global trade disputes are more likely than not to be resolved sensibly. But the challenge posed by fierce local competition will continue to be an effective motivator in the global economy, as it always has been. ●

Joanna Jonsson is Equity Portfolio Manager at Capital Group.

> 'Investors should be searching for companies establishing successful operations in their local markets, rather than retreating in the face of global trade barriers.'

2018 in review ★★★★★

Global economy in a position of 'relative strength'

Danae Kyriakopoulou
OMFIF

The world economy continued to grow in 2018, once again fending off fears of a correction in global asset prices amid a maturing cycle. This was in line with predictions from our advisory board, published in the January Bulletin, that 'a recession is unlikely to happen' and 'the world economy will surprise on the upside in 2018'. Trade tensions between the US, China and Europe provided the greatest source of angst for financial markets, but the worst has so far been avoided. Perhaps the same can be said of the UK's withdrawal from the European Union, with a Brexit deal inching closer. A few emerging markets faced investment volatility over the summer, but their long-term prospects are bright, especially as countries continue their efforts on regional integration. Still, there are risks on the horizon, especially in terms of policy normalisation by the world's major central banks. The advisers' January warnings that 'the greatest potential source of macroeconomic instability could come from central banks' and 'central banks must be aware of the sensitivity of economies and markets to policy tightening' will still apply in 2019.

>>

Euro area enters decisive decade

Following a year of record growth in 2017, economic momentum across the euro area slowed somewhat in 2018. Nevertheless, all 19 member states' GDP expanded. The recovery was supported by continued monetary accommodation by the European Central Bank, due to carry on until at least the end of the year. The question is what happens after that. In the absence of significant change in inflation predictions, the ECB is set to end net purchases and enter a tightening phase of interest rate increases in 2019. This should help free up space in its toolbox ahead of predicted deceleration as the global economic cycle matures. A major lesson from the past decade is that to ensure sustainable recovery, policy-makers must avoid relying on central banks as the only lever.

On the fiscal side, economies that have the capacity for expansionary policies seem unwilling to use it. This will probably continue in Germany, irrespective of who takes over the leadership of the ruling Christian Democratic Union after Chancellor Angela Merkel steps down this month. Other countries are pushing ahead with expansionary plans despite lacking fiscal space. A case in point is Italy, where the government's failure to resubmit its budget plans to the European Commission in November has elevated tensions between Brussels and Rome. The next six months will be crucial in determining whether the Commission will – for the first time – launch its excessive deficit procedure, which could lead to fines.

> 'The world's largest economies – the US, EU and China – have continued to grow.'

The third area of policy is structural reform, where Europe has notoriously lagged behind. This year saw important developments, with Merkel and French President Emmanuel Macron's Meseberg declaration in June setting steps towards the creation of a common euro area budget and the strengthening of the European Stability Mechanism into a European monetary fund. Still, progress is expected to be slow as political tensions build.

Headlines from The Bulletin in 2018

Three scenarios for the UK-EU relationship

Two and a half years after the UK voted to leave the European Union, uncertainty continues to dominate British politics. It is unclear whether 'Theresa May's days in Downing Street are numbered', as predicted by Brian Reading. The UK prime minister faces a crucial challenge in passing the deal she has negotiated with the EU through the British parliament, after the EU27 accepted it at the end of November. The agreement would offer Britain control over its immigration policy, while a proposed free trade area for goods would maintain the strong interconnectedness between the two economic regions. However, the deal would impose rules on Britain in many areas that are of great importance to the UK economy, including services. At this juncture, the three probable scenarios are: acceptance of May's deal or a version thereof by the UK parliament; a hard or 'cliff-edge' Brexit in March 2019 in the absence of a deal; or a second referendum that would include the possibility of staying in the EU.

Multilateralism at risk

Much was made of US President Donald Trump's decision to impose tariffs on China and the EU, and subsequent retaliation from the two blocs. In real terms, the effect on the global economy was contained. The sectors affected represent a small share of the trade flows among the partners and within their domestic economies. However, these events could signal bilateral agreements becoming the norm, at the cost of weaker multilateral institutions. The evidence is subtle; key

examples include the weakening of the World Trade Organisation through the blocking of its appellate body nominations, as well as the tightening of foreign investment screening rules directed at China by both the US and EU. The Democratic advances in the US midterm elections in November are unlikely to constrain the president's 'America first' focus and its application to trade and investment policy, and tensions are unlikely to abate in 2019.

Emerging market shocks overshadow progress on integration

This year, emerging economies made steps towards further integration. In March, during the 10th Ordinary Session of African Union heads of state summit in Rwanda, 44 out of 55 member states signed a historic agreement establishing a continental free trade area. It mirrors elements of the EU and aims to liberalise the market for goods and services trade across the continent. In Asia, integration across the Association of Southeast Asian Nations is a work in progress, while 'increased investment from China in these countries' has 'supported growth and integration', as predicted by OMFIF adviser Mark Crosby in January.

> 'Emerging economies face short-term macroeconomic risks, as demonstrated by market uncertainty in Argentina, Turkey, Brazil and South Africa this year.'

Still, emerging economies face short-term macroeconomic risks, as demonstrated by market uncertainty in Argentina, Turkey, Brazil and South Africa this year. China remains vulnerable as it seeks to deflate its debt burden while rebalancing its economy, but as Otaviano Canuto predicted, the authorities have so far demonstrated 'a wish to mitigate financial fragility and promote economic rebalancing'.

Overall, the US Federal Reserve's policy tightening cycle will continue to weigh on capital flow movements to emerging markets in 2019. However, there are strong chances that Elliot Hentov's reassuring claim that the Fed is unlikely 'to tighten sufficiently to end the economic cycle' and 'the real economy is unlikely to suffer much from tighter monetary conditions' will safeguard emerging markets from any upsets in the US economy.

Green finance market continues to grow

The Central Banks and Supervisors Network for Greening the Financial System was established in December 2017. It published its first progress report in October, outlining the risks of climate and environment-related change for financial stability and the steps that central banks could take to address them.

The green finance market has grown, with more than $100bn bonds issued by October. The same month, the Seychelles became the first sovereign to issue a 'blue bond'; proceeds will go towards the protection of marine life.

Devastating fires in Greece and California, as well as earthquakes and tsunamis in Southeast Asia, are important reminders of the need for policy-makers to back their commitment to the 2015 Paris climate change agreement with action.

Overall, the global economy enters 2019 from a position of relative strength. The world's largest economies – the US, EU and China – have continued to grow. However, risks remain, particularly as the economic cycle matures and central banks work to normalise policy. Moreover, fragmented politics in advanced countries could pose a threat to multilateralism. ●

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFIF

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GERMANY AT ITS BEST
NORDRHEIN-WESTFALEN

Worldview

This month's expert analysis

Services trade larger than reported

Growing role of foreign direct investment has implications for trade policy

Ben Robinson
OMFIF

The UK exports many more services than the trade account of the balance of payments suggests. Official trade statistics capture cross-border sales by services firms, as well as the movement of consumers to the service provider (as in tourism) and of the service provider to the consumer (including workers sent overseas). But these collectively account for only 30% of total services supply.

By contrast, 70% of exports are derived from services provided by foreign affiliates of UK companies operating abroad. These sales are not captured by existing trade statistics, as the companies operate through local affiliates established through foreign direct investment and are not, therefore, strictly transactions between residents and non-residents.

Net earnings on FDI are recorded on the primary income balance of the current account. The figures are substantial. Services account for the largest share of the UK's £1.2tn outward FDI stock. Within this, financial services makes up the largest position, at £302bn. Information and communication, retail, and professional, scientific and other services also contribute large shares. Taken together, net earnings by these firms generate the majority of FDI investment income, at £27bn in 2016, against £18.2bn for production industries (data for 2017 are released later this month).

If these figures were recorded in the trade account, the UK's services exports would have been more than 11% higher last year than the trade data suggest.

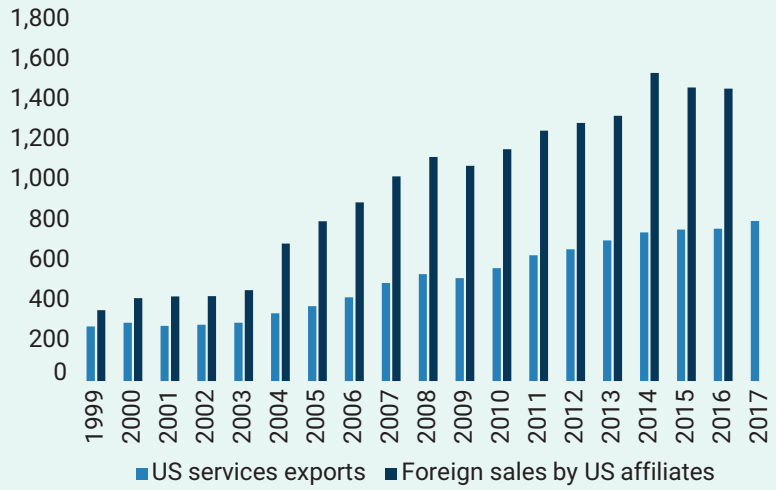
The real impact is larger still. While FDI earnings reflect net profits of overseas affiliates, they fail to capture total sales or turnover. Gross fixed capital formation, research and development expenditure, the value of assets, wages paid to employees and taxes generated in the host country are all discounted in the net profit figure.

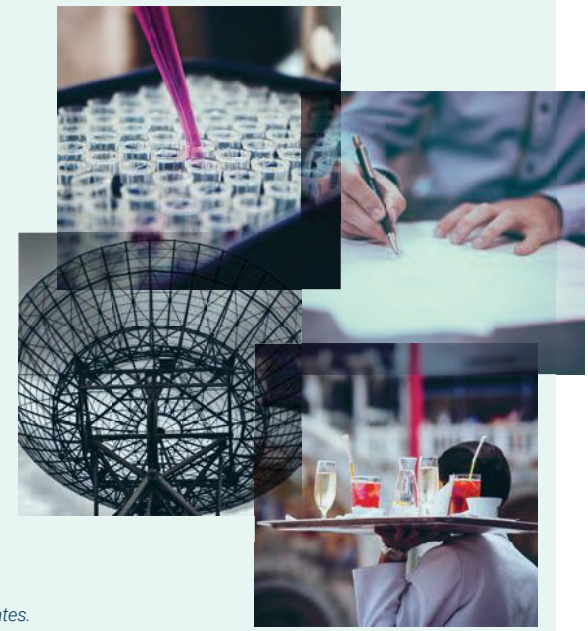
The total value of sales of services by foreign affiliates is therefore likely to be a multiple of the FDI earnings figure. This is not captured in either the trade or primary income accounts of the balance of payments, though employment and investment do contribute to the national accounts of the host country, and FDI asset value plays a role in determining countries' net international investment positions.

Policy implications

These findings have several policy implications. The UK is likely to face greater barriers to cross-border trade with Europe, particularly in services, after it leaves the European Union. One

US service firms export twice as much through FDI than cross-border
Value of services exports by mode of supply, $bn





Sources: US Bureau of Economic Analysis, OMFIF analysis. Note: No data for 2017 sales by foreign affiliates.

way to mitigate this will be for UK services firms to boost their FDI presence in the EU to sell into the European market. This shift has already started.

Between 2016-17, UK firms made the largest number of outward FDI projects on record, with 464 investments, according to EY. The number of UK FDI investments in European business services rose by 7%, logistics by 71%, financial services by 93%, digital by 147% and chemicals by 155%.

This carries additional costs. Banks will need to provide capital and other resources in each jurisdiction in which they wish to operate. Smaller firms are generally less able to navigate the complex processes and significant costs of establishing a foreign subsidiary. Regulatory and other non-tariff barriers to services trade remain pronounced, even in the single market. To combat these issues, the government should increase its support for businesses seeking to establish an FDI presence. The same is already done for cross-border trade by providing export credits, insurance and other trade finance.

Such support could take the form of tax incentives, preferential investment loans and financial, practical and legal advice for firms seeking to establish FDI. The 1995 General Agreement on Trade and Services is largely silent on such actions, making trade facilitation through support for FDI a relatively straightforward way for governments to promote services exports unilaterally.

UK trade negotiators should also focus on securing a hospitable investment environment for British firms operating in the EU, at least as much as on lowering tariffs and simplifying regulatory barriers to cross-border trade. This could help smaller firms gain access to foreign markets through FDI, something that is currently dominated by large companies.

Impact of tariffs

The growth of FDI as a way of delivering services without trading them across borders also helps to explain why, despite services growing to around 70% of global GDP now from around 53% in the 1970s, their share in global trade has remained constant at around 20%. Manufacturing, which has declined to 16% of global GDP from 27% over the same period, still accounts for around 70% of global trade.

This imbalance has contributed to the increased inelasticity of trade demand relative to GDP growth. Taking into account the primary income flows and NIIP valuations derived from FDI, as well as the impact on host-country national accounts from wages, turnover and taxes, the slowdown in global trade may not be as severe as the trade figures suggest.

> 'The total value of sales of services by foreign affiliates is not captured in either the trade or primary income accounts of the balance of payments.'

As several countries are raising trade tariffs and other barriers, reflecting heightened protectionist tendencies, FDI may provide one important way for companies to maintain export growth. Inward FDI is less likely to engender political antagonism in host countries, as it does not detract from the visible trade balance. Though associated net earnings can create gross outflows on the primary income account, inward FDI generally has a positive impact on domestic GDP, productivity and employment, as well as the capital account.

The current focus in the US on reducing the country's trade deficit fails to acknowledge the importance of this shift. The imposition of tariffs by Washington on Chinese imports has been met with restrictions on US companies operating in China and greater barriers to FDI. Sales of services by US affiliates abroad exceed the value of exports recorded in the balance of payments by a factor of two-to-one, according to data from the Bureau of Economic Analysis (see chart). Chinese restrictions could therefore prove very harmful for the US economy.

Moreover, while China's gross goods surplus with the US is highly visible, much of the value of the items it exports is derived from inputs provided by US affiliates operating in China and elsewhere in Asia.

Tariffs on Chinese imports are therefore likely to damage the earnings of these foreign affiliates of US companies and the associated revenue streams in the US primary income account. President Donald Trump's assertion that a trade war is 'easy to win' for a country with a large bilateral deficit simply reflects his lack of understanding of the intricate nature of modern economic interlinkages.

As the global trading environment becomes more complex, devising an appropriate trade policy is ever more important. Greater appreciation of the role played by the primary income balance and FDI in measuring export performance, in addition to focusing on the trade account, is a necessary step. The US has failed to grasp this reality; other countries should learn from Washington's mistakes. ●

Ben Robinson is Deputy Head of Research at OMFIF.

Peer pressure in banking supervision

Making Basel accords work for developing countries

Thorsten Beck
Cass Business School

Emily Jones and Peter Knaack
University of Oxford

The global prudential standards issued by the Basel Committee on Banking Supervision represent major efforts to increase the resilience of banking systems around the world and reduce the likelihood of another systemic financial crisis. The third Basel accord in particular is a key achievement by the global regulatory community. It tightens capital requirements and introduces liquidity requirements and macroprudential tools for large banks with cross-border operations.

But Basel standards are developed by and for Basel Committee members, and only represent major advanced and emerging economies. Regulators in many low and lower-middle income countries are pressing ahead with the implementation of Basel II and III, even though these standards are an imperfect match for the risk profile and level of development of their domestic banking systems. Analysis of data from the Financial Stability Institute at the Bank of International Settlements shows that 90 out of 100 surveyed non-member jurisdictions have implemented Basel II at least partially or are in the process of doing so. Moreover, 81 jurisdictions reported that they had taken steps towards the implementation of at least one component of Basel III. It is worth questioning why regulators in developing countries are adopting prudential standards that were not designed for their jurisdictions. This is the subject of our research project, combining cross-country panel analysis and in-depth case studies of the political economy of Basel standards adoption.

Reputational benefits

We found that regulators in developing countries do not simply adopt Basel II or III because these standards provide the optimal technical solution to financial stability risks. Instead, they are driven by concerns about reputation and competition. Politicians advocate for the adoption of Basel standards in order to signal sophistication to foreign investors.

Commercial banks headquartered in developing countries may endorse Basel II or III as part of an international expansion strategy, looking to reassure potential host authorities that they are well-regulated at home. Regulators in developing countries are subject to strong peer pressure in international policy circles to adopt Basel standards.

While the reputational benefits of fully embracing Basel II and III appear to be significant, the costs of a wholesale implementation of the global standards may be less obvious. For regulators in low and lower middle-income countries, Basel II and III adoption entails trade-offs and risks. The implementation of complex Basel components in particular may worsen existing capacity constraints and skew the regulatory agenda away from more fundamental reform areas. It could exacerbate information asymmetries between regulated banks and their supervisors in ways that may undermine financial stability.

Ideally, regulators would tailor global banking standards to harness their benefits in prudential and reputational terms while avoiding the costs of off-the-shelf implementation. However, they face disincentives for doing so. Tailoring is a resource-intensive task, and regulators receive little guidance from international policy-makers regarding proportional Basel standards adoption to meet development needs. Peer learning mechanisms among developing countries are still in their infancy. Moreover, national regulators face having to explain to incumbent politicians why the adapted rules and regulations fall short of global best practice.

The international policy community has advised low and lower-middle income countries to 'go slow' in their adoption of Basel II and III, recognising that full implementation may be ill-advised. But this leaves regulators in these countries without a means to credibly signal to international investors and other regulators that their banks are appropriately and effectively regulated. Instead, international standards should be designed so that they can be readily adapted for use by countries at all stages of development.

The Basel Committee can do more to build proportionality into the design of its standards, thus preventing an ill-fated race towards maximum Basel II/III implementation among developing countries. Furthermore, the World Bank and International Monetary Fund can make greater efforts in providing guidance in proportional Basel implementation to enable developing countries to keep up with international best practice in a manner that is genuinely aligned with their prudential regulatory needs. ●

Thorsten Beck is Professor of banking and finance at London's Cass Business School. Emily Jones is Director of and Peter Knaack is a Senior Research Associate in the University of Oxford's Global Economic Governance Programme.

Banking when the bank is shut

Tokenisation blends the benefits of digital and traditional finance

Antony Lewis
R3

Digital financial assets including cash, equities, bonds and derivatives are recorded by custodians as balances in accounts, rather than stored on owners' hard drives. Paper assets, by comparison, would be stored in drawers and safes. This is because digital assets are easy to copy or 'double spend'. As such, a large part of digital asset custodians' role is to provide assurances that these assets cannot and will not be double spent.

However, this critical function has been bundled together with additional services, such as foreign exchange and asset servicing. This creates a considerable downside for the asset holder. The custodian is the sole provider – temporarily – of the services that the holder is able to access. Additionally, the friction (fees, delays) to move the asset to another service provider is a burden that the asset owner must bear. The owner cannot carry out transactions when the bookkeeper is shut. This results in a conflict of interest to the custodian, who has little reason to facilitate moving an asset out to another custodian.

Bitcoin and public blockchains provide a way forward. The sole function of bitcoin's bookkeeping nodes is to prevent the double-spending of bitcoins. These bookkeepers do not provide loans, interest, foreign exchange into other cryptocurrencies, or any other ancillary services. The only service they offer is the guarantee of single-spend.

Financial applications

This model can be applied to traditional finance, splitting the prevention of double-spend from the provision of services against those assets being recorded. This is tokenisation.

A token resides on a person's hard drive, and that person owns or is party to it. They can manage it as they wish – within constraints – without needing to instruct a third party. Only the double-spend prevention is provided by a third party. In bitcoin's case it is the miners and the bookkeeping nodes; in enterprise blockchain Corda's case, it is the notary service.

By recording financial assets as tokens, where the single-spend-as-a-service is outsourced to a cloud of entities (sometimes nonspecific entities, other times permissioned and regulated), the owner of the assets regains control.

Best of both worlds

This system provides the best of both worlds. The token acts like a physical bearer asset, where the owner transacts the asset directly with other parties, yet a regulator can have oversight into the system. Rules governing how the asset develops can be built into the contracts that define them. For example, assets can be programmed with transaction limits, a whitelist of approved owners, or risk-based controls requiring additional approvers based on transaction parameters.

Outside of bookkeeping, there are still plenty of roles to play for traditional banks and asset custodians. These include asset issuance, standards, governance, dispute management, securities servicing and data analytics.

A tokenised economy has positive effects. By freeing the control of assets from their books, custodians relieve themselves of a risky but commoditised business (keeping books and records), and can focus on providing value-added services.

Tokens could de-risk financial services by reducing the reliance on systemically critical centralised services. The potential impact of a central service failing is far more serious than that of an owner losing their assets. Reducing the reliance of single points of failure is crucial in a world where state-sponsored cyber attacks are a clear risk.

Tokenisation opens up a competitive, innovative marketplace of service providers for asset owners. This is a healthier alternative to having a single provider.

Increased utility and liquidity of all digital assets recorded as tokens would increase their value. A tokens-based framework where companies transact directly, rather than through a cascade of debits and credits in third party systems, would improve the quality and speed of business. These benefits would translate in the real economy. ●

Antony Lewis is Director of Research, Cash and Central Bank Digital Currencies at R3, and author of *The Basics of Bitcoins and Blockchains*.

Metals scarcity expected after 2020

Commodities most undervalued in 50 years

Willem Middelkoop
Commodity Discovery Fund

Over the last decade, commodities have not been especially popular among western institutional investors, with only 1%-3% of their assets invested in this asset class on average. As a result, commodities are more undervalued today against the S&P 500 than they have been in more than 50 years.

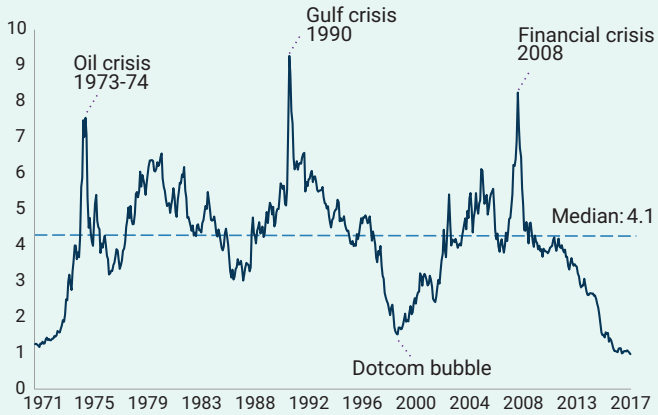
However, there are indications this is about to change. Commodity markets have proved rather resilient since the start of the correction in major equity markets in October, benefiting from a switch towards more defensive asset classes.

Several factors point to a revival of commodity investment. Demand for raw materials has been increasing since the start of the industrial revolution around 150 years ago. The fundamental investment outlook has improved even more of late, as the mining sector has not had enough success in finding new reserves over the past decade. Every year, the mining industry is finding fewer resources than we consume.

The rising world population, and the growing middle class in particular, intensifies the need for more raw materials. The middle class is expected to grow to around 5bn people in 2030 from 1bn in 1990. It is primarily this demographic development that is driving the strong and growing demand for raw materials.

Another development is that China is becoming increasingly aggressive in global commodity markets. In many metal markets, China accounts for almost half of total demand. One year since the launch of renminbi-denominated oil futures, China is now responsible for the trading of almost 10% of worldwide oil contracts. This all seems part of Beijing's plan to extend its influence over the global economy and expand its financial system in coming decades.

Commodities trading at lowest level in 50 years
GSCI Commodity Index / S&P 500



Source: Bloomberg, IncrementumAG

Electric vehicle spur

Climate change is another critical factor impacting the world of commodities. Reducing oil and coal usage and adding more gas and nuclear power to the energy mix is how countries can achieve the goals set out in the 2015 Paris climate agreement.

Most developed countries are encouraging a swift transition towards electric vehicles. In parts of the world, such as Southeast Asia, this is being exacerbated by the need for action against major smog problems. The Chinese government is installing initiatives to lower emissions from industry and transport.

Long-term forecasts by Bloomberg New Energy Finance project that 20% of all vehicles sold by 2030 will be electric, and 35% by 2040, or around 41m electric vehicles sold annually. If correct, around one-quarter of all cars on the road could be electric in 20 years. The rapid adoption of electric vehicles and hybrids over the next decade will spur the market for batteries as well. In 2016, Goldman Sachs predicted a sixfold increase in the market for electric vehicle batteries to $24bn in 2025.

The consequences for several commodities may be significant. While a traditional car uses around 10kg of copper, an average electric vehicle needs 60kg-100kg. As a result, demand for materials for batteries, including copper, nickel, lithium and cobalt, is already accelerating. At this rate of expansion, three times more lithium must be mined by 2030, and 25 times more by 2050. Cobalt production would need to double by 2030, and grow sixfold by 2050 to meet demand.

Accelerated demand for certain raw materials means that some are already becoming scarce. Prices of many metals will have to rise much higher in the long term to give mining companies an incentive to open new mines and increase production capacity. The markets for precious metals will become very tense in the coming years, especially in gold, silver, platinum, palladium, and base metals like zinc and nickel. Looking further ahead, past 2050, only iron ore and coal will still be sufficiently available. Investors may find an agreeable entry point at these levels, especially after the 2018 sell-off. ●

Willem Middelkoop is a Member of the OMFIF Advisory Board, founder of the Netherlands-based Commodity Discovery Fund and author of *The Tesla Revolution: Why Big Oil Has Lost the Energy War* and *The Big Reset: War on Gold and the Financial Endgame.*

Hong Kong exploring social impact bonds

Combination of public and private capital to tackle social issues

Ankie Ng
Shifted

Finding innovative solutions to foster systemic change is critical if the world is to overcome unprecedented social and environmental challenges. A new paradigm has evolved from the philosophy of deploying capital consciously: social impact investing.

The purpose is to make direct or indirect investments in organisations that deliver a positive impact on society. It involves blending various types of private capital, ranging from philanthropic to finance-only, and is sometimes combined with public capital. After more than a decade of growth, the Global Impact Investing Network estimates that global social impact investments reached $228.1bn in assets under management in 2017.

Higher barriers to entry

Social impact investing has picked up momentum in the Asia Pacific region. Strides have been made by different sectors to grow social impact investing in Hong Kong. But gaps remain that impede market growth. Fundamentally, this is due to Hong Kong's status as an advanced economy.

Developed markets face higher barriers to entry to social ventures than developing markets. This is because the former's social issues often require a higher level of engagement to mobilise resources. The lack of scalable and investment-ready social ventures is one of the main hindrances to market growth in Hong Kong.

The city must introduce new social finance models that can overcome scalability issues. Social impact bonds could invigorate this market in Hong Kong.

SIBs are a payment-by-results mechanism where investors provide upfront capital to finance non-profit organisations to deliver social services. The government only repays principal plus returns to investors if the non-profit achieves measurable social outcomes. In essence, through SIBs, non-profits leverage private investments to scale services to reach parts of society that are most in need by leveraging.

Multiple benefits

SIBs could benefit Hong Kong in several ways. First, they could improve non-profits' financial efficiency by moving away from the traditional grant-funding model. Non-profits are frequently subjected to uncertainties regarding grant-giving organisations' funding commitment. In the SIB model, investors provide upfront financing for non-profits to fund social programmes.

Second, return on investment is contingent on non-profits' ability to achieve social outcomes. As such, non-profits are encouraged to increase their organisational efficiency through results-based management.

Third, SIBs allow the government to transfer risks associated with funding and implementing social programmes to investors. With investors absorbing financial and reputation risks, non-profits could innovate and implement high-impact social programmes.

Fourth, by aligning incentives among stakeholders, SIBs could unleash the potential for cross-sector collaboration on complex social issues. This could include partnerships between the public and private sectors with non-profits and academia.

Hong Kong's government has announced an SIB pilot connected to its Social Innovation and Entrepreneurship Development Fund. This signals a new phase in the development of social impact investments in the city.

As an international financial centre, Hong Kong's infrastructure can support the growth of advanced social impact investing models beyond the scope of SIBs, such as social pension funds. However, the effectiveness of SIBs in the city must first be demonstrated by robust, evidence-based research.

Ultimately, the success of the SIB pilot scheme will pave the way for further experimentation with new social finance models to advance the social impact investing market in Hong Kong and the Asia Pacific region. ●

Ankie Ng is CEO of Shifted, a Hong Kong-based SIB intermediary.

'Developed markets face higher barriers to entry to social ventures than developing markets, because their social issues often require a higher level of engagement to mobilise resources.'

Appetite for infrastructure investment

Private sector is making up for shortfall in public sector funding

Steve McDowell
Estates and Infrastructure Exchange

Infrastructure investors are easy to please. Generally, they want to preserve value and receive moderate, steady returns. There are two types of infrastructure investors, which differ in appearance and attitude, yet are co-dependent – 'upstream' and 'downstream' investors.

Upstream, major institutional investors, like pension funds and insurers, buy debt. They are project innovators and owners; they build roads, airports and schools. Downstream, retail investors buy listed equity or fixed-interest infrastructure funds. 'The investors who buy infrastructure funds,' says James de Bunsen, manager of the £110m Henderson Alternative Strategies Trust, 'are exactly those who buy Unilever shares because everyone will always need toothpaste.'

Both groups of investors seek a consistent, reliable and comparatively low yield over the long term (30 years and beyond). And they both have a tremendous appetite. Yet, according to McKinsey & Company's 2017 Infrastructure Report, on the broad spectrum of infrastructure – in areas such as energy, transport, water and healthcare – the world spends just under $10tn every year, equivalent to roughly £280bn a day. McKinsey has calculated a massive yearly shortfall in funding of at least $800bn. This figure is rising.

Few would argue there is strong and growing demand for both big infrastructure projects in which to invest at the outset, and yet more from the retail side where the equity investor searches for operational standing assets. Therefore, there is plenty of money 'in the system' from large investors, but it is not reaching its destination. Prof. Ian Reeves, chairman of the Estates and Investment Exchange, says, 'Perfectly feasible projects very often do not get implemented. This we all know. The reasons for that are manyfold – anyone who has spent any length of time in this business can list dozens of them off the top of their heads. The reality is that most of them come down to the lack of a proper structure for access to investment capital.'

Fiscal constriction

Balance sheets the world over are stretched, and governments are reluctant to invest in large-scale infrastructure projects. This leaves the private sector as the only other source of funding.

During the next three to four years, 73% of senior pension fund professionals say they expect schemes to increase their allocation to infrastructure, according to a survey by First, which organises events for institutional investors. There is an appetite to invest in infrastructure, but there are complaints about lack of investment.

Downstream, the most popular funds in the retail market alongside the Henderson Alternative Strategies Trust are the larger John Laing Infrastructure Fund, HICL and 3i Infrastructure. De Bunsen explains, 'There is an immediate demand for a very low-risk, low return reliable investment class.'

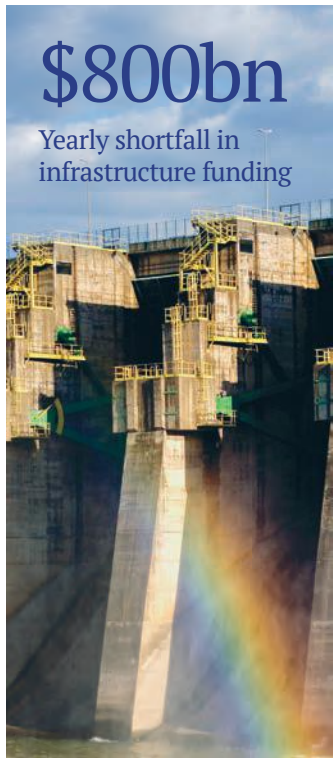
Considerable downgrading

De Bunsen says his fund invested considerably more in infrastructure at the beginning of 2018, after several of the bigger retail funds did the opposite and downgraded considerably. This followed a speech from UK Shadow Chancellor John McDonnell, where he announced it would be Labour's plan to renationalise most infrastructure and cancel private finance initiative contracts.

Looking further upstream at the institutional investors, he says, 'There are massive projects going on which pension funds are very interested in. If you can get into a project with a 10-15 year horizon – or longer – then great. The money is not being deployed because there is a log jam somewhere.'

Reeves, who has a 50-year track record of infrastructure funding and construction, believes a new exchange, such as the Estates and Infrastructure Exchange, is critical to facilitate investment in infrastructure. He says, 'An exchange can only help to bring these protections into sharper focus. The transparency and liquidity it will bring to capital markets is one aspect.

The pricing of bonds issued by the exchange will directly reflect the value of the project. There is a high degree of stability in infrastructure, particularly in the last 10 to 12 years. Notwithstanding what has happened in the wider economy, infrastructure goes on still producing returns.' ●



Steve McDowell is a Partner at the Estates and Infrastructure Exchange.

Rising external deficit 'made in America'

US currency confusion remains well entrenched

Mark Sobel
OMFIF

In an OMFIF commentary in May entitled 'America's currency confusion', I observed that for more than two decades the US followed a bipartisan currency playbook – supporting free floating; avoiding intervention except in rare cases of disorderly markets; and eschewing statements except when US officials were compelled to reaffirm support for a 'strong dollar'.

This aimed at limiting excessive reliance on the US as the global growth engine, reducing global imbalances and resisting protectionist pressures. Yet President Donald Trump's administration was ignoring the playbook six months ago. The White House was commenting on currencies and implying support for a weak dollar, putting forth language perhaps questioning free floating, and running a macroeconomic policy mix at odds with reducing global imbalances. Now, it appears America's currency confusion has worsened.

Administration officials have generally avoided directly commenting on the dollar. But the president's criticisms of Federal Reserve rate rises and accusations that China and the euro area manipulate their currencies are seemingly motivated in part by a desire to see a weaker dollar. Treasury Secretary Steve Mnuchin's unfounded remarks about guarding against Chinese 'competitive devaluation' have a similar effect.

Further, the G20 and International Monetary and Financial Committee continue to use ill-advised language. This ambiguous wording suggests that exchange rate stability should be a target of policy – contrary to G7 commitments – rather than an outcome of sound fundamentals. But it is the increasing divergence between the US and other major global economies, aggravated by the imbalanced US macroeconomic policy mix, which remains the most striking aspect of the worsening currency confusion.

Divergence favours dollar

The US economy is strongly outperforming the euro area and Japanese economies. The administration's procyclical tax cuts, which have caused a sharp increase in US deficits and debt, are fuelling this, at least in part. Indeed, expansionary US fiscal policy is burdening monetary policy and pushing up market rates and the dollar.

US growth in the second and third quarters has been around 4% annually. The euro area growth rate moved below 2% in the third quarter, and recent data show signs of further weakening. Markets are increasingly concerned about downside risks in Europe due to Italian fiscal developments, Britain's exit from the European Union and German political uncertainties. Looking through volatility in Japanese quarterly growth, the International Monetary Fund forecasts annual average Japanese growth at around 1% this year.

Chinese growth rates are around 6.5%, as always in line with official targets. However, all other signs, including Beijing's policy responses, point to softening activity. The trade war with the US appears to be contributing to China's slowing.

These divergences are reflected in official monetary policy developments and movements in bond yields, which favour placements in dollar assets.

In view of the strengthening US economy and job market, the Fed has raised rates eight times since end-2015. The central bank is on track for four fed funds rate increases this year, and members of the Federal Open Market Committee point to several more in 2019. The Fed continues to pursue balance sheet normalisation, which, coupled with the added supply of Treasury paper due to the booming fiscal deficit, is putting further upward pressure on rates. European and Japanese monetary policy remains highly accommodative and official rates are likely to remain unchanged for a considerable period of time, even if the ECB concludes its tapering later this year. China has been cutting reserve requirements.

Since May, US two- and 10-year bond yields have moved up, while European and Japanese bunds have been relatively flat, and Chinese bond yields have fallen. The trade-weighted dollar has appreciated against major currencies, and by even more against emerging markets, including China.

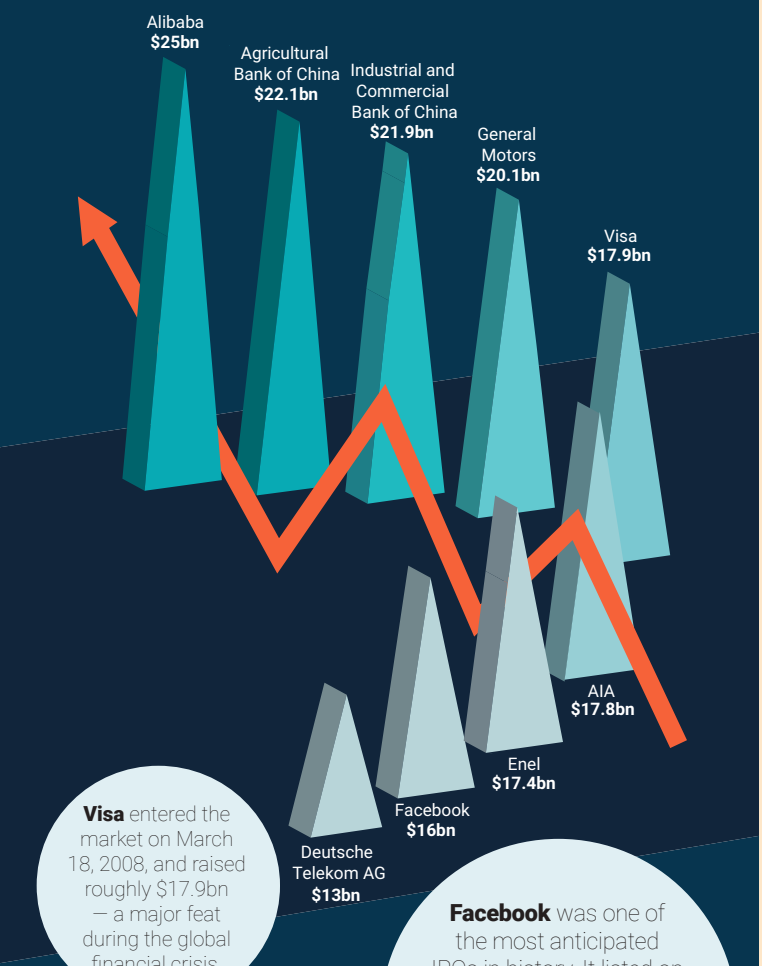
These divergent cyclical developments and dollar movements will only worsen US external deficits, even at a time when China's current account surplus is projected to fall under 1% of GDP. The IMF projects the US current account deficit will widen to 3% of GDP, or slightly higher, in 2019-20 from around 2.5% this year. Given the US services surplus, the trade deficit will be far greater, averaging around 5% of GDP in 2019-20.

As US external deficits widen in response to relatively strong US economic performance and imbalanced macroeconomic policies, there is a considerable risk the Trump administration could amplify its protectionist rhetoric and actions. Yet rising US trade and current account deficits are largely 'made in America'. ●

Mark Sobel is US Chairman of OMFIF. He is a former Deputy Assistant Secretary for International Monetary and Financial Policy at the US Treasury and until early 2018 was US representative at the International Monetary Fund.

The numbers

Top 10 largest **Initial Public Offerings**



Visa entered the market on March 18, 2008, and raised roughly $17.9bn — a major feat during the global financial crisis.

Facebook was one of the most anticipated IPOs in history. It listed on May 1, 2012 and raised around $16bn. However, the launch suffered from trading issues and information-sharing accusations.

Alibaba went public on September 18, 2014, at $21.8bn. Four days later underwriters exercised an option to sell more shares bringing the total IPO to $25bn.

The chart

Each month we take a look at a chart from the world's central banks. This month, the **Banca d'Italia**.

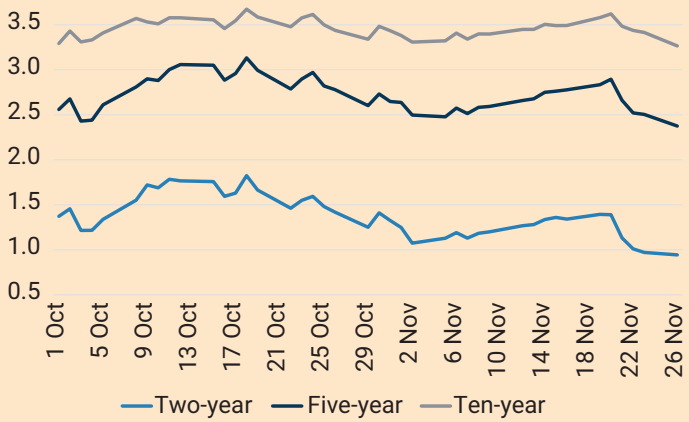
Italian government bond yields fell by more than 20 basis points to a two-month low following speculation that the governing coalition plans to reduce the budget deficit target for next year. Where previously it had threatened to defy the European Commission by refusing to change its deficit target and growth, it is now considering reducing the target to as low as 2% of GDP to avoid disciplinary procedures.

Month-long uncertainty surrounding the standoff with Brussels panicked holders of Italian debt. This led to a steady increase in government borrowing rates in the first half of November.

The Banca d'Italia expressed its concern over debt levels in its final financial stability report for 2018. It reiterated that Italy's greatest risks to financial stability derive from low growth and high public debt, and said higher interest rates are set to cost the nation billions a year in additional interest payments on its debt and could threaten the stability of banks and insurers.

Reports of a compromise between Rome and Brussels on Italy's budget was welcomed by markets on 26 November, with investors buying back into Italian debt.

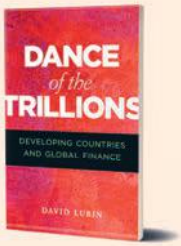
Financial stability risks lowered as Italian government bonds rally
Italian government bond yields in 2018, %



Source: Thomson Reuters, OMFIF analysis

Between control and chaos

Ben Robinson



THE history of emerging market financial crises may not repeat itself, but it often rhymes. While each episode over the last 100 years has had a different proximate cause – the collapse of sugar prices in 1920; a global recession sparked by the 1979 oil price shock; rapid depreciation of currencies across Asia in 1997 – the recurring theme, neatly outlined in David Lubin's *Dance of the Trillions*, is the way global capital flows 'respond to incentives shaped by US monetary policy'.

The Federal Reserve is again embarking on a cycle of monetary tightening after a decade of quantitative easing and negative real interest rates that boosted asset prices and pushed capital to higher-yielding emerging markets. Since the end of the Bretton Woods system of managed capital flows in the 1970s, all cycles of US tightening have ended in emerging market financial crisis as capital gravitates back to the US. The question now facing emerging economies is, 'Will this time be different?' Lubin, managing director and head of emerging markets economics at Citi, believes it will be.

The shift from pegged to floating exchange rates and the unprecedented build-up of foreign reserves by emerging market central banks since the 2000s remove significant factors behind the vulnerabilities these countries faced in previous crises. 'By the standards of recent history, emerging markets are remarkably well-protected,' writes Lubin.

Changes in the way capital flows are understood by major financial institutions lend credence to this idea. The International Monetary Fund, long the staunchest advocate for fully liberalised capital flows, now accepts restrictions on capital movements in some cases as an essential part of developing countries' toolkits.

The rise of China, moreover, exposes the 'awkward reality' for western policy-makers that 'the most successful case of a developing country experiencing rapid and sustained growth without financial crisis' has been in an economy that 'never signed up to the idea that the capital account should be open to all kinds of inflow'. Increasing numbers of developing countries are taking their cue more from Beijing than Washington, limiting the size of 'hot money' flows.

There are reasons to be sceptical of such optimism. Despite capital controls being 'destigmatised', most developing countries lack sufficient domestic savings to support investment and growth without relying on international capital. Nor do foreign reserves and floating currencies make emerging markets immune to Fed monetary tightening. Financial instability in Argentina and Turkey this year may portend greater uncertainty.

Latent financial risks

While emerging market financial buffers have increased, so too has the size of the financial system against which they may need to be deployed. The sheer size of asset growth over the last decade – global stock market capitalisation rose to around $85tn in 2018 from $30tn in 2008 – is suggestive of a bubble, with emerging markets likely to be on the sharp end of a correction. Meanwhile, the accumulation of foreign reserves has 'helped to misprice risk globally by pushing down yields' to levels that do not 'reflect the build-up of vulnerability in the financial system'.

Post-crisis regulations requiring banks to hold greater amounts of low-to-negative yielding safe assets against their risky exposures has led them to reduce risk appetite and shrink their balance sheets. While making the banks themselves safer, this has encouraged the growth of poorly regulated 'shadow' financial institutions. This could exacerbate the impact of a market correction.

Changes in the global trading system give further cause for alarm. Many emerging markets managed to export their way out of previous crises by relying on a lower exchange rate to run a current account surplus. This allowed them to build up financial reserves that outstripped their total external debt. With the global trade environment apparently becoming more protectionist, the path back to prosperity for countries that do experience shocks may become harder still. Combined with greater enthusiasm for capital controls and a stronger role for the state, it is not just the negative effects of globalisation that may be minimised, but the benefits, too.

Developing countries' relationship with international finance has always been difficult. As the global economic order undergoes a generational shift, expect more turbulence as countries navigate a delicate path between control and chaos. ●

Ben Robinson is Deputy Head of Research at OMFIF.

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Advisers network poll

Asia likely to improve trade deals

Network suggest Asean countries will push ahead with trade integration

This month's poll focuses on global trade integration. Participants were asked: **'Which parts of the world would most benefit from improved regional trade agreements?'** The majority saw Asia as a major beneficiary of stronger trade agreements. Citing areas such as the Asean Free Trade Area, continued efforts to break down trade barriers were suggested as becoming reality soon. In an economic environment dominated by unilateral policies in the US, this is especially encouraging for those who want to retain a free and multilateral commercial system. Moreover, areas like Africa and the UK stand to gain from similar deals, especially with the UK preparing to begin individual trade negotiations when it officially leaves the European Union in March 2019. Other responses from an online poll included the US and Latin America.

The UK and the European Union will stand to gain the most from improved regional trade agreements.

Brigitte Granville, Queen Mary University of London

Japan will be a major beneficiary of the CPTPP and EUJEPA, both of which will become effective soon. CPTPP, which currently covers 11 countries will expand to include a few more Asean countries.

Akinari Horii, The Canon Institute for Global Studies

Africa stands to benefit. The COMESA-EAC-SADC Free Trade Agreement shows the potential of regional trade agreements in injecting dynamism to the economies of the region through enlarged market access and opportunities for investments.

Hemraz Jankee, formerly Bank of Mauritius

Asean would benefit most from improved regional trade arrangements. The Asean Free Trade Area has had a disappointing impact and needs to be strengthened by incorporating at least some trade in services.

Boyd McCleary, former British high commissioner to Malaysia

Latin America has the most potential.

Denis Macshane, former UK minister of Europe

Africa – it still has large gains to make from intra-regional trade and the expansion of infrastructure across the continent could facilitate goods trade in the process.

Elliot Hentov, State Street Global Advisors

Asia would benefit most. However, the region needs to improve its broader infrastructure such as its legal framework, supervisory arrangements, more integrated cross banking arrangement and integrated capital markets.

Hans Blommestein, Vivid Economics

January's question:

Will China and US trade tensions alleviate or escalate in 2019?