The Bulletin

December 2017
Vol. 8 Ed. 11

Power plays

2017 winners and losers

Joaquim Levy on getting the most out of green bonds
Kalin Anev Janse on ESM expanding into dollar market
Nathan Sheets on the stability of inflation after the financial crisis
Burcu Ünüvar on quantitative easing and the rise of inequality
Elliot Hentov on Aramco sale buttressing Saudi financial triad
2017 in FOCUS: shortcomings in leadership

OMFIF

Contents - Vol. 8 Ed. 11

December 2017

OMFIF

The Bulletin FOCUS

2017 in review

OMFIF

Official Monetary and Financial Institutions Forum

30 Crown Place, London, EC2A 4EB
United Kingdom
T: +44 (0)20 3008 5262
F: +44 (0)20 7965 4489
www.omfif.org
@OMFIF

Company Number: 7032533
ISSN: 2398-4236

OMFIF

Dialogue on world finance and economic policy

The Official Monetary and Financial Institutions Forum is an independent think tank for central banking, economic policy and public investment – a non-lobbying network for best practice in worldwide public-private sector exchanges. At its heart are Global Public Investors – central banks, sovereign funds and public pension funds – with investable assets of $33.8tn, equivalent to 45% of world GDP.

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

Membership

Membership offers insight through two complementary channels – Analysis and Meetings – where members play a prominent role in shaping the agenda. For more information about OMFIF membership, advertising or subscriptions contact **membership@omfif.org**

Analysis

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

Meetings

OMFIF Meetings take place within central banks and other official institutions and are held under OMFIF Rules. A full list of past and forthcoming meetings is available on **www.omfif.org/meetings**. For more information contact **meetings@omfif.org**

OMFIF Advisers Network

The 178-strong OMFIF advisers network, chaired by Meghnad Desai, is made up of experts from around the world representing a range of sectors: Monetary Policy; Political Economy; Capital Markets; and Industry and Investment. They support the work of OMFIF in a variety of ways, including contributions to the monthly Bulletin, regular Commentaries, seminars and other OMFIF activities. Membership changes annually owing to rotation.

EDITORIAL

Power plays: 2017 winners and losers

Compared with the shock-filled 2016, this year saw the electoral pendulum swing back towards the mainstream. While populist forces gained ground in important polls across Europe, veteran figures held on to power, much to the relief of those worried about the prospect of a collapsing liberal world order.

Jacques Lafitte emphasises new French President Emmanuel Macron's progress on tax and labour reforms, while David Smith praises President Mauricio Macri's achievement of cutting inflation in Argentina by half. John Kornblum reassuringly argues that, despite the breakdown in coalition talks, Germany will maintain stability. In Saudi Arabia, Crown Prince Mohammad bin Salman took steps to address corruption – and, it seems, buttress his own power, ordering the arrest of several hundred policy-makers and businessmen. Elliot Hentov emphasises the need to build capital markets to facilitate economic development in the kingdom. Further east, both Xi Jinping and Shinzo Abe consolidated their power in China and Japan, setting the scene for a possible revival in co-operation, writes Adam Cotter.

In this month's Focus report we review the OMFIF Advisers Network's predictions for 2017 against the course of events. Overall, OMFIF advisers did well. Our advisers rightly predicted the Brazilian economy would stabilise in 2017 and that Chancellor Angela Merkel would be unable to win an outright victory in Germany's election. Where our advisers were less surefooted was in forecasting dangers that have not (so far) materialised, such as Donald Trump sparking global market volatility and the possibility of armed conflict between the US and China.

An unperturbed passage to 2018 is far from guaranteed. Britain remains in the spotlight. There are still considerable risks from the Brexit negotiations, as well as reasons to be optimistic, writes David Marsh in his review of *Clean Brexit: Why Leaving the EU still makes sense*, while William Wright debunks 10 myths about Brexit's impact on the City.

Europe will have to make important choices as it seeks to reform its political and financial architecture. One institution that is widely expected to play a bigger role is the European Stability Mechanism. Kalin Anev Janse, its general secretary, explains the rationale behind the ESM's first dollar bond. Stefan Bielmeier highlights that decisions on a European deposit insurance scheme must take account of the risks inherent in a fragmented banking system.

Central bankers will also be tested. Despite extraordinarily loose policies they are failing to reach their inflation targets at the same time as negative side-effects are gathering increasing attention, notes Burcu Ünüvar. Nathan Sheets compares central bankers' records in the pre- and post-crisis periods, while Gary Smith focuses on the role of technology in determining inflation. Structural shifts in the world economy are also transforming global value chains and international trade activity, according to Otaviano Canuto and Jodie Keane.

But the bull market may not last, as members of our Advisers Network predict in this month's poll. On a more positive note, we have seen undoubted progress in development of financial instruments backing efforts to combat climate change. Over 2017, the market for green bonds doubled. Joaquim Levy underlines the need to demonstrate the value of such instruments to investors – setting the scene for a range of OMFIF activities in 2018 supporting 'green finance' initiatives around the globe.

Global role for China, Japan will grow

Economic connections overcome frosty relations

Adam Cotter

Xi Jinping and Shinzo Abe, the Chinese and Japanese leaders, have reinforced their positions in the last few months , providing a solid platform for enhancing bilateral co-operation including in economic and monetary affairs. From these positions of strength, the Chinese president and Japanese prime minister can look in 2018 towards ironing out divergences, not least over territorial claims and differing interpretations of history, which remain impediments to the ambition of realising the 'Asian century'.

Although relations remain tinged with frost, much has improved in the six years since Abe and Xi assumed power in 2012 amid rising tensions over the disputed Senkaku/Diaoyu islands in the East China Sea. China is Japan's largest trading partner, while Japan is China's second-largest. Japan, benefiting from China's outbound tourism boom, has welcomed around 5m Chinese visitors in 2017, more than from any other country.

As US President Donald Trump continues to advocate unilateralist policies and a protectionist approach to global trade, the international role played by Asia's two largest economies appears likely to increase. Developments in North Korea will demand both countries' involvement.

Japan risks being left behind as an increasingly confident China seeks a bigger say in the global economic and security order. Xi is urging further regional economic integration and greater co-operation on trade and investment. Aside from the Beijing-led Regional Comprehensive Economic Partnership, he is proposing further talks on a free trade agreement between China, Japan and South Korea.

Trump's withdrawal of the US from the 12-nation Trans-Pacific Partnership trade agreement – which does not include China – was a setback for Abe. However, talks on a new iteration of the deal following November's Asia-Pacific Economic Co-operation summit in Vietnam are promising – even though Canada may be absent. At the same time, Xi has seen almost 70 countries sign up to his signature Belt and Road infrastructure initiative. Although it would be politically difficult, Japan's greater involvement in the Belt and Road would be hugely beneficial for the region.

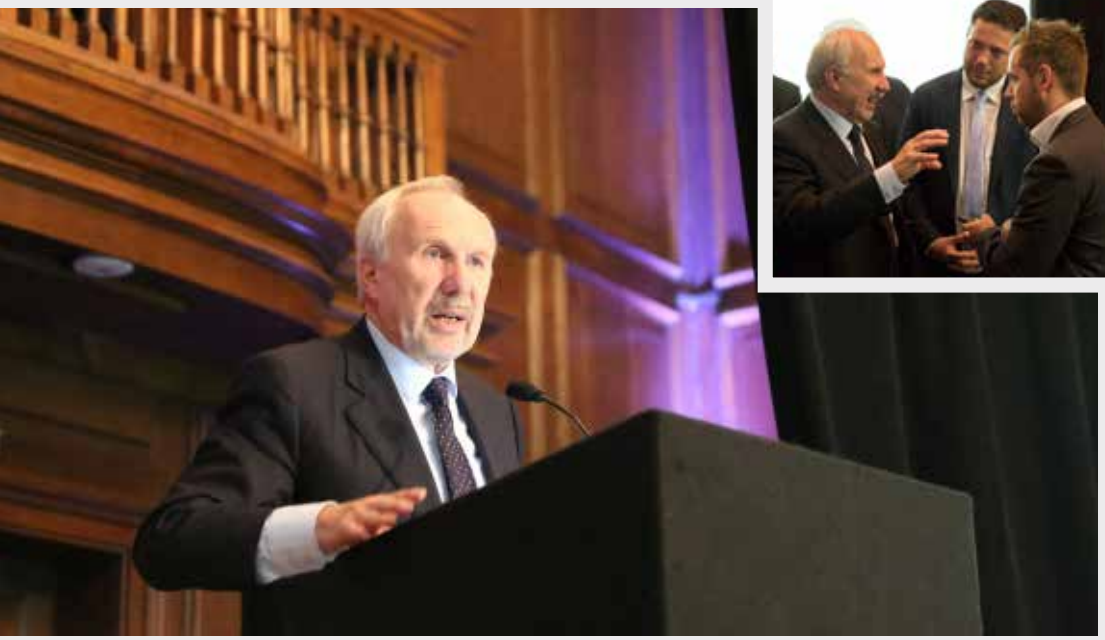
China's rise has engendered much speculation about the international role of the renminbi. Its inclusion in the special drawing right, the International Monetary Fund's composite currency unit, has met much fanfare. Japan has sporadically attempted to internationalise the yen. The future currency system for Asia remains an open question. China and Japan may jointly work towards an answer more quickly than many think. ■

Adam Cotter is Head of Asia at OMFIF.

ECB tapering 'depends on economy'

'If the euro area economy continues to perform well, the ECB has good reason to "taper" asset purchases at end-September 2018.' This is according to Ewald Nowotny, Oesterreichische Nationalbank governor, at an OMFIF City Lecture in London on 3 November.

So far the ECB has been careful to talk not about 'tapering' but rather of lowering the pace of bond-buying. Nowotny also focused on the European Central Bank's role in the euro area recovery, prospects for deeper euro area integration, and the strengthening of monetary and fiscal policy on strengthening the Austrian economy.

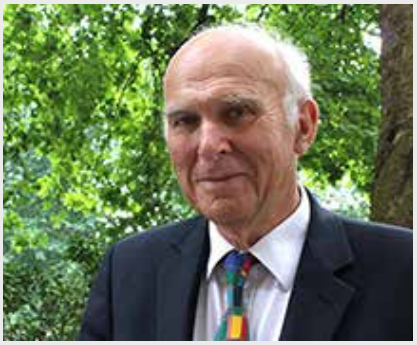


The UK and Europe: where are we heading?

OMFIF convened a lunch discussion in London with Chuka Umunna, Labour Member of Parliament for Streatham since 2010, who served as Shadow Business Secretary 2011-15. The discussion on 7 November examined the Brexit negotiation process, the role of parliament, the nature of a transition arrangement and the future relationship between the UK and Europe.

Avoiding the cliff edge

On 9 November, OMFIF organised a roundtable briefing in London with Kenneth Clarke, Member of Parliament for Rushcliffe, father of the House of Commons, and former Chancellor of the Exchequer (1993-97). Clarke expressed his views on Britain's tortuous exit talks ahead of a parliamentary and diplomatic struggle on the government's EU withdrawal strategy.



Prospects of further referendum

Sir Vince Cable, leader of the Liberal Democrats and Member of Parliament for Twickenham, discussed the UK's withdrawal from the EU at an OMFIF briefing on 29 November in London. Topics included the Liberal Democrats' perspective on the impact of Brexit; the prospects for a second referendum, and the role of parliament in the withdrawal process.

Greening infrastructure investment

As instruments of public policy, multilateral development banks must lead as 'torch bearers' in making financing sustainable, compared to other financial institutions. That was a key message at an OMFIF-DZ BANK roundtable in Beijing on the global green finance agenda and investing for a sustainable future in Beijing on 24 November.

The implementation of monetary policy

The European Central Bank has reiterated that it will decide in the autumn on the calibration of its policy instruments beyond the end of this year. Against this background, Joachim Wuermeling, member of the executive board of the Deutsche Bundesbank, discussed the operational challenges in the implementation of monetary policy, in a lunch discussion in London on 22 November.

Saudi Arabia's evolving economy

Fahad Ibrahim Alshathri, deputy governor for research and international affairs at the Saudi Arabian Monetary Authority, took part in a breakfast discussion in London on 13 November. He focused on developments in Saudi Arabia's economy, including diversification and growth in the financial services sector.

Forthcoming meetings

Implementing Basel III
A discussion with William Coen, Secretary General, Basel Committee on Banking Supervision. The discussion focuses on the challenges with Basel III accord, the state of global financial regulation and measures to enhance financial stability across countries.
5 December, London

Monetary policy and global capital markets
Launch of John Mourmouras' book, *Speeches on Monetary Policy and Global Capital Markets 2015-2017*. The themes include European Central Bank monetary policy, developments in global capital markets, and the future of Greece in Europe.
6 December, London

Reviewing Germany's economic policy
A roundtable with Volker Wieland, Managing Director, Institute for Monetary and Financial Stability and member of the German Council of Economic Experts. The discussion focuses on reforms in Germany, the political environment, shifting monetary policy, and euro area stability.
7 December, London

Roundtable for public sector asset managers
An investment meeting with a group of economic experts and asset managers, mainly from a public sector background, to summarise economic and financial developments and discuss the outlook for public sector investment management in Europe.
30 January, London

For details visit www.omfif.org/meetings

Green infrastructure investment

Ludger Schuknecht, of the German Ministry of Finance, took part in a lunch discussion in Singapore on 15 November. He focused on sustainable investments and developments in fiscal and international policy.

Unfinished Business discussion

OMFIF organised a lunch discussion on 7 November in London with Tamim Bayoumi of the IMF, focusing on his new book *Unfinished business: The unexplored causes of the financial crisis and the lessons yet to be learned*.

The challenges of climate change

Anne Le Lorier, first deputy governor Banque de France, gave a City Lecture in Singapore on 14 November. She discussed financing flows into low carbon activities, the definition of 'green' investment and proposed incentives.

A new phase of monetary policy

Asset bubbles in world bond markets and rising inequality in Japanese society formed the agenda at the second annual Japan Center for Economic Research-OMFIF seminar in Tokyo on 22 November.

Macron fulfilling his reform agenda

President is answering critics' greatest concerns

Jacques Lafitte, Avisa Partners

French President Emmanuel Macron was elected in May on – some would say despite – a platform of far-reaching economic reform.

He surmounted this obstacle with a substantial loosening of labour rules. Together with Muriel Pénicaud, his astute employment minister, Macron has managed to subdue France's combative unions without having to call in riot police; he is burying them under consultations.

Pénicaud has conducted 300 hours of closed-door talks with union bosses. This approach isolated the General Confederation of Labour (CGT), the unreformed communist union, and France Unbowed, a left-wing populist political party. Demonstrations and blockade attempts quickly collapsed. The next leftist mobilisation might not be so simple.

Macron and Bruno Le Maire, the finance minister, are busy with tax reforms, with the stated aim of enfranchising entrepreneurs. The main change in the 2018 budget – the replacement of the damaging wealth tax by a mere real estate tax – is already assured. The government is reforming France's dysfunctional vocational and further training processes.

Results are starting to show. Business confidence is at its highest in more than 15 years, and corporate investment is up. The net creation of factories in France turned positive last year, in part because of Macron's first labour law reform when he was economy minister in 2015, and the trend is accelerating.

Macron's greater test will come next year with the unification of France's myriad pension schemes. The public sector ones are very generous – and totally imbalanced – though the French do not find this unfair. People still vividly remember the previous attempt at unification, in 1995: there were three weeks of general strike, ending with the government dropping its plans for pension reform. There are many reasons to believe that the outcome will be different for Macron, though some caution is warranted. The CGT is likely to be joined in protests by Workers' Force, one of the other major union confederations with a strong civil servant base.

Success at home and abroad

There are other major problems that Macron must contend with. French primary and secondary education have decayed for decades. Until the last couple of years, the education ministry was run by all-mighty teachers' unions. It will take several years for the education system to recover, but the downward spiral has been stopped by another competent minister, Jean-Michel Blanquer. The unions are unhappy but are staying quiet, since Blanquer enjoys strong public support.

During the election campaign, law and order was considered Macron's weak point. In a country wounded by terrorist attacks, he was perceived by many as too lenient or insufficiently concerned. Whatever kind of candidate he was, President Macron has played the part of strongman. In November, together with Prime Minister Édouard Philippe, he ended the two-year state of emergency, but skilfully managed to make into law all measures that intelligence services and police forces wanted to keep. In the country which claims it invented human rights, opposition to the law was remarkably subdued.

But the biggest surprise with Macron is that he is such a gifted diplomat. He would have had all reasons to hate US President Donald Trump and Russian President Vladimir Putin, yet managed in record time to become their friend on the world stage. In the complicated Middle East he is an ally to many and the enemy of no one. He played his part in convincing Trump not to annul the Iran nuclear deal and helped to exfiltrate Lebanese Prime Minister Saad Hariri out of Saudi Arabia.

> ***"It is too early to say whether Macron's plans will succeed, but they comprise probably the boldest vision for transforming the continent by a European leader for 25 years.***

Closer to home, German Chancellor Angela Merkel is a big fan of Macron. They have returned Franco-German relations to their zenith. Macron's relations with UK Prime Minister Theresa May are more than cordial. Although he is a hardliner on Britain's exit from the European Union, he has managed to put Merkel on the front line of the debate.

In a speech at the Sorbonne university in September, Macron set out his plans for a 'profound transformation' of the EU. He advocated common EU policies on defence, asylum and tax, called for the formation of European universities, and promised to play the EU anthem at the Paris Olympics in 2024. It is too early to say whether the plans will succeed, but they comprise probably the boldest vision for transforming the continent by a European leader for 25 years.

'President Macron has played the part of strongman'

Macron's status as a beacon of European hope helped him realise a major tactical victory with the reform of the 'posted workers' directive, which relates to employees who are sent to carry out a service in another EU state. This is a point of great contention in France, and the bane of former presidents. Macron achieved almost 90% of what he wanted, managed to split the Visegrad group and isolated Poland, the only country which he openly scorns. The next step will be reform of the euro area.

Popularity an afterthought for Macron

Macron's image is far from stellar. Ironic nicknames range from Jupiter to Napoleon.

As always, the French are tougher than other electorates on their rulers; Macron lost more support in his first six months in office than former President François Hollande, infamously France's least popular leader. But such statistics miss several key factors. If the presidential election were to be re-run today, Macron's first round score would increase to 28% from 24%.

Macron was elected on a centrist platform but predominantly by centre-left voters. It turns out that he is running a centre-right programme. The much-reported drop in opinion polls was unavoidable. But it is reversible: Macron's popularity jumped 4% in November from the month before.

What matters most is that Macron says he does not care about his approval ratings, and everything suggests he really doesn't. ■

Jacques Lafitte is founder at Avisa Partners, Brussels, and formerly oversaw the euro dossier in the Cabinet of Yves-Thibault de Silguy, Economic and Monetary Affairs Commissioner, 1995-99.

Macri returns Argentina to world stage

Cutting inflation, improving competitiveness are priorities

David Smith, Advisory Board

This has been a year of living dangerously for the reform-minded government of Argentine President Mauricio Macri. Nonetheless, by almost common consent in Argentina, Macri is heading into 2018 backed by favourable conditions and moving towards fulfilling a large measure of his country's huge potential.

On a visit to New York to court foreign investors following a midterm election victory on 22 October that points to his probable re-election in 2019, Macri was bullish about the prospects for his reform programme.

'We've turned the corner in Argentina. This is just the beginning of a deep and constant cultural change in our country, intersecting economic and politics,' he told lead players on Wall Street. 'The key is telling ourselves the truth, and being confident enough in ourselves to face the truth. We're getting there.'

Inflation and widespread poverty

Macri's government has cut inflation in half, down to 22% as the year ends. The economy, which shrank by 2% in 2016, has rebounded and is on track to grow by 2.7% this year. The enormous deficit Macri inherited is falling, to a projected 3.2% of GDP in 2018 from highs of 6%. But the challenges ahead remain daunting. Without expansive reforms, Macri admits his grand project cannot succeed.

'My first commitment is to reduce widespread poverty, and that will take many years,' he says, acknowledging he still doesn't have control of congress. 'Reducing inflation, to single digits, alongside reforms creating good jobs, that's my number one priority, because inflation hurts the poor most.'

The government secured a substantial victory in the midterm elections, sweeping the country's main population centres. Macri defeated key populist Peronist opponents, including former President Fernández de Kirchner, in the province of Buenos Aires, the most important stronghold and home to almost 40% of the population.

> *"Reducing inflation, to single digits, alongside reforms creating good jobs, that's my number one priority, because inflation hurts the poor most.*

The weeks since have involved long days and nights of negotiations on everything from the way the central government funds the provinces, to labour reforms, to overhauling the vast state pension system, to a new tax code.

'What drives policy now is reducing inflation and the need to shrink the public deficit, to make us so much more competitive,' to quote a Macri adviser, expressing relief that this pivotal year ends without the unrest that brought down non-Peronist predecessors. 'High inflation keeps our social spending inflated, and keeps us reliant on external debt to finance the deficit. This has to stop.'

On the world stage

Public opinion suggests Macri will defy recent history and become the first non-Peronist leader to complete a term in office, let alone win re-election. Corruption scandals have made Peronism synonymous with grand theft. Senior figures from the Kirchner era are in prison, including the last vice-president and the minister who oversaw tens of billions of dollars' worth of public works.

'The alternative to Macri is seen, day after day, to have been stealing on an unimaginable scale,' says a leading pollster. 'Macri, and his successors, may have long life as Peronism sinks in the gutter.'

For the next 12 months Macri's government could find renewed success on the international stage. Between 10-13 December in Buenos Aires the World Trade Organisation will hold its annual ministerial meeting. It will be chaired by Susana Malcorra, the experienced United Nations figure who served as Macri's first foreign minister.

> *"This is just the beginning of a deep and constant cultural change in our country, intersecting economic and politics.*

Next year Macri will host the annual summit of the G20, the first in South America. The president's role will be greatly changed from that of his first G20 meeting in 2016, and entirely distinct from the first G20 summit in Washington in 2008. That day, the leaders managed to pose for the first group photo without then-President Kirchner, who managed somehow to be out of the room. The ambitious and reformist Macri is much more likely to be welcomed by the crowd. ■

David Smith is a Member of the OMFIF Advisory Board and represented the United Nations Secretary-General in the Americas between 2004-14.

Macri (far left) sitting alongside Barack Obama and Angela Merkel at the 2016 G20 summit

Voters on the threshold of change

Slow-moving Germany sees new definition of stability

John Kornblum, Advisory Council

When I first arrived in Hamburg as a vice-consul more than 50 years ago, every aspect of public life appeared to be frozen.

Ludwig Erhard, father of the post-war West German economic miracle, was confirmed as chancellor in the September 1965 election. The Berlin wall built in 1961 seemed to have sealed Europe's division more deeply than ever. German democracy was robust and the US reigned supreme as Germany's saviour and civilisational model.

Less than two years later, Erhard had been toppled, Ostpolitik (the normalisation of relations between West Germany and the East) headed the political agenda, and Germany was experiencing its first post-war recession. The war in Vietnam tarnished Washington's image, and the far-right National Democratic Party threatened the stability of German democracy.

An old and experienced observer advised me, 'Germany always takes a long time to change, but when stability seems to be in danger, voters strike back rapidly and dramatically. And you can never tell which way their drive for stability will take them.'

> *"A slow pace of change is typical of German political life. Voters seem to demand an emotional insurance policy before agreeing to anything new.*

The next few years more than proved this prediction true. By the mid-1970s things had changed almost beyond recognition. Soviet expansionism and Germany's recession led to a call for new leaders and new ideas. Peace, detente and the welfare state were the answer.

I cannot help thinking of those days as pundits puzzle over the dramatic collapse of Chancellor Angela Merkel's efforts to build a new Berlin coalition after her poor performance in the 24 September elections. So much has changed, but so much remains the same. The advice I received as a young man seems to have been borne out.

In the age of Donald Trump, realisation of the western democratic vision depends significantly on Germany's ability to remain a strong and confident partner in both Europe and across the Atlantic. Understanding events in German has suddenly become a major international task.

Slow pace of change

At first glance, Germany seems to have been infected by the same dynamics which burden the rest of the West – a turn to political populism and protectionist rhetoric. This is true to some extent, but the underlying causes are more long-term in nature.

What people are observing in Berlin is the inevitable erosion of a political consensus which has endured since the fall of Chancellor Helmut Kohl in 1998, who was defeated in federal elections by a large margin against the backdrop of rising unemployment. German voters are seeking a new definition of stability.

A slow pace of change is typical of German political life. In a nation traumatised by violent upheavals, voters seem to demand an emotional insurance policy before agreeing to anything new. Governments and leaders stay in office much longer than elsewhere. When change comes, it is usually defined as being much more dramatic than it really is.

Over the last 20 years, two chancellors have led Germany. The first, Gerhard Schröder, was ousted in 2005 after seven years in office for changing things too quickly. Merkel vowed never to repeat her predecessor's mistakes. She even managed to sell the dramatic abandonment of forward-thinking nuclear power as a necessary reaction to a tsunami in nuclear-heavy Japan.

Fresh faces

Regardless of how confusing such behaviour seems to outsiders, it appears to serve an important purpose in Germany. Observers must be careful neither to overestimate the immediate implications of what is happening, nor to underestimate the country's ability to adjust to change. Germany experienced exceptional upheaval in the 1970s and 1980s, only to enjoy great stability afterwards.

A small insight into the national mood was provided by an online poll conducted by the German daily Die Welt. Of more than 100,000 readers who responded, 72% welcomed the decision on 19 November by Christian Linder, leader of the liberal Free Democratic Party, the would-be junior member in Merkel's coalition, to abandon negotiations.

This suggests voters are looking for fresh faces and new approaches, and that Lindner may have struck the right note. But, for the time being, his success reflects more the novelty of a new personality, rather than new policy. Partners in Europe should take note, as I learned many years ago, 'You can never tell which way Germany will go.' ■

John Kornblum is a former US Ambassador to Germany, Senior Counsellor at Noerr LLP, and a Member of the OMFIF Advisory Council.

New dawn: 'Voters are looking for fresh faces and new approaches'

10 myths about Brexit and the City

Bank restructuring and fintech are greater threats

William Wright, New Financial

Almost 18 months after the British referendum to leave the European Union, politicians and market observers continue to debate the potential impact of Brexit on the City of London, the centre of the UK's financial services sector. But the debate is often dominated more by fiery quarrelling than reasoned deliberation. Myths and delusional thinking permeate both sides of the argument.

1. Brexit will kill the City

Some of the more fervent supporters of the Remain campaign say that, in a few years, the City of London will be left barren after a mass exodus of banks and asset managers to Frankfurt. But only around 25% of business in the City is EU-related, and much of that will be able to stay in London.

While firms will have to move some operations to the EU, most of their business will stay and London will continue to be the dominant European and global financial centre. The Bank of England's latest estimate of 75,000 job losses would be a substantial blow, but that figure amounts to less than 8% of the UK financial services industry.

2. Brexit is the biggest threat to the City

Brexit is not even the greatest risk to the City. The impact of technology and the acceptance that the pre-2008 financial crisis heydays are never coming back will force banks to automate, outsource and offshore many of their functions.

Brexit is the occasion and not the cause: it will concertina decisions about restructuring that might not have taken place for years. Employing thousands of support staff in London or other UK cities like Bournemouth or Manchester suddenly looks tremendously expensive compared with European cities such as Krakow or Riga. This process will probably cost far more jobs than Brexit itself.

3. Brexit will liberate the City from the burden of EU regulation

Those who hope Brexit will liberate the City from EU bureaucracy should listen more closely to the messages being transmitted by the Bank of England, the Financial Conduct Authority and the UK Treasury. Mass deregulation will not happen. A lot of EU regulation was designed in the UK, and the UK often 'gold plates' EU rules to make them tougher. There is scope for the UK to soften some regulation – perhaps there could be a separate regime for smaller domestic firms – but the country has been at the vanguard of helping set global rules, and wants to stay there.

4. The EU has held the City back

While Europe is an important market for the City, it is hard to argue that London has been held back when two-thirds of its financial services exports go to the rest of the world. One of the many reasons why the City's importance has grown over the last few decades is that firms are able to concentrate their European activities in one place under single market rules. Big US and Swiss banks employ more than 60,000 people in the UK, and tens of thousands more work at large Asian banks.

5. Frankfurt wants to steal all of the City's business

It is deceptively easy to argue that Paris or Frankfurt are not going to be able to replicate immediately what the City has built up over centuries. After all, roughly the same number of people work in and around the City as the entire population of Frankfurt.

But no financial centre in the EU has any plans to take all of London's business: they are after portions of it. Paris wants to attract 20,000 jobs after Brexit – about 2% of the total number of people working in financial services in the UK. A few percent here and there will quickly add up.

6. The EU needs the City more than the City needs the EU

The City plays a vital role in lubricating the EU27 financial system. More than 75% of all foreign exchange and derivatives trading in the EU takes place in London, and between 50%-70% of all investment banking activity, equity trading and bond trading in EU27 markets is conducted in London.

But banks that conduct that business in the City today will move as many functions as necessary to the EU27 to ensure that they can conduct it in Frankfurt or Paris tomorrow. UK banks' exposure to EU counterparties is about 4% of the total EU financial system, while EU banks represent about 30% of all activity in the UK.

7. The relocation of euro clearing will cost tens of thousands of jobs

Some countries would love to force the €1tn-per-day of euro-denominated clearing that takes place in London to move to the EU. The EU itself wants a larger role in the supervision of this business (much as US regulators have joint oversight of US clearing houses in London). But the EU would only push for relocation if it thought the UK's supervision was too relaxed.

To argue that tens of thousands of UK jobs will be lost one must assume the EU will demand that all activity related to the euro must take place inside the EU. This is not practical because it would lock the EU out of the global financial system.

8. Financial technology will save the City

The rapid growth in the fintech sector and London's dominant position in Europe has been a welcome boost for the UK over the last few years and created around 60,000 jobs. That will probably offset any Brexit-related job losses in the short and medium term. However, the point of fintech is to disrupt banks' business models: the more successful fintech becomes, the more jobs it will destroy in traditional banking. There will be more competition and better products for consumers, but fewer overall jobs.

9. A transition period will save the City

City-based banks and trade associations have been warning that unless the UK agrees a 'status quo' transition agreement with the EU in the coming months, firms will have put their Brexit relocations plans into action. This transition period would involve agreeing, in advance of a trade deal, that for two years after Brexit the UK's relationship with the EU would essentially stay the same – apart from the UK having no say in the rules it would have to apply. While it is an elegant idea, to many people it would look remarkably like an attempt to derail Brexit.

10. A bespoke deal can be reached before we leave

It is misguided to believe a comprehensive trade agreement that includes financial services – or a bespoke deal for the City – can be negotiated in the next 15 months. The only comprehensive trade deal to include financial services ever agreed is the EU itself, which is a work in progress that has taken decades to develop.

For context, discussions about Mifid II, the latest EU directive that comes into force in January 2018, began in 2010. The proposal to develop a system of mutual recognition for UK and EU financial services regulation is an excellent idea, but will take more than a decade to shape. ■

William Wright is Managing Director of New Financial, a capital markets think tank.

Stability of inflation after the financial crisis

Central bank vigilance essential to maintain equilibrium

Nathan Sheets, PGIM Fixed Income

Low and steady inflation has been a central feature of global economic performance over the last 15 years. In the period before the 2008 financial crisis, global headline inflation cycled around 3%. After showing some volatility during the financial crisis, reflecting sharp moves in commodity prices and the severe economic downturn, aggregate headline inflation fell to around 2%. In the last two years it dropped further still as commodity prices fell sharply.

Similarly, global core inflation trended down during the first half of the last decade, but then stabilised near 2% before dropping between 2009-11. Following the crisis, core inflation returned to 2%, where it has remained since early 2012.

These similarities in inflation performance are striking in the light of the divergent economic conditions in the years before and after the crisis. The pre-2008 period saw rapid growth, building leverage in the financial system, and overheating in asset markets. The post-crisis period has seen softer growth and a gradual reduction in unemployment rates. Financial markets have been recovering through the post-crisis period, but there is much less leverage in the core of the system than before 2008. In addition inflation has typically shown, both before and after the crisis, little imprint of variations in resource slack – the Phillips curve has been very flat.

Central bank inflation objectives

To examine the underlying drivers and features of global inflation, PGIM studied inflation data for before and after the financial crisis relating to a group of 18 advanced and emerging economies. These economies – namely the US, euro area, Japan, the UK, Australia, Canada, Brazil, Chile, Mexico, China, India, Indonesia, South Korea, Poland, Russia, Saudi Arabia, South Africa and Turkey – account for around 85% of global GDP.

Inflation performance in the advanced economies has been remarkably stable. Headline inflation has fallen somewhat, in line with the drop in commodity prices, but the path for core inflation is similar in the pre- and the post-crisis periods.

There are several reasons for this. First, central banks have clearly been successful in their long-term efforts to prevent inflation from escalating. In both periods, inflation does not typically stray much above 2%. Second, with the exception of Japan, central banks have successfully avoided deflation. Japan's experience has become a cautionary tale for central banks, highlighting how difficult it is to dislodge deflationary expectations once they become entrenched. Third, the centre of the distribution of core inflation outcomes is nearer 1.5% than 2%, and inflation has apparently run somewhat below central banks targets particularly in the post-crisis period. A deeper question is whether meeting inflation targets with greater precision is practically achievable for central banks.

Policy maturity in emerging markets

Inflation performance in the major emerging markets splits these economies into two groups. One set of countries with relatively high inflation in the pre-crisis period – Turkey, Russia, and Indonesia – has achieved markedly lower inflation since the crisis, although Turkey has given back some of these gains over the last two years. Many other emerging market economies have seen fairly stable inflation, much like the advanced economies, albeit with moderately higher average rates and somewhat more variability. These results are broadly encouraging. That inflation in many of these emerging countries has moved lower or become more stable confirms their increasing policy maturity and the strength of their core institutions.

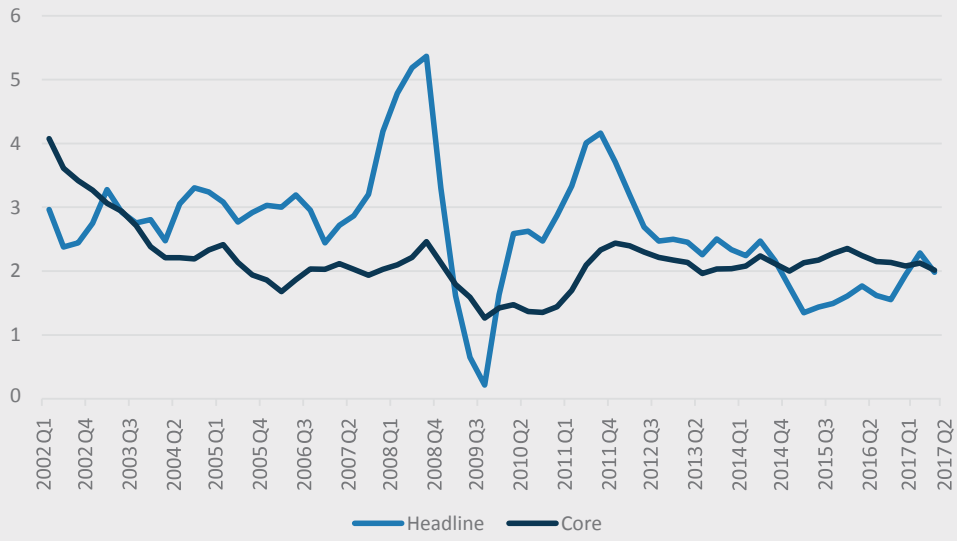
The relative stability of inflation across the globe has had important implications for financial markets. This is of central importance in explaining the low levels and relative stability of longer-term bond yields. It means investors have good empirical reasons for requiring low inflation compensation for holding bonds and for demanding relatively small compensation for inflation risk. The inflation process appears to have shifted relative to previous decades, which is reflected in these bond pricing features. The stability of inflation contributes to a more stable macroeconomic environment, which should reduce financial risks premiums more generally.

Central banks are crucial to this story. The stability of inflation reflects how effective monetary policy-makers have been over the last 15 years. They have responded to shocks in ways that have helped deliver stable inflation and, accordingly, inflation expectations in both the real economy and in financial markets have reinforced these efforts. To preserve this equilibrium, central banks must be vigilant and prepared to respond to emerging inflationary risks. ■

Nathan Sheets is Chief Economist and Head of Global Macroeconomic Research at PGIM Fixed Income, and former Under Secretary for International Affairs in the US Treasury department. The information in this essay is drawn from publicly available sources and represents the views of the author as of 15 November 2017. These views do not constitute investment advice, are for informational purposes only, and are subject to change.

Global inflation has remained subdued

Headline and core global inflation, %, year on year



Source: Haver Analytics and PGIM Fixed Income

Epoch-making scale of robotics

Technological change too fast for labour markets to absorb

Gary Smith, Advisory Council

The headlines read, 'Las Vegas self-driving bus crashes two hours after introduction of service.' We later learned the bus was stationary at the time and that the human driver of the second vehicle was issued with a driving misdemeanour ticket.

In the US and Europe, the story behind automation is usually told from the perspective of a threat, whether to road safety, job security, wages, or the accepted way of life.

In Japan, the story is markedly different. Machines are filling a gap created by a shortage of workers. The government's 'Japan revitalisation strategy' highlights a key role for robotics, and proposes a 'robot Olympics' to run alongside the official games, scheduled for Tokyo in 2020. The report states that robot technology will improve corporate profitability, thereby 'helping to raise wages'.

This contrast in perception is fuelled primarily by differing demographic backdrops. Japan is aging and shrinking. The population is around 127m, and 25% are at least 65 years old. In 40 years, the population might be just 100m, with 40% of people 65 years old and over.

In the West, although industries do not need robots to address such an acute demographic problem, automation will become more widespread. Multinational companies are the key factor, and their motivation to increase profits will accelerate the rate of investment in new technologies.

Displaced workers

In 1900, 40% of the US workforce were employed in agriculture. By 2000 that figure had fallen to 2%, but food production and overall employment rose significantly. In the 1920s cars replaced horses as the main form of transport in US cities. This was a more rapid disruption, but was still generally recognised as a job-positive story.

The risk today is that the pace of technological advancement is too fast for labour markets to absorb easily. This could have a pronounced impact on employment, wages and populist politics.

Developments in the US oil industry illustrate this effect (see Chart). Between 2015 and mid-2016, the number of rigs halved in response to the oil price decline. A recovery in the oil price and improvement in the efficiency of production – driving down the required break-even oil price – led to a rebound in the rig count to almost early 2015 levels. Oil and gas industry employment fell in line with the decline in the rig count, but has not responded to the increase over the last 12 months. Instead, automated rigs requiring a crew of only five are replacing those that required a crew of 20.

The critical question from a labour market perspective is what happens to these displaced workers. Perhaps, like horse-drawn carriage drivers in 1920s New York, they get better jobs earning more money. But then again, perhaps they take a lower-paid job as a temporary measure. Perhaps that temporary position becomes permanent. Perhaps these workers need to relocate to find a new job, made difficult by the fall in labour mobility in the US economy. For the newly unemployed rig worker, there is no evidence of a formal industry- or government-sponsored retraining programme, only self-help websites.

The days when low-skilled labourers were most at risk from automation are behind us. Studies show that mid-skilled workers are more at risk from disruption. A robot could, undoubtedly, be designed to cut hair, but developing that technology is not worthwhile when it costs only £20 for a haircut. Robots have moved up the value chain. Instead of cutting hair, they are piloting planes, trains and automobiles (although, for the time being, largely under human supervision).

Popular anger

While useful, the rig worker example might be said to overstate the extent of machine substitution for human labour. This is because it does not account for the complementarities between automation and labour that increase productivity, raise earnings, and boost the overall demand for labour through supply and ancillary industries. But concerns remain that the pace of technological advancement is becoming so rapid that the short-term waves created by disruption are making it more difficult to identify the longer-term benefits. Perhaps the positive effects will become clearer, but, in the meantime, people are becoming angry with these far-reaching changes.

In terms of wages, it is difficult to believe that job dislocation, and a period of unemployment, is beneficial for aggregate income growth. Dislocation is more likely to result in wage acceptance, rather than encouraging wage-demanding behaviour. As Claudio Borio of the Bank for International Settlements wrote in last month's edition of The Bulletin, technological advances threaten labour's pricing power. Technological change is another factor weighing on wage inflation statistics, and confounding advocates of the Phillips curve (which illustrates the inverse relationship between unemployment and inflation), including those at the US Federal Reserve.

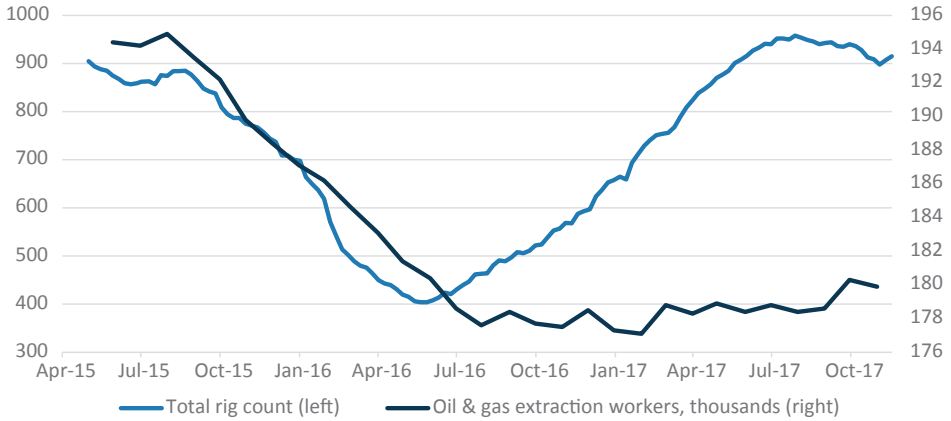
In the longer term, robotics and artificial intelligence might be a more positive story. But, while we wait, societies may have to work harder to deal with short-term disruption. Bill Gates has raised the idea of taxing robots, on the basis that every lost worker is a lost income tax payment. That tax could be used to pay for retraining programmes.

And in the very long term, if human labour is indeed rendered redundant by automation, then the world's economic problems will become one of wealth distribution rather than wealth scarcity. This would inspire arguments for society-changing measures such as universal basic income. The implications could be epoch-making in scale. ■

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

US rig count spikes but employment in oil & gas extraction drops

Total rig count and oil and gas extraction workers, 2015-17



Source: Baker Hughes Rig Count, US Department of Labor

Cryptocurrencies: growth and controversy

New products spark search for regulatory framework

Oliver Thew

Cryptocurrencies have undergone a transformation. They were originally designed as simple tokens for making financial settlements speedier and more efficient. The aim was to incentivise users of nascent distributed ledger technology platforms to decentralise mechanisms for anonymous peer-to-peer transactions that bypass the formal financial sector.

But over the last year, they have grown into a massive segment of the global financial market, attracting attention from investors, banks, exchanges, regulators, central banks and governments. There are more than 1300 active private digital currencies, 542 of which were issued since the start of 2017, compared to just 100 issued in 2016.

In addition to the number of different coins and volume of transactions, the value of cryptocurrencies has increased dramatically. The value of bitcoin, the most famous cryptocurrency, rose to more than $10,000 per unit on 29 November from $960 on 1 January. The market capitalisation of all cryptocurrencies exceeded $330bn at the end of November, from $17.7bn at the start of 2017.

Start-ups and new cryptocurrencies businesses have used initial coin offerings, a relatively new digital fund-raising method, to raise billions of dollars, rather than relying on venture capitalists or other investors. In 2017 ICOs were responsible for raising $3.2bn, outweighing venture capital funding threefold in total deal size.

The last 12 months have seen a surge of capital inflows from retail and institutional investors. Out of the total of 124 cryptocurrency hedge funds, more than 90 opened this year. In October, the first ever fund-of-funds for cryptocurrencies was established. And although no sovereign or public pension funds have publicly announced investments into cryptocurrencies, other institutional investors have established dedicated funds.

Asset class definitions

One key factor behind this boom is that investors, banks, other market participants and regulators have started to define cryptocurrencies in terms of asset classes. Despite the name, cryptocurrencies are rarely classified as currencies, and the task of asset class definition is typically left to the discretion of national regulator.

The US Commodity Futures Trading Commission classifies bitcoin as a commodity, as there will never be more than 21m bitcoins in existence. That figure is written into the currency's source code. Given its limited supply, the name for its production – mining – and strong performance over 2017, some have even described bitcoin as the 'new gold'.

New Zealand's finance regulator and the Monetary Authority of Singapore, however, have both announced that they classify cryptocurrencies as securities. The Canadian Securities Administrators likewise says ICO tokens and coin offerings fall under the definition of a security. The more that regulators treat cryptocurrencies as an asset class, the more clarity and certainty they will bring to the market.

Another reason for the markedly increased investment in cryptocurrencies is the development of new products and investment vehicles. This includes an increasing number of contracts for difference, which allow investors and brokers to trade cryptocurrencies. In November, the Chicago Mercantile Exchange announced that cryptocurrencies should be classified as derivatives and that it would be launching bitcoin futures. In addition, Grayscale, a digital currency investment company, has established three cryptocurrency-specific trusts that resemble exchange traded funds. In 2017, their value has increased exponentially compared to traditional markets, with the Bitcoin Investment Trust stock price rising to $960 in November from $136 in January.

> *"The more that regulators treat cryptocurrencies as an asset class, the more clarity and certainty they will bring to the market.*

Product innovation, increased investment and efforts to classify cryptocurrencies have prompted the development of a substantial trading infrastructure. There are more than 100 cryptocurrency exchanges around the world. Regulators in Japan approved 11 new exchanges and Keith Noreika, acting US comptroller of the currency, has stated he is considering imposing a nationwide licensing programme for digital currency exchanges.

Regulatory credibility

Cryptocurrencies have been met with their fair share of criticism. UBS analysts compared cryptocurrencies' performance to the 17th century Dutch 'tulip bulb bubble', business magnate Warren Buffet said the idea that bitcoin has any value is a joke, and BlackRock Chairman Larry Fink dismissed the market as an 'index of money laundering'.

At the core of these rebukes is the idea that cryptocurrencies lack any intrinsic value. Fiat currencies are valuable because they are a medium of exchange and offer a (mostly) stable store of value. Cryptocurrencies are inherently volatile, as events this year plainly show. Between 8-12 November the price of bitcoin fell to $5,857 from $7,458 before climbing again to $7,843 on 16 November.

It can be argued, too, that cryptocurrencies have no store of value mechanism since they can be replicated infinitely, as the increasing number of ICOs illustrates. This suggests there is no limit to the creation of cryptocurrencies, meaning price discovery is a function of speculation and momentum.

ICOs have garnered increased criticism. The most common is that the fund raising method is unregulated and, in some instances, potentially fraudulent. Regulators in the UK, Europe, Australia and the US are among those to have issued warnings in 2017. The Financial Services Regulatory Authority of Abu Dhabi released cryptocurrency guidelines, and ICOs have been banned in South Korea and China.

Restrictive policies are being introduced for other aspects of the cryptocurrency market. Global exchange volume for bitcoin dropped in January after the People's Bank of China issued guidance to domestic exchanges on their regulatory and operational policies. This led to periods where withdrawals and margin trading were stalled, and charges were instituted after years of no-fee trading.

Despite these steps, the cryptocurrency market is still condemned for lacking a robust regulatory framework. Attempts to label cryptocurrencies as an asset class have been pilloried on the grounds that the market is too small compared to fixed income, derivatives or stocks. Questions remain about the varying levels of anonymity within different private digital currencies, given the strict know-your-customer and anti-money laundering laws that apply to the financial services sector.

Nonetheless, the increase in regulation in 2017 will have a positive effect and help establish more credibility in cryptocurrencies. This could help stabilise price volatility and lead to more efficient price assessment processes. Such developments could, in turn, attract institutional investors. In spite of occasional controversy, 2017 has without doubt been the year of the cryptocurrency. That trend looks certain to continue. ■

Oliver Thew is Programmes Manager at OMFIF.

The Bulletin

FOCUS

2017

Review of the year

OMFIF

Looking back over year of predictions: risks remain

Members of the OMFIF advisory board highlighted political risk as a key concern in their predictions for 2017, published in the January edition of The Bulletin and reviewed here using a series of 'star ratings'. Risks remain, but – fortunately – many have not materialised. Military or economic conflict did not erupt between the US and China, and trade wars and accusations of currency manipulation were avoided. Yet a series of events that were not forecast, including the UK general election, the declaration of independence in Catalonia, and increased military tensions in the Korean peninsula, highlights the role of political events in driving markets during 2017. On a range of issues the Advisory Board predictions proved prescient.

As Michael Stürmer anticipated, 'Chancellor Angela Merkel's Christian Democratic Union will come out on top in Germany's election, but no one will be able to claim a real victory.' The breakdown in coalition talks in late November exacerbates the challenges for European integration. Donald Trump is mired in hostility from his own party, as well as the media and the courts. As Reginald Dale surmised, 'Congress will be more difficult than Trump expects. Public dissatisfaction will rise'.

The result is a weakening of leaders in Europe, the UK and the US, lowering their ability – and in some cases willingness – to shape the global agenda. Meanwhile the 19th Communist party congress cemented Chinese President Xi Jinping's authority. This could lead to a greater international role for China in political, economic and military terms. As Meghnad Desai predicted, China provided 'a major driving force for the world economy' in 2017, though it faces domestic challenges that Xi's government may address with more vigour in coming years.

The Federal Reserve looks set to raise rates for the third time this year in its December meeting, confirming Marsha Vande Berg's prediction of a rate of 1.4%. Growth in Europe and Japan was stronger than most expected. In Latin America, Brazil showed a robust economic recovery throughout the year, as forecast by Otaviano Canuto. External demand was a significant factor behind this growth, with domestic reforms remaining incomplete. This raises vulnerability to factors beyond these countries' control, including the pace of US interest rate rises and geopolitical tensions. Meanwhile, structural weaknesses in European banks, highlighted by Akinari Horii, and an excess of savings over investment in Japan, addressed by Jennifer Corbett, are continued sources of potential instability.

The least successful predictions were those regarding financial market imbalances, epitomised by John Plender's fear that 'there will be a spike in bond market yields, and heightened volatility will disturb global markets.' While vulnerability is on plentiful display, one of the most notable features of financial markets over the last 12 months has been the absence of marked volatility. Similarly, the 'transition from monetary to fiscal stimulus', highlighted by Colin Robertson, did not create market turbulence.

A coup in Zimbabwe could herald a change in economic and political prospects for the country. However, uncertainty could add to demand for hard currency, putting downward pressure on bond notes introduced last year, as anticipated by Mthuli Ncube. India's growth has moderated but remains robust, while low oil prices and poor economic diversification hampering Nigeria's performance. Rising tension between Saudi Arabia and Iran has added to instability in the Middle East. Oil prices rose throughout the year, but commodity exporting currencies suffered from mixed results.

Prediction: 'US interest rates will increase by an additional 75bps in 2017, to be spaced out in three hikes over the course of the year. The year will finish with a rate of 1.4%. Corporate tax relief and financial sector deregulation will provide fodder for continuing tightening.' (Marsha Vande Berg)

Outcome: The Federal Reserve raised interest rates to a range of 1-1.25% in two policy meetings during 2017, with a third rate rise of 25bps widely expected in December. That puts the prediction of 1.4% right in the centre range. The dollar weakened by 7.6% in real terms from the start of the year to September over the slow pace of fiscal expansion and political setbacks for Trump in the courts and in congress, before regaining some ground in October. This eased pressure on the Fed to tighten earlier, while the appointment of Jerome Powell as Fed chair, seen as a moderate candidate, reduces risk of more aggressive tightening.

'Chancellor Angela Merkel's Christian Democratic Union will come out on top in Germany's election, but no one will be able to claim a real victory. The right-wing Alternative for Germany (AfD) will enter parliament, reducing the conservatives' coalition leeway.' (Michael Stürmer)

Germany's two leading parties – Merkel's Christian Democratic Union-Christian Social Union pairing and the Social Democratic Party – achieved a combined vote share of 54% in September's election – the lowest on record. The anti-euro AfD gained 13%, beating expectations and making it the third-largest party. Merkel's political credibility suffered further setbacks when coalition talks broke down in late November. The chancellor seemed to favour new elections – which could have left Germany without a government until mid-2018 – before raising the prospect of a minority government. Attempts to form a wide coalition between the CDU-CSU and SPD have now become the main focus.

'Geert Wilders' Party for Freedom (PVV) will not become the largest party in the Dutch parliament, though his party will make gains. Mark Rutte will continue as prime minister and his party will be the winner of the elections. There will be a broad coalition of four, possibly five, parties in the next government.' (Roel Janssen)

Mark Rutte remains prime minister after his VVD party won the largest vote share, at over 21%, although his party lost eight seats. The populist PVV party came second, with 13% of the vote, giving them 20 seats – an increase of five. As anticipated, the PvdA was the worst performing party, losing 29 seats, while the Greens won the most, with 10 new seats. Talks to build a coalition government lasted almost seven months, the longest in Netherlands' modern history. As expected, four parties participate in the new government, and the PVV is not represented.

'After two years of GDP contraction, rising unemployment and credit crunch, the Brazilian economy will stabilise in 2017. The political crisis has not impeded the economic reform agenda, and the central bank has hinted at lowering interest rates as inflation has receded.' (Otaviano Canuto)

Brazil emerged from its worst recession in recent history in the first quarter of 2017, with 4% annualised growth, boosted by strong agricultural exports. Favourable weather conditions and a weaker real played a role, but structural reform and improved external accounts were key factors. Industrial production and the services sector stabilised and began to strengthen, consumption increased and the Bovespa equity index reached record highs. Growth has been supported by falling inflation, which declined to 2.5% in September from 11% in 2016, leading to a series of interest rate cuts by the central bank.

'Trump will make progress on deregulation and tax reform in 2017, but not as much as he would like on immigration and healthcare. Congress will be more difficult than he expects. Public dissatisfaction will rise.' (Reginald Dale)

In mid-November the House of Representatives passed Trump's tax bill, which will now move on to the Senate. The Republicans' margin in the upper chamber is much slimmer than in the lower, meaning the proposal may not secure the necessary votes, at least without amendment. Repealing regulations is notoriously complex and time-intensive, with little material progress so far. Difficulties in passing legislation has frustrated many of Trump's supporters and encouraged Trump to issue a range of executive orders, many of which have seemed to confirm some of the worst fears of his opponents. His approval ratings reached among the lowest of any president.

'The spectre of hyperinflation in Zimbabwe still looms, and the introduction of bond notes in late 2016 could make the situation worse. Given the demand for dollars in currency markets, the notes may begin to depreciate, forcing inflation upwards. The Zimbabwean authorities must watch out for this.' (Mthuli Ncube)

The national statistics agency of Zimbabwe puts the annual inflation figure at less than 0.8%. Inflation is significantly higher than official data suggest because these figures use hard currency prices, whereas electronic payments and newly introduced bond notes make up a significant amount of actual payments, and these have depreciated substantially against their official dollar exchange rate. Consumers and businesses report price rises of between 20%-50%. A military coup in mid-November is likely to lower confidence in government-sponsored bond notes increasing demand for hard currency, which could cause further depreciation, boosting annual price rises.

'Both India and China are expected to perform strongly in 2017, providing a major driving force for the world economy. Each faces risks, however. Implementation of Modi's reform agenda in India could encounter teething problems which disrupt economic activity. China faces high debts and a slowdown in the old economy.' (Meghnad Desai)

India's growth rate has slowed in each of the last four quarters, mainly due to two short shocks. Demonetisation in late 2016 affected economic activity in the informal sector. The introduction of the simplified Goods and Services Tax was beset by complexity from politically-inspired exemptions, increasing the burden on businesses. Despite this, growth remains healthy at 5.7% and, with inflation below the 5% target, the central bank could ease policy. Chinese growth remained strong ahead of the Communist party congress, following which a greater emphasis on rebalancing towards consumption and reducing debt was earmarked by the authorities.

'The regime in Syria will have significant success in the civil war and Aleppo will be totally in government hands. The downside is that Trump will cause real problems with Iran. He will not renege on the nuclear deal, but increased US pressure will create domestic problems for President Hassan Rouhani, who faces election in May.' (Boyd McCleary)

IS has been pushed back from much of the territory it held in Syria and Iraq. Raqqa, the capital of IS, was retaken in late 2017. Aleppo remains in government hands. As predicted, Trump has increased pressure on Iran, though he went further than anticipated by refusing to certify that Iran is meeting the terms of the nuclear deal. Increasing hostility from the US as well as Saudi Arabia has strengthened hard-line elements in Iran. Although Rouhani won a strong victory in May elections campaigning as a reformer, external opposition has boosted support for a more autarkic and conservative outlook.

'Structural reform in Japan will make progress in 2017, but by its nature the effects will only be felt with a lag. Nevertheless, Japan may surprise with stronger growth than anticipated, partly because domestic austerity has been abandoned and partly because the US will grow more strongly under Trump.' (Jennifer Corbett)

Japan grew at an annual pace of 1.4% in the third quarter of 2017, the seventh consecutive quarter of growth. Unemployment is at a two-decade low and some wages are rising to attract workers. Nevertheless, much of Japan's expansion was driven by external rather than domestic factors, questioning the effectiveness of Prime Minister Shinzo Abe's efforts at boosting the economy. Household consumption and public investment both subtracted from third quarter growth, and business investment provided only a minor contribution. Exports were the main factor, with a weaker yen reducing imports and boosting foreign sales, adding two percentage points to growth.

'European banking instability will be the most significant downside risk for the global economy in 2017. This is an election year for important EU countries and the problem is likely to get worse before the required public support is given to any plan of fundamental reform. Rising populism would make this process thornier.' (Akinari Horii)

Long-term weaknesses in Spanish and Italian banks came to the fore in June, with the dismantling of Banca Popolare di Vicenza and Veneto Banca, the rescue of Monte dei Paschi di Siena, and the resolution of Banco Popular, Spain's sixth largest bank. The orderly handling of these events prevented instability from spreading to the European banking sector as a whole, but there are significant concerns over whether future crises could be resolved as quickly. These events tested the euro area's new Single Resolution Board for dealing with failing banks. The uneven application of SRB rules to failing banks raises questions over its effectiveness in the event of an emergency.

'Nigeria's economic fortunes are unlikely to improve significantly in 2017. The solution to the country's challenges lies in fundamental policy adjustments, which the government is unwilling to make. The central bank's misaligned policy of seeking to maintain an artificial exchange rate for the naira is adding to challenges.' (Kingsley Moghalu)

After contracting by more than 1.6% in 2016, the IMF forecasts the Nigerian economy to grow 0.8% in 2017. The economy is around $175bn smaller than 2014, before the collapse in oil prices. Oil prices are rising owing to an agreement between the Organisation of the Petroleum Exporting Countries and non-Opec states, which Nigeria is not participating in. Increased output in 2017 means government revenues are growing. However, reforms to diversify the economy and boost manufacturing and services have stalled. The central bank exchange rate targeting programme remains in place, albeit in relaxed form, making foreign currency scarce for manufacturers and importers.

'The European Central Bank will be challenged by low inflation, sluggish growth and political uncertainty. Throughout 2017 policy will remain expansive and, following adjustments to the purchase programme rules, the topic of a possible shortage of bonds to buy will not play a role in 2017, as it did in 2016.' (Stefan Bielmeier)

Inflation in the euro area fell to 1.4% in October from a high of 2% in February, while weak nominal wage growth has weighed on consumption. However, growth was stronger than anticipated, with expansion of 2.5%, the highest since the 2011 debt crisis. Unemployment, at 8.9%, is at its lowest level since January 2009. Citing the need to support higher inflation in the medium term, the ECB announced continuation of bond purchases, at a decreased rate of €30bn per month, from January 2018 until at least September. The topic of bond shortages did not play an explicit role in the ECB's decision to reduce purchases, however it did lower the Bundesbank's purchases from April onwards.

'One could imagine a rapprochement where the US agrees that Russia should control its part of the world, and in return Russia agrees no longer to contest the enlargement of the North Atlantic Treaty Organisation and the EU. But this would be a fool's peace, and could open the door for further Russian meddling in the West.' (John Kornblum)

Trump's rhetoric towards Moscow has largely been informed by having to deny improper meetings between his team and Russia before and during the election campaign. This has prevented Trump becoming too close to Putin. Investigations have led to the resignation of Trump's national security adviser and former campaign manager, with more possibly to come. Nevertheless, in November both leaders had several informal discussions and Trump told reporters that he believed Putin's assertion that Russia did not meddle in the US elections. Other areas of agreement include the pledge of both countries to keep fighting IS in Syria. Broader reconciliation has, however, not materialised.

'Marine Le Pen will not become French president. The informed money stays on François Fillon, leader of the mainstream conservatives, who will take traditional conservative-catholic votes away from her. However, a surprise cannot be totally excluded.' (Jacques Lafitte)

President Emmanuel Macron's La République En Marche! political party was founded in April 2016. He was elected in May at the age of just 39 with 66% of the second-round vote, and REM went on to win an absolute majority in the French assembly. Fillon's Republican party has 112 seats and Le Pen's National Front has eight. This gives Macron a significant mandate for reform, a factor which contributed to some of the most important unions not participating in a general strike against policies to liberalise labour markets. Opposition from the socialist France Unbowed party is vocal but, with 17 seats, has little influence at the assembly.

'The greatest risk for financial markets in 2017 is the transition from monetary to fiscal stimulus. This is not typically kind to bond markets, especially when yields are exceptionally low. Higher bond yields could harm equities by raising the cost of share buy-backs.' (Colin Robertson)

Monetary policy remains loose across the major economies, albeit in reduced form, reflecting a still-weak recovery and low wage inflation despite falling unemployment. Unwinding the Fed's $4.5tn balance sheet will be a gradual process. The ECB remains committed to €30bn of bond purchases a month and the Bank of Japan will continue its monetary expansion. At the same time fiscal policy has been loosened in many economies, adding to concerns over rising debt. It is also occurring relatively late in the global recovery, potentially adding to instability. Overvalued financial assets and a lack of central bank manoeuvrability in the face of a future crisis remain key financial risks.

Fundamentals for many emerging market economies look sound and prices of many commodities have either stabilised or are rising. This should provide support for the currencies of commodity-producing nations. An emerging market currency rally in the beginning of 2017 may not last the entire year.' (Gary Smith)

The Mexican peso was among the best performing emerging market currencies in the year to September, rising more than 17% in real terms against a basket of 61 currencies. The Philippines saw one of the largest falls, of over 6%, while Saudi Arabia, Russia, Brazil and Indonesia declined by 4%-6%. After September a number of currencies fell on the expectation that the Federal Reserve would raise rates again before the end of the year. Strong economic growth in emerging markets generally and rising oil prices have supported some currencies. However, emerging market currencies faced large sell-offs towards the end of the year, reflecting concerns over high indebtedness and other factors.

★★

'The greatest threat in both economic and geopolitical terms is Donald Trump. Market observers expect a combination of loose fiscal and tight monetary policy, but the Fed may tighten more in response to inflationary pressure than markets expect. There will be a spike in bond market yields, and heightened volatility will disturb global markets.' (John Plender)

One of the notable features of financial markets during 2017 has been the lack of volatility in spite of the continued build-up of risks and imbalances. Although the US has raised interest rates to between 1%-1.25% so far (most likely rising to 1.25%-1.5% in December) and committed to gradual balance sheet reduction, this has barely affected markets. This reflects effective signalling and strong global economic growth, as well as continued stimulus in other key economies including Europe and Japan. However, there is a sense that markets are not adequately accounting for sizeable risks including domestic political uncertainty in the US, tensions in the Middle East and Asia, and high global debt levels.

★★

'The Chinese economy faces slower growth, capital outflows and external headwinds, particularly from potential US trade tariffs. Retaliation could be sought by a large devaluation, but that would risk the implosion of China's corporate and bank balance sheets that are most exposed to dollar debt.' (Neil Williams)

Economic stability in 2017 was a foregone conclusion ahead of China's quinquennial Communist party congress, in October. Official GDP figures show expansion of 6.8% in the third quarter of 2017, while capital outflows for the year to date have reduced substantially. This has been supported by restrictions on Chinese outward investment, appreciation of the renminbi and significant strengthening of corporate balance sheets in 2016, which had accounted for a large share of capital outflows last year. US firms signed deals worth more than $250bn with China during Trump's trip to Asia (although most of these are non-binding memoranda of understanding, and some may have already been announced).

★★

'This year will continue to see low oil prices, confirming that the current downturn is structural rather than a temporary cyclical shift. Demand growth worldwide is still being outstripped by production, and Opec does not seem strong enough to make the necessary dramatic cuts to raise prices.' (Nick Butler)

Production cuts of up to 1.8m barrels per days agreed between 21 Opec and non-Opec countries helped to push oil prices to over $64 per barrel in November, from $54 in January. Opec surpassed expectations of cohesion despite a significant diplomatic rift among Gulf countries. However, this was not uniform among the Opec countries, with non-Opec states including Russia, Sudan and Mexico responsible for much of the combined production cut. The extent of future rises is limited by a structural shift in oil markets created by US shale producers. The International Energy Agency expects the US to account for 80% of the increase in global oil supply between 2010-25, equivalent to 8m b/d.

★★

'Trump's spending and tax promises will widen the budget deficit and cause America's trade deficit to balloon. Trump will undoubtedly point an accusatory finger at China. A trade war between the world's top two economies in increasingly probable.' (Steve Hanke)

The federal government budget deficit grew by $82bn to $668bn in fiscal year 2017. While Trump's tax reform still has to pass congress, the difficulty of securing reductions in mandatory spending, which makes up the majority of federal outlays and requires the agreement of congress to amend, means any eventual tax cut is likely to widen the deficit. The trade deficit in the year to September increased by almost $35bn, or more than 9%, from a year before. Rather than single out China, Trump's response has been to reject the rules-based international order in general, threatening to resort to using national legislation to open investigations into trade partners it accuses of unfair practice.

★★

The greatest global geopolitical risk for the next five years is an armed conflict between the US and China, with India playing on the side of the US. Trump's opening up to Taiwan shows his determination to irritate China one way or another. There is also potential for a Japan-China conflict.' (Meghnad Desai)

The US and China appeared to grow closer in 2017, culminating in Trump praising both China and President Xi on his 12-day tour of Asia in November. Sources of disagreement, including US labelling of China as a currency manipulator and holding it responsible for the large US trade deficit, have faded. Trump 'doesn't blame' China, instead heaping condemnation on US policy-makers. The biggest flare-up has been in North Korea, where Trump seems to accept a trade-off with China in order to gain its support for increased sanctions. China understands well this national interest in international affairs. This could reduce antagonism between the two countries.

★

Shortcomings in global leadership

China moves into vacuum left by US shift to unilateralism

Shortcomings in global leadership proved to be a major source of concern in 2017, opening the way for growing competition for influence among emerging powers, particularly in Asia.

Chinese President Xi Jinping was quick to move into the vacuum left by the US shift to unilateralism under President Donald Trump. In contrast to the US, Xi is asking partner countries to take shared responsibility for global problems, a superficially beguiling multilateral approach. Trump's withdrawal of the US from the 2015 Paris climate agreement signals rejection of this multilateralism by the world's No. 1 economy (and second largest polluter). Similarly, withdrawal from the Trans-Pacific Partnership trade deal cedes US leadership over intellectual property protection, improved competition rules for state-owned enterprises and enhanced labour and environmental standards – all of which could have helped US exports – in the Asia Pacific region.

However, towards the end of the year there were signs of rapprochement between Trump and Xi, above all because of the need to find common policies to tackle the threat of conflict with wayward nuclear-armed North Korea.

On the European stage, UK Prime Minister Theresa May has been weakened by infighting in her Conservative party over the terms of Britain's exit from the European Union. In the snap June general election, the party lost its parliamentary majority. This reduces the government's ability to act boldly, whether on Europe or domestic issues – as illustrated by its highly defensive Budget in late November.

A wide coalition seems the most probable outcome of Germany's inconclusive elections, reducing the clout of Chancellor Angela Merkel and highlighting widening domestic divergence over controversial issues including immigrants' rights and euro area integration. Meanwhile, an unwieldly coalition in Italy may return former Prime Minister Silvio Berlusconi to government, with the eurosceptic Five Star Movement, which is on track to be the largest single party, as the main opposition.

Latin America has faced its own leadership problems. Brazilian President Michel Temer survived a vote in congress on whether he should face trial for allegations of corruption, although almost half of the votes cast went against him. The vote occurred barely a year after his predecessor, Dilma Roussef, was impeached on corruption charges. Such instability at the top of government creates difficulties for the large-scale reform package which the country needs to enact, particularly regarding labour and pension laws. Mauricio Macri, Argentina's president, exhibits the enhanced appeal of anti-establishment parties.

The overthrow of Zimbabwe's long-time President Robert Mugabe highlighted the dangers which the lack of a clear succession plan can present in countries ruled by strength and personal connections rather than democratic norms. The transition in South Africa, in which President Jacob Zuma is seeking to have his ex-wife succeed him (with parallels to Mugabe) – in part to shield him from prosecution – will add to regional uncertainty.

Vladimir Putin of Russia faces elections in March which may secure him another six years as president until 2024. The absence of a significant opposition party or credible candidate means his victory is almost assured. However, the absence of an alternative to Putin and the lack of a successor from within his own party adds fragility to the system.

These fluctuating political circumstances – in contrast to a marked lack of volatility on financial markets – are unlikely to yield the leadership necessary to tackle the global economy's challenges, from reining in under-regulated financial centres and taking thoroughgoing action on climate change to reforming euro area governance.

OTAVIANO CANUTO

US withdraws from Paris climate agreement

The US accounts for one-fifth of global carbon emissions, trailing only China. President Donald Trump's announcement in June that he would withdraw the US from the 2015 Paris climate agreement undercut collective efforts to lower carbon output and transition to renewable energy sources. The move jeopardises the US pledge of $3bn to the United Nations-backed Green Climate Fund, created to transfer capital from rich to developing countries to help mitigate and adapt to the effects of climate change. Regardless, 34 US states have undertaken their own ambitious carbon reduction plans – a marker for future administrations.

DENIS MACSHANE

UK triggers Article 50 of the Lisbon treaty

After almost 25 years of mounting euroscepticism following Britain's forced withdrawal from the exchange rate mechanism, the anti-Europeans secured victory in the referendum to leave the European Union. Prime Minister Theresa May's Article 50 letter from March set the process in motion, but no one knows how it will end. Policy-makers should see Brexit in the plural, not the singular. It is possible to leave the EU treaty, restore supremacy of law-making to the House of Commons, but remain a trading partner on the same terms as today. Quitting the single market and customs union would be an ideological step too far.

DAVID SMITH

Macri consolidates power in Argentina legislative elections

2017 was the year of the anti-establishment politician, riding sentiment, not ideology. Whatever one may think of Donald Trump, he has eschewed any semblance of 'business as usual'. And then look at Emmanuel Macron's victory in France. His party, barely months old at the time of the presidential election, came from nowhere to secure a strong majority in the national assembly. Latin America is two years into a similar brand of leadership. Mauricio Macri's government in Argentina, which proved victorious in mid-term elections in October, demonstrates that the anti-establishment tide, based on a movement rather than a conventional political party, can be of lasting significance.

JOSÉ-MANUEL GONZÁLEZ-PÁRAMO

Banking union: looking ahead and looking back

European banking union was launched in 2014. However, not the single rulebook nor the supervision nor the resolution framework are 'truly single' among member states, since different solutions have been implemented for troubled banks. The handling of cases over the last 12 months in Spain and Italy shows that bank failures in Europe are still not treated homogeneously.

The resolution framework must eliminate loopholes that are contrary to its spirit, to consolidate the idea that taxpayers should not bear the cost of a crisis. National insolvency regimes should be harmonised. This means, too, publishing clear guidelines on funding and liquidity provision.

STEFAN BIELMEIER

Minority government may be only way forward

Chancellor Angela Merkel is the outright loser from failed coalition negotiations after parliamentary elections in September. Until it forms a stable government Germany will not have a clear political voice on the future of the EU.

At present, consensus on Europe seems possible only in a minority government. On foreign policy, a government of this kind can set the tone together with the French President Emmanuel Macron. Economic and structural development in Germany and Europe would likewise be possible with a minority government in Germany, under a new style of policy-making.

ANTONIO ARMELLINI

Risks of populism in Italy

Italy will go to the polls between March and May 2018 under a new electoral law that encourages fragmentation and will make a clear majority hard to achieve. Former Prime Minister Matteo Renzi has been weakened by a split in his Democratic Party. Silvio Berlusconi has patched up a centre-right coalition, but its members are divided on most issues, and it could easily disintegrate. The populist Five Star Movement (M5S) is likely to be the largest party, but refuses to join forces with others. Paralysis and new elections seem probable. One alternative may be a Renzi-Berlusconi 'grand coalition', the least expected, but possibly least dangerous, outcome.

REGINALD DALE

Trump rejects Trans-Pacific trade deal

Donald Trump cancelled US participation in the Trans-Pacific Partnership on his first working day in the White House. He wanted to fulfil promises to oppose international trade deals he considers 'unfair'. The rejection was condemned by those who considered the TPP a great opportunity to contain Chinese expansionism in Asia and ensure continued US predominance in an open world trade order. The move did not kill the TPP, as the 11 remaining countries resuscitated the pact in November. While it will bring them fewer benefits without the US, it should still be economically worthwhile – and show that US leadership is not essential.

GEORGE HOGUET

Watch out for Trump monetary tweets

Donald Trump's nomination of Jerome Powell as Federal Reserve chair reflects his desire to remove Obama-era appointees from office. Powell will begin his term by presiding over rising interest rates and gradual normalisation of the balance sheet. He starts, too, when congress and regulators are weakening provisions of the Dodd-Frank Act.

A tight labour market and probable passage of a non-revenue neutral tax act increase the odds of unanticipated inflation and a more rapid firming of US monetary policy. The scale of the Fed's intervention in recent years may make a policy mistake more likely. If Powell pursues a monetary policy that Trump does not like, the president probably will not restrain himself from sending invective-filled tweets about the Fed.

MEGHNAD DESAI

Why May is safe

UK Prime Minister Theresa May's poor performance in the June general election eliminated her Conservative party's parliamentary majority and revived the credibility of the opposition Labour party. The Conservatives know she is weak, but removing her would further divide and weaken the party. A new leader may feel compelled to call a general election. In any of these scenarios, the risk of losing power is too great for the Conservative party to try.

This creates May's paradox of 'weakness as strength'. She has to be kept in office until the June 2022 due date of the next election, when there will be clarity over Brexit. Until then, May is safe.

VICKY PRYCE

Paradise Papers reveal lack of reform

Revelations from the 'Paradise Papers', stemming from the leak of confidential documents from Bermuda-headquartered law firm Appleby, are raising controversy about potentially questionable dealings in offshore financial centres. They follow April 2016's equally revelatory 'Panama Papers', which uncovered what looked like massive tax evasion and money laundering. There are many legitimate reasons for the existence of offshore finance centres. But the mood is changing. The Organisation for Economic Co-operation and Development is overseeing the development of a common reporting standard. The latest revelations suggest change is overdue.

ALISHAN GEDIK

Erdogan wins constitutional referendum in Turkey

Upward revisions of Turkey's official GDP statistics partially mask the impact of geopolitical tensions, increasingly authoritarian domestic policy and deteriorating growth prospects. April's constitutional referendum was intended to mitigate political uncertainty. However, the reinforcement of presidential power and the weakening of Turkey's system of checks and balances could undermine foreign investor confidence.

The referendum was seen by many as the ultimate test of President Recep Tayyip Erdogan's popularity. The Yes camp argued a strong presidency would create a robust and stable Turkey, while the No side said the changes would give the office of the president too many powers. Erdogan could now stay in office until 2029.

Getting the most out of green bonds

Financing adaptation to climate change

Joaquim Levy, World Bank Group

The implications of climate change require new ways of mobilising finance to fund mitigation and adaptation efforts. Green bonds can play an important role, as they raise resources from capital markets to fund climate-related activities by private and public actors. But getting the greatest benefit from green bonds, including in financing climate-smart infrastructure in developing economies, requires addressing issues around their economic foundations and pricing.

Green bonds are part of the emerging field of green finance, which is essential to achieving the United Nations' sustainable development goals for 2030. A large portion of this financing ought to come from the private sector, which is bolstering its efforts on environment-related challenges. Asset managers, insurers and pension funds have broadly adopted the UN-backed 'principles for responsible investment' and environmental, social and governance criteria to help guide long-term investments.

> *"While investors are now barred from asset classes that do not observe sustainability principles, most cannot afford to pay a premium.*

In 2016 the private sector played a crucial role in developing the recommendations from the Financial Stability Board's task force on climate-related financial disclosures. Large investors have created initiatives such as Climate Action 100+, which commits them to work with the companies they invest in 'to ensure that they are minimising and disclosing the risks and maximising the opportunities presented by climate change and climate policy.'

The International Bank for Reconstruction and Development was the first issuer of 'plain vanilla' green bonds for mainstream investors in 2008, after the European Investment Bank distributed its structured note in 2007.

The IBRD is the largest non-European supranational issuer of green bonds. The World Bank has supported corporates, banks and sovereign and sub-sovereign issuers, including in new types of green bonds. This year it has supported the first issuance of an Islamic green bond in Malaysia and the first sovereign green bond from a developing economy, issued by Fiji.

Pricing green bonds

Close to $140bn worth of green bonds will be issued in 2017, far above the previous record set in 2015. However, they have been the preserve of relatively short maturity and high seniority instruments. The market will need to absorb longer maturities and more diversity to play a greater role in climate and development finance.

The pricing of green bonds should better reflect whether these assets are less risky than other bonds. Green bonds were created in response to demand for socially responsible investment opportunities, as issuers sought to benefit from a demonstrable commitment to global sustainability. While many investors are now barred from asset classes that do not observe sustainability principles, most cannot yet afford to pay a premium when buying green bonds. This is because they are bound by fiduciary responsibilities focused on maximising returns along traditional definitions.

Fortunately, there is growing evidence that securities that follow the principles for responsible investment are more valuable than ordinary securities. This is easier to verify for stocks than for bonds, in part because of the limited upside of bonds relative to stocks, the prevalence of green bonds with high credit ratings, and because there is often insufficient risk segregation between green and ordinary bonds at the issuer level to point to different risk levels.

This is the case even if resources from green bonds are effectively applied in green projects. Demonstrating that green bonds offer higher risk-adjusted returns than ordinary bonds requires more empirical evidence and improved disclosure standards, including integrated financial reports that more fully reflect the overall balance sheet risk of issuers.

A second reason for green bonds to command a market premium occurs when governments price perceived positive externalities through policy action. This may include tax advantages, minimum holding requirements for institutional investors or smaller write-downs when green bonds are discounted by the central bank in open market operations.

Such incentives help address asset managers' constraints, but raise concerns on the issuer side, requiring new certification approaches. The current process, which is voluntary and fragmented, would become insufficient and could be open to abuse. This is why some governments are moving to define their own official standards for green bonds, and more international coordination and technical assistance is necessary.

Opening the market

These considerations are crucial as green bonds' maturity and diversification are extended to emerging markets and developing economies. The diversity brought by the Fiji bond is encouraging, with a seven-year maturity and below investment-grade ratings.

Climate-smart, resilient infrastructure can produce long-term, low-correlation and lower-risk cashflows. Capturing this value and opening the market to socially responsible investors requires good practices in host countries and better information mechanisms. It may, too, require government pricing of the macroeconomic, environmental and developmental benefits of such projects, through blended finance and some de-risking.

Multilateral financial institutions can help in both instances. They can likewise promote advances in more integrated corporate statements and the definition of green bonds. This will make it easier for investors to capture new opportunities, while fulfilling their fiduciary responsibilities. ■

Demonstrating that green bonds offer higher risk-adjusted returns requires more empirical evidence

Joaquim Levy is Managing Director and Chief Financial Officer of the World Bank Group.

New proposals on deposit insurance

European scheme must heed risks of fragmented markets

Stefan Bielmeier, DZ BANK

The European Commission in October put forward new proposals for a European deposit insurance scheme. It hopes these measures, which are intended to take better account of risk imbalances between national schemes, will go some way towards completing banking union in the region.

The proposal modifies a draft document put forward at the end of 2015. According to this earlier proposal, a single deposit insurance scheme for the euro area would gradually replace the existing system of independent national schemes. The Commission originally envisaged introducing a European 'reinsurance' phase by 2019. This was intended to syphon off some of banks' deposit insurance contributions for a new deposit protection fund. During the reinsurance phase, any depositor pay-outs were to be covered by the relevant national schemes. Only if these were overstretched would the new fund have intervened and provided limited support.

The second phase, a European 'coinsurance' scheme, was scheduled for 2020. The plan was to increase the share of contributions for the European scheme year-for-year. At the same time, the national insurance schemes' financial resources were to be increased to 0.8% of the covered deposits. On transition to the second phase the system was to be converted from subsidiary compensation to fixed quotas. The national protection schemes and the European scheme would have shared the cost of any depositor pay-outs.

> *"Europe's banking systems are still largely fragmented into national sub-markets with different risk conditions. This is reflected in loan interest rates.*

According to the 2015 proposal the third stage would have come into effect in 2024. Deposit insurance in the euro area, including the collection of contributions and depositor compensation, would have been taken over completely by the European deposit insurance scheme.

It provided for an automatic transition to the next phase without any 'emergency exit', for example in the event of risk imbalances between participating countries. The revised proposal put forward in October deals with this by providing for an audit of the banks' existing non-performing loans and other problems before the transition to the coinsurance phase. In addition, during the initial reinsurance phase, subsidiary support from the European deposit insurance scheme is only to be granted to overstrained national schemes in the form of liquidity support through loans.

Non-performing loans

Compared to the 2015 version, the October proposals offer an opportunity to reduce risk imbalances between the national protection schemes that result from NPLs. However, this can be done if levels of acceptable risk are not set too low and only if existing NPLs and other troubles are systematically exposed and eliminated.

The substantial differences between the share of bad loans in banks' overall exposure provides a rough impression of the extent of the problem. In some countries, such as Finland, Germany and the Netherlands, the NPL ratio is low, at 1.5%-2.5%. But it is worryingly high in Ireland, Italy and Portugal, at between 12%-17%, and still higher in Cyprus and Greece, where the ratio is 43%-46%.

To the extent that banks' existing NPLs are due to economic reasons, the bad banks, asset securitisation and other measures, as well as economic strengthening in Europe, are likely to improve the situation. The extreme differences between the individual countries are, however, partly due to different legal conditions. This involves bankruptcy law, rules regarding loan foreclosure, and the length of the foreclosure procedure. In addition, there are major differences between banks' lending cultures.

Fragmented European markets

Europe's banking systems are still fragmented into national sub-markets with different risk conditions. This is reflected in loan interest rates. This does not have to be negative as long as individual banks' higher risk affinity remains limited and is priced into the loan interest rate in the form of risk premiums. But a higher risk appetite affects the safety of customer deposits. Logically, such banking systems should build up bigger deposit protection funds and collect higher contributions.

Another reason for having different minimum funding levels for the deposit insurance funds lies in the structure of the member banks. Deposit protection schemes are not insurance schemes in the legal sense, but they function in a similar manner: the more banks with small risks participate, the easier it is to balance risks. But those schemes which are dominated by a few big banks are more problematic. Although the probability of a failure is lower in those circumstances, if one out of a few big banks does fail this can lead to a large amount of compensation for the insurance scheme. It is therefore necessary to build up significantly larger reserves.

There are several prerequisites for a viable and fair European deposit protection scheme. The first is the systematic and comprehensive elimination of banks' existing NPLs. Second, a legal framework that allows banks to enforce claims rapidly. Third, a volume of contributions from the national banking systems that accurately reflects the sector's risk situation.

> *"The new proposals offer an opportunity to reduce risk imbalances between the national protection schemes that result from NPLs.*

A deposit protection scheme that fails to meet these prerequisites brings the risk that depositor pay-out events occur repeatedly in countries with higher banking sector risk and that these pay-outs overstretch the insurance reserves built up by the banks in the corresponding country.

In such cases, banks would have recourse to the deposit insurance reserves created by the institutions of the other countries. A European deposit protection scheme that fails to fulfil these conditions would lead directly to a transfer union.

The political focus should be on implementing the measures of the last comprehensive reform on national deposit schemes across all countries. If smaller countries in which a handful of banks dominate the market struggle to organise a viable protection scheme, then several countries could form a single deposit protection scheme on a voluntary basis.

But a compulsory single European deposit insurance scheme must take account of the considerable risk emanating from still largely fragmented national banking markets. Anything else must be rejected. ■

Stefan Bielmeier is Global Head of Research and Economics at DZ BANK.

ESM expands into dollar market

Mitigating liquidity risk through investor diversification

Kalin Anev Janse, European Stability Mechanism

This autumn, the European Stability Mechanism turned five years old. This coincided with the ESM's debut bond deal in the dollar market, with which it raised $3bn.

The ESM is a young institution, but a mature capital market player. Together with its temporary predecessor, the European Financial Stability Facility, it is one of the largest issuers of euro-denominated bonds. The EFSF/ESM have more than €250bn in bonds and bills outstanding. That is a striking figure for an organisation employing only 170 people.

Among the landmarks, the EFSF/ESM have accomplished: the largest order book among sovereign, supranational and agency issuers; the first benchmark-sized deal with a negative yield; and the first ultra-long benchmark-sized deal. In April, the ESM raised €8bn on a deal with an order book of €21.6bn.

But issuing only in euros exposes the ESM to risks. If the euro market ebbs, the ESM would lose its source of funding. While taxpayers back the ESM's credit, it does not use any taxpayer money to disburse assistance loans. All of its money must come from capital markets. As the lender of last resort for euro area sovereigns, the mechanism has no back-up.

> *"Investor appetite for Europe has surged in 2017. The economy is expanding sturdily, and many non-European investors are interested in increasing their exposure to the region.*

Inaugural dollar deal

The ESM began to address this funding liquidity risk in 2016. Its aim was to spread risk over the two deepest capital markets – dollars and euros.

The goal was to launch the first dollar deal in October, around the time of the ESM's fifth anniversary, to diversify the investor base and capture cost efficiencies. It was decided to swap all of the proceeds back into euros, as this is the only currency the ESM uses to disburse loans to countries.

The inaugural dollar deal, on 24 October, attracted 130 investors assembling interest of $7bn, with a significant number of new names. As the ESM had announced that it would not raise the intended volume, it sold no more than $3bn of this five-year bond.

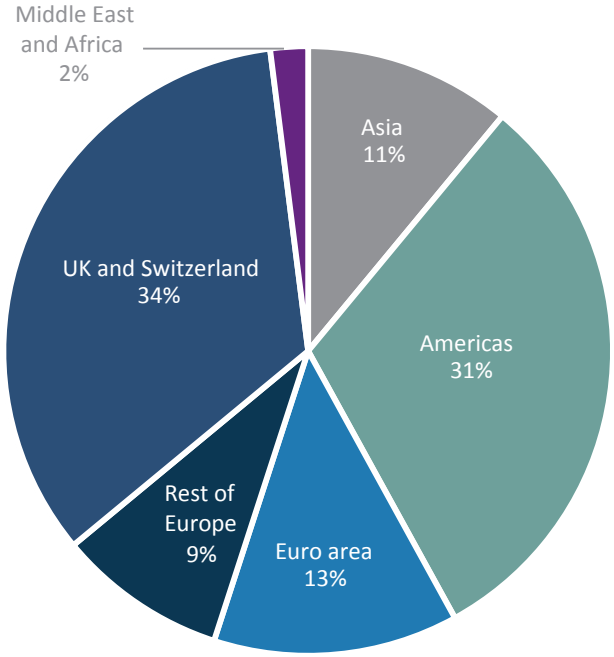
Investor appetite for Europe has surged in 2017. With the US and UK facing political challenges, Europe has emerged as a safe haven. The economy is expanding sturdily, and many non-European investors are interested in increasing their exposure to the region. The ESM is the only blended euro credit available – now also in dollars.

The ESM is borrowing in the two strongest global currencies. More importantly, it has achieved exceptional investor diversification (see Chart). The euro will remain the ESM's main issuance currency while it continues to develop a strategic presence in the dollar market. The ESM is aiming to build a yield curve with maturities of two, three and five years, and plans to go to market once or twice per year. ■

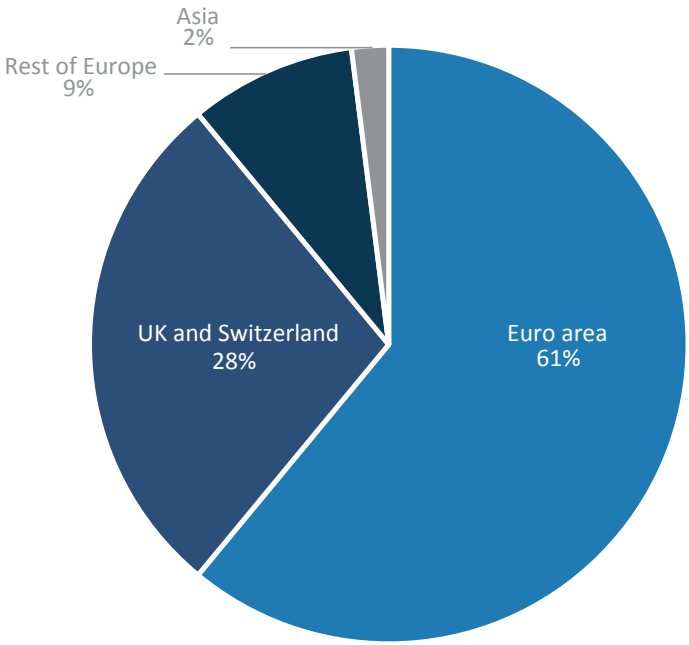
Kalin Anev Janse is Secretary General of the European Stability Mechanism.

Investor diversity in dollar v. euro issuance for European Stability Mechanism bonds

$3bn bond, geographical breakdown



€3bn bond, geographical breakdown



Source: European Stability Mechanism

Aramco sale buttressing Saudi financial triad

Riyadh's steps to build 'global investment powerhouse'

Elliot Hentov, Advisory Board

At the Future Investment Initiative conference in Riyadh between October 24-26, investors focused on the potential earnings of the planned privatisation of Saudi Arabia's national oil company, Saudi Aramco. But they were missing the broader point.

Widely expected to be the largest initial public offering in history, the partial listing of Aramco represents a unique opportunity for Saudi Arabia to quicken the development of its equity and bond markets. This will optimise capital allocation to propel growth and help diversify the economy, as well as complement social change in line with Vision 2030, the country's ambitious reform plan. One of the three pillars of this vision sets out the aim to make Saudi Arabia a 'global investment powerhouse'. While the country has a strong legacy as a sovereign investor in foreign markets, this ambition requires its local financial system to deepen across all sectors.

Saudi Arabia's triad of finance

There are several reasons why transforming its financial markets matters to Saudi Arabia's development. The first is to ensure sufficient access to capital for businesses. A simple way to think about financial systems is to consider banks, equity and bond markets as a 'triad' of finance. Strong economies tend to connect savers with borrowers through a mixture of these three channels.

Relying too much on one channel can lead to a capital supply shortage if it becomes impaired. European businesses, for instance, have historically been overly reliant on bank finance. This precipitated marked difficulties during the euro area crisis. Even companies with strong balance sheets struggled to access credit.

> *"Future debt would be better issued in riyal as part of a cohesive debt management strategy. This would anchor the construction of a sovereign yield curve.*

Saudi Arabia has a strong banking system, but bank liquidity moves procyclically in line with oil prices. Liquidity falls during oil downturns, just as other sectors retrench, exacerbating economic slumps. It is therefore critical for Saudi Arabia's equity and debt markets to expand and offer meaningful financing alternatives.

Second, the Tadawul, Saudi Arabia's stock exchange, is moving into a phase of internationalisation and is on the cusp of multiple index inclusions. This has prompted it to modernise rapidly in anticipation of increasing numbers of participants. Moreover, a concurrent surge of privatisations could dramatically deepen the equity market. The Aramco IPO is only the beginning of possible capital inflows, which could reach $140bn by the end of 2020 if Saudi Arabia fully embraces market reform. Much of these inflows would remain committed to the Saudi market and thereby buttress the country's foreign reserves in the medium term.

Third is the opportunity to include the Saudi people in the privatisation process. This could be achieved through a 'national privatisation fund'. This would offer ownership of the privatised assets to Saudi nationals at a discount, encouraging them to take a stake in the country's future. It would help set the foundations of a retail investor class and symbolise a shift in responsibility away from government policies to individual households. Fostering such a retirement and savings culture would facilitate other reforms and complement social change.

Fourth is the potential to build a domestic bond market. Saudi Arabia runs a fiscal deficit, but this presents an opportunity to develop the local debt market as a third financial pillar. For the sake of liquidity and ease of access, the kingdom has issued dollar bonds to finance the large deficits of 2016 and 2017. However, future debt would be better issued in riyal as part of a cohesive debt management strategy. This would anchor the construction of a sovereign yield curve, which in turn would set a reference price for the local corporate debt market and aid the introduction of other financial instruments.

Realising Riyadh's aspirations

It is crucial that citizens are offered the chance to participate in the upside of any economic reform. Apart from engaging households in financial markets directly, this can be done through non-bank financial intermediaries that serve households. Two important types of such intermediaries are private pension funds and insurers. Private pension funds in Saudi Arabia are embryonic, but the main public fund – the General Organisation for Social Insurance – is the major investor in the domestic stock market.

The Tadawul is moving into a phase of internationalisation

The key point is that the components of the financial triad – banks, equity and bond markets – are interdependent. Improvement in the price discovery mechanism in one segment refines pricing elsewhere until capital is optimally priced. Around 90% of Saudi businesses are small and medium-sized enterprises, but these represent only 2% of bank lending. If more firms could raise money through stock listings or debt issuance, banks would be more likely to increase their lending to worthy economic participants. This in turn would promote higher and broader economic growth.

The Future Investment Initiative reaffirmes Riyadh's aspiration to become a more important financial centre. Given the momentum behind its reforms and the potential scale of its domestic markets, this is a conceivable goal. However, it cannot be achieved without transforming the Saudi financial system to offer better access to capital, in line with Islamic values and social requirements. The Aramco sale is an ideal opportunity to catalyse these developments. ■

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

Dealing with disappointment

Quantitative easing and the rise of inequality

Burcu Ünüvar, Industrial Development Bank of Turkey

Sceptics remain uncertain about whether central banks saved the global economy after the 2008 financial crisis. Undeniably, however, monetary policy-makers helped bolster business sentiment by flooding the world with cheap money. Nearly 10 years on, there are confusing signals about the future of monetary policy. Central banks' forward guidance appears to be exerting diminishing influence.

Attitudes towards central banks appear to be following a similar course to those towards new technologies: exaggeration is followed by disappointment and, finally, understanding. Attitudes towards monetary policy appear to be reaching the end of the 'exaggeration' phase, and risk creeping towards 'disappointment'.

The separation principle in which monetary policy targets price stability and regulatory policies target financial stability is no longer valid. The consensus about the 'multi-tool, multi-objective' approach to central bank policy is well established. But juggling multiple objectives inevitably puts central banks in a position of great power, and loads expectations on policy-makers.

Policy-induced inequality

Central bankers, international financial institutions and market participants overestimated the power of unconventional policy and underestimated the extent of the fundamental problems in the world economy. Comparatively little is known about quantitative easing, as this is the first time it has been implemented on such a large scale.

Results which do not meet elevated expectations risk introducing the 'disappointment' phase of the new monetary policy perception. The prolonged period of abundant global liquidity boosted asset prices, creating a feeling of comfort which transformed into a state of 'reform fatigue'.

In economies where QE was pursued, it was generally observed that it is not a monetary cure-all. As structural weakness started to weigh on the economy, it became clear that people had not benefited equally from these unorthodox policies. This policy-induced inequality – a strong reason for overall disappointment over QE's effects – will need to be considered in the measures which central bankers will introduce in the period ahead.

Dealing successfully with this disappointment will be crucial for markets to move to the 'realisation' phase, which could broadly be interpreted as a return to market fundamentals.

Indirect consequences

Different economies are at various stages of recovery. The fear is that tapering by the leading central banks – while it might move their economies towards 'realisation' – could lead to negative repercussions on other countries and push some markets, especially emerging economies, into the 'disappointment' phase.

> *"Although central bankers claim that the benefits of their unconventional policies outweigh QE's distributional effects, they must address policy-induced inequality.*

Focusing only on the end of QE narrows policy-makers' perspective on exit policies. Asset markets in emerging economies will learn to navigate the consequences of the tapering, which is likely to be gradual and well communicated. It will take some time before central banks' balance sheets shrink to pre-crisis levels, if they ever do. But there are some indirect consequences of the unconventional monetary policies which may not diminish or reverse.

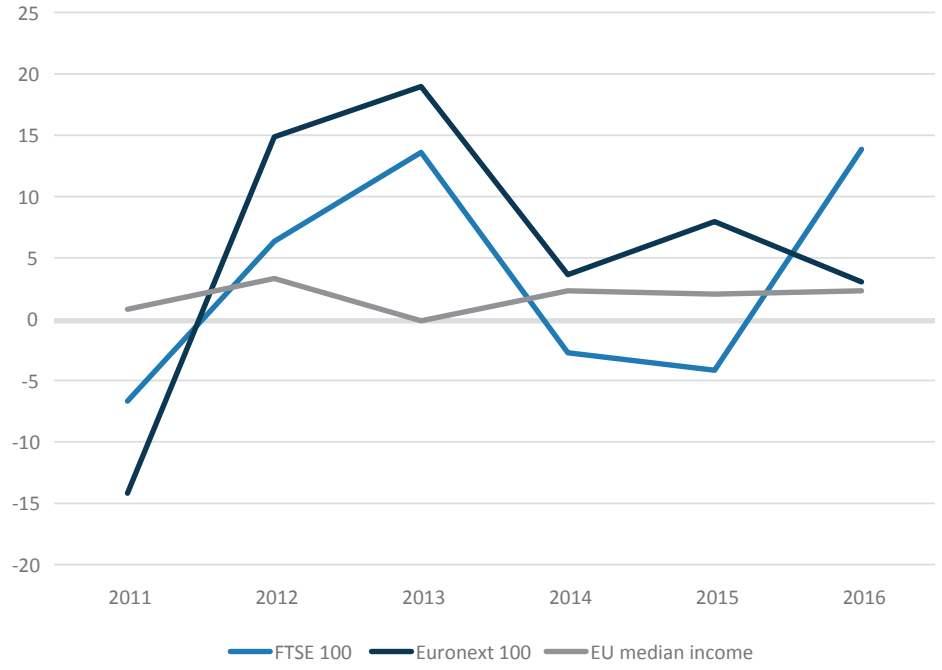
Although central bankers claim that the aggregate economic benefits of their unconventional policies outweigh QE's distributional effects, they must nonetheless address policy-induced inequality. This is not something that will improve gradually or naturally as QE ends.

Post-crisis asset price appreciation outpaced median wage growth, which is blamed as one of the key driving forces behind the rise of anti-establishment political parties in many developed countries. The shift towards political protectionism will not necessarily subside in harmony with the ending of QE. Policy-makers must be mindful of both the accountable and unaccountable impact of QE when they develop their tapering strategies. ■

Burcu Ünüvar is Head of the Economic Research department at the Industrial Development Bank of Turkey.

Stock prices have generally grown faster than median income

Annual growth in index value, %



Source: FTSE, Euronext, Eurostat, OMFIF Analysis

A new phase of trade expansion

China initiatives raise confidence in international co-operation

Otaviano Canuto, Advisory Council

Technological advances and the removal of trade barriers have generated sustained trade expansion over the last three decades. The falling cost of shipping and of managing complex production networks has accelerated fragmentation of manufacturing within global value chains. Companies have harnessed technology to bring into cross-border manufacturing large numbers of lower-wage workers in Asia and eastern Europe.

Countries linked by these global value chains have transformed their economic structures and achieved substantial increases in total factor productivity. Expanded foreign trade has driven these economies' transition from low-value, low-productivity activities towards production of modern tradable goods, with China a special case in speed and magnitude.

There are signs, however, that these developments have reached a plateau. The elasticity of global trade relative to global GDP has diminished by more than predicted by analysis of post-financial crisis trade-damping factors. Prevailing advanced manufacturing technology may not be conducive to further fragmentation of production processes. The scope for export-led hyper-growth has narrowed, not least because, in a more risk-averse climate, importing countries are no longer able to run large current account deficits on a pre-crisis levels.

Chinese rebalancing

Changes in aggregate demand in advanced economies point to the growing importance of local availability of goods and services compared with lower labour costs. The customisation of products is making proximity to markets more relevant than low production costs. Domestic consumption in advanced economies reflects the 'dematerialisation' of products – fewer materials are used to deliver goods – and increasing demand for sophisticated services. This partial reversal of offshoring and weaker demand for the typical exports of emerging markets will have a marked impact on these economies.

China is rebalancing its economy away from exports and towards domestic consumption. At the same time the country is shifting involvement in global value chains so that it can develop more value-added functions. If China discards more low-skill, labour-intensive manufacturing activities, opportunities may increase for countries with cheap and abundant labour. China's transition has been taking place from a starting point of low consumption ratios, low wages, low levels of public social spending and high household savings. The rebalancing process is proceeding slowly, for fear that domestic growth rates might fall significantly.

> *"The new proposals offer an opportunity to reduce risk imbalances between the national protection schemes that result from NPLs.*

Governments and central banks around the world adopted countercyclical policies to ward of economic collapse after the 2008 crisis. In China, quantitative easing generated increased shadow banking activities and capital expenditure on housing and infrastructure, with state-owned enterprises playing a key role. Overcapacity in some sectors and reliance on high debt levels have been used to meet official growth targets. Beijing has announced its intent to inhibit such measures before they can develop into more material risks to the domestic economy.

In 2013 Chinese President Xi Jinping announced the Belt and Road plan, China's international infrastructure initiative. Investments through the Belt and Road, as well as the acquisition of foreign assets around the world, appears to be a way for China to diversify partially its large foreign exchange reserves out of low interest-bearing government bonds.

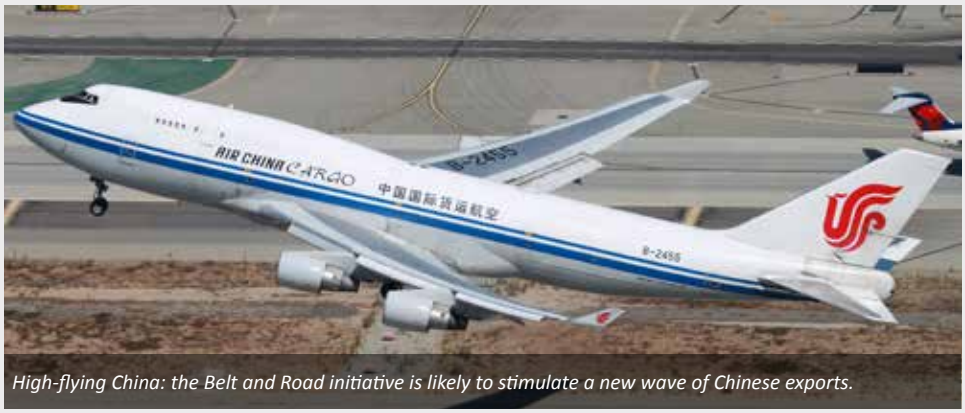
The Belt and Road will open new markets for Chinese companies, especially for the country's vast excess capacity in cement, steel and other metals. In addition to connections throughout Asia, Africa and Europe, Xi has offered Latin American countries access to the Belt and Road. The Regional Comprehensive Economic Partnership, a proposed China-led free trade agreement, will likewise solidify regional networks.

Parallel globalisation

Barack Obama, as US president up to the beginning of 2017, deliberately promoted the adoption of ambitious multilateral agreements – dealing with goods and services trade, investment and intellectual property rights – like the Trans-Pacific Partnership and Transatlantic Trade and Investment Partnership. By sidelining China from both, the US intended to pressure Beijing into adapting Chinese policy in line with a new international regulatory framework. In spite of President Donald Trump's rebuttal of the TPP, the 11 remaining countries involved agreed in November to the central elements of a new and still far-reaching agreement.

Meanwhile, the Belt and Road is likely to stimulate a new wave of Chinese exports and investments. Improved infrastructure networks in connected counties, most of them emerging markets, will strengthen trade integration. Prerequisites in terms of policy and regulatory harmonisation would not be as high as the ones embedded in the TPP or TTIP.

Both globalisation processes will evolve in parallel, and might even reinforce each other. Much will depend on the extent to which anti-globalisation sentiment rises or falls in key markets. Progress on trade deals like the new TPP and the wide reach of the Belt and Road should engender some confidence that international economic co-operation has not reached a nadir under President Trump – but can strike out in new and positive directions. ■



High-flying China: the Belt and Road initiative is likely to stimulate a new wave of Chinese exports.

Otaviano Canuto is an Executive Director of the World Bank and a Member of the OMFIF Advisory Council.

Perils of regulatory change

Small states losing access to trade finance

Jodie Keane, Commonwealth Secretariat

Regulatory changes intended to rectify the ramifications of the 2008 financial crisis are compounding the structural and institutional capacity constraints small states face over trade. De-risking has reduced the availability of trade finance because of the loss of correspondent banking.

At the Commonwealth heads of government meeting in 2013, against the background of a faltering global economy, members of the Commonwealth Secretariat called for efforts to boost trade finance facilities. Two years later in Malta, they secured support for a 'small states trade finance facility'.

The loss of corresponding banking relationships and potential effects on trade finance are a major concern for the Secretariat. These factors are especially relevant for small states, which comprise 31 of the Commonwealth's 52 member countries.

Closing corresponding banking relationships

While much attention has focused on the implications of anti-money laundering and countervailing terrorism regulations, the combined impact of post-crisis regulatory changes is squeezing corresponding banking relationships. Invariably, the smallest and poorest countries are disproportionately affected.

Small states depend more on trade than others for growth, but face far higher trade costs than the developing country average. The loss of correspondent banking relationships and increased challenges to securing trade finance are creating additional obstacles to growth.

Between September-December 2015, the Commonwealth Secretariat conducted a survey on de-risking among its members. It showed a worrying rise in correspondent banking relationship closures, which have doubled since 2013. This is having a marked impact on regions such as the Caribbean. Seven of Belize's nine banks lost their correspondent banking relationships. The country's central bank likewise lost one of its relationships. Of the states surveyed, 18 of 24 feel they comply with the requirements, and yet they have been penalised since larger financial institutions believe these economies are not worth the risk.

Changing regulatory standards

In surveys undertaken by the International Finance Corporation, respondents most frequently raised difficulties relating to compliance requirements imposed by national regulators and cross-border correspondent banks. Banks in countries across a broad range of regions, sizes, and income levels expect their costs to more than double this year. This will invariably impact the services these institutions can provide, including those where marginal costs may be high.

Small and medium-sized firms in poor countries rely on credit applications, which often depend on the rating of local banks in relation to international financial institutions and the global financial system. The removal of correspondent services from banks in purportedly high-risk jurisdictions, although they may be compliant with regulatory requirements, can adversely affect these states' ability to trade. This obstructs the only proven route for countries to lift themselves out of poverty.

> *"A fast-evolving regulatory environment is emerging and continues to see 'blacklisting exercises' being used as a means of enforcing new global norms.*

Conventional business models are under severe pressure in many small Commonwealth jurisdictions. The factors behind this withdrawal are numerous and complex. The international dialogue has emphasised the need for affected jurisdictions to implement global regulatory standards. Reflecting on the role that jurisdictional reputation may play on the withdrawal of these banking relationships, an International Monetary Fund report called on states hosting offshore financial centres to reconsider the sustainability of opaque business models.

In a fast-evolving regulatory environment, 'blacklisting exercises' are being used as a means of enforcing new global norms. This poses immediate challenges to jurisdictions as they try to adhere to rapidly evolving standards.

The international tax transparency agenda will continue to impact the role played by international financial centres located in small states. But the broader tax avoidance agenda, which has focused on curbing the shift of multinationals' profits to low- or no-tax jurisdictions, will clearly affect the role that some centres have played in the fragmentation of global value chains. Limiting small states' access to trade finance will reduce still further their inability to tap into these value chains. ■

Belize: The removal of correspondent services from banks can adversely affect these states' ability to trade

Jodie Keane is Economic Adviser in the Commonwealth Secretariat. The views expressed are those of the author and not the Secretariat.

Beyond the theatrical skirmishing

Rational case for UK departure from European Union

David Marsh

Protagonists in the process of Britain leaving the European Union display a wide gap in their psychological campaigning. The departing Britons must necessarily broadcast optimism about the future, play down possible hardships, and give as little as possible away in assistance, money or comfort to their adversaries.

The remaining 27 EU members have a natural opposing interest in preserving intactness, creating solidarity and conserving funding, pride and the moral high ground. Across this emotionally complex terrain, none of the participants can act or speak with totally honesty – setting the tone for the first 18 months of theatrical skirmishing over the terms of the post-June 2016 referendum divorce. In this fraught environment, there is ample need for a book that sets out constructively and dispassionately the economic case for why Britain's EU departure may turn out to be a success. *Clean Brexit – Why leaving the EU still makes sense*, goes a long way to meeting this requirement.

The authors, both economists – Liam Halligan, best known for his Sunday Telegraph columns, and Gerard Lyons, for many years at Standard Chartered before he worked for Boris Johnson as mayor of London – are both Leavers from the rational rather than rabid camp. For this reviewer who voted Remain, largely because he thought (possibly naively) the UK could best reform the EU from inside, the analysis is persuasive.

Avoid arduous compromises

The book argues for a clean break, involving withdrawal from the single market and customs union, with a two-year transition period. Halligan and Lyons say this would be a much better and less messy outcome – for both the UK and the EU – than attempting arduous compromises on combining the British desire to leave with the EU's 'four freedoms' of movement of goods, services, capital and people.

The authors set out why agreeing a 'bold and ambitious' (in the words of British Prime Minister Theresa May) free trade agreement with the EU is not a priority for the two-year window up to March 2019. 'Unless the EU sees that we are prepared not to sign a free trade agreement, we will only be offered a bad one.' The contingency of reverting to World Trade Organisation rules would be an acceptable option, the authors say.

They point out that the WTO provides the framework (buttressed often by sectoral regulatory accords) for present EU and UK trade with over 100 countries with which the EU28 has not signed a free trade agreement, including the US, China, India, Brazil and Singapore. The WTO likewise provides flexibility for the UK to fix sectoral import tariffs at zero if it wished. Prospects for a post-Brexit EU-UK automotive sector deal are brightened by EU car exporters' fears that their UK sales could fall if Britain adopts a zero-tariff option on auto imports – which would considerably cheapen non-EU countries' exports.

The authors apply similar thinking to a range of other areas. On the future of the City of London, they point out that vaunted 'passporting' is a relatively new phenomenon dating from 2007 that could be replaced in many cases by regularity 'equivalence'.

> ***"The authors set out why agreeing a free trade agreement with the EU is not a priority. The contingency of reverting to WTO rules would be an acceptable option.***

On immigration, they see the need for a constant net inflow of migrants, regulated through a work permit system adapted for specific regions using biometric identity cards. They identify a lack of affordable housing and worries over student debt as far greater problems than Brexit for most young people. They put forward a range of solutions for repairing Britain's 'broken' housing market which they rightly call an 'economic and social disaster'.

Within the chosen field of economic, industrial and social affairs, the holistic sweep of the book is an appealing feature. Better editing would have beneficially reduced the length and avoided unnecessary repetition. And for authors who espouse a British approach, it is odd that they favour the American use of 'likely' as an adverb meaning 'probably'.

More cogently, Halligan and Lyons lay out their wares at the beginning with pithy summaries of recommendations – extending from digitalisation through to infrastructure and a 'Bismarckian approach to welfare'.

There is a certain breathlessness about the relentless optimism, for example, over the prospects for a frictionless border between Northern Ireland and the Republic of Ireland, where the authors appear to rely a little too much on 'customs pre-clearance and information-sharing.'

The book deserves to be read by people on both sides of the debate – including those in the rest of Europe who have made up their minds that Brexit is inevitably a bad thing. It might make them think again. ■

David Marsh is Managing Director of OMFIF.

COUNCIL

Meghnad Desai, House of Lords; chairman, OMFIF Advisers
Johannes Witteveen, honorary chairman, OMFIF Advisers
Philip Middleton, EY
Louis de Montpellier, State Street Global Advisors
Frank Scheidig, DZ BANK
Songzuo Xiang, Renmin University of China
Otaviano Canuto, World Bank Group
Aslihan Gedik, OYAK Anker Bank
Robert Johnson, Institute for New Economic Thinking
William Keegan, The Observer
John Kornblum, Noerr
Norman Lamont, House of Lords
Kingsley Moghalu, Tufts University
Fabrizio Saccomanni, LUISS University
Gary Smith, Barings
Niels Thygesen, University of Copenhagen
Ted Truman, Peterson Institute for International Economics
Marsha Vande Berg, Stanford University
Ben Shenglin, Renmin University

CAPITAL MARKETS

John Adams, China Financial Services
Yaseen Anwar, Industrial & Commercial Bank of China
Irena Asmundson, California Department of Finance
Georgina Baker, International Finance Corporation
Stefan Bielmeier, DZ BANK
Hans Blommestein, Vivid Economics
Mark Burgess, Jamieson Coote Bonds
Hon Cheung, State Street Global Advisors
Michael Cole-Fontayn, BNY Mellon
Thomas Finke, Barings
Christian Gärtner, DZ BANK
Trevor Greetham, Royal London Asset Management
Gao Haihong, Institute of World Economics and Politics
Daniel Hanna, Standard Chartered Bank
George Hoguet, CFA Research Foundation
Soh Kian Tiong, DBS Bank
Stuart Mackintosh, Group of Thirty
Paul Newton, London & Oxford Capital Markets
Saker Nusseibeh, Hermes Fund Managers
Jukka Pihlman, Standard Chartered Bank
Colin Robertson, SW1 Consulting
Fabio Scacciavillani, Oman Investment Fund
Lutfey Siddiqi, National University of Singapore
David Suratgar, BMCE Bank International
Volker Wieland, German Council of Economic Experts
Katarzyna Zajdel-Kurowska, National Bank of Poland

MONETARY POLICY

Iain Begg, London School of Economics
Marek Belka, formerly National Bank of Poland
Harald Benink, Tilburg University
Mario Blejer, Banco Hipotecario
Stewart Fleming, St Antony's College, University of Oxford
José Manuel González-Páramo, BBVA
Brigitte Granville, Queen Mary, University of London
Graham Hacche, NIESR
Akinari Horii, The Canon Institute for Global Studies
Harold James, Princeton University
Hemraz Jankee, formerly Central Bank of Mauritius
Pawel Kowalewski, National Bank of Poland
Philippe Lagayette, formerly Fondation de France
Andrew Large, Hedge Fund Standards Board
Gerard Lyons, Policy Exchange
Rakesh Mohan, Yale University
Athanasios Orphanides, MIT Sloan School of Management
Nagpurnanand Prabhala, University of Maryland
Edoardo Reviglio, Cassa Depositi e Prestiti
Richard Roberts, King's College, London
Olivier Rousseau, Fonds de réserve pour les retraites
Miroslav Singer, Generali CEE Holding
Shumpei Takemori, Keio University
Makoto Utsumi, formerly Japan Finance Ministry
Tarisa Watanagase, formerly Bank of Thailand
Ernst Welteke, formerly Deutsche Bundesbank

INDUSTRY AND INVESTMENT

Andrew Adonis, National Infrastructure Commission
Jean-Claude Bastos de Morais, Quantum Global
Robert Bischof, German-British Forum
Albert Bressand, European Commission
Caroline Butler, Walcot Partners
Nick Butler, King's College, London
John Campbell, Campbell Lutyens
Mark Crosby, Monash University
Natalie Dempster, World Gold Council
Hans Genberg, The Seacen Centre
Steve Hanke, Johns Hopkins University
Hans-Olaf Henkel, University of Mannheim
Mumtaz Khan, Middle East & Asia Capital Partners
Joel Kibazo, JK Associates
Jürgen Krönig, Die Zeit
Oscar Lewisohn, Soditic
Boyd McCleary, 39 Essex Chambers
Luiz Eduardo Melin, International Economic Synergies
Willem Middelkoop, Commodity Discovery Fund
Célestin Monga, African Development Bank
Danny Quah, Lee Kuan Yew School of Public Policy
David Smith, formerly United Nations
Takuji Tanaka, Japan Finance Ministry
Daniel Titelman, ECLAC
Pasquale Urselli, Mazars
Paul van Seters, Tilburg University

OMFIF ADVISERS NETWORK

NETWORK

Bahar Alsharif
David Badham
Franco Bassanini
Eduardo Borensztein
Consuelo Brooke
Colin Budd
Michael Burda
Shiyin Cai
David Cameron
Forrest Capie
Stefano Carcascio
Desmond Cecil
Efraim Chalamish
Moorad Choudhry
John Chown
Vladimir Dlouhy
Obindah Gershon
Jonathan Grant
Peter Gray
François Heisbourg
Frederick Hopson
Matthew Hurn
Korkmaz Ilkorur
Karl Kaiser
David Kihangire
Ben Knapen
Ludger Kühnhardt
Celeste Cecilia Lo Turco
Bo Lundgren
Mariela Mendez
Murade Miguigy Murargy
George Milling-Stanley
Winston Moore
Wilhelm Nölling
José Roberto Novaes de Almeida
Michael Oliver
Francesco Papadia
Robin Poynder
Poul Nyrup Rasmussen
Janusz Reiter
Anthony Robinson
Philippe Sachs
Nasser Saidi
Pedro Schwartz
Vilem Semerak
Song Shanshan
Marina Shargorodska
Paola Subacchi
José Alberto Tavares Moreira
Jens Thomsen
David Tonge
Jorge Vasconcelos
Gottfried von Bismarck
Jack Wigglesworth
Paul Wilson

POLITICAL ECONOMY

Antonio Armellini, former Ambassador, OSCE
Frits Bolkestein, formerly European Commission
Laurens Jan Brinkhorst, University of Leiden
Peter Bruce, Business Day
Jenny Corbett, Australia National University
Reginald Dale, Atlantic Council
Maria Antonieta Del Tedesco Lins, University of São Paulo
Hans Eichel, former German Minister of Finance
Jonathan Fenby, China Research, Trusted Sources
Jeffry Frieden, Harvard University
Elliot Hentov, State Street Global Advisors
Roel Janssen, financial journalist
Thomas Kielinger, Die Welt
Ruud Lubbers, Minister of State, Netherlands
Denis MacShane, Avisa Partners
Kishore Mahbubani, Lee Kuan Yew School of Public Policy
David Owen, House of Lords
Vicky Pryce, Centre for Economics & Business Research
Brian Reading, independent economist
Robert Skidelsky, House of Lords
Gabriel Stein, formerly OMFIF
Michael Stürmer, WELT-Gruppe
Christopher Tugendhat, House of Lords
John West, Asian Century Institute
William White, OECD
Linda Yueh, St Edmund Hall, Oxford

End of bull market in sight

Majority sees equity market pullback occurring before the end of 2018

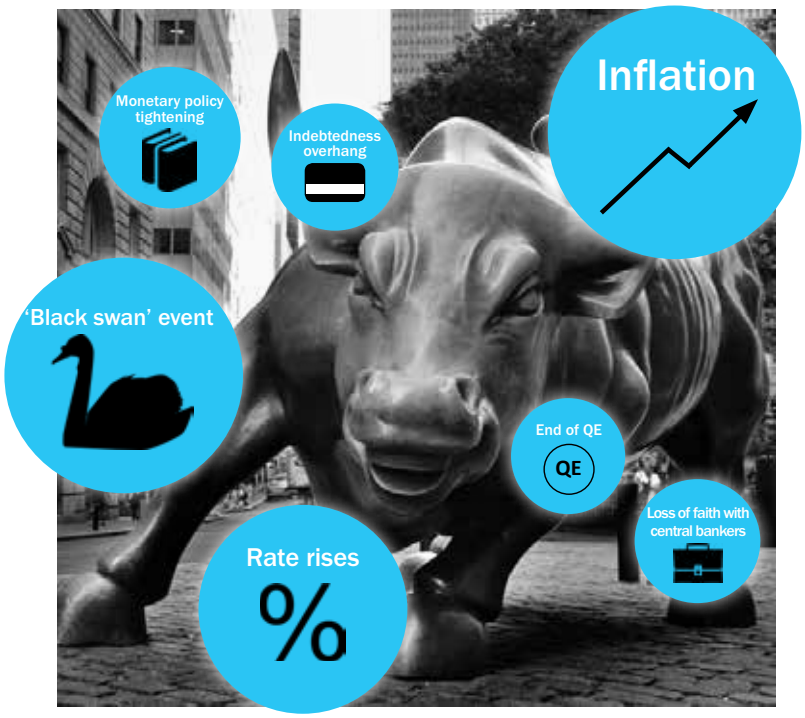
This month's advisers network poll focuses on when and how the current bull market might end. Members of the network were asked: 'Assets globally have benefited from a strong bull market in 2017. When will markets see a correction and what will be the cause?'

Strong asset performance since 2009 has continued well into 2017. This makes the current 'bull run', at 8½ years, the second longest on record. Earnings growth, relaxed lending conditions and a gradually expanding economy have combined to create an ideal environment for stock appreciation. Financial history suggests bull markets are not be permanent, and so a correction seems inevitable. However, the timeframe provides widespread debate with anywhere between a year and ten years proposed. Despite this, 70% of our Advisers Network who suggested to us a timeframe agree that a correction will occur in 2018, compared to 30% believing the buoyancy will continue for longer.

How this pullback might occur is also disputed, with causes including the influence of disruptive technology and monetary policy tightening. Underlining the unpredictability of market developments, respondents gave a wide variety of reasons such as a barely forecastable 'black swan' event with the escalating crisis in the Gulf cited as potentially jarring the market. Other possible factors include global increases in both inflation and interest rates.

Higher global inflation most likely to correct market

Size of circle represents number of responses



I believe that any overall correction is likely to be short-term due to the strong global underlying economic conditions. With the strengthening of the global upswing in economic activity, global growth is projected by the IMF to increase further to 3.7% in 2018, from 3.6% in 2017. Moreover, globally, monetary policy remains accommodative.
Hemraz Jankee, formerly Bank of Mauritius

The international financial market will face a correction when inflation accelerates in major countries, particularly in Japan, whose inflation risk the market totally neglects. This is unlikely to happen in 2018 unless some incident breaks out in the Gulf.
Akinari Horii, The Canon Institute for Global Studies

Market correction will occur within 12 months and the major causes will be loss of confidence in central bankers and reduced excess central bank liquidity. Regardless of the trigger, the ending of the major features which have driven this extended bull market across virtually all asset classes will characterise a highly correlated downward move across markets.
Colin Robertson, SW1 Consulting

The perceived dangers are the massive indebtedness overhang, the end of quantitative easing, and the political background of Brexit and Trump's erratic behaviour.
David Suratgar, BMCE Bank International

Higher inflation numbers or wage inflation will start a correction in the US bond and equity markets, potentially next spring. Of course any big geopolitical event could also trigger a correction.
Olivier Rousseau, Fonds de réserve pour les retraites

I expect a correction sometime in 2018, probably toward the latter half of the year. As always, the specific cause is probably impossible to project.
Jeff Frieden, Harvard University

These statements were received as part of the December poll, conducted between 4-23 November, with responses from 10 advisory network members.

January's question

Who will stay in office longer: Theresa May, Donald Trump or Angela Merkel?