The Bulletin

OMFIF

Summer 2020
Vol.11 Ed.3

Uncharted waters

Navigating the post-Covid recovery

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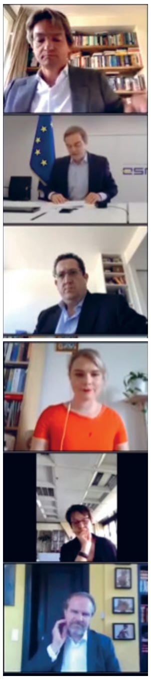

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Cover illustration by Darrel Rees

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OMFIF Advisers Network

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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Uncharted waters

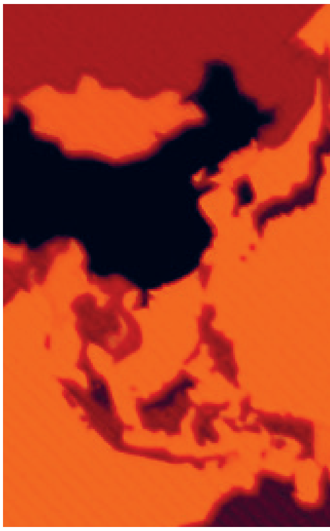
As lockdowns ease and the world enters the mysterious, daunting 'post-Covid era', *Robinson Crusoe* comes to mind. Like Daniel Defoe's shipwrecked explorer, the world is learning to adapt to life after a disastrous storm. Governments and central bankers took extraordinary measures to salvage what they could of the global economy. OMFIF provides a detailed looked at monetary policy actions in our central bank policy tracker, updated weekly.

It is difficult to know what shape the recovery will take. But not every part of our pre-pandemic lives will make it safely back to shore.

As OMFIF Chief Economist and Director of Research Danae Kyriakopoulou writes, for the euro area the health crisis hit the economy at a particularly vulnerable time. The bloc was still reeling from the European debt crisis, and new leadership at the European Commission and European Central Bank was finding its feet. Policy-makers have averted a financial crisis, but must now avoid exacerbating divergencies between core and periphery economies which threaten the single market.

Nathan Sheets, chief economist and head of global macroeconomic research at PGIM, believes the post-virus economy will bring winners and losers. He outlines four 'shifting rapids' the world will need to navigate carefully in the months and years to come. He notes the disproportionate impact of Covid-19 in poorer communities, which has highlighted the inequality so many are protesting across the US.

On a more positive note, Union Investment's Dijana Bogdanovic and Dieter Konrad report that socially responsible portfolios were better able to withstand the pandemic shock. Perhaps this will inspire a boost in environmental, social and governance investing, amid mounting calls for the recovery to be a green one. In steering the world through the pandemic, policy-makers must not lose sight of another titanic challenge, the climate crisis. OMFIF plans to facilitate important conversations on this topic with the forthcoming launch of our Sustainable Policy Institute. More on that soon.



»3 April

Coping with crisis: View from Asia

OMFIF convened a panel of in-house experts to discuss the responses and measures taken by central banks and governments to safeguard the economy and the financial system. Speakers included Mangal Goswami, executive director of the South East Asian Central Banks Research and Training Centre, Mark Burgess, OMFIF Asia chairman, and Grant Spencer, former governor of the Reserve Bank of New Zealand and OMFIF Advisory Board member.

»24 April

Long-term growth prospects post-pandemic

As the economic fallout from the global spread of Covid-19 increased, OMFIF convened a panel of experts to discuss the expected economic impact, responses taken by key central banks and governments to safeguard the economy and the financial system, as well as potential scenarios for a recovery.

»9 April

Covid-19 policy response

Ludger Schuknecht, who is responsible for promoting the Organisation for Economic Co-operation and Development's efforts on sustainable development, growth, and 'better policies for better lives', discussed the policies in place and the OECD's role in tackling the short-term health crisis and the longer term economic fallout.

»20 April

Brazil in the global economy

Fernanda Nechio, deputy governor of the Banco Central do Brasil, discussed Brazil's economic situation, the central bank's policy responses and its assessment of global developments.

»24 April

Global financial stability overview

Fabio Natalucci, deputy director of the IMF's monetary and capital markets department, discussed the Fund's Global Financial Stability Report and its outlook for the global economy.

»7 April

G20 response to coronavirus

OMFIF convened a panel of in-house experts to discuss the expected economic impact of the Covid-19 pandemic, responses taken by key central banks and governments to safeguard the economy and the financial system, as well as potential scenarios for a recovery.

»7 April

The economic impact of Covid-19

As uncertainty continued over the economic impact of coronavirus on the global economy, the National Institute of Economic and Social Research examined the potential ramifications, using stylised scenarios based on the National Institute's Global Econometric Model. Two architects of NIESR's report presented their findings.

»7 May

CBDC and maintaining the public role of money

In April, De Nederlandsche Bank announced it was ready to play a leading role in a Eurosystem central bank digital currency experiment. Peter Wierts elaborated on the role CBDC could play amid declining cash use, possible objectives – and which are the most important – as well as design choices.

»12 May

Economic shutdown has '90-day shelf life'

In response to the Covid-19 health crisis, the Federal Reserve has taken a number of policy actions to help steady both the US economy and global dollar liquidity. James Bullard, president and chief executive officer of the Federal Reserve Bank of St Louis, joined David Marsh, chairman of OMFIF, to discuss the Federal Reserve's policies, the outlook for the US economy, and global consequences of the pandemic.

»14 May

Japan's response to Covid-19

The Bank of Japan has pledged to buy an unlimited amount of government bonds and quadruple its purchases of corporate debt. Hirsohi Nakaso, former deputy governor of the Bank of Japan (2013-18) discussed the economic outlook for Japan and the impact of Covid-19 on foreign investors.

»27 May

Future of the euro area

Looking at how the external shock has highlighted structural issues at European level, this seminar discussed solidarity and Eurogroup response compared with the role of national governments. It considered the role of fiscal response alongside monetary policy and the European Central Bank bond-buying package.

»18 May

Prospects for a digital euro

Discussions on central bank digital currencies have moved from purely theoretical examinations to practical experimentation, including at the European Central Bank. Ulrich Bindseil outlined the ECB's CBDC agenda, honing in on its current priorities and collaboration with member states.

»27 May

Banque de France's wholesale CBDC experiment

Digital currency solutions for interbank settlement has the potential to transform current systems' speed, resilience and cost efficiency. Valérie Fasquelle and Christian Pfister outlined the Banque de France's latest work on a wholesale digital euro.

»12 June

Covid-19 recovery: View from the Netherlands

Elvira Eurlings, who is responsible for managing the financing conditions on the debt side at the Dutch state treasury agency, discussed the Netherlands' response to the Covid-19 crisis and how the country will manage its recovery.

»18 June

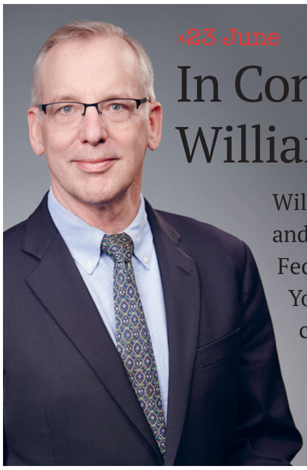
The bumpy road to recovery

Olivier Blanchard, former chief economist at the International Monetary Fund, and Prakash Kannan, chief economist and head of total portfolio management at GIC, discussed the shape of the recovery, changes in the nature of monetary policy and the European recovery fund.

»18 June

Demystifying central bank financing

Ministries, treasuries and central banks around the world are funding large amounts of stimulus to combat the effects of the Covid-19 pandemic. OMFIF convened a panel to discuss the real-world operations of central banks and treasuries and a deep dive into government deficits and public debt.



»23 June

In Conversation with William Dudley

William Dudley, former president and chief executive officer of the Federal Reserve Bank of New York, joined Mark Sobel for a conversation about the US economy and his outlook on the years ahead.

»23 June

CBDC and the future of payments

Jochen Metzger discussed the impact of the CBDC agenda on payments and banking operations at large, considering the perspectives from a national, European and global level.

»12 June

The role of the dollar and tensions with China

This panel discussed some of the major themes facing the global economy, in particular the international role of the Federal Reserve, US-China relations and the future of the dollar.

»3 June

Economic and financial trends in Latin America

This panel convened experts from financial institutions in Mexico, Brazil and Central America to discuss key trends in the Latin American economies and ways ahead through the downturn.

Agenda

»Monday 6 July, Virtual

Covid-19 response and recovery: Perspective from Germany

A roundtable with Jörg Kukies, German state secretary in the ministry of finance. Kukies discusses the German response to Covid-19 and the European Commission proposal for a recovery fund.

»Tuesday 7 July, Virtual

From protest to lockdown: Chile's economy in 2020

A roundtable with Joaquín Vial, deputy governor of the Banco Central de Chile, to discuss how Chile has been coping with the challenges of social unrest and protests at the start of the year, followed by the economic impact of the Covid-19 pandemic.

»»Wednesday 8 July, Virtual

CBDC and its potential impact on monetary policy

A roundtable with Scott Hendry, senior director, financial technology at the Bank of Canada. Hendry will discuss CBDC and its various design choices, and what they could mean for the future of monetary policy.

»»Wednesday 22 July, Virtual

Bank of Thailand's wholesale CBDC

A roundtable with leaders of Bank of Thailand's Project Inthanon to discuss how distributed ledger technology could enhance the country's financial infrastructure and pave the way to a decentralised real-time gross settlement system.

»Wednesday 29 July, Virtual

Launch of Global Public Investor 2020

Launch of the seventh edition of *Global Public Investor*. The launch, taking place virtually from London and Singapore, focuses on how key European, American and Asian institutions have managed the economic and financial fallout from Covid-19.

»Friday 25 September, Virtual

Navigating the digitalisation transformation

A seminar on what central banks are doing to respond to the challenges and risks of artificial intelligence, blockchain and digital currencies, and how they are preparing for potential cyber attacks and establishing regulations on cryptocurrencies.

»Tuesday 29 September, Virtual

The economics of artificial intelligence and machine learning

A joint seminar with OMFIF and the Federal Reserve Bank of Philadelphia on the economics of artificial intelligence. Topics of discussion include macroeconomic developments, transforming financial systems, the future of work and consumer finance.

For details visit omfif.org/meetings

Uncharted waters

Europe's useful crisis

Danae Kyriakopoulou
OMFIF

There is never a 'good time' for a negative economic shock. But for the euro area, the Covid-19 health crisis hit the economy at a particularly vulnerable moment. Countries across the monetary union were still recovering from the euro area crisis, with some economic indicators stuck below their pre-2009 levels.

In financial institutions, pre-pandemic debates focused on whether policy-makers would have enough ammunition to face the overdue market correction, irrespective of what may cause it. The European Central Bank, under new leadership, was slowly healing from the Draghi era divisions in the governing council on the level of accommodation of monetary policy. Politically, the freshly-appointed European Commission was finding its feet while preparing to face new rounds of Brexit negotiations, competition disputes with tech giants, and the climate crisis.

Dual challenge

The pandemic is a classic exogenous shock; the virus is not linked to misguided economic policy choices. By some unfortunate coincidence, it hit hardest in Italy, the union's 'weak link' and with limited fiscal and institutional capacity to respond. The under-preparedness is partly the result of a decade of austerity, when periphery countries were directed to focus on building primary surpluses to improve debt sustainability. Investments in health were among the first to go. In 2017, per capita spending on health in Italy and in Spain was 15% below the EU average.

For economic policy-makers, the pandemic challenge was dual. First, how to prevent a crisis in the real economy from morphing into a financial one. Second, how to avoid this turning into Europe's 'great fragmentation', exacerbating divergencies between core and periphery, undermining the functioning of the single market, and feeding euroscepticism.

The first challenge has been largely addressed – for now. Decisive action by the European Central Bank has shielded financial markets from the scale of destruction in the real economy; the health crisis has not coincided with a financial heart attack. But it has come at a price. Political opposition to the ECB – usually from eurosceptic groups – has motivated legal action. This culminated with the →

German constitutional court's ruling against the legality of the ECB's asset purchase programme. The Alternative for Germany, Germany's far-right official opposition party, has already begun the process to legally challenge the ECB's pandemic emergency purchase programme, alleging it amounts to illegal monetary financing.

But there is a more practical reason not to over-rely on central bank action in responding to the pandemic. This is primarily a supply side shock and the public policies put in place to curtail the spread of the virus are designed specifically to suppress economic activity. Trying to boost demand with one hand while trying to suppress it with the other makes little sense. This time, the economy needs a different kind of medicine.

Another game in town

Fiscal policy is particularly well-suited to respond to a supply side shock and propel the recovery once lockdowns ease. Direct, targeted investment can focus on the sectors most hit and rebuilding economies sustainably.

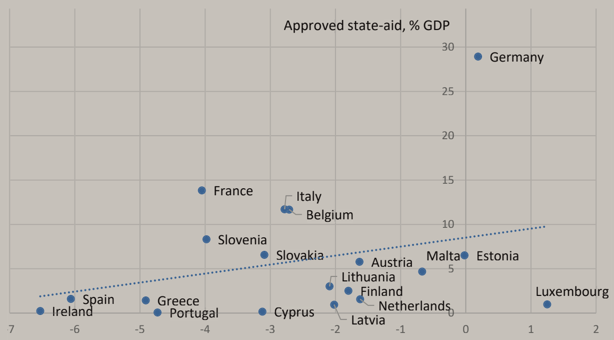
Encouragingly, national governments have begun to execute fiscal stimulus. This has been much to Frankfurt's delight, following worries that the ECB would once again turn out to be the only game in town, let alone a legally challenged and a relatively ineffective one.

But there is a problem with fiscal action. Not everyone can act at the same scale. Between March and June, Germany approved €994bn in state aid, compared with €209bn in Italy and €20bn in Spain (Figure 1). French President Emmanuel Macron and Fabio Panetta, ECB executive board member, have bemoaned EU countries' differing capabilities to provide fiscal support and state guarantees. They have warned this would compromise what is intended to be a level playing field. In a single market, the location of a corporate should not be the decisive factor in determining its prospects for survival and success.

Differing levels of state aid could undermine the competitiveness of the union as a whole given deeply interconnected supply chains. A German company may be hurt if its suppliers in Italy go under because of the Italian government's inability to provide state aid to the same extent that Germany does. However, interconnected supply chains could in theory mean that German stimulus trickles down to support the broader European economy as it translates into demand for imports from its trading partners. In practice, most of Germany's stimulus package has been in credit guarantees, rather than actual investment with a more direct transmission to the real economy.

Differing ability for economic support

Average budget deficit, 2010-19, % of GDP (x-axis); Approved state-aid in 2020, % of GDP (y-axis), euro area economies



Source: European Commission, Eurostat, FT, OMFIF analysis

No time for fiscal distancing

Thankfully, Jean Monnet's quip that 'Europe will be forged in crisis, and will be the sum of the solutions adopted for these' is proving prophetic. Europe is coming up with solutions. The pandemic laid bare gaps in the design of the monetary union and is accelerating progress on the old and well-known debates on risk sharing versus risk reduction, enhancing crisis response mechanisms, and strengthening the institutional architecture underpinning the common currency.

The Commission's proposal for a €750bn 'next generation' fund has been hailed as Europe's Hamiltonian moment, referring to the 1790 US agreement under which the federal government assumed states' debts following the war of independence. It is a step in the right direction. But it suffers from shortcomings of scale and limits to its ability to channel funds to those most in need. Crucially, the plan still needs to be unanimously approved, with some states still in opposition.

A more apt analogy to where Europe finds itself would be a Marshall plan to kick-start the recovery after winning the virus war. And as the world emerges from lockdown, policy-makers should prepare to face the climate emergency. So far, the pandemic has had a mixed effect on the climate agenda. Some institutions have postponed or relaxed climate-related regulations, citing the need for immediate support to facilitate a broader revival. Others have intensified efforts, attaching sustainability strings to stimulus packages and corporate bailouts.

In fighting the virus war, Europe should not lose sight of the next battle. Sustainability should be the guiding principle behind strengthening the union's institutional architecture. The long-term challenge for the continent will be to implement crisis measures in a way that they can help us return to more normal times, and remain useful when we do.

Danae Kyriakopoulou is Chief Economist and Director of Research at OMFIF.

Four themes of the post-virus economy

Evolving circumstances will bring winners and losers

Nathan Sheets
PGIM Fixed Income

The great American philosopher Yogi Berra once said, 'It's tough to make predictions, especially about the future.' If anything, Berra's quip understates the challenges of figuring out where the global economy is headed. Taking a stand on such issues, however, is the unavoidable task of economists.

In that spirit, we turn to the question of how global economic conditions – after Covid-19 has receded – will differ from those that previously prevailed. While our crystal ball is cloudy, we see four big themes that are likely to characterise the post-virus economy and markets.

First, the post-virus economy will bring winners and losers. The rebalancing will create a massive 'relative value' trade for investors. The winners will probably include producers of virtual technologies that bring people together, provide entertainment, or that offer information, education, or services. Even more than before the pandemic, the tech sector will be central to the economy.

The losers will be service providers that depend on face-to-face contact. This will reflect both lingering health concerns and, more fundamentally, that people are finding ways to interact and conduct business that require less physical contact. Brick-and-mortar retail will continue to lose ground to ecommerce, as consumers are increasingly attracted by the convenience.

Productivity, politics and aging

Second, this sectoral rebalancing could bring a resurgence in productivity growth. Recent years have brought a proliferation of impressive technologies, such as smartphones and artificial intelligence. Nevertheless, productivity growth over the past decade has been the slowest of the post-war era. The current situation may drive a transition to a more productive economy. While working from home during lockdowns, people have paid the fixed costs of learning and applying new technologies to work. Although these technologies will not fully replace face-to-face contact, they will remain in use once the virus has passed. They will allow jobs to be done more efficiently and will raise productivity levels. The exigencies of the outbreak may have created massive network externalities by coordinating adoption of key technologies across the economy.

Third, at least in the US, the unequal incidence of Covid-19 across economic cohorts is likely to stoke frustrations about inequality. Data indicate that poorer communities have borne the brunt of the virus, reflecting that these populations faced greater health challenges and sickness before the pandemic and, in many cases, lived in dense households or communities that aided the virus' spread. Moreover, lower paid workers have been more likely to lose their jobs or hold positions that were deemed 'essential' and, thus, were more exposed to the risk of infection. These realities are amplifying the frustrations expressed in the recent demonstrations across the US.

Fourth, aging populations will continue to shape global economic performance. Our previous research shows that greying demographics are associated with weaker real GDP growth, slower inflation and lower nominal interest rates. Thus, as aging demographics proliferate, the post-virus economy seems poised to carry forward many of the themes that have characterised the past decade – restrained growth, low inflation and low long-term rates. We expect that these will translate into a low volatility macro-financial environment, with many of the key uncertainties emanating from political developments.

Each of these four big themes is powerful individually. Occurring together, they promise to create a global economy that differs in important ways from before the pandemic. Navigating these shifting rapids will require us to remain alert and respond adroitly to evolving circumstances. ●

Nathan Sheets is Chief Economist and Head of Global Macroeconomic Research at PGIM Fixed Income.

China's post-Covid recovery continues

Recent Beijing outbreak shows virus eradication will be difficult

Andy Rothman
Matthews Asia

China's recovery continued in May, with consumer spending, manufacturing and investment all bouncing back strongly. With the virus largely under control three months after the lockdown was eased, further progress is probable, although a return to normal may not happen until next year.

When thinking about prospects for the Chinese economy, the most important factor is whether coronavirus remains under control. China appears to have wrestled Covid-19 into submission, but a new outbreak in Beijing provides a cautionary tale for all nations, suggesting that eradicating the virus will be extremely difficult.

On 14 June, only 177 coronavirus patients were in hospital, down from the 17 February peak of 58,016. The recovery rate for hospitalised patients is now 94% across China, up from 17% on 17 February. It was also encouraging that six weeks after a five-day national holiday in China, when over 100m people traveled for leisure, there had not been a spike in cases.

But that picture changed over the weekend of 13-14 June, when there was a total of 72 new cases in Beijing within two days. This is not a huge number, in the context of 395 new cases in New York on 14 June, as well as 302 in Dallas and 995 in Los Angeles on that same day.

For Beijing, however, which prior to the weekend had gone almost two months without a new case, it is a worrying sign. The government responded with widespread testing and contact tracing, closing schools near the outbreak, and sacking some local officials.

As in other countries, the potential for a rebound in coronavirus cases is the biggest risk to a post-lockdown economic recovery in China.

At the moment, a combination of testing, contact tracing and social distancing, as well as a strict quarantine of all international arrivals, seems to be keeping the virus largely at bay.

A V-shaped recovery

China's first quarter economic data was dismal, but that was the result of a virus that shuttered most shops, factories, offices and restaurants. It did not reflect structurally weak supply or demand, or a financial system crisis. Now that the virus has been brought under control, those businesses have gradually been reopening, and life is starting to return to normal, as are many key economic indicators.

China is a domestic-demand driven economy, so the recovery in consumer spending is critical. Last year was the eighth consecutive year in which the consumer and services (tertiary) part of China's GDP was the largest, and consumption accounted for almost 60% of GDP growth.

Real retail sales growth fell 23.7% year-on-year in January-February but bounced back to be only down 3.7% in May. Auto sales were down 79.1% year-on-year in February, but rose 14.5% in May, the first month of double-digit year-on-year auto sales growth since April 2018. Residential property sales rose 9.3% year-on-year in May (in square metre terms), after being down 39.2% year-on-year in January-February.

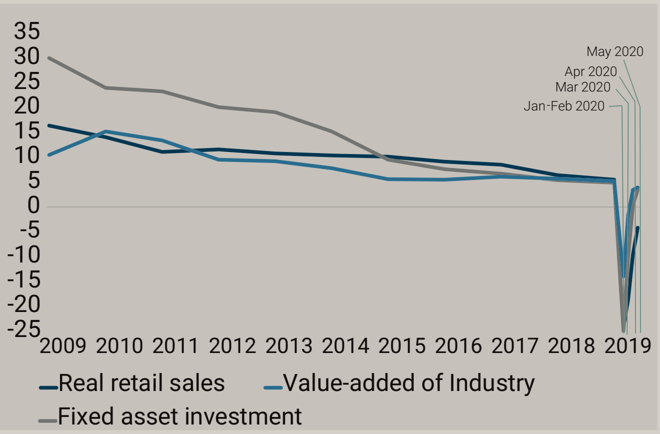
Online sales of goods rose 22% year-on-year in May, up from 16.2% in April and 10.7% in March, and faster than the 19.9% pace a year ago. During the first five months of the year, online sales accounted for one-quarter of total retail sales.

It is worth noting that this healthy economic recovery has come without a dramatic stimulus. Credit growth, for example, has only accelerated modestly. Unemployment remains a concern, but the absence of social unrest and the rebound in consumer spending suggests that the government's support for workers and businesses has provided a cushion for many who lost their jobs, laying the foundation for an economic recovery.

Andy Rothman is Investment Strategist at Matthews Asia.

China's economy bouncing back after Covid drop

Key macro data recovering, year-on-year increase, %



Source: CEIC

ESG strategies withstanding coronavirus

Sustainably managed companies tend to be more robust during crises

Dijana Bogdanovic and Dieter Konrad
Union Investment

Companies that excel in the environmental, social, and corporate governance spheres stand to gain more than 'just' money. But it can be complex to link these soft factors to the hard data of share price performance. Although it is still too early to make conclusive statements, an initial analysis provides interesting results regarding ESG performance during the coronavirus crisis.

Union Investment grouped the companies listed in the MSCI World index by sector and ranked them according to their ESG score. To focus on pure ESG factors and minimise risks related to sector allocation, the sectors are weighted equally.

Our results were divided into two baskets, representing the top and bottom 20% of the ESG score ranking. European companies are, on average, more advanced in the field of sustainability than their peers from the US or Japan. As such, European stocks dominate the top basket. Investment styles follow a similar pattern. Momentum and growth stocks are more likely to feature among the top ESG strategies. Value stocks, from sectors such as energy, banking or automotive, are less represented in ESG portfolios.

Success of sustainability stocks

Securities with poorer sustainability credentials were still on a par with the top ESG stocks while the market was treading water at the start of the year. However, they fell more sharply during the collapse that began in late February. At times, the top sustainability stocks had an advantage of as much as five percentage points (see figure 1). Although they too suffered losses during the Covid-19 crisis, a strategy focusing purely on such shares would have mitigated the impact of the downturn at the very least.

One reason for this is that ESG strategies benefited from their considerable underweight in certain energy stocks and thus the drop in crude oil prices, particularly up to mid-March, was (partly) avoided. The environmental impact of the exploration and extraction of oil – especially shale oil, which accounts for a large share of the US production – is significant. Companies operating in this sector, therefore, are not usually part of ESG portfolios. Despite the challenging market conditions, rising inflows during the market turmoil supported sustainable investments. ESG inflows grew at a higher rate than flows into broader and unspecific equity investments in the first quarter of 2020.

Companies with a high social score recorded a particularly strong share price performance in March. This could be because firms with satisfied employees were able to adapt better and more quickly to lockdown measures.

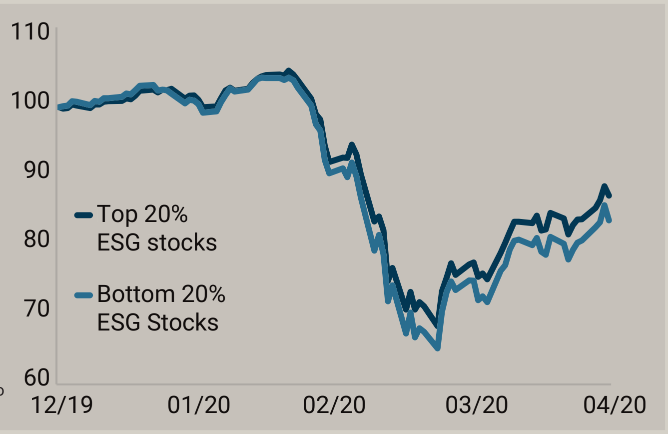
The environmental score reveals mixed results. These companies initially made a constant positive contribution to performance, which for a time suggested that the crisis was not pushing environment and climate issues aside. However, this trend was reversed in April. The corporate governance score proved similarly volatile. Its performance contribution slumped from the start of March onwards but rallied strongly in April. This underlines the influence of the regional allocation; one of the reasons for this trend was the underweighting of Japanese companies in the top ESG basket, which tend to have a poorer corporate governance score.

So far, the study only covers a limited period and the collation of relevant information is ongoing. Nevertheless, it is clear ESG strategies are delivering a more robust performance in the Covid-19 crisis than the overall market. The underlying causes of this phenomenon are not exclusively related to sustainability factors. Still, there are many indications that companies with particularly sustainable business models could act as a safety cushion for portfolios.

Dijana Bogdanovic is ESG Analyst and Dieter Konrad is Head of Quant and Smart Data at Union Investment.

Top sustainability stocks have advantage in 2020

Indexed performance of the ESG-ranked stock baskets



Source: Bloomberg; period under review: 30 December 2019 to 30 April 2020

Race to digitalisation

Banks must act fast to maintain competitive edge

Gary Hwa and Andrew Gilder
EY

In the economic pressure test of Covid-19, the world's banks have performed remarkably well. Even as lockdowns forced them to shut their doors and send workers home, most continued to operate, responding rapidly to unprecedented conditions and offering payment relief as economic hardship set in. Banks' operational resilience is largely due to the implementation of digital channels. As the initial crisis eases and banks consider how to adapt for what comes next, they have an opportunity to maintain and sustain this digital shift, leveraging strengthened relationships with customers to build a competitive advantage against fintech and 'big tech' firms.

The shift to digital banking was already well underway before the pandemic, but the virus accelerated the switch. EY Future Consumer Index research found that 59% of people were using contactless payments more during the crisis, while 54% were using smartphone apps to transact. Fidelity National Information Services found that mobile banking registrations jumped 200% in early April and mobile banking traffic rose 85%.

The rush to online banking revealed that some banks' digital capabilities were not as advanced as they may have thought. A 2019 EY survey of banks in Asia Pacific showed that just 50% had begun digital transformation of their main bank's business. Yet many banks in the region fared better than those in other parts of the world, due to higher levels of digital banking among customers. In China, for example, fintech adoption is the world's highest, and most consumers opt to bank via mobile channels. The impact of branch closures on consumers was much less severe than that experienced in some other markets. In contrast, the rate of fintech adoption is much lower in some European countries. In France, the rate is 35%, and the figure for Italy is 51%.

> 'Encouraging people to keep using digital channels requires banks to continue adapting them to meet changing needs.'

As lockdown measures ease, more people may prefer to continue banking online, but banks cannot assume this new behaviour will stick. Just 16% of respondents to an EY consumer survey said Covid-19 would change the way they bank over the longer term. Encouraging people to keep using digital channels requires banks to continue adapting them to meet changing needs, to drive awareness of these channels and support vulnerable customers that struggle to use them.

Strategic investment

In China, where post-pandemic recovery is further along, but still volatile, established banks are moving fast to do this, realising that creating better digital customer experiences is critical to competing with digitally-based companies. But the country's traditional banks know that their physical branches are a competitive advantage, and plan to adopt a dual online-offline customer service strategy.

This strategic investment in digitising the customer journey can help mature banks build a winning proposition that leverages technology and trust. Harnessing change will also reap bottom line benefits from a more efficient, digital organisation at a time when cost pressures are top of the board's agenda.

Getting businesses to adopt online banking has always been more difficult. However, once Covid-19 forced business customers online, many adapted quickly and discovered the advantages of being able to transact 24/7. Banks have a rare opportunity to make the shift more permanent. But doing so will require completely rethinking the relationship model – developing new digital tools that enable relationship managers to support customers remotely, while delivering a better, more personalised experience. For example, digitalisation supports rapid customer onboarding by extracting relevant data from client information files and automating credit approvals for low value loans. The use of advanced analytics enables banks to better assess the impact of changing market conditions on customers' credit risks and provide more accurate insights into which sectors may be most impacted by the economic downturn.

Mature banks may have been slow off the blocks in the race to build the best digitised customer experience, but unprecedented conditions have delivered an unexpected opportunity – and a burning platform for change. To sustain this position, and leverage it for greater competitive advantage, they'll need to move fast. The window is closing. Within just months, nimble competitors will be back at their heels. ●

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Low oil prices test GCC exchange rate pegs

Smaller GCC nations may need external support

Krisjanis Krustins
Fitch Ratings

This year's oil price crash has opened double-digit fiscal and external deficits for most Gulf Co-operation Council economies. While this has prompted some market participants to question the sustainability of the GCC's pegged exchange rate regimes, changes to GCC pegs are unlikely in the short-term. This reflects sovereigns' financial ability to defend their pegs and their preference for a policy of fiscal consolidation, as a way of rebalancing their fiscal and external accounts.

The sovereign net foreign assets of Abu Dhabi, Kuwait, Saudi Arabia and Qatar would be sufficient to cover their entire stock of broad money. They could, in principle, withstand a complete loss of confidence leading to a flight out of their currencies. In practice, full coverage of broad money by reserves is not necessary. For example, Saudi Arabia's reserves are larger than required by the International Monetary Fund's reserve adequacy metric.

Loss of external confidence centred specifically on currency pegs is not a significant short-term risk factor for GCC central banks, given the limited offshore availability of GCC currencies and the underdevelopment of their local-currency bond markets. However, broader loss of confidence in the financial stability of weaker sovereigns could make their currency pegs untenable, given their large external financing needs.

External support

In Bahrain and Oman, reserves and sovereign net foreign assets are much lower. Bahrain's dollar peg has, however, survived periods of exceptionally low reserve coverage, helped by the expectation that it would receive support from the GCC. Support for Bahrain reflects its close ties with the rest of the GCC, its small size and strategic importance. Regional policy-makers may also be wary of the contagion effects of a devaluation or financial crisis, even in a smaller member of the GCC.

An assumption about external support may also be supporting Oman's peg. The share of foreign currency deposits in total bank deposits, which can indicate concern about imminent devaluation, remains low, at about 10%. Support for Oman would be available if it is unable to return to external debt markets. Nevertheless, this assumption remains untested and is more tenuous than in Bahrain. Meanwhile, Oman benefits from having gross foreign assets (despite net sovereign foreign assets being negative) that are sufficient to cover near-term financing needs.

Countries can still abandon exchange rate pegs even when they have the resources to defend them, as happened in Azerbaijan and Kazakhstan in 2014-15. The GCC's commitment to its pegs rests in the recognition that the potential benefits of devaluation can be achieved through fiscal austerity, with less economic and social upheaval.

In the GCC, external demand and import substitution would contribute little to the rebalancing of the current account, given the bloc's continued reliance on hydrocarbons for external receipts and government spending. Devaluation could still foster external adjustment by reducing the real value of incomes and wealth of most domestic sectors, such as for households dependent on government wages. Despite some wage and cost inflation, the local currency value of oil export revenue would probably rise by more than government spending, narrowing the fiscal deficit.

> 'Currency pegs have been a feature of GCC economies for over 30 years, during which time fiscal policy has gone through several cycles of austerity.'

Compression of imports and domestic demand, rather than significant pick-up in non-hydrocarbon exports, was a key channel for the relatively successful external adjustments achieved by Kazakhstan, Azerbaijan and Russia, despite all of them being more diversified than the GCC. They combined exchange rate adjustments with a degree of fiscal reform.

Fiscal consolidation would work through many of the same channels as devaluation but would be easier to fine-tune to distribute the pain of adjustment in a politically acceptable way. Currency pegs have been a feature of GCC economies for more than 30 years, during which time fiscal policy has gone through several cycles of austerity. The potential social reaction to a breaking of those pegs is unpredictable. Soaring costs of living have been a factor in political unrest across the region, including in the Arab Spring protests in Tunisia, Jordan and Oman in 2011 and smaller scale protests in Azerbaijan and Kazakhstan in the wake of their currency devaluations. ●

Krisjanis Krustins is Director and Gulf Co-operation Council Sovereigns Analyst at Fitch Ratings.

US money growth reaches record high

Prices could be heading for double-digit increase

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

Economies all over the world are suffering severe falls in output due to government-imposed lockdowns. According to the Office for National Statistics, the UK economy shrank around 20% in April, three times the contraction suffered during the 2008 financial crisis. However, the nature of the Covid-19 crisis is so different from that of 2008 that they are not comparable. More important, the response to the crisis will result in contrasting macroeconomic outcomes in the next few years.

This is largely a supply-side crisis. People have been prevented from going to work and mixing with others. It is not a traditional demand-deficiency recession. Nevertheless, governments and central banks have taken drastic stimulus measures to mitigate the losses to output and employment, as if it were a demand-deficiency phenomenon. Unprecedented spending programmes are causing budget deficits to reach record levels. In the US, the federal deficit could reach at least 15% in fiscal year 2020. The Federal Reserve is likely to finance most of this directly. Massive monetisation of the deficit is one reason why the annual increase in M3 broad money has exceeded 25% and is the highest in modern peacetime history. In addition, the Fed and other major central banks have reactivated large-scale asset purchase programmes. Unlike the deflationary imposition of higher bank capital-asset ratios in the aftermath of the 2008 crisis, this time regulators have eased banks' capital requirements to make it easier for them to expand lending.

Money growth trends in other leading economies are following similar, but less extreme, patterns. By the end of the year or early 2021, we expect annual rates of money growth to be 20%-25% in the US, 7.5%-12.5% in the euro area, 4.5%-7% in Japan and 7.5%-15% in the UK. These rates are incompatible with low inflation macroeconomic stability over the medium term. In times of crisis, households and companies increase their demand for money. But once the economy reopens, an inflationary boom will follow the excess in money balances, particularly in the US. The American data show that in the next two to three years, double-digit annual increases in nominal GDP and prices are possible, even probable. Analysts must be concerned that the Fed is not paying attention to the monetary signals. ●

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

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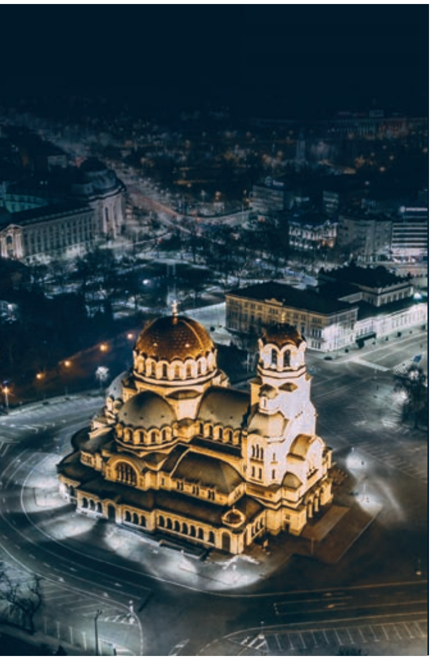
In love with the lev

Bulgarians are wary of abandoning a currency that has done so much for them

Steve Hanke
Johns Hopkins University

Earlier this year, we witnessed a dramatic dialing back of Bulgaria's headlong rush to abandon its lev and adopt the euro. Prime Minister Boyko Borisov felt that the Bulgarian public was in no mood to be dragged into the European Exchange Rate Mechanism.

1997 was both one of the worst and best years for Bulgaria. It started badly. In February, Bulgaria's hyperinflation peaked at the astronomical rate of 242% per month. Then, things got better. On 1 July, a currency board law was adopted, and the Bulgarian National Bank, specifically its issue department, began to operate under currency board rules. These required the lev to be fully backed by Deutsche Mark reserves, now euro reserves, and to trade at a fixed exchange rate with the German currency. With that, the lev became a clone of the Deutsche Mark, and good news followed.



The currency board results were immediate and dramatic. The annual inflation rate collapsed to 13% by mid-1998. Interest rates slumped, too, with the BNB basic rate falling to 5.3% in October 1998 from more than 200% in early 1997. That was not all. The demand for the currency board's remodeled lev soared. Foreign reserves at the BNB were boosted as well. After all, the only way lev could be obtained was by exchanging Deutsche Marks for lev at the fixed rate of exchange. The BNB's foreign reserves rocketed to $2.5bn by the close of 1997 from $864m at the end of 1996.

In addition to these immediate, positive results, the currency board allowed Bulgaria to weather all post-1997 external financial crises – including the collapse of the Russian ruble in 1998 and the 2008 financial crisis.

Discipline and resilience

The currency board also allowed Bulgaria to weather the 2014 collapse of the Corporate Commercial Bank (KTB). The KTB catastrophe was not caused by the currency board system, but by the failure of the banking and supervision departments of the BNB to properly regulate and monitor the KTB. Unlike most cases in which banking and currency crisis are joined at the hip, the KTB crisis did not disturb Bulgaria's currency. Thanks to the currency board system, the country did not witness a typical banking-currency crisis. The crisis was restricted to the banking sector. So, Bulgaria's currency board mitigated the damage that accompanied the collapse of the KTB.

Importantly, the currency board has imposed fiscal discipline on Bulgaria's politicians and fiscal authorities. The government cannot borrow from the currency board. In consequence, since the installation of the currency board in 1997, fiscal deficits have been tightly controlled, and the level of Bulgaria's debt relative to its GDP has plunged. It was 96.2% in 1997 and has fallen to 18.6% in the most recent accounts. Bulgaria's fiscal discipline and debt reduction have made it a star fiscal performer in the European Union.

The geopolitical aspects of Bulgaria's currency board should not be allowed to pass without mention. Former President Petar Stoyanov confided to me, while I was his chief economic adviser, that Bulgaria would have had much more difficulty entering the North Atlantic Treaty Organisation in 2004 and the EU in 2007 if it were not for the confidence and stability created by Bulgaria's currency board.

Perhaps that is why more than 50% of Bulgarians support the currency board and the lev, while only around 25% favour the adoption of the euro.

The Bulgarian public is smart enough to know that you never should try to 'fix' things that are not broken. But, with the onset of the coronavirus pandemic and while the Bulgarian public was looking the other way, Prime Minister Borisov changed course. He falsely argued that Bulgaria was missing out on EU funding because Sofia was not a member of the euro area. Then, in a desperate attempt to recapitalise the First Investment Bank, which is a precondition for Bulgaria's possible entry into the ERM II, the Bulgarian Development Bank, a state-owned bank, purchased rights to FIB shares at double their market price.

Only time will tell how the European Commission's directorate-general for competition will view this questionable manoeuvre and whether Bulgaria's government will move a step closer to what most Bulgarians fear: the loss of their beloved lev. ●

Steve Hanke is Professor of Applied Economics at the Johns Hopkins University and a Member of the OMFIF Advisory Board.

China opens its doors

Accelerating market liberalisation brings untapped opportunities

Rohan Singh
BNY Mellon

China's continuing liberalisation of its capital markets is opening the doors for global investors in search of higher returns. No institutional investor can afford to ignore the world's second-largest equities and bonds market as China shifts into the global investment mainstream.

In recent years, the country has accelerated the pace of market liberalisation, relaxing its capital market regulatory framework to ease access and promote capital mobility aimed at increasing foreign participation. We see five trends emerging in the next five to 10 years. First, the inclusion of China's securities in global indexes will bring an estimated annual foreign inflow into China's capital markets of $150bn in the medium term. Market reforms are essential impetus. Ease of market entry, new investment products and foreign exchange liberalisation are attractive factors for foreign investors.

Second, we expect the harmonisation of access schemes will continue, alongside the further relaxation of regulations that allow foreign institutional investors to invest in onshore securities. Clear moves towards harmonisation are evident – such as the removal of the Qualified Foreign Institutional Investor and Renminbi Qualified Foreign Institutional Investor investment quotas, ease of profit repatriation, simplification of registration process, shorter approval timeframe, and further foreign exchange liberalisation for QFII, RQFII and China Interbank Bond Market Direct schemes.

There is increased focus from market participants, collaborating to advocate for change to allow China bonds to be used as collateral within global transactions. Although a number of hurdles remain to be overcome, clear progress has been made and will continue in 2020 and beyond.

Third, China's economic performance in recent decades has been exceptional. But its growing economic clout on the international stage as the world's largest trading nation has not been matched by the adoption of the renminbi as a global payment currency.

The gap between China's trading power and its currency share of world payments suggests there is huge potential for growth in the use of the renminbi. China has been making rapid progress in internationalising its currency, with trading in the onshore market now available in Hong Kong through People's Bank of China-licensed foreign exchange settlement banks. This allows foreign institutional investors to trade renminbi without the need to open accounts in Hong Kong and remit the dollar equivalent into China. We expect to see greater cross-border transactions and renminbi advancements from its role as a trade settlement currency to an investment currency and potentially a reserve currency.

Diverse investors

Fourth, with the recent inclusion of China's securities in global indexes, we have seen a greater diversity of investors with differing risk appetites increasing their allocations to China. From the traditional US and European pension funds and sovereign wealth funds, the investor type broadens to hedge funds and insurance companies. This is more likely to create market depth, promote price discovery and make markets less susceptible to extreme volatility. Although the opening up of China's capital markets presents burgeoning opportunities, existing market challenges and new policy reforms being introduced at a rapid pace are making it challenging for institutional investors, especially those who are new to the market. Before these players enter the market, key factors to consider will be the choice of access schemes, foreign exchange optionality and counterparty risks.

Fifth, global institutional investors are calling for regulators to introduce hedging tools as they scale their portfolios in China and seek to manage more complex risks. The country's regulators are heeding these calls and expanding their investment scope to align with the government's plan to integrate China's capital markets with those of the rest of the world. New investment products that will emerge this year include: shares traded on the National Equities Exchange and Quotations market, futures, options, repo, margin trading, securities lending and private investment funds.

While an expansion of investment products is welcome, immediate attention is needed regarding the ability to efficiently trade in these instruments in organised markets, market regulations, and whether they are comparable to International Organisation of Securities Commissions standards are all important considerations before the new investment products see growth in demand. Ultimately, however speedy China's growth, the main focus for global institutional investors is to continue charting the right path into unfamiliar territory. ●

Rohan Singh is Head of Asset Servicing, Asia Pacific at BNY Mellon. The views expressed in this article are those of the author and not necessarily those of BNY Mellon.

China prefers gold over treasuries

Central bank gold reserves and private holdings have grown

Willem Middelkoop
Commodity Discovery Fund

Until 1927, China had a free banking system based on a silver standard. When Chiang Kai-shek's Nationalist Party came to power in 1927, he wanted to eliminate free banking in China. The nationalists used bank loans instead of taxation to finance their policies. When Manchuria was lost to the Japanese in 1931, the Japanese invaders robbed some 6,600 tons of gold from Nanking, then China's capital. Rebuilding gold reserves clearly has been one of the key components of China's monetary policy.

During the annual Federal Reserve symposium in Jackson Hole in July 2019, Mark Carney remarked that the time had come to work on a 'successor to the dollar', within a 'completely renewed monetary system'. A few weeks earlier, Ray Dalio, chief investment officer at Bridgewater, published 'Paradigm Shift', an article suggesting that the era of ever-increasing fiat money, in which assets rise in value by default, was ending. According to Dalio, gold could again become a permanent part of many portfolios. Soon after, CitiBank and Bank of America advised customers to add gold to their portfolios. BlackRock's CIO even told investors to turn to 'everything the government can't print'.

Many Eastern countries have been accumulating gold, especially since the start of the global financial crisis. Officially, Chinese central bank gold reserves are just shy of 2,000 tons, but experts estimate total Chinese gold holdings, including private holdings, to be around 25,000 tons. Furthermore, some Chinese companies closely aligned with the government, have been buying some of the largest available gold projects worldwide.

Building reserves

China worked hard to increase its gold reserves to at least 8,000 tons. This amount would put the Chinese on a par with the US and Europe on a gold-to-GPD ratio. This would open the way for a possible US-EU-China gold revaluation to support the financial system when needed.

Unlike the dollar, gold doesn't have any counterparty risks. When the US started quantitative easing in 2009, China felt trapped by the size of its dollar holdings. China has been looking for an exit strategy ever since. That same year, Yu Yonding, a leading official of the People's Bank of China, warned that China could turn away from the dollar, 'I wish to tell the US government: Don't be complacent and think there isn't any alternative for China to buy your bills and bonds.'

In 2012, the main academic journal of the Chinese Communist Party's Central Committee published an article explaining China's strategy of hoarding gold in order to safeguard economic stability and to strengthen its defense against 'external risks'. Private holding of gold was an important part of this strategy: 'Practice shows that gold possession by citizens is an effective supplement to national reserves and is very important to national financial security.'

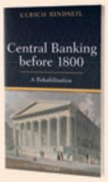
The Chinese have also pointed to the fact the US has promoted selling gold holdings by (Western) central banks, while keeping their own 8,000 tons safely stored in Fort Knox.

PBoC Governor Zhou Zhaoxue said, 'After the disintegration of the Bretton Woods system in the 1970s, the gold standard, which had been in use for a century, collapsed. Under the influence of the US dollar hegemony the stabilising effect of gold was questioned; the 'gold is useless' discussion began to spread around the globe. Many people thought that gold is no longer the monetary base, that storing gold will only increase the cost of reserves. Therefore, some central banks began to sell gold reserves and gold prices continued to slump. Currently, there are more and more people recognizing that the 'gold is useless' story contains too many lies. Gold now suffers from a 'smokescreen' designed by the US, which stores 74% of global official gold reserves, to put down other currencies and maintain the US dollar hegemony.'

An ancient geo-political expression, 'He who has the gold makes the rules', is well known to the Chinese. Now that they have stopped buying US treasuries the pressure on the dollar-system is increasing fast. This makes the growth of the balance sheet of the Fed necessary to support the successful 'sales' of treasuries.

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

Revisiting central banking history



There has always been much to debate in central banking. But in its history, and particularly its early history, there has up to now been a broad consensus. The received wisdom is that with the exception of Sveriges Riksbank (almost universally recognised as the oldest central bank), and the Bank of England (widely thought of as the main developer of much of early central banking practice), central banking largely dates from the start of the 19th century at the earliest.

Until today, and a new book by Ulrich Bindseil, *Central Banking before 1800*. Bindseil is the director general of market infrastructure and payments at the European Central Bank. He has worked in central banking, at the ECB and before that at the European Monetary Institute and the Deutsche Bundesbank, since 1994. He is steeped in central banking both theory and practice. And when he gives his book the subtitle 'A Rehabilitation', his readers are warned that a serious revision of history is in store.

For Bindseil's main argument is that central banking has a much older and richer history than is widely thought, and that instances of central banking operations in the 18th, 17th and even earlier centuries are widespread. He spends the great majority of this excellent and impressively researched book not only detailing early examples of central banking, but quoting copious papers, books and other references to show it.

Bindseil's contends that although the title of 'central bank' may be a post-1800 innovation, the operations of central banking, the main facilities and services they provide, have been commonplace for much longer. His position is unequivocally that if an institution thinks like a central bank, and operates like a central bank, then it is correct for us to consider it as a central bank, even if contemporaries had another name for it.

And what is the key function that Bindseil develops and uses as his touchstone to identify a de facto, even if not de jure, central bank? Interestingly, it is not the commonly thought one of 'banker to the government'. For Bindseil, this can be done by almost any banking institution. It is not even a monopoly function, as there is nothing to stop the authorities maintaining multiple accounts with many different banks.

Nor does Bindseil use a second commonly considered function, that of the 'lender of last resort', or final backstop for the banking system.

Rather, the author puts forward a more technical function, that of providing the ultimate final settlement in a banking system. He argues that central banking should be defined as concerned with the issuance of 'central bank money' or financial money (that is, money in the form of an asset that is a financial claim on someone else, rather than for example commodity money or specie, bullion, and the like) that is universally considered to have the highest possible credit quality within its economy and which is accepted for settlement of any other financial claim.

Debating independence

Such financial money will, if it is successful and widely accepted, quickly establish a central position in an economy's payment system. It will acquire two other features that Bindseil notes as important elements of central banking: that it forms both a public good and a natural monopoly. An economy or financial system with a successful final payment money will have no need to create a second.

'Bindseil has discovered institutions operating 500 years ago that were beyond doubt providing central banking services.'

This enables him to explore two more characteristics of early central banking: right from the earliest examples he can find (and they go back into the 15th century), the institutions set up to provide this final settlement facility were based on public charters, and also from very early on there was an active debate about their independence.

Without doubt, in undertaking this wholesale revision of our understanding of central banking, Bindseil has with this book made an important contribution to the study of the subject. By delving deep into history, he has rethought what the essential features of central banking are, and discovered institutions operating 500 years ago that were beyond doubt providing central banking services. Bindseil's work enables us not only to look at past institutions with renewed interest, but reassess their modern day successors as well.

Given the power that central banks have, with their extended balance sheets through quantitative easing and monetary financing, and their interaction with finance ministries and ever-deeper involvement in our economies as the world struggles to emerge from recession, this is not just an important book, but a hugely timely one as well. ●

John Nugée, a former Chief Manager of Reserves at the Bank of England, is Senior

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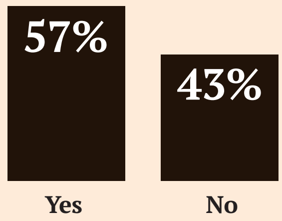
Die Welt

The new world order

There are marked differences in how eastern and western governments have handled the crisis, and the pandemic has heightened tensions between two of the world's superpowers, the US and China. With no single entity so far willing - or able - to lead a global response to the pandemic, is this the end of multilateralism, and the start of a new world order?

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



For years, our multipolar world has been full of regional conflicts. In this instance, the lack of a leader guarantees multilateralism. The emergence of a leader would end it. The pandemic has made it even clearer that the world has two competing superpowers, China and the US.

Miroslav Singer, Generali Group

This exceptionally severe global crisis, with an adverse impact on both the demand and supply side, does not mean the end of multilateralism. However, a pandemic of this nature forces governments, as well as local institutions, to co-operate more effectively. This, in turn, may trigger the start of a new world order because the current multilateral institutional set-up fails to address the underlying weaknesses for addressing this crisis.

Hans Blommestein, Vivid Economics

I am still hopeful that the US will reinvest in multilateralism under new leadership. The alternative is constant jockeying between global powers – a dynamic that has led to wars in the past.

Irena Asmundson, California Department of Finance

Multilateralism and global political stability are built on the intrinsic stability of their member parts. The post-1945 period enjoyed high stability among western democracies as well as newly Communist states under the auspices of their respective superpowers. The decline in the standing and power of global institutions is partially reflective of the failure of the social contracts within western democracies, thus undermining the strongest supporters of global order. It doesn't help that the dominant emerging challenger is composed of a political system consistently worried about its own legitimacy and social stability. This leaves little room for the restoration of world order, instead creating power vacuums across the globe, with regional initiatives of varying success to manage them.

Elliot Hentov, State Street Global Advisors

Yes, this is the end of the multilateralism to which we have become accustomed. This is due to the nature of the leadership in both the US and China as much as it is to the pandemic. In countries such as the US and UK, the same mentality has prevented the main political parties from coming together to address Covid-19 as might have been expected in the past.

Colin Robertson, SW1 Consulting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