The Bulletin

OMFIF

Winter 2020
Vol.11 Ed.1

Eurovision

Saving the European project

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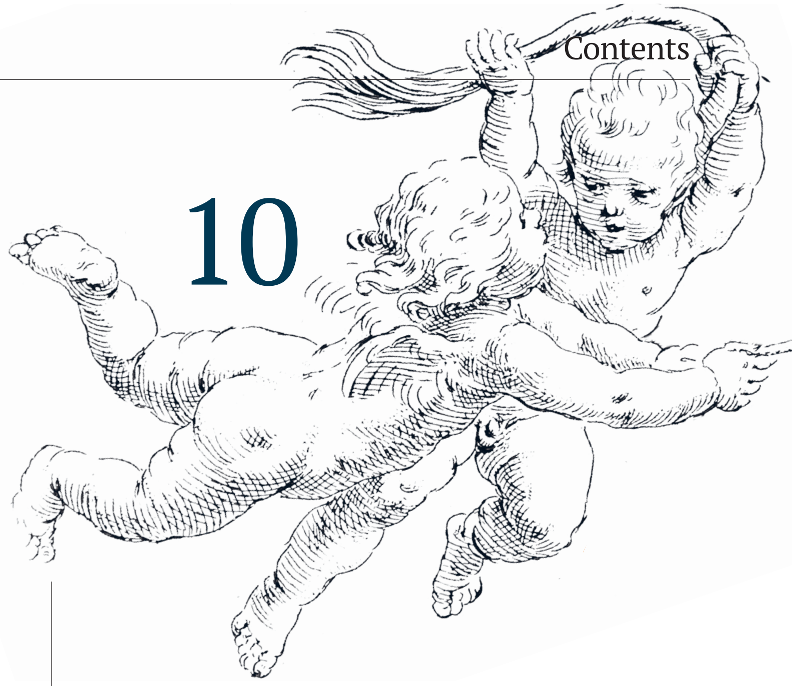
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Dialogue on world finance and economic policy

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

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

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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

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The 173-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.

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New era for the old continent

More than 60 years ago, the illustrious French statesman Charles de Gaulle said, 'From the Atlantic to the Urals, it is Europe… that will decide the fate of the world.' Those words reflected the optimism and big ideas needed to unite a region still coming to terms with the consequences of two world wars. Today, putting its own affairs in order rather than deciding 'the fate of the world' is at the top of Europe's agenda.

The European project is a subject close to OMFIF's heart. Our chairman, David Marsh, opens this edition of The Bulletin by assessing the relationship between France and Germany and their differing opinions on economic and monetary union. With Britain leaving the European Union – though with more years of vexing negotiations to come, as Denis MacShane writes – the relationship between French and German leaders will play an even more substantial role in determining the bloc's future. One matter for debate is developing a capital markets union, a topic explored by Ellie Groves, OMFIF's programmes manager for Europe.

In addition to those articles from our in-house experts, this Bulletin contains enviable contributions penned by a cast of senior European policy-makers. Representatives from as far afield as Portugal and Romania touch on various topics, from the single currency and euro area reform to green finance and export dynamism. One country represented herein has even played a part in inspiring the design of this magazine – the cover art depicts the abduction by the Greek god Zeus of Europa, after whom the region is named.

At its outset, 2020 seems like the beginning of a new era for the old continent. Across our numerous publishing ventures and engagements with policy-makers, you will be sure to see the OMFIF banner flying throughout Europe this year.

»17 October, Washington

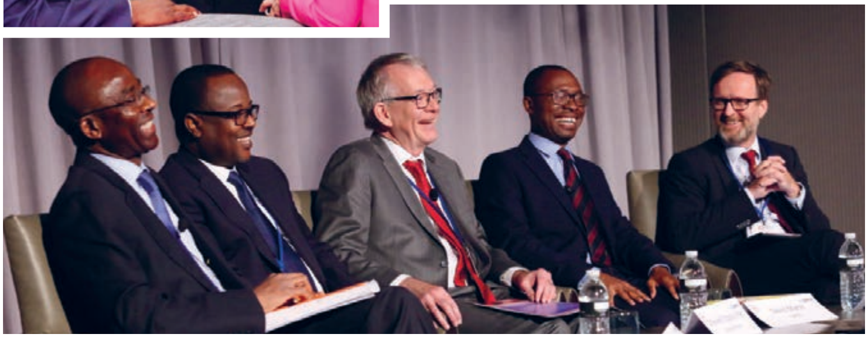
Cyber resilience in the financial system

Central banks should exchange best practice in producing counter-measures against potentially devastating cyber assaults, according to panellists at a Citi-OMFIF session in Washington on combating electronic attacks on security protocols and payments systems.

»15 October, London

Crypto-assets in payment systems

All risks must be properly assessed before central bank digital currencies can become a reality. This requires a coordinated, international approach, said Denis Beau, first deputy governor of the Banque de France. He was speaking at an OMFIF City Lecture on the role of crypto-assets in payment systems.



»18 October, Washington

Absa Africa Financial Markets Index

A panel discussion with senior African policy-makers marked the launch of the third annual Absa Africa Financial Markets Index, which records the openness to foreign investment of countries across the continent.

»10 October, London

Impact investing: Scaling the market

At an OMFIF roundtable in London led by Neil Gregory, the International Finance Corporation's chief thought leadership officer, representatives of a wide range of public and private institutions from the US, Europe and Asia discussed the development of the nascent 'impact investing' market.

»2 October, Tokyo

Unlocking sustainable finance

OMFIF, the Asian Development Bank Institute and Rocky Mountain Institute convened a group of emerging market policy-makers from Asia Pacific to discuss the role of national institutions in scaling up private sector climate investment plans.

»15 November, Rome

Strengthening euro area integration

At an OMFIF-Banca d'Italia seminar in Rome on the reinforcement of European economic and monetary union and challenges to euro area stability, Ignazio Visco, governor of the central bank, said, 'The tide of the global financial crisis and the sovereign debt crisis has long fallen, but its poisonous legacy and geopolitical tensions are fuelling distrust, fears and even prejudices once thought long buried.'

»12 November, Singapore

Gender balance across financial institutions

As young women see more role models in female leaders, the pool of talent from which institutions can recruit widens and increased gender diversity can be expected. OMFIF, supported by Barings, contributed to this conversation by launching, in Asia, the sixth annual Gender Balance Index, which tracks the presence of men and women in senior positions at central banks, sovereign funds and public pension funds.

»14 November, London

Brazilian economic outlook

The global economic outlook is uncertain and central bankers around the world are asking themselves how much space they have for monetary and fiscal policy. This was how Fernanda Nechio, deputy governor for international affairs at the Banco Central do Brasil, introduced her presentation on Brazil's economic outlook at an OMFIF roundtable.

»5 November, London

Negotiating a EU-UK trade deal

Simon Ridley, director general in the UK's Department for Exiting the European Union, discussed Britain's future economic partnership with the EU. He assessed the conditions for negotiating the terms of a trade deal, the potential move to World Trade Organisation rules, and the immediate and long-term impact on UK industry.

»19 November, London

The future of the euro area: Capital markets integration

With new leadership at the European Commission and a renewed focus on fiscal integration, dialogue on how regulation can move towards alignment is progressing. Olivier Guersent, director-general for financial stability, financial services and capital markets union at the European Commission, outlined the bloc's financing needs and regulation requirements to make these a reality.

»3 December, Paris

Meeting the capital needs for Europe's firms in the 21st century

As conversations in Europe move from firms accessing bank loans to capital market financing, the country with the deepest capital market access, the UK, is negotiating to leave the European Union. This discussion addressed how capital market liquidity can be deepened in Europe, the role the UK could continue to take, and how regulation and supervision can be better aligned.

»21 November, Frankfurt

Opportunities in sub-Saharan Africa

OMFIF, supported by the German state-owned development bank, KfW, and the Trade and Development Bank, convened a seminar to share expertise with European investors on opportunities and experiences of investing in sub-Saharan Africa.

»4 December, London

Supervisory technology for central banks

As financial technology continues to develop, central banks are reviewing their regulation requirements and supervision processes. Joachim Wuermeling, a member of the Deutsche Bundesbank executive board whose areas of responsibility include banking supervision, risk control, and information technology, elaborated on how central banks are engaging with increased digitalisation to ensure financial stability.

Agenda

»Wednesday 15 January, New York

Low interest rates and the new normal

A roundtable with Patrick Harker, president and chief executive officer of the Federal Reserve Bank of Philadelphia, to discuss the Fed's balance sheet and long-term policy normalisation as the Fed reverts to lowering interest rates and the US economy presents a mixed picture for policy-makers.

»Friday 24 January, London

Outlook for economic stability in Italy

A roundtable with Daniele Franco, deputy governor of the Banca d'Italia, on Italy's economic status against the backdrop of potential low growth and political uncertainty in the euro area in 2020. Franco will give his thoughts on the country's key challenges and where investment in the country can develop.

»Thursday 6 February, London

Sustainable investment in uncertain times

A seminar on public sector investment management with a group of economic experts and asset managers from a public sector background. Topics will include central bank monetary policy divergence, best practice on strategic asset allocation, and principles for sustainable and long-term investment.

»Monday 24 February, New York

The next decade of digital finance

A roundtable with Christian Catalini, Libra co-creator and head economist of Calibra, and Sunita Parasuraman, head of treasury and blockchain at Facebook. They will discuss the technological and policy implications for global finance of Libra, the global digital currency proposed by Facebook to be officially launched in 2020.

»Thursday 27 February, Frankfurt

Responding to uncertainty across Europe

A seminar with chief economists from central banks and public sector institutions to discuss the impact of global macroeconomic developments on Germany and Europe. Topics will include the future relationship between the EU and UK, and how Germany and Europe can navigate climate change and digitalisation.

»Thursday 5 March, London

Gender Balance Index 2020 launch

OMFIF, supported by Mazars and Barings, launches the seventh annual Gender Balance Index. Topics include organisational policies and practices for retaining female staff, gender bias in investment and decision-making, and how to promote gender balance at all stages of portfolio management.

»Tuesday 31 March, New York

Identifying key risks in US credit markets

A roundtable with Dominic Purviance, senior financial specialist in the Atlanta Federal Reserve's supervision, regulation and credit division, to discuss key trends in bank lending and the US housing market. He will also analyse vulnerabilities in the US housing market to help signal future challenges and financial risks.

For details visit omfif.org/meetings

Eurovision

Doubts endure over economic and monetary union

David Marsh
OMFIF

Disagreements over economic and monetary union between the two key member states, Germany and France, are nothing new. For decades, questioning over the compatibility of their objectives and methods has been a constant feature of EMU. A new querulousness surfaced in 2019 and hovers over perspectives for 2020. This is a dramatic reflection of a triple European challenge from the adversarial policies of US President Donald Trump, the rise of China, and Britain's departure from the European Union. →


Renus in. et fec

> ‘Two decades ago, member states hoped the euro would hand them back the key to their destiny, making them less dependent on foreigners and more resilient to external crises. The opposite is true.’

A feature of German thinking during the lacklustre premierships of French Presidents Nicolas Sarkozy (2007-12) and François Hollande (2012-17) was that Paris needed badly to show fulsome European leadership. The election of Emmanuel Macron two and a half years ago opened the prospect of a firmer Franco-German foothold. However, hopes quickly subsided when Chancellor Angela Merkel suffered significant setbacks in the September 2017 German parliamentary elections. This resulted in difficult and unconvincing coalition-building in Berlin and further doubt and indecision.

Macron laid out ambitious reform proposals in September 2017. The focus was a planned EMU overhaul with a long-sought fiscal union and euro area budget overseen by a euro finance minister. Macron proposed concrete steps to complete banking union, with a euro-area-wide bank deposit guarantee mechanism to buttress financial institutions in crisis times. He wished to transform the European Stability Mechanism, which offers financial assistance to euro members, into a European Monetary Fund, with greater powers and resources.

Repercussions of 2008

Macron was given full backing by other states, particularly the debt-burdened southern EMU members which have still not fully recovered from the repercussions of the 2008 financial crisis. However, hopes of significant advances have been stymied by one of the longest-lived legacies of the past decade of crisis-fighting – lack of trust between members of the 19-country single currency.

As Ignazio Visco, governor of the Banca d’Italia, put it at a joint seminar between OMFIF and the Italian central bank in Rome in November, ‘The tide of the global financial crisis and the sovereign debt crisis has long fallen, but its poisonous legacy and geopolitical tensions are fuelling distrust, fears and even prejudices once thought long buried.’ The consequence is further wrangling about the sequencing of the pivots of euro area renewal, ‘risk sharing’ and ‘risk reduction’.

Germany dismisses long-standing French arguments that the Germans have gained more from the single currency than any other European country. Rather, Berlin worries about a further build-up of German obligations towards other euro states to cover financial losses and other perturbations in case of more 2008-style turbulence. All this adds to the unpredictability of German politics. Merkel is in her final four-year term as chancellor. Post-Merkel perspectives are cloudy. The Alternative for Germany party, which formed in 2013 as an anti-EMU campaign group and entered the Bundestag for the first time in 2017, is ensconced as the formal opposition in Berlin to the chancellor’s strained coalition.

Two decades ago, member states hoped the euro would hand them back the key to their destiny, making them less dependent on foreigners and more resilient to external crises. The opposite is true. Outside pressure exerts undue influence. Low growth produces resentment, vulnerability and fatigue. And shorter-term palliatives, such as more European Central Bank bond-buying through the now-enacted resumption of quantitative easing, run into political flak that counters positive effects.

Olaf Scholz, the German finance minister, has put forward proposals for breaking the impasse on European banking union with a route to common European deposit insurance. However, officials elsewhere criticise the plan as incomplete, and hedged in with disruptive caveats about introducing capital weightings for banks’ holdings of weaker countries’ sovereign bonds.

Solidarity v. competitiveness

Germany has come to terms in a seemingly more equanimous way than France with the UK quitting the EU. Berlin faces an extra bill of €10bn per year as the result of withdrawal of British funding. Profiting from a large export surplus with Britain, Germany wishes to press forward as quickly as possible with negotiating a comprehensive UK-EU trade deal. It supports the idea of sign-off before the end of 2020, in line with the stretching UK target. Merkel will probably give broad support to British Prime Minister Boris Johnson’s post-Brexit timetable. Macron, for his part, is likely to prove more hostile on both the timing and the detail of UK deregulation.

Merkel has chided Macron’s ‘drastic words’ over the resilience of the North Atlantic Treaty Organisation. Despite some softening of the German tone now favouring a more balanced euro area mix of budgetary and monetary policies, deep-seated differences remain between French desire for ‘solidarity’ and the German wish for ‘competitiveness’. The best way for France to gain support for its ideas in Europe might be to establish leadership of a sub-bloc encompassing the other two big euro economies, Italy and Spain. However, forming an overt grouping with the ‘Club Med’ faction would fatally weaken France’s ability to operate on an equal footing with Germany. The dilemma is merciless. Ambiguity about France’s role in EMU will not go away. ●

David Marsh is Chairman of OMFIF.

How to fix the euro and why we should

Policy-makers must address single currency's design flaws

Daniel Dăianu
Romanian Fiscal Council

In November, György Matolcsy, governor of Magyar Nemzeti Bank, wrote an article in the Financial Times which is likely to have surprised European Union policy-makers. Titled, 'We need to admit the euro was a mistake', it was a diatribe against the single currency, which, according to Matolcsy, was a French ploy to limit German influence on the EU. It sounds like Hastings Ismay's famous saying that the North Atlantic Treaty Organisation is needed 'to keep the Russians out, the Americans in, and the Germans down.'

Several of Matolcsy's grievances have cropped up in public debate over the years. Many economists, including Otmar Issing, the European Central Bank's first chief economist, decried the introduction of the euro without proper fiscal underpinnings. The 1977 'report of the study group on the role of public finance in European integration', published by the Commission of the European Communities, concluded that a significant common budget was needed to ensure viable economic and monetary union. Moreover, the clear economic divergence between the euro area's north and south cannot be ascribed to external phenomena only.

Risk-sharing instruments

A robust euro area requires risk-sharing instruments (including a fiscal capacity) on par with risk-reduction measures. A solid resolution fund, a European deposit insurance scheme and 'smart' fiscal rules (which do not amplify procyclicality when imbalances require correction), are necessary.

The euro area must adopt a collective macroeconomic policy stance, as well as a joint safe asset to help boost the euro's global competitiveness. Matolcsy suggests that political hindrances have stalled progress. Ironically, Germany – arguably the biggest economic winner of the creation of the single currency – seems to underplay this reality. The euro has operated as an undervalued Deutsche Mark, which explains Germany's formidable current account surpluses, year after year. The Netherlands is in the same category.

But it is one thing to notice major flaws in the euro area's design and functioning, and quite another to say the euro's introduction was a strategic error.

Intended as a political construct to help the EU compete globally and maintain peace throughout the continent, the euro's creation was inevitable. Whether its introduction was premature is irrelevant. The focus should be on its design flaws. Some were dismissed by politicians, and others poorly understood by economists.

Deep economic integration

When the euro was introduced in 1999, China was not the seemingly unstoppable juggernaut it is today. Nor was the US a bitter economic rival of the EU. Today, European value chains in the EU reflect deep economic integration and risk denting the potency of independent monetary policies as adjustment tools. That is not to say, though, that independent monetary policies are devoid of utility for larger new member states (such as the Czech Republic, Hungary, Poland and Romania) against currency board regimes. New threats demand a collective EU response and a cohesive union.

Partial or complete dissolution of the euro area would not make the EU stronger. Rather, it would probably be fatal for the European project. That would be widely detrimental, including to the transatlantic relationship and Nato.

The euro area needs profound reforms to become robust, thereby bolstering the single currency and the EU as a whole. German Finance Minister Olaf Scholz's proposals for a common European deposit insurance, though not ambitious enough, are a step in the right direction. Hopefully, key ideas laid out in the European Commission's 2017 reflection reports on the future of Europe will turn into reality. Policy-makers should not wait for another deep recession to act boldly and do 'whatever it takes to save the euro', to quote former ECB President Mario Draghi.

Accession candidate countries would more than welcome reforms to strengthen the euro area. The Romanian economy, meanwhile, must achieve real convergence and control its imbalances on a sustainable basis to join the exchange rate mechanism and euro area under auspicious terms. ●

Daniel Dăianu is President of the Romanian Fiscal Council and a former Board Member of the National Bank of Romania.

Spending QE savings on growth

Southern divergence needs attention

John (Iannis) Mourmouras
Bank of Greece

Amid still muted inflationary pressures and concerns that the euro area is in a protracted period of weak economic growth, the European Central Bank cut its deposit rate by 10 basis points to minus 0.5% and imposed a tiering system to mitigate the effect of customer deposits floored at 0%. It removed all indications of a timeframe for its forward guidance on interest rates, and linked the continuation of its negative rate policy to inflation and a sustainable return to its 2% inflation target.

From 1 November 2019 the ECB resumed net asset purchases at a monthly pace of €20bn, leaving its asset purchase programme open-ended, and changed the modalities of the targeted longer-term refinancing operations. Their maturity was extended to three years from two, and the rate that banks will have to pay for this liquidity was lowered by 10 basis points.

In the first round of its full-scale quantitative easing programme (March 2015-December 2018), the ECB accumulated €2.6tn in bonds. The asset classes bought during the programme were sovereigns, supranationals, covered bonds, corporate bonds and asset-backed securities. Sovereign and supranational purchases were grouped under the public sector purchase programme. On average, 83% of the purchases came via the PSPP (74% sovereigns and 9% supranationals), while covered bonds, corporate bonds and asset-backed securities accounted for 9%, 7% and 1%, respectively.

The state of the euro area economy today can be characterised by three persistent lows: low growth, low inflation, and low rates. This has led some pundits to suggest the euro area is dipping into 'Japanification territory', referring to the period in the early 1990s when Japan entered recession after its 'bubble economy' burst. Japan's nominal GDP has been stagnant for almost 25 years, and real GDP essentially flat since the mid-90s at around 0.8%.

Over the past few years, there has been a growing debate on monetary policy being 'the only game in town', as well as on decreasing returns for the ECB's new stimulus package in terms of confronting another potential fall in inflation. Taken together with the Japanification warning signs, these factors have led some analysts to suggest the time has come to open the fiscal box.

Falling cost of borrowing

A significant volume of savings for euro area governments has come from a fall in interest expenditure in servicing their debts and financing primary deficits due to the historically low and/or negative yield in the post-QE environment. The PSPP, it seems, has given rise to a sizeable fiscal bonus for euro area governments.

Between 2009-14, the average cost of borrowing for euro area countries was 3.43%. However, during and after the QE period (2015-19), sovereign debt yields were drastically reduced. This pushed down respective costs of borrowing in the euro area to 2.32%, according to the annual macroeconomic database of the European Commission's Directorate General for Economic and Financial Affairs, resulting in several dozens of billions of euros in savings for regional governments.

One proposal is for these savings and the ones that will come from the new round of QE to be used to finance smart public investment projects, including research and development of innovative technologies such as artificial intelligence, cloud computing and bioinformatics. Given the source of these savings, fiscal decisions should be made at a centralised level in Brussels, through the existing institutional framework, and spending decisions at a decentralised, national level. This may be a useful consideration, especially for past savings and with regard to compliance with the common budgetary rules – including the so-called golden rule of public finance that certain items of investment expenditure be excluded from the calculation of the primary deficit or surplus – applied in the past in Germany and the UK.

A widening gap (in growth rates, productivity, GDP per capita) between Europe's core and its periphery perhaps justifies a sense of necessity for this sort of spending to take place in the South. This would foster higher growth rates in the region, create new jobs and improve public debt dynamics.

Since the euro's introduction, cumulative growth in northern European countries is 30% on average (for example, 36% in Finland, 34% for the Netherlands, and 30% in Germany). In southern countries, the corresponding figure is just 11% (17% for Portugal, 10% for Italy, and 9% in Greece). Clearly, something must be done to remedy this disparity and promote growth across the union. •

Prof. John (Iannis) Mourmouras is Senior Deputy Governor of the Bank of Greece and former Deputy Finance Minister. This article is written in memory of my dear wife, Vasiliki Karavakou, distinguished Professor of Philosophy at the University of Macedonia, Thessaloniki, Greece, who passed away in October 2019.

UK remains key to capital markets union

Europe can still benefit from London's unique skills after Brexit

Ellie Groves
OMFIF

The European project was established to ensure peace, foster cross-border co-operation and institute economic union. At its core, it set out to engender trust between member states.

This trust is waning, if it was ever there. Technological advances and trade across borders mean we have never been better connected, and yet nationalism is on the rise. Populist political parties are ascending across Europe. In 2016, just a few months after Britain voted to leave the European Union, Prime Minister Theresa May said in a speech at the Conservative party conference, 'If you believe you are a citizen of the world, you are a citizen of nowhere.'

The European Commission, now under the leadership of Ursula von der Leyen, has laid out its priorities – tackling climate change, responding to technological innovation, and encouraging greater convergence through the banking and capital markets unions. Effecting meaningful change in these areas requires close collaboration between member states, in direct opposition to political developments seen at the national level.

Developing CMU can help maintain cross-border capital flows and sustain investment across member states. It could also be directed towards offering the green investment initiatives desperately needed to combat climate change. It could help promote technological innovation and spur steps towards securing banking union, which in turn could mitigate country-specific shocks and offer another buffer against recession. While the need is accepted, the obstacles to achieving CMU are political, structural and cultural.

Third-party Britain

Historically, the UK was the EU member most fervent about developing CMU. Jonathan Hill, the British Conservative politician and former European commissioner for financial stability, financial services and capital markets union, pressed this agenda. Brexit means he no longer has a seat at Brussels' table.

But Brexit's implications are more far reaching than one voice lost. Compared with European financial centres, in the UK a larger rate of finance is raised through capital markets than through bank loans. Since the 17th century this strategy has seen London establish itself as a global financial hub. Losing EU-member access to the market with the deepest and most liquid capital markets will have implications for CMU. There is a desire to involve London, but, in the light of declining levels of trust, the political quandaries this raises might be thrown into sharp relief.

At a recent OMFIF meeting a French regulator said the UK and EU can benefit from each other in CMU's development. However, this same regulator raised concerns about the risks to the EU of relying on a non-member state.

> 'There is a desire to involve London, but, in the light of declining levels of trust, the political quandaries this raises might be thrown into sharp relief.'

The logical conclusion is that the EU will establish CMU alone and treat the UK as a third party. In theory, the UK can operate in CMU and benefit from the access this offers, and the EU can benefit from the capital held in the UK. But that would require regulatory equivalence on the part of the UK. This model of CMU stands in direct opposition to political reality. Prime Minister Boris Johnson's Brexit may not necessarily be a 'hard' one, but it will be difficult not to offer divergence at all.

Moreover, as London is Europe's largest capital market, UK regulators have been influential in crafting the EU rulebook. Post-Brexit policy-making could then be a challenge for the EU, both in terms of available expertise and access to the private sector to ensure regulation is sensible enough to support innovation and stringent enough to safeguard stability.

The finance industry has not left London, and seems not to have any plans to do so – for all its advantages, Europe still focuses on bank financing, and a culture of capital investment has not yet taken hold. This could pose a major issue for the market depth and effectiveness of CMU. To achieve the best possible ends for all parties concerned, UK-Europe co-operation must be at the heart of future CMU discussions. ●

Ellie Groves is Programmes Manager, Europe at OMFIF.

Two cheers for eastern progress

Former Soviet states must revive their reformist zeal

Beata Javorcik
European Bank for Reconstruction and Development

Thirty years ago, amid the collapse of the Soviet Union, the people of central and eastern Europe left behind their black-and-white lives of oppressive political control and economic stagnation and stepped into a technicolour world. They aspired to democracy and higher incomes brought about by rapid economic transformation. These aspirations have, to a large extent, been realised. Young people in the region feel they are no different from their peers in the West.

But economic slowdowns, growing social inequality, the rise of populist politics and erosion of the rule of law have prompted pessimism among observers. Some conclude that CEE has strayed from its reformist ways, and a few even suggest the initial model of liberalising reforms is at fault. In these conditions, one might forget that the first two decades of political and economic transition were highly successful.

Early reformers like Poland, the Czech Republic and Hungary capitalised on their initial advantages, including good levels of secondary education, low-cost labour and timely adoption of western technologies. They attracted foreign direct investment and achieved high levels of growth and convergence towards western income levels. Per the World Bank's definition, they have reached high-income status. However, not everyone benefited equally from the initial period of reforms, which is likely to have contributed to the malaise fuelling populism.

The early phase of income divergence was inevitable in the light of the decompression of wages that came after the artificially tight pay structures of the Soviet era. This was propelled by technological change, which boosted demand for highly-qualified specialists at the expense of middle-skilled industrial workers who often moved to low-skilled jobs or dropped out of the labour market altogether. This phenomenon was exacerbated by globalisation and competition from China. Falling population growth and emigration of young people have likewise fed pessimism and shifted the political debate towards social spending rather than investment in long-term growth.

High-quality institutions

In the early period, the direction and speed of reforms was aligned with CEE countries' efforts to join the European Union. The reformist zeal abated after accession, and some changes have even been reversed.

In G7 countries, 56% of citizens say they are confident in their national governments, judicial systems, honesty of elections and media freedoms, and believe that corruption is not widespread throughout government or business, according to a Gallup poll. Only 35% of CEE citizens report the same, and this figure has fallen slightly over the decade.

The sources of early catch-up growth are no longer sufficient to sustain rapid economic development in the region. The process of income convergence to advanced economies is at risk of slowing or stopping altogether. The next growth stage must be based on further productivity improvements coming from innovation and entrepreneurship, as well as the development of technology-based products and services. This more sophisticated model, typical of high-income countries, relies on high-quality economic and political institutions.

This is why improving governance, strengthening the rule of law and bolstering democratic institutions must be a key feature of the next wave of reforms. South Korea, a widely cited example of a successful transition to high-income status, is a case in point. While its early phase of rapid growth and poverty reduction was possible even in the context of authoritarian politics, the leap to high-income status only occurred after the country embraced full-throated democratic politics, reformed corporate governance and strengthened the rule of law.

The benefits of improving governance extend beyond higher incomes. As shown in the European Bank for Reconstruction and Development's latest Transition Report, better governance can deter emigration. This can create a virtuous circle: a larger share of young and highly-educated citizens in the population may enable innovation-led growth and shift the focus of policies towards long-term investment.

CEE countries face a clear choice: they can acclimate to lower growth and limited economic prospects, or they can introduce bold new reforms, similar in scope to those introduced 30 years ago as the Berlin wall crumbled. The latter will ensure that the region lives up to its potential and is ready for the dynamic world of tomorrow, the digital revolution, green growth agenda, changing patterns of global trade and investment, and the many challenges posed by growing inequality and demographic decline. The pace of change is accelerating, and political leaders must give full support to responsive, inclusive and agile institutions and policies. The time to act is now. ●

Beata Javorcik is Chief Economist of the European Bank for Reconstruction and Development.

East Europe in the green finance vanguard

Regulators must incentivise reallocation of capital to sustainable assets

Gábor Gyura
Magyar Nemzeti Bank

The green finance market is winning headlines each month and setting new records worldwide. The Network for Greening the Financial System, which brings together central bankers and other regulators, is shaping the global green finance agenda and offering recommendations for both the official sector and market participants. But some white space remains on the global green finance map. Central and eastern Europe seems to be one such gap.

There have been a handful of important successes in this region, such as the issuance in Poland of green sovereign and green mortgage covered bonds. But former 'eastern bloc' countries still have a long way to go in making sustainable finance a significant segment of their financial markets.

Among European countries, Hungary is one of the most vulnerable to the physical impacts of climate change. It needs annual investments of around 2% of GDP in fields such as renewable energy, transport and industrial energy efficiency. In the light of tight public budgetary limits and questions about the future of European Union budgets, mobilising private funds through the financial markets is more important than ever.

William Nordhaus, winner of the 2018 Nobel prize, has called climate change the ultimate challenge for economics. Magyar Nemzeti Bank, Hungary's central bank, intends to treat it as a market failure – entailing macrofinancial and microprudential risks – requiring a comprehensive regulatory strategy.

Finding the golden mean

In early 2019 the MNB joined the NGFS and launched its three-pillar green programme. A thorough understanding of the interlinkages of environmental and financial risks is foundational to the central bank's measures to combat the challenges stemming from climate change. Models provide information on the probable acute and chronic impacts of climate-related events on Hungary, but the potential consequences of much-needed decarbonisation of the economy are considerably more difficult to gauge. Well-designed climate stress testing will be invaluable for measuring resilience.

The MNB believes that financial markets must consider climate and environmental factors in their business strategies much more closely. Funds lent or invested should serve environmental sustainability to a greater extent than they do presently. But such a reallocation of capital will only occur when the proper incentives are in place. Some of that will come as awareness increases and market players grasp the long-term risks. However, it is crucial that central banks and regulators become more proactive and create a supportive environment for green finance. To help achieve this goal, the MNB is developing several structural and targeted prudential measures.

One critical structural condition is education. Regulators must broaden existing financial literacy programmes to cultivate an informed and risk-conscious demand side that understands how savings or borrowings can aid environmental sustainability, as well as the special risks associated with these products. Capacity building for professional staff of financial firms is similarly important. For these reasons the MNB partners with universities and training providers to conduct and publish research and to provide courses on green finance for professionals and would-be professionals.

For central banks, the most powerful potential measure is financial market regulation, especially capital requirements. By adjusting the risk weights of certain loans, regulators can influence capital allocation. The debate around whether it is reasonable to use this tool to incentivise green assets or disincentivise 'brown' lending through risk weights is ongoing. Some argue there should be no tinkering at all with capital regulation. While not a black-and-white dilemma, the MNB is pursuing a course of action that promises to offer the golden mean.

The MNB has recently launched a temporary programme providing capital relief for energy efficient mortgages and personal loans. This is based on the hypothesis that, owing to lower utility bills and other factors, borrowers are less likely to default on loans financing green buildings than on those for 'brown' projects. By collecting data and conducting further research through this programme, the MNB is building on and contributing to the work of the European Energy Efficient Mortgages Initiative, an example of the merits of cross-border green finance collaboration.

In November 2019 the MNB organised, alongside the NGFS and European Bank for Reconstruction and Development, a regional seminar for central banks and supervisors from central-eastern and southeastern Europe on the roles they can play in green finance. While regulators are pursuing separate climate change and environmental sustainability policies nationally, the consultation reflected the growing importance of these topics for the region as a whole. Perhaps eastern Europe is in the green finance vanguard, after all. ●

Gábor Gyura is Head of Sustainable Finance at Magyar Nemzeti Bank.

Export dynamism key to Europe's future

Portugal's post-crisis recovery offers lessons for regional partners

Pedro Duarte Neves
Banco de Portugal

For most of the world, the last 10 years have been associated with smaller gains from international trade than previous decades. Indeed, global trade intensity today is near or below levels recorded in 2007-08. There has been a persistent reduction in the elasticity of GDP with respect to trade, and protectionism is on the rise. But optimism has not vanished, with global tourism and digitalisation having brought forward new economic possibilities.

In this context, the evolution of Portugal's export sector is one of recent history's notable success stories. Its achievements since 2010 have been characterised by three economic indicators.

First, total nominal exports have grown by 64%. This figure is even more impressive bearing in mind the prevailing environment of price stability. Exports of goods and services have increased by 53% and 88% respectively, propelled by the remarkable growth, at 130%, of tourism revenue.

Second, market share gains in external markets accounted for around half of the increase in Portuguese real exports.

Third, the weight of the external sector – measured by the ratio of exports to GDP – reached 44% in 2018. This was a marked increase from the average figure, 28%, recorded between 1995-2007.

Advances in the export sector precipitated the gradual reorientation of resources to tradable sectors from non-tradable ones. This resulted in gains in aggregate productivity in manufacturing and, in particular, tradable services. Improved exports facilitated a small surplus in the current account balance – following a persistent deficit of around 8%-10% of GDP over the previous decade – reflecting the Portuguese economy's external financial capacity.

Future of European exports

Despite adverse domestic market conditions, Portuguese firms were able to reorientate their sales to external markets, reflecting their capacity for adaptation.

This also demonstrates, at least in Portugal's case, the negative relationship between exports and domestic demand. Evidence shows that the degree of this effect varies at an individual firm level, with the size of the business, the sectors they are active in and the ratio of sales between domestic and external markets being determining factors.

Other observations help to assess the persistence of those gains. In sectors like textiles, clothing, footwear, machinery and equipment, the country has recorded gains in terms of trade that correlate with improvements in quality, innovation and differentiation.

It is also worth mentioning that many Portuguese non-tourism service traders are active in both export and import flows, capitalising on new technologies that make it easier to provide services to distant markets. Moreover, the travel and tourism surplus – around 6% of GDP – has more than doubled since 2010, contributing mightily to Portugal's economic recovery.

Nonetheless, the evolution of Portuguese exports faces challenges that many European Union economies will share. There are at least four crucial factors that will impact the development and relative success of Europe's export sectors.

The first is the declining weight of the EU economy in the world economy. Purchasing power is increasing much faster in Asia, meaning European exporters will have to adapt to more distant markets with distinct characteristics.

> 'Purchasing power is increasing much faster in Asia, meaning European exporters will have to adapt to more distant markets with differing preferences and distinct characteristics.'

Second, the global trend towards digitalisation is forcing firms to adapt to new client preferences and, therefore, to be more innovative and agile in meeting demand.

Third, further automation of production processes will bring advantages to first-mover firms that reduce costs and achieve efficiency gains.

The final factor is firms' capacity to adapt to constraints resulting from any transition associated with measures to combat climate change, with asymmetric effects on the productive structure of the economy. The future of Portuguese and European growth will depend enormously on firms' determination and ability to address these challenges. ●

Pedro Duarte Neves is Former Vice-Governor of Banco de Portugal (2006-17). The opinions expressed in this article are those of the author and do not necessarily coincide with those of Banco de Portugal.

Brexit is only just beginning

Talks on the future of UK-EU relations will dominate 2020

Denis MacShane
OMFIF

In December 2019, UK Prime Minister Boris Johnson won an unchallengeable general election victory by promising to 'Get Brexit Done'. From 1 February, Britain will no longer be a signatory member of the various treaties that constitute the European Union.

Over centuries Britain has wanted to have open trade with where it makes most of its money –continental Europe. But when, in 2017, Europe's chief Brexit negotiator Michel Barnier presented to former Prime Minister Theresa May a deal offering free trade, no tariffs and no quotas, she said no. She hoped her hard-line positioning would help her secure a stronger majority in the House of Commons in the 2017 general election. Instead, May had to enter a confidence-and-supply agreement with Northern Ireland's Democratic Unionist Party to support her otherwise minority Conservative government. Her life in the Commons became intolerable.

> 'There is chatter about a 'bare-bones' EU-UK free trade agreement. But even the Canada-EU FTA, a simple one in relative terms, took seven years to negotiate and ratify.'

Johnson has overcome those hurdles. He has accepted that Northern Ireland will be detached from the rest of UK in terms of customs controls. By dint of sharing a land border with the Republic of Ireland, Northern Ireland will in all likelihood remain part of the EU's customs union. And by securing so strong a majority in December, the prime minister has made mathematically irrelevant his rival Labour and the Liberal Democratic parties.

In Scotland, Nicola Sturgeon, head of the ruling Scottish National Party, wants another independence referendum in the second half of 2020. Either possible result would suit Johnson. A 'no' would silence the debate on independence, while a 'yes' would leave what remains of the UK (England, Wales and Northern Ireland) a Conservative realm.

No one to hide behind

The prime minister must still decide how big a Brexit he wants. Can Johnson settle for the political divorce that comes from leaving the EU treaties on 31 January? Or does he want a full amputation, taking a chainsaw to the interlocking laws and rules that allow Britain and the rest of Europe to trade openly, have joint university research programmes, and allow 1.5m Britons to work or retire anywhere in Europe with full access to healthcare and social services?

In 2019, financial services in the UK paid £75.5bn in tax. Although accounting for just 3% of the UK workforce, that sector's personnel paid 11.6% of all UK employment taxes. Much of the City of London's profitability could be attributed to its unmitigated access to Europe's single market.

There is chatter about a 'bare-bones' EU-UK free trade agreement. But even the Canada-EU FTA, a simple one in relative terms, took seven years to negotiate and ratify. It is naïve in the extreme to assume that Johnson, even at his most charming, will win over wholeheartedly EU negotiators representing the differing interests of 27 sovereign member states.

The EU grants 350,000 licences or 'passports' to London-based financial service firms. Brussels is content to treat the City as 'the Wall Street of Europe' clearing trillions in foreign currencies – but on one condition. Wall Street must obey US laws. The City will find it cannot write its own UK-only laws and regulations and still expect to conduct business as today in the rest of the EU. If the UK repudiates Europe's rules because, for instance, Johnson wants to subject EU citizens to a points-based immigration system absent between EU member states, there will be a reaction.

Stakeholders in British business, the City and wider economy have a meaningful part to play in the coming months (or perhaps years) of negotiation. Since 2015, British economic actors have looked on bemused at the spectacle of Labour under left-wing leader Jeremy Corbyn and the spectre of a socialist government.

That threat has been removed. Johnson has no one to hide behind. One can wish the prime minister and his team well as they begin talks with the EU anew. Brexit is only just beginning. •

Denis MacShane is the UK's former Minister of Europe and a member of the OMFIF advisory council. His latest book, *Brexiternity: The Uncertain Fate of Britain*, is published by IB Tauris-Bloomsbury.

2020 departure from pattern of stability

Highest money growth rates for more than a decade

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

Propelled partly by the monetisation of the US government deficit, broad money growth in the US (as measured by M3) has soared since spring 2019. In the last three months to November 2019, M3 rose at an annualised rate of 12.5%. In the year to November it was up by 8.5%.

These rates of money growth are by far the highest for more than a decade. They signal a clear departure from the pattern of macroeconomic stability (annual money growth between 3%-5%) that prevailed for eight years until spring 2019. If they persist in coming quarters, they are likely to be associated with higher inflation than has been typical over the last decade.

But the Federal Reserve is indifferent to the surge in broad money growth. It does not publish an estimate of broad money in the US, nor does it track money in its monetary policy decision-making process. Research from the Institute of International Monetary Research show that the growth of nominal GDP is related to that of the quantity of money. Large changes in the growth of broadly-defined quantity of money, through the balance-sheet strength of the corporate sector, have a direct impact on economic activity, and hence on investment, inventory building and employment decisions.

> 'The Fed does not publish an estimate of broad money in the US, nor does it track money in its monetary policy decision-making process.'

Changes in the amount of money also matter indirectly to aggregate demand via changes in asset prices, particularly the prices of such variable-income assets as stocks and real estate. The argument is especially relevant now, with the US stock market up 25% in 2019 and its housing market showing signs of above-normal activity.

Money growth trends in major countries are uncertain in 2020, but key data signal a satisfactory first few months of the year. Fears of recession are misplaced. Demand and output ought to grow at least trend rates, while inflation will remain subdued in the short term. ●

Juan Castañeda is Director and Tim Congdon is Chairman of the Institute of International Monetary Research. Further details on the IIMR's latest money update can be found at https://mv-pt.org/monthly-monetary-update/.

Worldview

This season's expert analysis

Dissenters gone and positions vacant

Conformists rotating into voting positions on Federal Open Market Committee

Darrell Delamaide
OMFIF

All of last year's dissenters have rotated out of voting positions on the Federal Open Market Committee, but that is not the reason Federal Reserve monetary policy will enjoy smoother sailing in 2020.

Typically, only the Fed's regional bank heads dare to dissent – members of the Washington-based board of governors almost always follow the chair's lead. In 2019, St. Louis Fed chief James Bullard dissented at the June FOMC meeting because he wanted to lower rates while everyone else wanted to stand pat. In the next three meetings, it was Boston's Eric Rosengren and Esther George of Kansas City who fought a rearguard action against successive quarter-point cuts.

All three are relegated to non-voting positions in 2020. However, since the Fed has paused monetary policy actions, there may be little reason for any FOMC voter to dissent.

Loretta Mester, head of the Cleveland Fed and an avowed hawk, will rotate into a voting position, but she is unlikely to defy the consensus. The dovish Neel Kashkari of Minneapolis will be in the vanguard of those wishing further cuts, but only if unemployment rates take a decided turn for the worse.

Others coming into voting positions, Philadelphia's Patrick Harker and Robert Kaplan of Dallas, have been go-along types since taking office four years ago. New York Fed chief John Williams, a permanent voting member because of New York's role in executing monetary policy, is sure to follow protocol and stick with the chair.

If there is a wild card, it is more likely to be on the board of governors itself. The four current members along with Chairman Jerome Powell have proven themselves loyal troupers. But there are two empty slots, and nobody seems in any hurry to fill them.

Undermanned board

In July 2019, President Donald Trump said he intended to nominate Judy Shelton, his occasional economic adviser, and Christopher Waller, a longtime official at the St. Louis Fed, to the board. Two earlier potential nominees, Herman Cain, the pizza magnate and former Republican presidential nomination contender, and Stephen Moore, a pundit, crashed spectacularly even before their names were sent to the Senate for approval.

In the six months since he named Shelton and Waller, Trump has not sent the Senate the formal nominations. After the earlier missteps, the president's advisers certainly want to vet both candidates carefully before making such sensitive nominations. But the White House, in the meantime, has submitted a whole parade of judicial and ambassadorial nominees, and even a couple of cabinet positions have been approved.

Shelton has been vetted before and approved by the Senate for the board of directors at the European Bank for Reconstruction and Development. Waller is the St. Louis Fed's chief of research, a popular stepping stone to a regional bank presidency or the board of governors. With a Republican majority in the Senate, there is little doubt they would be confirmed.

> 'Trump has been notoriously critical of the Fed, publicly expressed regret at making Powell chair, and isn't rushing to bring the board to its full complement.'

Trump has been notoriously critical of the Fed, publicly expressed regret at making Powell chair, and isn't rushing to bring the board to its full complement. The FOMC is designed such that, even if all five vote-holding regional bank presidents dissented, the board will always have a majority. A draw in the voting is improbable even with only five on the board, but it is possible.

Lael Brainard, the only board member besides Powell who was appointed by President Barack Obama and the only one affiliated with the Democrats, has given no indication of leaving. Her term ends in 2026. Powell has maintained he will at least serve his four-year term as chair, ending in February 2022.

Opinions about Fed monetary policy this year are divided according to views on the economy. Those who see the economy ticking along without any severe problems through November's US presidential election anticipate no changes in interest rates. Those who believe a recession is imminent think the Fed may act in the second half of 2020. Trading in Fed futures, a volatile indicator, lends some credibility to that view.

What seems reasonably certain is that the coming months will be considerably less turbulent for the Fed than the past two years – during which it raised the benchmark federal funds rate four times and then cut it thrice – proved to be. •

Darrell Delamaide is US Editor at OMFIF.

Newer pensions look to private markets

Defined contribution schemes seeking access to higher-returning assets

Brian McMahon
BNY Mellon

For decades the world's largest, most sophisticated institutional investors have allocated a portion of their wealth to private rather than publicly-listed companies. That model rests on the belief that the best of private equity portfolios will deliver higher returns over the long term than an index of stock market companies.

This does not decree an 'either/or' choice between owning public and private enterprises. The need for prudent diversification dictates that even the most ardent 'off-market' investor maintains exposure to a range of assets, including bonds.

For large institutions, such diversification is a given. For high-net-worth individuals (those with more than $1m in savings), it is possible. But for other individual investors, opportunities to add private enterprise to their portfolios have been few, chiefly because of unsupportive regulation, unsuitable investment vehicles and the high cost of access.

Nowhere is the contrast between the habits of large institutions and individuals starker than in Europe's retirement savings arena. In that field, the scale and risk-sharing nature of defined-benefit pension plans enable them to venture into harder-to-trade assets, while newer defined-contribution plans prefer unitised investments and avoid opportunities that cannot be priced daily.

DB occupational pension plans account for most – but only just – of the $40.1tn explicitly saved for retirement globally. Many DB plans are closed to new entrants and invest conservatively for their older population, while DC investments are increasing at a faster rate as they serve a growing percentage of the workforce.

As longevity increases and DB plans shrink in numbers, these newer pensions will have to work harder to maintain DC savers' standards of living in retirement. Pension fund fiduciaries have a duty to look after the financial interests of their members, and this must include consideration of how to offer access to higher-returning private markets.

One way of achieving the desired level of financial security is to access higher-returning assets in private markets, a direction that politicians and regulators recognise. Guy Opperman, the UK's pensions minister, has talked favourably about widening the opportunity set to include social housing and green infrastructure.

The UK Financial Conduct Authority has realised that a slim allocation to commercial property by unit-linked funds does not reflect the economic opportunity set. The regulator is going to permit UK insurers' unitised funds to hold up to 50% of assets in any combination of real assets, including infrastructure.

Education and collaboration

Whatever regulators decide, considerable obstacles remain.

Share prices for companies on the world's advanced stock exchanges are refreshed every 15 minutes, making daily valuations relatively simple. Unlisted companies, on the other hand, are valued infrequently, often only on a quarterly or annual basis. Moreover, these valuations are conducted simultaneously by computers, but according to the judgements of portfolio managers and independent experts, based on a series of assumptions about the companies and markets in which they trade. Buying or selling these assets usually takes longer. For the patient capitalist, this makes private equity not more but less risky, because it is free from the noise of the market and media speculation that affects listed companies.

For DC pension provision, however, the norm is to provide daily valuations. Policy-makers must resolve this conflict between regulatory protection of individual savers and appropriate conduits for their savings to reach a fuller spectrum of investment opportunities.

Traditionally, private markets firms have had years to invest because they have used closed-end vehicles. Their large clients, not just DB pension plans but family offices and sovereign funds, have been content to commit capital that typically takes years to be deployed in the purchase of businesses.

But closed-ended funds are prohibited from marketing to retail investors. They typically have minimum investment levels that are higher than most investors' total savings. For those structures that do allow retail investors to access the funds, problems of tradability and valuations come to the forefront.

Fortunately, private markets specialists and DC pension plans are willing to find common ground. A handful of private markets specialists have launched open-ended or 'evergreen' investment vehicles for the DC market. These have daily valuations and dealings, as retail and small collective investors would expect.

Private markets are no longer the preserve of the world's elite investors, and soon both large and small DC plans will gain access to a wider range of assets. •

Brian McMahon is Managing Director of Alternative Investment Services for Europe, the Middle East and Africa at BNY Mellon. The full report on which this article is based, 'Defined Contributions: Matching Investments and Liquidity', is available at bnymellon.com/emea/en/our-thinking/defined-contributions-matching-investments-and-liquidity.jsp

US-China rivalry to persist through 2020

Dollar strength unlikely to waver

Taimur Baig
DBS Bank

Last year was marked by trade tensions and political polarisation, against strong labour markets, low inflation and low interest rates. Among other contrasting themes, investment has weakened, but the real estate sector is showing signs of recovery. The manufacturing and agriculture sectors are floundering, but the retail sector is stable. Asset markets have rallied, there is ample liquidity, and despite a sharp rise in corporate leverage, spreads have narrowed. Similarly, record fiscal deficits have not prevented the bond market from performing well. One longstanding concern, the rapid expansion of the collateralised loan obligations market, has yet to cause systemic problems.

These factors are unlikely to fade substantially in 2020, though there are signs the US economy is losing momentum. Consumption will probably hold up, but if investment remains low and fiscal monetary policy support space is limited, US GDP growth will struggle to surpass 2%. As policy-makers and markets come to terms with this eventuality, it may fuel populism and impact asset prices.

It would be wise for the world's major central banks to keep liquidity taps on, with a focus on monetary operations and regulations that weighed on funding conditions in 2019. There is little doubt the US Federal Reserve, European Central Bank and Bank of Japan wish to maintain low short-term interest rates. How they manage to keep yield curves relatively flat (and how that impacts corporate spreads) remains to be seen. With nearly $2tn of refinancing in the pipeline this year needed by Asian corporates alone, the challenges are daunting.

Trade tensions to endure

Trade tensions are unlikely to abate this year. There were plenty of posturing and investigations throughout 2017, but the trade war began officially in February 2018 when the US imposed tariffs on imported washing machines and solar panels. Steel tariffs soon followed, and US protectionism on trade, technology transfer and cybersecurity became increasingly China-centric. Since then, both Washington and Beijing have announced further tariffs. A 'phase one' trade deal may be forthcoming, but trade tensions and overall rivalry with China are unlikely to dissipate in 2020, regardless of economic and election outcomes.

Between January-October 2019, China's exports to the US fell 12% year-on-year, as importers looked for alternative markets to avoid tariffs. At the same time, China's imports from the US were down 25%, driven primarily by a sharp reduction in purchases of agricultural goods. Consequently, the US-China trade deficit has corrected by only 4% year-on-year, while remaining considerably worse than in 2017. Meanwhile, China's total trade surplus with the world remains healthy, up 0.7% of GDP through the first three quarters of this year.

Assuming some trade-related progress but no major breakthroughs, businesses will be hard-pressed to ignore lingering political uncertainties and embrace new capital expenditure. Rates are low, but corporate leverage and asset valuations are high, which would act as a cyclical impediment to investment fatigue.

Cautious optimism

One area of cautious optimism is technology. Global demand for semiconductors and mobile phone electronics has been sluggish in the last two years, but that may be about to change. Electronics exporters' billings have picked up in recent months, which is typically a useful indicator of shipment. As inventories decline and 5G and new generation mobile phone spending picks up, early 2020 could deliver much needed good news to manufacturers in the US and elsewhere.

A weaker dollar may help offset the cost of higher tariffs and restore competitiveness, but its reserve status worldwide limits the room for depreciation. If US growth slows, this will trigger worries over a global economic slump. In that case, not even a Fed rate cut would bring down the dollar; risk-adverse investors are more likely to turn to the US currency in a flight to safety. This was evidenced in 2019, when dollar optimism was revived unexpectedly by the Fed's decision not to raise rates. The bottoming out of the tech cycle, a US-China trade deal and the recovery of emerging market growth could weaken the dollar. The best way to mitigate dollar strength would be for the US to engage constructively with the rest of the world. ●

Taimur Baig is Managing Director and Chief Economist at DBS Bank.

Sovereign funds insulate GCC states

Kuwait, Abu Dhabi and Qatar prepared to withstand downturn in oil prices

Krisjanis Krustins
Fitch Ratings

A further weakening of oil prices and continued pressure on production volumes in 2020 will lead to wider fiscal deficits for most energy exporting members of the Gulf Co-operation Council. However, the large sovereign funds of Kuwait, Abu Dhabi and Qatar will enable them to endure even a prolonged downturn in oil prices, along with moderate fiscal deficits and low fiscal break-even prices.

The sovereign funds of Kuwait, Abu Dhabi and Qatar bolster these territories' sovereign ratings by two to five notches. They predominantly invest fiscal reserves in external assets but offer limited public disclosures. According to Fitch estimates, the foreign assets under management of the Kuwait, Abu Dhabi and Qatar investment authorities in 2019 are around $560bn, $500bn and $230bn respectively.

These sovereign funds are among the largest in the world in absolute terms and relative to the size of their economies, ranging from around 120% of GDP in Qatar to more than 400% in Kuwait.

The ratio of assets to GDP varies significantly with oil prices, but more stable indicators point to the strong buffer that sovereign funds provide. This is particularly relevant when accounting for GCC states' political economy, which demands extensive public employment, direct transfers to citizens and state-supported non-oil activity. The Kuwait Investment Authority's foreign assets are eight times greater than Kuwait's total government spending, non-oil GDP or the government non-oil primary deficit. The foreign assets of its equivalents in Qatar and Abu Dhabi are two to three times greater than their territories' non-oil GDP, four to six times greater than government spending, and 12 times greater than government non-oil primary deficits.

GCC sovereign fund assets are generally not disclosed. Fitch estimates their value by compounding estimated historical net inflows using assumptions about returns and asset allocations. Supporting data for such estimates is available to varying degrees, with Kuwait and Abu Dhabi offering significantly more transparency than Qatar.

Sovereign fund assets in Kuwait, Abu Dhabi and Qatar would remain substantial even if faced with significant further declines in oil prices, continued pressure on hydrocarbon production volumes and weak financial returns. Favourable asset market returns could allow sovereign fund assets to be maintained even amid persistent fiscal deficits. Although financial market returns are uncertain and could lead to sudden valuation losses, one could expect them to offset a drawdown rate of 1%-3% of assets, which Fitch forecasts for Abu Dhabi and Kuwait.

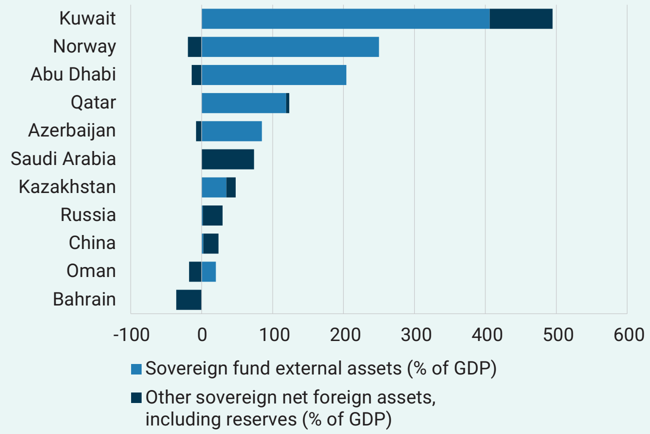
Kuwait, Abu Dhabi and Qatar have chosen to issue debt despite their large sovereign funds. This reflects their desire to preserve wealth for future generations and expectation that returns on assets will exceed the cost of debt.

Fitch expects around $35bn of gross foreign issuance from these countries in 2020-21, against a GCC total of $85bn. This would be accompanied by drawdown of wealth funds, deposits and other sovereign assets of around $55bn (half of the GCC total, with the rest mostly relating to Saudi Arabia). ●

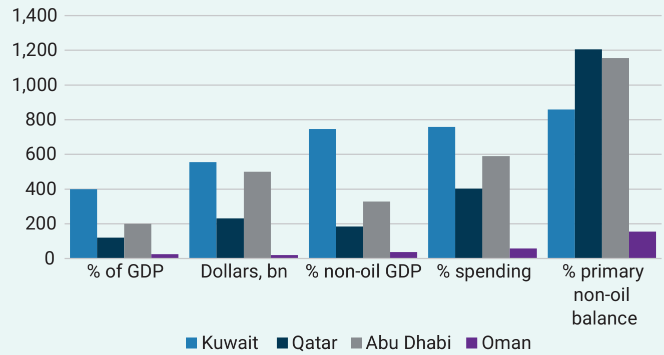
Krisjanis Krustins is Director, Middle East and Africa Sovereigns at Fitch Ratings.

Gulf wealth funds among world's largest

GCC countries v. selected peers, 2019



Estimated sovereign fund foreign assets in the GCC in 2019



Source: Fitch Ratings

Pension funds focus on climate change

Measuring environmental success is public investors' major hurdle

Colin Robertson
OMFIF

There is no shortage of advice on climate change being handed out to UK pension funds. Most conspicuously, 40 members of activist group Extinction Rebellion attended part of a recent pension committee meeting of a large pension fund that I advise. Most schemes are now having to document their environmental approach. From 2022, pension funds will be expected to report on climate change risk in line with recommendations from the Financial Stability Board's Task Force on Climate-related Financial Disclosure.

This desire to give guidance and enforce disclosure extends to The Pensions Regulator, which has established a working group to provide climate-related advice. Meanwhile, Bank of England Governor Mark Carney has highlighted the dangers of assets becoming 'stranded'.

This all means pension funds must be seen to be 'doing the right thing' on climate change. A State Street Global Advisors survey showed that reputational risk was a major motivating factor of environmental, social and governance-related investing for more than one-third of respondents and greater than this at public sector pension funds.

In contrast to targets for governments, pension funds have few measurable objectives relating to the environmental impact of their investment policies. This leads to pension funds adopting certain types of climate change policy in response to the greater disclosure required, notably excluding specific sectors from portfolios. Apart from being simpler, such strategies can win better publicity. It is more punchy to say 'We hold no coal or oil stocks' than to say 'Our weighted average carbon intensity is 58% of that of the index'.

It is easy enough to argue that companies that produce lots of carbon should be sold; but the shares sold will be bought by another investor who may not care about the carbon count. Alternatively, investors can engage with company managements, which may or may not be successful, and it may be difficult to isolate the impact of engagement from what would have happened in any event. Skill is needed to assess on a stock-by-stock basis what will work best in practice.

However, increasing amounts of analysis are available on the environmental characteristics of individual stocks, enabling more sophisticated assessments of investment approaches at the portfolio level. It is therefore possible to compare, for example, the effectiveness of 'low carbon' v. 'fossil fuel-free' approaches against various measures.

Technical issues must still be addressed. Though analysts are producing increasing volumes of research, more would be welcome. For passive equity funds, this includes whether it is better to exclude a proportion of the index representing the most environmentally unfriendly stocks in each sector (so maintaining exposure to all sectors) or the most environmentally unfriendly stocks in the index as a whole.

For actively managed funds, fund ratings on the range of environmental yardsticks will vary for reasons quite unrelated to any ESG policy. If a fund manager switches from 'growth' into 'value' stocks for valuation reasons, then an increase in the carbon exposure is probable as technology stocks are sold and energy or mining stocks are purchased. To avoid this ESG deterioration, guidelines for carbon exposure could be incorporated into fund managers' mandates.

Spectrum of capital

Pension funds can do good and not just avoid doing harm. The concept of a 'spectrum of capital', which maps out the various strategies that belong under the sustainable and impact investing rubric, is gaining traction. At one end sits traditional investment, and at the other sits philanthropy. The area of current focus lies in the middle – impact-driven investing. The idea is that pension funds can make a positive impact by contributing to the environmental solution, and not just avoiding negative impacts.

Investors take measuring both financial and environmental performance very seriously in impact investing, not least because of suspicions that environmental successes come at a financial cost, potentially breaching fiduciary duty. However, as illustrated by green bonds, which aim to fund sustainable projects, it can be difficult to prove the money raised is not being treated as general finance. Equity investment in renewable energy infrastructure is a more clear-cut case and is popular with UK pension funds.

Measuring the environmental success of pension funds' investments must improve in tandem with their greater guidance and disclosure requirements. Dramatic withdrawals from stock market sectors or certain types of company may be less effective than less publicised conversions of corporate managements to better environmental behaviour. Pension funds would benefit from more, better and well-publicised environmental yardsticks and research directly geared to stock selection and portfolio construction. •

Colin Robertson is Independent Adviser to two public sector pension funds and consults to institutional asset owners. He is a member of the OMFIF Advisers Network.

Mortgage lenders' role in EU climate goals

New initiative to boost buildings' energy efficiency

Luca Bertalot
European Mortgage Federation

As 2019 drew to a close, a new European Commission took office and presented its European 'green deal'. Christine Lagarde, the new president of the European Central Bank, has signalled clearly her intention to prioritise discussions on how the ECB, alongside other central banks and banking supervisors, can contribute to mitigating climate change. These moves will trigger market developments that will change irreversibly the economic landscape, not least because of the subsequent pressure on all market stakeholders to deliver the tools and best practices needed to transition to a greener Europe.

The EU will seek to set global benchmarks for the financial sector. In parallel, it will look to introduce legislation enabling lenders, investors and consumers to take significant steps in the right direction, without undue social and market disruption.

Through the Energy Efficient Mortgages Initiative, the mortgage industry is well-prepared for this colossal change and ready to play an active role in boosting the energy efficiency of the EU's building stock.

The mortgage industry is a crucial link between the financial world and the real economy. Helping citizens improve the quality of their home has a direct impact on their quality of life. This will engender a cascade effect on European society as a whole; more than 220m dwellings will have to be refurbished to comply with the 2015 Paris climate agreement.

Buildings are responsible for 40% of energy consumption and 36% of carbon dioxide emissions in the EU. By improving buildings' energy efficiency, the Union's energy consumption could be reduced by 5%-6% and carbon dioxide emissions by 5%. Energy efficient refurbishment is a top priority for Europe, as 75%-90% of its building stock is predicted to still exist in 2050. Delivering on the EU's 2030 climate and energy framework will require an estimated additional investment of €132bn per year in buildings alone.

Typically banks finance property purchases. They therefore have a significant role to play in achieving the EU's energy savings targets. Banks can raise energy efficiency considerations with borrowers at a crucial moment and incentivise them to acquire or build an energy efficient property, or improve its energy efficiency.

The EEMI is a pan-European effort to coordinate market interventions on the financing of energy efficiency in buildings. The initiative aims to deliver a virtuous circle between lenders, borrowers and investors, from the origination of a mortgage to the pooling of energy efficient collateral that would be the underlying deposit for green covered bonds.

The EEMI is the result of more than four years of extensive and wide-ranging engagement and consultation with banks, real estate advisory services providers, built environment professionals and consumers and borrowers. So far, 51 lending institutions have signed up to the energy efficient mortgages pilot scheme. They represent more than 55% of mortgages outstanding in the EU, equal to upwards of 25% of EU GDP at end-2018. These institutions are analysing the feasibility of implementing energy efficient mortgages in their jurisdictions. They are backed by 33 supporting organisations and an advisory council.

Making sustainable finance mainstream

The advisory council works to coordinate market action with public policies, with the goal of fostering consumer demand for green mortgages. It comprises 17 members, including the International Finance Corporation, World Bank and European Bank for Reconstruction and Development. Its role is to promote and facilitate dialogue between the financing and banking communities, property and construction sectors and policy-makers to address specific market failures identified during the implementation phase.

The strong engagement of the pilot lending institutions, supporting organisations and members of the EEMI advisory council marks a turning point

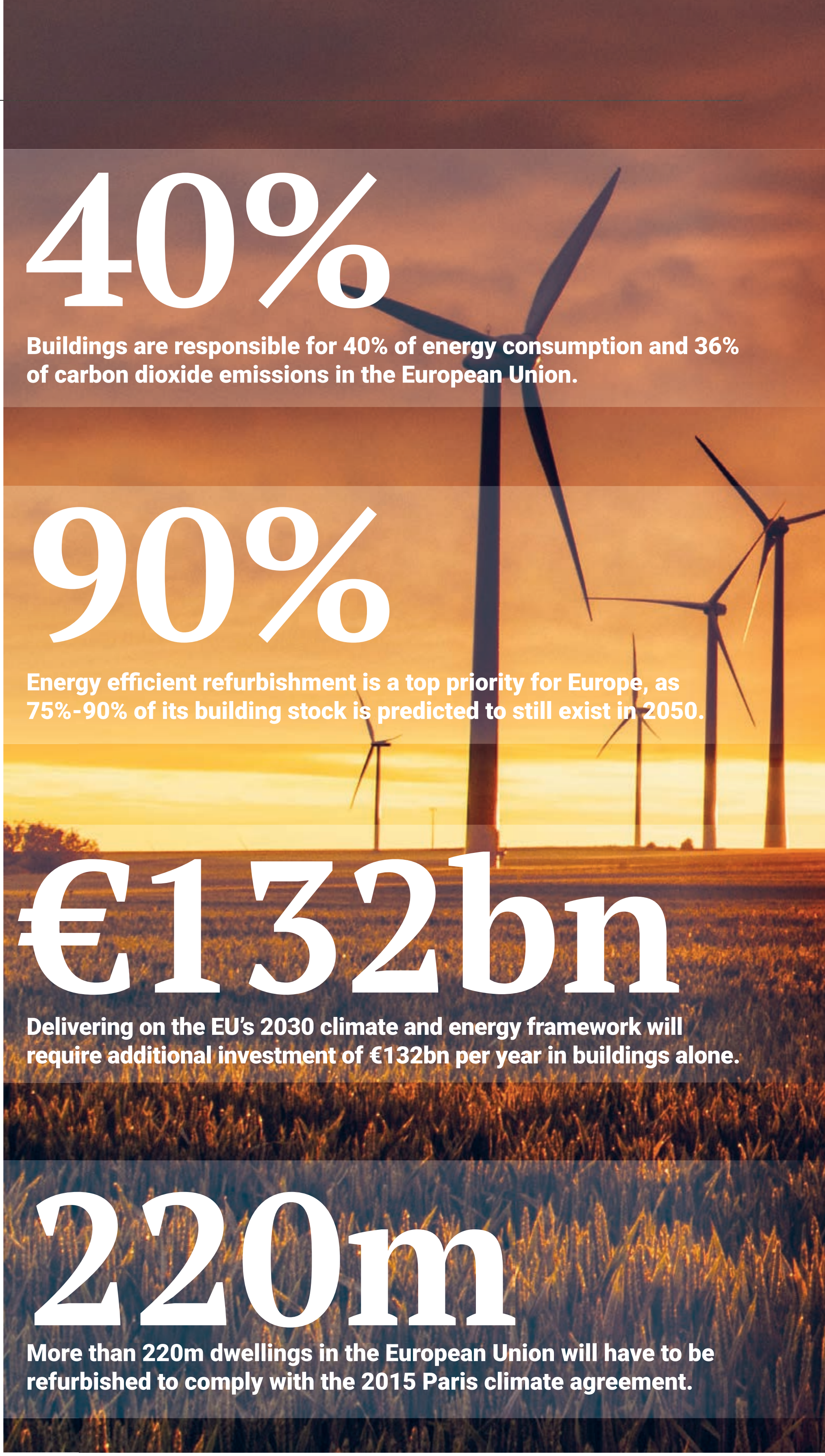
> 'Typically banks finance property purchases and have a significant role to play in achieving the EU's energy savings targets.'

in efforts to mainstream sustainable finance. This will help drive demand and pave the way for market transformation and significant energy savings. In this way, the EEMI is a concrete response to the EU's ambitions for a capital markets union and clean energy transition in line with the Paris agreement.

The EEMI pilot scheme is building on efforts to create an integrated market for energy efficient mortgages, and offers a blueprint for established and emerging markets around the world. The next steps include an analysis of extant market systems relevant to the development of an energy efficient mortgages market and supporting these green mortgages throughout their life cycle. There are plans to introduce an 'EEM' label to bolster recognition of and confidence in these loans, and to facilitate access to quality information for market participants. The initiative is putting together guidance for the inclusion of energy efficiency in credit risk assessments for lending institutions and supervisors. It is assembling policy recommendations for the prudential framework, in line with the principle of risk sensitivity, to promote a well-functioning banking market. EEMI directors are also seeking ways to enhance institutional co-operation.

These steps respond to the EU's sustainable finance and climate change objectives, in the wider context of capital markets union. The aim is to influence the entire value chain, from consumer to bond investor, changing mentalities and securing energy efficiency in market attitudes and best practices in Europe and around the world. ●

Luca Bertalot is Secretary General of the European Mortgage Federation–European Covered Bond Council and Coordinator of the Energy Efficient Mortgages Initiative.



Making the lira 'as good as gold'

Currency board would protect Turkey from devastating inflation

Steve Hanke
The Johns Hopkins University

It is no secret that Turkish President Recep Tayyip Erdoğan aspires to become his country's next sultan. But one substantial obstacle is blocking his path: the lira. Turkey's coin of the realm is one of the world's junk currencies, and it hangs like the sword of Damocles over Erdoğan.

For the decades of the 1970s, 80s, 90s and 2000s, Turkey recorded average annual inflation rates of 22.4%, 49.6%, 76.7%, and 22.3% respectively. Those horrendous numbers mask periodic lira routs. In 1994, 2000-01 and 2018-19, the lira has been devastated. But there is a way for Erdoğan to guard the currency from its downward spiral and suppress inflation. That path is paved with a currency board.

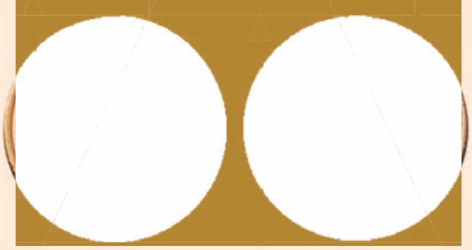
A currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. The relevant monetary authority is required to hold anchor-currency reserves equal to 100% of its monetary liabilities. It generates profits from the difference between the interest it earns on its reserve assets and the expense of maintaining its liabilities.

By design, a currency board has no discretionary monetary powers and cannot issue money on its own credit. It has an exchange-rate policy – the exchange rate is fixed – but no monetary policy. Its operations are passive and automatic. The sole function of a currency board is to exchange at a fixed rate the domestic currency it issues for an anchor currency. Consequently, the quantity of domestic currency in circulation is determined entirely by market forces, namely demand for domestic currency. Since the domestic money is a clone of its anchor, a currency-board country is part of an anchor country's unified currency area.

Currency boards require no preconditions, can be installed rapidly, and have existed in around 70 countries. Government finances, state-owned enterprises and trade need not be reformed before a currency board can issue money. The first was installed in 1849 in Mauritius, then part of the British Indian Ocean Territory. No currency board has failed. This perfect record includes the 'National Emission Caisse' established in northern Russia in 1918 during the country's civil war. The caisse issued 'British rouble' notes, backed by sterling and convertible into pounds at a fixed rate. The father of the British rouble was none other than John Maynard Keynes, at the time a British treasury official.

Despite the civil war, the British rouble never deviated from its fixed exchange rate. In contrast to other Russian roubles, the British rouble was a reliable store of value. Naturally, the British rouble drove other roubles out of circulation. Its life was unfortunately brief: the caisse ceased operations in 1920 after allied troops withdrew from Russia. That said, it redeemed all the obligations presented to it before closing.

> **'Government finances, state-owned enterprises and trade need not be reformed before a currency board can issue money.'**



Looking to the yellow metal

One doesn't need to reach far back in history to find a currency-board success story close to Turkey. Indeed, a relatively new currency board is located in Bulgaria, Turkey's immediate neighbour to the northwest.

In 1997, hyperinflation gripped Bulgaria. The lev had collapsed, and the monthly inflation rate had soared to 242%. Then serving as an adviser to President Petar Stoyanov, I designed a currency board that was installed on 1 July. With that, the lev became a clone of the Deutsche Mark. Inflation was immediately defeated, lev interest rates plunged, a hard budget constraint was put on Bulgaria's fiscal authorities, and the economy boomed. Since the installation of the currency board, fiscal deficits have been tightly controlled. Bulgaria's fiscal discipline and debt reduction have made it a star performer in Europe.

In Turkey's case, Erdoğan should install a gold-backed currency board. With a Turkish currency board, the lira would be tied to gold at a fixed exchange rate. Gold reserves would fully back the lira. The yellow metal is particularly attractive for countries like Turkey, since it is not issued by a sovereign and is highly revered. So, like gold, the lira would become an international currency that maintains its purchasing power over time. Indeed, the lira would be 'as good as gold'. ●

Steve Hanke is a Professor of Applied Economics at the Johns Hopkins University and a Member of the OMFIF Advisory Board. He is the co-author of Gelişmekte Olan Ülkeler İçin Para Kurullari (Monetary Boards for Developing Countries), published in Turkey by Liberte Publishing Group.

Central banking tome deserves wide audience

As the financial crisis recedes into the memory, books analysing the events of 2007-12 are starting to appear. Some are technical and detailed. Others are highly readable. The latest book by Francesco Papadia, *Central Banking in Turbulent Times*, co-authored with Tuomas Välimäki of the Bank of Finland, is both.

It is a subject of such complexity that proper comprehension of its scope and terrifying consequences seems impossible. Papadia was director general for market operations at the European Central Bank between 1998-2012. Before that he was with the Banca d'Italia, first as director of the international section of the research department and then as deputy head of the foreign department. He is versed in the practice of central banking and a deep thinker about its theory. It is unsurprising then that his latest book combines both theoretical analysis and practical experience.

The result is a book detailed and thoughtful enough for the expert while being neither too long nor too heavy for the interested observer. The first part provides an excellent summary of classical central banking as it was at the end of the 'great moderation' in 2006. The middle section, the most substantial part of the book, is a rich store of insights on central banking in the financial crisis. Not only do Papadia and Välimäki probe the conceptual and practical challenges central banks faced, they supply copious data to support their analysis.

Papadia has used the years since he retired from the ECB to marshal his thoughts and interpret the actions of his former employer and other central banks at that critical time. The result is a coherent assessment of the various actions taken to meet the multiple challenges to the financial system over the twin crises of 2007-09 in the US and 2011 onwards in the euro area. It is an excellent account of decision-making under pressure and will be a textbook for future central bankers.

If the book's heart is a blow-by-blow description of what central banks did to overcome the financial crisis, the final section is a detailed consideration of the state of central banking now that they have done so. Papadia's conclusion here is that the unconventional actions taken by central banks over the last decade have not only changed the way these institutions think and operate, but also, and more significantly, changed society's expectations of what a central bank can do. The innovative techniques used over the last decade cannot be uninvented; they will always now be part of a central bank's arsenal. Society is aware they exist and will expect them to be used where necessary.

Pendulum of independence

Papadia and Välimäki are unafraid to pose some more political questions, not least in their assessment of the uncomfortable position of the ECB, forced to act well beyond its comfort zone by the inactivity of the European Union's political class. The pressure that the ECB was under as politicians played a game of 'chicken' with the bank, forcing it to act to avoid a disaster that was as much as anything caused by the failure of the politicians themselves to act, is adeptly described. Papadia uses the experience to lead into a discussion of one of the major questions that the crisis has posed, which is whether, in a democracy, the independence of central banks is an unqualified good.

Did the ECB go beyond not just its technical remit but also its democratic remit, as many in Germany claimed? Independence is not a given for central banks, and the pendulum can and at times has swung back towards closer oversight. It is therefore legitimate to ask whether, as central banks take on more roles and are faced with more choices, their accountability needs to be strengthened and they need to be brought more closely under the scrutiny of the democratic process.

'The innovative techniques used over the last decade cannot be uninvented; they will always now be part of a central bank's arsenal. Society is aware they exist and will expect them to be used where necessary.'

This book will inevitably be mainly bought and read by those working in finance. And they, especially central bankers, will derive huge benefit from it. But it deserves a wide audience. There is much here for the interested generalist, and the conclusions will help shape central banking and the world's financial system for years to come.

John Nugée, a former Chief Manager of Reserves at the Bank of England, is Senior Adviser to OMFIF.

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Priorities for the European Union

Ursula von der Leyen, president of the European Commission, has expressed her support for opening accession talks with Albania and North Macedonia. French President Emmanuel Macron, however, has been a vocal opponent of that line of action, arguing that internal reforms should be prioritised over enlargement. What do you feel is the appropriate course of action for the European Union?

Poll of OMFIF website users, OMFIF advisory board and Twitter users

Internal reforms should be prioritised over enlargements. The case can be made that, thus far, enlargement has been prioritised over internal reforms. This has been a grave mistake, and the price paid for this strategy has been significant.

Hans Blommestein, Vivid Economics

It would be wiser for the EU to focus on internal reforms rather than to promote accession talks now with Albania and North Macedonia. Given the structural rigidities in many EU economies and the rise of populism in the region, efforts are best directed towards making EU economies more dynamic.

George Hoguet, Chesham Investments

Albania and North Macedonia are undoubtedly part of Europe and therefore they should find their place in the European Union. However, membership of the EU should no longer carry an obligation to join the single currency, as it has in the past.

Robert Skidelsky, University of Warwick

The EU should open accession talk with Albania and North Macedonia. It is about credibility, which the EU badly needs in the coming turbulent times.

Marek Belka, former prime minister of Poland

My considered view is for opening talks with Albania and North Macedonia in their bids for EU membership. We need to enhance the credibility of the EU enlargement policy, which appears to have run out of steam. Hence opening talks on accession negotiations would be an ideal opportunity for revisiting this policy and restoring credibility.

Hemraz Jankee, formerly Bank of Mauritius


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