The Bulletin

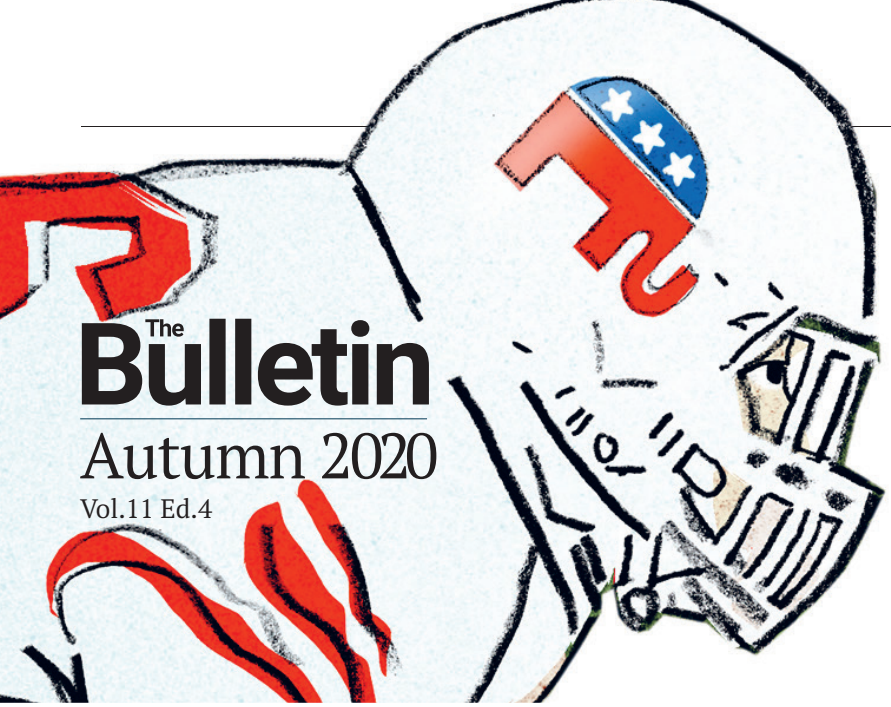
OMFIF

Autumn 2020
Vol.11 Ed.4

STATE OF THE UNION

US SPECIAL FEATURING:

The future of the Fed
Barriers to voting
US-China relations



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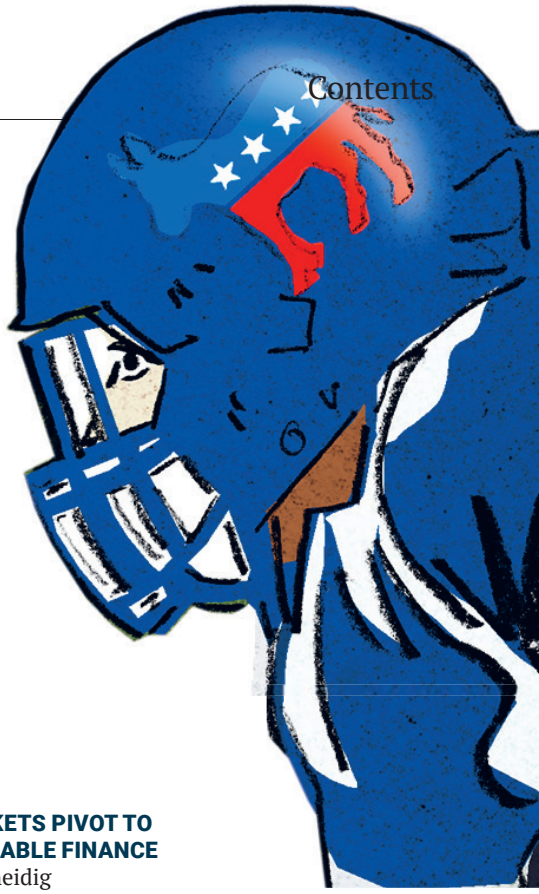

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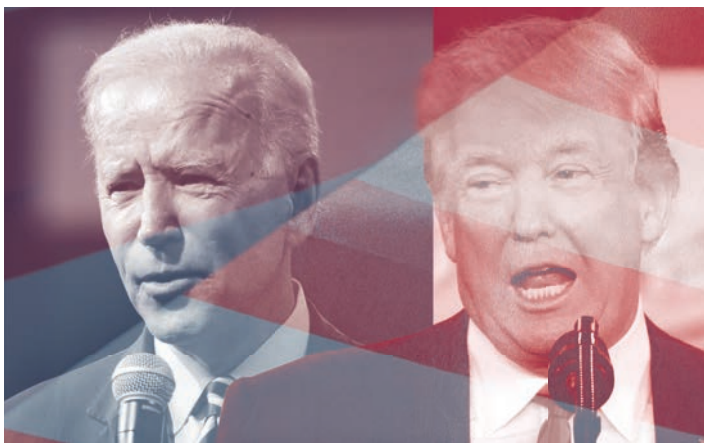
Cover illustration by Ellie Foreman-Peck @elliefp



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State of the union

Donald Trump's ascension to the White House upended US politics, and the Republican party in particular. This year's presidential contest offers voters a choice between the unorthodox and pugnacious incumbent, Donald Trump, and former Vice-President Joe Biden, who has promised a return to 'normal' politics if elected.

The run-up to 3 November has been nothing short of chaotic, marked by the largest presidential field in US history (28 candidates ran in the Democratic primary), and a virus that has killed more than 200,000 Americans and even infected the president and his entourage.

Biden has enjoyed a consistent lead in the polls, but if the 2016 contest is anything to go by, it would be unwise to underestimate Trump and his allies. The cloud of uncertainty enveloping this election is unlikely to dissipate on the night of 3 November. The president has hinted that he would reject the voting outcome should he lose, claiming that postal voting – which has surged in the light of the pandemic – would lead to the most corrupt election in US history. A protracted court battle for the White House may await.

The electoral outcome may depend on the measures that states take to ensure people are able to vote. Kat Usita dives into data from past contests to identify voting hurdles, and how to overcome them. Regardless of the result, writes Pierre Ortlieb, the Federal Reserve is likely to remain a pillar of stability, while continuously rethinking and reinterpreting its mission. Our US Chairman, Mark Sobel, draws on his extensive experience in the US Treasury to take stock of how the relationship between Beijing and Washington has evolved over the past 20 years, and what this tells us about where it might go next. Other contributions in this edition touch upon the future of the dollar, US sovereign debt, and how the election could affect interest rates.

For more on the US economic outlook, be sure to sign up to our regular updates to keep up to date with our analysis and forthcoming meetings.

» 7 July

From protest to lockdown: Chile's economy in 2020

Chile's economy faces a challenging 2020, with social unrest and protests at the start of the year, followed by the economic impact of the Covid-19 pandemic. Joaquín Vial, deputy governor at the Banco Central de Chile, discussed how Chile has been coping with these challenges as well as its outlook for the rest of the year and into 2021.

»15 July

Post-pandemic: China-Europe relations

Amid growing tensions between the US and China, the UK's ban on the use of Huawei in its 5G network, and Hong Kong protestors dominating the international stage, the Chinese Ambassador to the UK, Liu Xiaoming, spoke to OMFIF's David Marsh on the future of China-Europe relations.

»27 July

In conversation with Poul Thomsen

Europe faces numerous challenges, ranging from crisis response and fiscal co-operation, to questions on future integration, European Central Bank action and political uncertainty. Poul Thomsen, director of the European department at the International Monetary Fund, discussed the future of Europe.

»29 July

Global Public Investor 2020 Europe launch

The *Global Public Investor*, now in its seventh year, is devoted to public sector asset ownership and management around the world. The European virtual launch focused on how key European and American institutions have managed the economic and financial fallout from Covid-19. Themes included recovery plans, implications for central bank balance sheets, and debt sustainability.

»16 July

The acceleration of digital trade

OMFIF and the Institute of South Asian Studies at the National University of Singapore convened a panel to discuss the outlook for future trade deals, governance of the digital economy and cross-border payment networks.

»23 July

Artificial intelligence in finance

As the use of artificial intelligence and machine learning in financial services increases, the sector faces mounting technical, organisational, financial and policy challenges. Olivier Fliche, director of fintech and innovation at the Autorité de Contrôle Prudentiel et de Résolution, discussed the impact of AI on financial market regulation.

»6 August

Behavioural science in financial policy-making

Effective supervision and communication are core functions of central banks. Yet since the 2008 financial crisis, these tasks are becoming increasingly complex. This panel discussed how central banks use behavioural research to supervise the financial sector and implement communication strategies.

»18 August

State of Brexit

With the post-Brexit transition period set to end on 31 December, negotiations between the UK and European Union are in full swing. Bernard Jenkin, member of parliament for Harwich and North Essex, discussed the state of Brexit and the UK's trade relationships with the US, China and Australia.

»19 August

Policy response to Covid-19

Jens Ulbrich, director general for economics at the Deutsche Bundesbank, discussed the German and European policy responses to the Covid-19 pandemic.

»27 August

A five-point plan for sustainable recovery

William White, former chairman of the Organisation for Economic Co-operation and Development review committee, and Prakash Kannan, chief economist at GIC, discussed the importance of monetary and fiscal policies for a sustainable recovery.

»6 August

In conversation with Robert Kaplan

Robert Kaplan, president and chief executive officer of the Federal Reserve Bank of Dallas, joined OMFIF's David Marsh for a discussion on the US economy, the Fed's outlook and the global situation.

»12 August

2020 US election and the global economy

The US economy tends to fare better in election years, but the impact of the coronavirus pandemic is set to end that trend. The US is facing other challenges too, all of which make the outcome of the 2020 presidential election difficult to predict. OMFIF and the CFA Society Singapore convened a panel to discuss the potential scenarios, their impact on global financial markets and the effect on the US-China relationship.

»3 September

Public investors in the Covid-19 world

State Street Global Advisors and OMFIF convened a series of panel discussions on key strategic issues impacting the investment community. These meetings brought together senior representatives from sovereign funds, central banks and public pensions funds across Asia to discuss topics that are directly relevant to their investment challenges in the Covid-19 world.

»29 September

The economics of artificial intelligence

This seminar, held in partnership with the Federal Reserve Bank of Philadelphia, focused on the economics of artificial intelligence and machine learning. Topics of discussion included macroeconomic developments, transforming financial systems, the future of work, and regulatory challenges. Speakers included Patrick Harker and Simon Freyaldenhoven of the Federal Reserve Bank of Philadelphia.

»16 September

CBDCs and commercial banks: Evolution or revolution?

OMFIF's Digital Monetary Institute, in partnership with ING Group, convened a panel discussion to explore what a retail CBDC public-private partnership would look like and how this would shape banks' business models.

»21 September

Building a sustainable economic and financial future

The inaugural SPI meeting marked the release of a joint report with Refinitiv, The Role of Data in Sustainable Investment, Policy and Regulation. It featured a panel discussion and presentation of the report's findings. Key themes included sustainability risks in supervision and regulation, means of scaling up sustainable capital markets and sharing best practice for ESG investment.

»16 September

Five considerations for a sustainable recovery

William White, former chairman of the economic and development review committee at the Organisation for Economic Co-operation and Development, joined Robert Holzmann, governor of the Oesterreichische Nationalbank, Pierre Siklos, professor at the Balsillie School of International Affairs, and Danae Kyriakopoulou, chief economist and director of research at OMFIF, to discuss his paper on the five considerations for a sustainable recovery.

Agenda

»Tuesday 20 October, Virtual

David Lidington and Brexit

Virtual discussion with David Lidington, former Conservative member of parliament, minister of state for Europe under David Cameron, and deputy prime minister under Theresa May. In the aftermath of the EU-UK summit, he discusses the future of EU-UK relations, Boris Johnson and his cabinet, and the future for the Conservative party.

»Thursday 29 October, Virtual

Central America: Integration, investment and financial market developments

Virtual panel to discuss the findings of a new OMFIF report, Central America: Integration, Investment and Trade Opportunities, produced jointly with CABEI, and reflect on opportunities and challenges in financial market development.

»Tuesday 3 November, Virtual

Developing European capital markets: The next stage

Virtual seminar shedding light on the resilience of the European economy and the role of capital markets, and how to pursue the transition towards a more varied funding mix through the development of deep, liquid and integrated debt and equity markets.

»»Thursday 5 November, Virtual

City Lecture with Jens Weidmann, President, Deutsche Bundesbank

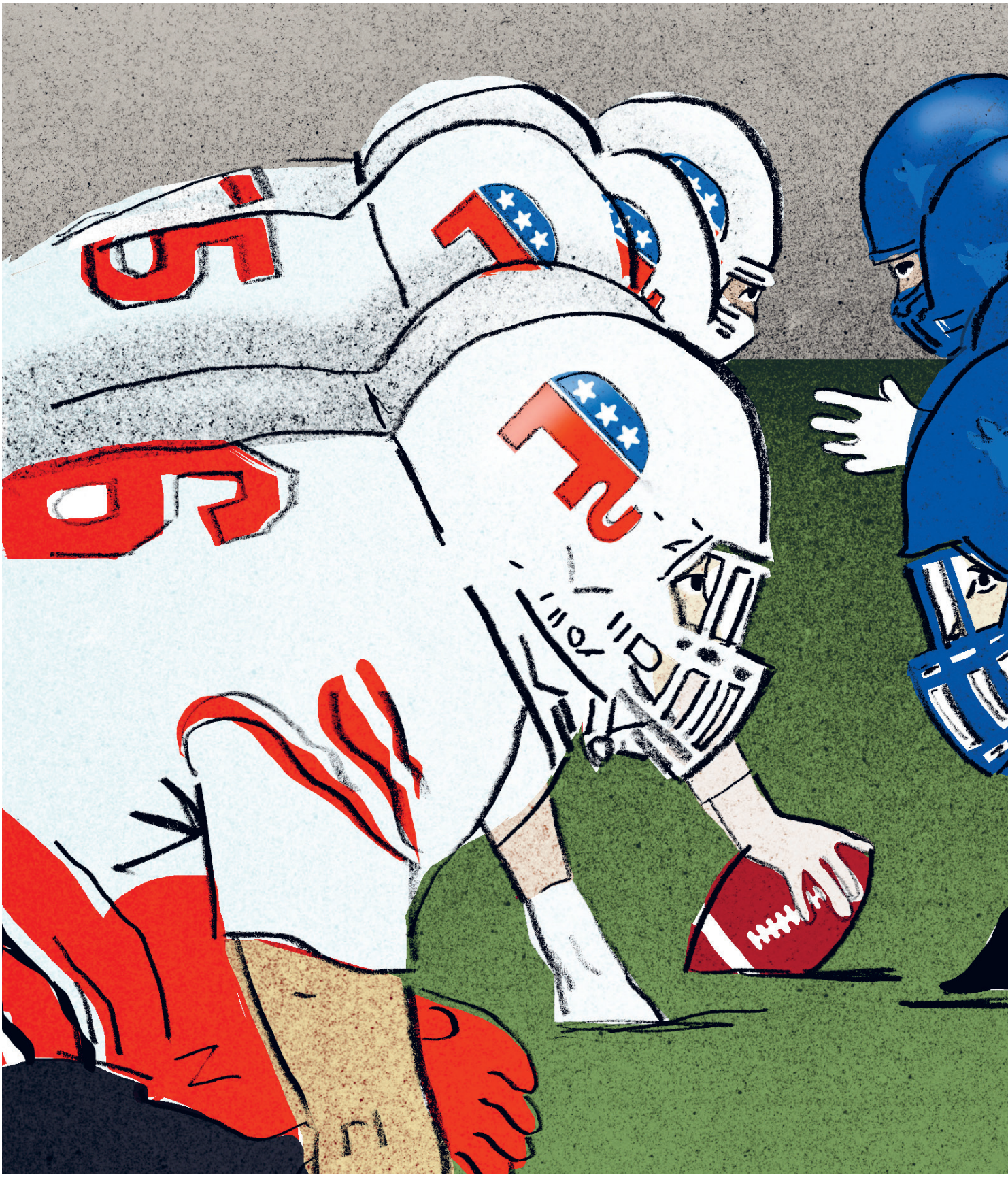
Virtual discussion with Jens Weidmann outlining his thoughts on economic developments and monetary policy issues. In the light of the Covid-19 pandemic, he discusses how the Eurosystem has adopted a range of crisis measures, and the risks involved in extensive purchases of sovereign bonds.

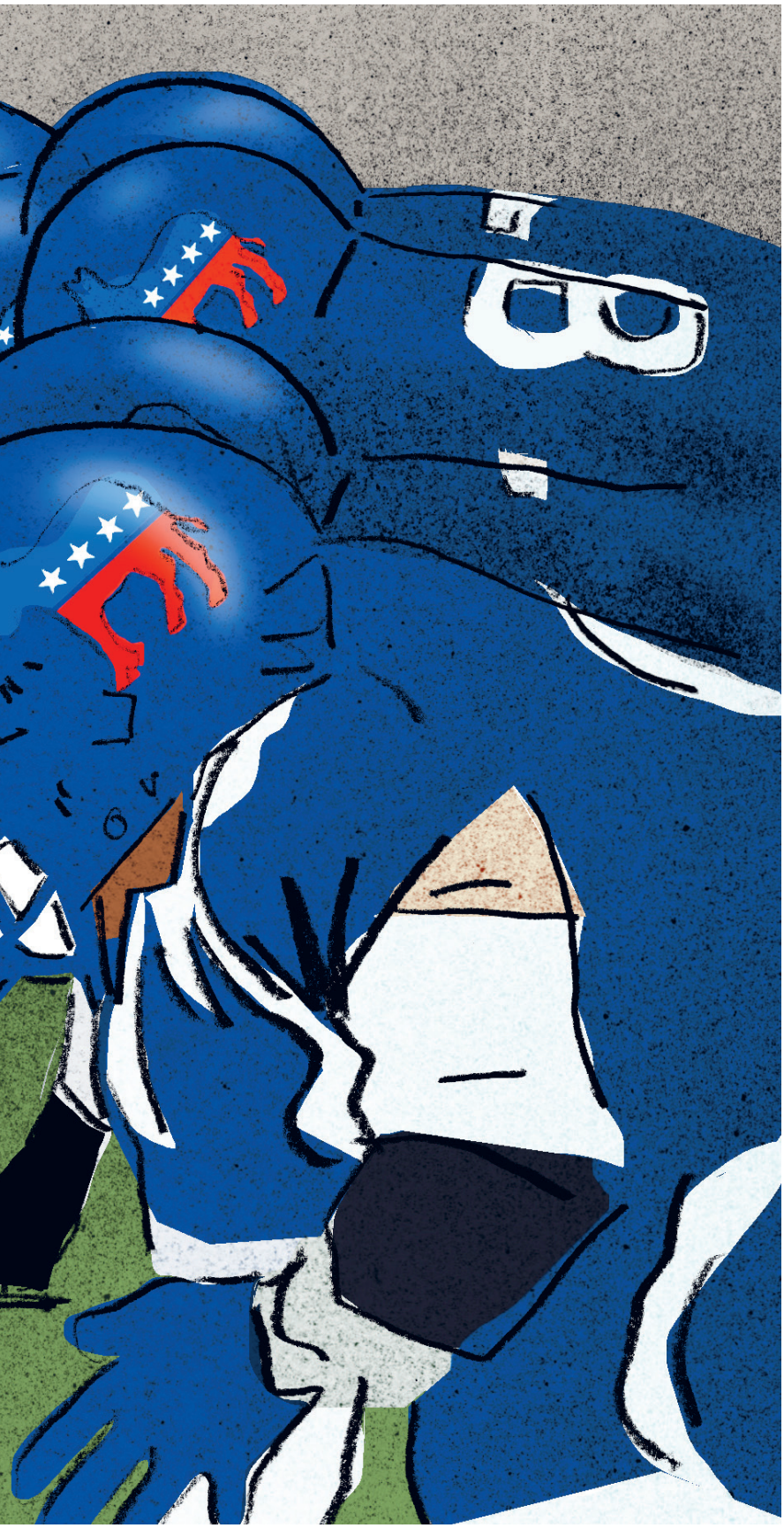
»Wednesday 11 November, Virtual

Beyond Libor

Virtual panel with OMFIF and the SEACEN centre to discuss the move away from Libor and its impact on financial stability. With the London inter-bank offered rate set for retirement at the end of 2021, regulators are working on the transition to alternative risk-free rates.

For details visit omfif.org/meetings





STATE OF THE UNION

As Americans head to the polls, the last few years of US policy-making and economic performance provide an indication of what could be next for Washington.

Remaking the Fed

Fed to shoulder ever-greater burden of policy-making

Pierre Ortlieb
OMFIF

The conclusion of the Federal Reserve strategic review represents an end and a beginning. It has decided to move away from the inflation target framework it has had in place since the 1990s. Yet this change is merely the first step in a long process of reimagining its interpretation of the Fed's dual mandate. Much like it has altered the way it interprets maximum employment in the wake of low inflation and the breakdown of the Philips curve – the inverse relationship between unemployment and inflation – it will have to square future economic policy responsibilities, such as racial inequality and climate change, with its congressionally-mandated objectives.

In August, Chair Jerome Powell announced that the Fed would shift away from an explicit 2% target and towards average inflation targeting. The central bank concedes that the relationship between growth, employment and prices is no longer as clear-cut as many macroeconomists and monetary policy-makers thought it to be a decade ago. Lacklustre inflation in developed economies since the 2008 financial crisis is a reflection of broader economic performance. The inflation targeting regime in place in Europe and the US meant that there was little chance to ever 'make up' for previous poor performance. The Fed's framework review is an acknowledgement of this limitation and its constraining effect on employment, and a promise to avoid repeating previous errors (Figure 1).

There is well-founded scepticism over whether monetary policy can achieve inflation above 2% for an extended period of time, given the shortfalls of the past decade. Yet the most important implication of the strategic review is that it represents a reinterpretation of the Fed's relationship to its mandate. The central bank has recognised that economic fundamentals and political necessity are different now. It has accordingly redefined and clarified how it intends to apply its mandate, allowing the economy to 'run hot' in order to better achieve its twin employment and price stability targets. The Fed's understanding of maximum employment, and the determinants and benefits thereof, have changed, and policy must evolve accordingly – this is the main conclusion of the strategic review.

Continuous dialogue

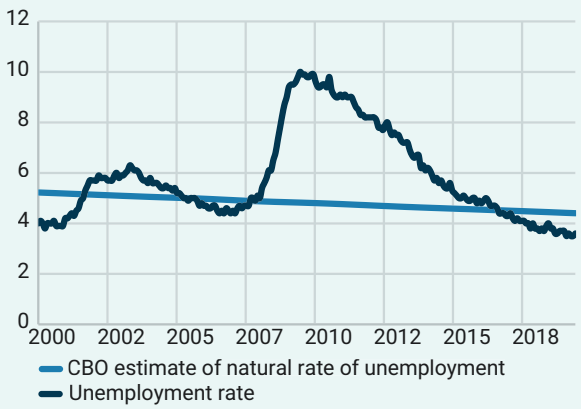
However, as the central bank becomes increasingly entrenched as America's dominant economic policy institution, it will acquire more and more responsibilities – whether this comes in the shape of tackling racial inequality or grappling with the climate crisis. These responsibilities will in effect require the strategic review to continue indefinitely, in a continuous dialogue with the dual mandate and the 1974 Humphrey-Hawkins Act. The Fed's future is an ongoing, creative, and necessary reinterpretation of its stated mission that will last as long as central bank independence does.

This process will bring a number of challenges. One of the most important has to do with distribution, employment, and racial inequality. The realisation that a hot labour market disproportionately benefits disadvantaged groups was one of the key rationales for the shift towards average inflation targeting. As Jerome Powell noted, 'a clear takeaway from these events was the importance of achieving and sustaining a strong job market, particularly for people from low- and moderate-income communities.' Yet this is only the first move in the Fed's relationship to racial justice issues. In recent months, it has faced calls from prominent US policy-makers, including presidential candidate Joe Biden and Congresswoman Ayanna Pressley, to pay greater heed to economic disparities between ethnic minorities. Biden has vowed to make racial injustice a greater priority for the Fed and to nominate minorities to its leadership.

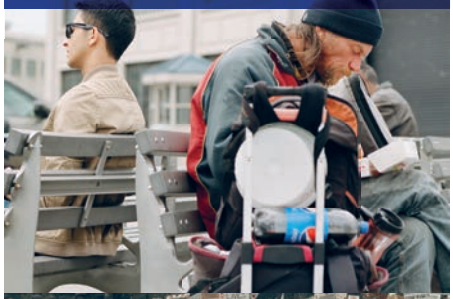
Figure 1: Hikes begin in December 2015 despite room to grow

Congressional Budget Office estimate of the natural rate of unemployment, %, and US unemployment rate, %, Jan. 2000 Jan. 2020

Source: FRED



'Much like the Fed has altered the way it interprets maximum employment, it will have to square future economic policy responsibilities, such as racial inequality and climate change, with its congressionally-mandated objectives.'



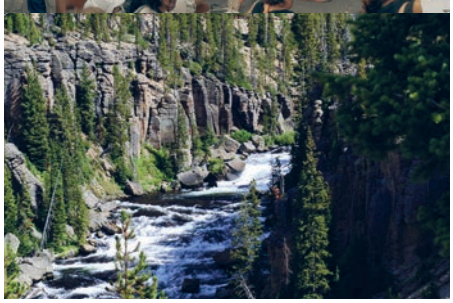
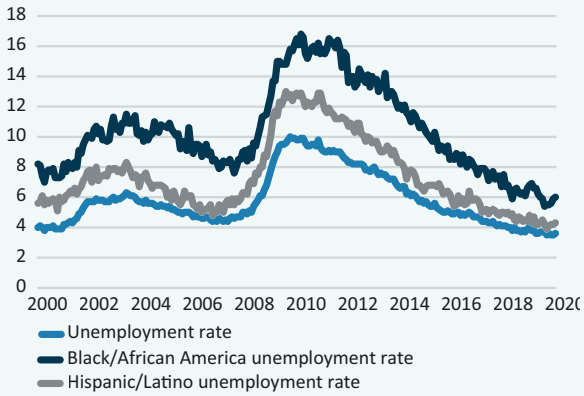


Figure 2: Hot labour market brings disavantaged groups into fold

Total unemployment rate, Black/African American unemployment rate, and Hispanic/Latino unemployment rate, %, Jan. 2000 Jan. 2020

Source: FRED



Congresswoman Pressley, meanwhile, has co-sponsored a bill that would require the Fed to regularly report on progress towards closing racial wealth and income gaps.

These demands on the Fed acknowledge its centrality to broader questions of political economy and exemplify its ongoing dialogue with its mandate. Humphrey-Hawkins requires the central bank to work towards reducing employment gaps between marginalised groups and the broader population. But the maximum employment legislation does not explicitly make this racial justice angle a cornerstone of monetary policy strategy. Rather, it is up to the Fed to define 'maximum employment'. Just as it has moved away from natural rates of unemployment and the Phillips Curve as part of its switch to average inflation targeting, future reviews, whether formal or informal, will require the institution to think about what maximum employment means for different ethnic groups.

Climate emergency

A similar process will be required as climate change becomes an increasing priority for the Fed. With Congress and other policy institutions seemingly unable or unwilling to engage with the climate emergency, the responsibility to act appears to be falling on the Fed. In a recent speech, Governor Lael Brainard noted that 'monetary policy-makers must accurately assess how disasters such as hurricanes, wildfires, and flooding affect labour markets, household and business spending, output, and prices.' She added that 'to fulfil our core responsibilities, it will be important for the Federal Reserve to study the implications of climate change for the economy and the financial system.' Yet it is far from clear how this will translate into monetary policy strategy, and how, specifically, it relates to the Fed's dual mandate. As Brainard herself pointed out, it will be 'challenging to assess what adjustments to monetary policy are likely to be most effective at keeping the economy operating at potential with maximum employment and price stability.' How the Fed chooses to do so, and which way it leans between the two objectives, will require introspection.

The Federal Reserve is at a critical juncture. On the one hand, it is carrying the burden of US economic policy to an ever-greater extent. On the other hand, it is situated within an institutional framework that does not yet give it the flexibility or potency to fully address the challenges it faces.

Balancing these two points requires a dialogue with Congress and its mandate, as it both specifies its strategic approach and broadens its horizon of responsibilities. ●

Pierre Ortlieb is Economist at OMFIF.

Voting hurdles, and how to overcome them

Socio-economic factors hinder political participation

Kat Usita
OMFIF

Voting is the most basic form of political engagement and democratic participation. However, socio-economic factors affect the ability of an American voter to participate in elections. These are likely to be exacerbated by the pandemic.

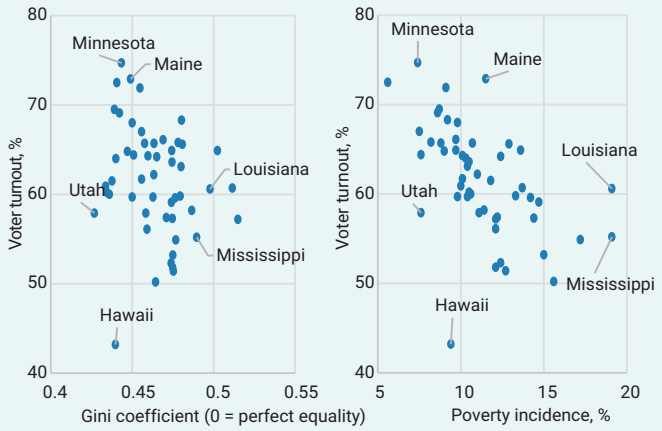
Data from the 2016 presidential elections reflect the relationship between household income and voting behaviour. Pew Research Center found that 56% of non-voters had annual household incomes under $30,000. Only 28% of voters fell under this lower income bracket.

The cost of taking time off work to vote may be too high, especially for hourly and daily wage earners. Lack of available transportation can make accessing a voting precinct difficult. Parents and other individuals with caregiving responsibilities may be unable to leave their homes on election day.

To mitigate the effect of resource constraints, some states offer alternatives: early in-person and postal voting. In the time of Covid-19, these alternatives are crucial to prevent virus outbreaks. The Center for Disease Control and Prevention recommends offering these alternative methods of voting, as well as lengthening voter periods to prevent crowd formation and shorten waiting times.

States struggling with high inequality and poverty incidence have lower voter turnout

Voter turnout, %, 2016 vs Gini coefficient, 2019, and poverty incidence, average %, 2017-19



Source: United States Elections Project, US Census Bureau, OMFIF analysis

Underlying factors

Other less tangible, underlying factors can impact voting behaviour. Educational achievement, which tends to be positively correlated with household income, can influence a person's motivation to vote. The ability – and more importantly, desire – to consume political information can determine whether one shows up to the polls. An eligible voter disillusioned by politics due to their lack of socio-economic mobility may be dissuaded from participating.

States with low levels of inequality and poverty tend to have better turnout rates. Minnesota, which had the highest turnout in the 2016 general election and 2018 midterms, has the second-lowest poverty incidence and is in the bottom quintile for income inequality as measured by the Gini coefficient. In contrast, Mississippi and Louisiana, tied for highest shares of poor households, fall on the lower end of voter turnout.

Nevertheless, states with high levels of poverty and inequality do not need to fall behind in turnout if they can make voting easier. Maine's poverty incidence of 11.5% hovers just above the average for states, but it came in second for turnout in 2016. It could be because Maine was the first of 21 states, plus the District of Columbia, to allow same-day voter registration.

There could be other factors at play, including the partisan dynamics spurred by the electoral college system. Utah enjoys low income disparity and has one of the smallest shares of poor households. It is also known to be a Republican-leaning state, which could explain why it has relatively low turnout. People who think that they are unable to influence the outcome have little incentive to vote.

Hawaii is an outlier. It has the lowest voter turnout by a wide margin, despite performing well on inequality and poverty metrics. Geography and time differences play a big part. Hawaiians get projections of results even before their polls close, which could discourage them from seeing the value of their participation.

For some of the 43 states (and DC) that offer early in-person voting, the 2020 elections are already ongoing. Undoubtedly, the results will be affected by how individual states are dealing with the pandemic and whether they are able to provide voters with a safe and efficient electoral process. The unprecedented circumstances of this election should compel state authorities to recognise the urgency of improving voting access, especially for households with limited resources. ●

Kat Usita is Deputy Head of Research at OMFIF.

Trump trade

Policy escalation would threaten recovery

Jean-François Perrault
Scotiabank

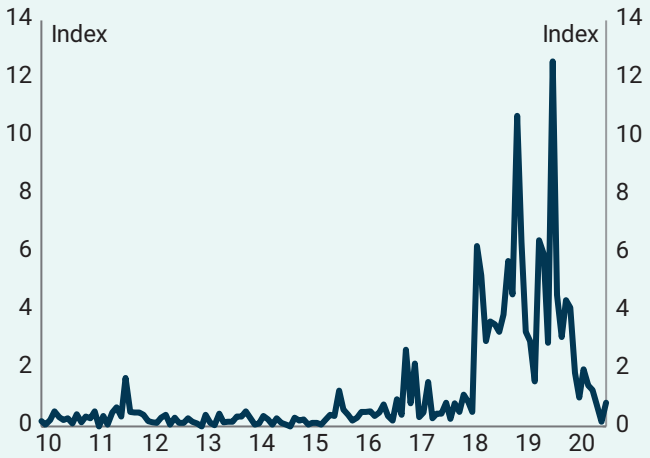
A key characteristic of US President Donald Trump is his open hostility to established trade rules and clear preference for managed trade. Falsely arguing that the trade deficit reflects the US' commercial partners taking advantage of America, and not a fundamental lack of national savings, he has sought to alter key relationships to reduce the trade deficit – to no aggregate effect. In fact, the US trade deficit in goods is 22% higher than it was when the president was inaugurated. More telling, once oil and gas are removed from the equation, the US trade deficit in goods is nearly 50% higher than it was in January 2017.

For a time, Trump's efforts to reduce the trade deficit through negotiations, threats, interventions and manipulation led to historically high measures of trade uncertainty. It may seem like the distant past, given the pandemic, but the US-China trade war and its potential evolution were the dominant risk to the global and US outlooks for much of 2018 and 2019. The uncertainty was not limited to China. On-again and off-again threats to pull out of the North American Free Trade Agreement, near constant threats to penalise Mexico, regular intimidation of European auto manufacturers, and the perversion of national security clauses to limit steel and aluminium imports, stand out in a long list of trade irritants. These conflicts created much unpredictability, affecting global business sentiment and activity. The high levels of risk probably contributed to the dollar's strength during this period, reducing US competitiveness, despite repeated, not-so-subtle attempts by Washington to talk the dollar down.

This uncertainty has come at a cost. In the US alone, we estimate that the sharp rise in trade uncertainty resulted in a cumulative reduction of nearly three-quarters of a percentage point in the level of economic activity by Q4 2019, relative to a scenario in which trade uncertainty was at its historical average. This is a formidable headwind, with global economic and policy implications.

Significant market volatility created from a sharp rise in trade uncertainty in late 2019

US Equity Market Volatility Index, trade policy component



Source: Scotiabank Economics, PolicyUncertainty.com

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'Recent statements by Trump suggest a second term would come with a potentially significant escalation of global trade tensions.'

Covid reprieve

In the early weeks of Covid-19, President Trump seemingly set aside his focus on trade issues. Our hope had been that with a 'phase one' deal with China agreed and the intense efforts needed to manage the pandemic, there would be more stability on the trade antagonism and policy front. This lasted for a while, but the need to assign blame for the effects of the virus in the US quickly led to a more contentious position against China, a threatened re-imposition of aluminium tariffs on Canada, and a renewal of concerns about European trading practices.

While there is little opportunity to inflict much trade-related economic harm for the remainder of his mandate, recent statements by Trump suggest a second term would come with a potentially significant escalation of global trade tensions. Of particular concern is an implied acknowledgement of the need to be economically self-sufficient. Recovering ground lost to the pandemic is going to be challenging. Escalating trade tensions would be a strong threat to recovery efforts, one which the US and global economies cannot afford. ●

Jean-François Perrault is Senior Vice-President and Chief Economist of Scotiabank.

China's rise underlies shifting US relations

Economic growth has emboldened Beijing

Mark Sobel
OMFIF

The tectonic plates under the US-China relationship have shifted over the last two decades.

In 2000, prior to joining the World Trade Organisation, China represented less than 4% of global GDP. Twenty years later, it accounts for more than 16%. Irritants when China's global economic weight was low could not be ignored as China became the world's second largest economy.

In the early 2000s, while problems were plentiful, US-China bilateral engagement was strong. The US sought to help integrate China into the global economy, promoting market reform and liberalisation. China favourably viewed US economic dynamism as worthy of some emulation. But the 2008 financial crisis diminished America in the world's and China's eyes. Many in Beijing asked whether a new teacher was needed.

After the crisis, America's view of China dimmed. There were national security challenges about whether China would help curb North Korean military behaviour, and Chinese territorial ambitions in the South China Sea, among others. Economic engagement remained strong, but longstanding trade complaints, the large bilateral deficit and alleged currency manipulation continued complicating the picture.

China's phenomenal growth bolstered the country's self-assertiveness. It was also associated with massive corruption and inequality, leaving many citizens behind. Some Chinese leaders viewed these developments as a threat to the Communist Party and to the state.

President Xi Jinping's ascent quickly increased concentration of power in the party, state, and himself. The state's role in economic life was reinforced. State-owned enterprises, financed by major state-owned commercial banks, were boosted in prominence. Under the rubric of 'indigenous innovation' and 'Made in China 2025', China heavily pursued an industrial policy predicated in part on widespread subsidisation. Foreign firms were subjected to forced technology transfers and arbitrary legal protections.

If, by its end, the Obama administration's view of China had darkened, the Trump administration took the darkness to a new level. Initial efforts to pursue economic engagement were seen as failing and abandoned. China was considered increasingly as an adversary and national security threat, bent on overtaking America's military and technological leadership. Problems concerning forced technology transfer and industrial policy remained acute.

Technological skirmishing intensified, evident in US actions on Huawei's 'death sentence', WeChat, TikTok and chipmakers. The US is concerned about hacking and cybersecurity, fearing that China is gathering personal data about American citizens. Some now speak of technological cold war and 'splinternet'.

US-China 'decoupling'

The Trump administration has ratcheted up tariffs on Chinese goods. Aggressive trade enforcement is here to stay. Chinese foreign direct investment in the US is drying up. Americans feel Beijing seriously erred in not quickly informing the world about the looming pandemic. Recently, there has been heightened attention to delisting Chinese firms from US exchanges.

It takes two to tango. China is an increasingly forceful global power. Its actions in Hong Kong exacerbate fears about Xi's growing authoritarianism. Beijing views the US as seeking to 'contain' China. It is a proud country that will not buckle to foreign pressure.

If US-China 'engagement' and China as a 'responsible stakeholder' had once been buzzwords in Washington, they were long ago replaced by 'strategic competition'. Today, 'decoupling' seems to be America's mantra. Whether decoupling is realistic given the presence of worldwide firms in China, global supply chains, and economic interdependencies is seemingly irrelevant.

The growing confrontation has helped make hawks ascendant in Beijing and Washington. Alarms about China are largely shared across the US political spectrum, among both Republicans and Democrats alike. In the presidential campaign, neither side will allow itself to be out-hawked by the other. The rhetoric against China will be extremely tough.

What happens after the elections is anybody's guess. There could be different approaches taken toward whether to place more emphasis on bilateralism, or on multilateralism to build alliances to confront China. There may be different views about what America must do at home to meet the challenge, and selective areas of engagement, including economics and finance, and the treatment of Chinese students at American universities.

But the dark view of China, tensions and hardened US attitudes are here to stay. ●

Mark Sobel is US Chairman of OMFIF. He was US Treasury Deputy Assistant Secretary for international monetary and financial policy between 2000-15.

Policy less uncertain than next president

Federal Reserve will maintain fiscal stability

Didier Borowski
Amundi

The outcome of the elections is uncertain. Democratic candidate Joe Biden retains the advantage. Since June, he has gained ground in national polls but has lost ground in swing states, a scenario reminiscent of 2016. Donald Trump won then by a few tens of thousands of votes in four states, while Hillary Clinton was 2.8m votes ahead of him nationally. The electoral college system, with the winner-takes-all rule in most states, makes the US presidential election unpredictable. Not to mention the possibility that the election results may be contested in some states. This naturally complicates foresight efforts, particularly in terms of fiscal policy or international relations.

The next four years of US international relations will be different depending on the outcome of the election. It is this dimension that is most difficult to grasp today in the event of Trump's victory. It is feared that his mercantilism could lead to a more conflictual relationship with Europe, with a possible increase in trade barriers. However, the harshness of transatlantic relations has ultimately contributed to strengthening European Union cohesion in spite of internal dissension. The management of Brexit and the setting up of the recovery fund in July are emblematic. EU leaders are able to agree when their strategic interests are at stake.

Regarding fiscal policy, Trump supports tax while Biden backs higher spending. There is a near consensus among investors that a Trump victory would be beneficial for equity markets, while a Biden presidency would cause a market correction. But this may well be a short-sighted view. Their proposals will only be able to pass through Congress if the House of Representatives and Senate are of the same colour, which seems unlikely. Yet the macro-financial context is different from what it was four years ago. Following a Trump victory, the craze could be short-lived given the already stretched valuations. And following a Biden victory, the correction could be short-lived if real interest rates remain in negative territory and the Democrats and Republicans agree on an infrastructure plan.

Fed continuity

The new fiscal stimulus that is expected before the end of September shows that the expansionary stance of fiscal policy is primarily dictated by the state of the US economy. Whoever wins, US economic policy will remain accommodative.

On the monetary side, the Federal Reserve, by formally adopting an average inflation target of 2% over the cycle, implicitly commits to keeping interest rates unchanged for even longer. The federal debt will thus continue to be very largely monetised in the coming years. And, all other things being equal, this should lead to a weakening of the dollar.

But it remains to be seen against which currency the dollar may fall. Since the beginning of the summer, the natural candidate has been the euro, as the currency was undervalued and Europe appears more credible and resilient than in the past. But no country wants to see its currency appreciate sharply against the dollar at a time when inflation is considered too low and growth too slow. The foreign exchange market is therefore likely to be the scene of new tensions, with a possible 'competition' between the major central banks. ●

Didier Borowski is Head of Global Views at Amundi.

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'The electoral college system, with the winner-takes-all rule in most states, makes the US presidential election unpredictable.'

Why the US AAA rating is at risk

Outlook revision reflects deterioration in US public finances

Charles Seville
Fitch Ratings

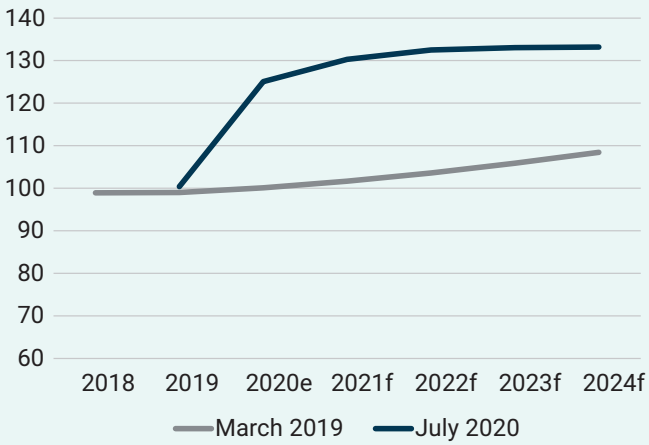
The Federal Reserve's framework review and the very low interest rate outlook it has ushered in have confirmed markets' expectations. This will help make public finances in advanced countries more sustainable than they would otherwise have been. Nevertheless, Fitch put the US AAA rating on negative outlook at the end of July, the first time since 2014.

The US benefits from issuing the dollar, the world's preeminent reserve currency, and from the associated extraordinary financing flexibility. This was highlighted once again by developments since March, namely the ability to borrow on a massive scale, and the supporting role played by the Fed both in the US and abroad. Fitch considers US debt tolerance to be higher than that of other 'AAA' sovereigns. But an outlook revision reflects the ongoing deterioration in US public finances and the potential risk that the system fails to deliver fiscal consolidation.

The Covid-19 pandemic has led to a massive rise in public spending to support demand, overlaying an already troubling picture in terms of deficits and debt. The US had the highest government debt of any 'AAA'-rated sovereign heading into the crisis, and Fitch expects general government debt to approach 130% of GDP by 2021.

Soaring US debt set to stabilise

US general government debt ratio projections, % of GDP



Source: Fitch Ratings

The federal deficit will reach $3.3tn in the fiscal year ending in September.

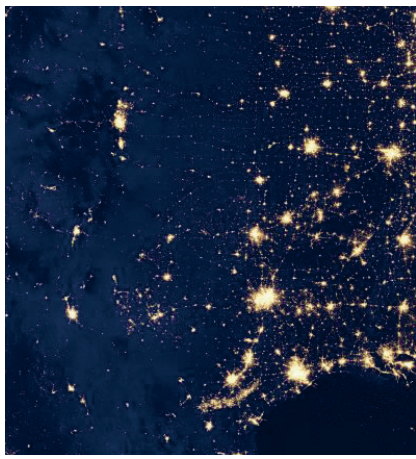
Debt dynamics

Fitch's debt dynamics analysis indicates that debt-to-GDP could stabilise temporarily from 2023 if fiscal balances return to pre-pandemic levels, but only assuming that interest rates stay very low. It is uncertain whether low long-term market rates will persist once growth and inflation pick up, even if the Fed holds down interest rates. Longer-term, a resurgence of inflation might call for a rise in interest rates, potentially even bringing the goals of the central bank and government into conflict, and adversely affecting debt dynamics, although this is not Fitch's core forecast.

At current levels of indebtedness, a 1% rise in the effective rate on the debt would add 1.2% of GDP to the interest bill in a single year. If real growth reverted to 2%, a debt stabilising primary deficit for the general government by 2024 could be around 3%-4% of GDP, comparable with 2019 levels. Healthcare and social security costs are still set to rise over the medium-term while federal revenue in fiscal year 2019 was close to its long-term average as a share of GDP.

The future direction of fiscal policy depends partly on November's presidential and congressional elections. Democratic contender Joe Biden leads presidential polls, and the odds of Democrats overturning the Republican majority in the Senate have shifted in their favour. However, neither party is likely to achieve a 60-seat majority. A continuation of policy gridlock is a risk. Political polarisation may weaken institutions and reduces the scope for bipartisan co-operation, hindering attempts to address structural issues (including some exposed by the pandemic and protests) but also longer-term fiscal challenges. The economic crisis has probably brought forward the point at which social security and healthcare trust funds are exhausted, demanding bipartisan legislative action to sustainably fund or reform these programmes. ●

Charles Seville is Senior Director, Americas Sovereigns at Fitch Ratings.



US shifts toward national distancing

Reactions to pandemic have long-term ramifications

Gary Smith
Sovereign Focus

Globalisation is in retreat. The pandemic has reduced trust between nations, and triggered a desire to shorten supply chains and re-shore production across the world. No one wants to be at the mercy of disruption to essential trade if there is another wave of infection. As physical distancing has become the norm within countries, we are seeing a trend for national distancing between countries.

Increased mistrust has characterised international discourse in recent years, and this has been intensified by the fall-out from the pandemic. An isolationist White House under President Trump is a key reason for the current state of affairs. With 'tough on China' a feature of both the Biden and Trump presidential election campaign rhetoric (albeit with differing points of emphasis), it is difficult to believe that frosty relations will improve in the short term.

News stories surrounding the provision of personal protective equipment helped to frame this problem. In case of a crisis, which nation's interest would a foreign investor in a PPE production facility seek to prioritise? Would the home or host sovereign have first call on the factory's output?

The global financial system is also feeling the cold wind of nationalism and international capital flows are coming under the spotlight. This represents quite a change in sentiment, as cross-border investment flows have traditionally been perceived as a positive aspect of globalisation.

From 1950 to 2000 the dominant flows came from developed nations and went to emerging nations. The Pax Americana liberal capitalist order was in the ascendency. Western rules facilitated access for western nations, and at the same time recipient nations viewed these rules with respect and thought them worth emulating. The risk to investors of expropriation and the risk to recipient nations of an erosion of national sovereignty were believed to be outweighed by the benefits of co-operation.

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'We are seeing a growing challenge to the liberal Western world view, especially by a determinedly nationalistic China.'

New world view

China joining the World Trade Organisation in 2001 and the growth of wealth in hydrocarbon producing nations, led to a surge of capital moving in the opposite direction. Nevertheless, trust in the system was maintained until recently. We are seeing a growing challenge to the liberal Western world view, especially by a determinedly nationalistic China. This has led to a growing resentment in the West towards foreigners having access to a system which they do not fully respect.

Today, pressure is growing to monitor investing across national borders in a manner that we have not seen since 2006-08. That was a period when there were concerns in Europe over the intentions of the Russian gas monopoly Gazprom, while in the US the Senate blocked the planned sale of port facilities to an Abu Dhabi based company. Sensitivity will apply (as it did in the mid-2000s) to investments in fields such as energy and transportation, but also to infrastructure investments such as water, and technology.

In the current climate it is unlikely that a state-owned investment vehicle will be able to achieve a better overall assessment than that of the sovereign nation that owns it. A sovereign fund, such as the China Investment Corporation, may in the future be bracketed with Huawei on national identity grounds, instead of the sovereign fund members' club that has committed to the Santiago Principles. Regulators in recipient nations may fear that in a situation of stress both CIC and Huawei would become equally answerable to Beijing.

The US response to the pandemic has been to focus on itself. This has left doors open for China to build influence. It is unlikely that Washington will be able to isolate China, whose use of both soft and hard power, especially via the Belt and Road initiative, may result in lasting changes to the geopolitical landscape. Developing nations may not have the luxury of being able to refuse help, and loans, from Beijing when there is no competing US offer. The US should wake up to the fact that the new normal after the pandemic may be more than just washing hands and working from home. ●

Gary Smith is Managing Director of Sovereign Focus and a Member of the OMFIF Advisory Board.

Major economies see rapid money growth

Test on competing inflationary theories awaits policy-makers

Juan Castañeda and Tim Congdon
Institute of International Monetary Research

The global policy response to Covid-19 has resulted in marked accelerations in money growth since March in the world's leading economies, particularly the US.

Asset price inflation has already materialised. Consumer price inflation has not yet increased, but an inflationary process is likely to raise the price of goods and services. The rates of increase of money and nominal national income are linked over the medium and long run. Changes in real money growth affect asset prices and balance-sheet strength in the short run, and hence the economy's cyclical path. This explains the signs of a rapid 'V-shape' recovery observed in recent weeks in the US and other major economies.

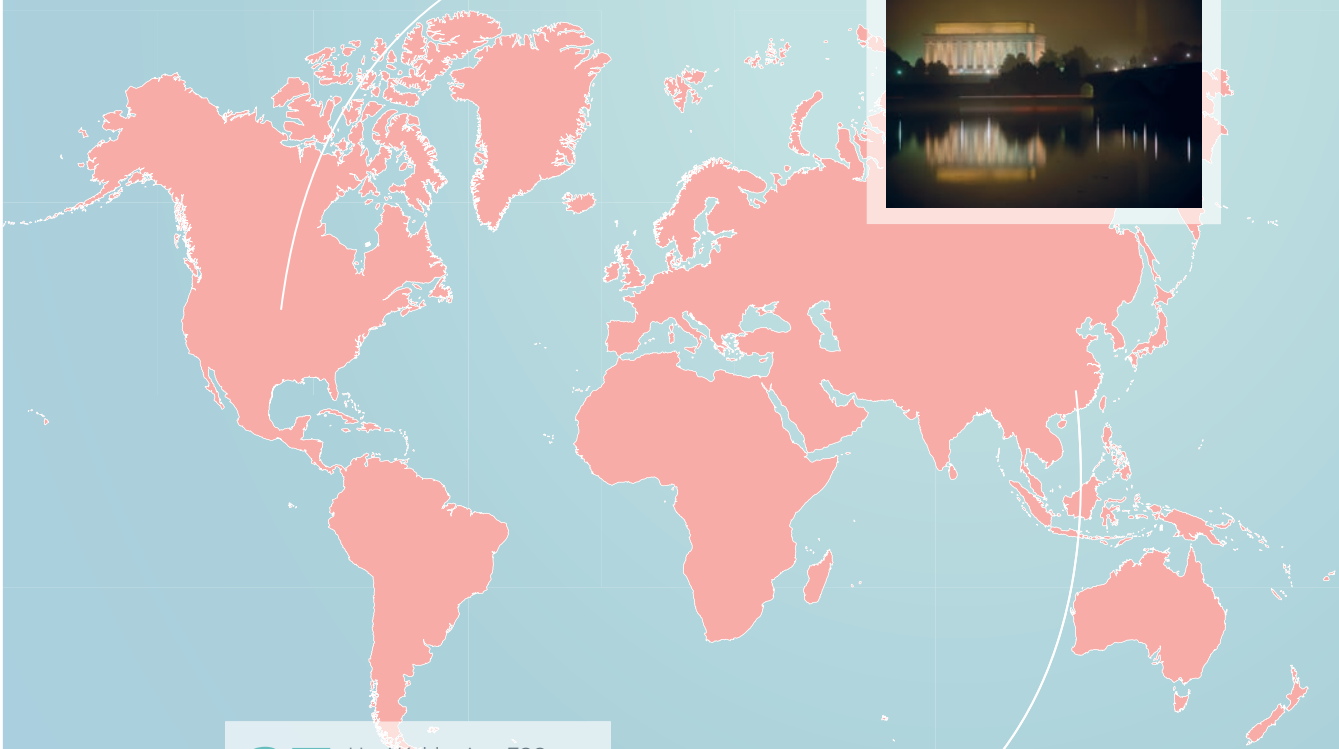
The ratio of cash to assets in market participants' portfolios has increased significantly, for precautionary reasons. This is equivalent to a notable fall in money velocity. It explains why the recent increase in money growth has not been reflected in an increase in nominal demand and overall inflation. However, once the global economy recovers from the Covid-19 crisis, the velocity of circulation will return to more normal levels, reflecting the long-run stability of households' and companies' money-holding preferences. At this point, the accelerations in money growth which occurred in 2020 will probably be followed by similar accelerations in the growth of nominal national income. Given that the pandemic affected the world's underlying productive capacity, much higher growth of nominal national income must lead to higher inflation.

Regrettably, central bankers mostly rely on non-monetary theories of inflation to question whether over the medium to long term, unduly rapid money growth causes inflation. The 'inflation vs. deflation' debate is certain to intensify. Last month, the Federal Reserve announced a new policy strategy ('flexible average inflation targeting'). It signalled that it is prepared to allow consumer inflation to rise above 2% for certain periods of time in order to deliver a long-run average very close to 2%. Unfortunately, the Fed did not provide details on how it will implement this strategy. It seems that the Fed is giving itself greater room to run more discretionary (and inflationary) policies in the future if need be. However, if the annual rate of US money growth exceeds 20% for more than a few quarters, the Fed leadership may be surprised by how quickly inflation takes off into the sort of numbers that worried its predecessors in the 1970s-80s. ●

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



US markets pivot to sustainable finance

Rising awareness is driving green shift

Frank Scheidig
DZ Bank

Sustainability knows no borders. Combating climate change is not a challenge for individual countries or sectors. It can only be tackled by the global community.

The financial sector's role in making society more sustainable has been overlooked for too long. Capital markets have started to take the right path to support this transformation.

For a long time, US financial institutions were said to be lagging their European counterparts when it came to sustainable finance. At one point, this was true. But rising awareness has led to increased levels of sustainable investing and funding.

Sustainable and responsible investing in the US grew 38% between 2016 and 2018. According to the Global Sustainable Investment Alliance, the US is the second largest market for sustainable and responsible investing. In 2018, sustainable assets amounted to around $12tn, representing 26% of total managed assets. In Europe, sustainable assets grew 11% between 2016 and 2018, amounting to around $14.1tn, making up 49% of total assets under management.

Given that the US is the world's largest market for investors, it has huge potential. Vice-President Al Gore said, 'Sustainable investing, defined as "improving quality of life without borrowing from the future", is the single largest investment opportunity in history. Sustainable investing has the magnitude of the industrial revolution but the speed of the digital revolution.'

The pandemic has accelerated the trend. According to Morningstar, sustainable funds in the US saw record inflows of $10.5bn of in the first quarter of 2020, more than half of the record $21.4bn pumped into sustainable funds in 2019.

The increasing importance of sustainable finance in the US is also reflected in the funding side. The global fixed income market, with a volume of more than $100tn, has huge potential to facilitate the transition to a sustainable future.

Sustainable bonds, expected to exceed the $400bn mark by the end of 2020, help industry meet sustainability challenges. They deliver returns on sustainable infrastructure investments, facilitate the reallocation of capital toward sustainable projects, and allow investors to attach purpose to their investments, reconnecting finance with hard assets in the economy. The green bond segment reflects the significant contribution of the US market. With an issuance volume of $51.3bn, the US was the leading country in the green bond market in 2019.

Green goes rainbow

Market diversification, described by us as 'green goes rainbow', has also hit the US funding business. More issuers are looking with more than a single environmental perspective. Covid-19 has boosted this trend. Social bonds have proved themselves a suitable financial instrument in the fight against the economic and social impacts of the pandemic. In March, the Washington-based International Finance Corporation issued a $1bn, three-year social bond, becoming the first issuer to offer a coordinated and global response to the pandemic. In June, the US-based Ford Foundation announced that it intended to issue $1bn of social bonds, making it the first non-profit foundation to offer a labelled social bond in the US corporate bond market.

However, the big difference between Europe and the US when it comes to sustainable finance is reflected in the support from the highest political level. In the US, the regulatory trend for sustainability is hands off; in Europe, it is much more hands on.

In March 2018, the European Union committed to lead the way in reforming the financial system to support the transition towards a sustainable economy, with the adoption of the first ever action plan for financing sustainable growth. At the heart of this is a classification system for green economic activities – the so-called taxonomy. Attracting capital to economic activities that mitigate climate change is the main priority.

In contrast, sustainable and responsible investing in the US faces political and regulatory hurdles. Just recently, the Department of Labour set out plans for a rule that would require private pension administrators to prove that they were not sacrificing financial returns by putting money in ESG-focused investments.

Despite headwinds, the US capital market is headed in the right direction in terms of sustainable finance. More and more financial institutions are aware of the central role they play in the sustainable transformation process. Sustainable funding is no longer a buzzword. Investors' rising awareness is driving demand for more sustainable and responsible investing. Cities and states across the US are building financial roadmaps for a more sustainable and resilient future. At some point, it should become clear to everyone that sustainability is not fake news. ●

Frank Scheidig is Global Head of Senior Executive Banking at DZ Bank.

ESG investment reaches critical stage

Technology is helping open up new data sources

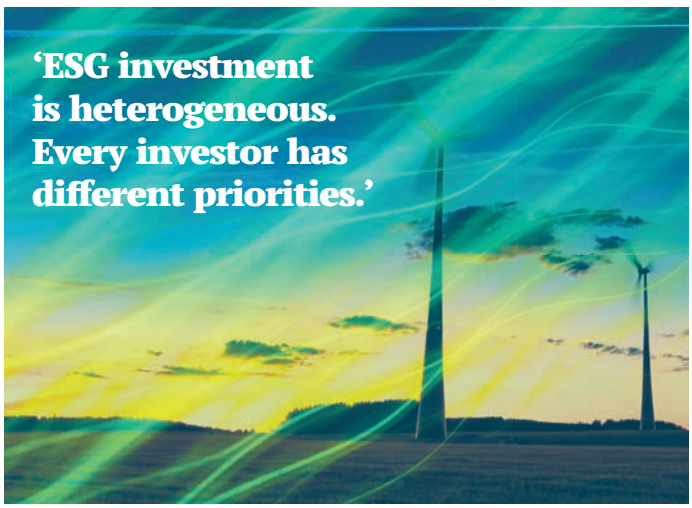
Hani Kablawi
BNY Mellon

Global public investors have a significant influence on the global investment industry. While highly diverse – some are early movers for new investment strategies while others may take a more conservative approach – their size and high profile impacts other investors as well as markets around the world.

Take, for example, sustainable investment. A survey conducted by OMFIF and BNY Mellon found that more than 85% of global public investors have specific environment, social and governance investment policies in place. A further 11% are in the process of developing them. In addition, 100% said they anticipate ESG principles will grow in importance at their institution over the next two years.

With the value of global assets applying ESG principles estimated at more than $40tn, one might argue that ESG investment is mainstream. It is certainly high on most institutional – and many individual – investors' agendas. But it is also at a pivotal stage in its development, one based on capturing and analysing multiple and varied sources of non-financial data.

ESG investment evolved from the socially responsible investment movement, which is based on ethical and environmental criteria and uses mostly negative screens, such as not investing in alcohol or firearms. While some motivations and outcomes are similar, ESG investment takes a fundamentally different approach. It is built on the assumption that factors relating to the governance of companies and their environmental and social impact have financial relevance. Investors set ESG criteria to assess the resilience, long-term sustainability and capacity for growth of companies, projects and other assets in which they invest.



Developing data

Accessing and analysing complex data from multiple sources is key to evaluating investments against ESG criteria, but it continues to be a barrier. Analysing investments against sustainability factors is a major task. Companies manage this voluntarily under the guidance of multiple standards and frameworks. This is where technology is coming to the rescue. Technology is not only enabling the provision of better data but, with the help of machine learning, it is helping access diverse data sources. This will be an area of heightened interest and development over the coming years.

There are a growing number of ESG data providers offering multiple methodologies, scoring criteria and data sources. This lack of standardisation risks confusion. However, especially for investors such as sovereign funds with sophisticated strategies, such diversity provides investors with a choice of datasets that can match their evolving ESG requirements.

ESG investment is heterogeneous. Every investor has different priorities. This is true for public investors, aware that investments viewed as socially irresponsible can lead to reputational damage. Public investors need to align their investment strategy with their fundamental purpose. The focus of ESG investment is constantly evolving. Environmental concerns – especially those relating to mitigating climate change – have come to the fore in recent years, but other issues are growing in prominence. The Covid-19 pandemic may be shifting the focus of ESG risks towards concerns such as biodiversity, environmental loss and healthcare, while social issues have moved up the agenda.

As some of the worlds' biggest and most prominent investors, public investors can and do influence direction and speed of change – not just in terms of investments and markets, but with real world implications for economies and societies. They will not only play an active role in the post-pandemic economic recovery but – in part through ESG investment strategies – they will ensure that recovery is sustainable. ●

Hani Kablawi is Head of International and Chairman of EMEA, BNY Mellon. The views expressed herein are those of the author only and may not reflect the views of BNY Mellon.

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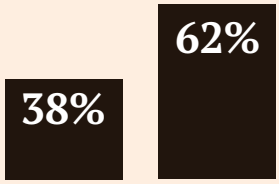
Race to the White House

Donald Trump's presidency has been a whirlwind of scandals, and many polls predict a Joe Biden victory. Will forecasts be proven correct?

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



No, I doubt it. Ahead of the 2016 US presidential election, most polls predicted a landslide victory for Hillary Clinton over Donald Trump. People hid their voting preference when surveyed because admitting support for Trump seemed 'unintellectual'. This could happen again.

Akinari Horii, Canon Institute for Global Studies

Joe Biden will be elected President, but how the result is received will help define American democracy. Together with UK Prime Minister Boris Johnson's attempts to suspend parliament and overrule his own Brexit agreement, Anglo Saxon adherence to the law is becoming a more questionable assumption for investors.

Colin Robertson, SW1 Consulting

I hope so. Donald Trump is no longer the insurgent as he was in 2016. Many commentators draw a comparison with 1968, when Richard Nixon was elected on a 'law and order' ticket at a time of social unrest. But it was far worse in 1968. After Martin Luther King Jr. was assassinated, 110 US cities were set ablaze and the US army mounted machine guns on Capitol Hill to protect Congress. It was only in 1962 that the first African-American student was escorted into the University of Mississippi by US troops. Most Americans repudiate the white supremacist outfits Trump sends coded messages of support to. His offer of four more years of division and hate, along with the country's 200,000 Covid deaths, are not enticing.

Denis MacShane, Avisa Partners

This year, the US election is more akin to an emerging market election. What matters is not only who wins the most votes, but also who can proclaim victory. If the end result is as close as polls predict – or closer – we can expect a historic election dispute with global implications. Add in the voting complications due to the pandemic, and there will be genuine uncertainty about the results. Donald Trump is likely to pursue all means necessary to prevent an election loss, given his family's commercial and legal interests. Conversely, Joe Biden could win a popular margin as great as 5% and still lose the electoral college. With Republicans being accused of voter suppression, the Democrat could also contest the outcome.

Elliot Hentov, State Street Global Advisors

Yes, I firmly believe that forecasts of a Biden victory will be proven correct. If the results are close, there could be a protracted post-election struggle in the courts. President Trump is trying to shift the focus from his handling of the Covid-19 pandemic. His recent nomination of Amy Coney Barrett to the Supreme Court may well give ammunition to those claiming that the balance of the court could shift.

Hemraz Jankee, formerly Bank of Mauritius